JPMORGAN CHASE & CO.

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By electronic submission

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, RIN 7100-AD-86

Ladies and Gentlemen:

JPMorgan Chase & Co. appreciates the opportunity to comment on the notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System to implement the enhanced prudential standards of section 165 and the early remediation provisions of section 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

I. Summary

Throughout the regulatory reform process following the financial crisis, we have supported key regulatory initiatives designed to reduce the likelihood and potential impact of future severe financial market stress, including initiatives such as enhanced capital and liquidity standards, resolution authority and central clearing of standardized derivatives contracts. However, we have concerns about several of the proposals made by the Federal Reserve to implement the section 165 standards.

Several components of the proposed rule reach well beyond the requirements of the statute to propose standards that are not only potentially disruptive in their own right, but which are also variously duplicative or in conflict with other rulemakings and regulatory directives. In particular, the proposal on single counterparty credit limits fails to define what would constitute success with respect to its stated goal of reducing interconnectedness in the financial system and employs a rudimentary methodology for calculating the single counterparty credit limit that is clearly inaccurate and inconsistent with state-of-the-art risk management. The proposed methodology overstates the amount of exposure associated with portfolios of OTC derivatives between dealers active in that market, as those portfolios are typically characterized by relatively large gross notional amounts but a relatively small amount of net risk.

The effect of the proposed single counterparty credit limit methodology will be to create additional pressure to unwind largely offsetting trades in a potentially disruptive manner—trades that an accurate measurement methodology would not show as producing meaningful risk. We believe this outcome is not desirable, for three reasons: (1) Congress neither authorized nor mandated it; (2) numerous other provisions of the Dodd-Frank Act and other regulatory initiatives are simultaneously and directly addressing broader systemic risks; and (3) most importantly, an arbitrary and overstated restriction in counterparty credit will have real and adverse effects on markets.

Should the single counterparty credit limit proposal go into effect, we believe it could destabilize markets in the short-term and make them less efficient and resilient in the long-term. According to preliminary results from the study being sponsored by The Clearing House Association L.L.C., many of the largest dealers in OTC derivatives would exceed the proposed limit by a factor of two to three times. The severe restrictions on market makers' ability to distribute among themselves the risks acquired from serving customers would result in a typical banking entity retaining risks on its balance sheet for significantly longer periods of time than it would otherwise or not taking the risks on in the first place. As further discussed below, this restriction would also affect non-U.S. dealers because covered companies would be restricted in their ability to deal with major non-U.S. counterparties. The effect of the rule is to remove sources of liquidity for counterparties, resulting in a less efficient market, a contraction in the availability of credit, higher costs to corporate hedgers and other end-users, and decreased use of valuable risk management products throughout the financial system. In some cases, the rule as proposed may result in banking entities simply losing the ability to execute certain risk management transactions, such as purchasing protection on concentrations of credit exposure arising from lending or hedging prepayment risk in the mortgage portfolio.

We strongly support the comment letter on the proposed rule being submitted jointly by The Clearing House Association L.L.C., the American Bankers Association, the Financial Services Roundtable, and the Securities Industry and Financial Markets Association (the "joint trade association comment letter"), as well as the comment letter by the Risk Management Association. We share the views and concerns expressed in those letters, and believe their recommendations provide a constructive way forward.

As described in detail in the joint trade association comment letter, there are sound alternatives to the proposed single counterparty credit limit methodology. There is an existing toolkit of methodologies, familiar to both market participants and regulators, that could produce a calculation that is economically meaningful, without the serious adverse effects of the proposed methodology. Either a stressed internal model methodology ("IMM") or a counterparty stress method, as proposed in the joint trade association comment letter, would produce a more accurate measurement of risk and avoid market disruption or distortion.

While the single counterparty credit exposure limit is clearly the most troubling and most significant aspect of the proposed rule, there are numerous other provisions that will have

significant effects and merit further review. We share the concerns expressed in the joint trade association comment letter, particularly with respect to stress testing and liquidity and risk management standards. We endorse their proposed solutions.

II. Single Counterparty Credit Limits

A. Methodology

Single counterparty credit limits are designed to contain the adverse effect that the failure of any individual counterparty could have on a covered company. In order to achieve this goal, it is critical to measure that exposure accurately, and JPMorgan and its peers devote considerable resources to doing so in a sophisticated manner.

The proposed rule, however, requires the use of a Current Exposure Method ("CEM") for some products and a notional-based substitution approach for others. These methodologies produce very large misstatements – and, in most cases, overstatements – of the true counterparty exposure. This misstatement is particularly severe when applied to the portfolios of active dealers in the OTC derivatives market.

