BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 1, 2008

Kathryn V. McCulloch, Esq.
Senior Vice President and
Associate General Counsel
JPMorgan Chase & Co.
270 Park Avenue, 40th Floor
New York, New York 10017

Dear Ms. McCulloch:

This is in response to the request by JPMorgan Chase & Co. ("JPMC"), New York, New York, for an exemption from section 23A of the Federal Reserve Act and the Board's Regulation W to allow JPMorgan Chase Bank, National Association ("JPMC Bank"), Columbus, Ohio, to purchase from JPMC a portfolio of derivative transactions (and associated hedges) that were acquired by JPMC in connection with its acquisition of The Bear Stearns Companies, Inc. ("Bear Stearns"), New York, New York.

On March 16, 2008, JPMC agreed to acquire Bear Stearns and to provide a guarantee of a substantial portion of the liabilities of Bear Stearns. To facilitate the acquisition by JPMC of Bear Stearns, the Board agreed on that same date to authorize the Federal Reserve Bank of New York to extend credit under section 13(3) of the Federal Reserve Act in an amount up to $30 billion, secured by a pledge of up to $30 billion of assets of Bear Stearns. The Board also agreed on that date to provide a limited, temporary exemption from section 23A and Regulation W for certain proposed covered transactions between JPMC Bank and Bear Stearns (the "March 16 exemption").[1]

[1] See Board letter to Kathleen A. Juhase, Esq. (JPMC) dated April 1, 2008. The Board also concurrently provided JPMC a limited, temporary exemption from the Board's capital adequacy guidelines for bank holding companies with respect to the assets and exposures of Bear Stearns to be acquired by JPMC. Id.

Specifically, the Board exempted for a period of 18 months extensions of credit by JPMC Bank to an affiliate and guarantees issued by JPMC Bank on behalf of an affiliate as long as (i) the transactions are fully collateralized; (ii) the transactions are subject to daily mark-to-market and re-margining requirements; and (iii) JPMC guarantees the performance of the affiliate on the transactions for the benefit of JPMC Bank. The Board limited the exemption to 50 percent of JPMC Bank's capital stock and surplus and required a reduction of the exemption amount by one-sixth in each subsequent quarter (until expiration of the exemption on October 1, 2009).

JPMC acquired 39.5 percent of the outstanding common stock of Bear Stearns on April 8, 2008, and Bear Stearns merged with and into JPMC on May 30, 2008. JPMC now proposes to have JPMC Bank purchase from JPMC a portfolio of derivative transactions (and associated hedges) that JPMC acquired in connection with its acquisition of Bear Stearns (the "Portfolio").[2]

Section 23A and Regulation W limit the aggregate amount of "covered transactions" between a bank and any single affiliate to 10 percent of the bank's capital stock and surplus, and limit the aggregate amount of covered transactions between a bank and all its affiliates to 20 percent of the bank's capital stock and surplus.[3] "Covered transactions" include the purchase of assets by a bank from an affiliate, the extension of credit by a bank to an affiliate, the issuance of a guarantee by a bank on behalf of an affiliate, and certain other transactions.[4] The statute and regulation also require a bank to secure its extensions of credit to, and guarantees on behalf of, affiliates with prescribed amounts of collateral.[5] JPMC

[2] The Portfolio represents the derivatives transactions of a number of companies previously owned by Bear Stearns, including Bear Stearns Forex, Inc. and Bear Stearns Credit Products Inc. JPMC also proposes to have JPMC Bank purchase from JPMC two mortgage companies previously owned by Bear Stearns: Bear Stearns Mortgage Capital Corporation and Bear Stearns Commercial Mortgage Inc. These two companies are engaged in a variety of residential and commercial mortgage financing activities. The bank's acquisition of these companies was approved by the OCC on June 30, 2008, and appears to qualify for the step-transaction exemption in Regulation W. 12 CFR 223.31(d).

[3] 12 U.S.C. § 371c(a)(1) and 12 CFR 223.11 and 223.12.

[4] 12 U.S.C. § 371c(b)(7) and 12 CFR 223.3(h).

