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OFFICE OF INSPECTOR GENERAL

Evaluation Report

2014-SR-B-017

The Board Should Enhance Its
Supervisory Processes as a Result of
Lessons Learned From the
Federal Reserve's Supervision of
JPMorgan Chase & Company's
Chief Investment Office

October 17, 2014

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
CONSUMER FINANCIAL PROTECTION BUREAU

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Abbreviations

Bank One	Bank One Corporation
BHC	bank holding company
BHC supervision manual	<i>Bank Holding Company Supervision Manual</i>
Board	Board of Governors of the Federal Reserve System
BS&R	Division of Banking Supervision and Regulation
CCAR	Comprehensive Capital Analysis and Review
CEO	Chief Executive Officer
CIGIE	Council of the Inspectors General on Integrity and Efficiency
CIO	Chief Investment Office
CPC	central point of contact
EMEA	Europe, Middle East, and Africa
FRB New York	Federal Reserve Bank of New York
GLB Act	Gramm-Leach-Bliley Act
JPMC	JPMorgan Chase & Company
JPMC Bank, N.A.	JPMorgan Chase Bank, National Association
LFI Team	Large Financial Institution Team
LISCC	Large Institution Supervision Coordinating Committee
LISCC OC	Large Institution Supervision Coordinating Committee Operating Committee
JPMC's management task force report	<i>Report of JPMorgan Chase & Co. Management Task Force Regarding 2012 CIO Losses</i>
MIS	management information systems
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
RWA	risk-weighted assets
SAA	Strategic Asset Allocation
Senate PSI report	United States Senate Permanent Subcommittee on Investigations report, <i>JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses</i>
SR Letter	Supervision and Regulation Letter
SSO	senior supervisory officer
TAA	Tactical Asset Allocation
VaR	value at risk
Whitefriars	the London branch of J.P. Morgan Whitefriars, Inc.



Executive Summary:

The Board Should Enhance Its Supervisory Processes as a Result of Lessons Learned From the Federal Reserve's Supervision of JPMorgan Chase & Company's Chief Investment Office

2014-SR-B-017

October 17, 2014

Purpose and Scope

In May 2012, media outlets reported that JPMorgan Chase & Company's (JPMC) Chief Investment Office (CIO) incurred approximately \$2 billion in losses due to a complex trading strategy involving credit derivatives. Losses continued over the following months and surpassed \$6 billion by the end of 2012. This matter highlighted corporate governance, risk management, and internal control weaknesses at JPMC, which resulted in reputational damage to the institution and considerable congressional, regulatory, and public scrutiny.

In July 2012, we initiated this evaluation (1) to assess the effectiveness of the Board of Governors of the Federal Reserve System's (Board) and the Federal Reserve Bank of New York's (FRB New York) consolidated and other supervisory activities regarding JPMC's CIO and (2) to identify lessons learned for enhancing future supervisory activities.

To address our objectives as comprehensively as possible, we selected July 2004 through April 2012 as the time period for our evaluation. July 2004 marked JPMC's merger with Bank One Corporation (Bank One), and JPMC created the CIO in 2005. April 2012 marked the publication of media articles describing the CIO's derivative positions. We selected this lengthy time frame so that we could trace the evolution of the CIO's strategy, activities, and governance and risk management framework.

Background

The Board serves as the consolidated supervisor for all bank holding companies, including JPMC. Under delegated authority from the Board, FRB New York performs the consolidated supervision of JPMC. The Office of the Comptroller of the Currency (OCC) supervises all national banks, including JPMorgan Chase Bank, National Association (JPMC Bank, N.A.). As the consolidated supervisor, the Board is required by the Gramm-Leach-Bliley Act to rely to the fullest extent possible on primary supervisors such as the OCC. Supervision and Regulation Letter (SR Letter) 08-9, *Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations*, states that effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and relevant primary supervisors.

The Board also has primary responsibility for examining Edge Act corporations on an annual basis. The CIO conducted the synthetic credit derivatives trading that resulted in the losses through the London branch of JPMC Bank, N.A., and ultimately booked the transactions that resulted in the losses in an Edge Act corporation subsidiary. We believe that the CIO's trading losses highlight that trading activities at large, complex institutions can span multiple legal entities and regulatory authorities.

Findings

Our report contains four findings. First, as part of its continuous monitoring activities at JPMC, FRB New York effectively identified risks related to the CIO's trading activities and planned two examinations of the CIO, including (1) a discovery

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review of the CIO's proprietary trading activities in 2008 and (2) a target examination of the CIO's governance framework, risk appetite, and risk management practices in 2010. Additionally, a Federal Reserve System team conducting a horizontal examination at JPMC recommended a full-scope examination of the CIO in 2009. However, FRB New York did not discuss the risks that resulted in the planned or recommended activities with the OCC in accordance with the expectations outlined in SR Letter 08-9. As a result, there was a missed opportunity for the consolidated supervisor and the primary supervisor to discuss risks related to the CIO and to consider how to deploy the agencies' collective resources most effectively.

FRB New York did not conduct the planned or recommended examinations because (1) the Reserve Bank reassessed the prioritization of the initially planned activities related to the CIO due to many supervisory demands and a lack of supervisory resources; (2) weaknesses existed in controls surrounding the supervisory planning process; and (3) the 2011 reorganization of the supervisory team at JPMC resulted in a significant loss of institutional knowledge regarding the CIO. We acknowledge that FRB New York's competing supervisory priorities and limited resources contributed to the Reserve Bank not conducting these examinations. We believe that these practical limitations should have increased FRB New York's urgency to initiate conversations with the OCC concerning the purpose and rationale for the planned or recommended examinations related to the CIO. Even if FRB New York had either initiated conversations with the OCC to discuss the planned or recommended examinations in accordance with SR Letter 08-9 or conducted the planned or recommended activities, we cannot predict whether completing any of those examinations would have resulted in an examination team detecting the specific control weaknesses that contributed to the CIO losses.

Second, we found that Federal Reserve and OCC staff lacked a common understanding of the Federal Reserve's approach for examining Edge Act corporations. In our opinion, this disconnect could result in gaps in supervisory coverage or duplication of efforts.

Third, we found that FRB New York staff were not clear about the expected deliverables resulting from continuous monitoring activities. Enhanced clarity concerning the expected deliverables could improve the effectiveness of this supervisory activity.

Finally, we found that FRB New York's JPMC supervisory teams appeared to exhibit key-person dependencies. In our opinion, these dependencies heightened FRB New York's vulnerability to the loss of institutional knowledge.

The Board indicated that management has taken various measures to address aspects of our recommendations. For example, senior Federal Reserve System officials have coordinated with senior OCC officials to discuss supervisory priorities since 2013. As part of our future follow-up activities, we will assess whether the Board's actions address our findings and recommendations.

Recommendations

Our report contains 10 recommendations that encourage the Board's Division of Banking Supervision and Regulation (BS&R) to enhance its supervisory processes and approach to consolidated supervision for large, complex banking organizations as a result of lessons learned from the Federal Reserve's supervision of JPMC's CIO. We received a response from BS&R that describes the division's feedback on our report and refers to a separate response from FRB New York.

BS&R acknowledged its appreciation for our recommendations for improving the Federal Reserve System's supervisory efforts. FRB New York also indicated its appreciation for the recommendations and acknowledged the Board's authority to implement the corrective action necessary to address those recommendations. BS&R indicated that it has taken action or has planned activities to address our recommendations. In many instances, those activities appear to be responsive to our recommendations. Our report clarifies our expectations for corrective action where necessary. We will conduct follow-up activities to determine whether the Board's actions fully address our recommendations.

In their respective responses, BS&R and FRB New York raised concerns about specific aspects of our report. Appendix E of our report contains BS&R's and FRB New York's full responses to our report. The appendix describes our perspectives on management's response and refutes several of BS&R's and FRB New York's comments.

For more information, contact the OIG at 202-973-5000 or visit <http://oig.federalreserve.gov>.

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Summary of Recommendations, OIG Report No. 2014-SR-B-017

Rec. no.	Report page no.	Recommendation	Responsible office
1	40	Issue guidance that reinforces the importance of effective collaboration and cooperation in joint supervisory planning to optimize the intended benefits of the consolidated supervision model, particularly in light of the Federal Reserve's updated framework for supervising large, complex institutions, which emphasizes financial resiliency and horizontal priorities.	Division of Banking Supervision and Regulation
2	40	Develop procedures that encourage staff to take immediate action to escalate significant concerns regarding interagency collaboration in executing consolidated supervision.	Division of Banking Supervision and Regulation
3	40	Develop guidelines for the supervisory planning process that require Federal Reserve System supervisory staff to <ul style="list-style-type: none"> a. reassess their strategy and approach for conducting supervision activities in light of emerging risks and changed circumstances within supervised entities. b. assure that sufficient supervisory resources are assigned to areas exhibiting significant emerging risks. 	Division of Banking Supervision and Regulation
4	40	Develop guidance on how Federal Reserve System supervisory staff should document and track supervisory activities that are included on a supervisory plan, including <ul style="list-style-type: none"> a. expectations for assigning priority ratings to supervisory activities using a consistent prioritization scheme and presentation. b. instructions for documenting the rationale for not performing planned or recommended supervisory activities and required approvals for deviating from supervisory plans. c. escalation protocols when activities on supervisory plans are not completed. 	Division of Banking Supervision and Regulation
5	41	Develop guidance on best practices for transitioning supervisory staff or teams.	Division of Banking Supervision and Regulation
6	41	Enhance the effectiveness of knowledge management capabilities for supervisory information so that supervisory materials can be searched and filtered as effectively as possible.	Division of Banking Supervision and Regulation
7	48	Clarify the Board's intentions and expectations regarding Edge Act entity supervision with the appropriate counterparts at the Office of the Comptroller of the Currency.	Division of Banking Supervision and Regulation
8	50	Issue guidance detailing expectations for documenting and approving the deliverables of continuous monitoring activities, tracking identified issues, and performing follow-up activities.	Division of Banking Supervision and Regulation
9	52	Issue guidance outlining the Board's preferred approaches for mitigating key-person dependency risk on Reserve Bank supervisory teams.	Division of Banking Supervision and Regulation
10	52	Direct the Federal Reserve Bank of New York to assess whether it needs to hire additional supervisory personnel with market risk and modeling expertise.	Division of Banking Supervision and Regulation



OFFICE OF INSPECTOR GENERAL
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
CONSUMER FINANCIAL PROTECTION BUREAU

October 17, 2014

MEMORANDUM

TO: Michael Gibson
Director, Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System

FROM: Melissa Heist 
Associate Inspector General for Audits and Evaluations

SUBJECT: OIG Report No. 2014-SR-B-017: *The Board Should Enhance Its Supervisory Processes as a Result of Lessons Learned From the Federal Reserve's Supervision of JPMorgan Chase & Company's Chief Investment Office*

The Office of Inspector General has completed its report on the subject evaluation. Our objectives were to (1) assess the effectiveness of the Board of Governors of the Federal Reserve System's (Board) and the Federal Reserve Bank of New York's (FRB New York) consolidated and other supervisory activities regarding JPMorgan Chase & Company's Chief Investment Office and (2) identify lessons learned for enhancing future supervisory activities.

We appreciate the cooperation that we received from Board and FRB New York staff during our evaluation. Please contact me at 202-973-5024 or Michael VanHuysen, Senior OIG Manager for Supervision and Regulation, at 202-973-5089 if you would like to discuss this report or any related issues.

cc: Sarah Dahlgren
Scott Alvarez
Thomas Baxter
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Contents

Preface	9
Introduction	11
Objectives	11
Scope	11
Methodology	11
Background on JPMC and Consolidated Supervision	13
Impact of the Financial Crisis on FRB New York	15
Board Guidance on Consolidated Supervision Issued During the Financial Crisis	15
Background on the CIO’s Portfolios.....	16
Chronology of the CIO’s Evolution and FRB New York’s Supervisory Plans and Activities	18
July 2004–December 2006	19
2007–2009	21
2010.....	25
January–June 2011	27
OIG Assessment of CPC Team 2’s Supervisory Activities.....	28
July–December 2011	29
2012.....	32
OIG Assessment of the SSO Team’s Supervisory Activities.....	34
Finding 1: FRB New York Did Not Coordinate With the OCC in Accordance With the Expectations Outlined in SR Letter 08-9	35
Interagency Collaboration in Executing Supervision of the CIO Proved Challenging	36
FRB New York Did Not Complete Planned or Recommended CIO Examinations for Various Reasons.....	36
Conclusion	39
Management Actions Taken.....	40
Recommendations	40
Management’s Response and OIG Comment.....	41
Finding 2: Federal Reserve and OCC Staff Did Not Have a Common Understanding of the Federal Reserve’s Approach to Conducting Edge Act Corporation Supervision	47
Federal Reserve and OCC Staff Conceptualized Edge Act Corporation Examinations Differently	47

Restricted FR

Recommendation 48
Management’s Response and OIG Comment 48

Finding 3: FRB New York Supervisory Staff Routinely Performed Continuous Monitoring, but the Board Had Not Defined Expected Deliverables From This Activity 49

Several FRB New York Supervisory Staff Did Not Know the Expected Deliverables From Continuous Monitoring 49
Recommendation 50
Management’s Response and OIG Comment 50

Finding 4: CPC Team 2 and the SSO Team Exhibited Key-Person Dependencies 51

CPC Team 2 and the SSO Team Concentrated Responsibility in Key Staff Members 51
Recommendations 52
Management’s Response and OIG Comment 52

Appendix A: Background on Methodology 54

Appendix B: Highlights From Chronology 55

Appendix C: Glossary 56

Appendix D: Bank Holding Company Rating System 60

Appendix E: Management’s Response 63

Preface

In May 2012, media outlets reported that JPMorgan Chase & Company's (JPMC) Chief Investment Office (CIO) incurred approximately \$2 billion in losses due to a complex trading strategy.¹ This strategy involved credit derivatives² in a portfolio known as the *synthetic credit portfolio*.³ The transactions associated with this portfolio occurred within JPMC's national bank. Over the following months, the CIO's derivatives positions continued to experience losses. By the end of 2012, the CIO's losses amounted to more than \$6 billion. These losses garnered considerable congressional, regulatory, and public scrutiny, and the resulting inquiries and reviews highlighted corporate governance, risk management, and internal control weaknesses at JPMC.

Without diminishing the significance of the corporate governance, risk management, internal control weaknesses, or the reputational damage incurred by JPMC as a result of the CIO's losses, we believe that it is important to view these losses in the context of the institution's balance sheet, income statement, and capital position during the relevant time period. JPMC had \$2.4 trillion in assets as of December 31, 2012. In its 2012 annual report, JPMC reported earnings of \$21.3 billion—a 12 percent increase over JPMC's 2011 earnings, even after incurring the losses associated with the CIO's trading activities. The losses reduced JPMC's earnings but did not jeopardize the institution's solvency or diminish its capital position.⁴

JPMC is a large, complex bank holding company (BHC)⁵ with a multinational presence. Consolidated supervision of a BHC encompasses the parent company and its subsidiaries. JPMC and its domestic and foreign subsidiaries are supervised by several U.S. federal regulators, including the Board of Governors of the Federal Reserve System (Board) and the Office of the Comptroller of the Currency (OCC). The OCC, an independent bureau of the U.S. Department of the Treasury, serves as the primary federal regulator for all national banks, including those of JPMC.⁶ The Board serves as the consolidated supervisor for JPMC, and the Federal Reserve Bank of New York (FRB New York) executes supervision of JPMC under delegated authority from the

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1. On April 6, 2012, media outlets reported the CIO's large positions in credit derivatives. In May 2012, media outlets published articles describing the magnitude of the CIO's losses.
 2. *Credit derivatives* are financial instruments that permit entities to assume or transfer credit risk on a specified asset or pool of assets.
 3. The *synthetic credit portfolio* refers to a portfolio of credit derivative positions on various credit indexes and tranches of those indexes.
 4. JPMC's total tier 1 capital was approximately \$150 billion as of December 31, 2011, and was approximately \$160 billion as of December 31, 2012.
 5. A BHC is a company that owns or controls one or more U.S. banks. A BHC may also own or control another BHC, which in turn owns or controls one or more banks.
 6. A national bank is a bank whose charter is issued by the OCC rather than by a state banking department.

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Board.⁷ The Board's Division of Banking Supervision and Regulation (BS&R) maintains responsibility for overseeing the Reserve Bank's supervisory activities.

