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By electronic submission to: baselcommittee@bis.org

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: March 2013 Consultative Document - Supervisory framework for measuring and controlling large exposures

Ladies and Gentlemen:

JPMorgan Chase & Co. appreciates the opportunity to comment on the Consultative Document, Supervisory *Framework for Measuring and Controlling Large Exposures,* issued by the Basel Committee on Banking Supervision (the Committee) to implement a large exposures framework that, as a backstop to risk-based capital requirements, protects banks from losses caused by the sudden default of a certain counterparty or group of connected counterparties.

I. Summary

Since the financial crisis, we have supported key regulatory initiatives designed to reduce the likelihood and potential impact of future severe financial market stress, including enhanced capital and liquidity standards, resolution authority and limits on certain activities and levels of risk taking. Our firm has used tools like counterparty and trading limits to manage risk taking for many years and we support well designed, risk sensitive limit systems. As a result, we agree with the Committee's objectives in establishing a global standard for measuring, aggregating and controlling large exposures to counterparties. We have concerns; however, about several aspects of the proposed guidance and the impact it will have on financial markets.

The Committee suggests that the proposals in this document have adopted, where practicable, existing rules in the Basel framework and depart from them only if necessary for the purpose of achieving the objectives of the large exposures framework. However, in reviewing the document, we do not find this to be the case. In fact, in most cases, the proposed standard employs neither the methodologies for calculating exposures as defined in the Basel framework nor broadly accepted state-of-the-art risk

management approaches. Further, the proposal requires banks to capture interconnectedness between counterparties or groups of counterparties thereby going beyond the objective of controlling single counterparty defaults to attempting to manage systemic risk. This adds greatly to the complexity of the proposal, but has little effect on a single counterparty basis.

Most troubling of these issues is the Committee's proposed approach to measuring exposures. In particular, the approach proposed to capture exposure to credit default swap protection providers, which largely relies on notional value, greatly overstates the amount of risk associated with portfolios of OTC derivatives between dealers active in those markets. Such portfolios are typically characterized by relatively large gross notional amounts but a small amount of net risk. The methodology for measuring protection provider risk the Committee has proposed is very similar to the approach proposed in 2012 by the Board of Governors of the Federal Reserve System to implement the enhanced prudential standards of section 165 of the Dodd-Frank Act[1], specifically the provisions on single counterparty credit limits (SCCL), which similarly overstated risk exposure. We are concerned about this overstatement of risk and the market implications that would result from implementation of this proposed approach (see Appendix for excerpts on market impacts from JPM's April 30, 2012 letter to the Federal Reserve on the SCCL proposal).

Furthermore, the Committee has indicated that it ultimately will adopt a non-internal models approach to the measurement of derivatives counterparty credit risk. We are aware that the Basel Risk Measurement Group's (RMG's) goal is to address several of the flaws that exist in today's Current Exposure Methodology (CEM). However, we still expect the non-internal models approach will increase the amount of exposure captured under the rule for derivatives counterparty credit risk as opposed to the internal model measurement approach (IMM), adding to the overstatement of risk exposures for purposes of applying the limits.

We are therefore very concerned to find these provisions for exposure shifting and use of non-internal models in the Committee's proposed large exposure framework. The higher resulting exposure levels from applying the proposed measures, use of Tier 1 capital as the base for setting the limits, as well as the lower proposed limits for G-SIBs, will have severe implications for the financial markets.

The industry did extensive research in 2012 on the implications of implementing the Federal Reserve's proposal on SCCLs. We found it greatly overstated exposures and, given the lower 10% limits level for G-SIFIs, immediately limited such large dealers' ability to trade with each other. That research was published in the Clearing House's July 2012 Industry Study on Single Counterparty Credit Limits (the "TCH SCCL Study)[2].

Unfortunately, we expect that the Committee's proposal for large exposures will have similar impacts. The effect of the proposed large exposure framework will be to force the unwind of largely offsetting trades in a potentially disruptive manner—trades that an accurate measurement methodology would show as having a considerably lower level of risk. While some might argue that very conservative risk measures are appropriate to protect the financial system from the sudden default of a single

[1] *See* Pub. L. No. 111-203 (2010) (Dodd-Frank); *see also* Federal Reserve System, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies; Proposed Rule*, 77 Fed. Reg. 594, 612-22, 649-54 (5 January 2012)

[2] *See* The Clearing House, *Single Counterparty Credit Limits: The Clearing House Industry Study* (July 2012), *available at* http://www.theclearinghouse.org/index.html

counterparty or group of connected counterparties, we believe the impact of this proposal is not desirable as it will create an arbitrary and overstated restriction in the ability of large dealers to trade with each other. This will have real and adverse effects on markets.

Should the standards proposed in the large exposure framework be adopted and implemented by national regulators across the globe, we believe it could destabilize markets in the short-term and make them less efficient and resilient in the long-term. The effect of the rule is to remove sources of liquidity for counterparties, resulting in a less efficient market, a contraction in the availability of credit, higher costs to corporate hedgers and other end-users, and decreased use of valuable risk management products throughout the financial system. This would be an unfortunate result for standards intended to enhance prudential risk management and thereby contribute to market stability.