Below we detail our particular objections to the Federal Reserve's proposed methodology and our proposed solutions. Before doing so, however, we outline key factors that appear to have driven the development of the proposed rule:

- A desire that the exposure calculation methodology be standardized, simple and model-independent, resulting in the adoption of the CEM methodology. A belief that certain models performed poorly during the crisis combined with the complexity in the financial system would explain the preference for simplicity and model independence. In addition, the Federal Reserve has an understandable desire to promulgate rules that are not excessively burdensome for banking entities other than major covered companies.
- A concern about "wrong-way risk", resulting in the adoption of the substitution methodology. During the crisis, certain institutions purchased protection from counterparties which, in hindsight, were very unlikely to have the financial wherewithal to perform on their obligations under the circumstances in which the protection was needed. Wrong-way risk can also arise in connection with secured lending activities, and the concern is also evidenced in the proposals governing those activities.
- A view that the outstanding gross notional amounts of OTC derivatives between systemically important financial institutions ("SIFIs") are an indicator of an undesirable level of interconnectedness and a risk in and of themselves, which is not captured by a net measure.[1] These concerns may translate into a desire to limit the amount of trading

[1] This view, however, does not take account of legally enforceable netting arrangements or implementation of protocols designed to further ensure certainty of legal outcomes among matched portfolios: the so-called "big bang" and "small bang" protocols, which were implemented with support by the Federal Reserve Bank of New York in order to facilitate the transition of the CDS market to central clearing by ensuring that offsetting economically equivalent contracts always produced identical economic results. See e.g., Section 2(c) of the 1992 ISDA Master Agreement (Multicurrency-Cross Border) published by the International Swaps and Derivatives

between dealers in uncleared OTC derivatives, and to provide further incentives for clearing and compression of gross notionals of OTC derivatives.

Our concerns with the proposed methodologies, our response to the foregoing factors and our proposed solutions divide into three parts: (1) the calculation of derivatives counterparty exposure, (2) the calculation of reference asset exposure and (3) the proposed "substitution" rules applicable to the calculation of derivative counterparty exposure on credit default swaps ("CDS") and equity derivatives.[2]

1. *Calculation of derivatives counterparty exposure for derivatives other than equity and credit*

The proposed choice of the current exposure method ("CEM") and the rejection of IMM appear to be driven by the desire for standardization, simplicity and model independence. As the Federal Reserve is aware, the CEM approach has long been used in the Basel 1 and 2 risk based capital framework, but it suffers from the following well-known serious weaknesses:

- it is not sensitive to future evolution of market factors from which derivatives originate;
- it does not recognize the multitude of deal maturities;
- it does not give credit for future collateral calls;
- it does not allow full netting;
- it double counts trades of opposite directions; and
- it does not recognize portfolio diversification.

Annex A illustrates with a simple example the weakness of the CEM approach.

The CEM approach can be a practical, simple solution for non-dealer financial institutions, but due to its misstatement of the risks it seeks to measure,[3] all major intermediaries in the OTC derivatives markets have developed IMMs that more accurately measure the risks in the

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Association, Inc., which provides for netting across transactions. See 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions, which parties incorporate by reference into their credit derivatives documentation in order to hardwire the "big bang" and "small bang" protocols into their contracts.

[2] The distinction between reference asset exposure and derivatives counterparty exposure is often the source of great confusion due to inconsistent terminology used in the marketplace. This comment letter adopts the following definitions: "derivatives counterparty exposure" means the exposure that arises specifically from the risk of non-payment on derivatives transacted *with* a defaulting entity (and is therefore not traditional "borrowed money" credit risk); "reference asset exposure" means the risk of loss that results from the bankruptcy or other insolvency of an entity affecting loans, securities holdings and derivatives referencing (but not facing) the defaulting entity. We use "credit exposure" to mean the sum of derivatives counterparty exposure and reference asset exposure. Confusion arises especially in the case of CDS because these instruments contain reference asset exposure to one entity and derivatives counterparty exposure to another entity. The correlation between these two sources of risk is the subject of the "wrong-way risk" discussion elsewhere in this comment letter.

[3] Although in some cases it actually materially understates the risks, these situations are overwhelmed by the portfolio netting effects for a typical OTC derivatives dealer.

portfolio of an OTC derivatives dealer. These methodologies are routinely reviewed by examiners and most firms will be seeking approval of them for regulatory capital purposes.

All models have weaknesses, and as risk managers we are very careful to avoid over-reliance on modeled outcomes. We apply judgment, and employ stress testing that challenges assumptions. We believe the best approach is to start with the most accurate initial estimate of exposure, which inevitably involves the use of models, and then continuously challenge all aspects of the calculation to ensure its robustness. In practice, each firm's IMM must be reviewed and approved by the Federal Reserve as part of implementation of risk based capital rules. In any event, they are reviewed as part of the banking agencies' evaluation of counterparty risk management practices. This regulatory review should allay concerns about the efficacy of these methodologies.

However, in order to strike the right balance between addressing the concerns of the Federal Reserve and improving the accuracy of the measurement of exposures, we support the two alternatives proposed in the joint trade association comment letter. The first is to calculate exposure using IMM, but then apply a multiplier, determined by the Federal Reserve, as a buffer against potential model error. The second is to use a CCAR-like approach under which the covered company would recalculate credit exposure across asset classes using specific stress scenarios determined by the Federal Reserve. Either of these methodologies would alleviate concerns about covered companies' use of their internal models, either by providing a significant cushion of conservativeness in the IMM multiplier approach or avoiding firm-specific models entirely in the case of the CCAR approach. We propose to use these approaches for *all* derivatives counterparty exposure, including the exposure arising from credit and equity derivatives. This raises some questions about the handling of wrong-way risk that are discussed further below.

2. Calculation of reference asset exposure

The proposal requires firms to calculate gross notional reference asset exposures and to offset those exposures with protection purchased under eligible credit and equity derivatives or short positions. Thus the rule tends to overstate reference asset exposures because it is based on notional amounts rather than mark-to-market values on a net risk basis. The calculation of exposure for loans, securities and derivatives in the trading book should reflect that these are trading assets, and therefore, the exposure measurement methodology chosen should be consistent with the actual risk management of the positions as trading assets. For this reason, we concur with the proposal in question 56 in the preamble of the proposed rule under which covered companies would calculate the net mark-to-market loss impact of an issuer default, applying a zero percent recovery rate assumption ("Default Exposure to Zero Recovery" or "D.E. Zero") to all instruments and positions in the trading book.

The proposed approach in question 56 is appropriate for the following reasons: (1) it is consistent with how the positions are actually risk measured and managed; (2) it is more

accurate in all cases; and (3) it is based on observable market prices that are subject to robust internal validation, as well as regulatory review.[4]

A potential concern of using the D.E. Zero methodology in the context of derivative offsetting trades may relate to netting and the ability of the banking entity to be certain that offsetting transactions facing the same counterparty and with the same reference asset underlier will produce identical, offsetting economic results in the event of default of the reference asset. This potential economic mismatch has been essentially eliminated from the marketplace with the adoption of the big bang and small bang protocols with the encouragement of the Federal Reserve Bank of New York.[5] For counterparties that have adhered to the protocols (and all major covered companies have), full netting of the D.E. Zero of transactions referencing the same underlier is appropriate and fully validated by the empirical experience of the 96 defaults that have been successfully processed in the CDS market under the auction approach, including most recently the restructuring of the debt of Greece.

Annex B provides examples demonstrating why the D.E. Zero methodology is a more accurate and appropriate representation of exposure.

3. Substitution Rule – Calculation of derivatives counterparty exposure on CDS and equity derivatives

The proposed rule imposes a substitution requirement that shifts the notional of the reference asset risk of a CDS or equity derivative to the protection provider. The combination of using notional and the substitution requirement greatly exaggerates the exposure to the eligible protection provider. The actual risk of loss if the protection provider fails is equal to the cost to replace the protection, not the entire notional amount of the protection. The only time the risk would be greater than the cost of replacement is when there is a simultaneous, instantaneous

[4] We note that question 56 refers to the use of "internal pricing models" to calculate the net mark-to-market loss impact. Bond prices are, of course, not models-based. Similarly, under current market practice CDS prices are not really models-based as that term is commonly understood. High yield CDS are quoted in the market on a price basis, so the NPV of the transaction is observable through simple multiplication, just as is the case for a high yield bond. Investment grade CDS are quoted on a spread basis in a way that is also analogous to investment grade bond market conventions. In the same way that an investment grade bond's price is obtained by adding the quoted spread to the benchmark yield to obtain a yield that is passed into a yield-to-price calculator, investment grade CDS prices are obtained by passing a quoted spread into a calculator that generates the price. Importantly, in recent years the market has adopted a standard calculator for CDS prices that is analogous to the yield to price calculator for a bond. Therefore, CDS prices are free from model error risk, and any uncertainty around their price relates to the reliability of the market data, which is a well-understood potential issue shared across derivatives and securities. Banking entities have in place extensive policies and procedures to ensure that uncertainty in fair market values, whether related to derivatives or securities, is handled prudently for both risk management and valuation purposes.

[5] See footnote 1.

default of both the reference entity and the protection provider.[6] Although such events can happen as a result of pure statistical coincidence, there are no examples of such "coincidental double defaults" in the history of the market to date.

When double defaults have taken place, they have been because of highly correlated wrong-way risk – that is, when the default of the reference asset and the protection provider are highly correlated (as in buying protection on a country from a bank in that country). We agree that the concern about wrong-way risk is legitimate. Both in the case of AIG's collapse and other instances, the failure to understand wrong-way risk led institutions to purchase protection from counterparties who were unable to perform when called on to do so. We have been concerned about wrong-way risk for over a decade, dating back to the Asian crisis of 1998. Our experience shows that wrong-way risk is a challenging risk to control. A proposed rule that simply presumes 100% correlation in all cases is not a real solution. This counterfactual presumption in the proposed rule would desensitize risks managers to actual wrong-way risk when it exists, thereby undermining risk management while imposing significant costs on the market.

Instead, we believe wrong-way risk should be addressed in a specific, targeted way that includes sensitizing all individuals in risk taking or risk control functions to the challenges of wrong-way risk management. Firms should be required to implement explicit policies governing the management of wrong-way risk, using either the stressed IMM approach or the CCAR-like counterparty stress approach. The multipliers in the stressed IMM approach would consider factors such as how well a firm addresses systematic wrong-way risk.[7] These policies should be aggressively scrutinized by risk managers, auditors and supervisors; risk shifting should take place on an optional basis according to these policies; and under the stressed IMM approach, multipliers would be driven in part by the quality of the handling of wrong-way risk in the IMM. This approach would make banking entities accountable for proper risk management of the true underlying risk that appears to drive the substitution requirement.

A covered company would also be required to establish policies to define and identify highly correlated wrong-way risk. Where highly correlated risk has been so identified with respect to an individual reference asset, the covered company would have the option to risk shift the net exposure for that particular reference asset, calculated in accordance with question 56, to the protection seller.

We believe that this approach is preferable to that of the proposed rule, which is to presume conclusively and counterfactually that wrong-way risk exists with respect to every CDS and equity derivative position.

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[6]Notably, even in these cases, the exposure to the protection provider is the net D.E. Zero of the derivative trades referencing the defaulting underlier, not the notional of all purchased protection.

[7] By systematic wrong-way risk, we mean the correlation between movements in broad market factors and the credit quality of a particular counterparty or counterparties.

B. Summary recommendations on credit exposure calculations

The following is a summary of our recommendations:

- Covered companies should be permitted to calculate all derivatives counterparty exposure, including that arising from credit and equity derivatives, using either the stressed IMM approach or the CCAR-like counterparty stress approach. A stressed IMM approach would consider factors such as how well a firm addresses systematic wrong-way risk.
- Covered companies should be permitted to calculate issuer and reference obligor exposure using market prices to calculate the net mark-to-market loss impact of an issuer default, applying a zero percent recovery rate assumption, to all instruments and positions in the trading book as contemplated in question 56 of the proposal. Cases of highly correlated wrong-way risk would be specifically addressed as outlined below.
- A covered company would be required to establish policies to define and identify highly correlated wrong-way risk between specific reference obligors or issuers and specific hedging counterparties. Where no such highly correlated risk is so identified, the reference asset exposure would be calculated according to the methodology in question 56 (i.e., the institution would be permitted to reduce its exposure by the amount of offsetting protection with no requirement to shift the notional exposure to the protection provider).
- Where highly correlated risk has been so identified with respect to an individual reference asset, the covered company would have the option to risk shift the net exposure for that particular reference asset, calculated in accordance with question 56, to the protection seller. In such cases, the exposure to the protection seller would be excluded from the counterparty risk calculation for the protection seller. In the alternative, the covered company would not take any benefit for having purchased protection.
- As further discussed in Section II.D. below, the statutory limit of 25% of capital and surplus should be retained for all covered companies unless and until a determination is made, after notice and comment, that a lower limit is necessary to mitigate risks to the financial stability of the United States.

C. Additional comments about OTC derivative markets and ongoing regulatory initiatives

By proposing a framework that exaggerates counterparty exposure and thereby causes major OTC derivative dealers to exceed the prescribed limit, the proposal creates additional pressure to accelerate the clearing and trade compression of OTC derivatives. We believe that this additional pressure is unnecessary and unwise.

- First, Title VII of Dodd Frank already mandates increased clearing and reduction of bilateral credit risk; it requires clearing for a large proportion of the OTC derivatives

business that currently drives the large gross notional amounts outstanding between counterparties.

- Second, increased clearing and compression has been encouraged by the Federal Reserve Bank of New York starting with initiatives as far back as 2005.[8] As a result of this process, clearinghouses for OTC derivatives have been established that did not previously exist, and as of today, for both Rates and Credit products over 90% of eligible inter-dealer trading is being cleared, on a purely voluntary basis, in advance of any legal requirement.[9]
- Third, as a result of both this activity and a parallel process to compress uncleared positions which has also benefitted from the encouragement of the Federal Reserve Bank of New York, the gross notional amounts outstanding among the G-14 dealers[10] have already been reduced by over $72 trillion in CDS notional and $138 trillion in notional principal outstanding for rates through July 2011.[11]
- Fourth, the arrival of the legally mandatory effective date for clearing in the Fall 2012 will bring customers into the clearing process, which will further serve to compress the notional amounts.
- Fifth, the OTC margin proposal[12] will fundamentally transform the established business practice within the dealer community. The proposal will require that dealers, in

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[8] See, e.g. Commitment Letter to the Federal Reserve Bank of New York, dated October 4, 2005, in which the signatories (including major dealers such as JPMorgan) committed to the active use of the industry compression process. See also Commitment Letter to the Federal Reserve Bank of New York, dated October 31, 2008, in which the signatories (including major dealers such as JPMorgan) committed to the "Global use of central counterparty processing and clearing to significantly reduce counterparty credit risk and outstanding net notional positions."

[9] See Commitment Letter to the Federal Reserve Bank of New York, dated September 8, 2009, in which the G-15 signatories (including JPMorgan) each committed to submit 90% of new eligible rates trades and 95% of new eligible credit default swap trades for clearing.

[10] The G-14 dealers are a group of the largest fourteen OTC derivatives dealers, listed as signatories on certain letters to the Federal Reserve Bank of New York. See e.g., Commitment Letter to the Federal Reserve Bank of New York, dated March 31, 2011. The G-14 dealers are included in the initial list of globally systemic important banks. See Annex A to Financial Stability Board's "Policy Measures to Address Systemically Important Financial Institutions."

[11] See http://www.trioptima.com/services/triReduce/triReduce-credit.html and http://www.trioptima.com/services/triReduce/triReduce-rates.html. Importantly, the fear of large gross notionals in and of themselves has never been justified, despite an opportunity to study this issue provided by the failure of Lehman. The size of the claims against Lehman from its dealer counterparties and the process by which those were resolved in relation to the gross notional composition of the portfolios provides a powerful scenario to test the premise that gross notional is a material contributor to risk, absent large net positions. We believe that a careful study of the publically available data from the Lehman bankruptcy would provide useful empirical insights into the relationship between the gross notional and net risk of OTC derivatives.

[12] See Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (the "Margin Rulemaking") and JPMorgan comment letter dated June 24, 2011 regarding the Margin Rulemaking. Although JPMorgan has voiced significant objections to this proposed rule, we have not challenged the core premise that initial margin will be required to be posted between dealers, which is the key requirement that both directly decreases interconnectedness risk and creates an incentive to minimize the exposures in the first place.

addition to the established practice today of posting variation margin to each other, also post initial margin into a third party segregated account. In addition to the obvious reduction in risk that results from the posting of the initial margin in the first place, the existence of the requirement also creates very strong incentives against the accumulation of large offsetting positions with different dealers. Currently, that proliferation carries relatively little cost, because in the simple case of a dealer with exactly offsetting positions with two other dealers, the margin posted by one dealer is simply passed through by the intermediary dealer to the third dealer. Once initial margin is required under the proposed rule, such a position, which involves very little market risk, and therefore little opportunity for profit, will require significant amounts of initial margin on both sides. This will create a very strong incentive for dealers to avoid needlessly accumulating gross notional positions between them and to participate actively in market-wide compression exercises to address the buildups when they do occur.

In light of all the above, there is no need to use the single credit counterparty limits as a method to force more clearing, particularly when doing so cannot meaningfully increase the speed of adoption without creating significant market disruption. Pre-existing, ongoing efforts by the industry together with the Title VII mandates mean that the rate of clearing and compression is already close to the maximum achievable. In contrast to this negligible benefit, the rule as proposed will certainly increase costs to corporate end users, undermine the quality of available risk management options for the dealer community itself, and possibly create a materially destabilizing event for the marketplace as a whole.

D. Limits

Congress set the counterparty limit at 25% of capital and surplus and authorized a lower limit only if "necessary" to mitigate risks to the financial stability of the United States. As the joint trade association comment letter describes in detail, the proposed rule makes no finding to support a lower 10% limit. We thus have had no opportunity to comment meaningfully on why such a reduction in the limit would be unwise or inconsistent with the language or purpose of section 165.

We also note that the proposal applies this lower limit to banks with more than $500 billion in assets, and applies the statutory 25% limit to banks under $500 billion. The proposed rule provides no stated rationale for making size alone the determinant for the more stringent 10% limit, nor any rationale for why $500 billion is the right threshold. As with the limit itself, the proposed rule provides no basis for this distinction. As a result, we are unable to assess how or why it is being imposed. We note that the financial crisis demonstrated that institutions with asset sizes considerably below $500 billion can pose systemic risk.

E. Central Clearing Counterparties ("CCPs")

The proposed rule fails to draw any distinction between CCPs and conventional SIFI counterparties. We strongly support prudent risk management of CCPs, both through appropriate regulatory oversight of CCPs themselves and through the management of the CCP counterparty risk by CCP members. Nonetheless, we do believe that CCPs should benefit from a framework that ensures that as long as the CCP's risk management is adequate, banking entities are not restricted from clearing transactions at any CCP due to the proposed rule.

In light of the dramatic increase of CCP-facing activity that will result from full phase-in of the Title VII requirements, together with the fact that under existing restrictions banking regulators have already had to supply exemptions from certain limits, we believe that CCPs should be excluded from the single counterparty credit limits. At the very least, we believe that application of regulatory counterparty credit limits to CCPs should await further developments in those areas, and be revisited once the structure and risks are more clear. Failure to provide a reasonable safety valve for CCP-facing activity would frustrate both the underlying intent of this proposed rule as well as running contrary to the Congressional intent to promote clearing contained in Title VII.

F. Federal Reserve Clearing

The proposed rule may also have unintended consequences for the clearing banks that support Fedwire securities clearance. In furtherance of reforms recommended by the Federal Reserve Triparty Repo Task Force, the clearing banks are reducing their intraday secured exposure to dealers, limiting it to committed secured clearance advance facilities. If clearing banks are unable to reduce their gross credit exposure by the adjusted market value of all collateral which is eligible for clearance on the Fedwire Securities Service, it will place constraints on the secured credit extended to, and other activities with, such dealers. The resulting limitations in clearing bank credit extensions may increase systemic risk and impact dealers' liquidity and ability to make intraday substitutions of securities in the triparty repo market and/or to finance their securities. Consequently, we recommend that the definition of eligible collateral be expanded to include, at a minimum, all securities currently eligible for clearance on the Fedwire Securities Service.

G. Market Impact – Consequences of the Proposed Rule

We agree with the discussion in the joint trade association comment letter of the likely market impact of the proposed rule. Since the proposed framework uses measures that are inaccurate to limit concentration exposure to third parties, it will constrain major participants in the financial markets and limit the activity they can conduct with each other even when such activity is otherwise within prudent internal risk management limits. The potential limits on the ability of covered counterparties, particularly dealers, to provide necessary liquidity and credit intermediation in the marketplace must in the end be commensurate with the goals of section 165 and not unduly harm the financial markets. The proposed rule as drafted does not reach

this correct balance and will have significant implications on the functioning of those markets. The many potential effects of the proposal should be studied prior to finalization of the counterparty concentration risk framework.

The Clearing House has commissioned a quantitative impact study in order to assess the effects of the proposed single counterparty credit limits on banking organizations and on the derivatives market more broadly. The study is currently being completed and will be delivered to the Federal Reserve upon its completion in the coming weeks. The study gathers data from 13 banking organizations. Preliminary results indicate that if the proposed rules for calculation of the single counterparty credit limits were adopted:

- there would be, in the aggregate, 100 exposures to 29 unique counterparties in excess of the applicable credit limit; and
- the average counterparty exposure for those excesses would be 248% of the applicable credit limit.[13]

Below, we provide some further discussion and examples to support the comments in the joint trade association comment letter, particularly reflecting our role as a major derivatives dealer, an end-user of derivatives for corporate risk management, and a provider of secured financing.

1. Market Liquidity and Cost

As a result of the proposed rule, market makers will face limits on their ability to deal with other major counterparties or to take collateral even when the collateral consists of low risk investment grade sovereign debt securities. This will result in the reduction of dealer capacity to provide liquidity and to intermediate credit risk in the markets. Moreover, it will harm end users that rely on dealers to provide derivatives and securities financing intermediation by decreasing overall liquidity and increasing the costs of doing business for all market participants.

Although unstated in the proposed rule, we recognize the possibility that it is motivated at least in part by a desire to achieve greater diversification in suppliers of funding and secondary market trading liquidity. This is similar to the Volcker rule, where some suggested that (the language or intent of the provision notwithstanding) a rule that encouraged non-bank entities to provide more market liquidity would be beneficial. We believe it would be inappropriate to overstate counterparty exposures to achieve an unstated policy goal; we also believe it would be unwise as a policy matter, for the same reasons we articulated in connection with the Volcker Rule Notice of Proposed Rulemaking:

> While there is the potential for non-regulated entities to fill some of this gap, we believe this idea is misplaced. We believe that market realities make it highly unlikely that non-regulated entities would have the incentive or resources to

[13] Joint trade association comment letter page 10.

serve as dependable market makers in volatile markets when such services are most necessary. Such a suggestion ignores lessons from recent financial crises and greatly underestimates the importance of housing critical financial services within the regulated banking sector.

One important lesson is that procyclical liquidity is not a substitute for through-the-cycle liquidity. We view our market making business as part of an overall franchise that includes commercial banking, lending and underwriting relationships. High-frequency traders and hedge funds play an important role in financial markets, but their business models do not require the development or maintenance of such relationships. As such, we believe that their willingness and ability to accept risk to support clients during periods of market stress (when, as we note above, a market maker's services are of the greatest value) will naturally be more limited than those of a banking entity.

Market making is optimally located within financial institutions that are subject to close prudential supervision. The minimum capital requirements to which banking entities are subject ensure that, even in stressed markets, they have sufficient capital to participate actively in market making. Also, banking entities typically have access to diversified sources of funding that allow them to assume less liquid and more volatile positions from clients with greater confidence. By contrast, non-regulated financial market participants are typically very thinly capitalized and have limited, if any, access to traditional capital markets. Furthermore, managing the complexity associated with large portfolios of lightly mismatched "leftover" risk over long periods of time and in all market conditions, which is a critical element of a market-maker's role, requires access to capital and risk management infrastructure that is only found in banking entities. As events like the collapse of Long Term Capital Management and others have demonstrated, market events like unexpectedly high margin calls threaten the viability of highly leveraged or lightly capitalized market actors with complex portfolios of offsetting positions.

Also, many non-regulated entities operate a business model that depends on executing a high volume of intra-day transactions and ending the trading day without any risk position at all. Even a small increase in execution uncertainty or operational risk can lead such an entity to exit a market. The "flash crash" of May 6, 2010 clearly demonstrates the destabilizing effect of such contingent liquidity.

We expect that the proposed rules will reduce liquidity. That impact will lead to a widening of bid-offer spreads that will attract non-regulated entities, at least temporarily. But we encourage the Federal Reserve to recognize that the

> business model of non-regulated entities means that any commitment to providing liquidity is likely to prove limited, high in cost, and fickle.[14]

In the case of securities financing transactions, the exaggerated risk calculation of the proposed rule may in the first instance constrain the ability of a financial institution to provide financing to clients and other market makers. Even if the financial institution seeks to mitigate that risk by taking account of the collateral pledged, it is required to shift the exposure to the issuer of the collateral. It is very common for market participants to seek financing for highly rated securities and in particular, sovereign debt securities. Such securities are also pledged as collateral pursuant to swap documentation.

While the proposed rule does not require an institution to shift its risk to issuers of collateral, in many cases a covered company may in effect have little choice when it is otherwise constrained in dealing with the original counterparty under the provisions of the framework. This is especially a concern in the context of CCPs, as discussed above. Moreover, if the substitution is made in the case of sovereign debt collateral, the shift of exposure may have the effect of limiting the ability of the covered company to take on additional exposure to the sovereign issuer. This impact will place unnecessary pressures on sovereign liquidity. This result is particularly unwarranted in the case of investment grade and marketable sovereign debt securities/issuers. We recommend that the final rule exclude from single counterparty credit limits exposure to sovereign obligors that are of comparable credit quality to the United States.

In short, the proposed rule will limit the credit capacity of the U.S. financial system, for all of its participants, not just dealers. Market participants will struggle to find replacement and hedge providers and will thus be constrained in intermediating risks for clients. As stated above, the shadow banking system will not have the capacity or desire to house long dated risks or provide protection on single names.

Finally, we observe that the proposal will have significant extraterritorial effects. First, the proposal will negatively impact the ability of U.S. covered companies to compete effectively with international peers since the risk measurement methodologies in the proposed rule are unduly restrictive and differ in material ways from similar provisions being implemented by non-U.S. regulators. Specifically, the European Union large exposure rules would allow internal modeling of exposures subject to this rule. It would also exempt CCPs and sovereign obligors with high credit quality from large exposure limits. Moreover international frameworks (such as the proposed European Union large exposure rules) generally do not impose a limits measure set below 25% of capital as is proposed by the Federal Reserve's rule for major covered companies. Paradoxically, the proposal would also affect non-U.S. dealers in a potentially negative way in that U.S. covered companies may find that they are restricted in their ability to deal with major non U.S. counterparties. Non U.S. financial firms will therefore

[14] JPMorgan comment letter dated February 13, 2012 addressed to the Federal Reserve, OCC, FDIC, SEC and Department of Treasury located at: http://www.sec.gov/comments/s7-41-11/s74111-267.pdf.

have less access to liquidity than otherwise would have been the case since the capacity of U.S. firms to provide liquidity to the global marketplace will be constrained.[15]

In light of all of the comments above concerning potential impacts of the proposal, we urge the Federal Reserve to conduct a quantitative impact study as to the effects of the proposal on individual firms and markets, and as to how any proposed methodology achieves a desired degree of permitted interconnectedness.

III. Stress Testing

We support the joint trade association comment letter, which describes concerns with the proposed rule's requirements regarding stress testing. In this letter, we want to emphasize our concerns regarding the lack of transparency in the Federal Reserve's models, the overlapping stress testing requirements from the federal banking agencies, the compressed schedule for conducting the stress tests, and the disclosure of results under certain scenarios.

A. Lack of Transparency into the Federal Reserve's Models

The Federal Reserve's stress test now governs the ability of boards of directors to determine when to return capital to the shareholders who elected them, and has other important ramifications for capital planning. Therefore, as with any other major regulation, we believe that the Federal Reserve is obligated to publish for notice and comment any test or model that it intends to use to determine the adequacy of a firm's capital and its eligibility to pay dividends or make share repurchases. We support such stress testing, and believe that a transparent process will yield a better methodology.