7. Consolidated supervision allows the Federal Reserve to understand the organization's structure, activities, resources, and risks, as well as to address financial, managerial, operational, or other deficiencies before they pose a danger to the BHC's subsidiary depository institutions.

Introduction

Objectives

In May 2012, we conducted preliminary research related to the losses incurred by JPMC's CIO. Based on this preliminary research, we concluded that our office should perform additional oversight activities. In July 2012, we initiated this evaluation. Our objectives were (1) to assess the effectiveness of the Board's and FRB New York's consolidated and other supervisory activities regarding JPMC's CIO and (2) to identify lessons learned for enhancing future supervisory activities.

Scope

To address our objectives as comprehensively as possible, we selected July 2004 through April 2012 as the time period for our evaluation. July 2004 marked JPMC's merger with Bank One Corporation (Bank One), and JPMC created the CIO in 2005. April 2012 marked the publication of media articles describing the CIO's derivative positions. We selected this lengthy time frame so that we could trace the evolution of the office's strategy, activities, and governance and risk management framework.

We conducted our fieldwork from July 2012 to June 2014. We performed our evaluation in accordance with the *Quality Standards for Inspection and Evaluation*, issued in January 2012 by the Council of the Inspectors General on Integrity and Efficiency (CIGIE). Our evaluation did not assess the effectiveness of the OCC's supervisory activities related to JPMC's CIO, although we discuss the OCC's supervisory activities to the extent that they affected the consolidated supervision of JPMC's CIO.

Methodology

To accomplish our objectives, we compiled various supervisory documents that contained references or content related to the CIO. These documents included FRB New York supervisory plans from 2004 through 2012, FRB New York and OCC examination reports and associated materials, a timeline of events document provided by FRB New York, minutes of selected meetings between CIO staff and supervisors, and other Federal Reserve System supervisory materials. We also reviewed public documents, such as a report published by the United States Senate Permanent Subcommittee on Investigations, *JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses*⁸ (Senate PSI report), and the *Report of JPMorgan Chase*

8. The Senate PSI report is available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses>.

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& Co. Management Task Force Regarding 2012 CIO Losses⁹ (JPMC's management task force report).

We acknowledge that the Senate PSI report and JPMC's management task force report found weaknesses and deficiencies in JPMC's management reporting for the synthetic credit portfolio. In addition, JPMC's management task force report acknowledged that the controls and oversight of the CIO did not evolve commensurately with the increased complexity and risks of the CIO's activities. JPMC management is responsible for implementing an effective risk management and control environment. Effective supervision is predicated on receiving timely, accurate, and reliable information from the supervised institution.

During our evaluation, we sought to determine, with the benefit of hindsight, whether FRB New York had any opportunities to pursue alternative courses of action that may have provided an understanding of the governance, risk management, and internal control environment that surrounded the CIO's activities. As a result, we focused our evaluation on FRB New York's (1) general knowledge and awareness of the CIO's activities and (2) specific knowledge and awareness of the synthetic credit portfolio. Our evaluation did not assess the appropriateness of FRB New York's relative prioritization of the CIO in comparison to other supervisory priorities at JPMC.

We interviewed more than 35 staff members from the Board, FRB New York, the Department of the Treasury Office of Inspector General (OIG), and the OCC. We appreciate each interviewee's participation in this evaluation and cooperation during the interview process. We interviewed OCC supervisory staff to understand their perspectives on the historical supervision of the CIO, as well as their work with their FRB New York supervisory counterparts to plan and execute supervisory activities for JPMC. Given the objectives and scope of our evaluation and its focus on the Board's and FRB New York's supervisory activities, we did not meet with any JPMC personnel to discuss matters related to the CIO's losses.

We submitted our initial request to interview FRB New York staff in June 2012. In response, FRB New York officials, at the request of FRB New York staff, proposed that attorneys from the Reserve Bank's Legal Group accompany their staff during our interviews. This proposal was not consistent with the OIG's standard practice for conducting evaluation interviews. Our office and FRB New York subsequently agreed to proceed with the interviews with a private law firm personally representing FRB New York employees. FRB New York facilitated the retention of a private law firm, and each interviewee selected the firm as their representative. Attorneys from this firm attended each of our interviews. This process delayed our interviews with FRB New York staff, which commenced in May 2013.

We met directly with Board staff. Financial institution supervision is a function that the Board delegates to each Reserve Bank. The OIG has the authority to perform audits and evaluations of

9. JPMC's management task force report is available at http://files.shareholder.com/downloads/ONE/2202068872x0x628656/4cb574a0-0bf5-4728-9582-625e4519b5ab/Task_Force_Report.pdf. JPMC's board of directors also issued its own report, *Report of the Review Committee of the Board of Directors of JPMorgan Chase & Co. Relating to the Board's Oversight Function With Respect to Risk Management*, which is available at http://files.shareholder.com/downloads/ONE/2202068872x0x628655/752f9610-b815-428c-8b22-d35d936e2ed8/Board_Review_Committee_Report.pdf.

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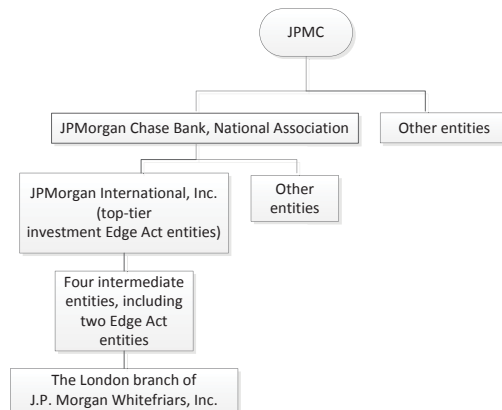
Board activities and functions, including functions delegated to Reserve Banks. This review of the Board and the supervision function of FRB New York was conducted under that authority.

For additional background regarding our methodology, see appendix A.

Background on JPMC and Consolidated Supervision

JPMC, a global financial services firm, is the largest BHC in the United States, with \$2.4 trillion in assets as of December 31, 2012. JPMC has a complex legal entity structure that comprises more than 2,000 legal entities. According to JPMC's 2012 annual report, it operates in 35 countries, has 258,965 employees, and serves 50 million customers daily.¹⁰ Figure 1 shows selected JPMC entities that are relevant to this evaluation.

Figure 1: High-Level Depiction of JPMC Entities Relevant to This Evaluation



Source: OIG compilation of information from the Federal Reserve System's National Examination Database.

JPMC and its domestic and foreign subsidiaries are supervised by several U.S. federal regulators, including the Board and the OCC. The Bank Holding Company Act of 1956, as amended, provides the Board with oversight responsibility for all BHCs, including financial holding companies formed under the Gramm-Leach-Bliley Act (GLB Act). The Board serves as the consolidated supervisor for JPMC. Under delegated authority from the Board, FRB New York performs the consolidated supervision of JPMC. The OCC supervises all national banks, including JPMorgan Chase Bank, National Association (JPMC Bank, N.A.).¹¹ As the consolidated

10. JPMC's *Annual Report 2012* is available at http://files.shareholder.com/downloads/ONE/2561829275x0x652147/a734543b-03fa-468d-89b0-fa5a9b1d9e5f/JPMC_2012_AR.pdf.

11. In 2004, JPMorgan Chase Bank converted from state member bank status to a national bank charter and became known as JPMC Bank, N.A.

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supervisor, the Board is required by the GLB Act to rely to the fullest extent possible on primary supervisors of BHC subsidiaries. The Board also has primary responsibility for examining Edge Act corporations and their subsidiaries on an annual basis under the Federal Reserve Act and Regulation K, International Banking Operations.¹²

According to JPMC's management task force report, the CIO is responsible for managing the firm's excess cash that results from JPMC's businesses accepting more deposits than they lend. The CIO also engages in trading activities for risk management purposes on behalf of the holding company and JPMC Bank, N.A. The office conducted the synthetic credit derivatives trading that resulted in the losses through the London branch of JPMC Bank, N.A. The CIO transferred the risk associated with these positions via intercompany transactions to the London branch of J.P. Morgan Whitefriars, Inc. (Whitefriars), a subsidiary of an Edge Act corporation.¹³ We understand that the CIO ultimately booked the risk associated with these transactions in Whitefriars in part because the noninvestment-grade synthetic credit derivatives positions could not be directly held by the national bank.¹⁴ The CIO's ability to conduct trading for risk management purposes on behalf of the holding company and national bank, the transaction activity conducted through the national bank that resulted in the losses, and the risk transfer and booking practices associated with those transactions highlight that trading activities at large, complex institutions can span multiple legal entities and regulatory authorities.

For the CIO transaction activity that resulted in the losses, the Board and FRB New York considered the OCC to be the primary federal regulator because the CIO conducted the transaction activity through the national bank. OCC officials also acknowledged the agency's role as the primary federal regulator of the CIO's transaction activity conducted through the national bank. Additionally, those same officials believed that the Federal Reserve participated in meetings related to the CIO along with the OCC's supervisory team at JPMC because of the Federal Reserve's primary responsibility for Edge Act entity supervision. We proceeded with our evaluation assuming that the CIO's trading activity conducted through the London branch of JPMC Bank, N.A., established a sufficient nexus to consider the OCC as the primary federal regulator.

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12. Regulation K governs the international banking operations of U.S. banking organizations and the operations of foreign banks in the United States.
 13. Edge Act corporations are chartered by the Federal Reserve to engage in international banking and financial activities. Edge Act corporations were established, in part, to allow federally regulated financial institutions to compete effectively with foreign-owned financial institutions operating in the United States and abroad.
 14. 12 C.F.R. Part 1, Investment Securities, categorizes the types of securities that national banks may hold. We heard multiple explanations for this risk transfer and booking practice, ranging from management's desire to consolidate risk in a single entity to tax advantages.

Impact of the Financial Crisis on FRB New York

In addition to outlining the legal entities associated with our evaluation, it is also important to acknowledge the impact of the financial crisis on FRB New York's supervisory activities. In 2008, the Federal Reserve System became heavily engrossed in responding to the financial crisis. For example, the Federal Reserve provided liquidity support to eligible depository institutions through the discount window, worked with other federal agencies and financial institutions to consider alternatives for corporate actions to absorb troubled institutions, and established lending facilities to support overall market liquidity. FRB New York played a crucial role in executing various crisis-containment efforts on behalf of the Federal Reserve System.

During this time frame, Goldman Sachs and Morgan Stanley submitted applications to become BHCs. On September 21, 2008, the Board approved the applications, which required FRB New York to establish two new teams to supervise these institutions. Further, FRB New York had to devote considerable attention and resources to other institutions within its supervisory district due to their weakened financial condition. This series of events placed a tremendous strain on FRB New York's personnel.

One senior FRB New York official described the financial crisis as an "all hands on deck" effort for FRB New York. Multiple interviewees indicated that FRB New York used a triage approach to deploying its resources during the crisis. A senior official also noted that FRB New York responded to the crisis by conducting more continuous monitoring¹⁵ activities and horizontal reviews.

Board Guidance on Consolidated Supervision Issued During the Financial Crisis

On October 16, 2008, approximately one month after Lehman Brothers filed for bankruptcy and FRB New York first extended credit to American International Group, the Board issued Supervision and Regulation Letter (SR Letter)¹⁶ 08-9, *Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations*. As part of our evaluation, we assessed FRB New York's compliance with SR Letter 08-9.¹⁷

Attachment A.1 of SR Letter 08-9 outlined fundamental principles for consolidated supervision; the nature of expected coordination between the Board as the consolidated supervisor and the

15. *Continuous monitoring* refers to nonexamination/inspection supervisory activities primarily designed to develop and maintain an understanding of the organization, its risk profile, and associated policies and practices. These activities also provide information that supervisory personnel use to assess inherent risks and internal control processes. Such activities include meeting with the supervised institution's management, analyzing management information systems (MIS) and other internal and external information, and reviewing internal and external audit findings.

16. SR Letters are issued by BS&R. They address significant policy and procedural matters of continuing relevance to the Board's supervisory effort. SR Letters are for distribution to supervised institutions as well as to Federal Reserve Banks.

17. SR Letter 08-9 remained in effect until the end of our evaluation period, April 2012. This guidance consists of four significant attachments according to the type of entity supervised. For the purpose of this evaluation, we referred to Attachment A.1, Guidance for the Consolidated Supervision of Domestic Bank Holding Companies that are Large Complex Banking Organizations, as the controlling document.

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relevant primary federal regulator; and the circumstances in which it would be appropriate for a Reserve Bank to conduct supervisory activities in a subsidiary depository institution, such as a national bank. This attachment also described the following guiding principles for consolidated supervision: The Federal Reserve will, to the fullest extent possible, (1) rely on the information and assessments of relevant primary supervisors and functional regulators; (2) focus supervisory activities on the BHC as well as its nonbank subsidiaries that could have a material adverse effect on the safety and soundness of a depository institution subsidiary of the holding company; and (3) use publicly reported information as well as reports that a large, complex BHC or a subsidiary prepares for other primary supervisors, functional regulators, or self-regulatory organizations. These guidelines effectively mirror the description of the Board's supervisory authority contained in the GLB Act.

Background on the CIO's Portfolios

The CIO's responsibilities included managing the firm's excess cash that resulted from JPMC's businesses accepting more deposits than they lend. According to the Senate PSI report, the CIO traditionally invested the bank's excess deposits in very safe instruments, an approach typical among large banks. At a congressional hearing, the firm's Chief Executive Officer (CEO) stated that "the bulk of CIO's responsibility is to manage [its] portfolio in a conservative manner," noting that the average credit rating for its investment holdings was AA+.

The CIO managed numerous portfolios,¹⁸ one of which was the Strategic Asset Allocation (SAA) portfolio. According to the Senate PSI report, the CIO used this portfolio to manage the firm's structural risk exposures using primarily available-for-sale assets. FRB New York informed us that this portfolio was also known as the *investment portfolio*. According to the Senate PSI report, bank officials described the SAA as a "high credit quality, liquid portfolio for investing excess corporate deposits." This portfolio grew from \$70 billion to \$350 billion after 2008, in part because JPMC experienced an "unprecedented inflow of deposits (more than \$100 billion)" from customers seeking a safe haven for their assets during the financial crisis. The Comptroller of the Currency testified that the OCC primarily focused its supervisory activities related to the CIO on this portfolio due to its significant growth.¹⁹

In addition, the CIO managed a mark-to-market portfolio, referred to as the Tactical Asset Allocation (TAA) portfolio, that was separate from the SAA. Among other investments, this portfolio included the synthetic credit portfolio. According to the Senate PSI report, JPMC officials described the TAA as "an 'idea' book for 'testing' new strategies." The Senate PSI report indicates that the CIO made numerous name and organizational changes to its portfolios over the years, which made them difficult to track. For example, the TAA was previously known as the Discretionary Trading portfolio.

18. For example, according to the Senate PSI report, the CIO maintained portfolios to hedge the bank's activities relating to foreign exchange and mortgage servicing rights and maintained a portfolio to fund the bank's retirement plans.

19. The Comptroller of the Currency testified before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, United States Senate, on March 15, 2013.

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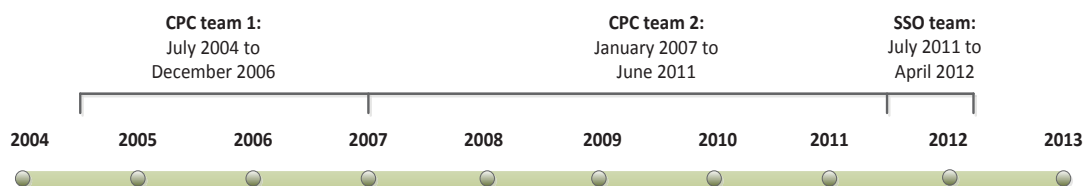
According to JPMC's management task force report, the synthetic credit portfolio was "composed of both long and short positions in credit default swap²⁰ indices and related instruments" and was "intended generally to offset some of the credit risk that JPMorgan faces, including in its CIO investment portfolio and in its capacity as a lender." As outlined in the Senate PSI report, the synthetic credit portfolio's net notional size increased from \$4 billion at the beginning of 2011 to \$157 billion in the first quarter of 2012.

20. A *credit default swap* refers to a contract that transfers credit risks from one party to another. The seller, who is offering credit protection in return for a periodic fee, agrees to compensate the buyer if a specific credit event, such as default, occurs.

