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Food For Thought

How does a major bank lose more than \$2 billion on just one trading strategy?

The short answer to this rhetorical question is that we do not know for a fact because we are not yet privy to all the details, which we expect would emerge with time. However, we do have a sense.

Based on what we know so far, it appears that the loss making trades in question stem primarily from synthetic credit derivative positions taken on an index known cryptically as CDX.NA.IG. This begs the question, what is the underlying that comprises the CDX.NA.IG index? As shown on Attachment - 1, we were able to procure from the public domain one example of this index, though we are not sure if this is the specific version of the index that caused the aforementioned loss making trades.

Why would a large bank need to trade this index?

As shown in Attachment - 1, the CDX.NA.IG index comprises 125 equally weighted North American Investment Grade Credits. Because of the broad diversification provided from owning the index, a large bank that needed to hedge itself from a potential downturn in the US credit markets, could do so by buying credit protection on the index. However, this decision would also require the large bank to pay monies upfront to buy credit protection. If the large bank's concerns about the potential downturn in the US markets proved to be prescient, purchasing protection on the index would make money for the large bank because the cost of buying similar credit protection, after the US markets had in fact deteriorated would increase, which in its turn would add value to the cheaper credit protection contracts bought by the large bank earlier. The large bank could then profit from this differential in the price of the index and cash out of this "in the money" position and use the money made on the trade to offset any losses actually experienced on its loan book.

Notwithstanding the previous paragraph, the same concept could also be used to make a speculative bet on the direction of the US credit markets, if the large bank had reasons to believe that the US credit markets were trended upward. Under that thesis, the large bank would sell credit protection with the expectation that once the US credit markets experienced an upswing, the cost of buying credit protection would decrease and the large bank would profit from the differential in index prices. Based on what we know so far, it appears that one set of trades pertain to contracts to buy protection until 2012, but sell protection until 2017, which appear to be the cause of the current woes. Also, there appear to be other

¹ *Food For Thought* is a periodic publication of JP CONSULTING tailored to address specific issues of interest in the insurance and banking industries. The opinions expressed in this publication are those of its authors alone – Joseph Prakash, CFA and Professor Herb Jacobs, New York University – School of Continuing Education. If you wish to have your name removed from the distribution list, please respond to our e-mail with the word "Unsubscribe" on the subject line of the e-mail.



trades to sell protection from 2014 to 2017 which also appear to have lost value and may contribute to additional losses, over and above the \$2 billion in losses already mentioned.

Keeping the amounts in perspective

While we acknowledge that \$2 billion is a large amount for most of us, it is important to keep the amount in perspective. For a large bank with Tier 1 Capital of \$150 billion in 2011, even a \$5 billion loss would be only a little more than 3% of the large bank's Tier 1 Capital. That being said, the fact that one set of losing positions could be allowed to accumulate to such large amounts without being closed out when the losses were much smaller (by taking an offsetting position after they had reached a loss limit of say \$20 million per position) appears to indicate some form of deficiency in internal controls. Also, it is curious that the large bank's Value At Risk (VaR) models did not warn management of this potential problem before it mushroomed to a level that captured the attention of the markets.

Another aspect of the trading book is the aggregate size of the loss making positions. If the aggregate size of the position had been allowed to build to say, \$200 billion, then even a small change in the value of the index could result in large losses. Simply put, a 1% change in the value of the index on a \$200 billion position could result in a loss of \$2 billion.

Impact on Volcker Rule

Large banks have argued (quite persuasively until now) that the kind of trading we have outlined above should be permitted so that they may efficiently hedge their internal risk exposures on a portfolio basis. That being said, now that this issue is again in the public domain, it appears that it will be vetted both in the media and Congress.

Silver lining

As we keep a watchful eye on the unfolding drama, the good news is that we are currently not aware of any insurance companies that engage in this type of trading. That being said, we are aware of at least one insurance company that owns an index similar to the CDX.NA.IG, but as a "buy and hold" investor and not as a trader. We plan to keep you posted, as warranted.

