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To avoid excessive repetition of comments previously made, we request the agencies incorporate by way of reference our March 26, 2007 letter in response to the Basel II NPR. Also in the Appendix to this letter, we indicate which portions of the Guidance refer to major issues previously addressed in our Basel II NPR response and include related excerpts from our NPR comments. We generally have not remarked on differences between the current and prior versions of the Guidance since earlier versions predate the NPR and are of limited relevance.

Our comment letter is structured as follows:

- I. Major Issues Addressed in Our NPR Response
- II. Summary of Additional Key Issues
  - Appendix A: Detailed Comments on Specific Standards
  - Appendix B: Excerpts from Our NPR Response

Our comments are formatted with reference to the draft standards including, where appropriate, the relevant explanatory text in italics. We have no comment on standards that are not referenced in this letter. Except for inclusion of prior Basel II NPR comments on counterparty credit risk, retail seasoning, and major issues identified in Section I, our comments are largely incremental to those made in the NPR response.

## **I. Major Issues Addressed in our NPR Response**

JPMorgan Chase & Co. has fully and consistently supported the goals of Basel II capital adequacy reform: to create a more risk-sensitive capital framework and provide incentives for banking organizations to improve their risk management and measurement practices. We have a substantial investment program in place to implement the most advanced approaches to Basel II.

In our response<sup>6</sup> to the Basel II Notice of Proposed Rulemaking (NPR)<sup>7</sup> we noted with concern several specific requirements in the NPR that depart significantly from the international Basel II Accord. These departures imposed constraints and calculations that reduced the risk sensitivity of capital calculations, ran counter to the objective of improved risk management, unnecessarily added to costs and placed firms subject to this NPR at a competitive disadvantage. Several of the proposed supervisory standards further amplify and reinforce some of these key NPR proposals and heighten our concerns.

The specific supervisory standards of concern in this regard are as follows:

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<sup>6</sup> Our comment letter is available on the <http://www.fdic.gov/> and other agency websites.

<sup>7</sup> *Federal Register*, Vol. 71, No. 185, September 25, 2006: p. 55830.

- Wholesale Definition of Default The proposed standards require use of the NPR definition of default for wholesale exposures, which is inconsistent with the definition in the Accord. In our NPR response, we opposed this change to the definition of default under which all obligations to a wholesale borrower must be considered in default if the sale or transfer of any exposure to the borrower resulted in a credit-related loss of 5% or more of initial carrying value. We requested that the agencies return to the language of the Accord, which requires recognition of default in the event of a material credit-related loss based on a bank's own judgment. We noted that imposition of a fixed percentage to determine materiality will create a greater risk of misclassification, substitute for a more fully fact-based determination of the obligor's likelihood to pay and impose additional regulatory burdens on those international firms operating in multiple jurisdictions because they will be required to maintain two definitions and two sets of capital calculations.
- Downturn Loss Given Default (LGD) The standards require the imposition of the supervisory mapping function for downturn LGD using the specific formula defined in the NPR. We opposed the application of this supervisory mapping function because it will systemically overestimate the impact of economic downturns on exposures with low to moderate LGDs. To the extent that banks can demonstrate sufficient conservatism in their estimation processes such that their estimate incorporates downturn conditions, the need to apply a markup via a supervisory formula to obtain a downturn LGD is obviated. The standards (consistent with the NPR) also impose supervisory LGDs in place of internal estimates for an entire exposure category where a bank can produce credible and reliable internal estimates for most but not all of the exposures<sup>8</sup>, which we also opposed in our NPR response. We previously noted that maintaining multiple LGDs (expected, downturn and supervisory) is further problematic because this creates a gap to internal practice. The final rule can reflect the objective that LGD estimates are reasonable and appropriately conservative for a range of economic conditions without these additional requirements or standards.
- Hedge Fund Treatment The supervisory standards for securitization exposures make it clear that any exposure that can be considered to be "tranching" must be treated under securitization rules. While the treatment of hedge fund investments and investment funds with material liabilities is not clearly specified in either the NPR or the Guidance, there is a strong implication that hedge funds would be considered first loss tranches and be deducted from capital. We oppose this interpretation, which in our view creates an overly broad definition that could be similarly extended to other exposure categories. We

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<sup>8</sup> The NPR defines five broad credit exposure subcategories: residential mortgage, retail revolving, other retail, high volatility commercial real estate (HVCRE) and wholesale ex HVCRE.

reiterate that hedge fund exposures should be subject to the equity rules, except for exposures in the trading account which should remain subject to market risk rules.