There are methodologies, familiar to both market participants and regulators, and other alternatives that could produce a calculation that is economically more meaningful without the serious adverse effects of the proposed methodology. Leveraging measures that better reflect actual risks, coupled with a broader use of Pillar 2 assessments, could provide the means for a workable framework. Specifically, limiting the approach for measuring protection provider risk to key concentrations, including wrong way exposures, rather than simply capturing the notional risk of a firm's entire portfolio of such transactions would better meet the objectives of the proposed rule. Similarly, using an internal model methodology (IMM) with an appropriate level of stress applied would produce a more accurate measurement of risk for derivatives and securities financing transactions. Finally, applying a Pillar 2 approach for collective investment undertakings, securitizations and other vehicles as well as connected counterparties, would be a way to provide assurance that large exposures do not exist in such transactions and relationships without the immense burden that would result from the approaches proposed in the consultation document.

Our comments above are consistent with the comment letter on the proposed rule being submitted jointly by The Clearing House Association L.L.C., the American Bankers Association, and the Global Financial Markets Association (the "joint trade association comment letter), as well as the comment letter by the Risk Management Association. We share the views and concerns expressed in those letters, and believe our collective recommendations provide a constructive way forward.

In summary, we recommend a framework that uses widely accepted risk-based measures for exposure calculations coupled with a Pillar 2 approach for other potential exposures like connected counterparties and exposure embedded in structured financing transactions. We would be pleased to meet with the Committee to elaborate on these recommendations and to provide analysis that would help create a viable large exposure framework.

II. Specific Comments and Recommendations

A. <u>Measurement Methodology</u>

Counterparty credit limits are a widely used, industry risk management tool designed to contain the adverse effect that the failure of any individual counterparty could have on a financial institution. However, for such limits to be effective, it is critical that the exposure is measured accurately. JPMorgan and its peers devote considerable resources to doing so in a sophisticated manner.

The proposed rule, however, requires a notional-based exposure shifting approach for protection providers and collateral as well as conservative, non-internal models based approaches for other exposure measurements, including ultimately, the use of a "standardized" approach like CEM for measuring derivative counterparty credit risk. These methodologies produce very large misstatements – and, in most cases, overstatements – of the true counterparty exposure. The overstatement of risk is particularly severe in the case of the required exposure shift of the notional amount of written CDS contracts to protection providers. Furthermore, depending on the outcome of the Basel Committee's RMG work on the new CEM approach (NIM), the overstatement could be significantly compounded by application of such "non-model-based measures" to portfolios of active dealers in the derivatives market. Finally, disallowing the use of internal modeling in measuring SFT exposure and requiring supervisory haircuts further compounds the problem.

Below we detail our particular concerns with the Committee's large exposure measurement methodology and our recommended solutions.

Our concerns with the proposed methodologies divide into three parts: (1) the proposed exposure shifting rules applicable to derivative counterparty exposure on credit default swaps (CDS);other protection providers, and to issuers of collateral, (2) the calculation of derivatives counterparty exposure, and (3) the approach for securities financing transactions.

1. Exposure shifting to providers of protection and collateral issuers

The Committee proposes to include unfunded credit protection (credit derivatives and guarantees) and financial collateral as exposures to the protection providers and collateral issuers (sovereigns excluded) when such protections are taken as a benefit for risk-based capital purposes. For trading portfolios, this effectively impacts the entire portfolio of written credit derivatives. The combination of using notional and the shifting of exposure of basically all written credit derivatives to protection providers, regardless of how diversified the underlying reference assets are, greatly exaggerates the exposure to such protection providers. The actual risk of loss if the protection provider fails is equal to the cost to replace the protection, not the entire notional amount of the protection. The only time the risk would be greater than the cost of replacement is when there is a simultaneous, instantaneous default of both the reference entity and the protection provider.[3] Although such events can happen as a result of pure statistical coincidence, there are no examples of such "coincidental double defaults" in the history of the market to date.

When losses have occurred, they have typically been because of a high concentration of protection purchased on a single underlier from a single hedge provider or highly correlated wrong-way risk – that is, when the default of the reference asset and the protection provider are highly correlated (as in buying protection on a country from a bank in that country). We agree that the concern about such risks is legitimate. Both in the case of AIG's collapse and other instances, the failure to understand concentrations and wrong-way risk led institutions to purchase protection from counterparties who were unable to perform when called on to do so. While these risks can be challenging to control, a proposed rule that simply presumes 100% correlation in all cases does not result in an accurate

[3]Notably, even in these cases, the exposure to the protection provider is the net default exposure of the derivative trades referencing the defaulting underlier, not the notional of all purchased protection.

measurement of risk. The sweeping assumptions in the proposed rule will desensitize risks managers to actual wrong-way risk when it exists, thereby undermining risk management while imposing significant costs on the market.

With respect to financial collateral, we recognize that the exclusion of sovereigns has helped greatly mitigate the impact of the "hybrid" approach proposed in the rule for those legal entities subject to the risk-based capital rules. However, there could still be an impact on entities taking eligible collateral other than sovereign-issued instruments, especially if the limits are applied at a sub-consolidated level. In these cases, the shift of exposure to the collateral issuer could present a constraint. Like with protection providers, the shifting of exposure to issuers of collateral is inappropriate in that the risk of double default of the counterparty and the collateral provider is highly unlikely. We strongly suggest that the Committee not require the shifting of exposure to issuers of collateral.

As a result, we make the following recommendations, which are also largely consistent with the proposal outlined in the "Associations" letter. Specifically:

- All credit protection, including written CDS transactions and guarantees, should only be captured and measured in their respective counterparty risk category, even when they reduce long exposure for risk-based capital purposes. Specifically, written CDS contracts should be treated as any other OTC derivative in the counterparty credit risk calculation and guarantees as offsets to other credit exposures as appropriate. Such written exposures should not be shifted to the protection provider, unless they pose a significant concentration risk as described below.

- Banks should be required to prepare Pillar 2 documentation, including identification of policies and procedures, to demonstrate that possible significant concentrations of protection provider and collateral issuer risk are monitored and controlled. These policies and reviews should be scrutinized by risk managers, auditors and supervisors. We suggest that significant concentrations be defined to include concentrations to a single provider-underlier pair over a certain limit and wrong way exposures as discussed in the following bullets.

- To monitor possible concentrations of risk to a single protection provider, the framework should require that contracts where the net notional protection on a single underlier-provider pair exceeds a specific level of Tier 1 Regulatory Capital, e.g., 5%, be captured and recorded as exposure to the protection provider. We would appreciate the opportunity to work with the Committee on the analysis needed to set appropriate limit levels on underlier-provider pairs.

- Additionally, in cases where a bank's policies and process identify a contract that presents a wrong way risk, banks should be required to "exposure shift" the exposure from the reference asset to the third party protection provider based on the maximum jump-to-default risk for limit monitoring purposes.

Such an approach supported by the other prudential reforms[4] designed to monitor and mitigate concentration risks arising out of derivatives trading should provide the protections to the financial

[4] See the Appendix for Comments about OTC derivative markets and ongoing regulatory initiatives from April 30, 2012 JPMorgan Comment Letter on Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

markets the BCBS seeks to implement without the major disruptions to the markets that would result from the approach currently included in the proposal.

2. Measurement of derivatives counterparty risk

The Committee's plan to ultimately use a non-models based approach for measuring derivatives counterparty credit risk seems to be driven by the desire for standardization, simplicity and model independence. We understand that a non-model's based approach can be a practical, simple solution for non-dealer financial institutions, but its simplicity often creates a misstatement of the risks it seeks to measure, as we have experienced with the current CEM approach.[5] This misstatement is critically important to consider in the context of limit setting. The industry found under the Federal Reserve SCCL proposal, that CEM exposure was approximately 12 times larger than under an IMM approach[6]greatly contributing to the overstatement of exposure and related multiple counterparty limit excessions.

As noted previously, we are aware that the Basel RMG's goal is to address several of the flaws that exist in today's CEM approach. However, we still expect the non-internal models approach will increase the amount of exposure captured under the rule for derivatives counterparty credit risk as opposed to the IMM approach, adding to the overstatement of risk exposures for purposes of applying the large exposure limits.

All models have weaknesses, and as risk managers we are very careful to avoid over-reliance on modeled outcomes. We apply judgment, and employ stress testing that challenges assumptions. We believe the best approach to managing risk is to start with the most accurate initial estimate of exposure possible, which inevitably involves the use of models, and then continuously challenge all aspects of the calculation to ensure its robustness. In practice, all major intermediaries in the derivatives markets have developed IMMs that more accurately measure the risks in the portfolio of a derivatives dealer than standardized approaches. These IMMs are well integrated into each bank's management processes and, therefore, substantial time and focus is placed on ensuring their integrity. Furthermore, IMMs are subject to robust regulatory model development standards, internal audit, and regular validation and back testing by the institutions. Moreover, each firm's IMM must be reviewed and approved by the Federal Reserve as part of implementation of risk based capital rules and reviewed as part of the banking agencies' evaluation of counterparty risk management practices. This regulatory review should allay concerns about the efficacy of these methodologies.

The Committee's goal in designing the large exposure framework is to ensure that the maximum loss a bank could incur if counterparty were to suddenly fail would not endanger the bank's survival as a going concern. To achieve this goal, we urge the Committee to require banks to use the most accurate possible measurement of exposures available to calculate derivatives counterparty risk exposure. In some cases this may be CEM. However, if the bank uses a more accurate IMM approach, it should be permitted to use its IMM to calculate derivatives counterparty risk exposure, but with a multiplier or higher confidence level applied. This multiplier or higher confidence level will serve two purposes. It

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[5] Although in some cases it actually materially understates the risks, these situations are overwhelmed by the portfolio netting effects for a typical OTC derivatives dealer.
[6] *See* Single Counterparty Credit Limits: The Clearing House Industry Study, July 2012, Page 6

will make the derivative counterparty risk calculation more consistent with the risk of a "maximum loss" the proposal seeks to capture, as well as a buffer against potential model error. We propose to use this approach for *all* derivatives counterparty exposure, including the exposure arising from credit and equity derivatives and options. Again, we would be pleased to work with the Committee to help determine an appropriate multiplier or confidence level to meet the proposal's objectives.

