Michael J. Cavanagh
Chief Financial Officer

January 18, 2006

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Docket No. 05-16
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RIN 1557-AC95

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Attention: Docket No. R-1238
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Regulation Comments
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Attn: No. 2005-40
regs.comments@ots.treas.gov
RIN 1550-AB98

Re: Joint Advance Notice of Proposed Rulemaking (ANPR)

Introduction

J.P. Morgan Chase & Co. is pleased to provide comments on the Joint Advance Notice of Proposed Rulemaking (ANPR) for modification of the existing risk-based capital framework, also known as Basel IA, as published in the Federal Register on October 20, 2005. As a large, internationally active banking organization, J.P. Morgan Chase & Co. is a "mandatory bank"[1] that is required to implement the Basel II framework rather than continue under either the current or Basel IA frameworks. Nevertheless, the proposed domestic modifications to the Basel I framework may have potential implications for our firm over the transition period leading up to full implementation of Basel II. Our

[1] For convenience, terms frequently used in this document are defined below.
"Basel I" regulations refer to the existing risk-based capital regulation in the US as of October 20, 2005, which represent the implementation of the original 1988 Basel Accord and subsequent modifications as published by the US Agencies.
"Basel IA" regulations refer to the modifications to the existing Basel I regulations as proposed in this ANPR.
"Basel II" regulations refer to the U.S. implementation of the Advanced Internal Ratings Based (A-IRB) and Advanced Measurement Approach for credit and operational risk, respectively, based on the June 2004 Basel Capital Accord as updated Nov. 15, 2005.
"Mandatory bank" refers to any banking organization with either assets of $250 billion or more or on-balance sheet foreign exposure of $10 billion or more that is required to adopt the advanced Basel II approach.
"Opt-in banks" refer to institutions that voluntarily may adopt the advanced Basel II approach.

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comments focus primarily on the implications of Basel IA for banking organizations adopting Basel II, particularly the proposal that Basel IA rules be used to calculate the transitional capital floor.

Summary

J.P. Morgan Chase & Co. is fully supportive of the goals of capital adequacy reform, including the reform of the Basel I framework for non-Basel II banking organizations. These goals include creating a more risk-sensitive capital framework and providing incentives for banking organizations to improve their risk management and measurement practices. Basel IA requirements, however, should not create an additional regulatory burden for banking organizations adopting the more advanced Basel II approaches. In particular, we are strongly opposed to the use of Basel IA capital calculations as a floor for Basel II capital for three key reasons:

- The proposed changes will result in significant additional compliance costs and increased operational complexity by creating another set of capital calculations and additional risk to the timely implementation of the Basel II program.

- The Basel IA proposal appears to be a hybrid approach to risk measurement that is not necessarily fully consistent with Basel II advanced or standardized approaches developed over several years through consultation with the industry.

- The use of a different methodology to compute the floor is unnecessary. There does not appear to be an additional safety and soundness benefit that would justify the cost and operational risk for a Basel II bank to replace the existing Basel I transitional capital floor.

We are also opposed to imposing unnecessary additional data collection and reporting requirements on Basel II banking organizations as a result of Basel IA, whether the Basel IA floor applies or not.

However, if the new Basel IA rules are applied to the calculation of the Basel II transitional capital floor, then we offer several additional comments below on the specific proposals.

Basel IA capital as the transitional floor for Basel II banks

The ANPR requests comment on whether the revisions resulting from this ANPR process should be incorporated into the definition of the Basel II capital floor.[2]

We oppose application of Basel IA to the Basel II floor calculation for the following reasons:

- The proposed changes will result in significant additional compliance costs and increased operational complexity by creating another set of capital calculations and additional risk to the timely implementation of the Basel II program.

  The ANPR states that information required to implement Basel IA is *"currently available as part of the organization's credit approval and portfolio management processes"*. It does not follow, however, that it is straightforward or costless to implement process changes.

