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Regulation Comments  
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RIN 1550-AC02

**Re: Risk-Based Capital Standards: Market Risk  
Action: Joint Notice of Proposed Rulemaking (NPR)**

**Introduction**

JPMorgan Chase & Co. (JPMC) is pleased to provide comments on the Notice of Proposed Rulemaking (NPR) which proposes modifications to the 1996 Market Risk Amendment (MRA) as published in the Federal Register on September 25th, 2006. We are also including our comments on related reporting requirements in Appendix A.

While the proposed changes apply to all banking organizations subject to the Market Risk Amendment, they are the result of the joint work of the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) in connection with the new Basel II Capital Accord (the Accord)<sup>1</sup>, which culminated in the July 2005 publication of "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects". Revisions to the MRA were undertaken in conjunction with the development of new risk-based capital framework known as Basel II. In addition to the Market Risk NPR, a separate Basel II NPR covering credit and operational risk was concurrently published in the Federal Register.

JPMC is currently subject to the MRA and thus the proposed revisions to the Market Risk Rules would apply.

<sup>1</sup> "International Convergence of Capital Measurements and Capital Standards, A Revised Framework", Basel Committee on Banking Supervision, June 2004, updated Nov. 15, 2005.

We will be providing separate comment letters on the Basel II NPR and other related Basel II reporting requirements. In addition, we will be submitting comments on the related Basel IA<sup>2</sup> proposal. Although each of these comment letters is intended as a stand-alone document, we request the agencies incorporate by way of reference our other comment letters as part of our response to this request for comment.

As a large, internationally active banking organization, JPMC is a “core bank”<sup>3</sup> that will be required to implement the U.S. version of the advanced approaches<sup>4</sup> described in the Basel II NPR rather than continue under the existing risk-based capital rules (Basel I<sup>5</sup>).

JPMC has fully and consistently supported the goals of capital adequacy reform: to create a more risk-sensitive capital framework and provide incentives for banking organizations to improve their risk management and measurement practices. JPMC remains strongly supportive of these goals and has made substantial investments to implement Basel II requirements, together with supporting systems and processes, over the past three years. We have developed a robust implementation plan designed to meet all qualification requirements at the earliest permissible date and continue to devote considerable resources to this ongoing effort.

Below is JPMC’s response to the agencies’ specific request for comment related to the proposed Market Risk NPR.

## **A. EXECUTIVE SUMMARY**

Banking organizations subject to the MRA, and particularly those adopting the more advanced Basel II approaches, should not be unduly burdened by the additional constraints imposed in the NPR. JPMC believes risk should not be segregated into separate components (e.g. VaR, specific risk and incremental default risk). Instead, we support a comprehensive risk framework for regulatory capital that calculates “total risk” for an organization inclusive of all relevant risk factors and measures.

The following are the key elements of the NPR that we believe require significant modification.

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<sup>2</sup> “Basel IA” regulations refer to the modifications to the existing Basel I regulations as proposed in a separate NPR.

<sup>3</sup> “Core bank” refers to any banking organization with either consolidated total assets of \$250 billion or more or on-balance sheet foreign exposure of \$10 billion or more that is required to adopt the Advanced Capital Adequacy Framework.

<sup>4</sup> “Advanced approaches” refer to the Advanced Internal Ratings Based (A-IRB) and Advanced Measurement Approach (AMA) for credit and operational risk, respectively.

<sup>5</sup> “Basel I” regulations refer to the current general risk-based capital regulations in the U.S., which represent the U.S. implementation of the original 1988 Basel Accord and subsequent modifications to date as published by the U.S. agencies.

1. The NPR proposes bifurcating the trading account into covered and noncovered positions and introduces the concept of residual securitization positions, which are to be deducted from capital. We oppose this bifurcation of the trading account and the deduction from capital under the residual securitization rules. We are also concerned that, if adopted in the final NPR, the residual securitization rules may become the default treatment for classes of positions that are not otherwise addressed in the NPRs. In particular, we are concerned by an interpretation by some agency staff that suggests that hedge fund positions, possibly without regard to level of seniority or diversification effects, will be included in the definition of residual securitizations.