3. Valuation of securities financing transactions

The Proposed Framework requires the use of a standardized approach (comprehensive approach with supervisory haircuts) for the calculation of securities financing transactions (SFTs) rather than a VaR or other internal models approach. As the Committee acknowledges this approach "deviates from the risk-based capital framework for those banks already allowed to apply their own estimates for haircuts or the IMM". This approach also overstates the risks of such transactions by applying separate haircuts to loan and collateral positions and overlooks the benefits of diversification or the impact of correlation between loan and collateral positions.

We believe the Committee should allow banks to use the most accurate possible measurement tools available to calculate SFT exposure. In our view, this would allow use of a firm's internal models for measure of exposures under this proposal. As described in the section above on measurement of derivatives counterparty risk, internal models used for measuring SFT exposure are subject to robust internal and external regulatory review processes which should allay concerns about the efficacy of these methodologies.

As a result, to address the Committee's concerns regarding model risk while at the same time ensuring the SFT exposure calculation is appropriate risk-sensitive, we recommend that the Committee allow banks to use internal modeling for estimating haircuts or for calculating exposure, e.g., VaR, but with a multiplier or higher confidence level applied.

The following is a summary of our recommendations on Measurement Methodology:

- All credit protection, including single name CDS transactions and guarantees, should be captured and measured in their respective counterparty risk category. Such written exposures should not be shifted to the protection provider, unless they pose a significant concentration risk as described below.

- Banks should prepare Pillar 2 documentation to demonstrate that possible significant concentrations of protection provider risk are monitored and controlled. We suggest that single underlier-provider pairs exceeding an appropriate level of Tier 1 Regulatory Capital and wrong way exposure be considered significant concentrations.

- Where significant concentrations of protection provider risk exist, exposure should be shifted to the protection provider and removed from the counterparty risk calculation.

- Banks should be allowed to use the most accurate possible measurement of exposures available to calculate derivatives counterparty risk and SFT exposures, specifically IMM. If the bank uses IMM, a multiplier or higher confidence level could be applied to ensure it represents a better estimate of "maximum loss" while also acting as a buffer against potential model error.

B. Collective investment undertakings, securitizations and other vehicles

The large exposure proposal suggests that relevant large exposures may arise "not only through a direct investment in a certain asset, but through an entity which itself invests in such assets", for example, investments in funds, securitizations, and other vehicles. In practice, however, we do not find that large exposures arise in the great majority of such transactions. As described in the examples below, the counterparties on exposures found in securitizations, funds, CIUs, CDOs/CLOs are typically not the same as the major counterparties who would begin to approach the Tier 1 limits, i.e., they are not large SIFIs. Furthermore, the majority of securities issued by these vehicles are commonly traded, financial markets transactions, subject to known criteria regarding the underlying assets that are established to ensure diversification of risks. Investors in most structured products typically would not be inclined to purchase securities that had very large, single name concentrations. For example:

- All retail securitizations (residential mortgage, auto, credit card) have small underlyings which are not comprised of large financial institutions and strict rating agency criteria for diversification.
- CLO/CDO – typically all corporate underlyings, the exposures to which are immaterial relative to level of Tier 1 limits
- CMBS – exposures are to SPV's secured by underlying real estate assets, not large financial institutions

The prudential benefit of looking through to the underlying exposures of such transactions is, therefore, highly limited.

Furthermore, securitization transactions include structural features to protect against concentration risk in the portfolio of securitized assets. These transactions typically have concentration limits which are designed to ensure a diversified portfolio. In addition, the structure of the securitization transaction includes credit enhancement which has been specifically sized to cover both credit and any obligor concentration risk. Therefore, should an obligor within the securitized pool default with regard to their obligation, losses are borne first by the credit enhancement and not by the investor in the transaction. This key differentiating factor therefore supports the view that underlying obligors within a securitization transaction should not be aggregated with the remainder of the bank's exposures for large exposure evaluation.

There are many other issues that make the look-through approach (LTA) framework very unworkable. Securitization pools and investment funds are not always static and may be subject to change without the bank's consent. The disclosure of the underlying exposures in certain of these vehicles can be infrequent and variable in its quality, so monitoring would be largely outdated. The approach in many cases is impossible to apply due to information not being readily available or the inability to aggregate underliers due to inconsistent reference data and naming conventions[7]. The result of this would be to have significant exposure captured in the "unknown client" category which provides no transparency into risks. Finally, the complexity and impossibility of applying the quantitative approach described in the proposal creates tremendous operational burden with little prudential benefit.

[7] Emerging global accepted reference data standards like the Legal Entity Identifier would greatly facilitate this type of counterparty aggregate across underliers in structured finance transactions like CLO/CDOs.

Given these issues, we suggest that the Committee's concerns regarding potential risk concentrations that may result from such a bank's holdings of such exposures would be much better addressed by using a Pillar 2 approach. Under such an approach, banks would be required to perform a review of possible concentrations of indirect exposure in their holdings of CIUs, securitizations, and similar vehicles on a regulator basis (quarterly) and document, with appropriate quantitative support, whether or not any large, indirect exposures exist. To ensure consistency of application by global banks of this approach, the Committee would likely need to provide some indication of what would be considered a large exposure. We recommend the Committee study the QIS results and work with banks that have had to apply the 5% threshold in Europe to make an informed judgment on an appropriate definition. If large exposures were found to exist, banks would include them as part of the large exposure limit and reporting processes. This review and documentation would be subject to monitoring and audit by national regulators and supervisors. Finally, as part of their review process, national regulators would always have the discretion to require banks to include certain indirect exposures in the amounts subject to the large exposure limit if such exposure is found to be of concern.

