David B. Edelson
Corporate Treasurer

November 3, 2003

Office of the Comptroller of the Currency
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Public Information Room, Mailstop 1-5
Washington, D.C. 20219
Attention: Docket No. 03-14
regs.comments@occ.treas.gov

Robert E. Feldman
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Attention: Comments
Federal Deposit Insurance Co
550 17th Street, N.W.
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Comments@FDIC.gov

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C., 20551
Attention: Docket No. R-1154
regs.comments@federalreserve.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attention: No. 2003-27
regs.comments@ots.treas.gov

Re: Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord

JP Morgan Chase & Co. is pleased to provide responses to the questions posed in the Advanced Notice of Proposed Rulemaking (ANPR) issued in regard to the implementation of the New Basel Capital Accord (Basel II). We appreciate the unique opportunity for internationally active banks to have a constructive dialogue concerning the evolution of regulatory capital requirements. We welcome the changes that have been made to the proposal thus far as a result of the consultative process. The proposed new capital regime is more risk sensitive than the current regime and provides some important incentives for better risk management and measurement. We believe further enhancements would be appropriate, most notably in the areas of credit hedging and securitization. These topics and others will be discussed at length throughout this letter, which is structured as specific responses to the questions posed within the Advanced Notice of Proposed Rulemaking.

Sincerely,

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JP Morgan Chase Responses to ANPR Questions

This document is structured in question-answer format. Before each question we have listed the ANPR page number on which it appears.

<u>Executive Summary</u>

P. 14 What are commenters' views on the relative pros and cons of a bifurcated regulatory framework versus a single regulatory framework? Would a bifurcated approach lead to an increase in industry consolidation? Why or why not? What are the competitive implications for community and mid-size regional banks? Would institutions outside of the core group be compelled for competitive reasons to opt-in to the advanced approaches? Under what circumstances might this occur and what are the implications? What are the competitive implications of continuing to operate under a regulatory capital framework that is not risk sensitive?

If regulatory minimum capital requirements declined under the advanced approaches, would the dollar amount of capital these banking organizations hold also be expected to decline? To the extent that advanced approach institutions have lower capital charges on certain assets, how probable and significant are concerns that those institutions would realize competitive benefits in terms of pricing credit, enhanced returns on equity, and potentially higher risk-based capital ratios? To what extent do similar effects already exist under the current general risk-based capital rules (e.g., through securitization or other techniques that lower relative capital charges on particular assets for only some institutions)? If they do exist now, what is the evidence of competitive harm?

Apart from the approaches described in this ANPR, are there other regulatory capital approaches that are capable of ameliorating competitive concerns while at the same time achieving the goal of better matching regulatory capital to economic risks? Are there specific modifications to the proposed approaches or to the general risk-based capital rules that the Agencies should consider?

> In general, we do not believe the decision to apply the New Accord only to the largest banks creates competitive inequality issues or leads to banking consolidation. The largest banks base their banking strategies on economic assessments which should be unchanged by the New Accord, provided the applicable regulatory rules constitute a *minimum standard* that is non-binding in the normal course of business.
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> There may be specific requirements that could place Basel II banks at a relative advantage or disadvantage. We will address these issues throughout this response letter. In the long-run, however, a bank's ability to opt-in to the A-IRB framework should take care of any potential short term advantages.
>
> As explained in our CP 3 response, we are concerned that the cumulative effect of consistently conservative choices tends to move Basel II away from a true

minimum standard. However, if the New Accord is calibrated properly to generate a true minimum capital standard, we do not believe it will change capital management practices. For example, we do not believe that institutions will dramatically reduce their capital ratios. Banks that are positively affected by Basel II will probably allow ratios to increase rather than reduce equity. Banks that are negatively impacted may reevaluate effected areas for the relationship between their internal and regulatory capital requirements. Rating agencies will be looking for this behavior in order to maintain current ratings.

We do not believe the new operational risk capital charge raises competitive inequality issues. Operational risk is increasingly a feature of the internal capital framework at large banks. Even though some competitors might not be subject to a regulatory operational risk requirement, the market expects all firms to be able to withstand failures of their people, processes and systems. Ultimately, we believe firms that incur similar risks should be subject to similar rules.

Application of the Advanced Approaches in the United States

P. 16 Recognizing that separate bank and thrift charters may, to a large extent, be independently managed and have different systems and portfolios, the Agencies are interested in comment on the efficacy and burden of a framework that requires the advanced approaches to be implemented by (or pushed down to) each of the separate subsidiary banks and thrifts that make up the consolidated group.

Although we support implementing the New Accord at the subsidiary level, it is imperative that banks be allowed to use parameter estimations in the capital framework based on data from the broader institution.

- Generally, there should be consistent parameter usage within a given institution.
- There may not be enough data to determine statistically meaningful parameters at the subsidiary level.
- It would be expensive to implement independent parameter estimations independently at each subsidiary.

P. 17 The Agencies are interested in comment on the extent to which alternative approaches to regulatory capital are implemented across national boundaries might create burdensome implementation costs for the U.S. subsidiaries of foreign banks.

The New Accord lacks provisions allowing for systematic cooperation on the supervision of internationally active banks that are regulated by supervisors in multiple jurisdictions. We appreciate the creation of the Accord Implementation Group. We hope it will be instrumental in creating processes to avoid potential complication and duplication. We support the view that supervisors should agree on the principle of a lead home country supervisor, which would have the primary responsibility for capital supervision. We also strongly support the view that there is a need for enhanced and pragmatic cooperation among supervisors, and strongly believe that the home country regulator should take charge here and lead this effort.

Increased costs will be incurred as duplicate approvals and validation work will be required in the instance of subsidiaries of JPMC in international locations/regulatory jurisdictions. It is also not clear as to which regulatory body will have the final say on the subsidiaries in a foreign location. To the extent that local implementation of the rules differs, we will have to comply in each foreign location which will trigger systems, technology and processing efforts which are different than in the head office. This will result in complexities and increased expenses.

These issues are particularly acute with respect to the operational risk component, although they effect the A-IRB qualification process as well. Please see our response to the question posed on page 93 of the ANPR, where we make our suggestions for the key features of a workable approach.

P. 18 The Agencies seek comment on whether changes should be made to the existing general risk-based capital rules to enhance the risk-sensitivity or to reflect changes in the business lines or activities of banking organizations without imposing undue regulatory burden or complication. In particular, the Agencies seek comment on whether any changes to the general risk-based capital rules are necessary or warranted to address any competitive equity concerns associated with the bifurcated framework.

A few selective changes to the existing framework may be helpful in addressing competitive concerns and creating greater comparability between general and A-IRB banks. We suggest the Agencies consider the following steps.

- Address the treatment of collateral as a credit risk mitigant uniformly across the industry to avoid potential conflicts. It may be difficult for Basel II banks to change haircut procedures that are already in place if other banks do not have to comply with Basel II.
- Modify the mortgage risk weights to those proposed in CP 3's standardized framework.
- Require capital for unused credit card lines consistently across the industry.
- We support the recent proposal to require all regulated banks to hold capital for some of the more significant Basel II securitization changes, namely (i) early amortization capital for revolving asset securitizations and (ii) short-term liquidity facility capital for conduits. Regulatory capital in the securitization area may well exceed economic capital measurements. It is not clear how banks will react in terms of charging for capital internally, but it is possible that competitive inequality issues may arise if regulators decide not to implement these particular changes more consistently across the banking community.

P. 19 The Federal Reserve specifically seeks comment on the appropriate regulatory capital treatment for investments by bank holding companies in insurance underwriting subsidiaries as well as other nonbank subsidiaries that are subject to minimum regulatory capital requirements.

> If supervisors retain the proposed framework, then only the minimum capital requirement should be deducted from Tier 1 capital. The subtraction of total capital would penalize firms with well-capitalized subsidiaries.
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> As a general matter, we do not believe insurance subsidiaries should be treated differently from banking and securities subsidiaries. However, we are concerned that the proposed policy would not give the holding company adequate recognition of excess capital in the subsidiary or the benefits implied by diversification.
>
> We suggest supervisors apply the A-IRB framework to the institution as a whole. Risks that are unique to the insurance business could be monitored with supervision in the Pillar II framework.

P. 20 Given the general principle that the advanced approaches are expected to be implemented at the same time across all material portfolios, business lines, and geographic regions, to what degree should the Agencies be concerned that, for example, data may not be available for key portfolios, business lines, or regions? Is there a need for further transitional arrangements? Please be specific, including suggested durations for such transitions.

Do the projected dates provide an adequate timeframe for core banks to be ready to implement the advanced approaches? What other options should the Agencies consider?

> As a general statement, it will not be possible for most large global banks to simultaneously meet the A-IRB qualification criteria and implementation requirements across all business activities at the same time. Historical data quality and coverage varies quite a bit across regions and products. For example, while EAD and LGD studies might cover developed corporate markets reasonably well, there may be a limited number of useable data points from certain markets or business lines such as private banking. Products and businesses that banks have gotten involved in recently may not be adequately represented in the samples.
>
> In general, the supervisory guidance contains many sensible standards. Successful implementation of Basel II, however, will depend on how supervisors apply the standards in practice. Supervisors should demonstrate flexibility and allow banks to make reasonable assumptions with respect to the applicability of their A-IRB parameters across different portfolio segments. Our expectation is that supervisors will look to banks to have a *well-understood process* for designing our ratings system, that we will have clear *logic* behind the choices we

make in the design process and that we have a method for evaluating the *reasonability* of our choices and outcomes. Rigid adherence to the specific words of the supervisory guidance will not work because no two banks will address the design and implementation of a complex ratings system exactly the same way.

To the extent that the banks are making significant efforts to conform to qualification criteria and implementation requirements, a prescriptive approach should not be necessary. Rather than extend the implementation date, we would prefer increased flexibility in applying the rules over the initial implementation period. This flexibility should extend to the use of external data. We understand supervisor's inclination to treat uncertainty with conservatism. However, the extent of conservative assumptions should not be onerous in cases where there is a consistent lack of data across the banking industry.

It will be critically important for the implementation period to be adjusted for any delays in publishing the final rules beyond year end, 2003.

We note the current floor proposal in which 2007 A-IRB capital requirements can not be less than 90% of the current rules and 2008 can not be less than 80%. We believe this floor proposal is costly and unnecessary especially in light of the fact that banks are meant to prepare shadow calculations in 2006.

P. 20 The Agencies seek comment on appropriate thresholds for determining whether a portfolio, business line, or geographic exposure would be material. Considerations should include relative asset size, percentages of capital, and associated levels of risk for a given portfolio, business line, or geographic region.

We would appreciate flexibility in applying the regulatory capital standards to relatively small exposures. However, following our internal policy, we suggest that supervisors consider individual cases through supervision rather than setting any hard and fast rules. Perhaps it would be useful to set a threshold under which banks could make the case for a materiality judgment. We suggest a threshold of a few percent of total assets would be reasonable for a large institution like JPMC.

P. 25 The Agencies seek comment on the conceptual basis of the A-IRB approach, including all of the aspects just described. What are the advantages and disadvantages of the A-IRB approach relative to alternatives, including those that would allow greater flexibility to use internal models and those that would be more cautious in incorporating statistical techniques (such as greater use of credit ratings by external rating agencies)? The Agencies also encourage comment on the extent to which the model's necessary conditions of the conceptual justification for the A-IRB approach are reasonably met, and if not, what adjustments or alternative approach would be warranted.

Given the critical role banking organizations play in providing credit and liquidity to the financial system and the real economy, we fully appreciate and respect the setting of minimum capital rules by bank supervisors. Minimum regulatory capital rules -- set at a reasonable solvency standard -- promote safety and soundness, provide a basis for potential supervisory intervention, help protect insurance funds, and establish a foundation for peer analyses of financial strength.

The suggested regulatory framework is based off of a single factor credit risk model, which generates results that are reasonably accurate. However, this simple approach can not be expected to capture all of the nuances of a complex portfolio. In particular more sophisticated simulations such as those used in internal capital models are needed to capture effects such as diversification and concentration.

Ultimately, the most effective and efficient way to reduce the divergence between regulatory rules and market practice is to allow banks to fully utilize their internal models in the process of measuring their regulatory capital requirements. For banks that demonstrate they have robust risk management and measurement processes, this would provide the best way for supervisors to ensure that regulatory capital reflects the true dimensions of a bank's credit risk, including credit quality, maturity, correlations and concentrations. The Committee has recognized the value of leveraging banks' modeling capabilities in developing the AMA for operational risk. The Committee previously recognized the value of leveraging banks' internal models in adopting the Market Risk Amendment to the current Capital Accord (Basel I). A full internal models approach to credit risk is where the Committee should be headed. Recognizing that supervisors are not prepared at this stage to fully endorse the use of credit risk models, we welcome the A-IRB as a significant step in that direction.

We hope supervisors share our view that the optimization of capital allocation decisions must be left to bank management if we are to fully realize the benefits of our market-driven financial system. For well-run banking organizations, minimum regulatory capital rules should not be a binding constraint in the normal course of business.

With this framework in mind, we are concerned about the cumulative effect of conservative decisions that move Basel II away from being true "minimum standards". Our sense is that this development largely reflects the Committee's attempt to create a risk sensitive regulatory capital regime while at the same time holding the amount of regulatory capital in the banking system roughly constant.

Examples of such decisions will be discussed throughout JPMC's response to the specific ANPR questions. A few examples are highlighted here.

- The 99.9% confidence interval used for credit and operational risk is conservative in light of regulator's goal to set a minimum solvency standard consistent with an investment grade rating. This standard is closer to the interval a well-capitalized AA bank would use for internal economic capital.

- An expectation that LGD and EAD estimates will be more conservative than "through-the-cycle" estimates.

- Asset value correlations (AVCs) for retail products remain above industry standards. In the case of residential mortgages, for example, the 0.15 value used is 1.5 times the industry median.