We believe that banks should continue to classify positions in accordance with GAAP for regulatory purposes. Banks should be able to demonstrate that their risk models capture all material risks of the positions in their trading account. Consistent with this philosophy, we oppose the exclusion of residual positions, including open hedge fund positions, from the definition of a covered position.

2. There are many transactions in the market involving effectively hedged trading structures where one or both sides of the transaction has restrictive covenants and the hedge is not traded in a liquid two-way market. Under the proposed rules these types of transactions would fail the definition of a covered position due to the requirement for the hedge to trade in a liquid two way market. If the distinction between covered and noncovered positions is adopted in the final rules, we believe that these types of positions should continue to fall within the definition of a covered position provided banks are able demonstrate that their models capture all material market risks of such positions.
3. The Market Risk Rules are scheduled to come into effect on January 1st, 2008. We request that the implementation date be aligned with the Credit and Operational Risk Rules (i.e. January 1st, 2009).
4. The proposal to exclude credit derivatives hedging noncovered positions from the VaR calculation should be extended to similar scenarios where covered positions hedge noncovered positions, thereby avoiding the overstatement of VaR calculations. This is necessary due to the artificial distinction between the banking and trading book imposed by the current rules.
5. We believe that it is appropriate to identify the primary purpose of each trading desk/business and whether it takes proprietary positions on behalf of the firm, acts as a market maker or engages in customer activities. The NPR's requirement to distinguish between trading and hedging strategies, particularly at the position level, is often neither meaningful nor practical in a mature trading environment.
6. The NPR proposes that fees, commission and net interest income should be excluded from the P&L used in backtesting VaR models. In principle we

understand the rationale for using a “clean” P&L for initial model valuation and ongoing backtesting. However, we believe that banks should be able to use either the actual or clean P&L for ongoing backtesting, depending on what they consider to be appropriate and operationally feasible.

7. The NPR suggests including commodity and foreign exchange trades in a specific risk calculation. These positions may contain some attributes of specific risk, such as event driven basis risks. However, the current regulatory capital framework is not designed to capture these risks accurately. We believe that a comprehensive market risk model is the correct approach to capturing all risk elements of these positions.
8. The NPR requires that VaR is disclosed by risk type. We believe banks should have the flexibility to disclose risk measures, including VaR, which are most meaningful to them.

## **B. GENERAL COMMENTS ON THE NPR**

### **1. A Comprehensive Risk Framework**

Overall, JPMC believes that the new trading book treatment has a number of improvements, but falls short of providing a truly comprehensive framework. This particularly concerns us in the context of new products and underlyings that may not be captured accurately by the rules. Firms should be encouraged to build a flexible and complete approach to risk measurement that covers the full spectrum of complex products and underlying risks and provides a consistent baseline for determining capital multipliers. JPMC believes that firms should be encouraged to maintain risk approaches that capture general market risk (VaR), specific risk and incremental default risk in a unified fashion.

The concept of differentiating liquidity of underlying assets is key to flexible market risk measurement and should be applied consistently across both VaR and IDR. Separation of IDR and VAR components is quite artificial in some circumstances. For example, for a senior tranche of a synthetic CDO, the default exposure for a specific name in the portfolio depends on the spread levels of non-defaulting names. Thus, there is significant (structurally-induced) correlation between the drivers of IDR and VaR. Other complex structures have credit contingent payoffs tied to other markets leading to similar structural correlation (e.g., risky-fied exotic interest rate derivatives). For emerging traded products, such as ABS loans, important market drivers of price may only be observable periodically.

During a severe market disruption, there will generally be a spectrum of liquidity with some positions taking longer to exit or hedge out than others. A consistent framework can be developed that handles the full range of liquidity time-scales in the risk measurement. JPMC's proposes using a single risk horizon for aggregation but to compute risk measures from a simulated terminal distribution of P&L including the impact of hedging activity. Hedge simulation would reflect, for example, the behavioral assumption that liquid, first order risks would be defeased as quickly as possible in the event of a severe market disruption.

Given concerns over portfolio rebalancing affecting risk calculations over an extended time horizon, the agencies have introduced the concept of "constant level of risk". JPMC believes that this is difficult to apply to a complex portfolio in a meaningful fashion, especially when VaR and IDR are captured together. There are many different prescriptions that could be considered for modeling a constant level of risk that would lead to very different capital measures. JPMC believes there are two choices to eliminate practical concerns over the proposed rules: 1) set short risk horizons so that portfolio roll off is not a material issue; and 2) make explicit behavioral assumptions about trading and hedging strategies, relevant in a crisis situation, that can be used to model portfolio changes.