If the Committee chooses to include some form of mandatory LTA, we strongly recommend that the scope of any look-through requirement be narrowed to specifically exclude those vehicles and positions that clearly do not present material risk of indirect counterparty credit concentrations. For example, retail securitizations – mortgage, auto, credit card, and student loan securitization should be excluded from the LTA given the nature of the underlying exposures (retail consumers). There are several other categories of outright exceptions to the LTA approach that we believe the Committee should consider as outlined in the "Associations" letter.

C. Connected counterparties

The proposal would require banks to aggregate exposures to connected counterparties as if they were a single counterparty where either a "control relationship" test or "economic interdependence" test is satisfied. We believe the large exposure rule should be based on accounting consolidation. i.e., control. Consolidated entities are those controlled by the parent organization and rightly included in the limit monitoring. However, we do not think a formal, rules-based approach that attempts to capture connected counterparties based on economic interdependencies and other qualitative guidance is workable. Good judgment is needed to capture indirect client relationships and relies on a strong understanding of a client's business activities and business relationships. Bright line rules are artificial and tend not to adequately capture these relationships. We have experienced this with the rules currently in place in the EU where trying to capture "connected" entities is a highly manual, imperfect exercise. Furthermore, the qualitative judgments needed to determine economic interdependence likely would vary significantly across banks and jurisdictions, thus leading to inconsistent implementation. Finally, as we have found with our experience with the EU large exposures rule, the cost and effort associated with assessing economic interdependence is not justified in terms of the amount of exposure that actually is identified and captured as coming from connected counterparties.

Therefore, as stated above, we recommend that the Committee base the quantitative assessment of large exposure on accounting consolidation only. The Committee could supplement this rule with a requirement that banks have policies and procedures as part of their credit underwriting processes to ensure economic interdependency is considered, monitored and managed appropriately.

D. Central Counterparties

The fact that central counterparties (CCPs) are a critical element in the toolkit for enhancing financial stability is well known. With increasing focus on the use of CCPs, the activity directed to these entities will only increase. For this reason, the document rightly recognizes the difficulty in implementing a hard exposure limit for CCPs given mandatory clearing requirements. In light of the dramatic increase of CCP facing activity that will result from full phase-in of a number of important regulatory requirements for CCPs, and the amount of exposure that will exist at such entities, we believe that CCPs should not be subject to the large exposure limits. Rather, steps are well underway by various regulatory bodies including IOSCO-CPSS and the BCBS to ensure the stability and adequate capitalization of CCPs exists. Any need for limits on CCP activity, should be undertaken as part of these frameworks.

The following comments address some of the specific points made in the paper around CCP limits:

- Application of the of limit constraints to CCPs is inconsistent with the widely accepted objective of regulators to drive more activity to be cleared by CCPs.

- Diversification in the use of CCPs may not be possible for client clearing given that clients might request clearing via a specific CCP. Banks would need to follow their client's request and would not have the flexibility to parse exposure among CCPs.

- Client clearing activity levels cannot be predicted or quantified in advance; as such risk managing such exposure and ensuring that it stays within a hard limit would be difficult and likely result in uncontrollable breaches of limits.

- It is also possible that the availability of CCPs that support certain cleared products would be insufficient. This could particularly be an issue in case of products specific to emerging markets where such products may be cleared only by the CCP of the relevant jurisdiction.

In case of non-qualifying-CCPs, there will be a natural preference for banks not to take much exposure with such entities since they do not meet CPSS-IOSCO standards. However, realistically if clearing is mandated in jurisdictions with non-qualifying-CCPs, banks will have no choice but to clear trades with such organizations. In such instances, if the large exposure rule is required, adherence to limits might not be possible. We are hopeful, that by the time this requirement becomes effective in 2019 nearly all CCPs where significant exposure exists will be confirmed as qualifying CCPs. To this end, we expect that even if banks have exposures to non-qualifying-CCPs, they are likely to be small and will not approach the level of exposure we believe is intended to be limited by this proposal.

For all these reasons, and the emerging, robust regulatory requirements for CCPs, we recommend that large exposure limits not be applied to CCPs, qualifying or otherwise.

E. Capital-base

The framework's proposed denominator of Common Equity Tier 1 (CET1) or Tier 1 capital is overly conservative and does not account for the full range of resources that a bank has available to absorb losses on a going-concern basis. For example, regardless of whether provisions are technically based on "expected losses", the provisions are available to absorb losses on a going-concern basis. The

framework should be revised to make use of a broader denominator that fully and appropriately reflects all capital and other financial resources with loss-absorbing capacity.

We support the recommendation in the Associations' letter that the denominator should include total regulatory capital, as well as loan loss reserves not included in regulatory capital, because such resources are available to absorb expected and unexpected losses from large exposures and therefore, accurately reflect the total resources available to an institution to absorb losses. Presumably recognizing the loss-absorbing value of this broader base, US regulators have long used this denominator for their lending limits regulations, and the Federal Reserve used this denominator as basis of their Proposed SCCLs.