Chronology of the CIO’s Evolution and FRB New York’s Supervisory Plans and Activities

From July 2004 through April 2012, FRB New York had three team leaders with primary responsibility for overseeing the development and execution of the supervisory program at JPMC. Two of those individuals were known as a central point of contact (CPC)²¹ and one individual was a senior supervisory officer (SSO).²² One CPC managed the supervisory program from July 2004 to December 2006, a second CPC managed the supervisory program from January 2007 to June 2011, and the SSO managed the program from July 2011 to the end of our evaluation period, April 2012. Thus, our report refers to these three teams according to the individual leading the supervisory team—CPC team 1, CPC team 2, and the SSO team.²³ Figure 2 illustrates the timing of each team’s respective responsibility for supervising JPMC during the scope of our evaluation.

Figure 2: FRB New York’s Supervisory Teams for JPMC, July 2004–April 2012



Source: FRB New York supervisory plans from 2004 through 2012.

This chronology describes (1) the evolution of the CIO’s activities, (2) FRB New York’s general knowledge and awareness of the CIO’s activities and specific knowledge and awareness of the synthetic credit portfolio, and (3) FRB New York’s supervisory plans and activities for the CIO. We also note relevant OCC supervisory materials related to the CIO to describe the extent to which those materials factored into FRB New York’s supervisory plans. We do not attribute knowledge of risks and knowledge gaps to individual members of FRB New York’s supervisory staff; rather, we focus on FRB New York’s collective institutional knowledge related to the CIO.²⁴

21. CPCs direct the supervision of large, complex banking organizations by coordinating the activities of an assigned team of examiners, obtaining appropriately skilled staff for supervisory activities, establishing partnerships with other regulatory entities, and communicating activities and results to a variety of constituencies.
22. SSOs are responsible for the development and implementation of the supervisory strategy, the synthesis of assessments of the firm, and the development and implementation of supervisory activities.
23. Each team was led by a particular individual, but the individual members of each team changed over time.
24. We occasionally refer to interviewees on a gender-neutral basis.

July 2004–December 2006

CIO Developments

In July 2004, JPMorgan Chase Bank, a state-member bank chartered in New York under the supervision of FRB New York and the New York State Banking Department, requested the OCC's approval to convert to a national bank charter as JPMC Bank, N.A. It also applied for approval to merge Bank One into the prospective national bank. The OCC approved this application, and in July 2004, JPMC and Bank One completed the merger of their holding companies. At this time, Jamie Dimon became the President and Chief Operating Officer of JPMC.²⁵ By December 2005, Mr. Dimon became President and CEO of JPMC.

In 2005, JPMC renamed its Global Treasury function the CIO, moved the CIO out of the Investment Bank, and made the CIO a corporate function.²⁶ That same year, Ina Drew²⁷ began to serve as the institution's Chief Investment Officer, and the CIO started to hedge the institution's foreign exchange risk.²⁸

In 2006, JPMC organized its activities into six major business lines:

1. Investment Bank
2. Retail Financial Services
3. Card Services
4. Commercial Banking
5. Treasury & Securities Services
6. Asset Management

JPMC's 10-K filing²⁹ for the period ending December 31, 2006, indicates that each business line was responsible for managing the risks associated with its activities. In addition to line-of-business risk management, the firm had five corporate functions, including the CIO, with risk management-related responsibilities; the CIO was responsible for "measuring, monitoring, reporting and managing the Firm's liquidity, interest rate and foreign exchange risk."³⁰

25. Mr. Dimon had been the Chairman and CEO at Bank One since March 2000.

26. Ina Drew, the former Chief Investment Officer, described the creation of the CIO in her testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, United States Senate, on March 15, 2013.

27. Ms. Drew had been the head of Global Treasury since 1999.

28. *Hedging* refers to entering into transactions that are intended to protect against specific risks of loss.

29. The Securities and Exchange Commission's Form 10-K is an annual report that provides an overview of a company's business and financial condition and includes audited financial statements.

30. JPMC's Form 10-K for the period ending December 31, 2006, is available at <http://files.shareholder.com/downloads/ONE/1886887423x0xS950123-07-3015/19617/filing.pdf>.

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According to the Senate PSI report, in 2006, the CIO approved a new business initiative that allowed the office to trade synthetic credit derivatives.³¹ The new business initiative documentation noted that the initiative would allow the CIO to “manage corporate credit exposures and diversify its asset classes.” In 2006, management assigned this program a value at risk (VaR)³² limit of \$5 million.

FRB New York’s Supervision of JPMC

In July 2004, FRB New York assigned a CPC the responsibility for designing and directing FRB New York’s supervision of JPMC. (b)(8)

(b)(8)

(b)(8) & (b)(5)

31. The Senate PSI report indicates that “according to the OCC, purchasing synthetic credit derivatives was unusual for a CIO-type asset-liability management function.”

32. VaR measures the potential gain or loss in a position, portfolio, or organization that is associated with a price movement of a given probability over a specified time horizon.

(b)(8) & (b)(5)

(b)(8) & (b)(5)



2007–2009

CIO Developments

The firm’s Chief Investment Officer testified that the CIO established the synthetic credit portfolio in June 2007. According to the Senate PSI report, in November 2007, JPMC’s internal audit group conducted an audit of CIO global credit trading, which rated the CIO’s control environment as *satisfactory*.³⁷

In 2008, JPMC acquired Bear Stearns and Washington Mutual. Due to these acquisitions and a large inflow of deposits during the financial crisis, JPMC’s balance sheet grew significantly. As institutions’ lending activity at the time generally tightened, JPMC deployed the excess cash associated with the inflow of deposits through investment activity conducted by the CIO.

In July 2008, the CIO broadened the scope of its synthetic credit portfolio by initiating a credit derivative trading program intended to “benefit from large defaults on High Yield [noninvestment-grade] names.” In 2008, the CIO’s synthetic credit portfolio generated approximately \$170 million in revenue. In June 2009, General Motors filed for bankruptcy and the CIO’s positions on specific credit derivatives gained in value. The CIO closed these positions to lock in profits. By the end of 2009, the synthetic credit portfolio generated \$1 billion in revenue.

FRB New York’s Supervision of JPMC

In January 2007, FRB New York assigned a new CPC to lead the supervision program and team for JPMC. (b)(8) & (b)(5)




37. JPMC’s internal audit group identified that the CIO commenced credit trading activities in 2006.

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(b)(8); (b)(5) and (b)(4)



(b)(8); (b)(5) and (b)(4)

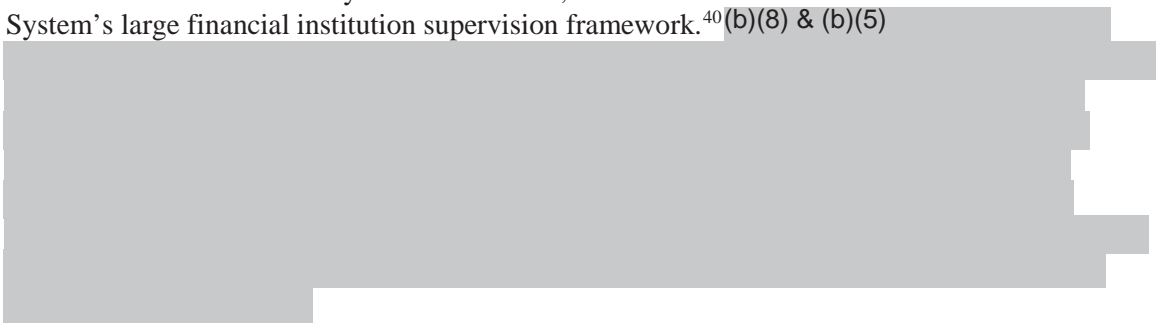


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(b)(8) & (b)(5)



In August 2008, after CPC team 2 developed its supervisory plan for JPMC, the Large Financial Institution (LFI) Team and risk specialists discussed priorities for large financial institutions across the Federal Reserve System. At the time, the LFI Team coordinated the Federal Reserve System's large financial institution supervision framework.⁴⁰(b)(8) & (b)(5)



In December 2008, a few months after the OCC concluded its review of the CIO's products, staff from FRB New York, the Federal Reserve Bank of Chicago, and the Board participated in a horizontal examination.(b)(8); (b)(5) and (b)(4)



40. The LFI Team was chaired by senior FRB New York officials.

(b)(8) & (b)(5)



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(b)(8); (b)(5) and (b)(4)

According to the Senate PSI report, by the end of 2009, the synthetic credit portfolio's revenues "had increased fivefold" over 2008, producing \$1 billion in revenues for the bank.

The August 2009 memorandum also noted that the CIO's market risk management unit had recently implemented significant staffing changes and recommended a full-scope examination of the CIO. (b)(8) & (b)(5)

Despite the recommendation in an August 2009 memorandum to conduct a full-scope examination of the CIO, (b)(8) & (b)(5)

(b)(8); (b)(5) and (b)(4)

(b)(8) & (b)(5) JPMC's internal audit function reviewed the CIO over the second half of 2008 through the first half of 2009 and assigned the CIO (b)(8) and (b)(4) (b)(8) & (b)(5)

SR Letter 08-9 indicated that "the extent to which supervisors can rely on or utilize the work of internal audit is an essential determinant of the risk-focused supervisory program that is tailored to the activities and risks of each large complex BHC."

In this situation, we believe that FRB New York placed too much reliance on JPMC internal audit's review, which concluded in the first half of 2009 (b)(8) & (b)(4) of the CIO. As noted above, in August 2009, Federal Reserve System staff determined that a full-scope examination of the CIO was needed. (b)(8) & (b)(4)

In our opinion, FRB New York should have included this full-

(b)(8); (b)(5) and (b)(4)

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scope examination in its supervisory planning materials and discussed the planned activity with the OCC in accordance with the expectations outlined in SR Letter 08-9.

2010

CIO Developments

In 2010, the financial crisis began to ease. According to the Senate PSI report, in 2010 JPMC management decided to reduce the positions in the synthetic credit portfolio due to its belief that the firm needed less credit protection after the crisis. By closing out profitable positions in 2009 and reducing the synthetic credit portfolio's size in 2010, this portfolio's 2010 revenue decreased approximately 85 percent to \$150 million.

Adjustments to the Board's Supervisory Approach

In the aftermath of the financial crisis, the Board implemented several strategic changes to its supervisory approach. It established the Large Institution Supervision Coordinating Committee (LISCC) to coordinate the Federal Reserve System's large bank supervision framework. The LISCC Operating Committee (LISCC OC) implements the LISCC's supervisory strategies and priorities and is chaired by a senior Board officer.⁴³ The LISCC OC replaced the LFI Team and assumed responsibility for coordinating the Federal Reserve System's supervisory planning activities for certain large, complex banking organizations. In the aftermath of the crisis, the Board established high-priority Federal Reserve System initiatives or mandates, including the Comprehensive Capital Analysis and Review (CCAR),⁴⁴ Comprehensive Liquidity Analysis and Review,⁴⁵ and horizontal supervisory priorities such as resolution planning and incentive compensation.

In April 2010, the Board issued its *2010 Safety-and-Soundness Supervision Priorities Framework* and established key objectives for prioritizing supervision activities. The transmittal letter associated with this guidance indicated that "it is imperative that supervisory resources be allocated and coordinated to ensure the availability of sufficient resources to meet the System's highest priorities, which may take precedence over local Reserve Bank priorities." According to the guidance, Reserve Bank staff assessing large, complex banking organizations should "reduce or eliminate focus on low-risk, static operations." Further, it stated that in the absence of information giving rise to material supervisory concerns, "business lines/products or control functions that have been assessed as low risk should not be examined in 2010."

In September 2010, the LISCC OC issued the *Guidance for OC Vetting of Supervisory Plans* and noted that supervisory teams should not "pre-filter" their proposed supervisory plans to account for perceived resource limitations. Rather, supervisory plans should "reflect the full extent of exams (Federal Reserve and other agency) and continuous monitoring events deemed

43. The LISCC OC consists of senior Federal Reserve System officials whose primary focus is the supervision of large BHCs.

44. CCAR is a supervisory assessment of the capital planning processes and capital adequacy of large, complex BHCs.

45. The Comprehensive Liquidity Analysis and Review is a supervisory assessment of the liquidity positions and practices at some of the largest U.S. banks.

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necessary by the team between January and December 2011.” In a presentation related to this guidance, the LISCC OC communicated that supervisory plans should include targeted examinations of high-risk activities, examinations mandated under the supervisory program related to SR Letter 08-9, horizontal reviews, and continuous monitoring activities.

FRB New York’s Supervision of JPMC

(b)(8) & (b)(5)



In our opinion, CPC team 2 appropriately assessed the risk factors associated with the CIO’s activities and operations and planned to conduct a target examination of the CIO in accordance with the *2010 Safety-and-Soundness Supervision Priorities Framework* and the *Guidance for OC Vetting of Supervisory Plans*.

(b)(8)



(b)(8)



(b)(8); (b)(5) and (b)(4)



January–June 2011

CIO Developments

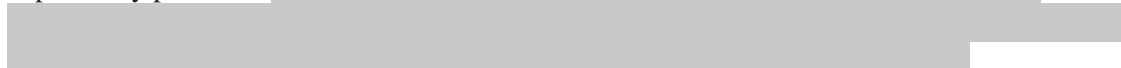
Despite CIO management’s previously stated intentions to wind down the synthetic credit portfolio, this portfolio grew significantly in 2011. This significant growth occurred because market conditions changed and the CIO anticipated additional corporate defaults resulting from deteriorating credit conditions in Europe. According to the Senate PSI report, “At the beginning of 2011, the SCP’s [synthetic credit portfolio’s] notional size was \$4 billion; by the end of 2011, it was \$51 billion, a more than tenfold increase. Most of this growth occurred in the first half of 2011.” The Senate PSI report indicated that this expansion was driven by the CIO’s “new trading strategy requiring the purchase of both long and short credit instruments, and the addition of some distressed securities.”

FRB New York’s Supervision of JPMC

(b)(8); (b)(5) and (b)(4)



(b)(8); (b)(5) and (b)(4), the LISCC OC in December 2010 highlighted the need to reassess the 2011 supervisory priorities. (b)(8); (b)(5) and (b)(4)



(b)(8) & (b)(5)



(b)(8) & (b)(5)

OIG Assessment of CPC Team 2's Supervisory Activities

(b)(8); (b)(5) and (b)(4)

As described above, in July 2008 CPC team 2 identified the need to conduct a discovery review of the CIO's proprietary trading activities, and in August 2009, a Federal Reserve System team identified the need to conduct a full-scope examination of the CIO. In September 2010, CPC team 2 also recommended a target examination to assess the CIO's governance framework, risk appetite, risk management practices for the "banking book vs. trading [book]," and the composition of its hedging portfolio. Nevertheless, CPC team 2 did not initiate discussions with the OCC regarding these activities. In our opinion, this lack of communication deviated from the interagency collaboration and coordination envisioned by SR Letter 08-9. In this respect, we believe that there was a missed opportunity for the consolidated supervisor and the primary federal regulator to discuss risks related to the CIO and consider how to deploy the agencies' collective resources most effectively.

We also sought to assess whether FRB New York had opportunities for alternative supervisory activities, such as conducting any of the planned or recommended examinations. We acknowledge that FRB New York faced a multitude of supervisory priorities during this time period and staff members with key expertise were oversubscribed because of the financial crisis. At the time, CPC team 2 also faced several priorities, such as the integration of Bear Stearns, the Basel II implementation, and the Supervisory Capital Assessment Program.⁴⁸ These activities strained the availability of CPC team 2's resources. Given JPMC's stronger financial condition relative to its peers, CPC team 2 also had difficulty making a compelling case for additional resources. We acknowledge that competing demands and resource constraints contributed to the team not conducting the planned or recommended examinations. In our opinion, these practical limitations

48. The 2009 Supervisory Capital Assessment Program was a forward-looking exercise designed to estimate losses, revenues, and reserve needs for eligible U.S. BHCs with assets exceeding \$100 billion.

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should have increased CPC team 2's urgency to initiate conversations with the OCC in accordance with the expectations outlined in SR Letter 08-9.

Even if FRB New York had (1) initiated conversations with the OCC to discuss the planned or recommended examinations in accordance with SR Letter 08-9 or (2) conducted the planned or recommended activities, we cannot predict whether completing any of those examinations would have resulted in an examination team detecting the specific control weaknesses that contributed to the CIO losses.