## II. Summary of Additional Key Issues

The specific standards raise a number of additional issues, as summarized below. A more detailed discussion of these and other issues is included in Appendix A.

In most cases the standards discussed here lack sufficient flexibility and would either impose additional implementation costs without a commensurate risk management benefit or create inappropriately stringent conditions as, for example, in instances cited below which limit the use of internal models, the role of the expert in expert judgment systems or the recognition of implied support.

### Governance Standards

- Role of the Board of Directors Several of the standards suggest a very substantial level of board involvement in detailed oversight of credit and operational risk that is better placed with senior management and is inconsistent with a board's role in the oversight of other risks. The board of directors should have the discretion to delegate authority for the oversight of the implementation and ongoing assessment of the advanced Basel II systems for credit and operational risk to senior management.

### Wholesale Credit Risk Standards

- Implied Support The supervisory standards contain numerous additional conditions for recognition of implied support that are not in the NPR or the Accord. We propose that these conditions should be excluded from this Guidance on the grounds that they are excessively prescriptive. While some of the specified conditions make practical credit sense, requiring that all of these conditions apply prior to recognizing implied support is inconsistent with market and internal practice.
- Expert-Judgment Systems While expert systems are recognized, flexibility is needed to permit the expert to decide how much weight to give to each rating criterion. It should also be clear that in an expert judgment system that there are no "overrides" per se in assessing the rating of a wholesale obligor because the application of judgment is the essential element of this system's design.
- Application of Wholesale Mapping Where raw historical probability of default (PD) data necessitates a smoothing and adjustment to the PDs, it is inconsistent for the standards to

require that the resulting risk weighted assets (RWA) be unaffected. Such a requirement to adjust PDs without changing RWA will in many cases negate a common sense adjustment process.

- Exposure at Default (EAD) Estimation Consistent with industry practice, EAD should only incorporate draws up to the default event, not post-default draws as the standards require.
- Use of Internal Models for All Similar Transactions With the frequent innovation in the derivatives marketplace and introduction of new products, banks will face significant operational challenges in calculating EAD for all transactions via internal models. As existing system limitations will always result in a number of transactions which cannot be handled by internal models, we recommend the flexibility to apply the Current Exposure Methodology to such transactions until they can be migrated to the internal models approach. The standard requires that all similar transactions use only the internal models approach and should be modified as indicated.
- Pre-collateral Calculations Not only do the standards require capital calculations on a pre-collateral basis, but the separately proposed reporting requirements would also require public disclosure of PDs without the effects of collateral. Running internal exposure models on a routine basis both with and without the effect of collateral agreements does not yield meaningful results and is not consistent with internal risk management processes. Our view is that a bank's internal model should have the capability to measure current and expected exposures gross and net of collateral, and this capability can be demonstrated to supervisors on an ad-hoc basis. On a routine basis, however, where banks can demonstrate legal confidence in collateral enforceability, banks should be required to estimate current and expected exposure only net of collateral.
- Historical Backtesting For internal models for counterparty credit risk, the standards require multiple backtesting exercises for several historical dates covering a wide range of market conditions (e.g., rising rates, falling rates, quiet markets, volatile markets). We have two concerns about historical backtesting: (1) its limitations as a validation tool with respect to historical stress periods; and (2) practical concerns that detailed requirements may result in unnecessary additional backtesting and create an operational burden without commensurate risk management or validation benefit.

We do not believe it is necessary or appropriate to do historical back-testing based on stressed market environments in the manner suggested. Given the large number of relevant market variables and complex dependencies of exposure on these variables, it is not practical to search out historical market periods that would stress a given portfolio of

trades. Testing a current portfolio against an historical stress period is unrealistic because the trades on the book now reflect recent market conditions. In addition, banks who are major derivative market makers typically actively hedge counterparty exposure against potential changes in the underlying markets which significantly mitigates the economic impact of stressed periods in the market.

If stress market environments must be addressed, banks should have sufficient latitude to propose solutions that address the limitations noted above rather than adhere to the specified historical data requirements.

- Own Estimate of Alpha For the expected positive exposure (EPE) methodology for counterparty credit risk, our internal models demonstrate that the 1.2 floor for internal alpha estimates required by the Guidance is unduly conservative. We do not understand the rationale for imposing such a high floor.

