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| **To:** | Basel II NPR Public File |
| **From:** | Anna Lee Hewko |
| **Date:** | November 21, 2006 |
| **Re:** | Meeting of Federal Reserve, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation Staff and the JP Morgan Chase |

Representatives of JP Morgan Chase, the Federal Reserve Bank of New York, the Board of Governors, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation held a conference call on November 21, 2006 at which certain aspects of the interagency notice of proposed rulemaking (NPR) to implement a new risk-based capital framework based on the Basel II capital accord issued by the Basel Committee on Banking Supervision were discussed. JP Morgan Chase representatives identified operational concerns with the proposed capital calculation for exposures to defaulted wholesale obligors; the eligibility requirements for the double default treatment; the qualifying criteria for the internal models methodology; and the capital calculation for unsettled or failed foreign exchange transactions. In each case JP Morgan Chase identified practical considerations that make the proposed treatments problematic, and recommended an alternative approach. These recommendations are outlined in the attached presentation by JP Morgan Chase.

The list of participants included:

<u>Agency Participants</u>

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| Kevin Clarke | FRBNY |
| Kimberly DeTrask | FRB |
| Ken Egan | FDIC |
| Anna Lee Hewko | FRB |
| James Vesely | OCC |
| Paul Whynott | FRBNY |

<u>JPMC Participants</u>

Lisa Broomer
Adam Gilbert
Bipasha Majumdar
Paul Ricci
Tamana Kochar
David Alexander
Michelle Rosenthal-Hubertus

# FED / OCC MEETING – November 21, 2006



JPMorgan

# Capital Calculation for Wholesale Defaulted Exposures

**NPR Requirement** (Section 31, "Mechanics for Calculating Total Wholesale & Retail Risk Weighted Assets")

The capital requirement for a wholesale defaulted exposure is the larger of:

- 8% multiplied by the EAD of the wholesale exposure, plus the amount of any charge-offs or write-downs on the exposure; or
- K for the wholesale exposure (immediately before the obligor became defaulted), multiplied by the EAD of the wholesale exposure immediately before the obligor became defaulted

## Recommended Approach

- Apply treatment proposed in the Accord which relies on current risk parameters associated with exposure

# Double Default Eligibility Requirement

**NPR Requirement** (Section 34, "Guarantees and Credit Derivatives: Double Default Treatment")

One of the eligibility requirements for Double Default treatment to be applied is:

- <u>At the time the guarantor issued the guarantee or credit derivative</u>, the bank assigned a PD to the guarantor's rating grade that was equal to or lower than the PD associated with a long-term external rating in the third-highest investment grade rating category (i.e. A-)

## Recommended Approach

- Modify above criterion to state that <u>at any point after the protection was obtained</u>, the bank assigned a PD to the guarantor's rating grade that was equal to or lower than the PD associated with a long-term external rating in the third-highest investment grade rating category

# Qualifying Criteria for Internal Models Methodology

**NPR Requirement** (Section 32, "Counterparty Credit Risk")

Banks must satisfy certain qualifying criteria before using the Internal Models Methodology, one of which includes:

- The bank must measure and manage current exposures gross and net of collateral held, where appropriate. The bank must estimate expected exposures for OTC derivative contracts both with and without the effect of collateral agreements.

## Recommended Approach

- Bank's internal model should have capability to measure current and expected exposures gross and net of collateral and banks can be requested to demonstrate capability on ad-hoc basis.
- On a routine basis, however, where banks can demonstrate legal confidence in collateral enforceability, banks should be required to estimate current and expected exposure only net of collateral.

# Capital Calculation for Unsettled/ Failed FX Transactions

**NPR Requirement** (Section 35, "Risk-Based Capital Requirement for Unsettled Transactions")

- Our understanding is that OTC Derivative exposures such as FX Forwards are not to be included in the proposed capital calculations for unsettled/failed FX transactions. Treatment applies only to spot transactions.

**Recommended Approach**

- For implementation ease, banks should be permitted to calculate capital requirement on the net payment to the counterparty, which may potentially include failed amounts associated with derivative trades.