

JPMORGAN CHASE & CO.

Adam M. Gilbert
Managing Director

March 13, 2009

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

baselcommittee@bis.org

Ladies and Gentlemen:

JPMorgan Chase & Co. (JPMC) is pleased to provide comments on the documents: "Revisions to the Basel II market risk framework" (BCBS 148) and "Guidelines for computing capital for incremental risk in the trading book" (BCBS 149) recently issued by the Basel Committee on Banking Supervision (the Committee).

JPMC appreciates the time and effort undertaken by the Basel Committee in developing this revised framework. JPMC believes that the revised framework is designed to remedy the most significant deficiencies of the current Basel I, value-at-risk (VAR) / Specific risk (SR) capital calculation while maintaining practicality. However, JPMC is disappointed that the revised framework moves away from the conceptual underpinnings of the more ambitious proposal from 2008 which included total price risk and differentiation of asset liquidity in the IRC. The over-arching motivation for setting regulatory capital standards should be to ensure that sufficient capital exists in support of ongoing risk-taking activities given the liquidity constraints of a bank particularly in scenarios where structural positions have to be held over longer horizons in disrupted markets. It is essential that the new framework can accommodate an internal model treatment of products representing the full spectrum of asset liquidity.

JPMC fully acknowledges the need for pragmatism in risk capital modeling; comprehensive and risk sensitive capital models require considerable resources to formulate, implement, maintain and validate. Given the complexity of the problem and the absence of any broadly accepted modeling framework, JPMC feels strongly that banks willing to make the required investment should be given the flexibility to develop their own 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 approach requires continuous supervisory

dialogue around model specification and validation, but will lead to the most thoughtful and complete treatment for risk aggregation across products and asset classes.

The unified capital framework JPMC envisions would reflect all sources of price risk (including event risks e.g. credit default and migration and discontinuities in risk premium), differentiate capital consumption based the appropriate liquidity horizon and be consistent with the standard of credit risk capital measurement.

Key characteristics of a unified capital framework are as follows:

- Such a framework would ensure a strong linkage between risk measurement and capital calculation including stress testing, as it naturally allows for constructive interactions between model developers and risk managers, including the injection of expert opinion on the completeness of the risk factors and the reasonableness of the parameter settings and results.
- The market risk calculation should be consistent with the credit risk framework when applied to products with one year liquidity. This will help close regulatory and accounting arbitrage. A unified capital framework provides a macro view of the firm's positions across the liquidity and accounting spectrum which, along with stress testing across risk disciplines, is essential for a comprehensive understanding of the firm's risk position. It would allow in time for better capture of the impact of market event risk on counterparty credit risk measurement.
- The economic capital calculation should fit into an actionable and predictable total risk framework suitable for evaluating alternative risk reduction strategies. To this end, it should be technically possible to predict capital requirement in a stress environment.

The alternative of having largely independent frameworks for regulatory capital and internal risk limits and decision-making is undesirable. Internal economic capital approaches are at risk of being marginalized in the investment / disinvestment decision-making and financial ex-post performance analysis processes. As proposed, a regulatory formula capturing risk only partially and combining risk measures based on fixed weights opens the potential for a disconnect between the underlying risks and the result of the regulatory formula, leading to incorrect incentives.

Below are JPMC's specific comments on the revised framework.

Capital Formula

JPMC's view is that banks should be given the option to either use the multiplier and add-on approach or use a unified model that captures general, specific and IRC risk drivers together to compute a total risk capital measure. If a separated VAR / Stressed VAR / SR / IRC approach is required, a unified model should be allowed as a way to quantify multipliers and adjust for double count between components. JPMC supports the forthcoming Quantitative Impact Study aimed at measuring the impact of the

proposals and hopes that results would be thoroughly considered before finalization of the rules. It is also worth noting that the separation of spread and default risk over the longer IRC horizon from the general and specific credit spread risk assumed to be hedgeable over the 10-day horizon is a subtle and model dependent challenge. This would require further dialogue between each firm and supervisors.

VAR Component

Most VAR measurement, whether based on historical or monte carlo simulation, is calibrated off daily or weekly time series. This practical approach requires that the measurement needs to be supplemented when it comes to modeling products with structural risks that are difficult to hedge or where the underlying assets are less liquid. JPMC considers it important that firms be encouraged to directly model market jumps and discontinuous moves in risk premia. The scope of the IRC should allow for these to be included in addition to jump risks in equities and credit. JPMC believes strongly that simply scaling 1-day VAR by $\sqrt{10}$ is inadequate for capturing 10-day risks to general market factors and firms should be required to validate their scaling factor via an auxiliary model.