## 2. Effective date of January 1st, 2008

The proposed revisions to the Market Risk rules are due to become effective as of January 1st, 2008. However the NPR for Credit and Operational Risks states that a parallel run will begin in 2008 with the three transitional years running from 2009 to 2011. This discrepancy will result in certain positions (e.g. residual tranches of securitizations) being excluded from the definition of covered positions in 2008. Also the population of trades classified as residual positions will change from 2008 to 2009 because the definitions are different under Basel I and Basel II rules. Additionally Market Risk NPR disclosures will become public a year earlier than those for the Credit and Operational Risk NPR.

Given that comments on the Market Risk NPR are not due to be submitted until late January 2007 it is unlikely that final rules will be published until Q2/3 2007 meaning that banks will have very little time to implement and test the new Market Risk calculation methodologies and processes before having to publicly disclose results.

We suggest that the new Market Risk rules are implemented at the same time as those for the Credit and Operational Risk NPR to reduce operational burdens on the banks and increase the chances of smooth implementations.

We would also like further clarification regarding which Basel I rules will apply during the transition period, the rules in effect as of December 31st, 2007 or the amended rules in effect at the time of each reporting cycle.

### **C. RESPONSES TO THE 14 SPECIFIC QUESTIONS IN THE NPR**

Question 1: The agencies seek comment on the thresholds for the application of the Market Risk capital rule and, if they should be changed, on what appropriate thresholds might be.

Response 1: The limits would appear to be appropriate.

Question 2: The agencies request comment on all aspects of the proposed definition of covered position. The agencies are particularly interested in comment on additional safeguards that the agencies might implement to prevent abuse of the hedge component of the definition of covered position and increase transparency for supervisors.

Response 2: We do not support the bifurcation of the trading account into covered and noncovered positions. As long as banks are properly capturing the counterparty risk of hedges under the Credit Risk rules, then agency concern about less liquid two way markets should be mitigated.

Banks have many effectively hedged trading structures where one or both sides of the transaction have restrictive covenants and the hedge is not traded in a liquid two-way market. Under the proposed rules these types of transactions would fail to meet the definition of a covered position.

We believe that we should classify positions consistent with GAAP and ensure capture of those positions classified in the trading account in our Market Risk systems where appropriate. Regulatory guidelines require each bank to demonstrate the effective capture of the material risks of all trading positions. Partial or mismatched hedges would result in increased VaR and other Market Risk measures. Pillar 2 can be used to monitor the risk measurement process with appropriate adjustments made as necessary.

Question 3: The agencies propose to allow the exclusion of credit derivatives that hedge the credit risk of noncovered positions from the definition of a covered position. The agencies request comment on whether there is a better approach that matches more effectively the true economic impact of these transactions.

Response 3: If the bifurcation of the trading account is adopted in the final NPR, we support the agencies view that credit derivatives hedging noncovered positions should be excluded from VaR provided that there is no material unhedged residual risk. We would like the agencies to confirm that this would also mean that these transactions will be excluded from the Specific and Incremental Default Risk calculations.

We recommend that this approach is extended to encompass other trade structures where covered positions hedge noncovered positions, for example interest rate derivatives and debt positions which are used to hedge Mortgage Servicing Rights. This would avoid inflating the VaR-based measure of Market Risk due to only one side of a hedged position falling into the current definition of a covered position. These asymmetric VaR calculations are a result of the artificial distinction between the trading book and banking book that the current framework dictates.

The preamble to the rules<sup>6</sup> suggests that interest rate derivatives that are hedges of noncovered positions would not be classified as covered positions, however the rules themselves<sup>7</sup> do not specifically state this. We would appreciate it if the agencies would confirm whether it is the general intent that all hedges of noncovered positions are themselves noncovered positions and are therefore to be excluded from the Market Risk calculations.

Question 4: The agencies request comment on the extent and materiality of any distortion of the VaR-based measure due to the inclusion of some, but not all, offsetting transactions, and on any appropriate approaches to address this distortion in the final rule, including, subject to certain restrictions, (1) permitting a bank to include in its VaR-based measure the interest rate risk associated with certain noncovered positions that are hedged by covered positions (while remaining subject to a credit risk capital requirement for the noncovered positions) or (2) permitting a bank to include in its VaR-based measure certain internal interest rate derivatives hedging noncovered positions. The agencies also request comment on any operational considerations such approaches would entail.

Response 4: JPMC supports a total risk framework that captures offsetting positions based on explicit portfolio risk profiles. As a rule, JPMC does not manage its interest rate risk on a portfolio basis but separates hedges of covered positions from those that hedge noncovered positions. Including noncovered positions that are being hedged by covered position in VaR, would also remove the asymmetry within the Basel I calculation; so, we conceptually agree with proposals (1) and (2). However, we should point out that only a portion of noncovered positions may be hedged by covered positions. Therefore, including the full amount of the noncovered position in the VaR would result in an overstatement of the calculation. Operationally, it would be burdensome to include just the hedged portion of the noncovered position because the portion of noncovered positions being hedged by covered positions changes on a daily basis.

As indicated in our response to Question 3 above, we would propose to exclude all effective hedges of noncovered positions, both internal and external transactions, from

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<sup>6</sup> Federal Register, Volume 71, Number 185, September 25th, 2006; P.55964.

<sup>7</sup> Federal Register, Volume 71, Number 185, September 25th, 2006; P.55971.

the VaR calculations (e.g. hedges that qualify under FAS 133) provided that no material risk remains.

Note that both internal and external transactions are currently included in the VaR calculation.

Question 5: The agencies seek comment on the proposed definition of residual securitization position, and on the market maker exception and the conditions to use that exception. With respect to positions that do not qualify for the market maker exception, the agencies request comment on the treatment of those positions under the credit risk capital rules and whether such treatment could give rise to any operational or other issues.

Response 5: The timing gap between the implementation of the Basel II Market Risk and Basel II Credit & Operational Risks rules causes operational complications. In 2008 the term "residual securitization" position is defined and will result in certain positions being moved to the banking book and given Basel I credit treatment. In 2009 the definition of a residual position changes again and will result in additional positions being excluded from the definition of covered positions. From 2009 positions classified as residual securitizations will be removed from the trading book and deducted from capital in accordance with the Basel II Credit and Operational Risks NPR. This will create onerous operational issues due to RAP / GAAP breaks, both in terms of reconciling the breaks and explaining them.

The NPR proposes to apply Credit Risk rules and exclude residual securitization positions from trading book treatment. There is an exception for those positions where a bank is acting as market maker with the following qualifying conditions:

- (i) *a two-way market exists for the securitization position, or in the case of a securitization position that relies solely on credit derivatives, for the securitization position or all of its material risk components;*
- (ii) *the bank holds itself out as ready to buy or sell these securitization positions for its own account on a regular and continuous basis at a quoted price,*
- (iii) *the bank's internal models fully capture the general Market Risk and specific risks of its securitization positions and sufficient market data are available to model these risks reliably; and,*
- (iv) *the bank has adequate internal systems and controls for the trading of securitization positions.*

We disagree with applying the Credit Risk rules to residual securitizations (which results in a deduction from capital for these positions). The market risk rules are more appropriate as they allow for more accurate and comprehensive modeling of the risk in these transaction types. We believe that items (iii) and (iv) above are sufficient to determine whether a position can receive trading book treatment. We are concerned that



(i) and (ii) will force banks to exclude positions that meet the intended definition of a trading asset.

### **Hedge Fund Positions**

We understand that there may be an alternative interpretation by agency staff, with which we do not agree, that residual securitization positions would include hedge fund positions on the basis that:

- (i) They are tranching positions.
- (ii) They would result in a deduction against capital if treated under banking book rules.

We do not agree with this interpretation for the reasons outlined below.

Banks have four generic types of hedge fund positions:

1. Transactions where a bank provides leverage to a hedge fund structure but remains senior in the structure protected by the investor's equity position.
2. Liquidity facilities where a bank provides liquidity to structures in order to fund differences between cash inflows from hedge fund investments and outflows to investors. The bank concerned is also senior to the investors in these structures.
3. Effectively hedged offsetting trades where the return on a position in a hedge fund or fund of funds is passed straight through to investors via a derivative or note.
4. Open stakes in hedge funds, many of which are in well-diversified funds of funds.

None of the above structures is the result of a securitization and in 1, 2 and 3 banks are senior in the structure and therefore do not hold first loss positions. Position type 4 is no more a residual securitization position than an equity holding in a publicly listed company is. We believe this interpretation is confined to the United States so if it were to be enacted it would create a competitive disadvantage compared to our overseas peers. We recommend that these positions continue to be included in the definition of covered positions but that the banks should be required to capture all material market risks of such positions, including longer term default risk as appropriate. If they are to be excluded then they should receive the same treatment as equity investments under the Credit Risk NPR.

We also request that the agencies provide clarification regarding what other types of structure they would consider to fall within the definition of "Residual Securitization Positions". We are concerned that, without a more specific definition, residual securitization treatment (i.e. a deduction against capital) will be used as the default treatment for scenarios where positions have no alternative treatment identified within the banking and trading book rules.

Question 6: Excerpt from the Market Risk NPR:

*The proposal introduces new requirements for the identification of trading positions and the management of covered positions. The agencies believe that these new requirements are warranted based on the trend towards the inclusion of more credit risk related, less liquid, and less actively traded products in banks' covered positions. The risks of these positions may not be fully reflected in the requirements of the market risk capital rule and may be more appropriately captured under the credit risk capital rules.*

*A bank would be required to have clearly defined policies and procedures for determining which of its trading assets and trading liabilities are trading positions. In determining the scope of trading positions, the bank would be required to consider (i) the extent to which a position (or a hedge of its material risks) could be marked-to-market daily by reference to a two-way market, and (ii) possible impairments to the liquidity of a position.*

*In addition, the bank must have clearly defined trading and hedging strategies. The bank's trading and hedging strategies for its trading positions must be approved by senior management. The trading strategy must articulate the expected holding period of and the market risk associated with each portfolio of trading positions. The trading strategy must also articulate whether the purpose of each portfolio of trading positions is to accommodate customer flow, to engage in proprietary trading, or to make a market in the positions. The hedging strategy must articulate for each portfolio the level of market risk the bank is willing to accept and must detail the instruments, techniques, and strategies the bank will use to hedge the risk of the portfolio. The hedging strategy must clearly articulate which positions are being hedged and which positions serve as hedging instruments.*

*A bank would be required to have clearly defined policies and procedures for actively managing all covered positions. In the context of nontraded commodities and foreign exchange positions, active management could focus on managing the risks of those positions within the bank's risk limits. For all covered positions, these policies and procedures would be required to address, at a minimum, marking positions to market or model on a daily basis; assessing on a daily basis the bank's ability to hedge position and portfolio risks and the extent of market liquidity; and the establishment and daily monitoring of position limits by a risk control unit independent of the trading business unit. Senior management would be required to monitor all of this information on a daily basis. The policies and procedures would be required to provide for reassessment by senior management of established position limits on at least an annual basis, as well as annual assessments by qualified personnel of the quality of market inputs to the valuation process, the soundness of key assumptions, the reliability of parameter estimation in pricing models, and the stability and accuracy of model calibration under alternative market scenarios.*

The agencies seek comment on these requirements and on whether different or additional policies and procedures would be beneficial for ensuring appropriate identification of positions to which the Market Risk capital rule should be applied and appropriate risk management of covered positions.

Response 6: We appreciate the agencies' desire to document strategies identifying trading positions, and indeed it is our standard practice to document such strategies during our product approval process. We believe that this is a sufficient control to ensure the appropriate treatment of positions under the Market Risk rule. We also believe that it is reasonable for firms to simply differentiate between desks/businesses that engage in proprietary positioning versus those that are market makers transacting business on behalf of customers. This level of differentiation is consistent with the way that trading businesses are managed.

Trade structures mature over time and the original purposes for trading them may change. Therefore, it would be an overly burdensome operation to maintain an up-to-date library of policies for all positions. We believe existing policies and procedures are sufficient to ensure appropriate treatment.

The requirement to distinguish between trading and hedging strategies and to "clearly articulate which positions are being hedged and which positions serve as hedging instruments" is neither meaningful nor practical in a mature trading environment where the long and short positions act as hedges to each other, e.g. credit derivatives hedging bonds and vice versa. The trading and hedging strategies are essentially combined. We recommend that the distinction between trading and hedging positions be removed from the NPR. Similarly it is not practical to distinguish between the purpose of individual trades in most lines of business. Generally trading desks engage in a mixture of client, proprietary and market making trades. To maintain records of which is which is operationally impractical and not meaningful. We therefore oppose the introduction of these requirements.

Question 7: The agencies request comment on all aspects of prepayment risk, including the extent and materiality of prepayment risk, whether material prepayment risk may warrant a further explicit requirement that banks hold capital against prepayment risk over a one-year horizon under both the internal models and standard approaches to specific risk, and the interplay between prepayment risk and default risk for purposes of determining the bank's overall measure for Market Risk. The agencies also seek comment on how an explicit capital requirement for prepayment risk could be designed.

Response 7: We believe that a VaR model that captures the material risk of positions should capture prepayment risk for positions where that is relevant.

The need to accurately compute the market risk of securities, which would include their prepayment risk, is no different than the need to capture material market risk elements of any covered position. The manner in which prepayment risk is captured will vary according to the nature of the position concerned and the materiality of any prepayment risk.

Question 8: The agencies request comment on the exclusion of fees, commissions, reserves, and net interest income for the trading profit or loss used for regulatory backtesting, including the appropriateness and feasibility of these exclusions, and whether additional items should also be excluded. The agencies also request comment on the role of hypothetical backtesting-- specifically, whether hypothetical backtesting is feasible as part of model validation; whether other forms of backtesting should also be used; and whether regulatory backtesting should be based on hypothetical backtesting.

Response 8: We support the exclusion of fees, commissions, reserves, and net interest income (NII) from model validation backtesting but not necessarily from ongoing regulatory backtesting. We employ "clean P&L" (i.e. excluding NII, fees, commissions, etc.) when using real and hypothetical portfolios to validate risk models. However, the actual reported P&L of JPMC includes NII, and other additional components, the calculation of which is currently embedded in JPMC's P&L process.

Therefore, for operational reasons it is not currently practical to exclude NII from ongoing regulatory backtesting as this element will be inextricably embedded in the actual profit and loss reported. Additionally, it can be argued that NII is also a legitimate source of revenue generated by trading activity and should be included when comparing the P&L against potential losses, as indeed occurs under current Basel I rules. Given that, we believe it would be appropriate for banks to measure VaR either against actual P&L or "clean" P&L depending on what they consider to be appropriate and operationally feasible.

### **Backtesting**

We would like to take this opportunity to comment on Backtesting as a validation tool. There are several rationales for employing Backtesting as an approval tool, these include:

- validating distributional assumptions for underlying market factors in the risk calculation;
- demonstrating that the selection of risk factors modeled by the risk calculation is adequate for the products;
- testing the numerical accuracy of approximations or numerical schemes used in the risk calculation or associated valuations;
- demonstrating portfolio diversification by comparing the overall portfolio backtest behavior against that of more concentrated sub portfolios; and,
- confirming the operational integrity of the system.

Although we acknowledge that backtesting can provide some information on each of these dimensions of validation, it is never the preferred way to test any of these aspects. For example, the distributional assumptions should be tested directly through statistical validation of the model input parameters and output market scenarios. The accuracy of the pricing models can only be rigorously tested by examining a large number of defined scenarios and convergence tests. Even viewed as a holistic adjunct to other more specific model testing, backtesting provides very limited value to the banks and therefore is a regulatory burden without commensurate internal risk management benefit.

Question 9: The agencies request comment on the proposed timeframe for phasing out partial modeling of specific risk and on whether it would allow banks enough time to implement the proposed changes.

Response 9: We concur with the agencies' encouragement of banks to develop and implement models that integrate the measurement of VaR and specific risk. We strongly support the philosophy of moving to an environment where all material aspects of specific risk are captured within our models. January 1st, 2010 would seem to be an appropriate timeframe for banks to implement the proposed changes.

Question 10: The agencies seek comment on the extent and materiality of specific risk for commodities and foreign exchange positions and on whether and how a specific risk capital requirement for those positions could be developed under both the internal models and standard approaches.