  A Basel IA floor would require Basel II banks to implement another capital calculation using different input data and different methodology, creating additional costs and a new set of operational risks. The operational risks are compounded by having more "moving parts", i.e. introducing multiple processes, systems and data requirements simultaneously across multiple exposure categories.

  For Basel II banks, any projects undertaken to meet Basel IA requirements will compete for many of the same scarce resources currently devoted to implementing Basel II.

  Even if the Basel II banks were not required to apply Basel IA to the floor calculation, but were required to provide some or all of the underlying incremental information needed for the Basel IA calculation in Call Reports or elsewhere, they may still incur a similar compliance burden and operational risk. We oppose creating such additional requirements.

  These costs and risks can be avoided by simply retaining the Basel I calculation method for the capital floor. Since the floor is temporary, there does not appear to be a compelling need or benefit to justify these additional costs.

  Should the supervisors pursue the adoption of Basel IA as the floor for Basel II banks then firms should have the option to apply a floor based on either Basel I or IA.

[2] Italics are used to indicate a quote or paraphrasing of material from the text of the ANPR.

- The Basel IA proposal appears to be a hybrid approach to risk measurement that is not necessarily fully consistent with Basel II advanced or standardized approaches developed over several years through consultation with the industry.

  Some of the proposed changes resemble the Standardized Approach under Basel II but with a number of specific risk-weight differences. At the same time, other parts of the proposal, e.g. segmentation, differ from both the Standardized and IRB Approaches. (Some of these differences are noted below.)

  We question whether this hybrid approach represents a new and different view of risk than any of the Basel approaches, and if so, why this new approach should be viewed as an appropriate floor for A-IRB banks.

- The use of a different methodology to compute the floor is unnecessary. There does not appear to be an additional safety and soundness benefit that would justify the cost and operational risk for a Basel II bank to temporarily replace the existing Basel I capital floor.

  From a safety and soundness perspective, there are numerous other elements of capital regulation, including the leverage ratio, as well as other supervisory tools that, in conjunction with the existing Basel I floor, are more than sufficient to prevent any sudden erosion of capital.

  In addition, the transitional capital floor percentages that would apply to Basel II banks, announced on September 30, 2005, are significantly higher than originally proposed[3] and remain in place over a longer time period.

  Although we recognize that the Basel I framework is not very risk-sensitive, we question the practical value of a marginally more risk sensitive floor for Basel II banks when the A-IRB framework is itself risk-sensitive, and other prudential capital safeguards remain in place.

However, if the new Basel IA rules are applied to the calculation of the Basel II transitional capital floor, then we offer the following additional observations on the specific proposals.

Comments on Specific Basel IA Proposals

In this ANPR, relative to current Basel I rules, the Agencies are considering:

A. *Increasing the number of risk-weight categories to which credit exposures may be assigned;*
B. *Expanding the use of external credit ratings as an indicator of credit risk for externally-rated exposures;*

[3] The new floor percentages are 95% in 2009, 90% in 2010, and 85% in 2011, versus the original percentages of 90% in 2008 and 80% in 2009.

C. *Expanding the range of collateral and guarantors that may qualify an exposure for a lower risk weight;*
D *Using loan-to-value ratios, credit assessments, and other broad measures of credit risk for assigning risk weights to residential mortgages;*
E. *Increasing the risk sensitivity of capital requirements for multifamily residential mortgages, and for other retail exposures;*
F. *Modifying the credit conversion factor for various commitments, including those with an original maturity less than one year;*
G. *Requiring that certain loans 90 days or more past due or in a non-accrual status be assigned to a higher risk-weight category;*
H. *Modifying the risk-based capital requirements for certain commercial real estate exposures, and for small business loans;*
I. *Assessing a risk-based capital charge to reflect the risks in securitizations backed by revolving retail exposures with early amortization provisions.*

To the extent that the above proposals would be used in calculating the Basel II floor, we make the following broad observations:

- The proposed changes do not appear to consistently take advantage of the Basel II Standardized and IRB Approaches, which were developed over several years through a consultative dialogue with the industry.