- A highly conservative maturity adjustment for transactions under one-year, including the requirement to use one-year PDs except in limited circumstances.

- There is insufficient recognition given to the benefits of credit hedging.

We recognize that these choices apply to the setting of the Total Capital requirement and that only half of that must be met with Tier 1 Capital. We note, however, that in the United States banks are already subject to a minimum standard that is 50% above the Basel minimum (Basel 4% Tier 1 ratio vs. Well-Capitalized 6% Tier 1 ratio). As a result, there are knock-on effects if Basel II minimum requirements are set too high.

The QIS 3 results showed significant divergence regarding the impact of Basel II on banks' risk weighted assets relative to Basel I. It should be noted, in regard to the second bullet point above, that most banks were unable to make their QIS3 measurements using recessionary values for LGD or EAD inputs. Recessionary parameter values are not currently available and in most cases there is a lack of adequate data to generate them with a reasonable level of statistical accuracy. Some practitioners estimate that using these stressed inputs could increase the QIS3 capital results as much as 40%.

An important analysis relates to how Basel II compares to banks' internal economic capital allocations. The experience of many large banking organizations with QIS 3 showed that Basel II Tier 1 capital requirements exceeded, or came very close to exceeding, internal economic capital allocations in certain wholesale and retail portfolio segments, even though the banks tended to target a higher solvency standard than the Committee's. This strongly suggests that the sum total of the decisions the Committee has taken, in combination with its targeted solvency standard, result in regulatory rules that could become binding for well-run banks in the normal course of business.

Throughout this ANPR response letter we suggest modifications that we believe move in the direction of addressing this general concern. With respect to the targeted solvency standard, we understand that the Committee chose the 99.9% confidence level as the basis for a solvency standard that is consistent with a solid investment grade rating. We support the attempt to set a minimum solvency standard that is investment grade. However, we observe that this confidence level implies a loss frequency that is considerably lower than that associated with a

BBB/BBB+ rating and a true minimum standard. Accordingly, we recommend a review of this critical parameter choice to target a solvency standard that is more consistent with the BBB/BBB+ rating level, such as 99.5%.

A similar principle should be applied throughout the decision-making process around the new capital rules. Parameter choices and operational requirements should be set to achieve a true minimum standard, not to solve back to an existing capital level. To be sure, any one choice should be reviewed in the context of the other decisions that have been made with respect to the calculation of risk-weighted assets and eventually the definition of capital. Ultimately, banking organizations and bank supervisors must be comfortable that Basel II creates a regulatory standard that, on balance, is truly a minimum standard.

P. 25 Should the A-IRB capital regime be based on a framework that allocates capital to EL plus UL, or to UL only? Which approach would more closely align the regulatory framework to the internal capital allocation techniques currently used by large institutions? If the framework were recalibrated solely to UL, modifications to the rest of the A-IRB framework would be required. The Agencies seek commenters' views on issues that would arise as a result of such recalibration.

We applaud supervisors for the decision to convert the Basel II framework to a UL only model, announced in the press release following the Basel Committee's recent Madrid meeting. Within the new framework, supervisors will also be able to adjust capital for a bank's ability to cover EL with ALLL. As a general matter, US banks cover EL through reserving practices. Accordingly we would not be troubled by such a capital adjustment. We would like to point out, however, that banks also anticipate a certain amount of losses in their pricing decisions. Supervisors previously recognized this point by reflecting the benefit of Future Margin Income (FMI) in the credit card capital framework. As a conceptual matter, we believe supervisors should be consistent in recognizing all available financial resources to cover losses, however the Committee defines them in Basel II.

The Committee has proposed to compare expected losses to provisions for loan losses, and deduct any shortfall in provision from capital (50% from Tier I and 50% from Tier 2). Any excess provision would be counted as Tier 2 capital, up to a limit of 20% of total Tier 2 capital. We believe that excess provision should be counted as Tier 1 capital, or at the very least 50% should be treated as Tier 1, so excesses and shortfalls are treated symmetrically.

Wholesale Exposures

P. 29 The Agencies seek comment on the proposed definition of wholesale exposures and on the proposed inputs to the wholesale A-IRB capital formulas. What are views on the proposed definitions of default, PD, LGD, EAD, and M? Are there specific issues with the *standards for the quantification of PD, LGD, EAD, or M on which the Agencies should focus?*

PD

The definition of default should be simplified to correspond more closely to that commonly used by risk managers. Default for the corporate model should be entry into non-accrual or charge-off status. The definition of default for the retail model should be consistent with the Uniform Retail Credit Classification standards published by the FFIEC. A unique regulatory definition of default would not make capital more risk sensitive. It would simply shift the accounting for losses from an LGD parameter setting to a PD parameter setting. This policy would require a lot of work on the part of banks without adding any meaningful risk sensitivity benefit.

LGD

We do not support the requirement to use model input parameters (LGD and EAD) that are measured during recessionary periods of the credit cycle. Correlation effects between PD and LGD should be handled in portfolio simulation models, but short of this level of sophistication we do not know of a simple way to capture the effect. The requirement to hold stressed levels of capital at all times is inappropriate for a minimum capital standard.

There are also practical concerns. We do not believe there is sufficient data to make statistically relevant measurements from observations taken exclusively during recessionary periods.

As a workable alternative, we suggest the use of long-run default-weighted measurements. The default weighting will automatically impose a reasonable measure of conservatism by emphasizing stressed periods in the credit cycle.

Maturity

We strongly believe that the regulatory capital requirement should reflect the effective remaining maturity of all transactions, including above five years and below one year. Please see a more complete discussion on this topic in the response concerning the maturity adjustment.

P. 33 If the Agencies include a SME adjustment, are the $50 million threshold and the proposed approach to measurement of borrower size appropriate? What standards should be applied to the borrower size measurement (for example, frequency of measurement, use of size buckets rather than precise measurements)?

Does the proposed borrower size adjustment add a meaningful element of risk sensitivity sufficient to balance the costs associated with its computation? The Agencies are *interested in comments on whether it is necessary to include an SME adjustment in the A-IRB approach. Data supporting views is encouraged.*

We do not expect the borrower size adjustment to have a large impact at JPMC. In order to get a worthwhile benefit for our middle market loan portfolio the threshold would need to be raised to a value of at least $200mm.

Currently the influence of borrower size is captured in our internal capital calculations through the KMV asset correlations that are used in the portfolio simulations. More generally, for other purposes such as pricing or risk management JPMC typically uses correlations that have either been measured from equity time series or obtained from KMV. We believe these correlation values to be more appropriate than those implied by the inverse PD correlation assumption in the A-IRB framework. This is yet another reason to commend the methodology being used by banks for internal capital calculations. We recognize that these correlation measurements cannot easily be adopted into a regulatory framework. However, we suggest that a correlation formula based on firm size would be preferable to the currently proposed inverse PD relationship.

As a firm's size grows, diversification will cause the idiosyncratic risk component to reduce and the systematic risk component to increase. Under normal circumstances, the weak relationship between correlation and default probability is probably just a reflection of the tendency for larger companies to be highly rated. The following data supports this theoretical argument. These numbers would suggest that size is more strongly tied to correlation than PD.

Table 5B2. Calibrated Average Asset Correlations at the 99.9% Percentile for the U.S. Portfolios based on EDF and Asset Size Categories

Asset Size Categories	EDF Categories (%)		
	0.00% to 0.52 %	0.52% to 6.94%	6.94% to 20.00%
$0 mm to $100 mm	0.1375	0.1250	0.1250
$100 mm to $1,000 mm	0.1875	0.1875	0.1750
> $1,000 mm	0.3250	0.2750	0.2250

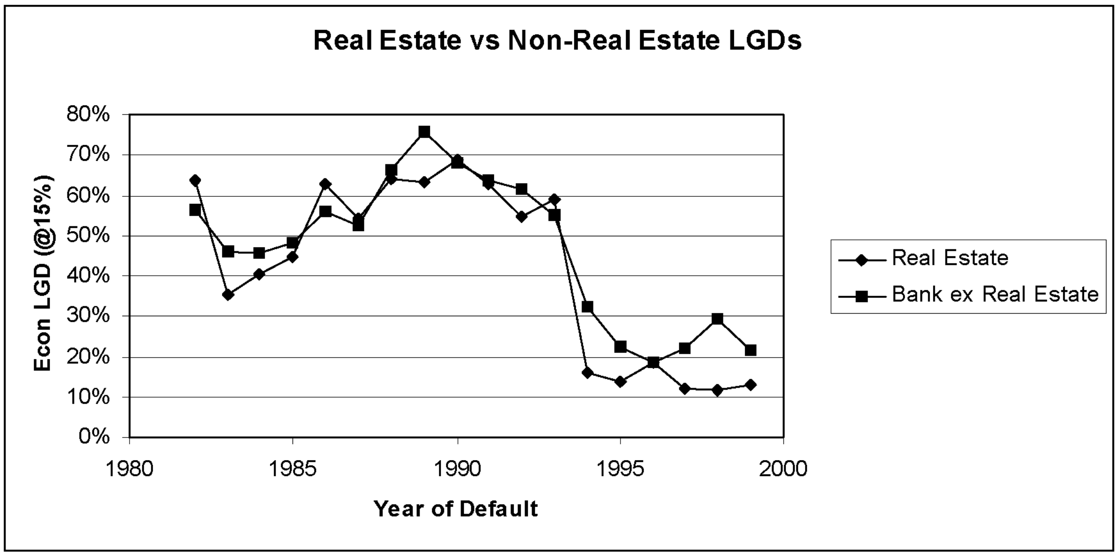
Source: Jose A. Lopez, "The Empirical Relationship between Average Asset Correlation, Firm Probability of Default and Asset Size", June 17, 2002

The adjustment should be continuous in size across the portfolio. A second, less optimal alternative would be a bucketing approach that differentiates between small business (Sales <= $10mm), middle market ($10mm < Sales < $500mm) and corporations (Sales >= $500mm). Sales size may be a logical basis on which to differentiate, however, it will probably be necessary to assess whether sales size is appropriate in all cases. It may not be appropriate, for example, for certain service businesses such as financials. While providing ease of implementation, the bucketing approach is less precise and would potentially introduce cliff effects.

P. 34 The Agencies invite comment on ways to deal with cyclicality in LGDs. How can risk sensitivity be achieved without creating undue burden?

The scarcity of data will create problems for specialized lending LGD estimations. To address this concern, supervisors should be flexible in allowing banks the use of external data without imposing unduly conservative adjustments. The requirement to estimate LGD based on data from stressed environments will be impossible to meet.

In looking at our data history for all classes of real estate, we find that there is not greater cyclicality in real estate LGDs. We examined 2,336 non-real estate LGDs and 501 real estate LGDs over the 18 year period (1982-1999) with the resultant graph:



In addition we calculated the standard deviation of LGD over the entire time period for real estate (30.9%) versus non-real estate (32.5%) and did not find them appreciably different. Looking at the standard deviation of the annual mean LGDs we find that there is somewhat more volatility of real estate LGDs (22.2%) versus non-real estate (18.2%) but hardly enough to declare that there is more cyclicality of real estate LGDs.

P. 34 The Agencies invite comment on the merits of the SSC approach in the United States. The Agencies also invite comment on the specific slotting criteria and associated risk weights that should be used by organizations to map their internal risk rating grades to supervisory rating grades if the SSC approach were to be adopted in the United States.

We do not expect to use the SSC approach at JPMC.

P. 36 The Agencies invite the submission of empirical evidence regarding the (relative or absolute) asset correlations characterizing portfolios of land ADC loans, as well as *comments regarding the circumstances under which such loans would appropriately be categorized as HVCRE.*

The Agencies also invite comment on the appropriateness of exempting from the high asset correlation category ADC loans with substantial equity or that are presold or sufficiently pre-leased. The Agencies invite comment on what standard should be used in determining whether a property is sufficiently pre-leased when prevailing occupancy rates are unusually low.

The Agencies invite comment on whether high asset correlation treatment for one- to four-family residential construction loans is appropriate, or whether they should be included in the low asset correlation category. In cases where loans finance the construction of a subdivision or other group of houses, some of which are pre-sold while others are not, the Agencies invite comment regarding how the "pre-sold" exception should be interpreted.

The Agencies invite comment on the competitive impact of treating defined classes of CRE differently. What are commenters' views on an alternative approach where there is only one risk weight function for all CRE? If a single asset correlation treatment were considered, what would be the appropriate asset correlations to employ within a single risk-weight function applied to all CRE exposures?

> We believe that high or low correlation real estate exposures can only be characterized as such in the context of the rest of the real estate portfolio as well as the rest of the entire firm's credit portfolio. Thus, if the real estate is concentrated geographically and further by improvement type there may be high correlations. We would suggest that the HVCRE be shifted to Pillar 2 (Supervision).
>
> One needs to be careful not to always associate riskier (or less risky) exposures with high or (low) asset correlations. Riskiness would be assessed as part of the PD and LGD determination. For example, the correlations of underlying asset values are not a function of the amount of equity in a project. Asset correlations are more closely tied to the type of property being constructed and its relationship to the national business cycle along with local factors. The relationship of asset values to systemic factors appears to be significantly lower for residential as opposed to commercial real estate in spite of the degree of pre-selling or pre-leasing.

P. 37 The Agencies are seeking comment on the wholesale A-IRB capital formulas and the resulting capital requirements. Would this approach provide a meaningful and appropriate increase in risk sensitivity in the sense that the results are consistent with alternative assessments of the credit risks associated with such exposures or the capital needed to support them? If not, where are there material inconsistencies?

On the whole we believe the framework is directionally sensible. As with any effort on this scale, the proposal is not without its specific problems. We highlight these areas throughout this response letter.

P. 37 Does the proposed A-IRB maturity adjustment appropriately address the risk differences between loans with differing maturities?

