JPMORGAN CHASE & CO.

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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: June 2013 Consultative Document – Capital treatment of bank exposures to central counterparties ("CCPs")

Ladies and Gentlemen:

JPMorgan Chase & Co. ("JPMC") appreciates the opportunity to comment on the Consultative Document ("the proposal"), Capital treatment of bank exposures to central counterparties ("QCCPs"), issued by the Basel Committee on Banking Supervision (the "Committee"). We support the Committee's efforts to further develop a workable capital framework for QCCP Capital.

Our views on many of the technical aspects of the Committee's QCCP proposal are consistent with the comment letter on the proposed rule being submitted jointly by The Clearing House Association L.L.C., the Global Financial Markets Association, the Institute on International Finance, and the International Swaps and Derivatives Association, Inc. (the "Association's" comment letter). As a result, we will not separately comment on all the points already made in that letter. Our comments on certain aspects of the proposal, in particular, the proposed use of Cover*, are presented below.

Summary

- Overall, we support the Committee's efforts to further develop a workable capital framework for QCCP Capital.
- Notwithstanding, we are concerned that the proposal will result in banks having to hold an amount of capital on their default fund contributions, trade exposures and top-up commitments that will substantially increase the cost of clearing derivatives and create a disincentive to clear trades. We have three key areas of concern:
    - Using Cover* to determine the hypothetical default fund capital requirement will result in an overstatement of risk and the amount of capital required to cover such risk.

- Similarly, requiring additional capital to be held against top up commitments will further increase the cost of clearing.
- Finally, increasing the current 2% risk weight established in the interim rules for trade exposures to QCCPs to as much as 20% grossly overstates the risk of a QCCP's default.

Contributions to default funds

The proposal introduces two methodologies for calculating capital requirements against QCCP default fund (DF) contributions: the Ratio approach and the Tranches approach. Both methodologies use a reference level of default fund ("RLDF") resources to quantify the risk of loss of default fund contributions as a result of clearing member defaults where RLDF is defined as the greater of the two default fund measures, Cover* or K_{CCP}(NIMM).

K_{CCP} (NIMM) is a risk-based measure of the capital required to cover clearing member default risk that takes into account the risk weighting of each of the clearing members. As such, the K_{CCP} (NIMM) component of RLDF reflects the risk of each clearing member defaulting and is consistent with the regulatory risk-based capital framework. Defaults of clearing members are rare events, and we believe that K_{CCP}(NIMM) would correctly provide for a lower capital requirement than actual default fund contributions given that it incorporates the risk weighting of the clearing member's exposure and the non-internal model method[1] ("NIMM") measure of EAD.

In contrast, Cover* is a stressed EAD measure conditioned on the default of one or two largest clearing members depending on whether Cover* is based on a Cover 1 or a Cover 2 calculation. Cover* is not a capital measure since it does not take into account the likelihood that clearing members default – it is not risk weighted. The regulatory framework utilizes expected exposure measures and risk weights for individual counterparties and would need to combine a stressed EAD measure with a probability of multiple clearing member defaults in order to appropriately incorporate Cover*. Using Cover* as a capital measure assumes with 100% probability that one or two clearing members default every year, an unrealistic assumption. Further, the use of Cover* combined with the use of a 1250% risk weight to determine the RLDF results in an overstatement of risk and consequently higher capital.

If the Committee decides to retain Cover* in the determination of default fund capital, we do not believe a risk weight of 1250% is appropriate. We agree with the arguments put forth in the Association's letter that a more reasonable risk weight for use with a Cover* EAD is 50%. We urge the Committee to revisit the 1250% if Cover* is retained in the QCCP capital framework.

In summary, we believe that K_{CCP} (NIMM) is the appropriate risk-based measure on which to base default fund capital requirements. Essentially, the approach correctly looks through to the risk that each clearing member poses to the QCCP. As such, we believe that K_{CCP}(NIMM) will provide an appropriate risk-based measure of capital that will incentivize firms to act as clearing members, thereby supporting the G20 objective of increasing the clearing of trades with CCPs.

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[1] Reference our response to BCBS254 *The non-internal model method for capitalising counterparty credit risk exposures* issued for comment 27 September 2013.

On a technical note, we observe that the NIMM methodology is silent as to whether actual default fund contributions would be considered as collateral. Since a QCCP would have access to the default fund contribution of defaulting clearing members in a default scenario we think actual default fund contributions should be used to offset EAD using NIMM in K_{CCP} and suggest that the Committee make this change to the framework.