Response 10: We agree with the current exclusion of commodities and foreign exchange positions from the specific risk capital requirements. Under the current rules, Specific risk is intended to capture additional charges for instruments with debt or equity components. The current rules are not designed to capture the specific risk attributes embedded in some commodity and foreign exchange positions. We support a comprehensive market risk model that would capture all risk elements of a position including event driven basis risks for commodity and foreign exchange trades.

Question 11: The agencies request comment on how a bank should adjust the incremental default risk capital requirement to adjust for the impact of liquidity, concentrations, hedging, and optionality.

Response 11: We agree with the concept of a liquidity horizon for a particular underlying asset, defined as the expected time under stressed market conditions to exit or hedge the position. In this fashion, the liquidity horizon will also capture concentrations. To implement this in a portfolio risk framework, our proposal is to have a common risk

horizon but to capture the impact of hedges in the distribution. The behavioral assumption is that the firm would hedge out liquid first-order risks in the position as rapidly as possible as captured in the relevant liquidity horizon. For options there would likely be residual risks not covered by the simulated hedging.

Question 12: The agencies request comment on all aspects of the proposal to reflect in the Market Risk capital requirement a measure of incremental default risk.

Response 12: We have no issues with the 1-yr 99.9% quantile measure, provided adjustments for risk defeasance over shorter horizons are allowable where appropriate. Additional details on our response to this question are provided in General Comment 1 in this letter.

Question 13: The agencies request comment on the extent to which banks, at present, measure incremental default risk and the prospects for development of methodologies to capture this risk fully in internal models by the proposed January 1, 2010 deadline. The agencies also request comment on the fallback methods proposed for banks unable to develop an internal model to capture incremental default risk by January 1, 2010.

Response 13: We have internal models capable of measuring incremental default risk over a fixed horizon for a variety of credit products, capturing effects of optionality. The additional development to differentiate by liquidity and capture hedging impact has been explored theoretically and for some specific cases. We believe that the January 1st, 2010 deadline is feasible based on our current understanding of the standard.

Question 14: The agencies seek comment on all aspects of the proposed public disclosure requirements.

Response 14: We have concerns that some of the disclosures may be burdensome to produce and could be subject to misinterpretation or force us to disclose proprietary information.

*(i) Quantitative disclosures for internal models.*

*For each portfolio of covered positions, the bank must publicly disclose the following information at least quarterly:*

*(1) The high, low, and mean VaR-based measures over the reporting period;*

*(2) Separate VaR-based measures for interest rate risk, credit spread risk, equity price risk, foreign exchange risk, and commodity price risk; and*

*(3) A comparison of VaR-based estimates with actual gains or losses experienced by the bank, with analysis of important outliers.*

Item (i)(2): Statistical risk measures, such as VaR, by necessity include volatility and correlation assumptions. Therefore, the value of decomposing VaR is somewhat questionable from a management perspective. We believe banks should have the flexibility to disclose risk measures, including VaR, that are most meaningful to them. We have no theoretical objection to the requirement to report VaR by risk type provided we are able to report risk based on the predominant characteristic of a given position.

Point (i)(3): VaR is a measure of expected losses not gains so a comparison against actual gains and losses would not be meaningful. Backtesting results that show actual losses against VaR estimates are available and are disclosed in JPMC's annual report. It would be operationally burdensome and not meaningful to provide similar analysis for the gains.

*(ii) Qualitative disclosures for internal models.*

*The bank must publicly disclose the following information at least annually, or more frequently in the event of material changes:*

*(1) The composition of material portfolios of covered positions;*

*(2) The bank's valuation policies, procedures, and methodologies for covered positions;*

*(3) The characteristics of the internal models used for purposes of this rule;*

*(4) A description of the approach used for validating and evaluating the accuracy of the internal models and modeling processes for purposes of this rule;*

*(5) For each Market Risk factor (that is, interest rate risk, credit spread risk, equity price risk, foreign exchange risk, and commodity price risk), a description of the stress tests applied to the positions subject to the factor;*

*(6) The results of a comparison of the bank's internal estimates for purposes of this rule with actual outcomes during a sample period not used in model development; and*

*(7) The soundness standard on which the bank's internal capital adequacy assessment under this rule is based, including a description of the methodologies*

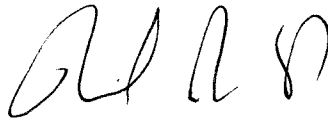
*used to achieve a capital adequacy assessment that is consistent with the soundness standard and the requirements of this rule.*

Item (ii)(5): We support a more detailed disclosure of the process and approach to stress testing but not the disclosure of detailed stress tests and their results.

Item (ii)(6): Please would the agencies clarify how this differs from the current backtesting approaches used.

JPMC appreciates the opportunity to comment in this NPR and supports the effort to provide a more risk sensitive capital framework. If you have any questions, please contact Adam M. Gilbert, Managing Director, Risk Management, at (212) 270-8928 or Andrew M. Abrahams, Quantitative Research, at (212) 270-2924.

Sincerely,

A handwritten signature in black ink, appearing to read 'MJC', is positioned above the typed name.

Michael J. Cavanagh  
Chief Financial Officer  
JPMorgan Chase & Co.

CC: Andrew Abrahams, JPMC  
Adam Gilbert, JPMC  
Ned Pollock, OCC  
Barbara Yelcich, FRBNY



## Appendix A: JPMC Comments on Market Risk Reporting Requirements

### 1. Market Risk Capital Charge.

Schedule 1 requires that all amounts are submitted in terms of capital charge. The concept of "Capital Charge" is an anachronism that has not been used by banks for many years. The current norm is for banks to manage their businesses in terms of Risk Weighted Assets (RWA). We therefore suggest that the title of the schedule is changed to "MARKET RISK - RISK WEIGHTED ASSETS". An additional benefit of doing this is that if the amounts are disclosed in terms of RWA then that will mean that the total of Line 27 of Schedule 1 should agree to the "Market Risk Equivalent" amount in Schedule B of the Credit and Operational Risk Reporting Rules, which would act as a control check for the agencies.

### 2. Previous Day Disclosures.

Lines 1 to 9 of Schedule 1 require the disclosure of Previous Day VaR numbers. For large institutions the prior day's VaR number is always significantly less than 3 times the average 60 day VaR because VaR is not very volatile for businesses of such size. Therefore reporting such information is not helpful to a reader of this schedule as 3 times the 60 day average is always used in the calculation. We believe this requirement is not meaningful and should be discarded.

### 3. Counterparty Credit Risk Disclosures.

Line 28 of Schedule 1 requires the disclosure of counterparty risks with respect to derivative and repo-style transactions. We believe it is inappropriate to disclose the RWA in relation to counterparties on this schedule. Counterparty Risk is calculated by applying banking book rules and is reported on Schedules C to K as required by the Credit Risk Regulatory Reporting Requirements. We also question the validity of including the repo-style transactions within this line item as these transactions are specifically excluded from full trading book treatment by the Market Risk NPR and are also separately disclosed in Schedules C to K. We recommend that, as Schedule 1 is designed to capture information with respect to Market Risk, Line 28 is removed from the template.

### 4. Standardized Approach Disclosures for Specific Risk.

Lines 29 through 44 of Schedule 1 require extremely granular information with respect to debt and equity positions that receive standard model treatment. We believe that this requirement is overly burdensome and will not provide the agencies with the ability to perform meaningful peer-to-peer comparisons due the differing extents to which those banks use specific risk models. We suggest that this section of the template is amended so that only the total RWA for equities and total RWA debt instruments are required, rather than broken out by rating, maturity etc.

## 5. Reporting Burden.

We would also like to comment on the estimate of burden highlighted in the supervisors' proposal. The supervisors estimate that a total of 36 respondents would incur a burden of 11.75 hours per response on average. While JPMC appreciates the difficulties in determining the estimated burden, we believe that the supervisors' estimate is significantly underestimated for large banking organizations based on the burden we currently incur in satisfying the regulatory reporting requirements for the bank holding company and the lead bank only.

Based on the proposed requirements, JPMC currently estimates that six legal entities including the bank holding company and the lead bank will be deemed to fall within the scope of Basel II. While those legal entities within the scope of Basel II other than the bank holding company and the lead bank are smaller in size, the burden for current filing is not significantly less. Furthermore, each of the Firm's lines of business will incur significant burden throughout each quarter in compiling and enriching their data to meet the proposed regulatory reporting requirements, particularly in light of the amount of detail currently proposed by the supervisors.