

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 – The non-internal model method for capitalizing counterparty credit risk exposures

Ladies and Gentlemen:

JPMorgan Chase & Co (“JPMC”) appreciates the opportunity to comment on the Consultative Document (the “Proposal”) *The non-internal model method (“NIMM”) for capitalizing counterparty credit risk exposures*, issued by the Basel Committee on Banking Supervision (the “Committee”). We support the Committee’s efforts to develop an improved standardized approach for use in the risk-based capital framework.

Our views on many of the technical aspects of the 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 of the points already made in that letter. Our comments on other aspects of the proposal, in particular, its application to other areas of the regulatory oversight framework, are presented below.

Summary

- Overall JPMC supports NIMM as an improved standardized approach for regulatory capital purposes, including the use of NIMM for the leverage ratio calculation (assuming full cash collateral netting), as NIMM addresses a number of major flaws in the Current Exposure Method (“CEM”).
- Similarly, we generally agree that NIMM should replace CEM in other areas of the regulatory framework where CEM is used, but caution that this broader application must be undertaken only after the impact of NIMM in those regimes is thoroughly reviewed and understood.

- Finally, there are several areas in the proposal that result in a misstatement of exposure because of NIMM's limited risk-sensitivity both at the portfolio level and in certain narrower applications for individual asset classes and counterparties. We believe that these areas warrant modification.

Use of NIMM

The Basel Committee has indicated that it is considering whether NIMM should be adopted for all areas of its framework once the methodology is concluded. Specifically, NIMM would potentially replace CEM in:

- Risk-Based Capital
- Leverage Ratio Capital
- CCP Capital
- Large Exposure Limits and Monitoring

Risk-Based Capital

JPMC supports the use of NIMM as an improved standardized approach for risk-based capital purposes. The proposed rules address a number of the major flaws in CEM, most notably the recognition of collateral and netting. However, while we support moving forward with NIMM, we believe there are a number of modifications and technical corrections to the proposed rules outlined below that we believe should be made to ensure that NIMM does not result in a misstatement of exposure.

Leverage Ratio Capital

JPMC strongly believes that NIMM represents a more accurate tool than CEM for derivative exposures. As a result, we would support the use of NIMM over CEM in the leverage ratio calculation assuming that full recognition of legally enforceable cash collateral netting is permitted in measuring derivative exposures. Please see the industry responses on this topic.¹

CCP Capital

We have commented on the application of NIMM for calculating capital against CCP exposure in our response to the Basel Committee on Banking Supervision ("BCBS") Consultative Document: Capital treatment of bank exposures to central counterparties ("CCPs"). In summary, we are largely supportive of using NIMM for calculating capital against default fund exposure and have provided our comments on areas that we believe require some modification. Notwithstanding, we urge the Committee to carefully review the quantitative impact study ("QIS") results received from CCPs to ensure NIMM does not inappropriately penalize any CCPs that clear trades in a single asset class.

Large Exposure Limits and Monitoring

While we strongly prefer that the BCBS allow the use of internal models for calculating counterparty exposure in the large exposure framework ("LEF"), we support the use of NIMM as an improvement over CEM. Notwithstanding, because NIMM uses simplifications in its representations of risk, e.g., using

¹ See The Clearing House Association and The Global Financial Markets Association ("GFMA"), American Bankers Association, Financial Services Roundtable, Institute of International Bankers, Institute of International Finance, and the International Swaps and Derivatives Association (collectively, "the Associations") comment letters on the June 2013 Consultative Document issued by the Basel Committee on Banking Supervision, *Revised Basel III leverage ratio framework and disclosure requirements*

maturity as a multiplier in the Add-on calculation, we are concerned about the appropriateness of the resulting exposure measure for single counterparties that may have a majority of exposure in a particular asset class. The accurate measurement of exposure is critical in a framework that limits trading activity based on an individual counterparty's exposure level. As a result, we urge the Committee to study this possible outcome carefully before adopting NIMM for the LEF.

Technical Comments

While we support moving forward with NIMM, we believe there are a number of modifications and technical corrections to the proposed rules as outlined below that should be made to ensure that NIMM does not result in a misstatement of exposure. The specific areas of concern include the use of Alpha to scale up the capital charge, flooring of the Potential Future Exposure ("PFE") multiplier, using full maturity as a multiplier in the Add-on calculation, treating Minimum Transfer Amount ("MTA") and Threshold Amount ("TA") as fully drawn commitments without a cap, and the calculation of Foreign Currency ("FX") Add-ons. Our specific comments follow.

Alpha

Basel risk-based capital rules require the use of a 1.4 multiplier to produce a scaled Exposure at Default ("EAD") when a bank uses the Internal Models Method ("IMM"). This accounts for a number of risks including possible general wrong way risk and model deficiencies. Under NIMM, EAD is calculated as the sum of replacement cost ("RC") (current exposure) and an Add-on based on stressed assumptions. Therefore, even if volatility were properly calibrated between NIMM and IMM to produce the correct at-the-money exposure, before application of Alpha, the NIMM approach would still produce a higher exposure than IMM providing the conservatism the Committee requires. We note that the Committee in paragraph 93 states that, with respect to the second step calibration, "The results indicated that for the trades and portfolios tested, the NIMM results in exposure measures that range from 125% to 254% of the exposure measures computed using the supervisory IMM model on average". Furthermore, since the calculation of current exposure (RC) has no model uncertainty or wrong way risk, there is no need for Alpha to be applied to that portion of the EAD measure.

