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How The London Whale Debacle Is Partly The Result Of An Error Using Excel

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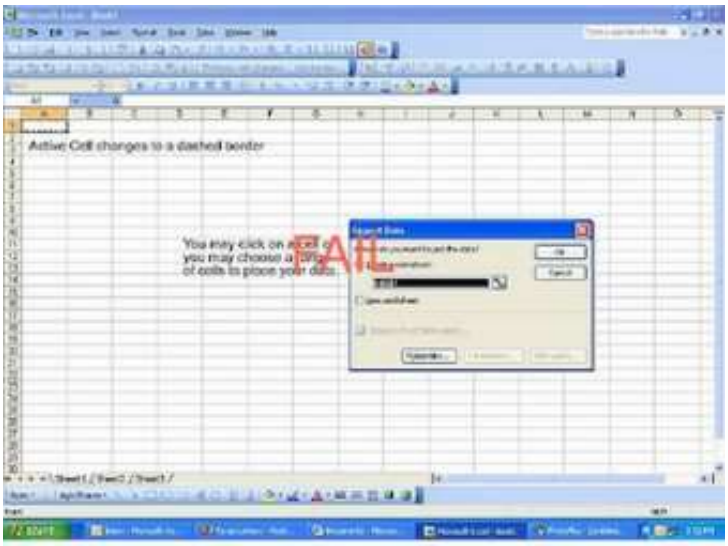
FEB. 12, 2013, 2:04 PM

This is something people are starting to talk about in the blogosphere that should give all of Wall Street pause.

Over at The Baseline Scenario, law professor James Kwak, says that what has been generally under-reported about the London Whale debacle is how badly Excel failed as a financial modeling program.

It's all in JP Morgan's 129 page report on the $6 billion trading loss. In an appendix on page 127, the report talks about how one London-based quant was working on a new VaR (Value at Risk) model for the Chief Investment Office.

On top of not being tested correctly, the report states that the model suffered from some pretty standard Excel flaws.



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From the report:

> During the review process, additional operational issues became apparent. For example, **the model operated through a series of Excel spreadsheets, which had to be completed manually, by a process of copying and pasting data from one spreadsheet to another...** in a January 23, 2012 e-mail to the modeler, the trader to whom the modeler reported wrote that he should "keep the pressure on our friends in Model Validation and [Quantitative Research]." **There is some evidence the Model Review Group accelerated its review as a result of this pressure, and in so doing it may have been more willing to overlook the operational flaws apparent during the approval process.**

There are some nuances about oversight and the analytic suite that the CIO was using, but the gist is this — volatility appeared lower than it should've because of issues with this model that can, in part, be traced back to how Excel was used.

Wall Street uses Excel for everything, so this is pretty troubling, but it shouldn't be surprising. Excel is just like any program — numbers can get lost, equations can get written over and a user might not even notice.

Kwak points out that when it comes to VaR models, if there's a mistake using Excel shows that there's *more* at risk than there actually is, banks will act. If a mistake using Excel shows that there's *less* at risk than there actually is, banks can run into a problem.

For Kwak's full take, head to The Baseline Scenario>