

# JPMORGAN CHASE & CO.

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Basel Committee on Banking Supervision  
Bank for International Settlements  
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Ladies and Gentlemen:

JPMorgan Chase & Co. ("JPM") is pleased to provide comments on the Consultative Document: "Guidelines for Computing Capital for Incremental Risk in the Trading Book" (the "Consultative Document") issued by the Basel Committee on Banking Supervision (the "Committee") in July 2008.

JPMorgan is largely in agreement with the conceptual underpinnings of the proposed trading book rules and fully appreciate their motivation by recent market behaviour. In particular the inclusion of event risks through the incremental risk charge (IRC) and the differentiation of liquidity horizons are enormous steps towards a comprehensive capital framework that is robust enough to handle disrupted markets and complex instruments.

It has been increasingly obvious that, in order to be useful for understanding P&L volatility and economic capital, VaR models and their calibration need to be enhanced; they must measure risk over longer horizons and capture potential large moves of market prices, risk premia and market implied parameters used in valuation.

Given the complexity of the problem at hand and the absence of any commonly accepted modelling framework, JPM feels strongly that banks need to be given the flexibility to develop their own internal approaches that align conceptually with the rules, yield appropriate capital numbers and can evolve through time as new products emerge, portfolios change and understanding of risks improves. This flexible approach requires a continuous supervisory dialogue around model specification and validation. In addition, to maintain consistency across firms and to maximize transparency of model behaviour, JPM advocates a highly detailed and ongoing standardized test deck approach to model validation (discussed more below).

Please see below JPM's responses to specific issues raised in the consultative document.

## Question 1.

Under the proposal, the IRC would reflect all price risks except those directly attributable to movements in commodity prices, foreign exchange rates, or the term structure of default-free interest rates ("non-IRB market factors").

(a) Would it be preferable for supervisors to list specific types of events that must be captured (eg defaults, migrations, and only certain types of movements in credit spreads and equity prices)? What should be the basis for determining which types of events would be included, and how could the Committee ensure that the framework was not largely backward looking?

(b) Would it be worthwhile to expand the scope and coverage of the IRC to capture price risks associated with commodity prices, foreign exchange rates and the term structure of default-free interest rates?

a) JPM feels that it should be possible to enumerate broad classes of events that should be captured in the IRC framework. This list should be maintained by the regulators with input from banks and industry working groups. Banks should be required to analyze the materiality of the impact of these events on their specific portfolio and discuss their inclusion in risk capital calculations as part of the ongoing supervisory oversight of internal models.

b) Yes, JPM feels that there is no reason to arbitrarily limit the scope to equity and credit markets even though those high-dimensional markets are most prone to large discontinuous moves in price/risk premium.

#### Question 2

For covered IRC positions, Pillar 1 charges would depend in various ways on three types of risks: general market risks and specific risks, as defined under the current MRA, and IRC covered risks. Are the differences among these types of risks clear and measurable?

JPM prefers that the rules allow for an option of a unified model that would not require the explicit separation of these risks. Within any modelling framework it should be possible to come up with acceptable definitions that allow for the separate calculation of these quantities. In particular, the separation of general and specific risks (SR) becomes subtle in the presence of portfolio convexity. For example, the default exposure of a credit tranche can depend heavily on the level of portfolio credit spreads; this effectively couples the general market risk of the credit spreads and the name-specific default exposure. To properly compute specific risk in the case of nonlinear positions requires:

- a) Identification and segregation of factors driving specific and general risk;
- b) Calculation of distribution of total market risk including all factors;
- c) Calculation of conditional expectation of total market risk conditional on general risk factors; and
- d) Calculation of the specific risk distribution from the difference of b & c.

#### Question 3

While the capital horizons and confidence levels underlying the IRC and the 10-day VaR charge would differ, the risk factors captured by these risk measures would overlap to a significant degree. However, any adjustments to offset double-counting would complicate the framework and diminish the Pillar 1 importance of the 10-day VaR calculations including incentives to estimate the 10-day VaR as accurately as possible. Is it possible to provide double-counting adjustments that do not raise such concerns? How?

JPM's view is that banks should be given the option of either using the multiplier and add-on approach or using a unified model that captures general, specific and IRC risk drivers together and computes a total risk capital measure. Even if a separated VAR / SR / IRC approach is used, a unified model should be allowed as a way of quantifying and adjusting for the double count. In JPM's view, only a consistent framework preserves a coherent link between P&L, total risk measurement, and risk taking and hedging opportunities, and therefore would suit internal purposes for capital allocation.

For the use-test for 10-day VaR, JPM feels it is important to consider the risk measurement technology separately from the computation of economic capital. A VaR system can be used to capture the positions associated with general market factors that can then be used with an internal capital model which may make different assumptions about the distributions of those market factors over a longer time horizon. The economic capital calculation also requires risk position capture that may go beyond the scope of general market VaR (for instance, name-specific exposures and stress test results). The use of VaR system for internal risk management and control allows for the quality of the data to be continually monitored; it isn't necessary for the capital result to be a simple multiple of the VaR risk measure.

#### Question 4

The proposal stipulates that an IRC model incorporate a one-year capital horizon, a 99.9 percent confidence level, and a liquidity horizon appropriate for each trading position.

The Committee recognises that such an approach could present considerable practical challenges, including the need for data to calibrate key parameters.

(a) What alternative guidelines would achieve the Committee's objectives, but in a manner that would be less costly or difficult to implement?

(b) Given the current state of risk modelling, is it feasible to estimate the portfolio loss distribution (excluding non-IRC market factors) over a one-year capital horizon at a 99.9 percent confidence level?