We appreciate that the Committee has incorporated a maturity adjustment in the risk weight formula. However, the Committee has constrained the impact of the adjustment by bounding the effective maturity of transactions between one year and five years with limited exceptions. The exceptions are for financial market transactions and one-off transactions with original exposure of less than three months.

We strongly believe that the regulatory capital requirement should reflect the effective remaining maturity of all transactions, including above five years and below one year.

The determination of effective maturity can be made on the basis of any of at least three factors: the contractual end date of the transaction, the remaining cash flows in the transaction, and the demonstrable existence of a substantive, actionable credit decision available to exit the credit. With respect to the last factor, the key consideration is that capital should not be required for credit decisions a bank has not yet made.

For transactions with maturities below one year, industry analysis indicates that the capital required is excessive relative to the economic risk. The slope of the capital curve for these transactions is very flat, reflecting the fact that the formula does not properly adjust for the lower probability of default associated with the shorter time horizons. As currently designed under the A-IRB, for example, a one-month transaction where the borrower has a one-year PD of 0.03% would require 45% of the one-year capital. Our analysis, which extrapolates the PD down to reflect the likelihood of default over one month, indicates the capital for the one-month transaction should be only 13% of the one-year capital, meaning the proposed regulatory capital is too high by a factor of more than four. This problem is exacerbated as PD increases and remaining maturity decreases. For example, the regulatory capital for an exposure of one day, assuming a one-year PD of 2.00%, is 88% of the one-year capital. Imposing a one-month floor on the maturity, our analysis shows that the capital would only be 17% of the one-year capital.

It is sensible for the maturity adjustment above one year to be based on the "b-factor" which is designed to capture changes in economic value due to migration risk. However, the maturity adjustment for transactions with effective maturities below one year should be based on an adjustment to PD to reflect lower default risk. The extrapolation of the PD down to the effective maturity would replace the "b-factor".

We appreciate supervisors' concerns about potential arbitrage if banks were to continuously roll very short-term transactions simply to take advantage of lower capital requirements. However, we believe that if banks legitimately reassess their decision to extend credit on a frequent basis they should receive benefit in the capital rules. A bank's intent and practices can be adequately assessed through Pillar 2. Nevertheless, from a prudential standpoint it would seem reasonable for the Committee to subject the PD adjustment to a one-month floor, recognizing that supervisors would not be comfortable with much shorter horizons which could effectively push the associated capital requirement to zero. Please see Appendix 1 for additional details on our PD adjustment proposal.

Finally, we wish to request a clarification that settlement exposures for transactions such as foreign exchange are exempt from the capital rules, as is the case today.

Retail Exposures

P. 38 The Agencies are interested in comment on whether the proposed $1 million threshold provides the appropriate dividing line between those SME exposures that banking organizations should be allowed to treat on a pooled basis under the retail A-IRB framework and those SME exposures that should be rated individually and treated under the wholesale A-IRB framework.

The Agencies should permit substantial flexibility in determining the dividing line so that institutions are not arbitrarily required to revise their current practices, including underwriting and scoring, to conform to a rigid threshold. This would add cost and complexity to implementation without any significant benefit. Generally, any group of small business exposures for which the credit decision is based on scoring models should qualify for "other retail" treatment.

P. 40 In addition, the Agencies are proposing to define a retail default to include the occurrence of any one of the following three events if it occurs prior to the respective 120- or 180-day FFIEC policy trigger: (1) a full or partial charge-off resulting from a significant decline in credit quality of the exposure; (2) a distressed restructuring or workout involving forbearance and loan modification; or (3) a notification that the obligor has sought or been placed in bankruptcy.

We do not agree with the above proposal, which seems to differ from the existing FFIEC guidelines. In our credit card business, for example, we currently recognize chargeoffs in accordance with FFIEC guidelines. All the loan loss data that we produce is based on those underlying rules, e.g. we contractually chargeoff accounts once they are 180 days past due; we charge off an account within 60 days of receiving the bankruptcy filing notification. The additional criteria go beyond FFIEC rules and create ambiguity. Based on how ANPR reads, we understand that we would have to recognize a bankruptcy immediately at filing which is not consistent with what we do today. Furthermore, these additional rules for Basel II would create significant data processing issues. Also, the definition of a distressed restructuring, as put forth by ANPR, can have many meanings. For example, it could include accounts that are in consumer credit counseling. While we understand that these types of accounts should be treated differently when calculating capital requirements, our current and accepted practice does not treat these types of accounts as "defaults".

P. 41 The Agencies are interested in comments and specific proposals concerning methods for incorporating undrawn credit card lines that are consistent with the risk characteristics and loss and default histories of this line of business.

The Agencies are interested in further information on market practices in this regard, in particular the extent to which banking organizations remain exposed to risks associated with such accounts. More broadly, the Agencies recognize that undrawn credit card lines are significant in both of the contexts discussed above, and are particularly interested in views on the appropriate retail IRB treatment of such exposures.

We believe the data-driven approach, as defined in the proposal, using historical information on EAD and LGD adequately captures the actual behavior of consumer usage of undrawn lines. We believe it is appropriate to incorporate losses associated with undrawn lines directly into EAD or LGD calculations based on actual historical experience.

We also note that EAD estimates for certain segments should not be constrained to be larger than current exposure. That is, we have found solid evidence that the credit management process often results in an exposure at default that is less than the outstanding amounts a year prior.

P. 42 For the QRE sub-category of retail exposures only, the Agencies are seeking comment on whether or not to allow banking organizations to offset a portion of the A-IRB capital requirement relating to expected losses by demonstrating that their anticipated FMI for this sub-category is likely to more than sufficiently cover expected losses over the next year.

As stated, we concur with the recent Basel Committee decision to focus on UL in capital requirements across all retail products. We view this as the most appropriate conceptual approach. We note that expected losses are typically covered by credit provisions, and are also built into loan pricing.

The Agencies are seeking comment on definitions of the retail A-IRB exposure category and sub-categories. Do the proposed categories provide a reasonable balance between the need for differential treatment to achieve risk sensitivity and the desire to avoid *excessive complexity in the retail A-IRB framework? What are views on the proposed approach to inclusion of small business exposures in the other retail category?*

The definition of the retail exposure category appropriately recognizes that such exposures are fundamentally characterized by the use of automated decision tools and analytical models used to compute credit scores rather than individual credit analysis. To the extent that loans to small businesses are credit scored and can be treated as a pool, similar to retail, inclusion of these exposures in the other retail category appears appropriate.

However, small business credit card accounts should be included within the QRE category, since they are more like consumer credit card exposures. The size of the credit lines offered, our underwriting procedures and the structure of our legal agreements for our small business product are very similar to that of our consumer credit cards.

As to whether the three retail sub-categories are adequate, it is important to note that once EL is excluded for all retail products, the primary difference between the three formulae lies in the different AVC assumptions. As noted by the Risk Management Association (RMA) in their letter to the Federal Reserve Bank of New York of February 26, 2003, we remain concerned about level of capital implied by the correlations used in the retail formulae. The resulting capital requirements generally exceeded internal economic capital calculations used by the institutions participating in the RMA study. This is due in part to the fact that the asset value correlations (AVC) used in the three risk-weight functions are generally higher than the values used by the industry for internal capital allocation purposes. In particular, the 15% AVC for mortgages is much higher that the 6% to 10% range shown in the RMA study. For the two non-mortgage formulae, which use a sliding scale AVC, the unanimous view of the RMA study participants was that the AVC was too high for the best quality customers, i.e. those customer segments with the lowest probability of Default (PD).

We recommend lower AVC for the low PD range of the non-mortgage formulae, and a lower AVC for mortgages overall, consistent with the RMA study.

The Agencies are also seeking views on the proposed approach to defining the risk inputs for the retail A-IRB framework. Is the proposed degree of flexibility in their calculation, including the application of specific floors, appropriate? What are views on the issues associated with undrawn retail lines of credit described here and on the proposed incorporation of FMI in the QRE capital determination process?

We appreciate the degree of flexibility outlined in the ANPR with respect to the determination of appropriate risk drivers and degree of segmentation. We do not agree, however, that floors on PD or LGD are necessary or desirable, particularly the 10% floor on LGD for mortgages. This runs counter to the use of appropriate data-driven calculations that are grounded in the actual PD and LGD of each risk segment.

The Agencies are seeking comment on the minimum time requirements for data history and experience with segmentation and risk management systems: Are these time requirements appropriate during the transition period? Describe any reasons for not being able to meet the time requirements.

In general, the 5-year data requirement for PD, LGD and EAD is reasonable. There may be situations for some portfolios where it is more cost-effective to accumulate the necessary data on a going-forward basis rather than reconstruct past history. Consequently, we believe some modest flexibility should be permitted in meeting the 5-year requirement. In addition, for recently or newly purchased portfolios, where complete historical data may not be available from the seller, there will be a need for some interim approach.

The requirement for 3 years of segmentation and risk systems experience will be more difficult to meet under a strict interpretation, since this implies full compliance with certain requirements in 2004. We suggest that standards allow for the fact that this period will be a learning curve during which institutions may be upgrading their information systems and risk management techniques.

P. 44 The Agencies also seek comment on the competitive implications of allowing PMI recognition for banking organizations using the A-IRB approach but not allowing such recognition for general banks. In addition, the Agencies are interested in data on the relationship between PMI and LGD to help assess whether it may be appropriate to exclude residential mortgages covered by PMI from the proposed 10 percent LGD floor. The Agencies request comment on whether or the extent to which it might be appropriate to recognize PMI in LGD estimates.

A data-driven approach to LGD estimation should capture the impact of the presence or absence of PMI and, for that matter, government mortgage insurance or guarantees.

Imposition of an arbitrary 10% floor on LGD appears to us to be unnecessary and contrary to the concept of empirical determination of risk. Consequently, we do not believe a floor should be imposed, irrespective of PMI considerations. Having said this, any exclusion from such a floor would be a positive development and PMI protection would seem to provide the most appropriate exclusion, consistent with the thinking surrounding the imposition of a floor, notwithstanding its flawed nature. Again, we believe that a data-driven approach is the most sound, robust and stable means to capital regulation in this and other applications.

To the extent that institutions base their pricing decisions on economic capital today, and will continue to do so in the future, we do not see or believe there are any significant competitive implications to PMI recognition for A-IRB banks versus other institutions. This assessment flows from the broad application of PMI by all firms originating mortgages, the universal PMI requirements imposed by market-making institutions (the GSEs), and the competitive nature of PMI pricing across institutions.

More broadly, the Agencies are interested in information regarding the risks of each major type of residential mortgage exposure, including prime first mortgages, sub-prime mortgages, home equity term loans, and home equity lines of credit. The Agencies are aware of various views on the resulting capital requirements for several of these product areas, and wish to ensure that all appropriate evidence and views are considered in evaluating the A-IRB treatment of these important exposures.

We believe the credit risks associated with holding prime first mortgages are well-understood. The data history on this product is long-standing and robust, making PD and LGD predictable within a very small margin of error by utilizing ever more advanced statistical techniques and technology.

Although the data is somewhat less broad and deep for home equity loans and lines, this small disadvantage is offset in the nature of home equity lending, which is based more on ability to repay (cash-flow lending) than on collateral (equity lending). The robust nature of credit history analysis as applied in the credit card industry greatly assists firms in estimating home equity PD, which is of greater significance than LGD in this type of lending.

Subprime mortgages constitute a much smaller market than either of the above. Credit risk is significantly more operative, given the lack of consistent historical credit standards and the resultant relative lack of data for building predictive models. These aspects are reflected in both the securitization structures common to this asset and the more direct risk management role of subprime mortgage underwriters. Securitization agreements and trustees require close monitoring of delinquencies and defaults, along with the related cash or collateral funding of the sub-structures required to protect bondholders. Credit risk management is further aided by the relatively short life of subprime mortgages, driven by the strong pricing incentives for the mortgagor to "climb the credit ladder" at the first opportunity.

The risk-based capital requirements for credit risk of prime mortgages could well be less than one percent of their face value under this proposal. The Agencies are interested in evidence on the capital required by private market participants to hold mortgages outside of the federally insured institution and GSE environment.

The Agencies also are interested in views on whether the reductions in mortgage capital requirements contemplated here would unduly extend the federal safety net and risk contributing to a credit-induced bubble in housing prices. In addition, the Agencies are *also interested in views on whether there has been any shortage of mortgage credit under general risk-based capital rules that would be alleviated by the proposed changes.*

> Under our own economic capital analysis as currently applied, and given the predictability of mortgage defaults as discussed above, we are comfortable with capital requirements for prime mortgage and home equity lending of less than one percent. This predictability emphasizes EL and thereby minimizes UL, indicating appropriately low credit risk capital levels for these assets. We believe such a level would more closely align economic and regulatory capital and would not, therefore, have any significant negative competitive implications or raise problems with regard to the extension of the federal safety net. We have seen and would expect no evidence of a mortgage credit shortage.

P. 46 The Agencies are interested in views on whether partial recognition of FMI should be permitted in cases where the amount of eligible FMI fails to meet the required minimum. The Agencies are also interested in views on the level of portfolio segmentation at which it would be appropriate to perform the FMI calculation. Would a requirement that FMI eligibility calculations be performed separately for each portfolio segment effectively allow FMI to offset EL capital requirements for QRE exposures?

> See previous comments on EL and FMI in response to the question on page 42.

P. 48 The Agencies are seeking comment on the retail A-IRB capital formulas and the resulting capital requirements, including the specific issues mentioned. Are there particular retail product lines or retail activities for which the resulting A-IRB capital requirements would not be appropriate, either because of a misalignment with underlying risks or because of other potential consequences?

> Because the AVC for other retail varies with PD, and is highly non-linear for low PD values, certain very high quality loan portfolios, such as high quality auto loans, attract disproportionately higher capital relative to underlying risk. This appears to create a potential disincentive for high quality borrowers and is an undesirable signal to banks from a policy perspective.

<u>A-IRB: Other Considerations</u>

P. 49 The Agencies recognize the existence of various issues in regard to the proposed treatment of ALLL amounts in excess of the 1.25 percent limit and are interested in views on these subjects, as well as related issues concerning the incorporation of expected losses in the A-IRB framework and the treatment of the ALLL generally. Specifically, the Agencies invite comment on the domestic competitive impact of the potential difference in the treatment of reserves described.

P. 49 The Agencies seek views on this issue, including whether the proposed U.S. treatment has significant competitive implications. Feedback also is sought on whether *there is an inconsistency in the treatment of general specific provisions (all of which may be used as an offset against the EL portion of the A-IRB capital requirement) in comparison to the treatment of the ALLL (for which only those amounts of general reserves exceeding the 1.25 percent limit may be used to offset the EL capital charge).*

Please see the earlier UL discussion arising from the question posed on page 25.

<u>Purchased Receivables</u>

P. 52 The Agencies seek comment on the proposed methods for calculating credit risk capital charges for purchased exposures. Are the proposals reasonable and practicable?

JPMC will have trouble fulfilling the current data standards for purchased receivables.

- Our purchased receivable data is exclusively collected on a pooled basis. While this may be satisfactory for retail pools, assets such as trade receivables may not qualify for the top-down approach. Trade receivables follow S&P criteria for concentration limits and reserve levels. The concentration limits are generally based on ratings with exceptions given to certain "Special Obligors". This is standard practice for the industry. Supervisors should follow the same guidelines when setting criteria for use of the top-down approach.

- The data typically tracked in purchased receivable pools does not necessarily correspond to the inputs required for Basel II capital formulas. In particular, this business typically tracks losses rather than PD and LGD.

- Substantiating any of the inputs with five years of historical information will typically not be possible under current practices. Currently, the initial pools generally contain somewhere between one and three years of history.

The conduit business has risk managed this business using their own framework with outstanding results. Losses have been de minimus. This should indicate that the conduit risk management processes (including the risk information being tracked) is effective and sufficient. It is difficult to generalize purchased receivable risk management practices since each pool has its own distinct features. However, the following points attempt to broadly summarize the risk management of this business.

- At inception many pool characteristics are considered, the most important of which is the loss history. The amount of history required varies with the type of receivable asset. The business requires the over-collateralization (OC) to be able to withstand some multiple of the worst loss performance demonstrated in the historical data. Additional OC buffers are required depending on the particular assets or the seller. The particular buffer multiple follows published S&P methodology which sets gross-up factors based on the desired rating. The business generally targets a Single-A internal rating, but this could vary depending on the Seller or the receivables. Sometimes this rating is formalized by a rating agency, but not always.

- The business conducts an extensive review of the pool attributes at the inception of the deal to establish an appropriate level for OC. With some asset classes (but not all) the OC level is dynamic, varying each month with some multiple of the current default and dilution loss levels. Once the deal is live the business monitors various risk attributes, but these quantities are all measured on a pooled basis. The business also relies on eligibility tests, concentration limits, enhancement grids, and termination events to maintain the credit quality of the pool.

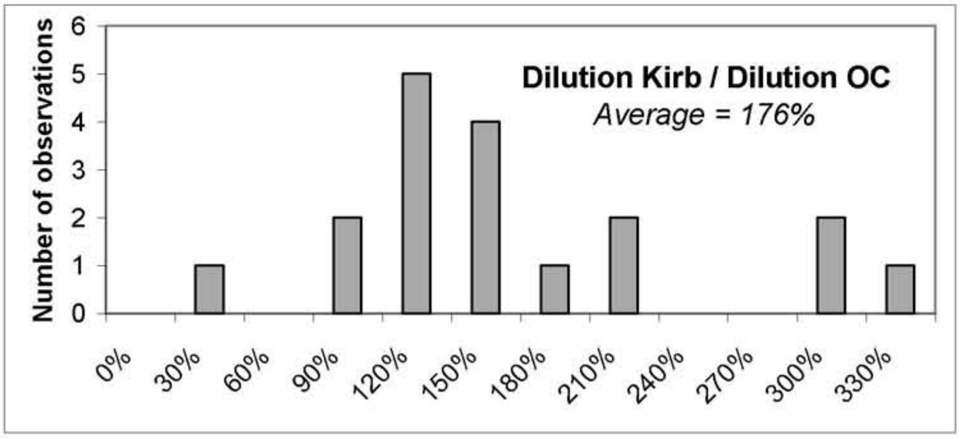
For committed revolving purchase facilities, is the assumption of a fixed 75 percent conversion factor for undrawn advances reasonable? Do banks have the ability (including relevant data) to develop their own estimate of EADs for such facilities? Should banks be permitted to employ their own estimated EADs, subject to supervisory approval?

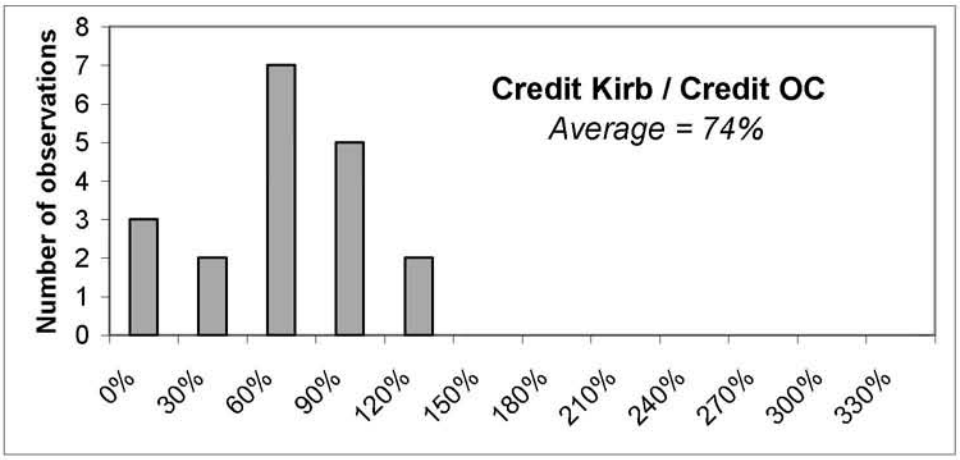
It is difficult to opine on an appropriate EAD value considering our experience to date. We do not have loss history on purchased receivables as an asset class. We might be able to use the loss history that generally corresponds to the types of assets within a particular pool, but even some of that general data would have to come from outside sources.

P. 53 The Agencies seek comment on the proposed methods for calculating dilution risk capital requirements. Does this methodology produce capital charges for dilution risk that seem reasonable in light of available historical evidence? Is the corporate A-IRB capital formula appropriate for computing capital charges for dilution risk?

In particular, is it reasonable to attribute the same asset correlations to dilution risk as are used in quantifying the credit risks of corporate exposures within the A-IRB framework? Are there alternative method(s) for determining capital charges for dilution risk that would be superior to that set forth above?

We looked at 18 pools of trade receivables to measure the ratio of Kirb to the over-collateralization levels required by S&P rating methodology for Single-A rated liquidity facilities. The measurements were made for credit and dilution components separately. We found that the dilution results are systematically higher (average Dilution_Kirb / Dilution_OC = 176%) than the credit results (average Credit_Kirb / Credit_OC = 74%). The following histograms show the ratio results for 18 facilities.





At JPMC we follow S&P guidelines for setting OC levels for both credit and dilution. Based on the S&P methodology, which is the industry standard, these results suggest that the Basel capital requirement for dilution losses is significantly higher than for credit losses.

P. 54 The Agencies seek comment on the appropriate eligibility requirements for using the top-down method. Are the proposed eligibility requirements, including the $1 million limit for any single obligor, reasonable and sufficient?

Please see response to the question posed on page 52 above.

The Agencies seek comment on the appropriate requirements for estimating expected dilution losses. Is the guidance set forth in the New Accord reasonable and sufficient?

Please see response to the question posed on page 53 above

<u>Credit Risk Mitigation Techniques</u>

P. 57 The Agencies seek comments on the methods set forth above for determining EAD, as well as on the proposed backtesting regime and possible alternatives banking organizations might find more consistent with their internal risk management processes for these transactions.

We believe that VaR Models should be validated through the supervisory framework rather than through the use of a rigid back-testing regime. The proposed back-testing methodology is operationally burdensome. The Federal Reserve has recently allowed for the use of VaR models to determine risk-based capital requirements without imposing a specific regime. We question why supervisors are creating a more prescriptive standard for credit risk on repo-style transactions.

At a minimum, banks should be allowed the flexibility to use (i) a hypothetical portfolio when back-testing their VaR model and (ii) a static sample of counterparties each quarter rather than adjusting the sample on a daily basis.

ISDA research has indicated that the back-test multipliers are unnecessarily punitive. The methodology set out in the 1996 Market Risk Amendment produces significantly lower multipliers than those currently proposed under this regime. We would like to understand the justification for the higher calibration.

Netting arrangements should not be a pre-requisite for using the VAR methodology. Transactions do not move simultaneously against a financial institution. Portfolio diversification will act to mitigate risk whether or not a netting agreement is in place.

There should be a higher level of conformity than suggested thus far in the capital calculations for products that exhibit similar economic risks, notably repo-style transactions and OTC derivatives. It is not clear from a risk perspective why supervisors would restrict the use of a VaR approach to repo-style transactions. We would also like to understand why repos would be allowed to adjust EAD in order to reduce exposure for collateral, while derivatives are required to adjust LGD. Our internal practice is to adjust EAD for both products.

P. 57 The Agencies also request comment on whether banking organizations should be permitted to use the standard supervisory haircuts or own estimates haircuts methodologies that are proposed in the New Accord.

We greatly appreciate the broadened recognition of collateral in the New Accord. The revised treatment of collateral will better align industry and regulatory practice for this critical credit risk mitigation tool.

We support the use of collateral haircuts that are determined internally. Large highly rated banks such as JPMC tend to collect more collateral than they pledge. As a net collateral receiver, our incentives to use fiscally sound haircuts are aligned with those of the supervisors. It therefore makes sense to rely on a bank's internal practices, subject to regulatory oversight. It would be difficult, however, for us to change collateral arrangements that are already in place, especially since (i)_ many of our collateral arrangements follow common market practices, and (ii) the majority of our counterparties will not be Basel II compliant entities.

The ANPR does not reiterate all of the collateral details specified in CP3. It is not clear if this means U.S. Agencies have yet to map out that level of detail, or if they are proposing to adopt a more flexible approach. For the record, we would like to point out certain requirements in CP3 which are not in line with our internal collateral policies.

- Paragraph 125 of CP3 implies that non-investment grade or unrated corporate bonds would not be eligible collateral, even for banks that qualify to use their own haircuts. Paragraph 129 of CP3, which requires banks using their own haircuts to take into account the liquidity of lower quality assets, addresses the supervisory concern that banks might not be able to easily liquidate such collateral. The liquidity of collateral is a key consideration in the assignment of our internal haircuts. The exclusion of non-investment grade corporate debt altogether is unduly harsh in light of this practice, which is standard at well-managed firms. We strongly recommend that US supervisors make all securities eligible for use of own haircuts if a bank has qualified for the A-IRB. No distinctions should be made as to whether the underlying exposures are in the banking book or trading book.

- CP3 requires a separate assessment for foreign exchange risk even for banks under the A-IRB that will be setting their own haircuts. The separate assessment of foreign exchange risk presents problems from an implementation standpoint given that we apply a portfolio view to collateral. This view is consistent with the way in which our collateral arrangements are legally documented. It appears that the proposal essentially requires banks to look at each transaction to determine whether there is a currency mismatch. For our largest counterparties we may have thousands of transactions, which would make such an approach infeasible. Our practice is to agree with our counterparty on a schedule of eligible collateral assets and applicable haircuts. Eligible collateral can include US dollar cash and securities and certain non-US dollar cash and securities. Most non-US dollar collateral is in euros, yen, and pounds, where there is generally low volatility over the short period of the exposure. The counterparty can cover its collateral requirements for its net exposure by delivering any of the eligible assets. We do not separately try to identify a currency mismatch. It would be helpful if supervisors clarified whether their intent is to require banks to assess foreign currency mismatches on a transaction basis – we believe this is neither market practice nor feasible as a practical matter.

- CP3 requires banks to use a 99% confidence level in setting their own collateral haircuts. While it is, of course, the prerogative of supervisors to set the prudential standard, the Committee should be aware that we do not typically use such a high confidence level in setting our internal haircuts. We typically use a 97.5% confidence level for derivatives collateral and for securities lending.

- A potential competitive issue here underscores the importance of applying similar rules to financial firms engaged in similar businesses. For example, our principal competitors for swap business are the non-bank investment firms, and the largest collateral arrangements in the derivatives arena are between dealers. If Basel II banks must impose more stringent haircuts on their dealer counterparts in the future, it is possible the dealers will do more business with other non-bank dealers as the cost of doing business will be cheaper.

Although we expect to apply the A-IRB, we wish to call your attention to a potential unintended consequence of a set of collateral haircuts imposed by regulation for those banks that will not be using their own haircuts. There is some risk that the regulatory standard haircuts might become the basis on which certain market participants try to negotiate more lenient collateral arrangements. For example, banking organizations like ourselves might want to impose more onerous haircuts than those in the Standardized/Foundation IRB proposal to satisfy our own internal haircut policies (e.g. for short-term sovereign debt). We would not like to see our counterparties use a regulatory standard to negotiate for lower haircuts and thus inhibit our business practices or relationships. It would be helpful for supervisors to emphasize that the regulatory haircuts are for purposes of satisfying minimum regulatory capital requirements and are not meant to substitute for sound market practice.

We recommend that any modifications to the current approach properly recognize the risk-reducing effects of collateral support agreements, which require the delivery of collateral upon the breach of pre-agreed thresholds, thereby reducing potential future exposure.

We recommend that supervisors permit VaR modeling for transactions that are marked to market and margined or collateralized daily and meet high standards of legal enforceability. We also would expect banks applying this approach to make appropriate adjustments for less liquid collateral.

Our commercial lending businesses, in particular Middle Market, frequently lend money secured by tangible assets such as accounts receivable, inventory, and machinery and equipment. The ANPR sets forth requirements for collateral management which imply uniformly high levels of ongoing monitoring and valuation in order to obtain any improvement in LGD. We believe that this may not be either realistic or appropriate in all circumstances, and that the degree of benefit ascribed to collateral in assigning LGDs should be flexible. Such benefit should give recognition to the particular risk elements and collateral arrangements in each transaction. The frequency of collateral monitoring and re-appraisal of assets is a function of numerous factors including the quality of the asset class, the amount of collateral relative to the loan, the financial strength of the borrower, and the structure of the facility in question. It is not clear that the ANPR allows for this necessary degree of flexibility.

For example, in some situations with a weak borrower we might structure a facility with a borrowing formula based on net forced liquidation values, weekly or even daily reporting, regular field examinations, and dominion of cash. In this situation a high degree of collateral benefit would be reflected in a significant adjustment of the LGD. In other situations with stronger borrowers (but not strong enough to warrant an unsecured loan), we might structure a looser collateral arrangement with conservative loan to value ratios based on initial appraisals only with reliance on amortization and covenants to keep the loan to value relationship on an improving trajectory. In this sort of situation, we would ascribe a lower (but not zero) degree of collateral benefit and the adjustment of the LGD would be commensurately less. Finally, we note that a bank's legal right to take possession of and liquidate this type of collateral may be delayed by the "stay" provisions of the Federal bankruptcy laws. Provided that the LGD protocols take this factor into account, we do not believe that this should preclude some degree of benefit being recognized in the assignment of the LGDs.

P. 58 Industry comment is sought on whether a more uniform method of adjusting PD or LGD estimates should be adopted for various types of guarantees to minimize inconsistencies in treatment across institutions and, if so, views on what methods would best reflect industry practices. In this regard, the Agencies would be particularly interested in information on how banking organizations are currently treating various forms of guarantees within their economic capital allocation systems and the methods used to adjust PD, LGD, EAD, and any combination thereof.

We appreciate the ANPR's movement toward a reliance on internal procedures for determining the effects of credit hedging. However, we believe that the benefits of this flexibility will be lost when a floor is imposed at the substitution approach level.

The substitution approach does not adequately recognize the lower risk of joint default or double recovery. Based on these highly desirable features of credit hedging, we believe that the approach is inconsistent with its stated objective of promoting better risk management practices through revisions to the original Capital Accord. We are concerned that the policy will send inappropriate signals to banks about the use of credit derivatives, financial instruments that have provided enormous value to banks seeking to actively manage the risk in their credit portfolios.

As one illustration of the proposal's inadequacy, consider the case of hedging a Double-A rated entity with another unrelated Double-A entity. Using the substitution approach there would be no capital benefit. Moreover, unless there is a clarification to the contrary, our understanding is that the bank would have to add a capital charge for the counterparty exposure associated with the hedge provider. In effect the bank would be required to hold more capital than if it had not hedged at all. The substitution approach discourages the dissemination of credit risk among institutions participating in credit derivatives market, acting to further concentrate credit exposure into a handful of the most highly rated financial institutions.

For the purpose of internal economic capital measurements, JPMC's treatment of credit hedges varies with (i) the nature of the relationship between the guarantor and the borrower, and (ii) the form in which the hedge is provided.

- When the two parties are related the substitution approach is used.
- If the parties are unrelated then the approach differs between guarantees and CDS.
  - In the case of CDS, we use the hedge as a full capital offset. In its stead, we introduce a counterparty exposure to the guarantor. The measurement technique for this residual exposure captures the effects of (i) joint default probability, (ii) joint recovery, and (iii) potential wrong-way aspects for each trade. These effects are captured by use of a monte carlo simulation of correlated credit and market factors.
  - In the case of a guarantee, we replace the default probability of the original obligor with a joint default probability. Estimates of this parameter depend on asset correlations. Partial guarantees or contracts insured by multiple parties require special consideration. We would be happy to share a full description of our policy including the table of joint default probabilities upon request.

As you can see from our internal approach, we will not be able to use existing internal methodologies to satisfy the new requirement to reflect credit risk mitigation because our internal approaches rely on double default, which is not allowed in the ANPR framework. We are not aware of a viable alternative outside of the substitution approach. Clarification or suggestions would be helpful.

We would also like to understand why PD or LGD can be adjusted, but not both. They will both change with a CDS or guarantee. If supervisors are suggesting that changing both parameters would result in some form of double counting, then we respectfully disagree.

For regulatory capital purposes we would recommend the approach we take internally for a CDS provided by an unrelated entity. A bank should treat the hedge as a full capital offset for the underlying exposure and hold capital only for the counterparty exposure associated with the hedge provider. Preferably, banks would be allowed to use their own methods for incorporating double default, double recovery, and wrong-way risk into the calculation of the residual counterparty risk, subject to supervisory review. Monte carlo simulations are the most advanced methods available for capturing correlation effects such as these. This type of modeling is only practical for use as an internal application.

Failing the use of internal models, we strongly support the approach recommended in the Federal Reserve research paper which maps PDs and LGDs for obligors and guarantors into capital charges for hedged exposures using a risk weight formula similar to the existing formula for unhedged exposures - the so called "ASRF approach" which relies on asymptotic single risk factors. The research paper notes that it would be helpful for the industry to engage on issues related to the correlation assumptions that would have to be incorporated by the Committee in the ASRF approach, including on issues related to "wrong-way exposures". We have focused on these issues for some time in the evolution of our internal economic capital model and would be pleased to work with supervisors on these important parameters.

We support the suggestions contained in the following ISDA papers.

- ISDA's CP3 comment letter with respect to the operational requirements applicable to credit default swaps under Master Agreements.
- ISDA's comments on the Federal Reserve Board White Paper on the Treatment of Double Default and Double Recovery Effects for Hedged Exposures under Pillar I of the New Basel Capital Accord.

P. 60 The Agencies invite comment on this issue, as well as consideration of an alternative approach whereby the notional amount of a credit derivative that does not include restructuring as a credit event would be discounted. Comment is sought on the appropriate level of discount and whether the level of discount should vary on the basis of, for example, whether the underlying obligor has publicly outstanding rated debt or whether the underlying is an entity whose obligations have a relatively high likelihood of restructuring relative to default (for example, a sovereign or PSE). Another alternative that commenters may wish to discuss is elimination of the restructuring requirement for credit derivatives with a maturity that is considerably longer -- for example, two years -- than that of the hedged obligation.

We appreciate the flexibility in CP3 which does not require restructuring to be included as a credit event in a credit derivative contract, provided the bank has control over the decision to restructure. At the same time, we acknowledge that a contract with restructuring can provide greater coverage than one without it. For these reasons the restructuring discount seems like a sensible approach. However, we do not believe that any restructuring discount should be implemented until a reasonable amount of protection has been recognized in the first place. Placing a discount on top of the meager benefit granted by the substitution approach will almost completely nullify the effect of the credit hedge altogether.

We support ISDA's proposed methodology for determining a discount factor, which is documented in a paper issued jointly by ISDA-TBMA entitled "Proposed Discount Factor for Restructuring Risk".

ISDA made an assumption about the *probability of restructuring given default* (PRGD) of 20% and the *loss given restructuring* (LGR) of 40%. The *probability of restructuring* (PR) was then determined as the product of the obligor's probability of default (PD) and PRGD. PR and LGR were then used in the existing A-IRB methodology to get the capital charge for restructuring risk only. This restructuring risk charge is added to the residual counterparty risk of the guarantor to get the capital charge for a transaction with a hedge that does not include restructuring as a default event.

ISDA has suggested that banks use their own input assumptions for PRGD and LGR according to the bank's history of restructuring losses. We support this suggestion, as our own experience would suggest lower values for both parameters than those used in the ISDA paper.

An example in the ISDA paper illustrates the concern that a restructuring discount on top of the substitution approach results in very little benefit for a credit hedge. In the ISDA example the guarantor is of sufficiently higher credit caliber to cut the risk weight in half using the substitution approach. However, when the restructuring discount is applied in conjunction with the substitution approach the risk weight is back up to 92% of its original value.

We agree that certain types of borrowers, such as sovereigns, who are more likely to restructure than undergo any other form of default should not get credit for a hedge without restructuring.

P. 61 Comment is sought on this matter, as well as on the possible alternative treatment of recognizing the hedge in these two cases for regulatory capital purposes but requiring that mark-to-market gains on the credit derivative that have been taken into income be deducted from Tier 1 capital.

Supervisors are worried that banks are recognizing too much capital as a result of the inconsistent treatment for a loan with accrual accounting versus its CDS hedge with MTM accounting. We acknowledge the existence of an accounting asymmetry. Despite our best efforts, we are not allowed to move to a more consistent framework for reporting purposes. However, we do not believe that supervisors should attempt to solve FAS133 problems within the Basel II framework. The right approach is to fix US general accounting principals.

If supervisors were to enact this proposal then virtually no benefit could be given to credit hedging in the Basel II framework. We believe this would be a highly inappropriate policy decision.

From a safety and soundness perspective we do not believe that there is a capital advantage being granted by this asymmetry. The combination of counterparty and market risk capital on the swap, in addition to adjustments made to the ALLL for the loan counteracts any potential MTM advantage realized in the trading book. Despite this counterbalance, if some residual benefit did exist under a spread widening situation, then an equivalent penalty must arise in the spread tightening scenario. It is reasonable to expect these two effects to balance one another out over time in a large portfolio. Banks should not be penalized for one effect without being given credit for the other.

An example will help illustrate our counterbalance argument. Consider a loan fully hedged with a CDS written by an OECD bank.

Before the hedge:

- RWA = 100% x Notional for the loan

After the hedge:

- The loan will require RWA = 20% x Notional (using the substitution approach we chose a risk weight for the bank rather than the underlying name)
- Counterparty Risk Capital will be required for the CDS. It would not be unusual for this component to contribute another RWA = 10% x Notional.
- Depending on the reference name's rating and maturity, an additional capital charge will be assessed for the market risk of the CDS.
    - For Investment Grade names, a bank might base the market risk component off of an approved VAR model. A value of RWA = 10% x Notional might be indicative of the size of such a charge.
    - For High Yield names, the bank may not have an approved VAR model. If this were the case, the market risk charge for high yield names would be RWA = 100% x Notional.

If the reference name were high yield, the bank in this example would be holding more capital after the hedge (RWA = 130%) than before the hedge (RWA = 100%). Clearly no advantage exists for high yield reference names in this example. To continue exploring the case of an investment grade reference name, in this indicative example the bank would be holding RWA = 40% after the hedge rather than 100% before.

When the name's credit quality deteriorates (and hence its spread increases):

- A MTM gain will be recognized in the trading book for the CDS and hence the numerator of Tier 1 capital will increase
- To counterbalance this effect:
    - the CDS counterparty risk capital requirement will increase since the CDS is more in-the-money to the bank,
    - the market risk capital requirement will increase due to the increase in VAR, and
    - the bank's ALLL would likely increase if the credit deterioration is significant. At JPMC, the ALLL would also be modified for systemic effects, since our loan loss reserves are dependent on averaged EDF factors.

We can not say that absolutely no benefit for the bank could ever result from a spread increase due to the accounting asymmetry. However, it is clear from this example that no large benefit would result, certainly not large enough to compel a bank to choose such a cumbersome booking inconsistency for the purpose of a regulatory capital advantage.

Even if it were clarified that regulatory capital is not necessary for counterparty credit and market risk, we do not believe that the proposed adjustment is appropriate. Deducting capital for the MTM gains on the CDS in the trading book would doubly penalize banks that are recognizing the credit deterioration in the accrual portfolio through a reserving practice.

If this proposal were implemented, however, then it would only be fair to go both ways, i.e. either

- capital would be deducted for trading book gains, or
- a capital benefit would be granted for trading book losses.

Such an approach would introduce inconsistency between regulatory and general accounting practices, which supervisors and the industry have labored to avoid.

P. 61 The Agencies have concerns that the proposed formulation does not appropriately reflect distinctions between bullet and amortizing underlying obligations. Comment is sought on the best way of making such a distinction, as well as more generally on alternative methods for dealing with the reduced credit risk coverage that results from a maturity mismatch.

At JPMC, credit risk is primarily hedged from a client portfolio perspective, not on a transaction-by-transaction basis. For each client, a credit exposure profile is created through time. These profiles net exposures arising from all of the transactions across the bank with that particular client. The effect of amortizing risk is manifested in the time profile.

Client portfolio hedges are crafted to conform to the exposure profiles as closely as possible. After the hedge profile is netted against the exposure profile, any residual un-hedged exposure is converted into a set of bullet loan equivalents and charged for internal economic capital. A percentage increase is added on to the residual exposure to account for the difference between volatile derivative exposures and bullet loans.

If supervisors would adopt the approach we suggested previously (i.e. write off the hedged exposure and replace it with a counterparty exposure to the guarantor) then the portfolio view for matching hedges that we use internally could be followed for regulatory capital purposes. Any amortizing distinctions or maturity mismatches would be captured as a residual exposure to the obligor.

As currently proposed, the credit risk mitigation procedures would require us to match a particular hedge to a particular trade. We would have to perform this matching to the best of our abilities, erring on the side of conservatism and subject to supervisory review.

We do not support the suggested approach for the proportional adjustment for maturity mismatches. Under this approach, for example, a three-year hedge of a five-year loan would receive only 60% of the benefit of a five-year hedge of the same loan. Even worse, in the following year the benefit would be reduced to 50% (a two-year hedge of a four-year loan). In addition, hedges of one-year or under are not recognized if the remaining maturity of the hedged asset is longer. This treatment is far more conservative than the maturity adjustment associated with the underlying loans of equal tenors.

