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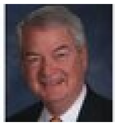

THOUGHT PIECE

THE MYTH AND REALITY OF HEDGING

GEORGE BOLLENBACHER, CAPITAL MARKETS ADVISORS, LLC

A recent article in the Wall Street Journal predicted that the looming “Volcker Rule Won't Allow Banks to Use 'Portfolio Hedging.'” This subject has been discussed and re-discussed for a while, but much of the discussion, and perhaps the rule itself, appears to misunderstand the very nature of hedging.

The essence of the current discussion is whether banks should be allowed to hedge portfolios, as opposed to individual holdings. Much of what has been said, and apparently some of the rule itself, was influenced by Jamie Dimon’s statement, "My attitude on portfolio hedge would be if you look at what we did in the whale, we made a mistake. It was portfolio hedging badly done." The implication is that JPM viewed the transactions that led up to the $6.5 billion loss as a hedge.

The Nature of Risk

So it is important, at this juncture, to understand a bit better the real nature of hedging. The first thing we need to know is that you don’t hedge a position, or a security, or a portfolio, but a *risk*. A risk is the possibility that something – a position, a commitment, a collection of positions, the provision of a service – will cause you to suffer a loss. If an offsetting position doesn’t relate directly to the risk, it isn’t a hedge.

The next thing we need to know is that risk is about the unknown, either the impact of furure events or , if we know the impact, the possible future occurance of those events. Those are two very different unknowns. If we know what effect an event will have, we can begin to hedge it, but if we don’t know what the effect will be, we have a very hard time hedging. That second class of risks has to be managed another way.

However, even knowing, or thinking we know, the impact of certain events, we can’t start hedging until we know two more things: the size of the potential loss from a particular change or event, and the size of the potential profit from the offsetting, or hedge, position resulting from the same event.

The Nature of Hedging

Thus a proper hedge would identify

1. The cause of a potential loss
2. The effect and size of that cause
3. The the causal factors and impact of any offsetting position

Proper hedge management would document and track all three of these factors, so as to be as sure as possible that the hedge was working. If you can’t do those three things, you don’t have a hedge. At best you have a guess, and at worst you have a speculation. So the litmus test of a hedge is whether the relationship was tracked, and especially whether the P&L of the hedge was combined with the P&L of the risk position, which is what SFAS 133 requires.

The London Whale

Now let’s look at the London Whale trades. The best synopsis is provided by the Senate Permanent Subommittee on Investigations’ report, dated March 15, 2013. In its executive summary, the report indicates that the situation began when “the SCP’s [Synthetic Credit Portfolio’s] net notional size jumped from $4 billion to $51 billion, a more than tenfold increase. In late 2011, the SCP bankrolled a $1 billion credit derivatives trading bet that produced a gain of approximately $400 million,” after which the bank attempted to reduce the risk weighted assets (RWA).

However, “rather than dispose of the high risk assets in the SCP – the most typical way to reduce RWA – 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. That 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 was originally supposed to provide.”

So, did the bank track all three of the factors cited above, and account for the P&L according to SFAS 133? Apparently not, which meant that, whatever they wanted to call it, the position wasn’t a hedge. Unfortunately, attempting to portray it as a hedge ended up causing immense harm, because it apparently convinced the regulators that the only way to ensure that a position was a hedge was to link it to a specific position, ignoring the much better practice of linking it to a risk.

The Volcker Rule

In a few days we will see just how much harm was done to the VR, when the five regulatory agencies approve the final version. If the hedging exemption requires tying trades to specific positions, it will certainly do more harm than good, adding further fuel to an already very destructive fire.

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A much better criterion would be the following:

1. The bank must identify the causal factors of the risk being hedged, using either historical or mathematical correlations;

2. The bank must estimate the financial impact of the causal factors, using replicatable formulas;

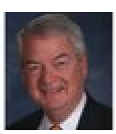
3. The bank must demonstrate a comparable countervaling causal relationship for the hedging instrument, along with a comparable financial impact estimate;

4. The bank must track the perfomance of both the risk and the hedge throughout the hedge's life, making adjustments as performance dictates;

5. The bank must account for the P&L of the hedge position in accordance with SFAS 133; and

6. The bank must structure any incentive compensations for employees involved in managing the hedge based on the combined P&L as determined in accordance SFAS 133.

Set up this way, the VR would both promote good risk management, and allow banks to hedge both complicated and simple risks. Now, what are the chances, do you think, that the VR will be structured that way? I agree. It looks like another opportunity lost.



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