(c) Would it be worthwhile to allow banks to use a single horizon for all covered positions (e.g. three months) and a lower confidence level (e.g. 99 percent), together with a supervisory scaling factor that was calibrated to achieve broad comparability with the IRB Framework for the banking book? Would such an approach be as useful for internal risk management purposes as the proposed IRC?

a) Although there are many practical challenges of data collection, parameter estimation and simulation associated with the new framework, JPM feels that these are a necessary price to pay for a model that appropriately differentiates risk. For practicality, all model parameters (including liquidity horizons) should have conservative default values in case a bank decides not to invest in the necessary validation.

b) JPM feels it is technically feasible to compute the portfolio loss distribution (including all relevant risk factors) at the one-year horizon, 99.9% quantile. There is enormous model risk associated with such a calculation and these results will be quite sensitive to the model calibration.

c) JPM would prefer that a three-month horizon and 99% confidence interval be used as the primary definition of IRC (and indeed for total risk in the context of a unified model). Capital could be computed either using a supervisory scaling factor or one derived from an internal model computing the full one-year, 99.9% quantile that was calibrated and run on a less frequent basis and perhaps subject to supervisory constraints. The internal model used in deriving the scaling factor should have transparent assumptions about the tails of underlying market factors, the time-aggregation of these distributions, the term structure of event risks and the rollover of the portfolio. There will be underlying market risk factors and/or products for which a three-month liquidity assumption is aggressive. For these cases, JPM would advocate rescaling the intensity of the relevant IRC jump processes to reflect the extra risk.

#### Question 5

Given the IRC soundness standard of a one year time horizon and 99.9th percentile loss, the Committee seeks comment on how the resulting risk measure might be validated quantitatively. For example, would it be reasonable to validate the underlying model at shorter horizons and/or at lower percentiles? If so, how might one ensure that the validation exercise is relevant for the one year 99.9th percentile standard? Also, would different aspects of the model likely require different validation approaches?

Direct empirical validation of the portfolio loss distribution at the one-year 99.9% quantile is clearly impossible. Even at a shorter horizon (one quarter) and lower loss quantile (e.g. 99%) empirical validation is challenging for many traded markets. The pragmatic approach to capital modelling requires the various model components to be validated separately. Given a model specification (choices of market factors, assumed form of distributions and dependency structures etc), available historical data is used to estimate distributions of market factors and other model parameters and determine statistical errors bars. These are augmented with parameters that are motivated anecdotally by historical events or are purely judgmental in nature.

The shorter horizon and lower confidence interval would likely ease the validation demands associated with the re-pricing of the portfolio under (possibly unprecedented) market conditions as well as numerical convergence of the model.

#### Question 6

The flexibility built into the proposed IRC potentially could make Pillar 1 charges for trading positions less comparable across banks. How might the framework ensure greater comparability without unduly limiting firms modelling choices? In particular, would it be productive to require banks to calculate risk measures for standardised test decks of trading portfolios, which could be used to compare model results across banks

Recognizing the need for more sophisticated and risk sensitive models to capture the IRC, the flexibility required to accommodate a spectrum of modelling approaches and the wide variety (and dynamic nature) of portfolios across institutions, JPM feels it is essential that the validation process should rely heavily on regular capital measurement of standardized benchmark portfolios – test decks. Comparing capital outputs at a high level will yield very little insight as to the quality/completeness of the risk modelling.

JPM envisions a master set of portfolios defined by a regulatory-industry consortium. Each portfolio would have sub-portfolios representing standard risk decompositions: e.g. long-short, by risk rating, maturity, product etc. Portfolios would be designed to include vulnerability to recognized event risks and firms would be required to run those portfolios materially relevant to their own risks. These capital benchmarks would be run regularly (at least quarterly) and would also be used as part of the standard model approval process to demonstrate and explain the impact of a new product or model feature on the bank's capital.

#### Question 7

Is the proposed implementation schedule feasible? If not, which IRC guidelines, and what specific types of positions or risk factors, are most problematic?

JPM's preference would be for a rapid adoption of the new rules with more pragmatism around the validation requirements. Although aggressive, JPM believes that the implementation timetable is manageable. JPM is keen to initiate transitional discussions with supervisors so that necessary refinements of JPM's existing and proposed models can be started as early as possible.

#### Question 8

What additional Pillar 3 disclosures related to the IRC, or the trading book more broadly, would be helpful to market participants and contribute to market discipline?

JPM favours transparency around disclosure of both the qualitative and quantitative aspects. The qualitative disclosure should cover the scope of the internal model in terms of the risks captured (e.g., a unified model would include all risks- interest rate, equity, FX, commodity, spread and default). It should include a description of the approach to determining the liquidity horizons underpinning the model; the methodologies used to achieve a capital assessment that is consistent with the required soundness standards; and the approaches employed in validation of the model.

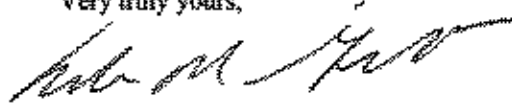
JPM's preference for the quantitative disclosure is based on a unified model that includes general, specific and IRC risk drivers together into a combined total risk measure. However, JPM can also support a disclosure approach that separates the total risk into general market risk, specific risk and IRC.

#### Question 9

Paragraph 50 requires a capital charge for re-securitisations. This would start on 1 January 2009 and last until the IRC has been implemented for these positions. Would it be worthwhile to expand the scope of these positions to all securitisations?

From a practical perspective, it is going to be extremely challenging to switch from trading book to banking book approach for specific securitisation positions by January 1, 2009. JPM would prefer that banks be allowed sufficient lead time to incorporate such changes after the proposal is finalized. JPM is unable to comment on expanding the scope of these positions to all securitizations as the full picture of the proposed changes is not available.

Very truly yours,



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