Given the currently proposed substitution approach we suggest that a maturity mismatch should be recognized as the difference between the capital for assets with the relevant tenors per the A-IRB formula. The bank would need to hold additional capital for the counterparty exposure associated with the hedge provider. Clearly, there is benefit to a hedge in its final year, and we strongly recommend that the Committee recognize this, even if it reduces the recognition proportionately over the course of the year.

P. 62 The Agencies are seeking industry views on the PFE add-ons proposed above and their applicability. Comment is also sought on whether different add-ons should apply for different remaining maturity buckets for credit derivatives and, if so, views on the appropriate percentage amounts for the add-ons in each bucket.

The method for calculating the capital charge for counterparty credit risk is left unchanged from today's method (i.e. current mark to market plus notional times a factor reflecting instrument and tenor). This approximate approach is inconsistent with the best practice of leading banks. We recognize that supervisors are at the early stages of reassessing this approach. We believe reevaluating this policy should be a high priority. We strongly suggest that it will be addressed by supervisors, either during any delay in finalizing the current Basel II proposals, or very soon thereafter.

The ISDA paper recently submitted to the Committee provides a useful basis on which to discuss future changes to the treatment of counterparty credit exposures, and we are committed to working with supervisors on this matter going forward. We believe that ISDA's proposal on the use of expected exposure profiles is very promising and we encourage supervisors to actively consider it. In addition, as we have been saying for some time, wrong-way exposures should be treated directly in any revised approach.

We do not apply Basel-type add-ons for the purpose of our internal economic capital. However, in the process of determining capital for counterparty risk we do gross up the exposure to account for the difference between volatile derivative exposures and bullet loans. We have studied the time dependence of these gross up factors. These studies may have some relevance for Basel-type add-ons. However, we do not believe that the over-all level of our factors has any relevance to the level of Basel-type add-ons since they are applied to completely different bases.

- Internal studies showed our factors to have a reliance on maturity. If we look at the average results by maturity bucket, ignoring all other distinctions, the values can range from 1%-2% percent for 1 year exposures to as much as 30% for some 20 year exposures.
- However, when looking at the result of using an average value as opposed to maturity specific values, we found the aggregate difference to be small. Therefore, we decided not to distinguish our factors by maturity for reasons of simplicity.

<u>Equity Exposures</u>

P. 64 The Agencies encourage comment on whether the definition of an equity exposure is sufficiently clear to allow banking organizations to make an appropriate determination as to the characterization of their assets.

We have found the definition to be sufficiently clear and the examples to be helpful in determining if an asset should be classified as equity for regulatory capital purposes. As the Agencies reserve the right to make the ultimate determination if an instrument is considered a debt or an equity position, it may be contrary to how financial instructions view such instrument. We would like to urge the regulators to continue to issue advance notices discussing its specificity prior to revising the FR Y-9C and the Call Report instructions.

P. 64 Comment is sought on whether the materiality thresholds set forth above are appropriate.

The 10% materiality threshold is reasonable; however it needs to be applied on a tiered basis. The 10% threshold would create regulatory capital dislocations for financial institutions operating near the 10% limit. In order that all banking institutions are treated equally, we recommend that the first 10% of the equity exposures be risk weighted at 100%. The incremental equity exposures, in excess of 10%, should then be subject to the internal model approach.

We strongly recommend that the investments in non-central government public-sector entities, such as the Federal Reserve Bank and the Federal Home Loan Bank stock, in which holding is conditional for membership, be excluded from the 10% materiality computation. These holdings are mandated and are not a part of the managed portfolio. Therefore, such holdings should not be included in the materiality test.

P. 65 Comment is sought on whether other types of equity investments in PSEs should be exempted from the capital charge on equity exposures, and if so, the appropriate criteria for determining which PSEs would be exempted.

The proposed exempt entities are appropriate. We have no other PSEs to recommend.

P. 65 The Agencies seek comment on what conditions might be appropriate for this partial exclusion from the A-IRB equity capital charge. Such conditions could include limitations on the size and types of businesses in which the banking organization invests, geographical limitations, or maximum limitations on the size of individual investments.

An exemption based on a dollar amount, i.e., 10% of Tier 1 plus Tier 2 capital, is reasonable and practical. The 100% risk weight is also appropriate. There should be no other criterion in determining the exemption since these investments are already highly regulated and closely monitored by the governing bodies.

P. 66 The Agencies seek comment on whether any conditions relating to the exclusion of CEDE investments from the A-IRB equity capital charge would be appropriate. These conditions could serve to limit the exclusion to investments in CEDEs that meet specific public welfare goals or to limit the amount of CEDE investments that would qualify for the exclusion from the A-IRB equity capital charge. The Agencies also seek comment on whether any other classes of legislated program equity exposures should be excluded from the A-IRB equity capital charge.

We are in full support of the Agencies' proposal to exclude CEDE from A-IRB requirement without a dollar limit. As the Agencies noted, banking organizations made these investments as part of their corporate responsibilities in supporting the public welfare of their communities. Such investments should be encouraged. A good way to demonstrate the Agencies' support for such programs is by allowing these investments to be exempted from the complex A-IRB requirement.

P. 68 Comment is specifically sought on whether the measure of an equity exposure under AFS accounting continues to be appropriate or whether a different rule for the inclusion of revaluation gains should be adopted.

We have no specific comments regarding this matter since we do not hold meaningful AFS equity securities.

<u>Supervisory Framework</u>

P. 78 The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the A-IRB requirements. If this balance is not appropriate, what are the specific areas of imbalance, and what is the potential impact of the identified imbalance? Are there alternatives that would provide greater flexibility, while meeting the overall objectives of producing accurate and consistent ratings?

The Agencies also seek comment on the supervisory standards contained in the draft guidance on internal ratings-based systems for corporate exposures. Do the standards cover all of the key elements of an A-IRB framework? Are there specific practices that appear to meet the objectives of accurate and consistent ratings but that would be ruled out by the supervisory standards related to controls and oversight? Are there particular elements from the corporate guidance that should be modified or reconsidered as the Agencies draft guidance for other types of credit?

In addition, the Agencies seek comment on the extent to which these proposed requirements are consistent with the ongoing improvements banking organizations are making in credit-risk management processes.

JPMC is currently undergoing an extensive gap analysis to access our institution's ability to implement the requirements of Basel II. We expect this work to be completed early in 2004, at which point we will be able to provide supervisors with comprehensive feedback. In the meantime, we support the feedback on this topic provided by the RMA in their ANPR response letter.

<u>Securitization</u>

We commend supervisors for proposing a framework for this complex area of finance. We believe the framework is directionally sensible, but it needs simplification, clarification and increased transparency. The following points summarize the primary suggestions we will discuss in the body of this response letter.

- The definition of an originating bank should be limited to the bank that directly or indirectly originates the securitized assets. The broader definition causes an undue amount of operational burden for sponsor banks.

- Supervisors will need to be flexible in implementing the input data requirements for the Supervisory Formula - or its replacement.
- Banks should be allowed to use internal ratings, subject to supervisory review, when their rating model follows standard well-published rating agency criteria.
- Supervisors should not require externally rated tranches to deduct capital below Kirb. Although we appreciate the theoretical underpinnings of the original proposal, we would like to see it changed for the sake of operational simplicity. Failing that step, at a minimum the rule should be relaxed when a rated position has credit enhancements that are not recognized by the securitization framework (e.g. external credit enhancements, non-defaulted status for draws, triggers, asset quality tests, etc).
- The liquidity facility eligibility criteria should be edited to reflect industry standards. Failure to comply with the criteria should relegate the facility to the same treatment received by any other credit enhancing position. Compliance with the criteria should allow the bank to use a credit conversion factor in the liquidity facility capital calculation.
- Banks should never be required to hold more capital than the sum of Kirb plus applicable deductions.
- Investors should be allowed to use initial values for N and Q when choosing the appropriate RBA risk weights.
- Liquidity Facilities should be able to recognize the benefits of an externally purchased credit enhancement which overlaps with the facility in the capital structure.
- The look-through approach should reference the average asset value of the pool, not the worst asset.

P. 74 The Agencies seek comment on the proposed operational requirements for securitizations. Are the proposed criteria for risk transference and clean-up calls consistent with existing market practices?

Clarification would be helpful on the following conditions that limit the amount of credit risk transferred.

> *"Clauses that materially limit the credit protection or credit risk transference (e.g. significant materiality thresholds below which credit protection is deemed not to be triggered even if a credit event occurs or those that allow for the termination of the protection due to deterioration in the credit quality of the underlying exposures);"*

Materiality thresholds are common in some securitizations. For example, as in the standard CDS contract, protection can be provided with a failure to pay requirement of $1MM or a default requirement of $10MM. We assume these levels would not be deemed "significant".

> *"Clauses that increase the banks cost of credit protection in response to deterioration in the pool's quality;*

Clauses that increase the yield payable to parties other than the originating banks, such as investors and third-party providers of credit enhancements in response to a deterioration in the credit quality of the underlying pool; "

Some long-dated synthetic CDO transactions contain "step-up" provisions. This feature allows the protection seller to step-up the fee using a specified formula at a certain date given certain conditions. These types of features might be found in a synthetic ABS CDO or mortgage securitization, for example, where the maturity is expected to be 7 years (in all likelihood the deal will clean up by then) but the legal life of the underlying securities is much longer. When we purchase protection with this feature, we typically assume that the step-up date is the end date of the protection in our risk management systems. We suggest supervisors apply a similar approach. This would be more reasonable than not recognizing the protection all together.

Comment letters from the American Securitization Forum (ASF) and the European Securitization Forum (ESF) go into detail about other specific concerns in the language, and we commend this analysis to you.

P. 76 Comments are invited on the circumstances under which the retention of the treatment in the general risk-based capital rules for residual interests for banking organizations using the A-IRB approach to securitization would be appropriate.

Supervisors should clarify their intentions for the deduction of a gain on sale. The ANPR states:

"Any increase in equity capital resulting from a securitization transaction would be deducted from Tier 1 capital".

We acknowledge that when FMI and reserve accounts are available to absorb losses they are still at risk and therefore should be deducted. However, this treatment should be limited to gains that remain at risk. Banks should not be required to deduct crystallized gains. For example, mortgage-backed securitizations sell their future margin income strips and lock in the profit upon securitization. More generally, banks should not be required to deduct gains when the securitization *locks in* an arbitrage, i.e. banks can buy assets in one format (single-name credit exposures) and repackage the risk for sale in another format (portfolio-tranched credit exposures). The bank's gains should only be deducted when they pertain to amounts which remain at risk due to the future performance of the exposure pool.

P. 77 Should the Agencies require originators to hold dollar-for-dollar capital against all retained securitization exposures, even if this treatment would result in an aggregate *amount of capital required of the originator that exceeded KIRB plus any applicable deductions? Please provide the underlying rationale.*

We do not believe that a bank should be required to hold more capital than the sum of Kirb plus applicable deductions under any circumstances.

- The basic logic for this proposal is flawed. Banks have various reasons for retaining tranches and not all of them are related to the cost of capital.
- Supervisors should not selectively look to market pricing, which can be influenced by many factors, to correct for any perceived weaknesses in Kirb. It would be inappropriate to hold certain banks to a higher standard than others because of a perceived market observation.
- A requirement to hold more than Kirb would treat originating banks more harshly than their non-securitizing counterparts. Banks that are hedging credit risk in the securitization market could be required to hold more capital than banks that are sitting on similar pools of assets without any protection. This result undermines supervisory intentions to align regulatory capital requirements with prudent risk management.
- The securitization framework is already complex. Clauses like this would add to the complication and potentially introduce market distortions. It would not compensate by adding a measure of sensible risk management.

P. 79 The Agencies seek comment on the proposed treatment of securitization exposures held by originators. In particular, the Agencies seek comment on whether originating banking organizations should be permitted to calculate A-IRB capital charges for securitizations exposures below the KIRB threshold based on an external or inferred rating, when available.

In theory, we understand why supervisors want *true* originating banks to hold dollar for dollar capital for *true* first loss positions up to Kirb, regardless of a rating. However, we believe that the definition of an originator should be limited to the institution that directly or indirectly originates the assets. In addition, the rule should not be applied to rated positions which have credit enhancements that are not recognized by the securitization framework.

- *The broad definition of an originator will cause an undue amount of operational burden for large banks that perform a variety of roles in securitizations.* Currently, the definition includes banks that advise the program, place the securities, and provide liquidity or credit enhancement. The requirement for these institutions to calculate Kirb each quarter, and then test their positions for straddling Kirb will be onerous.

  Consider a case where JPMC's conduit business invests in a Triple-A tranche which is co-distributed by JPMC's ABS sales desk. In this example JPMC is a sponsor and an investor. JPMC is not a true originator. As an investor, the conduit business will not be set up to access the pool's underlying obligor information. Like most investors, they monitor the credit quality of their position through rating agency reports, along with various performance-driven pooled ratios from the investor reports. Under the new rules, the conduit would need to calculate Kirb each quarter to make sure its Triple-A tranche is not straddling. This involves getting name-by-name information for each asset in the pool. The operational burden becomes onerous considering the number of assets potentially held by the conduit.

Similar difficulties will be faced when banks provide facilities to third-party securitizations. At JPMC we have more than a hundred of these positions. Our credit officers make detailed credit assessments before approving a new facility. Once the deal goes live, they regularly monitor the pooled portfolio performance ratios which they receive through investor reports. They also monitor rating agency reports. They only delve more deeply into the portfolio details when these sources alert the officer to a potential problem.

Similar difficulties will be faced with positions we hold in our investment portfolio. For example, JPMC may have been involved in placing an issuance of liquid mortgage-backed securities. Years later, some of them may find their way into our investment portfolio. We use this portfolio to manage the interest rate risk of the bank. These are highly liquid positions. We do not monitor the pools under these securities and should not be expected to measure Kirb to test for straddling each quarter.