### **Retail Credit Risk Standards**

- Retail Seasoning The requirement to estimate the annualized cumulative default rate (ACDR) for all segments to assess whether seasoning is material for each individual segment creates a burdensome estimation process that does not necessarily produce better PD estimates. We continue to recommend regulatory flexibility to permit alternative approaches, including a conservative adjustment to PD as suggested in the Accord.
- Alternative Segmentations for Retail Portfolios While banks should explore alternative segmentation schema in the development stage, the Guidance appears to require that banks invest in building and maintaining alternative segmentation schema on an ongoing basis for benchmarking purposes, creating an operational burden without significant risk management benefits. Alternative benchmarking procedures short of building multiple segmentations should be adequate based on the initial conceptual design and the statistical or risk management framework used in development.
- Securitization Treatment of Tranched Guarantees of Multiple Retail Exposures The Guidance emphasizes that any exposure involving the tranching of credit risk must be considered a securitization. We request banks should be permitted the option to ignore the benefit of tranched guarantees for multiple retail exposures and not apply synthetic securitization treatment if the result is more conservative. Not only would this avoid an operational burden, but we note that the ceiling for capital under the securitization approach is the capital calculation without the guarantee.
- Retail Footprint The Guidance appears to be inconsistent in its definition of geographic

footprint. We support flexibility to define footprint based on a bank's judgment of the appropriate combination of product and geography at a suitably disaggregated level.

- Guarantees in Support of Retail Exposures We wish to confirm that private student loan guarantees/insurance and insurance covering any other retail exposure would also be considered guarantees similar to mortgage insurance.

### Other Credit Risk Issues

- Stress Testing We believe stress testing is a capital adequacy element under Pillar 2 of the Accord. The standards call for additional stress testing as part of Pillar 1 minimum capital requirements, although how the results would be applied under Pillar 1 is unstated. We oppose this additional requirement and recommend that it be dropped from the international Accord as well. We also note that the language in the Guidance is less clear than the Accord in describing the nature of the stress test.
- "All or None" Use of the Internal Models Approach (IMA) for Equity In cases where a bank can apply the IMA approach consistently to a substantial portion of its equity portfolios, then it should be permitted to do so even if it applies the SWRA to its remaining exposures.
- Securitization The Guidance requires that securitization treatment must always be applied for all exposures that may involve tranching of risk. In our view this is not always appropriate for exposures that more naturally fall into a different exposure category.

### Operational Risk Standards

- Summing Operational Risk Exposures if Dependence Estimates Cannot be Demonstrated  
The proposal to sum the exposure estimates in the absence of required demonstrability has two fundamental drawbacks:  
(1) It is unsupported by any empirical analysis and will result in a punitive and unrealistic increase in capital in almost any circumstance; and  
(2) It provides the strongest disincentive for institutions to fully and appropriately investigate relevant units of measure. The potential for regulators to require the simple aggregation of capital across units of measure will drive banks to reduce units of measure to the lowest number possible consistent with the conditions laid out in the Guidance.

Moreover, the proposal to sum capital across measurement units is inconsistent with the Basel II Capital Accord. An alternative proposal to require the bank to be conservative in its dependence assumptions, instead of the extreme of aggregation, would be more reasonable and in line with other guidance standards.

The industry should be encouraged to continue model development in this area. Banks should be able to pursue a level of measure appropriate to their organization and circumstances, together with an approach to dependence that in combination will produce a realistic result reflective of the risk profile. The assessment of the appropriateness of dependence assumptions cannot simply rely on statistical / empirical demonstration alone, but must provide for banks' discretion in their assumptions and ultimately rest on the reasonability of the result.

- Isolating Components of Operational Risk Models It is not always feasible to meet the requirement to isolate the effect on exposure of each model component (internal operational loss event data, relevant external operational loss event data, scenario analysis, and assessments of the bank's business environment and internal control factors) of the quantitative model, and the results are not always relevant.

It would be reasonable to expect that banks can adequately demonstrate the rationale for directly including or excluding each of the four elements in/from the calculation, without specifically requiring irrelevant calculations and/or the creation of benchmarks. Wherever the effects of a given element can be shown with relevance and without a benchmark, this could be required (e.g. an ex post facto adjustment of an initial exposure calculation to reflect Business Environment and Internal Control Factors).

- 20% Limit on Recognition of Operational Risk Mitigants Imposing an arbitrary ceiling on the recognition of Operational Risk mitigants will restrict not only the benefit to a single bank, but also the potential size of the risk transfer market, and consequently impede the development of sound risk mitigation tools.
- Operational Risk Offsets The eligibility for operational risk offsets for losses that are highly predictable and reasonably stable should be allowed in all circumstances that conform to the established criteria and not be limited to external credit card fraud and securities processing errors as the Guidance suggests.

## **Pillar 2 Capital Adequacy Standards**

- Increase in Capital Commensurate with Increase in Risk A real or projected change in



















