If the Committee nonetheless chooses to take a more narrow view of capital, we recommend that the denominator include not only Tier 1 capital, but also general loan loss provisions and Tier 2 instruments that are mandatorily convertible into Tier 1 instruments, as each of these resources are available to an institution to absorb losses to any counterparty on a going-concern basis.

F. G-SIBs (Globally Systemically Important Banks)

The Committee has indicated that a lower limit threshold should be set for banks deemed as G-SIBs to address concerns that the failure of such banks, including those with high levels of interconnectedness, would have a significant systemic impact. The Committee has determined that a lower limit should be set at 10% or 15% of Tier 1 capital to address such concerns. We caution against doing so at this time for the following reasons:

- As described in the TCH Study, and as we expect will be confirmed in the Committee's QIS results, such lower limits – given the deficiency in the measurement approaches discussed above – would be highly disruptive to financial markets (please see Appendix).

- Specifically, for banks to bring their exposures within the proposed limits, they would need to rebalance their derivatives activities among counterparties by moving exposures from constrained counterparties to non-constrained ones, if such counterparties are available, and/or reduce overall derivatives product offerings. As estimated in TCH Study:

    - The estimated required reduction or rebalancing in outstanding OTC derivative notionals could be in the range of $30-$75 trillion

    - This estimated required reduction range is equivalent to roughly 10%-25% of the outstanding notionals for all U.S. BHCs, and 5%-10% of the global derivatives market.

    - The total theoretically achievable reduction by constrained dealers through rebalancing was estimated at only 20%-30% of derivatives overages.

    - There could be significant challenges associated with rebalancing exposures to non-constrained counterparties given currently their available capacity and capital levels.

We are unsure whether such impacts were an explicit intention of the large exposure framework. Given that the very function of large financial institutions with capital markets businesses is to warehouse and redistribute risk and to provide market liquidity to a wide range of counterparties, including other

dealers, it is unclear what level of interconnectedness the committee is seeking to achieve with these lower limits. Moreover, the regulatory community has already raised the capital charges on inter-financial company transactions, especially for traded credit products, thus adding significant loss absorbing capacity to the banks. In view of the aforementioned issues and the substantial prudential and structural market reforms already in place and underway for GSIBs, we recommend that the proposed lower limits for G-SIBs not be incorporated into framework at this time.

G. Other issues

Netting of Long and Short Exposures

We support the Committee's perspective that offsetting of long and short positions both in the same issue and across issuances by a single counterparty should be permitted. However, we do not agree that the Committee should disallow netting across banking and trading books, nor should it adopt a new approach that requires banks to consider the seniority of the positions when netting across issuances. This will impose an additional burden of determining and tracking the various seniorities of the bank's long and short exposures, with little or no prudential benefit. In addition, for internal risk management, banks tend not to draw banking book-trading book distinctions as they exist in the risk-based capital framework. Thus prohibiting netting across trading and banking books as defined by Basel is inconsistent with the internal risk management practices of banks. We recommend that the framework be revised to permit netting of long and short positions across banking and trading books to better reflect the way banks manage the risks of such long and short positions.

Sovereign Exposures

We support the Basel Committee's exclusion of sovereigns from the large exposure limits. We also support the recommendation put forth in the Associations' letter that the framework be revised to explicitly grant national regulators to include certain additional entities—such as government sponsored entities or entities serving a public purpose—within the scope of the sovereign exclusion. The risks posed by such exposures are often adequately captured by national regulatory frameworks, and subjecting these types of entities to the large exposure limit could potentially encumber or obstruct their critical function, especially as a source of collateral in the funding markets.

Interbank Exposures

As acknowledged in the proposal, application of the large exposure limits to intra-day exposures, certain overnight interbank exposures, and exposures arising from the provision of payment and clearing services to clients could significantly impact the "smooth functioning" of these systems. As a result, we support the recommendations in the Associations' letter requesting that intra-day exposures, overnight interbank exposures, and payment and clearing systems be exempted from the large exposure framework.

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We thank you for your consideration of our comments and reiterate our willingness to work with the Committee to elaborate on these recommendations and to provide analysis that would help create a viable large exposure framework.

Sincerely,

Adam M. Gilbert

Appendix

Excerpts on Market Impacts from April 30, 2012 JPMorgan Comment Letter on Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

Comments about OTC derivative markets and ongoing regulatory initiatives

By proposing a framework that exaggerates counterparty exposure and thereby causes major OTC derivative dealers to exceed the prescribed limit the proposal create additional pressure to accelerate the clearing and trade compression of OTC derivatives. We believe that this additional pressure is redundant, unnecessary and unwise.

- First, Title VII of Dodd Frank already mandates increased clearing and reduction of bilateral credit risk; it requires clearing for a large proportion of the OTC derivatives business that currently drives the large gross notional amounts outstanding between counterparties.
- Second, increased clearing and compression has been encouraged by the Federal Reserve Bank of New York starting with initiatives as far back as 2005.[8] As a result of this process, clearinghouses for OTC derivatives have been established that did not previously exist, and as of today, for both Rates and Credit products over 90% of eligible inter-dealer trading is being cleared, on a purely voluntary basis, in advance of any legal requirement.[9]
- Third, as a result of both this activity and a parallel process to compress uncleared positions which has also benefitted from the encouragement of the Federal Reserve Bank of New York, the gross notional amounts outstanding among the G-14 dealers[10] have already been reduced by over $72 trillion in CDS notional and $138 trillion in notional principal outstanding for rates through July, 2011.[11]

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[8] See, e.g. Commitment Letter to the Federal Reserve Bank of New York, dated October 4, 2005, in which the signatories (including major dealers such as JPMorgan) committed to the active use of the industry compression process. See also Commitment Letter to the Federal Reserve Bank of New York, dated October 31, 2008, in which the signatories (including major dealers such as JPMorgan) committed to the "Global use of central counterparty processing and clearing to significantly reduce counterparty credit risk and outstanding net notional positions."