In the interest of simplification, and to relieve undue operational burden, we suggest that the definition of an originator be limited to the institution that directly or indirectly originates the assets.

– *Certain positions have obtained a rating by virtue of credit enhancements that are not recognized by the A-IRB framework.*
    - Consider the case of an ABCP conduit of purchased receivables where the bank originating the conduit provides a rated liquidity facility and then purchases credit enhancement from another institution. The facility is required to provide liquidity from the first (non-defaulted) dollar to the last, but this is not a *true* first loss position. Banks are only allowed to recognize overlapping positions when they hold both of them. Because the facility will overlap with an *externally* provided credit enhancement, it will receive no benefit for purchasing true first loss protection from an outside provider. Liquidity facilities can only be drawn to fund non-defaulted assets. When this feature is combined with the credit enhancement the facility is economically placed in a second loss position.
    - Conduits may have recourse to the seller for dilution risk. There is no benefit given to this feature.

- There are multiple triggers and credit quality tests that are given no benefit.
- Many securitizations, such as credit card or auto loan ABS have excess spread available to cover expected losses. The SFA does not recognize this credit enhancement.
- Securitizations often have provisions to build up reserve accounts when excess spread or OC begin to deteriorate. The proposed methodology does not give any credit to unfunded reserve accounts.

There are various solutions to the problems that will result from the requirement to deduct portions of rated tranches below Kirb.

- Supervisors could show flexibility and monitor exceptions through the Pillar II framework.
- Supervisors could propose a list of legitimate exceptions. We do not favor this solution because it is difficult to devise a comprehensive list, and it would further complicate the framework.
- Supervisors could do away with the requirement all together. In the interest of simplification, this is our recommendation.

P. 79 The Agencies seek comment on whether deduction should be required for all non-rated positions above KIRB. What are the advantages and disadvantages of the SFA approach versus the deduction approach?

As stated earlier, we do not believe that supervisors should ever require deduction above Kirb. To site an obvious example, it would not make sense for originators to hold dollar for dollar capital on a retained super-senior tranche. We will discuss later how difficult the SFA can be to implement, but at the moment it is the only reasonable method available for calculating capital on *un*-rated positions. The look-through approach is seriously flawed for this purpose. We believe that banks should be allowed to use internal ratings for certain un-rated positions, subject to supervisory approval. This suggestion is discussed later in more detail.

P. 81 The Agencies seek comment on the proposed treatment of securitization exposures under the RBA. For rated securitization exposures, is it appropriate to differentiate risk weights based on tranche thickness and pool granularity?

We support the decision to differentiate risk weights by granularity and thickness, but we would like to have a better understanding of the risk weight calibrations.

- We understand that the work of Perraudin and Peretyatkin was a contributing factor. It would be helpful to better understand this work. The industry's understanding has been that Perraudin's approach implies an LGD of 50% for "thick" tranches and an LGD of 100% for "thin" tranches. If this is the case then we believe the thick tranche assumption is an unreasonably high LGD. A value such as 10% is more appropriate.

- The industry also has understood that the risk weights in the "thick" tranche column are remarkably similar to Perraudin's calculations for "thin" tranches. If true, we believe this is another example of inappropriate conservatism.
- We would like to see a benefit given to thick Single-A tranches. Our conduit business structures liquidity facilities to target a Single-A rating above the over-collateralization. This Single-A tranche typically accounts for 80-90% of the pool notional. An LGD of 100% is egregious for this senior position.

We suggest that the supervisors revisit the assumptions for calculating the capital floor based on the issues raised above. We sense that a revised set of assumptions might reasonably result in halving the current floor. Such a result could well satisfy the supervisors' desire to have a non-zero capital charge based on prudential grounds and at the same time address industry concerns that senior positions are overcapitalized in the New Accord. In adopting a non-zero floor that is more than just a few basis points, however, the Basel Committee should be mindful that it will be requiring more capital in the systems as a whole than would be required had the bank simply maintained the assets on balance sheet. We recognize that this can also be the case today and is alleviated to a fair degree by the A-IRB.

P. 81 For non-retail securitizations, will investors generally have sufficient information to calculate the effective number of underlying exposures (N)?

At inception investors should know the values for N and Q. However, investors are not set up to measure these quantities on a quarterly basis. They would need to extract the information from investor reports. This manual process could become quite cumbersome for investors with many positions. In theory, investor reports could include aggregated measurements such as these, but for existing securitizations this would involve re-negotiating administrative contracts and fees. Even on future securitizations it may be difficult to require these quantities since only a few banks will need them.

As used in the RBA, N and Q are blunt risk measurement devices. Considering the operational burden, a meaningful amount of risk sensitivity is not achieved by requiring investors to update these quantities on a quarterly basis. We suggest the qualifications for using a particular risk weight column be based on original values for N and Q.

P. 81 What are views on the thresholds, based on N and Q, for determining when the different risk weights apply in the RBA?

The thresholds for N and Q seem reasonable.

P. 81 Are there concerns regarding the reliability of external ratings and their use in determining regulatory capital? How might the Agencies address any such potential concerns?

The ANPR suggests that U.S. supervisors are likely to adopt the requirements in Paragraph 525 of CP3. There are some minor concerns with these ECAI requirements as they are applied to securitizations.

- The 3rd bullet in paragraph 61 of CP3 requires that an eligible rating agency must make its methodology publicly available. One of the two primary agencies with securitization expertise does not publish any of its securitization methodology.
- Paragraph 525 (b) requires that the rating is of the type included in the ECAI's transition matrix. We are not sure what this means in reference to securitizations.

Along with our colleagues at the ASF, we recommend that supervisors "maintain a list of eligible ECAIs that are well established, of sufficiently high caliber, and have demonstrated enough expertise in securitization to warrant recognition of their private letter ratings".

Unlike the A-IRB framework for wholesale exposures, there is no maturity adjustment within the proposed RBA. Is this reasonable in light of the criteria to assign external ratings?

Even with a rated position, a 10-day transaction involves substantially less risk than a 10-year transaction. Nevertheless, we believe that the current securitization framework needs simplification, not further complication. For this reason, we do not recommend introducing a maturity adjustment.

P. 86 The Agencies seek comment on the proposed SFA. How might it be simplified without sacrificing significant risk sensitivity? How useful are the alternative simplified computation methodologies for N and LGD?

We commend the Basel Committee for devising the SF approach, and we support its conceptual design. We are concerned with recent reports that indicate supervisors intend to do away with this approach. The SFA may be necessary for capital calculations on unrated positions if banks are not allowed to use internal ratings, because not all internal rating procedures follow a published S&P methodology.

We acknowledge that many challenges arise when applying the SF approach. However, we believe it is workable if supervisors will be flexible in the implementation. These difficulties are most clearly illustrated by stepping through applications. We summarized below some of the issues that were uncovered in the investigation of various risk positions at JPMC.

- It is typical to write conduit liquidity facilities on each underlying asset individually. By contrast, the credit enhancement is typically written on the entire conduit portfolio of assets. It is not clear which point of view should be used when determining capital for the inputs to the SF for liquidity facilities. Supervisors suggested distributing the program-wide credit enhancement pro-rata to each facility in QIS3. This treatment or some alternative should be formalized in the rulemaking.
- One of our conduits buys credit enhancement from a third party. Although this position technically overlaps with the liquidity facility, it is clear that the credit enhancer takes the first loss. The rules indicate that we are not allowed to recognize this overlap since we do not hold both positions. This would be a harsh treatment since liquidity facilities are not required to fund defaulted assets.
- At JPMC we have a conduit whose underlying assets are CDO and ABS tranches. These assets are all rated either AAA or AA. They are the most senior positions in their original securitizations. In the ANPR, "resecuritizations" are required to set LGD = 100% for the underlying assets. This rule seems unreasonable for thick senior AAA and AA positions. We suggest that supervisors designate a "thick and granular" LGD assumption that is less than 100% for resecuritizations.

  JPMC will have trouble fulfilling the current data standards for purchased receivables. Please see our feedback for purchase receivables in response to the question posed on page 52. When the purchased receivables do not satisfy the data requirements, the ANPR suggests that banks set PD = EL and LGD = 100%. In one example we ran, these settings more than doubled the conduit's regulatory capital requirement. We believe our conduit business keeps track of relevant risk information, but that information is not in the format required by the SF approach. Doubling the capital on the basis of a data format issue is an unduly conservative penalty. We believe that supervisors should be flexible in adapting this data for use in the SF.

A few additional clarifications on the SF rules would be helpful.

- The ANPR explains that the definitions of both Exposure and Kirb are to exclude undrawn lines. They are to "reflect only those underlying exposures that have actually been securitized to date." However, N is defined in terms of "Exposure at Default". This requires recognition of the undrawn line. If this was not an oversight, then we would appreciate the underlying rationale for this choice.
- The proposal states that for large pools using the SF approach, if the portfolio share associated with the largest exposure is no more than 3% of the underlying pool, then the bank may use the simplified N calculation and set LGD = 50%. It is not clear how this LGD assignment corresponds to the requirement for purchased receivables which sets PD=EL and LGD

= 100% if certain data standards are not met. Supervisors should clarify which rule takes precedence.

P. 87 The Agencies seek comment on the proposed treatment of eligible liquidity facilities, including the qualifying criteria for such facilities.

This section of the ANPR is poorly constructed. Most of our facilities would fail the currently proposed eligibility criteria. Furthermore, passing the criteria gives the risk position virtually no benefit whatsoever.

JPMC's liquidity facilities would fail the 1st, 3rd and 5th eligibility requirements. We doubt that rating agencies would be willing to rate the commercial paper if these features were implemented.

- Liquidity facilities are drawn for the non-defaulted value of the underlying assets, not their market value.
- Liquidity contracts are not written such that the obligation knocks out if credit enhancements are exhausted.
- Contracts are not written such that the obligation ramps down or disqualifies if the underlying pool quality falls below investment grade.
  - Many of our CDOs are structured for a pool of high yield names. The liquidity facilities for these CDOs can be sufficiently credit enhanced with subordination. These facilities pay out upon termination either (i) before the AAA investors or (ii) pari pasu with the AAA investors. These facilities should not become in-eligible because of the underlying pool quality.
  - Guidance is needed on interpreting this eligibility requirement for purchased receivables. These pools are typically composed of retail assets, or as in the case of trade receivables the assets can be un-rated.

The penalty for failing eligibility needs to be clarified. Paragraph 600 of CP3 implies that only *eligible* Liquidity Facilities may use the RBA or the SFA. Paragraph 603 states that only *eligible* facilities may use the Look-Through Approach. Paragraph 603 goes on to state that all other cases will require deduction. We assumed that this deduction refers to ineligible liquidity facilities. Supervisors should clarify whether this was the intention. Our expectation is that the eligibility criteria are meant to distinguish true liquidity facilities from credit enhancing positions. Ineligible facilities should therefore be required to use the same capital treatment as other credit enhancing positions, i.e. the facility should be required to use the RBA if it is rated or the SF if it is unrated. The facility would therefore not have access to the Look-Through approach, or a discounting CCF. It would be helpful to explicitly clarify this policy in the text.

We believe that eligible liquidity facilities should be given a capital benefit over other credit enhancing positions. A credit conversion factor should be available for this purpose.

P. 87 Does the proposed Look-Through Approach -- to be available as a temporary measure -- satisfactorily address concerns that, in some cases, it may be impractical for providers of liquidity facilities to apply either the "bottom-up" or "top-down" approach for calculating KIRB? It would be helpful to understand the degree to which any potential obstacles are likely to persist.

We do not believe that the Look-Through Approach is a useful method in its currently proposed format. The worst asset in a large pool is quite likely to be of poor quality. This communicates very little information about the risk of the pool, much less the risk of a true liquidity facility supporting the pool. As a result, the Look-Through Approach gives punitive results which are way out of line with the risk associated with these positions. The *average* asset quality in the pool would be a more appropriate risk proxy for use in this approach.

The following section of the ANPR text relating to the Look-Through Approach needs clarification.

> *The Agencies propose that the risk weight be set equal to the risk weight applicable under the general risk-based capital rules for banking organizations not using the A-IRB approach (that is, to the underlying assets or obligors after consideration of collateral* or guarantees or, if applicable, external ratings).

- CP3 requires banks to reference the *highest* risk weight among the assets being securitized. The ANPR text above does not specify which asset is to be referenced.
- It is unclear which risk weight table the user is to reference. Retail assets and purchased receivables do not have risk weight tables.

P. 87 Feedback also is sought on whether liquidity providers should be permitted to calculate A-IRB capital charges based on their internal risk ratings for such facilities in combination with the appropriate RBA risk weight. What are the advantages and disadvantages of such an approach, and how might the Agencies address concerns that the supervisory validation of such internal ratings would be difficult and burdensome? Under such an approach, would the lack of any maturity adjustment with the RBA be problematic for assigning reasonable risk weights to liquidity facilities backed by relatively short-term receivables, such as trade credit?

We support the use of internal ratings. Their use would circumvent the problems associated with implementing the SFA. Internal ratings for conduit facilities are usually determined using simple and well-understood S&P criteria.

However, if this decision were combined with a plan to do away with the SF approach all together, banks would be left without any approach for unrated positions that do not necessarily follow a simple S&P methodology to achieve an internal rating. Any plan that relegates all other unrated positions to the deduction approach is far too conservative.

We suggest that supervisors monitor our internal rating procedures for these positions just as they monitor rating procedures for every other position in the bank. In the United States we already have positive experience with such an approach for credit enhancements provided to conduits. It is not clear why supervisors consider the job of assigning a rating to a securitization a more complex task than assigning a rating to other entities. In our view the securitization is a relatively simple structure compared to many of the firms we rate on a regular basis, especially privately held firms.

P. 87 Should the A-IRB capital treatment for securitization exposures that do not have a specific A-IRB treatment be the same for investors and originators? If so, which treatment should be applied – that used for investors (the RBA) or originators (the Alternative RBA)? The rationale for the response would be helpful.