July–December 2011

CIO Developments

According to the Senate PSI report, in 2011, the synthetic credit portfolio generated \$453 million in revenues. The report also noted that in late 2011, the CIO entered into a derivatives transaction that, due to American Airlines' declaration of bankruptcy, generated approximately \$400 million in unexpected revenues for JPMC. The Senate PSI report noted that the OCC indicated the following:

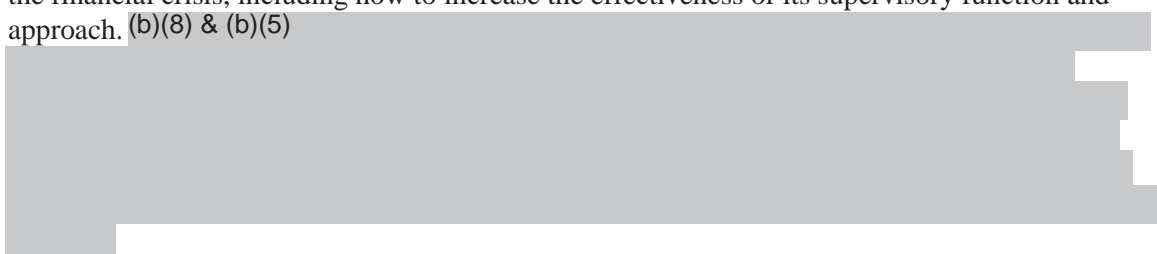
[The] gain came from a concentrated position in illiquid credit derivatives, that had been “pretty risky” and was completely dependent upon timing. That is, if American Airlines had defaulted three weeks later, the SCP's [synthetic credit portfolio's] short position would have already expired, and the SCP [synthetic credit portfolio] would not have reaped its “massive” profit.

The Senate PSI report also noted that “JPMorgan Chase senior risk managers told the Subcommittee that they had been unaware of the 2011 trades involving the SCP [synthetic credit portfolio] at the time.” The gains resulting from these trades were reported in multiple executive management reports circulated to JPMC's senior management. From 2007 through 2011, the synthetic credit portfolio had been extremely profitable for JPMC, generating revenues of approximately \$2.5 billion.

FRB New York's Supervision of JPMC

Transition from CPC Team 2 to the SSO Team

Senior FRB New York officials evaluated lessons learned related to supervision resulting from the financial crisis, including how to increase the effectiveness of its supervisory function and approach. (b)(8) & (b)(5)



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In summer 2011, FRB New York reorganized its Financial Institution Supervision Group, which included considerable changes to the supervisory team for JPMC, such as assigning more senior staff to the team. As a result of the reorganization, the CPC transitioned to another role within the Reserve Bank, and FRB New York assigned a more senior individual to lead the supervision of JPMC. This individual had previously served as a senior relationship manager for JPMC at FRB New York. As part of this reorganization, FRB New York revised the CPC title to SSO.

(b)(8) & (b)(5)

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The reorganization resulted in a nearly wholesale change to the composition of the supervisory team, with only two individuals from the prior CPC team remaining on the SSO team. Neither of these two individuals had previously focused on supervisory activities related to governance or market risk for the CIO. With respect to the other members of the new SSO team, we learned that some staff had participated in JPMC-related supervisory activities prior to the reorganization; however, that prior supervisory work was generally unrelated to the CIO. The nearly wholesale change of the supervisory team contributed to a considerable loss of institutional knowledge regarding the CIO.

FRB New York's Supervisory Activities from July to December 2011

(b)(8); (b)(5) and (b)(4)

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49. Previously, risk specialists were not dedicated to the teams; they provided ad hoc consultative support on an as-needed basis and were limited in their ability to interact with supervised entities.
 50. JPMC's management task force report, issued in 2013, acknowledged that the CIO's risk limits applicable to the synthetic credit portfolio were not sufficiently granular and noted that JPMC applied 25 new granular limits to the synthetic credit

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In 2011, the Federal Reserve System performed the first CCAR, a supervisory assessment of the capital planning processes and capital adequacy of large, complex BHCs. Members of the SSO team informed us that the team became heavily involved in CCAR. Interviewees noted that CCAR was a resource-intensive activity and a clear Federal Reserve System priority. (b)(8) & (b)(5)

Interviewees explained the benefits of the team's focus on CCAR, noting that it demonstrated JPMC's ability to withstand losses of approximately four and a half times the losses resulting from the CIO's trading activity in 2012.

(b)(8), (b)(5) & (b)(4)

(b)(8) & (b)(5)

(b)(8); (b)(5) and (b)(4)

portfolio. The Board's January 2013 consent order with JPMC also noted the need for the CIO to maintain adequate risk limits.

(b)(8) & (b)(5)

(b)(8) & (b)(5)

2012

CIO Developments

As previously mentioned, in 2011 JPMC had reported that the CIO was reducing its RWA. According to JPMC's management task force report, reducing RWA was one of a series of competing priorities related to the CIO's trading activity in the synthetic credit portfolio in early 2012. Additional priorities included balancing the risk in the synthetic credit portfolio, managing profits and losses, and managing or reducing VaR. JPMC's management task force report also indicates that the competing priorities may have resulted in the traders implementing a complex trading strategy designed to achieve multiple objectives. According to the Senate PSI report, rather than reduce RWA by divesting high-risk assets in the synthetic credit portfolio, the CIO "launched a trading strategy that called for purchasing additional long credit derivatives to offset its short derivative positions and lower the CIO's RWA that way." This strategy did not work as the CIO traders intended; the Senate PSI report indicated that this "trading strategy not only ended up increasing the portfolio's size, risk and RWA, but also, by taking the portfolio into a net long position, eliminated the hedging protections the SCP [synthetic credit portfolio] was originally supposed to provide."

In January 2012, the CIO hired a new Chief Risk Officer. In the following months, the CIO continued its trading activities and the portfolio continued to grow considerably. The Senate PSI report indicated that the net notional size of the synthetic credit portfolio increased threefold, from \$51 billion to \$157 billion in the first quarter of 2012. The Senate PSI report indicated that a sole JPMC position in a specific credit derivative represented more than half of the market for that product.

The Senate PSI report also indicated that the CIO's new Chief Risk Officer spent the key growth period from January 2012 through March 2012 acclimating to the role and not responding "in a vigorous way to CIO breaches of various risk metrics." On April 6, 2012, media outlets published articles regarding the large positions within JPMC's CIO. Articles dubbed the JPMC trader executing the trades as the "London Whale." In May 2012, the CIO reported a loss of \$2 billion, which increased to over \$6 billion by the end of 2012.

FRB New York's Supervision of JPMC

The SSO team continued its CCAR efforts from November 2011 through February or March 2012. One interviewee noted that once the transition to the SSO team was complete, the team committed significant resources to the CCAR exercise, (b)(8) & (b)(5)

Another interviewee raised similar concerns, (b)(8) & (b)(5)

One interviewee noted that CCAR is resource intensive, (b)(8) & (b)(5) Another interviewee noted that there is a "tension" between Federal Reserve System mandates, such as CCAR, and

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firm-specific activities; (b)(8) & (b)(5)

(b)(8) & (b)(5)

On March 28, 2012, the LISCC OC convened a meeting.⁵² (b)(8) & (b)(5)

(b)(8) & (b)(5)

52. This meeting included Board and Reserve Bank staff involved in the supervision of institutions in the LISCC's portfolio.


(b)(8) & (b)(5)

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(b)(8); (b)(5) and (b)(4)

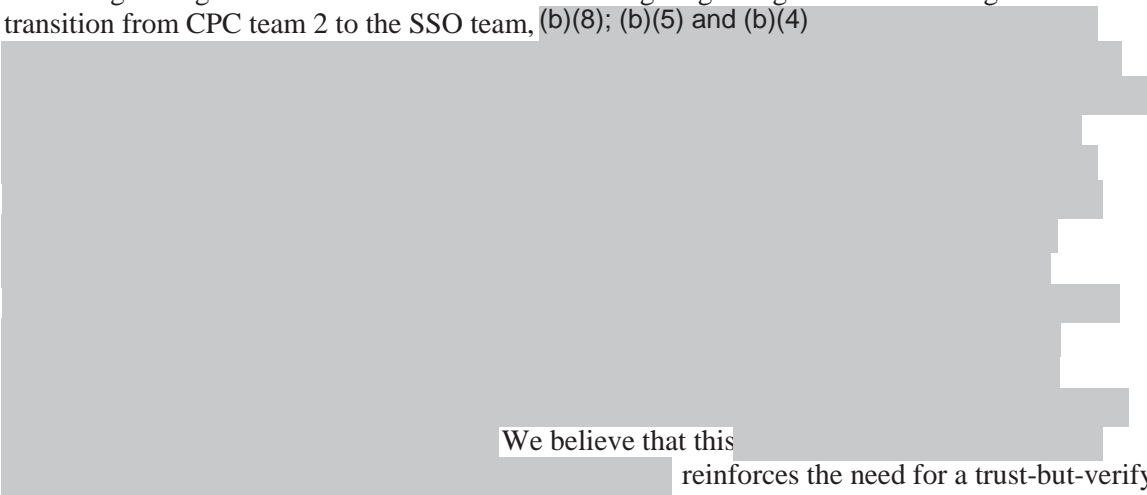


On April 6, 2012, approximately two weeks after the LISCC OC's March 28, 2012, meeting, media outlets published articles regarding the large positions within JPMC's CIO. Board and FRB New York employees indicated that they learned of the significance of the CIO's trading activity by reading these media articles. (b)(8) & (b)(5)



OIG Assessment of the SSO Team's Supervisory Activities

Following the significant loss of institutional knowledge regarding the CIO resulting from the transition from CPC team 2 to the SSO team, (b)(8); (b)(5) and (b)(4)



We believe that this reinforces the need for a trust-but-verify approach to supervision.

Finding 1: FRB New York Did Not Coordinate With the OCC in Accordance With the Expectations Outlined in SR Letter 08-9

FRB New York effectively identified risks related to the CIO's trading activities and planned two examinations of the CIO, including (1) a discovery review of the CIO's proprietary trading activities and (2) a target examination of the CIO's governance framework, risk appetite, and risk management practices. Additionally, a Federal Reserve System team conducting a horizontal examination of JPMC recommended a full-scope examination of the CIO. However, FRB New York did not (1) discuss those planned or recommended activities with the OCC or (2) conduct those examinations for various reasons.

As previously mentioned, the GLB Act requires the consolidated supervisor to rely to the fullest extent possible on primary supervisors of BHC subsidiaries. Further, SR Letter 08-9 states that effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and relevant primary supervisors. For example, the guidance requires the Federal Reserve to have periodic and as-needed contacts with primary supervisors to discuss and coordinate matters of common interest, including the planning and conduct of examinations and continuous monitoring activities.

SR Letter 08-9 also contains expectations for effective collaboration with the primary federal regulator when the Federal Reserve has indications of risk in a depository institution subsidiary, such as JPMC Bank, N.A. For example, the guidance acknowledges that circumstances can arise that require the consolidated supervisor to perform examinations in subsidiary depository institutions. The guidance outlines a process in which the consolidated supervisor discusses material weaknesses or risks with the primary supervisor. If the consolidated supervisor concludes that the primary supervisor has not undertaken activities to address the concern in a reasonable period of time, it can perform an examination. We learned that FRB New York did not discuss the risks related to the CIO that resulted in the planned or recommended examinations with the OCC.

As part of our evaluation, we also sought to understand why the planned or recommended examinations did not occur. We identified a series of contributing causes that resulted in FRB New York not conducting those examinations, including (1) many supervisory demands and a lack of supervisory resources which resulted in CPC team 2 reassessing the prioritization of the initially planned activities related to the CIO; (2) weaknesses in controls around supervisory planning; and (3) the 2011 reorganization of the supervisory team, which resulted in a significant loss of institutional knowledge regarding the CIO.

Even if FRB New York had (1) initiated conversations with the OCC to discuss the planned or recommended examinations in accordance with SR Letter 08-9 or (2) conducted the planned or recommended activities, we cannot predict whether completing any of those examinations would have resulted in an examination team detecting the specific control weaknesses that contributed to the CIO losses.

Interagency Collaboration in Executing Supervision of the CIO Proved Challenging

During the course of our interviews, supervisory staff from both FRB New York and the OCC described challenges with interagency collaboration. One FRB New York interviewee described the relationship between the FRB New York and OCC supervision teams as “tense” and indicated that the leads on both supervisory teams did not cooperate. Some FRB New York interviewees stated that OCC staff were “territorial” concerning the OCC’s role as the primary federal regulator of the national bank. As an example of poor coordination between the two agencies, multiple interviewees described a situation in which FRB New York examiners tried to join an OCC examination of the CIO but were denied. Another interviewee noted a situation in which OCC employees questioned FRB New York’s participation in certain supervisory meetings. An FRB New York official noted that there were “turf battles” between the two supervisory agencies.

(b)(8) & (b)(5)

. Despite two planned examinations and a recommendation to conduct a full-scope examination of the CIO, our evaluation did not reveal any evidence that CPC team 2 made any efforts to influence the OCC’s supervisory plans with respect to the planned or recommended activities related to the CIO. We were also told that duplication of efforts between the two teams contributed to the tension between the FRB New York and OCC teams.

Despite the strained relationship, FRB New York staff indicated that the OCC provided sufficient coverage of the risks related to the CIO. We believe that FRB New York reached this conclusion without sharing the purpose or rationale for the planned or recommended examinations related to the CIO with the OCC. In March 2013, the Comptroller of the Currency testified that the OCC’s supervisory activities related to the CIO primarily focused on the investment portfolio rather than the synthetic credit portfolio. We believe that FRB New York should have initiated discussions with the OCC consistent with the expectations described in SR Letter 08-9. In our opinion, those conversations could have helped to broaden the supervisory coverage of the CIO’s two portfolios with considerable risk.

FRB New York Did Not Complete Planned or Recommended CIO Examinations for Various Reasons

Beyond the coordination and collaboration issues, we also sought to understand whether FRB New York could have conducted the planned or recommended examinations. We identified a series of contributing causes that resulted in FRB New York not conducting those examinations, including (1) many supervisory demands and a lack of supervisory resources during and after the financial crisis which ultimately resulted in CPC team 2 reassessing the prioritization of the initially planned activities related to the CIO; (2) weaknesses in controls around supervisory planning; and (3) the 2011 reorganization of the supervisory team, which resulted in a significant loss of institutional knowledge regarding the CIO.

CPC Team 2 Had Limited Resources and Numerous Supervisory Demands

During our evaluation, interviewees informed us that FRB New York faced a multitude of supervisory demands during the financial crisis. For example, FRB New York had to establish de novo supervisory teams for Goldman Sachs and Morgan Stanley and devote senior staff to manage crisis-related issues at troubled institutions within FRB New York's district. During this time frame, JPMC was considered to be in a stronger financial condition than its peer institutions. Interviewees indicated that, as a result, it was difficult for the JPMC supervisory team to make compelling requests for additional supervisory resources given FRB New York's triage approach and risk-based deployment of its resources. Within JPMC, CPC team 2 also faced several priorities, such as the integration of Bear Stearns, the Basel II implementation, and the Supervisory Capital Assessment Program. Our evaluation indicated that these demands, in addition to the LFI Team's and LISCC OC's guidance for Federal Reserve System supervisory teams to focus on key supervisory priorities, contributed to FRB New York revisiting the prioritization of its planned supervisory activities related to the CIO.


(b)(8) & (b)(5)



(b)(8) & (b)(5)

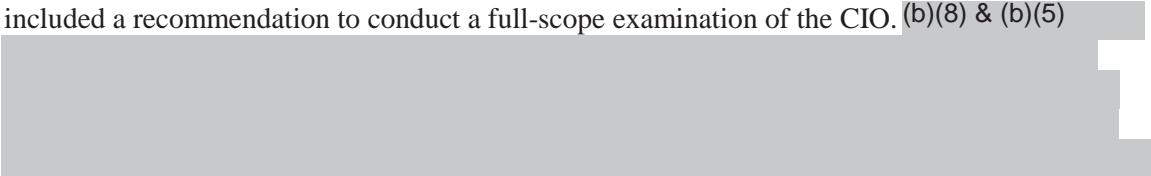
In our opinion, oversight of market risk management, and particularly the complex derivatives trading activities in which the CIO was engaged, required specialized subject-matter expertise.