[9] See Commitment Letter to the Federal Reserve Bank of New York, dated September 8, 2009, in which the G-15 signatories (including JPMorgan) each committed to submit 90% of new eligible rates trades and 95% of new eligible credit default swap trades for clearing.

[10] The G-14 dealers are a group of the largest fourteen OTC derivatives dealers, listed as signatories on certain letters to the Federal Reserve Bank of New York. See e.g., Commitment Letter to the Federal Reserve Bank of New York, dated March 31, 2011. The G-14 dealers are included in the initial list of globally systemic important banks. See Annex A to Financial Stability Board's "Policy Measures to Address Systemically Important Financial Institutions."

[11] See http://www.trioptima.com/services/triReduce/triReduce-credit.html and http://www.trioptima.com/services/triReduce/triReduce-rates.html. Importantly, the fear of large gross notionals in and of themselves has never been justified, despite an opportunity to study this issue provided by the failure of Lehman. The size of the claims against Lehman from its dealer counterparties and the process by which those were resolved in relation to the gross notional composition of the portfolios provides a powerful scenario to test the premise that gross notional is a material contributor to risk, absent large net positions. We believe that a

- Fourth, the arrival of the legally mandatory effective date for clearing in the Fall 2012 will bring customers into the clearing process, which will further serve to compress the notional amounts.
- Fifth, the OTC margin proposal[12] will fundamentally transform the established business practice within the dealer community. The proposal will require that dealers, in addition to the established practice today of posting variation margin to each other, also post initial margin into a third party segregated account. In addition to the obvious reduction in risk that results from the posting of the initial margin in the first place, the existence of the requirement also creates very strong incentives against the accumulation of large offsetting positions with different dealers. Currently, that proliferation carries relatively little cost, because in the simple case of a dealer with exactly offsetting positions with two other dealers, the margin posted by one dealer is simply passed through by the intermediary dealer to the third dealer. Once initial margin is required under the proposed rule, such a position, which involves very little market risk, and therefore little opportunity for profit, will require significant amounts of initial margin on both sides. This will create a very strong incentive for dealers to avoid needlessly accumulating gross notional positions between them and to participate actively in market-wide compression exercises to address the buildups when they do occur.

In light of all the above, there is no need to use the single credit counterparty limits as a method to force more clearing, particularly when doing so cannot meaningfully increase the speed of adoption without creating significant market disruption. Pre-existing, ongoing efforts by the industry together with the Title VII mandates mean that the rate of clearing and compression is already close to the maximum achievable. In contrast to this negligible benefit, the rule as proposed will certainly increase costs to corporate end users, undermine the quality of available risk management options for the dealer community itself, and possibly create a materially destabilizing event for the marketplace as a whole.

Comments on Market Impacts

1. Market Liquidity and Cost

As a result of the proposed rule, market makers will face limits on their ability to deal with other major counterparties or to take collateral even when the collateral consists of low risk investment grade sovereign debt securities. This will result in the reduction of dealer capacity to provide liquidity and to intermediate credit risk in the markets. Moreover, it will harm end users that rely on dealers to provide derivatives and securities financing intermediation by decreasing overall liquidity and increasing the costs of doing business for all market participants.

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careful study of the publically available data from the Lehman bankruptcy would provide useful empirical insights into the relationship between the gross notional and net risk of OTC derivatives.

[12] See Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (the “Margin Rulemaking) and JPMorgan comment letter dated June 24, 2011 regarding the Margin Rulemaking. Although JPMorgan has voiced significant objections to this proposed rule, we have not challenged the core premise that initial margin will be required to be posted between dealers, which is the key requirement that both directly decreases interconnectedness risk and creates an incentive to minimize the exposures in the first place.

Although unstated in the proposed rule, we recognize the possibility that it is motivated at least in part by a desire to achieve greater diversification in suppliers of funding and secondary market trading liquidity. This is similar to the Volcker rule, where some suggested that (the language or intent of the provision notwithstanding) a rule that encouraged non-bank entities to provide more market liquidity would be beneficial. We believe it would be inappropriate to overstate counterparty exposures to achieve an unstated policy goal; we also believe it would be unwise as a policy matter, for the same reasons we articulated in connection with the Volcker Rule Notice of Proposed Rulemaking:

> While there is the potential for non-regulated entities to fill some of this gap, we believe this idea is misplaced. We believe that market realities make it highly unlikely that non-regulated entities would have the incentive or resources to serve as dependable market makers in volatile markets when such services are most necessary. Such a suggestion ignores lessons from recent financial crises and greatly underestimates the importance of housing critical financial services within the regulated banking sector.
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> One important lesson is that procyclical liquidity is not a substitute for through-the-cycle liquidity. We view our market making business as part of an overall franchise that includes commercial banking, lending and underwriting relationships. High-frequency traders and hedge funds play an important role in financial markets, but their business models do not require the development or maintenance of such relationships. As such, we believe that their willingness and ability to accept risk to support clients during periods of market stress (when, as we note above, a market maker's services are of the greatest value) will naturally be more limited than those of a banking entity.
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> Market making is optimally located within financial institutions that are subject to close prudential supervision. The minimum capital requirements to which banking entities are subject ensure that, even in stressed markets, they have sufficient capital to participate actively in market making. Also, banking entities typically have access to diversified sources of funding that allow them to assume less liquid and more volatile positions from clients with greater confidence. By contrast, non-regulated financial market participants are typically very thinly capitalized and have limited, if any, access to traditional capital markets. Furthermore, managing the complexity associated with large portfolios of lightly mismatched "leftover" risk over long periods of time and in all market conditions, which is a critical element of a market-maker's role, requires access to capital and risk management infrastructure that is only found in banking entities. As events like the collapse of Long Term Capital Management and others have demonstrated, market events like unexpectedly high margin calls threaten the viability of highly leveraged or lightly capitalized market actors with complex portfolios of offsetting positions.
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> Also, many non-regulated entities operate a business model that depends on executing a high volume of intra-day transactions and ending the trading day without any risk position at all. Even a small increase in execution uncertainty or operational risk can lead such an entity to exit a market. The "flash crash" of May 6, 2010 clearly demonstrates the destabilizing effect of such contingent liquidity.

> We expect that the proposed rules will reduce liquidity. That impact will lead to a widening of bid-offer spreads that will attract non-regulated entities, at least temporarily. But we encourage the Federal Reserve to recognize that the business model of non-regulated entities means that any commitment to providing liquidity is likely to prove limited, high in cost, and fickle.[13]

In the case of securities financing transactions, the exaggerated risk calculation of the proposed rule may in the first instance constrain the ability of a financial institution to provide financing to clients and other market makers. Even if the financial institution seeks to mitigate that risk by taking account of the collateral pledged, it is required to shift the exposure to the issuer of the collateral. It is very common for market participants to seek financing for highly rated securities and in particular, sovereign debt securities. Such securities are also pledged as collateral pursuant to swap documentation.

While the proposed rule does not require an institution to shift its risk to issuers of collateral, in many cases a covered company may in effect have little choice when it is otherwise constrained in dealing with the original counterparty under the provisions of the framework. This is especially a concern in the context of CCPs, as discussed above. Moreover, if the substitution is made in the case of sovereign debt collateral, the shift of exposure may have the effect of limiting the ability of the covered company to take on additional exposure to the sovereign issuer. This impact will place unnecessary pressures on sovereign liquidity. This result is particularly unwarranted in the case of investment grade and marketable sovereign debt securities/issuers. We recommend that the final rule exclude from single counterparty credit limits exposure to sovereign obligors that are of comparable credit quality to the United States.

In short, the proposed rule will limit the credit capacity of the U.S. financial system, for all of its participants, not just dealers. Market participants will struggle to find replacement and hedge providers and will thus be constrained in intermediating risks for clients. As stated above, the shadow banking system will not have the capacity or desire to house long dated risks or provide protection on single names.

Finally, we observe that the proposal will have significant extraterritorial effects. First, the proposal will negatively impact the ability of U.S. banks to compete effectively with international peers since the risk measurement methodologies in the proposed rule are unduly restrictive and differ in material ways from similar provisions being implemented by non-U.S. regulators. Specifically, the European Union large exposure rules would allow internal modeling of exposures subject to this rule. It would also exempt CCPs and sovereign obligors with high credit quality from large exposure limits. Moreover international frameworks (such as the proposed European Union large exposure rules) generally do not impose a limits measure set below 25% of capital as is proposed by the Federal Reserve's rule for major banks. Paradoxically, the proposal would also affect non-U.S. dealers in a potentially negative way in that U.S. banks may find that they are restricted in their ability to deal with major non U.S. counterparties. Non U.S. financial firms will therefore have less access to liquidity than otherwise would

[13] JPMorgan comment letter dated February 13, 2012 addressed to the Federal Reserve, OCC, FDIC, SEC and Department of Treasury located at: http://www.sec.gov/comments/s7-41-11/s74111-267.pdf.

have been the case since the capacity of U.S. banks to provide liquidity to the global marketplace will be constrained.[14]

In light of all of the comments above concerning potential impacts of the proposal, we urge the Federal Reserve to conduct a quantitative impact study as to the effects of the proposal on individual banks and markets, and as to how any proposed methodology achieves a desired degree of permitted interconnectedness.

[14] We also note that the current proposal would apply to U.S. based bank holding company banks and would not apply to foreign banking organizations that have U.S. banking operations (U.S. FBOs). While U.S. FBOs that have global total consolidated assets of $50 billion or more are subject to the enhanced prudential standards in the statute, the Federal Reserve notes that it is difficult to determine how the standards should be applied to such entities and that it must give due regard to the principle of national treatment and equality of competitive opportunity. We believe that the Federal Reserve should align implementation of the proposal with the timing of rules that will apply to U.S. FBOs to ensure that the overall affect of its proposals strikes an appropriate competitive balance both within the U.S. and abroad.