We do not know of any assets that fall into this category.

P. 90 The Agencies seek comment on the proposed treatment of securitization of revolving credit facilities containing early amortization mechanisms. Does the proposal satisfactorily address the potential risks such transactions pose to originators?

The proposed Early Am rules make sense for credit card securitizations. It is not clear how to apply the rules to other revolving retail assets. For example, our HELOC securitizations provide for an early triggering of the planned "rapid amortization" if the insurance policy is drawn. This will occur if the over-collateralization is depleted. Therefore the appropriate indicator for our HELOC early amortization should be the level of over-collateralization rather than the level of excess spread. These securitizations are all unique. Supervisors will need to be flexible in the application of the rules.

Comments are invited on the interplay between the A-IRB capital charge for securitization structures containing early amortization features and that for undrawn lines that have not been securitized. Are there common elements that the Agencies should consider? Specific examples would be helpful.

We are not sure we understand this question, but we would like to comment on the policy that requires banks to calculate capital for undrawn lines outside of the securitization framework.

We are required to hold significantly more capital by recognizing additional draws in the EAD parameter (and computing the capital outside of the securitization framework), as opposed to recognizing additional draws in the LGD parameter (and applying the increase inside the securitization framework). The impact can be several million dollars of additional capital for a one billion dollar securitization.

In the case of a credit card ABS, the entire account including the undrawn line has been securitized. Investors and sellers alike share losses on a pro-rata basis from defaulting accounts, which are more highly drawn than the norm. It would be helpful to understand why supervisors have proposed a rule that implies the seller owns all of the un-drawn line risk.

Are proposed differences in CCFs for controlled and non-controlled amortization mechanisms appropriate? Are there other factors that the Agencies should consider?

The proposal seems reasonable.

P. 91 When providing servicer cash advances, are banking organizations obligated to advance funds up to a specified recoverable amount? If so, does the practice differ by asset type? Please provide a rationale for the response given.

The practice of providing servicer cash advances does differ by asset type. We are aware of some auto and credit card securitizations that do not require a servicer cash advance. For mortgage-backed securities, the level and types of advancing performed by the servicer is dependent upon the specifics of the governing contracts. In some cases funds are advanced when servicing for others in non-securitization situations. Servicing advances of taxes and insurance can be made on any serviced loan. The servicer advances funds for delinquent interest, or principal and interest, when contractually specified. Thresholds are also contractually or programmatically specified. Subprime contracts typically allow the servicer to make the determination of recoverability of the advance and do not require advances to be made if they are determined not to be recoverable. Some agency deals require advancing regardless of recoverability. Some "advances/cash payments" are non recoverable by the servicer, such as payments of compensating interest on loans that payoff without a full 30 days of interest in the final payment to the trust.

Operational Risk

P 92 The Agencies are proposing the AMA to address operational risk for regulatory capital purposes. The Agencies are interested, however, in possible alternatives. Are there alternative concepts or approaches that might be equally or more effective in addressing operational risk? If so, please provide some discussion on possible alternatives.

The AMA as proposed for operational risk has been designed to accommodate sufficient flexibility and alternative methodologies within acceptable boundaries established by the parameters and standards in CP3 and the ANPR. With the exception of certain comments contained below we fully support the AMA as proposed and see no need for additional alternatives.

Does the broad structure that the Agencies have outlined incorporate all the key elements that should be factored into the operational risk framework for regulatory capital? If not, what other issues should be addressed? Are any elements included not directly relevant for operational risk measurement or management? The Agencies have not included indirect losses (for example, opportunity costs) in the definition of operational risk against which institutions would have to hold capital; because such losses can be substantial, should they be included in the definition of operational risk?

We support the current definition of operational risk as proposed and believe all key elements have been captured. We do not believe capital should be required for expected losses as proposed. Yet the accommodation of excluding such amounts from capital requirements if otherwise covered by reserving or budgeting appears workable.

While elements such as indirect losses and other items may indeed be important to understand from a business standpoint, it would be inappropriate to include these in capital calibrations as these items would not add meaningfully to the level of capital required. The added precision achieved by inclusion of such elements would not outweigh the incremental administrative burden necessitated.

P 93 The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the operational risk requirement. If this balance is not appropriate, what are the specific areas of imbalance and what is the potential impact of the identified imbalance?

As proposed, we believe there is appropriate balance between flexibility and comparability. However, this balance could be inappropriately and significantly reduced by overly prescriptive regulatory implementation practices. To the extent regulators require specific adjustments or overrides to an otherwise robust AMA model, there could be a divergence of the calibration of economic capital for business purposes and regulatory capital. If these become significant, banks would be required to manage two different capital models and the considerable advantages of the AMA approach would be diminished.

The Agencies are considering additional measures to facilitate consistency in both the supervisory assessment of AMA frameworks and the enforcement of AMA standards across institutions. Specifically, the Agencies are considering enhancements to existing interagency operational and managerial standards to directly address operational risk and to articulate supervisory expectations for AMA frameworks. The Agencies seek comment on the need for and effectiveness of these additional measures.

We believe this is a particularly important issue to the success of the operational risk initiative and framework under Basel II. The key issue is how US regulatory agencies will coordinate their individual efforts within the United States and, more importantly, how their actions are coordinated and standardized across jurisdictional boundaries internationally. This issue, commonly known as the "Home / Host" issue, is the most critical challenge remaining for both the regulatory community and the industry in the successful implementation of the operational risk framework contemplated under the AMA in Basel II. We strongly encourage supervisory authorities, both domestic and international, to consider and adopt certain key principles, processes and guidelines governing their actions as both 'home' and 'host' regulators as it relates to the approval and ongoing review of the AMA generally, and required operational risk capital levels specifically. We offer three specific comments.

First, the AMA approval process should be well prescribed and documented. Standards and processes of review should be formally stipulated and followed across all jurisdictions. Importantly, initial approval and any subsequent periodic reviews of the overall AMA methodology should include all relevant regulatory authorities, domestic and international. While 'home' regulators should lead the review, 'host' regulators should be able to participate actively. In addition to a review of the overall AMA framework and qualifications, the approval process should include a review of key items such as the level of operational risk capital required relative to the risks as measured, the calibration of diversification benefits, and the allocation of capital across legal entities, and the methodologies used to arrive at this allocation.

Approval for use of the AMA should cover application of the AMA on a consolidated basis as well as its implications for all meaningful legal entities. Objections, adjustments or special stipulations to the overall application of an AMA, including the allocation process, by any regulator should be raised, discussed and resolved in the context of this approval process. To the extent it is appropriate to periodically review an institution's qualifications for AMA, subsequent reviews and approvals should be processed similarly.

Second, if it is determined that an institution has a sound control environment, a robust AMA capital model and otherwise meets all the qualifying standards for the AMA, 'host' regulators should agree that they will abide by the review and approval process and not institute a separate review effort; nor will they independently impose arbitrary and permanent Pillar 2 adjustments or add-ons for operational risk capital for specific legal entities within their jurisdictions on top of those already determined and approved in the initial AMA approval or review process. It is important to note that this provision is not intended whatsoever to prevent any Pillar 2 capital adjustments or other regulatory actions deemed appropriate resulting from specifically identified control deficiencies or other weaknesses. Such capital adjustments are entirely appropriate if they are targeted to specific issues and are reduced or eliminated as such deficiencies are corrected. Indeed, banks may incur a level of financial difficulties during which time 'home' and 'host' regulators could withdraw AMA approval and its attendant capital benefits.

Third, if the AMA review process determines that certain deficiencies exist and AMA approval is denied or withdrawn, regulatory authorities should be required to specifically identify those aspects of an applicant's qualifications deemed inadequate. Once these inadequacies are sufficiently addressed, AMA approval should not be unreasonably withheld or delayed.

The position of the US supervisory authorities on this issue will be important in shaping a favorable resolution of the Home / Host debate. We strongly encourage the U.S. regulators to adopt this approach in their respective roles as both 'home' and 'host' regulators.

The Agencies also seek comment on the supervisory standards. Do the standards cover the key elements of an operational risk framework?

While we are strongly supportive or most of the supervisory standards as proposed, we believe the current proposal for loss classification of certain operational losses is ill advised. Operational risk can manifest itself as credit losses, even when credit risk had little or nothing to do with the actual loss incurred. The ANPR specifically stipulates the requirement to capture and report such operational risk matters as credit losses. In addition, under the current proposal, AMA banks capturing all other internal operational losses are encouraged, but not required, to track these 'credit-related' operational events as long as they are reported as credit losses. While we recognize the advantage and convenience of maintaining the integrity of historical credit loss data, the proposed guidelines are directly contrary to the objective of continued development and improvement of good risk measurement and management practices. Indeed, in many circumstances classifying such a loss as a credit risk matter is completely inaccurate and misleading. The ANPR as drafted perpetuates an archaic convention of risk classification in the face of compelling evidence that better methodologies are under development.

At a minimum, we suggest that all AMA institutions be required to track all internal operational risk losses even if accounting convention and regulatory rules require certain of these be treated as credit losses. Optimally, regulatory rules should promote and encourage more accurate and meaningful data classification and reporting and improved risk management techniques. The problem of double counting events for capital purposes is easily avoided and the incremental costs of such an effort are insignificant. Moreover, the industry and regulatory community can manage through the transition of the historical database for credit losses while improving the integrity of the data definition and capture for risk reporting and risk management purposes.

Separately, the ANPR stipulates that institutions must collect relevant data and be able to map this information to certain risk and business line categories. We fully support the adoption of such data hierarchies and standard reporting conventions. However, it is important to note that these categories are in the early stage of development. With additional data and experience it is fully expected that the industry will develop and identify more accurate, risk-based categories. Regulatory rules and guidance in this regard should be flexible to adjust to improved data conventions as they develop.

P. 95 The Agencies are introducing the concept of an operational risk management function, while emphasizing the importance of the roles played by the board, management, lines of business, and audit. Are the responsibilities delineated for each of these functions sufficiently clear and would they result in a satisfactory process for managing the operational risk framework?

We believe the proposals are consistent with good governance and prudent risk management principles. As long as interpretation and application of these concepts and the related supervisory standards are reasonable, we are supportive of the proposals.

P. 97 The Agencies seek comment on the reasonableness of the criteria for recognition of risk mitigants in reducing an institution's operational risk exposure. In particular, do the criteria allow for recognition of common insurance policies? If not, what criteria are most binding against current insurance products? Other than insurance, are there additional risk mitigation products that should be considered for operational risk?

We generally support the comments within the ANPR regarding risk mitigation for operational risk. Quantification of this risk class is still in its early stage of development and aggressive use and recognition of risk transfer techniques for capital purposes is premature. Further, we believe standards governing the use of risk mitigation for operational risk should be sufficiently conservative to prevent the development of techniques and practices solely meant to reduce regulatory capital in the absence of real risk mitigation. Indeed, we believe that as part of the ongoing AMA review, regulators should aggressively discourage banks from engaging in inappropriate capital management practices. Arbitrary limits such as a 20% cap on the use of insurance are consistent with a conservative approach and are appropriate as long as such restrictions are temporary. The industry's ability to measure the risk mitigation value of insurance will improve over time. Moreover, we firmly believe that other bona fide risk mitigation tools and techniques will develop. It is important that a flexible and timely regulatory process exists that permits banks to incorporate risk mitigation into its operational risk framework. We oppose the imposition of permanent and arbitrary limitations on such risk mitigation techniques.

<u>Disclosure</u>

P. 102 The Agencies seek comment on the feasibility of such an approach to the disclosure of pertinent information and also whether commenters have any other suggestions regarding how best to present the required disclosures.

Comments are requested on whether the Agencies' description of the required formal disclosure policy is adequate, or whether additional guidance would be useful.

Comments are requested regarding whether any of the information sought by the Agencies to be disclosed raises any particular concerns regarding the disclosure of proprietary or confidential information. If a commenter believes certain of the required information would be proprietary or confidential, the Agencies seek comment on why that is so and alternatives that would meet the objectives of the required disclosure.

The Agencies also seek comment regarding the most efficient means for institutions to meet the disclosure requirements. Specifically, the Agencies are interested in comments about the feasibility of requiring institutions to provide all requested information in one location and also whether commenters have other suggestions on how to ensure that the requested information is readily available to market participants.

We appreciate that supervisors have attempted to scale back the amount of required detailed disclosures. We also appreciate that supervisors have shown flexibility as to where and how the disclosures should be made (e.g. on a web site and not necessarily in an annual or quarterly report.) Nevertheless, we remain concerned that some of the credit risk disclosures would be burdensome to produce and could be subject to misinterpretation that could be only surmounted by further detailed disclosures. The prime example is the requirement for banks to disclose their loss estimates against actual outcomes over a long period such that a meaningful assessment of the performance of the internal ratings process for each portfolio could be made. Validation exercises of this sort require long data histories and are difficult to conduct and interpret.

It would be helpful for supervisors to clarify the level of detail that is meant to be disclosed in connection with the information suggested in the A-IRB acceptance process. The items listed in the ANPR could result in extraordinarily detailed and lengthy disclosures.

We suggest that banks be asked to discuss why they are comfortable with their ratings system and LGD and EAD estimates in light of their historical experience and to provide relevant supporting analysis where available. Also, supervisors should allow banks the flexibility to disclose exposures according to risk characteristics that are meaningful to them.

While some banks are already complying with many of the disclosure requirements in the ANPR, there is a clear expectation of even greater disclosure. We believe that there is a potential competitive inequity issue here because financial institutions engaged in similar activities will not be required to make the same disclosures. All institutions taking similar risks should make similar disclosures. In addition, there are already existing recommendations for enhanced public disclosures that are not being adhered to by all targeted financial institutions. Rather than increasing the amount of disclosures for a subset of financial institutions, supervisors should focus on encouraging comparable disclosures across the full range of financial institutions engaged in similar risk activities.