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### The Dark Side of Banking

Kyrgyzstan is a country home to just under 6 million people. Together, over the course of 2012, these people produced around \$6 billion worth of goods. In the same year, a man named Bruno Iksil *lost* \$6 billion dollars in a few months. What societal infrastructure allows one man to lose an amount of money earned by 6,000,000 people? The answer is trading.

Most college students have utilized the services of a bank at one point in their life, and many use their debit or credit card every day. To these people, their perception of banks is influenced by their experiences with banks. The most fundamentally incorrect view of banks is that banks simply store and loan money. Although these remain two principal functions, large banks like JPMorgan & Chase also offer financial services like trading and private wealth management. According to an NPR Planet Money blog, JPMorgan & Chase reported in 2012 that only 52.1% of its revenue came from retail banking, or banking that deals with everyday people (“How America’s Biggest Banks...”). In essence, the other 47.9% represents the hidden side of banking, because few consumers understand the nature of these non-retail operations that include trading and managing money for wealthy clients. The riskiest of these retail operations is trading.

Simply put, trading is “the activity or process of buying, selling, or exchanging goods or services” (Merriam-Webster Dictionary). These goods can include stocks,

commodities, or even mortgages. The goal in trading these goods is to make a profit, and that can be done in two ways: buying and selling. When a trader buys a good, they profit when it increases in value. When a trader sells a good, they profit when it decreases in value. Stocks increase in value when a company does well. Commodities like gold

increase in value when the price of gold increases. A mortgage will increase in value if the probability of repayment increases. Using market research and monitoring trends, traders predict which goods will increase in value, and which goods will decrease in value. Large banks like Bank of America, JP Morgan Chase, and Goldman Sachs are extremely wealthy. Therefore, in order to use wealth to create more wealth, they have created trading floors to invest their money and generate profit. See a

Therefore, by leveraging resources and predicting trends, large banks like JP Morgan, Goldman Sachs, and Bank of America can generate billions of dollars by trading. However, with this reward comes a dangerous amount of risk. In recent years, trading culture within banks has driven two catastrophic events: the “London Whale” incident and the sale of fraudulent mortgage-backed securities (MBS). In these examples, banks acted irresponsibly, and their reckless actions betrayed both depositors and shareholders. In order to avoid future trading disasters, large banks must embrace internal controls including strict human resource management and community-oriented trading goals.

Few organizations have \$350 billion in excess cash. JP Morgan Chase, also known as JP Morgan, is one of these few. JP Morgan’s Chief Investment Office (CIO) holds the responsibility to distribute extra cash in low-risk investments (Scuffham). Although these low-risk investments typically garner a smaller return, it is important to realize that even a yearly 1% return on \$350 billion is equal to \$3.5 billion dollars. One trader in this department, named Bruno Iksil, was authorized to take control of a \$10 billion slice of this fund in early 2012. What he did next would shock financial markets markets for years to come.

Instead of obliging the office’s low-risk mandate, Iksil invested the money in high-risk investments, believing that certain markets would strengthen in the future. However, economic downturn in Europe caused his wagers to fail. Over the course of 3 months across March, April, and May, Iksil lost \$6 billion dollars (Silver-Greenberg). . Despite their overwhelming significance, these losses were not announced immediately. When they were finally announced, in early May, JPMorgan’s stock plummeted and stockholders lost \$25 billion. How did this happen? The answer is simple: one man commanded responsibility over too much money.

**Commented [NW1]:** How does this happen? Why does the price of metals (gold/silver) change?

**Commented [NW2]:** This is perhaps an ignorant question, but are these physical floors? Actual spaces? Or is this a digital construction? (I don’t know that this is something that you need to add into the paper, but it was my reaction).