(b)(8) & (b)(5)



Supervisory Planning Controls Exhibited Weaknesses

CPC team 2's supervisory plans reflect its intent to conduct a discovery review and a target examination of the CIO. In addition, a 2009 market risk horizontal examination memorandum included a recommendation to conduct a full-scope examination of the CIO. (b)(8) & (b)(5)



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(b)(8) & (b)(5) We did not identify any documentation describing the rationale for not incorporating this recommendation (b)(8) & (b)(5)

(b)(8) & (b)(5)

Transition to a New Supervisory Team in 2011 and Inadequate Knowledge Transfer Resulted in a Loss of Institutional Knowledge Regarding the CIO

The 2011 reorganization resulted in a considerable loss of institutional knowledge regarding the CIO and hampered the effectiveness of FRB New York's CIO supervision. Contributing factors for the loss of institutional knowledge included (1) the nearly wholesale change of the supervisory team members and (2) an inadequate knowledge transfer regarding the CIO. Although we did not identify any Board guidance detailing expectations for how supervisory teams should transition their staff in such situations, the BHC supervision manual notes the importance of maintaining institutional knowledge among supervisory staff.

Transition to a New Supervisory Team

The nearly wholesale change of supervisory staff between CPC team 2 and the SSO team, with only two former CPC team 2 staff members remaining on the SSO team, contributed to a significant loss of institutional knowledge regarding the CIO. We asked interviewees to share their perspectives on the effectiveness of the transition. While the SSO had previously served as a senior FRB New York relationship manager for JPMC, a senior Reserve Bank official noted that the supervisory team had a "tough knowledge transfer because essentially the entire team changed." Some members of the SSO team had participated in JPMC-related supervisory activities prior to the reorganization; however, their previous supervisory work was generally unrelated to the CIO.

Moreover, an interviewee indicated that FRB New York conducted the entire transition during a narrow window of time. While we learned that former CPC team 2 members remained available to consult with the new SSO staff, one official opined that during future transitions, it may be more effective to stagger the exit of team members to enable staff to transition their knowledge to new team members over a more extended period. We acknowledge that several members of the new SSO team had previous bank supervision experience, including at JPMC. However, according to a senior FRB New York official, some of the SSO team members assigned to JPMC

Restricted FR

were new to the Reserve Bank and others were new to supervision, and accordingly, it was a challenge for certain staff members to understand the types of issues or risks that they should escalate to FRB New York management.

A senior OCC examiner explained that it took about 18 months to become knowledgeable about the firm, despite having joined a preexisting team familiar with the institution. Another OCC interviewee indicated that in the case of the 2011 reorganization, FRB New York essentially reset its supervision of JPMC. This interviewee explained that following the 2011 reorganization, members of the new SSO team had to acquaint themselves with JPMC and conduct high-level meetings with JPMC personnel. The interviewee noted that supervisory staff conducted more detailed meetings with JPMC personnel prior to the 2011 reorganization. The OCC interviewee explained that to continue its discussions with JPMC at a more granular level, the OCC had to conduct its own meetings with the firm.

Inadequate Transfer of Knowledge Regarding the CIO

We learned that once FRB New York announced the reorganization, the SSO team had approximately six weeks to complete the transition, although CPC team 2 remained available to provide additional support to the SSO team. CPC team 2 and the SSO team held several high-level meetings to transition the supervisory responsibilities for JPMC as a whole. After these meetings, CPC team 2 and SSO staff conducted meetings on more specific areas within the firm.

(b)(8) & (b)(5)



(b)(8) & (b)(5)



Conclusion

We believe that FRB New York deviated from the interagency collaboration and coordination process expected by SR Letter 08-9 by not initiating discussions with the OCC concerning the purpose and rationale for the planned and recommended activities related to the CIO. We

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acknowledge the numerous supervisory demands, limited resources, and supervisory prioritization processes that resulted in FRB New York not conducting the planned or recommended examinations. We believe that these practical limitations should have increased the Reserve Bank's urgency to discuss its concerns related to the CIO with the OCC.

Management Actions Taken

The Board indicated that management has taken several measures to address aspects of our recommendations. For example, senior Federal Reserve System officials have met with senior OCC officials semi-annually to discuss supervisory priorities since 2013. In addition, the Board developed an application, C-SCAPE, to improve its monitoring and tracking capabilities for supervisory activities on an institution and horizontal basis. This system generally requires supervisory staff to document the reasons for cancelling a supervisory activity contained in an approved supervisory plan. We intend to conduct future follow-up activities to determine whether the Board's actions are responsive to the concerns raised in this finding.

Recommendations

We recommend that the Director of BS&R

1. Issue guidance that reinforces the importance of effective collaboration and cooperation in joint supervisory planning to optimize the intended benefits of the consolidated supervision model, particularly in light of the Federal Reserve's updated framework for supervising large, complex institutions, which emphasizes financial resiliency and horizontal priorities.
2. Develop procedures that encourage staff to take immediate action to escalate significant concerns regarding interagency collaboration in executing consolidated supervision.
3. Develop guidelines for the supervisory planning process that require Federal Reserve System supervisory staff to
 - a. reassess their strategy and approach for conducting supervision activities in light of emerging risks and changed circumstances within supervised entities.
 - b. assure that sufficient supervisory resources are assigned to areas exhibiting significant emerging risks.
4. Develop guidance on how Federal Reserve System supervisory staff should document and track supervisory activities that are included on a supervisory plan, including
 - a. expectations for assigning priority ratings to supervisory activities using a consistent prioritization scheme and presentation.
 - b. instructions for documenting the rationale for not performing planned or recommended supervisory activities and required approvals for deviating from supervisory plans.
 - c. escalation protocols when activities on supervisory plans are not completed.

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5. Develop guidance on best practices for transitioning supervisory staff or teams.
6. Enhance the effectiveness of knowledge management capabilities for supervisory information so that supervisory materials can be searched and filtered as effectively as possible.

Management's Response and OIG Comment

Management's Response to Recommendation 1

In its response, management stated the following:

We [respectfully] suggest that such guidance is already contained in section C(c) of SR Letter 12-17. In keeping with that guidance, we continuously work to improve cooperation and collaboration with the primary regulators of BHC subsidiaries. The chairman of the Committee on Banking Supervision has regular meetings with principals at other domestic supervisory agencies; the BS&R Senior Associate Director of LISCC (who is also the chair of the LISCC OC) similarly has frequent interactions with his counterparts at other agencies, as do several of his subordinates. In addition, the onsite supervision teams understand the importance of collaboration and generally work very closely with their counterparts at the other agencies. While there will always be room for improvement, we believe that BS&R supervision efforts are focused on working as effectively as possible with our fellow supervisors. Additionally, beginning in 2013, senior officials from the FRS, OCC and FDIC with supervisory responsibilities for the largest firms have had semi-annual supervision strategy and planning meetings where each of the agencies' views on priority areas of focus are discussed in an effort to ensure that areas that warrant scrutiny are noted and agreed upon, and that work to address those issues is built into supervisory plans.

OIG Comment

Management's response highlights the efforts of senior Board officials to improve collaboration and coordination with their counterparts at other supervisory agencies and references an excerpt of SR Letter 12-17 that briefly addresses interagency collaboration. We acknowledge that the interagency discussions outlined above are responsive to our recommendation. We also acknowledge that the paragraph contained in SR Letter 12-17 is generally consistent with the foundational principles of effective consolidated supervision previously described in SR Letter 08-9. Nevertheless, we expect a more robust reinforcement of the importance of interagency collaboration for effective consolidated supervision as part of the response to this recommendation. We acknowledge that such reinforcement could take many forms in addition to supervisory guidance. We will conduct follow-up activities to determine whether the Board fully addresses this recommendation.

Management's Response to Recommendation 2

In its response, management stated the following:

An informal process exists by which staff can raise concerns over interagency collaboration. The examiner experiencing such problems will discuss this with his/her supervisor and, if the problem cannot be resolved between the onsite team leader and his/her counterpart, the matter will be escalated within the Reserve Bank and, if necessary, to the SAD [Senior Associate Director] of LISCC or beyond. However, any such escalation necessarily is based on business judgment and that is dependent on numerous situational factors. BS&R interacts with other supervisory agencies on a number of fronts, from policy development to firm-specific issues such as supervisory matters and applications. While we believe the informal system generally has served us well, we will consider whether there are additional or more formal procedures that could improve interagency collaboration.

OIG Comment

As noted in this report, our evaluation determined that interagency collaboration in executing supervision of the CIO proved challenging. We learned of such challenges during the course of our interviews with supervisory staff from FRB New York and OCC personnel. We acknowledge that determining when to escalate a concern regarding interagency collaboration is based on professional judgment and dependent on situational factors. In this instance, we are concerned that the lack of escalation appeared to allow relationship challenges to remain unresolved and impact the effectiveness of consolidated supervision. Given the subjectivity of the assessment concerning when to escalate an issue related to interagency coordination, we believe that it would be useful for the division to provide examples of situations for which it considers such escalation appropriate. We will conduct follow-up activities to determine whether the Board fully addresses this recommendation.

Management's Response to Recommendation 3a

In its response, management stated the following:

Supervisory planning for the largest and most systemic firms, including JPMC, is now conducted under the auspices of the Large Institution Supervision Coordination Committee (LISCC). Among other matters, the LISCC provides strategic and policy direction for supervisory activities and seeks to improve the consistency and quality of supervision within the LISCC portfolio. The operational arm of the LISCC is the Operating Committee (OC). The OC prioritizes areas of focus for supervisory activities in order to develop a coordinated, comprehensive supervisory program for the largest banking organizations. The OC has implemented a semi-annual process that provides for greater flexibility to deploy and adjust supervisory resources to address emerging risks and changed circumstances.

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OIG Comment

In our opinion, the actions described by the Director of BS&R appear to be responsive to our recommendation. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

Management's Response to Recommendation 3b

In its response, management stated the following:

BS&R believes that key business lines and areas that exhibit significant emerging risks are currently being effectively monitored through horizontal analysis and exercises as well as team-specific activities. For example, the OC, directly and through its subcommittee the Capital and Performance Secretariat, provides horizontal analysis of business lines with the aim of identifying emerging risks across the portfolio. In addition to this horizontal perspective, the on-site teams assign individuals to monitor key business lines. The risks of major business activities are also examined through both recurring horizontal reviews conducted on the LISCC portfolio, such as the Comprehensive Capital Analysis and Review (CCAR), the Comprehensive Liquidity Analysis and Review (CLAR), and non-recurring horizontal reviews determined to be priority supervisory initiatives by the LISCC and LISCC OC.

OIG Comment

In our opinion, the actions described by the Director of BS&R appear to be responsive to our recommendation. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

Management's Response to Recommendation 4

In its response, management stated the following:

BS&R has developed a management information system (C-SCAPE) that documents and tracks supervisory activity. The C-SCAPE application is designed to provide integrated supervision planning and workflow processes supported by robust dashboard and reporting tools across the various portfolios, including the LISCC firms. The LISCC OC, Reserve Bank management and Board staff utilize C-SCAPE to gain insights into and monitor supervisory planning and assessments on a firm-specific and horizontal basis.

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OIG Comment

We outline our perspectives on each component of recommendation 4 below.

Management's Response to Recommendation 4a

In its response, management stated the following:

Decisions on what supervisory work will be conducted at a given firm are made in accordance with the "Supervisory Plan Prioritization Framework" (available upon request) developed by the OC. In conjunction with Supervisory Plan Prioritization Framework, the OC reviews proposals for horizontal reviews of multiple firms in conjunction with the proposals by the supervisory teams for firm specific work and prioritizes the importance of those proposals based on LISCC priorities, including those of a macro-prudential nature. Based on these criteria, the OC determines which proposed supervisory activities should be considered "committed activities." Committed activities denote activities that the OC will ensure are undertaken and completed and have the appropriate allocation of resources. These initiatives consist of both cross-firm events and firm-specific idiosyncratic work identified by the teams and others as key to our goals. Any team that believes a need has arisen for firm specific work after the supervisory plan has been approved can present its request to the OC for consideration. However, the move to a semi-annual planning cycle, as discussed in our response to recommendation 3.a, reduces the likelihood that such requests would need to be brought to the OC between planning cycles.

OIG Comment

Management's response describes the LISCC OC's supervisory planning and prioritization processes. This particular recommendation seeks to assure that the prioritization process described is clearly reflected in the documentation in an easy to follow format. We will conduct follow-up activities to determine whether the Board fully addresses this recommendation.

Management's Response to Recommendation 4b

In its response, management stated the following:

The C-SCAPE application requires supervisory staff to document the reasons why a committed supervisory activity contained in its approved supervisory plan is cancelled.

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OIG Comment

In our opinion, the actions described by the Director of BS&R appear to be responsive to our recommendation. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

Management's Response to Recommendation 4c

In its response, management stated the following:

During each round of supervisory planning teams are expected to discuss any institution specific committed activities that they were unable to conduct during the previous supervisory phase and the reason they were unable to conduct the activity – such as limited availability of resources or work that did not align with other OC committed projects etc. The OC will provide teams guidance on how to address this work. That guidance could include recommending that the work be folded into the scope of some other committed activity, be undertaken at some other point of the supervision cycle after careful consideration of the prioritization of OC activities, be included in the scope of another regulator agency's work, or not addressed because of changing priorities.

OIG Comment

In our opinion, the actions described by the Director of BS&R appear to be responsive to our recommendation. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

Management's Response to Recommendation 5

In its response, management stated the following:

We agree that transitioning supervisory teams is important, particularly at the most complex firms. Practices within the FRS [Federal Reserve System] on this matter may differ to some degree and could be improved by conducting a best practices exercise. It is worth noting that much of the supervision of firms in the LISCC portfolio is carried out by experts from across the FR [Federal Reserve] System, and effective supervision is not the sole responsibility of the onsite teams.

OIG Comment

In our opinion, the actions described by the Director of BS&R appear to be responsive to our recommendation. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

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Management's Response to Recommendation 6

In its response, management stated the following:

We acknowledge that knowledge management capabilities had been a weakness and was a weakness during the period covered by this review. However, we believe that this issue is being addressed with tools to more effectively search and filter supervisory information that were developed under the auspices of the OC and implemented during the first quarter of 2014. Less formal product memos, meeting minutes, firm presentations, etc. had been stored in Lotus Notes databases that were not conducive to effective searches. Those databases have been moved to SharePoint sites, where each document is being given "metadata" tags that facilitates searches on a number of criteria. Final examination reports and key correspondence with firms have been and will continue to be stored in BOND.

OIG Comment

In our opinion, the actions described by the Director of BS&R appear to be responsive to our recommendation. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

Finding 2: Federal Reserve and OCC Staff Did Not Have a Common Understanding of the Federal Reserve’s Approach to Conducting Edge Act Corporation Supervision

The results of our evaluation indicate that Federal Reserve and OCC supervisory teams for JPMC did not have a common understanding of the Federal Reserve’s approach to conducting Edge Act corporation examinations. As the approval authority for Edge Act corporations, the Federal Reserve serves as the primary supervisor of JPMC’s Edge Act corporations and is required by the Federal Reserve Act to examine each Edge Act corporation entity annually. SR Letter 08-9 outlines the factors that Reserve Banks should consider when developing a supervisory approach for an Edge Act corporation. These factors include potential areas of focus for Edge Act corporation examinations in addition to Regulation K compliance. Federal Reserve and OCC supervisory teams for JPMC had differing views of the scope and coverage of Edge Act corporation examinations. In our opinion, this disconnect can lead to gaps in supervisory coverage or duplication of efforts.

Federal Reserve and OCC Staff Conceptualized Edge Act Corporation Examinations Differently

SR Letter 08-9 outlines the Board’s expectations that Reserve Banks should consider when developing a supervisory approach for an Edge Act corporation. These expectations include potential areas of focus for Edge Act corporation examinations in addition to Regulation K compliance. For example, the guidance indicates that the Federal Reserve should consider the extent to which risk management and internal control functions are unique to the Edge Act corporation or are shared with a parent bank, an affiliate, or the BHC. SR Letter 08-9 indicates that the Federal Reserve will perform an examination of each Edge Act corporation and will assess the corporation’s Bank Secrecy Act/Anti-Money Laundering compliance program on an annual basis. However, the guidance stresses that the “scope will be risk-focused to reflect the organization’s scale, activities, and risk profile.”

The CIO ultimately booked its synthetic credit derivatives transactions in Whitefriars, a subsidiary of an Edge Act corporation within JPMC Bank, N.A. (b)(8); (b)(5) and (b)(4)

[REDACTED]

[REDACTED] e believe that these comments illustrate a lack of shared understanding between FRB New York and the OCC regarding the value to be derived from conducting more comprehensive examinations of Edge Act corporations.

(b)(8) & (b)(5)

[REDACTED] An OCC official indicated that he does not have a clear understanding of what

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FRB New York's Edge Act corporation examinations covered. He indicated that, as a result, the OCC might need to consider conducting more detailed examinations of Edge Act corporations. We believe that FRB New York and the OCC should resolve this issue to avoid gaps in supervisory coverage or duplication of efforts.

