Summary Report:

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.

Our complete report contains supervisory information that is privileged and confidential and is thus restricted from public distribution.

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 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.

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. Specifically, we recommend that BS&R take the following corrective actions:

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.

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.

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

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

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

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. In its response, BS&R acknowledged its appreciation for our recommendations for improving the Federal Reserve System's supervisory efforts. BS&R stated that in several instances, the division has taken action or has planned activities to address issues raised in our report. 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 future follow-up activities to determine whether the Board's actions fully address the issues raised in our report.

In its response, FRB New York stated that it is committed to improving supervision and believes that the report's recommendations will help it achieve that goal. FRB New York noted that the core mission of the Federal Reserve is promoting the safety and soundness of the financial system. Accordingly, FRB New York stated that the Federal Reserve's focus is to foster forward-looking capital processes and assure that supervised institutions maintain sufficient capital to withstand severely stressed economic conditions. FRB New York also noted that statutory law and supervisory guidance require FRB New York to leverage other resources whenever possible due to resource constraints. FRB New York stated that here it was required to leverage, to the fullest extent possible, the work of the OCC and JPMC's internal audit group. FRB New York stated that communications with the OCC regarding the CIO never revealed any concerns that the OCC was not already addressing.

In their respective responses, BS&R and FRB New York also raised concerns about specific aspects of our report. In general, our office does not append management responses to its summary reports. Moreover, aspects of the responses reference confidential supervisory information and accordingly are not contained in our summary report. Our unabridged report includes BS&R's and FRB New York's full responses.

OIG Comment

Our unabridged report 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.