JPMorgan Chase and Compliance Risk

Most of the business news over the past few days has been dominated by JPMorgan Chase & Co (JPM) and its announced $2.3 billion trading loss. Early on there was focus on JPM's trading operations in London as the cause of this massive loss and even one trader, nicknamed the "London Whale", has fuelled the debate about banks taking such large positions which caused or may have helped to cause these massive losses. The news stories intimated that these losses may have been the work of this 'rogue trader' who worked for the company in its London operation. However, an article in the Saturday Wall Street Journal (WSJ), entitled "*Bank Order Led to Losing Trades*", reporters Dan Fitzpatrick, Robin Sidel and David Enrich wrote that the company told the traders to "make the bets aimed at shielding the bank from the market fallout of Europe's deepening mess. But instead of shrinking the risk, their complicated bets may have backfired into losses as much as $200MM a day".

One of area that is an important part of a minimum *best practices* compliance program under the Foreign Corrupt Practices Act (FCPA) or the UK Bribery Act is risk assessment. Indeed in a recent video podcast on the site MainJustice.com, Kimberly Parker, a partner at WilmerHale, said that both the Department of Justice (DOJ) and the UK Serious Fraud Office (SFO) have made clear that a risk assessment is now the key initial step in crafting a compliance program under either the FCPA or Bribery Act. However, from information available to-date, it is not clear how JPM may have assessed its risk which led to it instructing its traders to make such risky bets. Yet the Bank must have thought its risk was quite high to bet up to $200MM per day the other way in an attempt to manage said risk.

So it would appear that not only does a company need to assess its risk but it must also judge that risk. This is termed 'risk intelligence' and it appears that such intelligence was sorely lacking in the case of JPM. In an article, coincidentally also appearing in the Saturday WSJ, entitled "*How to Beat the Odds at Judging Risk*", author Dylan Evans reviewed how two different groups, weathermen and gamblers, gauge probabilities. He believes that these two groups "have managed to overcome these biases and are thus able to estimate probabilities more accurately than the rest of us." He termed this phenomenon as "high intelligence with respect to risk." He cited to Sarah Lichtenstein for three characteristics of groups with high intelligence with respect to risk. First, these groups "tend to be comfortable with assigning numerical probabilities to possible outcomes." Second, such groups "make predictions only on a narrow range of topics." Third, these groups "tend to get prompt and well-defined feedback, which increases the chance that they will incorporate new information into their understanding."

Evans wrote that both weathermen and gamblers received "prompt and well-defined feedback" for their predictions. Weathermen usually know the next day if their forecast is correct and gamblers received almost instantaneous results with the next roll of the dice, turn of a card or drop of a roulette ball. The key for gamblers seems to be in the quantification of wins and losses; they can review these strategies in order to learn from their mistakes.

Most compliance practitioners use a risk assessment to manage risk going forward. However, I believe that one of the lessons which can be learned from the JPM debacle is that a compliance program requires more than a risk assessment and management of the quantified risk. You need to use risk intelligence to learn from the risk and help your company anticipate FCPA or Bribery Act compliance issues that may arise from your business model, geographic sales locations or interactions with foreign government officials. Evans concludes his article by stating that given the right conditions and right self-reflection and practice, we can make substantial improvement to our risk intelligence.

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