Recommendation

We recommend that the Director of BS&R

7. Clarify the Board's intentions and expectations regarding Edge Act entity supervision with the appropriate counterparts at the OCC.

Management's Response and OIG Comment

Management's Response to Recommendation 7

In its response, management stated the following:

Board staff is currently in the process of assessing the Reserve Banks' approach to Edge Act entity supervision. Upon completion of that assessment, BS&R will determine whether additional guidance is needed and whether any such guidance should factor into supervisory efforts by a bank's primary federal regulator that encompass the activities of the bank's Edge Act entities.

OIG Comment

In our opinion, the actions described by the Director of BS&R appear to be responsive to our recommendation. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

Finding 3: FRB New York Supervisory Staff Routinely Performed Continuous Monitoring, but the Board Had Not Defined Expected Deliverables From This Activity

CPC team 2 and the SSO team performed continuous monitoring of the CIO; however, several FRB New York staff did not know the deliverables that should result from continuous monitoring. FRB New York supervision staff mentioned that continuous monitoring allows the Reserve Bank to be more nimble in its supervisory activities and to provide broader coverage of the institution's activities. We did not identify any Board guidance describing the expected deliverables from continuous monitoring activities or the required approvals for such materials. We did not assess the potential value to be derived from continuous monitoring in this evaluation; however, we believe that this supervisory activity may have been more effective had staff clearly understood the expected deliverables from continuous monitoring.

Several FRB New York Supervisory Staff Did Not Know the Expected Deliverables From Continuous Monitoring

During the period under review, CPC team 2 and SSO team staff performed continuous monitoring activities regarding the CIO. (b)(8) & (b)(5)

[Redacted]

(b)(8) & (b)(5)

[Redacted]

However, this senior official indicated that the Board has not formally defined the deliverables that should result from continuous monitoring activities.

Further, several FRB New York supervisory staff members did not know the expected deliverables that should result from continuous monitoring. (b)(8) & (b)(5)

[Redacted]

his interviewee explained that it was not particularly obvious as to what he or she should be looking for in reviewing certain reports; the interviewee opined that it may be beneficial to have more guidance in this area, including the specific deliverables that are expected as a result of such continuous monitoring. Another FRB New York interviewee indicated that the "concept of continuous monitoring can sometimes mean 20 different things to 20 different people."

An FRB New York official indicated that there is a need to more clearly define the expectations for continuous monitoring and its deliverables. A senior Board official also

Restricted FR

indicated that continuous monitoring is “somewhat of a nebulous concept.” In our opinion, these comments illustrate the need to establish clear guidance detailing BS&R’s expectations regarding the deliverables that should result from continuous monitoring activities. In addition, the guidance should outline the approvals that should occur before sharing the materials within the supervisory team.

Recommendation

We recommend that the Director of BS&R

8. Issue guidance detailing expectations for documenting and approving the deliverables of continuous monitoring activities, tracking identified issues, and performing follow-up activities.

Management’s Response and OIG Comment

Management’s Response to Recommendation 8

In its response, management stated the following:

Open supervisory issues are tracked in C-SCAPE, which also facilitates linkage of those issues to planned supervisory activities. We concur that further guidance is needed with respect to deliverables expected from continuous monitoring. We would note that what one calls a particular supervisory exercise is less important than the work carried out to support the assessment that may result from such work. The use of continuous monitoring can be an effective way to utilize scarce staff resources. The key challenge in this regard is to do a better job of outlining the expectations around the work required in support of an assessment carried out through ‘continuous monitoring’ and to better document and act upon any conclusions coming from such work.

OIG Comment

In our opinion, the actions described by the Director of BS&R appear to be responsive to our recommendation. We plan to follow up on the Board’s actions to ensure that the recommendation is fully addressed.

Finding 4: CPC Team 2 and the SSO Team Exhibited Key-Person Dependencies

Both CPC team 2 and the SSO team appeared to exhibit key-person dependencies. We did not identify Board guidance that addresses mitigating key-personnel risk within supervisory teams; however, the BHC supervision manual advises examination staff to assess key-personnel risks at the institutions they supervise. We believe that the principles outlined in this manual regarding key-personnel risk at supervised institutions can be applied to supervisory teams. We attribute the key-personnel dependencies within the supervisory teams to high demands for certain specialized skill sets and the scarcity of staff with such skill sets. In our opinion, these key-person dependencies concentrated knowledge and responsibility in a limited number of staff members, heightening FRB New York's vulnerability to significant losses of institutional knowledge that could impair the continuity and effectiveness of supervision if unforeseen departures occur.

CPC Team 2 and the SSO Team Concentrated Responsibility in Key Staff Members

While conducting our evaluation, we identified apparent key-personnel dependencies within both CPC team 2 and the SSO team. (b)(8) & (b)(5)

[REDACTED]

During our interviews with FRB New York staff to discuss the CIO, they routinely deferred to and recommended that we speak with this individual.

(b)(8) & (b)(5)

[REDACTED]

We did not identify any Board guidance that addresses mitigating key-personnel risk within supervisory teams. The BHC supervision manual, however, contains a supervision checklist that advises examiners to assess whether supervised institutions have adequate provisions for management succession or for continuing operations in case of the loss of key personnel. In our opinion, this guidance can also be applied to assessing key-person dependencies within supervisory teams.

In our opinion, if FRB New York relies on key supervisory staff and has not taken measures to mitigate the risk associated with such dependencies, it could lose institutional knowledge should these individuals transition out of their roles or are unable to continue to serve in their positions. In our opinion, the Board's supervisory teams should consider alternatives for

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mitigating such risks, such as conducting contingency and succession planning, facilitating job shadowing, or implementing knowledge management techniques.

Recommendations

We recommend that the Director of BS&R

9. Issue guidance outlining the Board's preferred approaches for mitigating key-person dependency risk on Reserve Bank supervisory teams.
10. Direct FRB New York to assess whether it needs to hire additional supervisory personnel with market risk and modeling expertise.

Management's Response and OIG Comment

Management's Response to Recommendation 9

In its response, management stated the following:

We agree that key person dependency risk on supervisory teams may arise on occasion. We will consider whether guidance should be developed and issued.

OIG Comment

Management's response acknowledges that key person dependency risk may arise. We will conduct follow-up activities to determine whether the Board has fully addressed the recommendation.

Management's Response to Recommendation 10

In its response, management stated the following:

We agree that the Federal Reserve System may need additional supervisory personnel particularly with market risk and modeling expertise. Under the LISCC framework, personnel with specific expertise are utilized system wide, and not necessarily strictly within the entity (Reserve Bank or Board) that employs them. As part of the next budget cycle, we will review the needs of the system for such expertise, and if such expertise is warranted, assess where that expertise would be most efficiently housed.

Restricted FR

OIG Comment

In our opinion, the actions described by the Director of BS&R appear to be responsive to our recommendations. We plan to follow up on the Board's actions to ensure that the recommendation is fully addressed.

Appendix A

Background on Methodology

To accomplish our objectives, we compiled various supervisory documents that contained references or content related to the CIO. These documents included FRB New York supervisory plans from 2004 through 2012, FRB New York examination reports, a timeline of events document provided by FRB New York, minutes of selected meetings between CIO staff and supervisors, and other Federal Reserve System supervisory materials. During our project, we learned that a senior Board official led a review of the supervisory oversight of the CIO; we reviewed the memorandum resulting from this review, which outlined several lessons learned regarding the supervision of the CIO. We reviewed the BHC supervision manual and relevant supervisory guidance concerning consolidated supervision, including SR Letter 08-9, *Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations*, and SR Letter 12-17, *Consolidated Supervision Framework for Large Financial Institutions*.⁵⁵

We reviewed public documents, such as media articles, transcripts from congressional hearings featuring JPMC executives as well as federal regulators overseeing JPMC, and the Senate PSI report. We also reviewed JPMC regulatory filings for selected years. In addition, we reviewed two reports that JPMC published in 2013 regarding the CIO matter—*Report of the Review Committee of the Board of Directors of JPMorgan Chase & Co. Relating to the Board's Oversight Function With Respect to Risk Management* and JPMC's management task force report.

We interviewed more than 35 staff from the Board, FRB New York, the U.S. Department of the Treasury OIG, and the OCC. Given the objectives and scope of our evaluation and its focus on the Board's and FRB New York's supervisory activities, we did not meet with any JPMC personnel to discuss matters related to the CIO's losses.

55. The Board issued SR Letter 12-17 on December 17, 2012. SR Letter 12-17 sets forth the framework for the consolidated supervision of large financial institutions and currently is the controlling guidance for the consolidated supervision of systemically important financial institutions such as JPMC.

Appendix B

Highlights From Chronology

Team	Year	Event
CPC Team 1: July 2004 to December 2006	2004	• JPMC and Bank One merged.
	2005	• (b)(8); (b)(5) and (b)(4)
	2006	• The CIO approved a new business initiative that allowed the office to trade synthetic credit derivatives.
	2007	• (b)(8); (b)(5) and (b)(4)
	2008	• (b)(8); (b)(5) and (b)(4)
		• The team planned to conduct a discovery review of (b)(8) & (b)(5) [redacted] " Subsequently, the LFI Team issued guidance for large financial institution supervision teams to reassess their supervisory priorities, and CPC team 2 decided to conduct continuous monitoring in lieu of the discovery review.
CPC Team 2: January 2007 to June 2011	2009	• Following a horizontal examination of JPMC, Federal Reserve System staff recommended a full-scope examination of the CIO. (b)(8) & (b)(5) [redacted]
	2010	• (b)(8); (b)(5) and (b)(4)
		• The team recommended conducting a target examination to assess the CIO's governance.
		• (b)(8); (b)(5) and (b)(4)
		• In December, the LISCC OC encouraged supervisory teams to reassess their supervisory plans.
SSO Team: July 2011 to April 2012	2011	• (b)(8); (b)(5) and (b)(4)
		• (b)(8) and (b)(5)
		• (b)(8); (b)(5) and (b)(4)
		• The Senate PSI report indicated that the synthetic credit portfolio's notional size increased from \$4 billion to \$51 billion in 2011, with most of the growth occurring in the first half of 2011.
		• In July, FRB New York implemented a nearly wholesale change to the supervisory team, which resulted in a considerable loss of institutional knowledge regarding the CIO.
		• (b)(8); (b)(5) and (b)(4)
		• The CIO's December 2011 executive management report noted that the office had made significant gains from "key bankruptcy credit related events."
	• (b)(8); (b)(5) and (b)(4)	
	• (b)(8) & (b)(5)	
	• The Senate PSI report indicated that the synthetic credit portfolio's net notional size increased to \$157 billion by the end of March.	
	• (b)(8); (b)(5) and (b)(4)	

Sources: Senate PSI report; OIG interviews with supervisory staff; and several Board and FRB New York supervisory documents, including supervisory plans, examination reports, and supervisory meeting minutes.

Note: This table contains highlights of the CIO's evolution and FRB New York's supervisory plans and activities and awareness of risks related to the CIO; it does not reflect the multitude of other significant supervisory priorities that FRB New York had to address during the scope of our evaluation.

Appendix C

Glossary

Bank Holding Company (BHC)

A company that owns or controls one or more U.S. banks. A BHC may also own another BHC, which in turn owns or controls one or more banks.

Central Point of Contact (CPC)

CPCs direct the supervision of large, complex banking organizations by coordinating the activities of an assigned team of examiners, obtaining appropriately skilled staff for supervisory activities, establishing partnerships with other regulatory entities, and communicating activities and results to a variety of constituencies. Finally, CPCs must continually remain aware of and contribute to the understanding of industry-wide risk exposures.

Consolidated Supervision

Supervision of a BHC on a group-wide basis, including the BHC's nonbanking subsidiaries.

Continuous Monitoring

Nonexamination/inspection supervisory activities primarily designed to develop and maintain an understanding of the organization, its risk profile, and associated policies and practices. These activities also provide information that supervisory personnel use to assess inherent risks and internal control processes. Such activities include meeting with the supervised institution's management, analyzing MIS and other internal and external information, and reviewing internal and external audit findings.

Credit Default Swap

A contract that transfers credit risks from one party to another. The seller, who is offering credit protection in return for a periodic fee, agrees to compensate the buyer if a specified credit event, such as default, occurs.

Credit Derivatives

Financial instruments that permit entities to assume or transfer credit risk on a specified asset or pool of assets.

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Credit Risk

The potential for loss due to a borrower's failure to meet its contractual obligation to repay a debt in accordance with the agreed terms.

Discovery Review

An examination/inspection activity designed to improve the understanding of a particular business activity or control process, for example, to address a knowledge gap identified during the risk assessment or other supervisory process.

Edge Act Corporation

A corporation that is chartered by the Federal Reserve to engage in international banking and financial activities. Edge Act corporations were established, in part, to allow federally regulated financial institutions to compete effectively with foreign-owned financial institutions operating in the United States and abroad.

Examination/Inspection Activities

Examination activities are applicable to the supervision of banks and other depository institutions, as well as U.S. banking offices of foreign banking organizations. Inspection activities are applicable to the supervision of BHCs and nonbank subsidiaries and affiliates.

Hedge

To enter into transactions that are intended to protect against specific risks of loss.

Idiosyncratic Risk

A risk that is specific to a certain institution.

Interest Rate Risk

The potential that changes in interest rates may adversely affect the value of a financial instrument or portfolio, or the condition of the institution as a whole.

Large Institution Supervision Coordinating Committee (LISCC)

A multidisciplinary committee formed to coordinate the Federal Reserve System's large bank supervision framework.

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Matter Requiring Attention

A bank practice identified during an examination that (1) deviates from sound governance, internal control, and risk management principles, which may adversely impact the bank's earnings or capital, risk profile, or reputation, if not addressed or (2) results in substantive noncompliance with laws and regulations, internal policies or processes, OCC supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by a bank.

Market Risk

The risk to a banking organization's financial condition resulting from adverse movements in market prices.

National Bank

A bank whose charter is issued by the OCC rather than by a state banking department.

Proprietary Trading

Trading in stocks or other financial instruments using the institution's own funds to profit from short-term price changes.

Risk-Weighted Assets (RWA)

A measure of a bank's total assets, adjusted according to the assets' risk.

Senior Supervisory Officer (SSO)

SSOs are responsible for the development and implementation of the supervisory strategy, the synthesis of assessments of the firm, and the development and implementation of supervisory activities. They perform these responsibilities by leading a large onsite team.

Supervision and Regulation Letter (SR Letter)

SR Letters are issued by BS&R. They address significant policy and procedural matters of continuing relevance to the Board's supervisory effort. SR Letters are for distribution to supervised institutions as well as Reserve Banks.

Synthetic Credit Portfolio

A portfolio of credit derivative positions on various credit indexes and tranches of those indexes.

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Value at Risk (VaR)

An approach that measures the potential gain or loss in a position, portfolio, or organization that is associated with a price movement of a given probability over a specified time horizon.

Appendix D

Bank Holding Company Rating System

The Federal Reserve's BHC supervision program operates under the RFI/C (D) rating system, which provides a comprehensive framework for assessing and rating the potential impact of the parent holding company and its nonbank subsidiaries on its subsidiary depository institutions. Under RFI/C (D), each BHC is assigned a composite rating (C) based on an evaluation of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s). The primary components of the rating system are risk management (R), financial condition (F), and potential impact (I) of the parent company and nondepository subsidiaries on the subsidiary depository institution(s). A fourth component rating, depository institution (D), generally reflects the primary regulator's assessment of the subsidiary depository institution(s). Composite, component, and subcomponent ratings are assigned based on a 1 to 5 numeric scale. The highest rating, 1, reflects the strongest performance and practices and the least degree of supervisory concern. The lowest rating, 5, reflects the weakest performance and the highest degree of supervisory concern.

Composite

C is the overall composite assessment of the BHC as reflected by consolidated risk management, consolidated financial strength, and the potential impact of the nondepository entities on the subsidiary depository institutions. The composite rating encompasses both a forward-looking and a static assessment of the consolidated organization, as well as an assessment of the relationship between the depository and nondepository entities. Consistent with current Federal Reserve practice, the C rating is not derived as a simple numeric average of the R, F, and I components; rather, it reflects examiner judgment with respect to the relative importance of each component to the safe and sound operation of the BHC.