Stressed VAR component

JPMC agrees with the concept behind a stressed VAR, namely producing a risk measurement for liquid market factors that captures extreme market moves relevant for the current portfolio and which generally will be more stable through time. JPMC has specific concerns regarding the proposal at hand. It is important that the calibration of the stressed-VAR not be tied to a particular historical period. JPMC favors an approach where a long historical time-series is used for calibration but the model automatically emphasizes market events to which the current portfolio is vulnerable. JPMC believes that to produce a conceptually reasonable stressed-VAR, a more sophisticated model may be required than that used for the normal VAR measurement. Thus, separate use-tests may be warranted. For instance, the normal, predictive VAR could be used for risk monitoring of the book and the stressed-VAR for limits and capital. Ideally, there would be a single VAR component (stressed) in the regulatory capital formula. If properly formulated, the stressed VAR could be guaranteed to never drop below a predictive VAR measure estimated based on a recent historical window. JPMC understands that it is attractive to have part of the model amenable to historical backtesting, but believes the stressed VAR component can be put on statistical terra firma and validated via the benchmark portfolio approach.

IRC Component

JPMC is generally supportive of the IRC concept and approach in the rules. As mentioned earlier, it should be extended to allow for risks beyond credit and equity asset classes. Although the IRC will likely lead to much higher capital results for covered products as compared to the current VAR / SR treatment, JPMC fully expects that the introduction of IRC will allow for a number of less liquid products that did not fit into the current market risk rules to be treatable under the internal model regime. JPMC therefore feels that securitizations, especially synthetic corporate securitizations where there is a

liquid market for hedging most of the underlying risks, should be well-captured with a suitably sophisticated IRC model.

It is JPMC's view that firms be allowed to model IRC in the way most appropriate to its activities. For example, it should be at the firms' discretion whether to directly model rating transitions or use a model for credit spreads that produces similar levels of volatility.

By design, the proposed rules would not allow for diversification between market variables and the risk drivers of IRC. JPMC notes that these relationships are ingredients to an IRC calculation where the exposure to default or migration can depend on the behaviour of market variables. JPMC believes it should be possible to prudently reflect diversification.

Model Validation

With respect to model validation, the guidelines put significant emphasis on additional back-testing of specific risk while recognizing the need for alternatives in the case of IRC. It is unclear how less liquid products would be validated through back-testing under the rule. In JPMC's view validation approaches should be tailored to the particular sets of products being considered. While back-testing should be used for model validation purposes when a clean experiment can be constructed, it may not always be applicable.

To maintain consistency across firms and to maximize transparency of model behavior, it is essential that a new approach to model validation be established in conjunction with the new rules; this is especially relevant for the stressed-VAR and IRC components. In addition to analysis of P&L attribution results, historical simulated back-testing, on-going evaluation of theoretical assumptions, and understanding the errors in empirical estimation of model parameters and their impact on capital, model validation should rely heavily on periodic capital measurement of standardized benchmark portfolios – test decks. Comparing capital outputs at the bank level will yield very little insight as to the quality / completeness of the risk modeling. JPMC 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.

Treatment for Illiquid Positions

JPMC has some concern about multiple valuations for illiquid instruments. JPMC believes the current valuation methods used for financial reporting adequately address the lack of liquidity in the illiquid instruments. By requiring an additional liquidity adjustment, the Committee is potentially widening the gap between financial reporting based on accounting standards and reporting for regulatory capital purposes.

Alternative Approach: Applying Banking Book Treatment to Positions in the Trading Book

JPMC believes that the Committee's alternative approach of applying banking book treatment to the trading book would result in perverse incentives and encourage banks to move exposures out of trading book into banking book. This is due to capital charges for VAR and Stressed VAR that are applicable only in the trading book but not in the banking book. JPMC is uncertain how trading book positions would use banking book treatment given the interplay between market variables and credit risk.

Regarding the alternative of applying banking book treatment only to illiquid positions, JPMC believes that a better approach is to model illiquid positions using IRC.

In closing, JPMC appreciates the opportunity to comment on the revised framework and would be pleased to discuss the contents of this letter at your convenience.

Very truly yours,



Adam M. Gilbert

cc:

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Norah Barger

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219
Attention: Amrit Sekhon