J.P. Morgan Slashes Its Mortgage Business

WSJ 9/18/95 **CREDIT MARKETS** C1

By Fred Vogelstein
And Timothy L. O'Brien
Staff Reporters of The Wall Street Journal

Banking company **J.P. Morgan** & Co. is drastically shrinking its mortgage-trading business after incurring a $120 million loss in the mortgage-derivatives market.

The losses appear to have contributed to a management reshuffle in which Morgan's former co-head of North American fixed income, Thomas Kalaris, had his responsibilities assumed by Peter Hancock, who continues as head of global fixed income for the bank.

Most of the losses were fueled by traders making leveraged bets on interest-rate movements, people familiar with the situation said. The bets were set up so that Morgan would make huge profits if rates remained stable or slowly drifted higher. Instead, rates plummeted for the first six months of the year.

Morgan issued an internal memo on Sept. 5 announcing the restructuring. At that time, traders were told to liquidate the bank's $750 million inventory of mortgaged-backed securities by the middle of last week, a step that marked the end of a sell-off of mortgage positions that totaled $2 billion at the beginning of this year.

The mortgage losses are noteworthy because J.P. Morgan has been at the forefront of moves by usual commercial banks to enter the riskier securities business in order to offer its clients a more diversified menu of financial services.

Some traders said Morgan, which also had setbacks in emerging-markets trading, betrayed a surprising naivete about what it would take to succeed in this corner of the business.

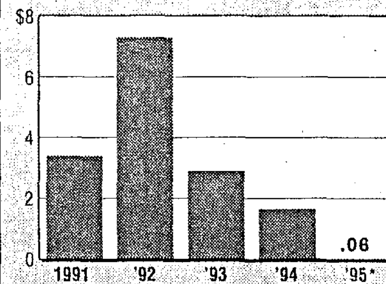
One of the individuals said Morgan, which had big mortgage derivative losses in 1992 and has never been strong in this market, misunderstood how to sell such complicated products. He said the bank "probably underestimated the importance of distribution" through a large retail network.

For the most part, Morgan has already reflected the mortgage losses in its earnings reports through the first half of this year. "We've seen no cause to make an announcement before third-quarter results are posted," Morgan spokesman Richard Mahony said Friday.

Mr. Hancock acknowledged that Morgan is exiting the exotic side of the mortgage business but said Morgan will continue to be active in "plain vanilla" mortgage securities.

Losses in mortgage derivatives, also known as collateralized mortgage obligations, or CMOs, aren't new on Wall Street. In the past year bad CMO bets have fueled the demise of Askin Capital Management and Kidder, Peabody & Co. And at practically every other Wall Street firm the evaporation of investors willing to buy these complicated, once hugely profitable securities has cut deeply into trading revenue.

Still, traders and investors said Morgan's large losses are noteworthy because it isn't the first time it has had losses in this arena. In 1992, for example, analysts estimated that the bank incurred as much as $300 million in mortgage-backed trading losses. Those familiar with this year's CMO losses said $60 million, or half of the total amount, was offset by other profitable mortgage-related trades.



And analysts said the losses Morgan has absorbed in its CMO portfolio are muted because of the breadth of the bank's $1.3 billion trading operation, which includes a wide array of debt instruments, swaps, interest-rate contracts, foreign exchange, equities and commodities.

"Looking back on the year to date, if there were fairly large losses that have already been taken, it wasn't particularly discernable," said Merrill Lynch & Co. analyst Judah Kraushaar. "It speaks to the emphasis at Morgan on having a very diversified capital markets trading operation."

Mortgage derivatives, or CMOS, are securities backed by home mortgages that have been sliced into parts of varying maturities and risk profiles. Some are low risk, but the types Morgan traded were quite risky and volatile securities known as interest-only strips and inverse

Please Turn to Page C16, Column 4

J.P. Morgan Slashes Mortgage Business After Derivative Loss

WSJ 9/18/95

Continued From Page C1

interest-only strips — in other words, risky interest-rate bets with the potential for big profits or losses.

Some traders were shocked at the size of Morgan's losses, saying a bank would have to work hard with such a small mortgage derivative operation to lose that much money. Morgan was the first commercial bank allowed to set up a separate securities underwriting and trading operation in 1990, and has long prided itself on its trading prowess.

Newer Business Lines

In 1980, when Morgan began pursuing investment-banking opportunities, about half of its revenue came from traditional banking businesses such as credit and interest-rate forecasting. Last year, about 75% of its revenue came from newer lines of business such as trading and underwriting. In the first nine months of this year, Morgan ranked third among securities firms in underwriting asset-backed securities and fifth in underwriting corporate bonds.

The CMO losses have hastened a realignment of Morgan's fixed income group, part of a larger reorganization the bank announced in May. That move consolidated Morgan's financial services and products along regional lines.

57