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Attachment – 1
CDX.NA.IG

Constituents for CDX.NA.IG					
Index Constituents					
Short Name	Entity CLIP	Reference Obligation	Av Rating	Sector	Weight
ACE Ltd	0A4848	ACE-INAHldgs 8.875 15Aug29	A	Financial	0.80%
Aetna Inc.	0A8985	AET 6.625 15Jun36 BondCall	A	Financial	0.80%
Alcoa Inc.	014B98	AA 5.72 23Feb19	BBB	Materials	0.80%
Altria Gp Inc	0C4291	MO 9.7 10Nov18	BBB	Consumer Stable	0.80%
Amern Elec Pwr Co Inc	027A8A	AEP 5.25 01Jun15	BBB	Utilities	0.80%
Amern Express Co	027D97	AXP 5.5 12Sep16	A	Financial	0.80%
Amern Intl Gp Inc	028EFB	AIG 6.25 01May36 Struc	BBB	Financial	0.80%
Amgen Inc.	0D4278	AMGN 2.5 15Nov16	BBB	Consumer Stable	0.80%
Anadarko Pete Corp	0A3576	APC 5.95 15Sep16 BondCall	BBB	Energy	0.80%
Arrow Electrs Inc	0E69A8	ARW 6.875 01Jun18	BBB	Industrial	0.80%
AT&T Inc	0A226X	ATTINC 2.5 15Aug15	A	Communications and Technology	0.80%
Autozone Inc	0F8665	AZO 5.5 15Nov15 Struc	BBB	Consumer Cyclical	0.80%
Avnet, Inc.	058B87	AVT 6 01Sep15 BondCall	BBB	Industrial	0.80%
Barrick Gold Corp	06DG91	ABX 5.8 15Nov34	BBB	Materials	0.80%
Baxter Intl Inc	0H8994	BAX 6.625 15Feb28	A	Consumer Stable	0.80%
Beam Inc	07AAA3	BEAMINC 5.375 15Jan16 BondCall	BBB		0.80%
Berkshire Hathaway Inc	08CAD7	BRK-FIN 2.45 15Dec15	A	Financial	0.80%
Boeing Cap Corp	09G715	BA-CapCorp Frn 15Sep23 Float	A	Financial	0.80%
Boston Scientific Corp	1B124A	BSX 6.4 15Jun16 BondCall	BBB	Consumer Stable	0.80%
Bristol Myers Squibb Co	1C1134	BMV 6.8 15Nov26	A	Consumer Stable	0.80%
CA, Inc.	138DAS	CAINC 5.375 01Dec19	BBB	Communications and Technology	0.80%
Campbell Soup Co	1E786B	CPB 3.05 15Jul17	A	Consumer Stable	0.80%
Cdn Nat Res Ltd	1E99BD	CNQ 6.25 15Mar38 BondCall	BBB	Energy	0.80%
Cap One Bk USA Natl Assn	1F445B	COF-BNKNA 5.125 15Feb14	A	Financial	0.80%
Cardinal Health Inc	1F55D7	CAH 4 15Jun15	BBB	Consumer Cyclical	0.80%
Carnival Corp	1F79BD	CCL 6.65 15Jan28	A	Industrial	0.80%
Caterpillar Inc	15DA35	CAT 5.7 15Aug16 BondCall	A	Consumer Cyclical	0.80%
CBS Corp	136CDC	CBSCOR 4.625 15May18	BBB	Consumer Cyclical	0.80%
CenturyLink Inc	16BCFO	CLINKI 6 01Apr17 BondCall	BBB	Communications and Technology	0.80%
Cigna Corp	137A59	CI 7.875 15May27	BBB	Financial	0.80%
Cisco Sys Inc	1I99CW	CSCO 5.5 22Feb16 BondCall	A	Communications and Technology	0.80%
Comcast Corp	2C033N	CMCSA 6.5 15Jan17 BondCall	BBB	Communications and Technology	0.80%
Computer Sciences Corp	2C5899	CSC (4) 6.5 15Mar18	BBB	Communications and Technology	0.80%
ConAgra Foods Inc	225DGF	CAG 7 01Oct28	BBB	Consumer Cyclical	0.80%
ConocoPhillips	228A7H	COP (3) 5.9 15Oct32	A	Energy	0.80%
Cox Comms Inc	2E6448	COX-CommInc 6.8 01Aug28	BBB	Communications and Technology	0.80%
CSX Corp	138A48	CSX 5.6 01May17	BBB	Industrial	0.80%
CVS Caremark Corp	138CAK	CVSCRM 6.125 15Aug16 BondCall	BBB	Consumer Cyclical	0.80%
Darden Restaurants Inc	25A8AD	DRI 6 15Aug35 BondCall	BBB	Consumer Cyclical	0.80%
Deere & Co	2G85AI	DE 4.375 16Oct19	A	Consumer Cyclical	0.80%
Dell Inc	26B72T	DELLN 7.1 15Apr28	A	Communications and Technology	0.80%
Devon Engy Corp	2H68GV	DVN 7.95 15Apr32	BBB	Energy	0.80%
DIRECTV Hldgs LLC	2H99EY	DTV-Hldgs 3.5 01Mar16	BBB	Communications and Technology	0.80%
Dominion Res Inc	27CBAF	D 5.15 15Jul15	BBB	Utilities	0.80%
Duke Energy Carolinas LLC	28A85G	DUKECO 6.1 01Jun37	A	Utilities	0.80%
E I du Pont de Nemours & Co	2I9887	DD 5.25 15Dec16 BondCall	A	Materials	0.80%
Eastman Chem Co	29EB75	EMN 7.6 01Feb27	BBB	Materials	0.80%

