JPMorganChase

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March 23, 2007

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Docket No. 06-09
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RIN 1557-AC91

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Attention: Docket No. R-1261
regs.comments@federalreserve.gov

Regulation Comments
Chief Counsel's Office
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Attn: No. 2006-33
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RIN 1550-AB56

Re: Joint Notice of Proposed Rulemaking (NPR) Implementing New Risk-Based Capital Framework in the United States

Introduction

JPMorgan Chase & Co. is pleased to provide comments on the Notice of Proposed Rulemaking (NPR) implementing a new risk-based capital framework in the United States, also known as Basel II, as published in the Federal Register on September 25, 2006. As a large, internationally active banking organization, JPMorgan Chase & Co. is a "core bank"[1] that will be required under this NPR to implement the U.S. version of the advanced approaches[2] described in the new Basel II Capital Accord[3] (the Accord) rather than continue under the existing risk-based capital rules (Basel I[4]).

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[1] "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 proposed rule.
[2] "Advanced approaches" refer to the Advanced Internal Ratings Based (A-IRB) and Advanced Measurement Approach (AMA) for credit and operational risk, respectively.
[3] "International Convergence of Capital Measurements and Capital Standards, A Revised Framework." *Basel Committee on Banking Supervision*, June 2004, November 2005 and June 2006.
[4] "Basel I" regulations refer to the current 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.

We believe very substantial progress has been made in developing a new, more risk-sensitive capital framework for large, internationally active banking organizations since the Advance Notice of Proposed Rulemaking (ANPR) was published in August 2003. Having been actively involved in the Basel II process since it began under the Basel Committee on Banking Supervision (Basel Committee), we greatly appreciate this opportunity to comment as part of a continuing, constructive dialogue with the agencies.[5]

We are including as appendices to this letter separate comments on Basel II information collections activities and the Basel 1A[6] proposal. We also have previously submitted comment letters on the Market Risk NPR and associated reporting requirements. Although each of these comment letters is a stand-alone document, we request the agencies incorporate by way of reference our other comment letters as part of our response to the Basel II NPR.

Our comment letter is structured as follows:

I. Executive Summary
II. Support for a Risk Sensitive Capital Framework
III. Constraints on the Overall Level of Capital
IV. Capital Requirements for Credit Risk
V. Capital Requirements for Operational Risk
VI. Responses to Specific Questions in the NPR

Appendix A – Downturn LGD and the NPR
Appendix B – Comments on the Basel II Reporting Requirements
Appendix C – Comments on the Basel 1A NPR

I. Executive Summary

JPMorgan Chase & Co. has fully and consistently supported the goals of Basel II 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. We have a substantial investment program in place to implement Basel II.

While we continue to support the direction of Basel II, we are principally concerned with several specific requirements in the NPR that depart significantly from the international Basel II Accord. These departures in turn impose constraints and calculations that reduce the risk sensitivity of capital calculations, less effectively promote the objective of improved risk management or unnecessarily add to costs. The net impact of these

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[5] The term "agencies" refers collectively to the Federal Reserve Board, FDIC, OCC and OTS, as defined in the NPR. Unless expressly defined, other terms of art employed in this letter are generally consistent with the NPR definitions.

[6] "Basel 1A" refers to proposed modifications to the Basel I regulations as published in the *Federal Register*, Dec. 26, 2006.

The additional text of this comment letter does not relate to the Risk-Based Capital Guidelines; Docket No. R-1238. However, to review any portions of the additional text please refer to Risk-Based Capital Standards: Advanced Capital Adequacy Framework, Docket No. R-1261, Comment #45.

Attached in Appendix C is the response by JPMorgan Chase relating to Docket R-1238.

Appendix C: Comments on the Basel 1A NPR

Below are our comments on the proposed modifications to the existing risk-based capital framework (Basel 1A).[68] These modifications are intended for those institutions not subject to the Advanced Capital Adequacy Framework, as an alternative to the existing capital framework (Basel I). As a core Basel II banking organization, we will be required to implement the U.S. version of the Advanced Capital Adequacy Framework and will not have the option to adopt Basel 1A.

In response to this Notice of Proposed Rulemaking (NPR), we are not commenting in detail on the Basel 1A capital rules, but are limiting our remarks primarily to the last four questions posed in the text that relate to Basel II.

To summarize our responses below, we strongly support the adoption of alternative approaches to the most advanced Basel II approaches in the U.S. including the Standardized approaches to credit and operational risk. We believe such approaches should be open to all banking organizations and their use should not merely be on a temporary basis. In our view, a key difference between Basel 1A and the Standardized approach is the treatment of operational risk. If Basel 1A does not explicitly require an operational risk charge, then the 1A risk weights should reflect operational risk considerations. We oppose additional U.S.-only incremental requirements for Standardized and other alternative Basel II approaches that would lead to competitive inequities due to international inconsistency or would impose requirements that would lessen the risk sensitivity of the approach.

Possible Alternatives for Basel II Banking Organizations

In the Basel II NPR, the agencies inserted an additional question requesting comment on whether "*Basel II banking organizations should be permitted to use other credit and operational risk approaches similar to those provided in the Accord.*"[69] In this Basel 1A NPR, the agencies seek comment on all aspects of the following questions and "*seek the perspectives of banking organizations of different sizes and complexity.*" Since this NPR poses significantly more detailed questions regarding the rules that would apply to Basel II banks, we are responding to them in order to ensure that the agencies have a fuller appreciation of our support for the adoption of alternative Basel II approaches.

Question 19: To what extent should the agencies consider allowing Basel II banking organizations (mandatory and opt-in banks as defined in the Basel II NPR) the option to calculate their risk based capital requirements using approaches other than the Advanced Internal Ratings Based (A–IRB) approach for credit risk and the Advanced Measurement Approach (AMA) for operational risk? What would be the appropriate length of time for such an option?

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[68] *Federal Register*, Vol. 71, No. 247, December 26, 2006: p. 77446.
[69] Federal Register, Vol. 71, No. 185, September 25, 2006: p.55841.

Response: As stated above, we fully support offering all U.S. banks the option to adopt any of the less advanced Basel II approaches for operational risk and credit risk contained in the Accord, including the Standardized approach. Banks would thus be permitted to choose an approach that takes into account benefits of improved risk sensitivity, competitive considerations, implementation cost and operational complexity. Any alternative that limits the options open to banks runs the risk of creating competitive inequities, since some banks will be required to adopt an approach that they would find sub-optimal. We do not believe that permission to adopt Standardized or other simpler Basel II approaches should be limited only to Basel II banks, as this will not provide the benefits of choice for other banks on an equal footing with Basel II banks.

We oppose the use of the Standardized or other approaches by Basel II banks on a temporary-only basis. This suggests that use of a less advanced approach is only a steppingstone to a more desirable A-IRB and AMA final state. We believe the intent of the Accord was to provide other approaches on a more permanent basis. In other jurisdictions, banks can choose to remain on less advanced approaches indefinitely or move to the more advanced approaches at a later date at the bank's discretion. Please refer to our earlier comments for further elaboration on this issue.

Question 20: If Basel II banking organizations are provided the option to use alternatives to the advanced approaches, would either this Basel IA proposal or the Standardized approach in Basel II be a suitable basis for a regulatory capital framework for credit risk for those organizations? What modifications would make either of these proposals more appropriate for use by large complex banking organizations? For example, what approaches should be considered for derivatives and other capital markets transactions, unsettled trades, equity exposures, and other significant risks and exposures typical of Basel II banking organizations?

Since the stated objective of Basel II is to provide a more risk sensitive risk-based capital framework, Basel II banks are almost certain, given their support for this goal, to prefer the Basel II approaches to Basel 1A.

An overly detailed comparison of Basel 1A and Standardized rules is not particularly meaningful given the very fundamental differences between them, including:

- Scope: The Standardized approach is part of an international accord whereas Basel 1A is by design a modification of the existing framework for domestic institutions;
- Operational Risk: There is not recognition of Operational Risk in the Basel 1A framework.
- Disclosure: There are no additional disclosure requirements in this NPR, whereas Pillar 3 is a fundamental building block of the Basel II approaches.

If Basel 1A were modified to remedy these fundamental differences and begin to address the more complex activities of large international banks, the result would be a set of rules closely resembling the Standardized approach. If Basel 1A were to include a separate operational risk capital requirement, for example, then questions would inevitably arise regarding the justification for any detailed differences in credit risk weights between Basel 1A and Standardized rules. Not only would there be little rational for such differences, but this would once again raise the issue of creating consistency across jurisdictions and a level playing field for all competitors.

With respect to further modifications to the Standardized approach, we believe the Standardized rules contained in the Accord can be adopted without change and be suitable for use by Basel II banks. This approach is the result of several years of development by the Basel Committee, and any further modifications deemed necessary should be introduced only after consultation with the Committee, so that there is the highest degree of international consistency and the least degree of competitive inequity in the application of the rules at the national level. In our view, a rule to allow use of the Standardized approach without modification in the U.S. can be introduced without undue delay, given that these rules have already been introduced in other jurisdictions.

Question 21: The risk weights in this Basel IA proposal were designed with the assumption that there would be no accompanying capital charge for operational risk. Basel II, however, requires banking organizations to calculate capital requirements for exposure to both credit risk and operational risk. If the agencies were to proceed with a rulemaking for a U.S. version of a Standardized approach for credit risk, should operational risk be addressed using one of the three methods set forth in Basel II?

Yes, a U.S. version of the Standardized Approach should address operational risk using one of the three methods set forth in the Accord.

Question 22: What additional requirements should the agencies consider to encourage Basel II banking organizations to enhance their risk management practices or their financial disclosures, if they are provided the option to use alternatives to the advanced approaches of the Basel II NPR?

The computation of an adequate capital requirement and the employment of sound risk management practices are separate processes, even though the effectiveness of the latter impacts the capital number. This is true irrespective of the method of capital measurement. Adequacy of risk management practices should continue to be monitored as a regular part of the supervisory review process and any noted deficiencies addressed on a timely basis.

In general, we oppose additional requirements for financial disclosure or other additional requirements beyond those already specified in the Accord for any of the alternative advanced approaches that would apply only to banking organizations subject to the U.S. version of Basel II rules but not to other competitors. Please see our comments above on disclosure and the need for international consistency to maintain competitive equity.