In summary, while we would suggest the full removal of Alpha given that NIMM is already based on stressed parameters and there is no model risk or wrong way risk for the RC component, we acknowledge the Committee's desire to ensure enough capital is held against potential risk. We therefore recommend that the Alpha multiplier only be applied to the Add-on component and not to replacement cost. Applying Alpha only to the add-on clearly would reduce the impact below 1.4. Our initial analysis suggests that this application results in exposure equivalent to using an Alpha, applied to RC plus add-on, not less than the 1.2 IMM floor.

Replacement Cost

As discussed in the Association's letter, the guidance on RC could be interpreted as requiring the application of the entire amount of collateral collected under a Credit Support Annex ("CSA") repeatedly to non-nettable trades. Although we do not interpret the proposed rules this way, this is important technical guidance that is missing from the RC formula. Uncertainty of this nature in applying the rule

could lead to very large misstatements of risk. We urge the Committee to make the appropriate clarifying changes to the rules to ensure such misinterpretations are not made.

Thresholds

With respect to the calculations involving thresholds, there is also the potential for overstatement of exposure. The proposed NIMM calculation uses the minimum transfer amount (MTA) and threshold amount (TA) in the calculation of replacement cost in a way that is consistent with the IMM shortcut method (i.e., treating MTA and TA as fully drawn commitments regardless of their size relative to that of the un-margined exposure). However, in the IMM shortcut method, the exposure is capped at the un-margined calculation to ensure that the uncollateralized exposure will be an upper bound for the collateralized exposure. This is not the case in NIMM.

Margining is expected to reduce exposure and thus the un-margined exposure correctly represents an upper bound for exposure. This option should also be included in NIMM. We recommend that the Committee undertake to include such guidance in the final rule.

Multiplier Floor

We agree with the Committee's aim to recognize excess collateral in the NIMM framework. We also share the Committee's concerns about fat-tailed distributions (paragraph 87) and therefore agree that a desirable property of a supervisory formula is that this formula be more conservative than one assuming a normal distribution. In this respect, we note that the supervisory formula in paragraph 85, when used with floor of zero, already has this fat-tailed property as shown by the Committee's own results presented in the graph referred to in paragraph 86 (i.e., the multiplier without the floor is already above the internal model normal distribution line).

Given this relationship, we do not support the introduction of the five-percent floor (or any floor) on the inclusion of excess collateral in the PFE calculation. This floor (or any other floor) will produce a non-zero exposure in cases where the true economic exposure is clearly zero. For example, a client enters into an unfunded CDO tranche swap where the client posts at inception initial margin in cash equal to the full notional of the tranche (and where there is no further collateral posting or return of collateral by either JPMC or the client until maturity). In this case, the trade has no economic exposure due to the benefit of initial margin, yet the five percent floor would not allow the exposure to be reduced to zero. We urge the Committee to remove the five percent floor on including excess collateral in the PFE calculation.

Trades with no counterparty exposure

There are other situations besides the excess collateral example above where the NIMM approach can misstate risk by producing a non-zero exposure for trades whose economic exposure is clearly zero. For example, if a bank sells a cash-settled option (on an unmargined basis) and receives the premium upfront, then clearly the bank has no counterparty exposure once the premium is received. However, NIMM would still calculate an exposure proportional to the notional of the option.

The sold-option example above is a specific case of the general problem of NIMM calculating exposure where no risk exists. We recommend that the Committee modify the proposed rule to ensure that any unmargined trade where all remaining cash flows are payable by the bank (i.e., no remaining cash flow is payable by the counterparty) attracts no counterparty exposure under NIMM.

Maturity vs. Duration

NIMM includes a maturity multiplier in the calculation of Add-ons. However, multiplying by maturity could overstate risk especially in the case of long dated contracts since the duration of such long dated contracts is far less than maturity. For example, the duration of a 50-year swap might be only 17 to 25 years. As a result, using maturity as a proxy for duration would overestimate risk easily by a factor of two to three times. We are concerned that exposures to corporate clients will be particularly misstated since their trades are often long dated and unmargined. As a result, using maturity to adjust notionals in such cases will make derivatives for corporate clients more expensive. We strongly suggest that using an approach that leverages duration (e.g., DV01 and CS01) to determine the adjusted notionals for derivative and credit products, and DV01 for FX forwards would be more appropriate.

FX Add-on

The Add-on (supervisory) scalars for FX forward deals result in an overstatement of exposure because they are calibrated to one year risk, when in fact a high percentage of FX deals have short maturities, e.g., less than 3 months. As a result, the FX scalars, which are ten times as large as the interest rate scalars, are leading to a disproportionately large amount of EAD being attributed to FX products. We recommend that the Committee review this calibration to one year risk in light of this potential overstatement.

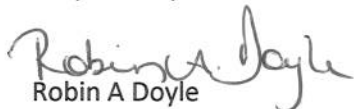
Asset Class Designation

NIMM calculates exposures as the sum of exposures to each asset class, utilizing asset class specific methodologies. This requires firms to map all trades to a regulatory asset class. While CEM has asset class specific add-ons, there is a clear fallback mechanism for trades that cannot be assigned to an asset class. NIMM does not have a fallback methodology and assumes that each trade can be assigned to a particular asset class. The process for assigning trades to asset classes could be considerably more burdensome than the equivalent process in CEM. We urge the Committee to consider providing additional guidance in this area.

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We would be happy to further discuss the concerns raised within our response to ensure that a viable standardized capital framework is adopted and appropriately applied to areas beyond the risk-based capital framework. Please feel free to contact me at your convenience at 212-270-9140.

Respectively Yours,



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