[5] 12 U.S.C. § 371c(c) and 12 CFR 223.14.

Bank's purchase of the Portfolio from JPMC would be a covered transaction under section 23A and Regulation W.[6]

The amount of the covered transaction – approximately $44 billion – would exceed JPMC Bank's quantitative limits under the statute and rule. In addition, the covered transaction would not qualify for the March 16 exemption because the form of the transaction is an asset purchase by the bank, whereas the March 16 exemption only applies to extensions of credit and guarantees by the bank. Accordingly, the bank has requested an exemption from section 23A and Regulation W to permit it to acquire the Portfolio from JPMC. Section 23A and Regulation W specifically authorize the Board to exempt transactions or relationships from the requirements of the statute and rule if the Board finds such an exemption to be in the public interest and consistent with the purposes of section 23A.[7] The Board previously has indicated that the purposes of section 23A are (i) to protect against a depository institution suffering losses in transactions with affiliates and (ii) to limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution's access to the Federal safety net.[8]

The Board routinely has approved exemptions under section 23A for one-time asset transfers that are part of a corporate reorganization and that are structured to ensure the quality of the transferred assets.[9] The Board also has routinely approved exemptions under section 23A to facilitate the integration of recently merged companies.[10] The proposed transaction in this case is a byproduct of a one-time corporate reorganization and would facilitate the integration of recently merged companies.

JPMC has indicated that granting the requested exemption would provide substantial benefits to JPMC, JPMC Bank, and the public. Currently, JPMC

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[6] See 12 CFR 223.3(h)(3).

[7] 12 U.S.C. § 371c(f)(2) and 12 CFR 223.43.

[8] 67 Federal Register 76560 (Dec. 12, 2002).

[9] See, e.g., Board letter to Carl Howard, Esq. (Citigroup) dated June 30, 2006; Travelers Group Inc. and Citicorp, 84 Federal Reserve Bulletin 985, 1013-14 (1998).

[10] See Board letter to Troland S. Link, Esq. (Deutsche Bank AG) dated May 28, 1999; Board letter to Ronald C. Mayer, Esq. (The Chase Manhattan Bank) dated August 18, 2000.

principally operates its derivatives business in JPMC Bank, and transfer of the Portfolio to the bank would expand the bank's base of derivatives counterparties, enhance the bank's relationship with existing derivatives counterparties, and correspondingly increase the bank's revenues. In addition, the transfer of derivatives transactions with overlapping clients gives JPMC and the bank the potential to reduce their credit exposures and collateral-posting requirements through netting of offsetting mark-to-market values. Moreover, consolidating the Portfolio with the derivatives transactions already at JPMC Bank should reduce the operational risk and increase the systems efficiency of JPMC and the bank. Beyond the benefits to JPMC and the bank, the expanded scope for netting agreements should result in increased overall liquidity in the financial markets. The proposed transaction will reduce the credit exposure of JPMC and the bank to major financial institution counterparties and the credit exposure of major financial institutions to JPMC.

JPMC has made a number of commitments designed to help ensure that the proposed transaction would not harm JPMC Bank. First, JPMC has represented that JPMC Bank's acquisition of the Portfolio would not result in the bank purchasing any low-quality assets (as defined in Regulation W). In addition, JPMC has committed that if JPMC Bank downgrades a Portfolio derivatives counterparty to a [ ] in the bank's internal credit rating system at any time between the date of the proposed transfer until June 30, 2013, JPMC will promptly after the end of the quarter pay JPMC Bank an amount equal to any change in the credit valuation adjustment ("CVA") of the counterparty from June 30, 2008, to the time of the downgrade, multiplied by the allocation percentage (defined below).[11] Moreover, JPMC has committed that, if a Portfolio derivatives counterparty defaults at any time between the date of the proposed transfer and June 30, 2013, JPMC will promptly pay JPMC Bank an amount equal to the then replacement cost of the bank's derivative transactions with the counterparty (net of proceeds from any liquidation of collateral) multiplied by the allocation percentage. In calculating JPMC's payment obligation to the bank on counterparty default, JPMC may net any previous payment made by JPMC to the bank as a result of an internal-rating downgrade of the counterparty. For purposes of these commitments, the allocation percentage would equal (i) 100 percent, for any Portfolio derivatives counterparty that is not a derivatives counterparty of JPMC Bank; or (ii) for any other Portfolio derivatives counterparty, the ratio of the

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[11] [ ].

counterparty's CVA in the Portfolio on June 30, 2008, to the counterparty's combined Portfolio/JPMC Bank CVA on June 30, 2008.