    The set of proposals (A) through (I) above appears to be a hybrid combination of the Basel II Standardized Approach and supervisory determined segmentation schemes that is not fully consistent with any of the Basel II approaches. Where certain proposals appear to partially agree with the Standardized Approach, the illustrative risk weights differ from those published in the Basel II framework. (We provide several examples in the next section.)

    Moreover, there are some areas of risk that not specifically addressed in Basel IA, including Operational Risk and trading book changes.

- Basel IA segmentation proposals create risk buckets within product categories that are inconsistent with Basel II segmentation schemes.

    For Basel II banks, the segmentation options utilizing various risk drivers should not be required for floor calculations. The Basel II segmentation choices can differ from the Basel IA segmentation scheme, and must meet a number of additional supervisory standards.

    To illustrate how Basel II differs from Basel IA, under proposed supervisory standards, Basel II banks must demonstrate that their choices of risk drivers and segment ranges separate exposures into homogeneous risk buckets. Under the Basel II approach, these segmentation choices are likely to vary by institution.

The Basel IA segmentation proposals, in contrast, would impose a uniform segmentation scheme on all banks. This would not require validation of the choices of risk drivers or ranges, or demonstration that the Basel IA segmentation appropriately differentiates for risk at the banking organization level.

- Basel IA should not produce systematically lower risk-based capital requirements for credit risk than the corresponding IRB calculations for the same exposures. Otherwise, this could be a disincentive for non-mandatory banking organizations to opt-in to Basel II.

Use of external credit ratings (B)

The Agencies propose to modify the November 2001 "Recourse Rule"[4] *revisions to the Basel I risk-based capital standards which permitted banking organizations to rely on external credit ratings that are publicly issued by Nationally Recognized Statistical Rating Organizations (NRSROs) to assign risk weights to certain recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities.* The Agencies propose to broaden the scope of application of the Recourse Rule to most exposures with NRSNO ratings, including corporate debt, but excluding Fed Funds Sold, other short-term inter-bank lending, U.S. government, agency and government-sponsored entity obligations.

		Basel IA ANPR	**Standardized Approach**	**Standardized Approach**
Long-term rating category	**Illustrative Rating**	**Illustrative Risk Weights**	**Corporate Risk Weights**	**Securitization Risk Weights**
Highest two investment grade ratings	AAA/AA	20%	20%	20%
Third-highest investment grade rating	A	35%	50%	50%
Third-lowest investment grade rating	BBB+	50%	100%	100%
Second-lowest investment grade rating	BBB	75%	100%	100%
Lowest investment grade rating	BBB-	100%	100%	100%
One category below investment grade	BB+/BB/BB-	200%	100%	350%
Two or more categories below investment grade	B and lower	350%	150%	Deduction

- For traditional credit products (i.e., non-securitization exposures), the illustrative risk weights in the ANPR are not fully consistent with the risk weights for corporate exposures under the Standardized Approach, as shown in the table above.

- Similarly, for securitization exposures, the illustrative risk-weights differ from the Standardized Approach (shown above), as well as from the current Recourse Rule.

- These differences appear to represent a different view of risk and it is unclear what motivates these differences. We request the Agencies to explain their rationale and, if

[4] Final Rule to Amend the Regulatory Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, Residual Interests in Asset Securitizations, and Asset-Backed and Mortgage-Backed Securities (Recourse Final Rule), 66 FR 59614 (November 29, 2001). Under this Rule, residual interests not eligible for the ratings-based approach receive dollar-for-dollar capital treatment. Other recourse obligations and direct credit substitutes are subject to a "gross-up" rule. An unrated position senior to a traded rated position is treated as if it had that rating.

a different view of risk is justified, then this should be reflected in the Basel II approach as well.

Similarly, to the extent that the proposed expanded recognition of collateral and eligibility of guarantors differs from the Standardized Approach, we question what the rationale is for any difference. The minimum rating required for guarantor eligibility, for example, is BBB- in the Basel IA proposal, versus A- in the Standardized Approach.