Constituents for CDX.NA.IG					
Index Constituents - continued					
Short Name	Entity CLIP	Reference Obligation	Av Rating	Sector	Weight
ERP Oper Ltd Pship	28EGCE	EQR-ERPOperLP 5.75 15Jun17	BBB	Financial	0.80%
Exelon Corp	3D177O	EXC 4.9 15Jun15 BondCall	BBB	Utilities	0.80%
EXPEDIA INC	3D233R	EXPD 7.456 15Aug18 BondPut	BBB		0.80%
FirstEnergy Corp	36AGC5	FE 7.375 15Nov31	BBB	Utilities	0.80%
Freeport McMoran Copper & Gold Inc	38BD8E	FCX 3.55 01Mar22	BBB	Materials	0.80%
G A T X Corp	3J758C	GMT 6 15Feb18	BBB	Industrial	0.80%
Gen Elec Cap Corp	39FF84	GE-CapCorp 5.625 15Sep17	AA	Financial	0.80%
Gen Mls Inc	3A7367	GIS 5.7 15Feb17 BondCall	BBB	Consumer Stable	0.80%
Goodrich Corp	3BA5BG	GR (2) 6.29 01Jul16 BondCall	BBB	Industrial	0.80%
H J Heinz Co	4G537B	HNZ 6.375 15Jul28	BBB	Consumer Stable	0.80%
Halliburton Co	4E6837	HAL-EnSvcs 8.75 15Feb21	A	Energy	0.80%
Hewlett Packard Co	46AA59	HPQ 5.4 01Mar17 BondCall	A	Communications and Technology	0.80%
Honeywell Intl Inc	47BD67	HON 5.7 15Mar36 BondCall	A	Industrial	0.80%
Ingersoll Rand Co	49BEEC	IR-NJ 9 15Aug21	A	Industrial	0.80%
Intl Business Machs Corp	49EB20	IBM 5.7 14Sep17	A	Communications and Technology	0.80%
Intl Paper Co	4A615A	IP (2) 5.3 01Apr15	BBB	Materials	0.80%
Johnson Ctls Inc	4BF89C	JCI 7.125 15Jul17	BBB	Industrial	0.80%
Kinder Morgan Engy Partners L P	4DD9A5	KMP 3.5 01Mar16	BBB	Energy	0.80%
Kohls Corp	5F027A	KSS 6.25 15Dec17	BBB	Consumer Cyclical	0.80%
Kraft Foods Inc	5F07CS	KFT 6.5 11Aug17	BBB	Consumer Stable	0.80%
Lockheed Martin Corp	58CHB3	LMT 7.65 01May16	A	Industrial	0.80%
Loews Corp	5J4466	LTR 5.25 15Mar16	A	Consumer Stable	0.80%
Lowe's Cos Inc	59CEC7	LOW 5.4 15Oct16 BondCall	BBB	Consumer Cyclical	0.80%
M D C Hldgs Inc	5A78DD	MDC 5.625 01Feb20	BBB	Consumer Cyclical	0.80%
Macy's Inc	5AB77V	M (3) 7.45 15Jul17	BBB	Consumer Cyclical	0.80%
Marriott Intl Inc	5C8A93	MAR 5.81 10Nov15 BondCall	BBB	Consumer Cyclical	0.80%
Marsh & McLennan Cos Inc	5C88BC	MMC 5.75 15Sep15 BondCall	BBB	Financial	0.80%
McDONALDS Corp	5D8148	MCD 5.8 15Oct17	A	Consumer Cyclical	0.80%
McKesson Corp	UZDD52	MCK 7.65 01Mar27	A	Consumer Cyclical	0.80%
MetLife Inc	5EA6BX	MET 5 15Jun15 BondCall	A	Financial	0.80%
Motorola Solutions Inc	61209O	MOTSOL 6 15Nov17	BBB	Industrial	0.80%
Nabors Inds Inc	68BEBE	NBR-Inc (3) 6.15 15Feb18	BBB	Energy	0.80%
Natl Rural Utils Coop Fin Corp	69AB75	NRUC 8 01Mar32	A	Utilities	0.80%
Newell Rubbermaid Inc	6B634B	NWL 6.25 15Apr18	BBB	Industrial	0.80%
News America Inc	6B76CA	NWS-AmInc 7.25 18May18	BBB	Communications and Technology	0.80%
Nordstrom Inc	6BABCA	JWN 6.95 15Mar28	A	Consumer Cyclical	0.80%
Norfolk Sthn Corp	6BADC8	NSC 7.7 15May17		Industrial	0.80%
Northrop Grumman Corp	6CCE9H	NOC-SysCorp (3) 7.75 15Feb31	BBB		0.80%
Omnicom Gp Inc	6E9AAA	OMC 5.9 15Apr16 BondCall	A	Communications and Technology	0.80%
Pfizer Inc	718789	PFE 4.65 01Mar18	A	Consumer Stable	0.80%
Pitney Bowes Inc	7J68BG	PBI 6.25 15Mar19	BBB	Consumer Cyclical	0.80%
Quest Diagnostics Inc	7BCB7P	DGX 6.95 01Jul37	BBB	Industrial	0.80%
Raytheon Co	7CA622	RTN 7.2 15Aug27	A	Industrial	0.80%
Reynolds Amern Inc	7D7884	RAI (3) 7.625 01Jun16 BondCall	BBB	Consumer Stable	0.80%
Ryder Sys Inc	7FB89D	R 6.95 01Dec25	A	Industrial	0.80%
Safeway Inc	7-Feb-65	SWY 7.25 01Feb31	BBB	Consumer Stable	0.80%
Sara Lee Corp	8I3422	SLE 6.125 01Nov32	BBB	Consumer Stable	0.80%
Sempra Engy	897ED6	SRE 6.15 15Jun18	BBB	Utilities	0.80%
Simon Pty Gp L P	8AAG87	SPG-LP 5.25 01Dec16 BondCall	A	Financial	0.80%