JPMC also has committed that the proposed transaction will not have an adverse impact on the regulatory capital position of JPMC Bank as of June 30, 2008. Specifically, JPMC has stated that it would make a cash capital infusion into JPMC Bank on July 1, 2008, in an amount equal to the estimated amount of additional regulatory capital that would be required to ensure that each of the bank's regulatory capital ratios as of June 30, 2008 – its tier 1 risk-based capital ratio, total risk-based capital ratio, and tier 1 leverage capital ratio – does not decline as a result of the proposed transaction (regardless of any regulatory capital relief provided to the bank by the OCC) (the "Estimated Payment").[12] JPMC also will compute the actual regulatory capital impact of the proposed transfer during the calendar quarter in which the transfer occurs. To the extent that the actual regulatory capital impact exceeds the Estimated Payment, JPMC promptly will pay the bank the difference. To the extent that the Estimated Payment exceeds the actual regulatory capital impact, the bank will pay JPMC the difference (but will in no circumstance be obligated to pay back to JPMC more than the Estimated Payment).

The purchase of the Portfolio by JPMC Bank from JPMC would be subject to the market-terms requirement of section 23B of the Federal Reserve Act. Section 23B requires that the proposed transaction be on terms that are substantially the same, or at least as favorable to JPMC Bank, as those prevailing at the time for comparable transactions with unaffiliated companies.[13]

In light of these considerations, the Board has determined that providing an exemption from section 23A and Regulation W for the proposed transaction would be consistent with the purposes of the statute and in the public interest. Accordingly, the Board hereby grants the requested exemption.

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[12] JPMC Bank requested that the OCC allow the bank, on a temporary basis, to exclude (i) from its total on-balance-sheet assets (the denominator of its tier 1 leverage capital ratio) certain Bear Stearns-related assets the bank might acquire from JPMC; and (ii) from its total risk-weighted assets (the denominator of its tier 1 and total risk-based capital ratios) certain risk-weighted assets generated by Bear Stearns–related exposures the bank might acquire from JPMC. The OCC granted this request on June 30, 2008.

[13] See 12 U.S.C. § 371c-1(a)(1).

The Board granted the March 16 exemption to JPMC Bank to permit it to finance the operations of Bear Stearns temporarily and in limited amounts. The amount of the March 16 exemption is 50 percent of the bank's capital stock and surplus for the second quarter of 2008 (approximately $58 billion) and falls to approximately 42 percent of the bank's capital for the third quarter of 2008 (approximately $48 billion). The Board granted the March 16 exemption subject to the understanding that it would be revoked to the extent that JPMC transferred Bear Stearns businesses to third parties or to JPMC Bank. The combined covered transaction amount of the proposed Portfolio transfer and certain other imminent transfers of Bear Stearns positions to JPMC Bank equals approximately $46 billion and substantially accomplishes the purpose of the original exemption. In light of the exemption granted for this transaction, the Board has determined to reduce the March 16 exemption in connection with granting this exemption request to $5 billion as of July 1, 2008, and revoke the March 16 exemption in full as of October 1, 2008.

These determinations are specifically conditioned on compliance by JPMC and JPMC Bank with all the commitments and representations made in connection with the request. These commitments and representations are deemed to be conditions imposed in writing by the Board in connection with granting the request and, as such, may be enforced in proceedings under applicable law. These determinations are based on the specific facts and circumstances of the proposed transaction. Any material change in those facts and circumstances or any failure by JPMC or JPMC Bank to observe any of its commitments or representations may result in a revocation of the exemption.

Sincerely yours,

*(signed)*

Robert deV. Frierson
Deputy Secretary of the Board

cc: Federal Reserve Bank of New York
Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation