BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

BEST IMAGE AVAILABLE

Date: March 15,2004

To: Myron Kwast

From: Paul Calem and Jim Follain

Subject: Meeting with J.P. Morgan Chase (JPMC) on the Competition Project

---

Attendees from JPMC: Adam Gilbert (Managing Director for Credit Portfolio Group), Joe Lyons, John Grace and Greg DeVany. Alexa Philo of the New York Fed was also in attendance. This memo highlights the major themes emphasized during the meeting.

1. *JPMC would tend to agree with the appropriateness of the reductions in regulatory capital for residential mortgages under Basel II.* That is, their internal models would be roughly consistent with the rankings and levels presented to them.
2. *The potential competitive effects of Base/ Il have to be evaluated in the context of the capital management processes currently in place at A-IRB banks.* Key issues are the weights currently placed on regulatory capital by the banks and their current capital positions. To the extent that economic, rather than regulatory capital, drives investment strategy, the effects of Basel II will be limited.
3. *Economic capital tends to dominate decision-making relative to regulatory capital at JPMC and likely at other A-IRB banks, in part due to capitalization well in excess of regulatory requirements.*
    a. Rating agency capital requirements generally exceed regulatory requirements (with target AA rating).
    b. A strong capital cushion serves as a signal of strength.
    c. Sophisticated capital management systems and development and implementation of techniques of regulatory capital arbitrage have increased the relative importance of economic vs. regulatory capital.

d. "It is easy to overstate the impact of regulatory capital."

4. *Because economic capital drives current investment strategy, Base/ Il reductions in regulatory RBC requirements for the most part will not lead to changes in behavior at A-IRB banks*

5. *It is plausible that incentives will change on the margin: some individual product lines that were previously not attractive investments due to excessive regulatory capital may become attractive investments. But a variety of factors will limit the potential competitive effects versus small bank originators of such products.*
   a. Leverage requirement and established product line strategies will limit the extent of investment in new product lines.
   b. Smaller banks can choose to opt in.
   c. Many factors other than cost-of-capital affect the competitive landscape for originating mortgages, such as personal service, branch location, etc.

6. *Basel II is may have an effect on investments in product lines where the new regulatory capital requirement is calibrated too high relative to economic capital, but the degree of change will vary among products and circumstances and the effects will be minor.*
   a. In particular, the proposed securitization formula implies excessive regulatory for senior tranches of mortgage-backed securities, which may discourage bank investment in mortgage credit risk.
      i. They expressed a willingness to discuss specific examples with us at a later date.
      ii. The impact of Basel II is likely to be asymmetric—more likely to cause reduced investment in lines where regulatory capital exceeds internal economic capital compared to where it is below economic capital,
      iii. The size of the impact may be small and will vary with economic circumstances.

7. *The impact of Basel II on bank behavior will be much less than that experienced when Basel I was implemented, due to significant differences in the industry context.*
   a. Large banks' have higher capital levels now than they had then.

b. Large banks now have more sophisticated capital management systems with a stronger focus on economic capital.

c. Basel I generally required larger banks to raise their capital levels or reduce their risk-weighted assets, and was neutral toward small banks. Basel II generally will lead to little change or modest reductions in required capital and the amount will depend upon the risk profile and circumstances of the particular institution.

5. *Basel I was implemented largely during a stress environment in hanking, where banks had some incentive to adjust their ratios by making balance sheet adjustments.*

9. *The mortgage originations business of the mortgage bank subsidiary is unlikely to be affected by Basel II.* The business model for the JPMC's mortgage subsidiary is that of a mortgage banking firm. As such, they are primarily in the business of originating and selling the loans and do little direct investment in the credit risk associated with mortgage portfolios. Such investment in mortgages and MBS is done in another part of the bank. All agreed that the Basel II would have little impact on the mortgage originations business. This business is much more affected by operating efficiencies and customer relationships than regulatory capital.