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Index Constituents - continued					
Short Name	Entity CLIP	Reference Obligation	Av Rating	Sector	Weight
SLM Corp	7FC86R	SLMA 6.25 25Jan16	BBB	Financial	0.80%
Southwest Airs Co	8C8BB5	LUV 5.125 01Mar17	BBB	Consumer Cyclical	0.80%
Starwood Hotels & Resorts Wwide Inc	8DAE9A	HOT 6.75 15May18	BBB	Consumer Cyclical	0.80%
Target Corp	8FD73G	TGT 5.375 01May17	A	Consumer Cyclical	0.80%
Allstate Corp	0C2002	ALL 6.75 15May18	BBB	Financial	0.80%
Chubb Corp	1I8355	CB 6.6 15Aug18	A	Financial	0.80%
Dow Chem Co	2I6597	DOW 7.375 01Nov29	BBB	Materials	0.80%
GAP INC	39ABD6	GPS 5.95 12Apr21	BBB	Consumer Cyclical	0.80%
HARTFORD FINL SERVICES GROUP INC	457B66	HIG 4 30Mar15	BBB	Financial	0.80%
Home Depot Inc	47A77D	HD 5.875 16Dec36 BondCall	A	Consumer Cyclical	0.80%
The Kroger Co.	5F1148	KR 6.15 15Jan20	BBB	Consumer Stable	0.80%
Sherwin Williams Co	8A677C	SHW 7.375 01Feb27	A	Consumer Cyclical	0.80%
Walt Disney Co	279AEF	DIS 5.625 15Sep16 BondCall	A	Consumer Cyclical	0.80%
TIME WARNER CABLE INC	8GFA5L	TW-Cab 5.85 01May17	BBB		0.80%
Time Warner Inc	8GFA48	TW 5.875 15Nov16 BondCall	BBB	Communications and Technology	0.80%
Transocean Inc	8HCBB3	RIG 7.375 15Apr18 Struc	BBB	Energy	0.80%
Tyson Foods Inc	9J26DD	TSN 6.6 01Apr16 Struc	BBB	Consumer Stable	0.80%
Un Pac Corp	997F99	UNP 6.625 01Feb29	BBB	Industrial	0.80%
Utd Parcel Svc Inc	9A2443	UPS-AmericaInc 8.375 01Apr30	AA	Industrial	0.80%
UnitedHealth Gp Inc	9A456T	UNH 6 15Feb18	A	Financial	0.80%
Valero Energy Corp	9AAA4I	VLOC 8.75 15Jun30	BBB	Energy	0.80%
Verizon Comms Inc	9B579L	VRZN 4.9 15Sep15 BondCall	A	Communications and Technology	0.80%
Viacom	9B7A8S	VIAINC 6.875 30Apr36 Struc	BBB		0.80%
Vornado Rlty LP	9BB947	VNO-LP 3.875 15Apr25 Struc	BBB	Financial	0.80%
Wal Mart Stores Inc	9C4256	WMT 5.875 05Apr27	AA	Consumer Cyclical	0.80%
Whirlpool Corp	9F9652	WHR 7.75 15Jul16	BBB	Consumer Cyclical	0.80%
Xerox Corp	9HC533	XRX 6.35 15May18	BBB	Consumer Cyclical	0.80%
XLIT Ltd	GPHABP	XLITLTD 6.25 15May27	BBB	Financial	0.80%
YUM Brands Inc	9HGCDH	YUM 6.25 15Mar18	BBB	Consumer Cyclical	0.80%
Totals					100.00%

Source: Markit

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