Finally, JPMC would like to ensure that the Committee understands the extent of the operational complexity placed on QCCPs to calculate hypothetical default fund capital (RLDF) and may require considerable operational investment to ensure that banks receive timely information in order to guarantee the integrity of their capital calculations.

Capital treatment of commitments[1] to top up default funds

The proposal includes a requirement for banks to hold capital against commitments to top up default funds. We do not believe that additional capital needs to be held against top up commitments to a QCCPs default funds and that holding such additional capital will create further disincentives for banks to clear OTC derivatives.

A bank should be required to hold default fund capital against the possible risk of loss incurred by a QCCP due to the default of its clearing members using a risk weighted measure. This is contemplated in the K_{CCP}(NIMM) approach included in the proposed rules. A separate capital contribution for commitments to the QCCP to top up default funds is therefore unnecessary since the default fund capital is calculated based on looking through to the default risk of all counterparties as captured in the K_{CCP}(NIMM) calculation which will not change even if members commit to top up funding.

To illustrate the adequacy of capital against committed default fund contributions consider the following examples for a clearing member of a QCCP (assume QCCP itself makes no default fund contribution). In scenario one the pro-rata K_{CCP} (NIMM) and default fund contributions of the clearing member are \$100 and \$200, respectively, with \$100 of commitments to top up default funds. Under scenario one, the effective risk weight on default fund contribution is 50%. In scenario two, the pro-rata K_{CCP} (NIMM) and default fund contributions of the clearing member are \$300 and \$200, respectively, with \$100 of commitments to top up funds. The effective risk weight on default funds is 150%. In both cases, the measure of clearing member default risk and the level of capital required is not impacted by the level of top-up commitment. The risk profile and exposure of the CCP to the clearing members is driving the amount of hypothetical capital (K_{CCP} (NIMM)), as the capital requirement may be more or less than the cash default fund contributions, irrespective of a top-up requirement. In effect, the capital held against committed default funds captures the potential for funds greater than default fund contributions to be used because it is based on the risk of default of the clearing members.

[1] We would note that the US prudential regulators, in the final US rules that will implement Basel III, have taken the position that "defined [DF] contribution amounts are a prerequisite to being a QCCP"[1] and, accordingly, the US Basel III rules relating to computation of RWA for DF contributions to QCCPs do not even contemplate the possibility of such contributions being unlimited. We applaud this position and believe that it will promote safer QCCPs and overall systemic stability.

Given the above, we strongly urge the Committee to use K_{CCP} (NIMM) for the default fund capital calculation as this captures the full risk of clearing member default and simultaneously removes any need for capital to be held for top up commitments.

Trade exposures

We believe that the 2% risk weight established by the interim rules for trade exposures to QCCPs should remain unchanged. As the Committee observes, "[u]nder the interim rules, banks' trade exposures to QCCPs are assigned a nominal 2% risk weight, reflecting that the risk of a QCCP defaulting is assumed to be very low." JPMC is not aware of any new circumstances that would call for an abrupt (and potentially significant) increase in risk weighting of trade exposures to QCCPs up to 20% as set forth in the proposal. Indeed, if anything, QCCPs are better regulated and more prudently risk-managed today than they were at the time the 2% risk weight was adopted, and we fail to see a compelling reason for the Committee's proposed change.

Additionally, the proposal seems to make changes to the current framework for capitalization of non-bankruptcy remote initial margin in that banks will need to assess whether a QCCP has legally enforceable rules that make initial margin a senior claim to variation margin in the event of losses in excess of default resources before a 2% risk weight can be used. We see no compelling justification for a change to the existing treatment of initial margin. Moreover, the meaning of the proposed legal enforceability requirement is not clear to us and we are, thus, unable to assess whether supporting legal opinions could be obtained. Nor is it clear what risk weight would apply if a bank is unable to satisfy the requirement. We recommend that a simple statement that a bank should use a 2% risk weight when the initial margin is not-bankruptcy remote – as in the current rules – is more appropriate. We suggest the language proposing the new requirement be removed.

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We would be happy to further discuss the concerns raised within our response to ensure that a viable capital framework that promotes central clearing of derivatives is adopted. Please feel free to contact me at your convenience at 212-270-9140.

Respectively Yours,

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