**Commented [M3]:** Industry-wide issue, but JP Morgan cases

**Commented [NW4]:** I assume this is your thesis.

**Commented [NW5]:** Small point, but how do you know this without the hindsight of these “years to come?”

**Commented [NW6]:** good

Human beings are not machines. Unlike machines, **human beings** are affected by emotions, and these emotions can often lead to irrational decisions. Specifically, emotions such as greed and fear can catalyze irresponsible investments. When handling a non-significant amount of money or equipment, then these emotional risks may not represent a significant threat to a business. However, when one man controls \$10 billion dollars, the emotional risk is extremely high. For this reason, a responsible company **would** monitor this man closely. **an assistant and supervisor coordinate all their trades** However, Bruno Iksil, nicknamed “The London Whale” for the size of his trades, was not monitored closely. The New York Times stated during the midst of the losses, that, “The trader, Bruno Iksil, added that ‘I can’t keep this going’ and that he didn’t know where his boss in London ‘wants to stop.’” (Silver-Greenberg). Although brief, these comments reflect a confused and overwhelmed trader, **unsure** of the best **course** of action. Iksil did not say “we can’t keep this going;” instead he used first-person because he felt like he had autonomous control over the portfolio. **failed** Furthermore, the latter comment indicates **that the trading floor managers were clear in regards to their recommendations on Iksil’s trading position,** and that Iksil did not consult his boss about this. Essentially, not only did Iksil handle dangerous autonomy of the portfolio, but he also failed to reach out to my superiors for help. Clearly, from these comments, JP Morgan’s trading floor represents one that did not strictly monitor their human resources. **And ifu**

The monitoring of employees that control large sums of money is neither a daunting nor expensive task. Had Bruno Iksil sat down with a manager once a week for fifteen minutes to discuss his trades, then this fiasco may have been avoided. **While it may be convenient for trading managers to take a hands-off approach to take advantage of plausible deniability, these managers must take responsibility to manage their employees.** In an industry driven by risk, it should be reasonable that a trading floor manager focuses on risk management.

In addition to poor human capital management, there is another driver that catalyzes irresponsibility in banking. This driver is the employee incentive model. Brian DeChesare, founder of Mergers & Inquisitions (M&I)—the biggest investment banking blog in the world—explains of traders that: “you may get a **very low base salary** – or

**Commented [NW7]:** They? We?

**Commented [M8]:** Explain org structure

**Commented [M9]:** Unguided

**Commented [NW10]:** I don’t know that I understand this connection. Where does this come in the quote? How is Iksil’s job related to trading floor managers? Was he directing them?

**Commented [NW11]:** This is interesting, what is the value of deniability? Who is ultimately responsible?

perhaps nothing at all...with 100% of your pay being performance-dependent” (DeChesare). In other words, the salary of many traders depends entirely upon the profit they garner through trading.

This salary model is, without a doubt, one that creates high-pressure environments. As part of a series on interviews exploring culture in finance, Guardian writer Joris Luyendijk interviews an anonymous, around twenty-year old trader that worked in JP Morgan’s trading floor. This trader claims that JP Morgan incentivized profit, and that failing traders were quickly fired. He explains, “It is really like this: somebody gets a phone call at his desk. He gets up and never comes back. You may receive a call: 'Hey, can you bring me my coat and bag?' They'll be outside, not allowed back in.” (Luyendijk). This meritocratic environment causes traders to focus on their own profit, knowing that individual success will bring significant reward. Furthermore, the volatile lack of job security encourages risk-taking. When traders know that a poor run of trades may lead to dismissal, they become exponentially more likely to engage in high-risk yet high-reward trades. When multiple traders take this high-risk approach and fail, the trading floor itself is at jeopardy.

This culture especially creates problems when banks embrace non-traditional lending and borrowing. Most people understand the concept of interest on bonds, which are loans typically used by businesses to raise money. A bank sells the customer a bond, and the bank pays the customer back this amount with interest. For example, a bank might sell a \$100 bond with a 10% annual interest rate to be paid at the end of the year. A customer can buy this bond for \$100 and receive \$110 at the end of the year. This investment is relatively safe, because the investor is guaranteed \$110 at the end of the

year. However, during the housing boom, JP Morgan started selling more complex loans, called mortgage-backed securities.

Mortgage-backed securities (MBS) are created when banks bundle multiple mortgages together, and link this bundle to a loan. Unlike a bond, with which pays out a fixed rate at the end of the borrowing period, a MBS pays out depending on how well mortgage-owners repay their mortgage. For example, an investor that buys a MBS tied to mortgages owned by responsible homeowners can expect a safe return on his investment. Therefore, the risk in investing in mortgage-backed securities is directly linked to the credit score of the homeowners that own the linked mortgages (Ingram). Before selling these packages to consumers, it is the bank's responsibility to clearly state the risk involved in the loan.

However, JP Morgan misrepresented the risk of many MBS packages, and sold these packages to unsuspecting customers. The New York Times outlines that JP Morgan hired a company called Clayton Holdings to examine MBS before they were sold. Ben Protoss, a New York Times financial reporter, explains that "[JP Morgan] hired Clayton Holdings and other third-party firms to examine the loans... the firms scoured them for potential red flags like borrowers who had vastly overstated their incomes or appraisals that inflated property values" (Protoss)., tied to MBS. If a homeowner earns a lower income than reported, then he or she may not earn enough to cover mortgage payments—investment risk of an MBS. However, JP Morgan ignored these "red flags" when auditors found them. According to the legal statement of facts, JP Morgan sold 6,238 MBS that did not meet auditor standards (Protoss). And despite these packages being deemed too risky to sell to customers, JP Morgan continued to sell them. During this time, many

**Commented [NW12]:** Nice explanation.

**Commented [NW13]:** Following this quote might be another good place to restate why these red flags are bad – lowers their ability to pay, allows banks to lend more,. A good place to work on pushing that explanation part of quote integration.

**Commented [M14]:** Make more concise

investors would buy MBS packages that had been 3<sup>rd</sup> party approved as low-risk investments, despite being dangerously high-risk investments. This had led to the loss of over \$7 billion dollars on behalf of investors since 2005.

How did this happen? Essentially, JP Morgan told investors they were selling one thing despite selling something completely different. This would be the equivalent of buying a TV online from Amazon and receiving a lawn chair. From 2005-2008, the JP Morgan sales and trading division sold these fraudulent MBS packages to eager investors. When some of these packages expired, and investors realized they weren't receiving nearly enough money than they were supposed to, the inherent scandal became clear. For this reason, this fraud was not a sustainable one. Yet, for two years, these MBS packages were sold, despite being riddled with unreasonable risk.

Commented [NW15]: nice

Commented [M16]: too informal

The main reason why these mortgages were sold is simple: profit. As the housing market continued to boom in 2005, more and more investors were looking to invest in MBS packages. During this time, as more houses were being sold, mortgage sales also increased, which made MBS a desirable investment option. When JP Morgan realized they could mislabel the risky MBS packages as safe to make a profit, they did.

As explained before, employees in sales and trading are paid based upon their sales. Therefore, despite the obvious reality that MBS fraud would inevitably be uncovered, traders continued to sell these packages because it allowed them to make more money. Each trader individually paid based upon profit, needed to make more money than the other traders to ensure job security. As more and more traders started selling these fraudulent MBS packages, traders not selling them would lag behind in regards to profit. These traders lagging behind may have been incentivized to embrace

the fraud so not to lose their jobs. cutthroat Each trader, caught in their only little world of maximizing profit, sold fraudulent mortgages for that sole reason: they maximized profit.

Based upon Joris Luyendijk's interview and described sale of mortgage-backed securities, it becomes clear that JP Morgan traders rarely interact in a community environment. The act of trading is an individual task, and therefore there may not be an obvious need for workplace interaction. Furthermore, traders will not want to share their trading ideas, because popularity of an idea may threaten its profitability. However, when individuals fail to collaborate in this way, it can blind them from sustainable trading. Each trader selling mortgage-backed securities continued to sell mortgage-backed securities because they were extremely profitable during the housing boom. The structure of these trading floors is not extremely transparent, but one could argue that long-term, community-oriented goals were probably not implemented. If each trader sat in a meeting, and openly discussed their sales and how this would affect the company in five years, then this catastrophe may not have happened. Such internal controls would require that each trader is not only aware of their own sales, and not only aware of other traders' sales, but are also aware of the sustainability of all sales being made. Such a meeting in 2005 may have caused JP Morgan employees to open their eyes, and realize that selling MBS packages would inevitably lead to a financial catastrophe when it became clear that packages were fraudulent. Furthermore, if the floor had a community-oriented goal to maximize total trading profit, across all traders, in five years, then this fraud may not have occurred. In summary, one solution to insure trader responsibility would be to shift short-term, individual profit goals into more long-term, community-oriented profit goals.

**Commented [NW17]:** Is this illegal? Are there external controls in place? It seems like this would be something the company would want to eliminate.

**Commented [M18]:** Legal implications.

As reported by Matt Clinch, Assistant Producer of CNBC, such repercussions usually include fines, redistributed to mislead investors who suffered losses. Clinch writes of the MBS sales that “The banks included in the [legal] report are Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Wells Fargo” (Clinch). Cumulatively, these banks may face fees of over \$100 billion. This case, led by the U.S. government, highlights that corruption is not an issue that JP Morgan Chase faces alone. Six major banks ended up selling MBS for the reason: internal controls could not tame individual greed.

Some might argue that banks cannot be trusted to regulate their own internal controls within trading floors. Instead, this argument might suggest external regulations to be enforced by the government. One such external regulation is called a capital requirement, and represents the amount of money a bank must keep on them at all times. Essentially, by raising the capital requirements, there is less money the bank can potentially lose by making shady deals or engaging in risky trading. (Carpenter) With higher capital requirements, the “London Whale” may have lost less money, and for this reason, many people advocate external regulations.

However, the current banking culture is not conducive to external controls. Evidence for this view stems from the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), a government employee tasked with enforcing external controls. This employee, Christy Romero, stated herself that “At SIGTARP, we have arrested and continue to arrest bankers who cultivated a culture of reckless arrogance, believing they were untouchable even as they broke the law. When their risky gambling went south these bankers lied, plain and simple” (Romero). Clearly, Romero describes a

**Commented [M19]:** List off multiple external regulations

**Commented [NW20]:** Good it's great to mention this, there others? I don't think you need to necessarily need to explain them, but you might want to represent the scope of this regulations.

culture that will break external rules or regulations if they are implemented. If bankers were lying, disobeying, and manipulating existing external regulations, why would more external controls reduce corruption? In reality, the problem is this culture. The culture inevitably drives the corruption, and only internal controls can quell this environmental factor. Until banks can internally manage their culture, then this problem will persist.

The energy company Enron, although not a bank, housed a trading floor that truly illuminates the epitome of trading culture. Enron's trading floor often profited when earthquakes or power shortages reduced the supply of energy. The traders' reactions to these events—that often devastated homeowners—remained disturbingly positive. CBS Evening News reports that one trader, caught on tape, sang about a forest fire: "Burn, baby, burn. That's a beautiful thing" (Roberts). The Enron culture celebrated profit, mourned losses, and ignored all other qualitative factors like moral integrity. The trader singing about the forest fire couldn't care less about the homes or landscaped affected by the fire, because in his eyes they represented irrelevant external outcomes. This cultural mindset, to prioritize profit over everything, still permeates the trading floors of banks—evidenced by the London Whale and MBS cases.

Before trading can cleanse itself of irresponsibility, the culture has to change. Luckily, internal controls can help change this culture. If, instead of working as isolated units, traders begin to discuss community goals and expectations, then perhaps they will one day choose long-term sustainability over short-term profit. If, for example, trading floors took 30 minutes a day to discuss the implications of their trades as a community, then each trader may not dig themselves into an inescapable hole like they did by selling faulty MBS.

**Commented [M21]:** After this Enron example and JP Morgan whore example

Unlike ice cream shops or bicycle stores, society *needs* banks to economically develop. Although we might miss the taste of ice cream or the convenience of bicycles, our society could continue to function without them. Banks, on the other hand, provide support to facilitate many vital functions within society. Without loans offered by banks, most consumers would not be able to buy houses or start businesses. Without offering a place to store money, we might all have to store money in our mattresses. For this reason, by their nature, civilians *rely* on banks. This reliance creates a social responsibility on behalf of banks for them to fulfill. As a cornerstone of economic development, banks should, if anything, act *more* responsibly than other private businesses. And, illustrated by the London Whale and MBS cases—they don't. Although tighter human capital management and community-oriented goals might fix the solution, a cultural paradigm shift may have to occur before banks are willing to put these internal controls in place. Despite being typically illustrated as places of security and trust, banks—and especially the traders within them—embrace greed over responsibility. Luckily, in the past, banks have always made enough profit to cover huge losses, and therefore depositors rarely lose money. If this changes, though, a penny saved may no longer represent a penny earned.

Appendix A -

**Commented [NW22]:** This is an interesting line of thought.

**Commented [NW23]:** One overall comment: Your argument references JP Morgan Chase. Is it just a problem of one bank? Or do others engage in the same conduct. I think you can focus on Chase, but it might be beneficial to address the field as a whole in a sentence or two.



Source: [https://www.db.com/medien/en/images/DB\\_Handelsraum1.jpg](https://www.db.com/medien/en/images/DB_Handelsraum1.jpg)

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