Assigning risk weights to residential mortgages (D)

The Agencies have proposed replacing the current 50% risk-weight for first lien mortgages with a sliding scale based on LTV ratio.

Table 3: Illustrative Risk Weights for First Lien One-to-Four Family Residential Mortgages (after consideration of PMI)

LTV Ratio	Risk Weight
91-100	100%
81-90	50%
61-80	35%
≤ 60	20%

The Agencies also proposed a second option to include additional risk drivers in a supervisory determined segmentation scheme. The Agencies seek comment on:

(1) the use of an assessment mechanism based on LTV ratios in combination with credit assessments, debt-to-income ratios, or other relevant measures of credit quality, (2) the impact of the use of credit scores on the availability of credit or prices for lower income borrowers, and (3) whether LTVs and other measures of creditworthiness should be updated annually or quarterly and how these parameters might be updated to accurately reflect the changing risk of a mortgage loan as it matures and as property values and borrower's credit assessments fluctuate.

- The Basel IA proposals for residential mortgages are not consistent with the Basel II approaches. The Standardized Approach applies a simple risk-weight of 35% to all prudentially written loans, including but not limited to those with a substantial margin of additional security over the loan amount.

- Regular quarterly or annual updates to risk drivers are in some cases either not readily available or costly.

Standard practice is not to update LTV on a regular basis.

Updating credit scores would require significant investment.

Debt-to-income ratios are not meaningfully updateable due to the confidentiality and unavailability of specific income information, as well as the lack of accurate proxies for this information.

For a Basel II bank, these quarterly or annual updates would be solely for the purpose of re-computing the floor.

- The availability of reliable, contemporaneous, combined LTV information is a concern in the context of multiple lenders to one borrower and the increased popularity of HELOCs with borrower-controlled draws.

Modifying the credit conversion factor for various commitments (F)

- We support in concept that the credit conversion factor (CCF) for commitments under one year should be non-zero, and that the CCF factors should be risk sensitive and vary with maturity. We observe, however, that the two proposed CCF options (10%/50% and 20%/20% for under/over one year, respectively) differ from the Standardized Approach (20%/50%). We are unsure of the rationale for either option.

Securitizations backed by revolving retail exposures with early amortization provisions (I)

The Agencies propose two options for an early amortization capital charge to securitizations of revolving credit exposures. One option would be to assess a flat conversion factor, (e.g., 10 percent) against off-balance sheet receivables. A second option would be to assess capital based on three-month average excess spread levels.

- The first option, a flat conversion factor, is not consistent with any of the Basel II approaches, whereas the second option is consistent with the A-IRB calculation for early amortization.

Conclusion

In summary, there does not appear to be a sufficiently demonstrated need or benefit to justify the incremental costs for Basel II banks to adopt the Basel IA floor.
The proposals appear to differ so significantly from the Basel II A-IRB Approach that little synergy exists with Basel II implementation programs.

The differences between Basel IA and Basel II data, calculation and reporting requirements would result in a significant additional regulatory burden.

Even if Basel IA rules are not used for floor calculations, but Basel II banks are still required to modify their Call Reports and provide additional information solely in order to comply with Basel IA, they would incur additional compliance costs.

Since a Basel IA floor calculation is temporary, it should not only be relatively easy and costless to implement, but also represent a more rational estimate of aggregate risk-based credit capital. However, the specific Basel IA proposals appear to represent a combination of approaches that are not fully consistent with Basel II approaches. The rationale for these differences is unclear, including whether a different view of the relevant risks has emerged.

J.P. Morgan Chase & Co appreciates the opportunity to comment in this ANPR and supports the effort to provide a more risk sensitive capital framework. If you have any questions, please contact Adam M. Gilbert, Managing Director, Risk Management, at (212) 270-8928.

Sincerely,

Michael J. Cavanagh
Chief Financial Officer