Risk Management

R represents an evaluation of the ability of the BHC's board of directors and senior management, as appropriate for their respective positions, to identify, measure, monitor, and control risk. The R rating underscores the importance of the control environment, taking into consideration the complexity of the organization and the risk inherent in its activities. The R rating is supported by four subcomponents that are each assigned a separate rating. The four subcomponents are as follows: (1) board and senior management oversight; (2) policies, procedures, and limits; (3) risk monitoring and MIS; and (4) internal controls. The subcomponents are evaluated in the context of the risks undertaken by and inherent in a banking organization and the overall level of complexity of the firm's operations. They provide the Federal Reserve System with a consistent framework for evaluating risk management and the control environment.⁵⁶ Moreover, the subcomponents provide a clear

56. A simplified version of the rating system that includes only the R and C components is applicable to noncomplex BHCs with assets at or below \$1 billion.

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structure and basis for discussion of the R rating with BHC management, are familiar to examiners, and parallel the existing risk-assessment process.⁵⁷

1. The board and senior management oversight subcomponent evaluates the adequacy and effectiveness of board and senior management's understanding and management of risk inherent in the BHC's activities, as well as the general capabilities of management. It also includes consideration of management's ability to identify, understand, and control the risks undertaken by the institution, to hire competent staff, and to respond to changes in the institution's risk profile or innovations in the banking sector.
2. The policies, procedures, and limits subcomponent evaluates the adequacy of a BHC's policies, procedures, and limits given the risks inherent in the activities of the consolidated BHC and the organization's stated goals and objectives. This analysis will include consideration of the adequacy of the institution's accounting and risk-disclosure policies and procedures.
3. The risk monitoring and MIS subcomponent assesses the adequacy of a BHC's risk measurement and monitoring and the adequacy of its management reports and information systems. This analysis will include a review of the assumptions, data, and procedures used to measure risk and the consistency of these tools with the level of complexity of the organization's activities.
4. The internal controls subcomponent evaluates the adequacy of a BHC's internal controls and internal audit procedures, including the accuracy of financial reporting and disclosure and the strength and influence of the internal audit team within the organization. This analysis will also include a review of the independence of control areas from management and the consistency of the scope coverage of the internal audit team with the complexity of the organization.

Financial Condition

F represents an evaluation of the consolidated organization's financial strength. The F rating focuses on the ability of the BHC's resources to support the level of risk associated with its activities. The F rating is supported by four subcomponents: capital (C), asset quality (A), earnings (E), and liquidity (L). The CAEL subcomponents can be evaluated along individual business lines, product lines, or on a legal-entity basis, depending on what is most appropriate given the structure of the organization. The assessment of the CAEL components should use benchmarks and metrics appropriate to the business activity being evaluated. Consistent with current supervisory practices, examination staff should continue to review relevant market indicators, such as external debt ratings, credit spreads, debt and equity prices, and qualitative rating-agency assessments as sources of information complementary to examination findings.⁵⁸

57. For a detailed description of the R subcomponents, see SR Letter 95-51, *Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies*, available at <http://fedweb.frb.gov/fedweb/bsr/srltrs/SR9551.htm>.

58. This appendix does not include comprehensive information regarding the F rating. For additional detail regarding the subcomponents of the F rating, see the BHC supervision manual.

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Impact

Like the other components and subcomponents, the I component is rated on a five-point numerical scale. However, the descriptive definitions of the numerical ratings for I are different than those of the other components and subcomponents. The I ratings are defined as follows:

- 1—low likelihood of significant negative impact
- 2—limited likelihood of significant negative impact
- 3—moderate likelihood of significant negative impact
- 4—considerable likelihood of significant negative impact
- 5—high likelihood of significant negative impact

The I component is an assessment of the potential impact of the nondepository entities on the subsidiary depository institution(s). The I assessment will evaluate both the risk management practices and financial condition of the nondepository entities. Consistent with current practices, nondepository entities will be evaluated using benchmarks and analysis appropriate for those businesses. In addition, for functionally regulated nondepository subsidiaries, examination staff will continue to rely, to the extent possible, on the work of those functional regulators to assess the risk management practices and financial condition of those entities. In rating the I component, examination staff is required to evaluate the degree to which current or potential issues within the nondepository entities present a threat to the safety and soundness of the subsidiary depository institution(s). The analysis under the I component should consider existing as well as potential issues and risks that may impact the subsidiary depository institution(s) now or in the future.⁵⁹

Depository Institutions

The D component will reflect generally the composite CAMELS rating assigned by the subsidiary depository institution's primary supervisor.⁶⁰ In a multibank BHC, the D rating will reflect a weighted average of the CAMELS composite ratings of the individual subsidiary depository institutions, weighted by both asset size and the relative importance of each depository institution within the holding company structure. In this regard, the CAMELS composite rating for a subsidiary depository institution that dominates the corporate culture may figure more prominently in the assignment of the D rating than would be dictated by asset size, particularly when problems exist within that depository institution. The D component conveys important supervisory information that reflects the primary supervisor's assessment of the legal entity. The D component stands outside the composite rating, although significant risk management and financial condition considerations at the depository-institution level are incorporated in the consolidated R and F ratings, which are then factored into the C rating.⁶¹

59. This appendix does not include comprehensive information regarding the I rating. For further detail regarding the I component rating, see the BHC supervision manual.

60. For a description of the CAMELS rating system, see the *Commercial Bank Examination Manual*, available at <http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf>.

61. This appendix does not include comprehensive information regarding the D rating. For further detail regarding the D rating, see the BHC supervision manual.

Appendix E

Management's Response

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: September 26, 2014

To: Mark Bialek, Inspector General

From: Michael S. Gibson, Director, Banking Supervision and Regulation

Subject: Response to July 14, 2014 Draft - "The Board Should Enhance Its Supervisory Processes as a Result of Lessons Learned from the Federal Reserve's Supervision of JPMorgan Chase & Company's Chief Investment Office"

The staff of the Division of Banking Supervision and Regulation has reviewed the above referenced draft report prepared by the Office of Inspector General ("OIG"). We appreciate the effort that the OIG has put into this report and the recommendations you provide for improving our supervisory efforts. As noted in greater detail below, in a number of instances recommended improvements have already been made or are in process.

We are attaching a separate response that has been prepared by the Federal Reserve Bank of New York ("FRBNY").

The report provides very helpful historical context to the supervision efforts in the years prior to the losses incurred in the Chief Investment Office's (CIO's) synthetic structured credit portfolio. The report also highlights the effectiveness of the supervisory program, as it documents both the FRBNY's role that led to an independent risk management function over the CIO and the FRBNY's assessments of the risks posed by the CIO.

We appreciate your understanding of the scarcity of resources during much of this review period, given the outsized role that the FRBNY played in responding to the financial crisis. We also appreciate your recognition of the strain on the FRBNY resources that could be allocated to JPMC because of the demands created by the financial crisis, including those related to JPMC's acquisitions of Bear Stearns and WAMU during this period. In our view, the resource challenges faced by the Federal Reserve System and the FRBNY during this period cannot be underestimated. In light of the circumstances, we believe it was wholly appropriate and consistent with SR Letter 08-09, which was the operative guidance during the period in which the CIO incurred losses on its synthetic credit derivative portfolio, for the supervisory teams to rely on the assessments of the Office of the Comptroller of the Currency (OCC) and JPM's internal audit department in lieu of conducting its own examinations of the CIO. In that regard, we do not note any ex-ante support for the report's conclusion that too much reliance was being placed on JPMC's internal audit review (page 24). We also appreciate the acknowledgement that the weaknesses that led to the CIO losses may not have been detected even if the FRBNY had conducted the examinations that members of its staff had recommended.

We would like to point out that the report mischaracterizes the roles of the Board and the FRBNY in the supervision of LISCC firms. The Background section contains the following sentence: "Under delegated authority from the Board, FRB New York performs the consolidated

Page 1 of 6

Restricted FR

Restricted FR

supervision of JPMC.” While this was the case for some of the period covered by the review, and remains the case for most non-LISCC firms, it no longer accurately and completely describes the way that firms in the LISCC portfolio are supervised. The report criticizes the FRBNY for not conducting certain examinations that had been recommended by its staff. It should be noted that responsibility for supervisory planning for the LISCC portfolio was moved to the LISCC Operating Committee (the “OC”) in 2010 and, commencing with the 2011 planning period, final decisions on supervisory plans have rested with the OC. This process is discussed more fully in our response to recommendation 3. Execution of those plans is the responsibility of the both the OC and the host Reserve Bank, and horizontal reviews carried out across the LISCC portfolio are supervised by the OC (or its subgroups) and Board staff, and are staffed with personnel from across the Federal Reserve System.

Finally, we question the purpose of the comments regarding the Comprehensive Capital Assessment Review (CCAR) program that are found on page 32 of the report. The suggestion seems to be that CCAR precluded additional CIO work to the detriment of our supervisory program. You quote individuals who state that CCAR absorbs a significant amount of their time. The CCAR program is staffed by system-wide personnel, including members of the supervisory teams. As a factual matter, while it is true that the program places significant time demands on participating members, much of the work is not conducted by members of the supervisory team.

We do acknowledge, however, that CCAR is a high priority program that is a cornerstone of the supervisory program for systemically important banking organizations and is also one which is prescribed by regulation.¹ As such, it does take precedence over examinations that may be considered high priority, but which are not prescribed by regulation. Importantly, the CCAR process helps ensure that a firm such as JPMC holds enough capital to be able to survive a variety of stressed outcomes, including idiosyncratic losses such as those incurred by the CIO.

Our responses to your recommendations are as follows:

1. Issue guidance that reinforces the importance of effective collaboration and cooperation in joint supervisory planning to optimize the intended benefits of the consolidated supervision model, particularly in light of the Federal Reserve’s updated framework for supervising large, complex institutions, which emphasizes financial resiliency and horizontal priorities.

We respectively suggest that such guidance is already contained in section C(c) of SR Letter 12-17. In keeping with that guidance, we continuously work to improve cooperation and collaboration with the primary regulators of BHC subsidiaries. The chairman of the Committee on Banking Supervision has regular meetings with principals at other domestic supervisory agencies; the BS&R Senior Associate Director of LISCC (who is also the chair of the LISCC OC) similarly has frequent interactions with his counterparts at other agencies, as do several of his subordinates. In addition, the onsite supervision teams understand the importance of collaboration and generally work very closely with their counterparts at the other agencies. While there will always be room for improvement, we believe that BS&R supervision efforts are focused on working as effectively as possible with our fellow supervisors.

¹ See 12 CFR 225.8.

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Additionally, beginning in 2013, senior officials from the FRS, OCC and FDIC with supervisory responsibilities for the largest firms have had semi-annual supervision strategy and planning meetings where each of the agencies' views on priority areas of focus are discussed in an effort to ensure that areas that warrant scrutiny are noted and agreed upon, and that work to address those issues is built into supervisory plans.

2. Develop procedures that encourage staff to take immediate action to escalate significant concerns regarding interagency collaboration in executing consolidated supervision.

An informal process exists by which staff can raise concerns over interagency collaboration. The examiner experiencing such problems will discuss this with his/her supervisor and, if the problem cannot be resolved between the onsite team leader and his/her counterpart, the matter will be escalated within the Reserve Bank and, if necessary, to the SAD of LISCC or beyond. However, any such escalation necessarily is based on business judgment and that is dependent on numerous situational factors. ES&R interacts with other supervisory agencies on a number of fronts, from policy development to firm-specific issues such as supervisory matters and applications. While we believe the informal system generally has served us well, we will consider whether there are additional or more formal procedures that could improve interagency collaboration.

3. Develop guidelines for the supervisory planning process that require Federal Reserve System supervisory staff to:
 - a. reassess their strategy and approach for conducting supervision activities in light of emerging risks and changed circumstances within supervised entities.

Supervisory planning for the largest and most systemic firms, including JPMC, is now conducted under the auspices of the Large Institution Supervision Coordination Committee (LISCC). Among other matters, the LISCC provides strategic and policy direction for supervisory activities and seeks to improve the consistency and quality of supervision within the LISCC portfolio. The operational arm of the LISCC is the Operating Committee (OC). The OC prioritizes areas of focus for supervisory activities in order to develop a coordinated, comprehensive supervisory program for the largest banking organizations. The OC has implemented a semi-annual process that provides for greater flexibility to deploy and adjust supervisory resources to address emerging risks and changed circumstances.

- b. assure that sufficient supervisory resources are assigned to areas exhibiting significant emerging risks.

BS&R believes that key business lines and areas that exhibit significant emerging risks are currently being effectively monitored through horizontal analysis and exercises as well as team-specific activities. For example, the OC, directly and through its subcommittee the Capital and Performance Secretariat, provides horizontal analysis of business lines with the aim of identifying emerging risks across the portfolio. In addition to this horizontal perspective, the on-site teams assign individuals to monitor key business lines. The risks of major business activities are also examined through both recurring horizontal reviews conducted on the LISCC

Page 3 of 6

Restricted FR

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portfolio, such as the Comprehensive Capital Analysis and Review (CCAR), the Comprehensive Liquidity Analysis and Review (CLAR), and non-recurring horizontal reviews determined to be priority supervisory initiatives by the LISCC and LISCC OC.

4. Develop guidance on how Federal Reserve System supervisory staff should document and track supervisory activities that are included on a supervisory plan, including:

BS&R has developed a management information system (C-SCAPE) that documents and tracks supervisory activity. The C-SCAPE application is designed to provide integrated supervision planning and workflow processes supported by robust dashboard and reporting tools across the various portfolios, including the LISCC firms. The LISCC OC, Reserve Bank management and Board staff utilize C-SCAPE to gain insights into and monitor supervisory planning and assessments on a firm-specific and horizontal basis.

- a. expectations for assigning priority ratings to supervisory activities using a consistent prioritization scheme and presentation.

Decisions on what supervisory work will be conducted at a given firm are made in accordance with the "Supervisory Plan Prioritization Framework" (available upon request) developed by the OC. In conjunction with Supervisory Plan Prioritization Framework, the OC reviews proposals for horizontal reviews of multiple firms in conjunction with the proposals by the supervisory teams for firm specific work and prioritizes the importance of those proposals based on LISCC priorities, including those of a macro-prudential nature. Based on these criteria, the OC determines which proposed supervisory activities should be considered "committed activities." Committed activities denote activities that the OC will ensure are undertaken and completed and have the appropriate allocation of resources. These initiatives consist of both cross-firm events and firm-specific idiosyncratic work identified by the teams and others as key to our goals. Any team that believes a need has arisen for firm specific work after the supervisory plan has been approved can present its request to the OC for consideration. However, the move to a semi-annual planning cycle, as discussed in our response to recommendation 3.a, reduces the likelihood that such requests would need to be brought to the OC between planning cycles.

- b. instructions for documenting the rationale for not performing planned or recommended supervisory activities and required approvals for deviating from supervisory plans.

The C-SCAPE application requires supervisory staff to document the reasons why a committed supervisory activity contained in its approved supervisory plan is cancelled.

- c. escalation protocols when activities on several supervisory plans are not completed.

During each round of supervisory planning teams are expected to discuss any institution specific committed activities that they were unable to conduct during the previous supervisory phase and the reason they were unable to conduct the activity

Page 4 of 6

Restricted FR

Restricted FR

such as limited availability of resources or work that did not align with other OC committed projects etc. The OC will provide teams guidance on how to address this work. That guidance could include recommending that the work be folded into the scope of some other committed activity, be undertaken at some other point of the supervision cycle after careful consideration of the prioritization of OC activities, be included in the scope of another regulator agency's work, or not addressed because of changing priorities.

5. Develop guidance on best practices for transitioning supervisory staff or teams.

We agree that transitioning supervisory teams is important, particularly at the most complex firms. Practices within the FRS on this matter may differ to some degree and could be improved by conducting a best practices exercise. It is worth noting that much of the supervision of firms in the LISCC portfolio is carried out by experts from across the I/R System, and effective supervision is not the sole responsibility of the onsite teams.

6. Enhance the effectiveness of knowledge management capabilities for supervisory information, so that supervisory materials can be searched and filtered as effectively as possible.

We acknowledge that knowledge management capabilities had been a weakness and was a weakness during the period covered by this review. However, we believe that this issue is being addressed with tools to more effectively search and filter supervisory information that were developed under the auspices of the OC and implemented during the first quarter of 2014. Less formal product memos, meeting minutes, firm presentations, etc. had been stored in Lotus Notes databases that were not conducive to effective searches. Those databases have been moved to SharePoint sites, where each document is being given "metadata" tags that facilitates searches on a number of criteria. Final examination reports and key correspondence with firms have been and will continue to be stored in BOND.

7. Clarify the Board's intentions and expectations regarding Edge Act entity supervision with the appropriate counterparts at the Office of the Comptroller of the Currency.

Board staff is currently in the process of assessing the Reserve Banks' approach to Edge Act entity supervision. Upon completion of that assessment, BS&R will determine whether additional guidance is needed and whether any such guidance should factor into supervisory efforts by a bank's primary federal regulator that encompass the activities of the bank's Edge Act entities.

8. Issue guidance detailing expectations for documenting and approving the deliverables of continuous monitoring activities, tracking identified issues, and performing follow-up activities.

Open supervisory issues are tracked in C-SCAPE, which also facilitates linkage of those issues to planned supervisory activities. We concur that further guidance is needed with

Page 5 of 6

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respect to deliverables expected from continuous monitoring. We would note that what one calls a particular supervisory exercise is less important than the work carried out to support the assessment that may result from such work. The use of continuous monitoring can be an effective way to utilize scarce staff resources. The key challenge in this regard is to do a better job of outlining the expectations around the work required in support of an assessment carried out through 'continuous monitoring' and to better document and act upon any conclusions coming from such work.

9. Issue guidance outlining the Board's preferred approaches for mitigating key-person dependency risk on Reserve Bank supervisory teams.

We agree that key person dependency risk on supervisory teams may arise on occasion. We will consider whether guidance should be developed and issued.

10. Direct FRB New York to assess whether it needs to hire additional supervisory personnel with market risk and modeling expertise.

We agree that the Federal Reserve System may need additional supervisory personnel particularly with market risk and modeling expertise. Under the LISCC framework, personnel with specific expertise are utilized system wide, and not necessarily strictly within the entity (Reserve Bank or Board) that employs them. As part of the next budget cycle, we will review the needs of the system for such expertise, and if such expertise is warranted, assess where that expertise would be most efficiently housed.

OIG Comment

We appreciate BS&R's response to our report. BS&R stated that in several instances, the division has taken action or has planned activities to address our recommendations. In many instances, those activities appear to be responsive to our recommendations. We included BS&R's responses to our specific recommendations in the findings sections of this report, and we clarified our expectations for corrective action where necessary. We will conduct follow-up activities to determine whether the Board's actions fully address our recommendations. BS&R's response raised some concerns about specific aspects of our report. We outline our perspectives on that feedback below.

We agree with BS&R's comment that applicable guidance allowed the Reserve Bank, as the consolidated supervisor, to rely on the work of JPMC's internal audit, as appropriate. Nevertheless, we are concerned about the application of this general principle to a situation described on page 24 of our report. In that situation, we believe that subsequent evidence provided a basis and the opportunity for FRB New York to question the reliability of internal audit's prior review.

Regarding our description of the Board's delegation of authority, we included this content in the background section of our report to outline the supervisory framework for the majority of our scope period—July 2004 to April 2012. We acknowledge that the background section does not describe the involvement of the LISCC, but page 25 of the chronology section of our report details the transition to the LISCC structure in 2010.

Finally, we included FRB New York interviewees' comments regarding their time commitments associated with CCAR to highlight a recurring theme of our interviews. Our report (1) highlights the tension between System priorities and Reserve Bank discretion to conduct examination activity related to institution-specific risks and (2) acknowledges the benefits of the CCAR exercise. Our report notes on page 31 that in this situation, CCAR demonstrated JPMC's ability to withstand losses of approximately four and a half times the losses resulting from the CIO's trading activity in 2012.

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September 25, 2014

VIA E-MAIL

Mr. Mark Bialek
Inspector General
Board of Governors of the Federal Reserve System
Mail Stop 300, 20th Street & Constitution Avenue, NW
Washington, DC 20551

Re: Office of Inspector General Evaluation Report *The Board Should Enhance Its Supervisory Processes as a Result of Lessons Learned From the Federal Reserve's Supervision of JPMorgan Chase & Co.'s Chief Investment Office*

Dear Mr. Bialek:

Thank you for providing the Federal Reserve Bank of New York ("New York Fed") an opportunity to comment on the Office of Inspector General ("OIG") evaluation report "The Board Should Enhance Its Supervisory Processes as a Result of Lessons Learned From the Federal Reserve's Supervision of JPMorgan Chase & Co.'s ("JPMC") Chief Investment Office ("CIO")" ("Report"). We appreciate your constructive recommendations to the Board of Governors of the Federal Reserve System ("Board of Governors") Division of Banking Supervision and Regulation ("Board BS&R"), which are directed toward improving existing supervisory processes. We leave those recommendations to the Board of Governors, which has the authority to address them. These comments, which we submit on behalf of New York Fed management, address your factual findings.

We agree with the finding that supervision is predicated on timely, accurate and reliable information, and that our success in supervising institutions cannot be measured by the number of idiosyncratic losses we prevent. Instead, in accordance with our core mission of ensuring the safety and soundness of the financial system, we must take reasonable measures so that firms in our District are appropriately capitalized to withstand large, unpredictable losses. Here, as the Report recognizes, we were successful. Furthermore, we concur that statutory law and supervisory guidance require us to leverage other resources whenever possible due to resource constraints. As such, the New York Fed was required to leverage—to the fullest extent possible—the work of the Office of the Comptroller of the Currency ("OCC") and the firm's internal audit group. Coordination with the OCC, however, was not perfect, especially during peak times of the crisis, and particularly in light of the CIO's highly-complex booking structure.

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Mr. Mark Bialek
September 25, 2014

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Notwithstanding these areas of agreement, we believe that the OIG's findings relating to the New York Fed's prioritization of supervisory activities are incomplete, and that the Report does not accurately reflect certain events.

Prioritization of Supervisory Activities

Clearly, during the worst financial crisis since the Great Depression, New York Fed staff had difficult decisions to make regarding how to prioritize its supervisory activities. The OIG, as the Report acknowledges, did not investigate whether the New York Fed prioritized appropriately. Nevertheless, the Report still makes findings with respect to this uninvestigated area, concluding that the New York Fed should have conducted the three proposed CIO-related exams instead of other unidentified exams. Criticizing a decision *not* to do an exam cannot fairly be done without knowing what was done instead, especially since the work that was done satisfied supervisory planning guidance. Given the comprehensive OCC reviews of the CIO, internal audit's substantial coverage of the CIO, and other competing priorities for the same resources, it is not reasonable to substitute the OIG's priority judgment, in hindsight, for the New York Fed's. As the Report acknowledges, JPMC was positioned to withstand the CIO losses, in part because of the Federal Reserve's appropriate focus on capital.

In addition, the Report wrongly faults the onsite team for prioritizing other supervisory work over the CIO exams proposed in its supervisory plans. This focus on the onsite team is inconsistent with the Federal Reserve's supervisory process. The Federal Reserve System Large Financial Institution ("LFI") supervisory process at the time was a year-long iterative process, which involved a number of other constituencies from across the Federal Reserve System. As we have explained previously in great detail, the term "plan" was a misnomer. Each onsite team was required to develop an exhaustive wish list of potential supervisory activities without regard to availability of resources or time constraints. The portion that could be completed was dependent on the availability of experts, and only after all Board-mandated initiatives (such as CCAR) were scheduled. Here, after staffing the mandatory initiatives and other more pressing concerns, the New York Fed did not have the resources to complete the proposed CIO exams.

Factual Concerns

While we appreciate that you have corrected many of the facts that we identified in your preliminary drafts, errors still remain. The most important of these are:

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Mr. Mark Bialek
September 25, 2014

3

- The Report inaccurately reflects the frequency and nature of communications between the OCC and New York Fed, including those regarding the CIO. OCC and New York Fed onsite examiners shared office space and spoke in person frequently. They shared supervisory plans and discussed the scope of their exams. With respect to the CIO, among other things, the OCC and New York Fed jointly held quarterly meetings with CIO management, in addition to joint market risk meetings with the CIO chief risk officer. Prior to the joint meetings, the OCC discussed the agenda with the New York Fed and vice versa.
- When staff proposed the two CIO-related exams in its supervisory plans, the motivation was not due to some “urgent” concern as compared to the tens of other exams with the same risk profile. To be clear, the New York Fed never knew that there were trading irregularities in the CIO, and the Report confirms that. The OCC’s exams and quarterly reports also repeatedly assured the New York Fed that the CIO had a well-functioning control framework, and the New York Fed had no reason to mistrust these reports.
- With respect to the recommendation to conduct a CIO-related exam in an August 2009 product memo, the Report omits important context. As explained to OIG staff, that recommendation was included due to recent staffing changes in the CIO and *not* because of any finding or any other reason.
- Even though the OIG did not investigate the OCC’s supervision of the CIO, it still concludes that the OCC’s supervisory efforts fell short by finding that the New York Fed should have alerted the OCC to its supposed “urgent” concerns regarding the CIO. We do not see how the OIG could make this finding without first determining what the OCC actually knew at the time.
- The LFI team was not controlled by New York Fed senior staff members, but instead led by staff from across the Federal Reserve System, including the Board of Governors.
- SR letters are principle-based, high-level guidance, which the Board of Governors supplements with additional, far more specific, instructions (including templates for supervisory plans and exam tables) on a routine basis. The Report largely ignores the extensive instructions that the Board of Governors issued to carry out SR Letter 08-9, even though it was this guidance that caused the variance in supervisory plans from year to year. It was not due to a lack of New York Fed controls.
- The OIG says that the New York Fed’s reorganization of supervisory staff caused the cancellation of CIO exams. This is incorrect—the last proposed CIO exam was cancelled in February 2011, which was prior to even the announcement that staff would be reorganized in mid-2011.

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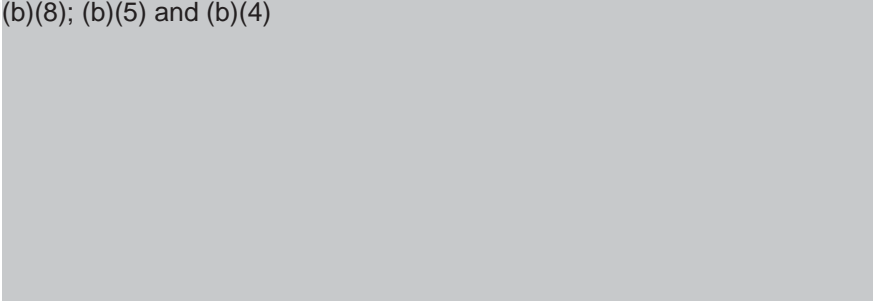
FEDERAL RESERVE BANK of NEW YORK

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Mr. Mark Bialek
September 25, 2014

4

- (b)(8); (b)(5) and (b)(4)



Notwithstanding these concerns, we welcome the OIG's recommendations to improve the Federal Reserve's supervisory process.

Sincerely,

Handwritten signature of Thomas C. Baxter, Jr. in cursive.

Thomas C. Baxter, Jr.
EVP, General Counsel

Handwritten signature of Sarah J. Dahlgren in cursive.

Sarah J. Dahlgren
EVP, Financial Institution Supervision Group

c: Scott Alvarez
Michael Gibson

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OIG Comment

We appreciate FRB New York's response to our report. FRB New York acknowledged the Board's authority to implement the corrective action necessary to address the recommendations. FRB New York's response raised concerns about certain aspects of our report. We outline our perspectives on that feedback below.

Our report acknowledges an inherent limitation of our evaluation. Specifically, page 12 of our report indicates that we "did not assess the appropriateness of FRB New York's relative prioritization of the CIO in comparison to other supervisory priorities at JPMC." On page 29, our report also acknowledges that we cannot predict the outcome associated with the planned or recommended examinations of the CIO that did not occur. Therefore, we cannot conduct the exercise that FRB New York suggested we needed to conduct, which is to assess the relative merits of the examinations that may have occurred versus those that did occur. We disagree that our report substitutes our view of supervisory priorities for FRB New York's actual prioritization. As a factual matter, our report notes that certain planned or recommended examinations of the CIO did not occur. We also acknowledge the circumstances that prevented FRB New York from conducting those examinations. Our report highlights the fact that FRB New York did not discuss the planned or recommended activities with the primary federal regulator in accordance with the applicable guidance either (1) as part of supervisory planning activities or (2) when FRB New York experienced constraints that prevented it from conducting those activities. We also disagree with the assertion that the OCC provided comprehensive coverage of the CIO. Based on our review of the relevant OCC examination materials related to the CIO, we agree with the Comptroller's March 2013 testimony, which indicated that the OCC's supervisory activities related to the CIO primarily focused on the investment portfolio. Finally, pages 23, 25, and 37 of our report acknowledge the role of the LFI and the LISCC in the supervisory planning process during the relevant time periods.

FRB New York also raised nine concerns about the accuracy of specific facts in our report. Our perspectives on that feedback are as follows. First, regarding the Reserve Bank's comments about the frequency and nature of communications between OCC and FRB New York supervisory staff, we acknowledge that some level of coordination occurred between the agencies' respective supervisory teams at JPMC. We interpreted the relevant supervisory guidance to require a more active partnership between the two agencies, which includes discussing planned supervisory activities. Our interviews with FRB New York and OCC staff indicated that the coordination of the supervisory teams at JPMC did not rise to that level. The fact that the two onsite supervisory teams shared office space indicates that there was a prolonged opportunity for FRB New York to initiate formal or informal discussions regarding the planned or recommended examinations related to the CIO.

With regard to FRB New York's second comment about its motivation for including two CIO examinations in its supervisory plans and the urgency of those activities, again, our evaluation did not assess the appropriateness of the Reserve Bank's prioritization decisions. FRB New York also noted that it did not have any awareness of the trading irregularities in the CIO and that the "OCC's exams and quarterly reports also repeatedly assured the New York Fed that the CIO had a well-functioning control framework, and the New York Fed had no reason to mistrust these reports."

The basis for the planned or recommended examinations indicated that FRB New York did have a reason to question those reports. For example, (b)(8) & (b)(5)

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(b)(8) & (b)(5)

In an August 2009 memorandum, a Federal Reserve System team identified that the CIO's market risk management unit had recently implemented significant staffing changes and recommended a full-scope examination of the CIO. (b)(8); (b)(5) and (b)(4)

Regarding FRB New York's third concern related to the 2009 recommendation to conduct a full-scope examination of the CIO, we believe that our report provides sufficient context for the rationale for this recommendation. Specifically, our report acknowledges that the turnover of market risk personnel in the CIO provided the basis for the recommendation. We believe that the turnover of these key risk management personnel could have had an impact on how effectively the CIO managed market risk.

Fourth, based on our review of relevant OCC examination materials related to the CIO, we agree with the Comptroller's March 2013 testimony indicating that the OCC's supervisory activities related to the CIO primarily focused on the investment portfolio. Our evaluation acknowledges that competing demands and resource constraints contributed to CPC team 2 not conducting the planned or recommended CIO examinations. As outlined in our report, we believe that these practical limitations should have increased CPC team 2's urgency to initiate conversations with the OCC in accordance with the expectations outlined in SR Letter 08-9.

FRB New York's fifth concern related to a footnote in our report describing the LFI team. Our footnote indicates that this team was chaired by senior FRB New York officials. In accordance with government auditing standards, we engaged in a thorough process to validate all facts, figures, and other content in our reports. This process requires us to ensure that we have sufficient and appropriate evidence to support our report content. In this particular instance, we supported this statement from FRB New York's intranet website.

With regard to FRB New York's sixth concern, we recognize that SR Letters are guidance that the Board supplements with additional instructions. Nonetheless, based on our evaluation of the supervision of JPMC's CIO, we noted additional weaknesses in supervisory planning controls beyond the issues related to layout and presentation described on pages 37-38 of our report.

Regarding FRB New York's seventh concern, our report does not indicate that the reorganization of supervisory teams in 2011 caused the "cancellation" of any CIO examinations. Pages 38 and 39 of our report describe the loss of institutional knowledge regarding the CIO as a result of the transition to a new supervisory team and note that the attendees of a transition meeting regarding the CIO did not discuss CPC team 2's inability to conduct (1) the CIO discovery review noted in a 2008 supervisory plan or (2) the full-scope CIO examination recommended in 2009.

(b)(8) & (b)(5)

As noted previously, we engaged in a thorough process to validate all facts, figures, and other content in our report. (b)(8) & (b)(5)

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(b)(8) & (b)(5)



(b)(8) & (b)(5)



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did not limit our evaluation to the synthetic credit portfolio; we focused on noteworthy events related to the CIO more broadly that could warrant supervisory attention.



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