

**From:** Sandra.L.Marconi@chase.com on 11/07/2003 12:40:58 PM  
**Subject:** Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord

This letter was faxed to you yesterday evening.

November 6, 2003

Mr. John D. Hawke, Jr.  
Office of the Comptroller of the Currency  
250 E Street SW, Washington, DC 20219  
Fax: (202) 874-4448  
Attention: Docket No. 03-14

Ms. Jennifer J. Johnson, Secretary,  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue, NW, Washington, DC 20551  
Fax: (202) 452-3819  
Attention: Docket No. R-1154

Mr. Robert E. Feldman, Executive Secretary  
Federal Deposit Insurance Corporation  
550 17th Street, NW, Washington, DC 20429  
Fax: (202) 898-3838  
Attention: Comments, FDIC

Regulation Comments, Chief Counsel's Office,  
Office of Thrift Supervision  
1700 G Street, NW, Washington, DC 20552  
Fax: (202) 906-6518  
Attention: No. 2003-27

Dear Sir or Madam:

The JPMorgan Chase Community Development Group appreciates the opportunity to comment on the proposed Basel II Capital Accords.

The JPMorgan Chase Community Development Group's mission is to strengthen the communities in which we do business through expanding access to capital and providing the resources of JPMorgan Chase. In this endeavor we have historically provided significant financial support for low- and moderate-income communities through investments in community and economic development entities (CEDEs).

We are concerned about a potential unintended consequence of the proposed Basel Accord rules that could adversely affect the amount of equity capital invested in affordable housing, community and economic development. The proposal appears to be in conflict with 12 CFR Part 24, the regulation governing investments that are designed primarily to promote the public welfare.

The vital role of these investments in the United States is clearly recognized in part of the proposals. It is apparent that thoughtful U.S. bank regulators, working with those of other nations, negotiated a special

rule for "Legislated Program Equity Exposures." This section wisely preserves the current capital charge on most equity investments made under legislated programs, "recognizing this more favorable risk/return structure and the importance of these investments to promoting public welfare goals." Insured depository institutions investing as a result of such programs therefore would set aside, by and large, the same amount of capital for CRA equity investments under the new rules as they do now ? about \$8.00 for every \$100.00 of capital invested.

Given that CRA investments in affordable housing and community and economic development all have a different risk/return profile than other equity investments, the foregoing treatment is very appropriate. Based on the considerable experience in the U.S. to date, CRA equity investments may well provide lower yields than other equity investments. They also have much lower default rates and volatility of returns than other equity investments. For example, the public accounting firm of Ernst & Young reported in 2002 that the incidence of foreclosure, the single greatest risk to a tax credit investor, was only .14% on tax credit properties over the period 1987-2000, and .01% on an annualized basis. It is important that the final regulations make clear that "investments in CEDEs" comprise all types of activities that are eligible for bank investment under Part 24 as "Legislated Program Equity Investments" that are held harmless from higher capital charges.

The "materiality" test of the proposed rules is of great concern. The materiality test requires institutions that have, on average, more than 10 percent of their capital in ALL equity investments, to set aside much higher amounts of capital on their non-CRA investments, such as venture funds, equities and some convertible debt instruments. As drafted, this calculation even includes CRA investments that are specifically held harmless from the new capital charges. This has the effect of creating unfair competition for space in the "materiality bucket between investments in CEDES (CRA equity investments) and all other equity investments." It causes unfair competition between CRA investments that are equity investments, and those that are not (like mortgage-backed-securities and loan pools).

Having to include CEDE equity investments, with their very different risk/reward profile, in the proposed "materiality" bucket of more liquid, higher-yielding, more volatile equity exposures will have an unintended chilling effect on the flow of equity capital to those in need. Some insured depository institutions that meet the credit needs of their communities with substantial investments in affordable housing tax credits and/or Community Development Financial Institutions, currently approach or even exceed, the 10 percent cap from CRA-qualified investments alone. While the proposed rule would grandfather these institutions' current levels of investment for 10 years, it would serve to raise a red flag discouraging comparable levels of equity investment in low- and moderate-income communities going forward. If the test is adopted as proposed, it will put pressure on depository institutions to minimize investments in low-yielding and less liquid CRA equity investments, to avoid triggering the much higher capital charges on non-CRA equity investments. These higher capital charges will double on publicly traded equities, and triple or quadruple on non-publicly traded ones.

We understand that the rules will initially apply only to the biggest banks. Yet we believe it is fair to say that regulators expect that most other insured depository institutions will comply, sooner or later, and some banks will voluntarily comply immediately, as a matter of best

practices. It makes no sense to set up a conflict between the profitability of non-CRA equity investments, and the level of CRA-qualified equity investments. The support of depository institutions for affordable housing and community revitalization is well-established public policy in the United States. Numerous, recent studies, including those conducted by both the U.S. Treasury Department and the Federal Reserve Board, document that programs supporting these goals have had considerable positive impact on the nation's low- and moderate-income communities, with little or no risk to investors.

Four solutions to the "materiality test" of the proposed rules are suggested:

- First, it is important that the rule make clear that "investments in CEDEs" comprise all types of activities that are eligible for bank investment under Part 24 as "Legislated Program Equity Investments" that are held harmless from higher capital charges.
- Second, the rules should exclude all CRA-related equity investments that qualify under the Part 24 regulations from the materiality test calculation.
- Third, the proposal that SBIC investments receive only a "Partial Exclusion" from higher capital charges should not be expanded to include any other CRA-related equity investments.
- Fourth, the ANPR proposes a "cliff effect" whereby if total equity investments and/or SBIC investments exceed 10% of capital, then all of the non-CRA and SBIC equity investments will require higher capital. We suggest that only the additional equity investments above the 10% level should require more capital.

These suggestions will avoid disrupting an important marketplace serving accepted U.S. public policy goals. It will also preserve the flexibility of depository institutions to respond to the credit needs of their respective communities without regard to the form of that response.

On behalf of the JPMorgan Chase Community Development Group, I urge that appropriate changes be made to the proposed Basel Accord rule to remove CRA-related investments from the materiality test for determining capital requirements for other bank equity holdings. I appreciate this opportunity to comment and would be pleased to provide additional information of any form of assistance that will be useful in deliberations on these rule proposals.

Sincerely,

Mark A. Willis  
Executive Vice President  
JPMorgan Chase Bank