The design of the Federal Reserve's models, techniques and underlying assumptions that are used as part of the capital plan approval process should be transparent and subject to consultation and input before adoption and implementation. Understanding the Federal Reserve's models and assessment process would enable banks to more effectively plan their capital actions requests given that the Federal Reserve's capital plan rule dictates a binary outcome (i.e., an approval or rejection of the capital action request by the Federal Reserve).

In addition, as required under the Dodd-Frank Act, banks and the Federal Reserve will both be disclosing their respective results under the Federal Reserve's most severe scenario. The

[15] We also note that the current proposal would apply to U.S. based bank holding company covered companies and would not apply to foreign banking organizations that have U.S. banking operations ("U.S. FBOs"). While U.S. FBOs that have global total consolidated assets of $50 billion or more are subject to the enhanced prudential standards in the statute, the Federal Reserve notes that it is difficult to determine how the standards should be applied to such entities and that it must give due regard to the principle of national treatment and equality of competitive opportunity. We believe that the Federal Reserve should align implementation of the proposal with the timing of rules that will apply to U.S. FBOs to ensure that the overall affect of its proposals strikes an appropriate competitive balance both within the U.S. and abroad.

inability to explain the differences between the banks' and the Federal Reserve's numbers, which may be material based on the 2012 CCAR experience, may result in market confusion.

B. Overlapping Stress Test Requirements

Banks with over $50 billion in assets are subject to numerous statutory and regulatory requirements mandated by the Federal Reserve, the OCC and the FDIC. We are concerned that these multiple overlapping stress test requirements, if not properly implemented and coordinated among the relevant agencies, will lead to a great degree of burdensome duplication and will add little marginal utility, particularly in instances where a subsidiary depository institution represents a significant percentage (e.g., over 70%) of the BHC's consolidated assets. Additionally, given the codification of the Federal Reserve's "source of strength" doctrine as a part of the Dodd-Frank Act, we believe that separate stress testing of smaller subsidiary depository institutions may not add significant value from a supervisory perspective that outweighs the substantial costs and burden to perform the stress test.

Should a BHC and its subsidiary depository institutions be required to complete separate stress testing requirements, we urge the Federal banking agencies to work collectively to effectively minimize the duplicative burden, specifically by ensuring consistency in scenario development, reporting forms, and models use to evaluate results.

C. Compressed Schedule for Conducting the Stress Test

The proposed timing of the annual stress test, which is consistent with the 2012 CCAR timing, is compressed. Assuming publication of the stress scenarios by mid-November as set forth in the preamble to the proposed rule, banks will only have approximately six weeks to complete a robust stress-test along with comprehensive supporting documentation, which also overlaps with normal year end and financial closing activities and the seasonal holidays. Moreover, as the 2012 CCAR process demonstrated, there may be an initial period when the relevant scenarios are released, but where covered companies and the Federal banking agencies must work together to clarify ambiguities in the supervisory scenarios, thus effectively decreasing the timeframe. In order to provide banks with an appropriate amount of time to thoroughly complete all of the required templates, prepare robust supporting documentation and review with its board of directors prior to the early January submission date, the Federal banking agencies should provide the supervisory stress test scenarios and model-related information by October 15 of each year.[16]

[16] This timing is consistent with that contemplated by the OCC in its proposed rule regarding stress tests. OCC Notice of Proposed Rulemaking, "Annual Stress Tests" at http://www.occ.gov/news-issuances/news-releases/2012/nr-occ-2012-10a.pdf.

D. Disclosure Should be Limited to Results Under the Severely Adverse Scenario

As the proposed rule is currently written, banks would be required to publish the results under all scenarios, including the baseline scenario, which is akin to providing long-range earnings guidance. Under no circumstances should the Federal Reserve disclose, or require to be disclosed, base case stress test results or other information that could be used to effectively reverse-engineer earnings guidance or other quarter by quarter results under either the supervisory or company-run stress test requirements of the proposed stress test rules. Accordingly, for purposes of publication of both the results of the supervisory stress test conducted by the Federal Reserve and the annual and semi-annual stress tests conducted by covered companies, we urge the Federal banking agencies to generally adopt the template utilized in the 2012 CCAR exercise, which only disclosed results under the supervisory stress scenario, which was equivalent to a severely adverse scenario.[17]

IV. Role of the Board of Directors in Liquidity and Risk Management

We are concerned that the proposal blurs the lines between the proper roles of the board of directors versus that of senior management. Specifically, the proposed rule inappropriately imposes operational responsibilities on the board of directors. These proposed responsibilities would interfere with the directors' ability to spend time on their proper duties of oversight. The proposal requires board of directors review of detailed documents such as liquidity risk management strategies; as well as requiring Risk Committee approval of liquidity risks and liquidity risk tolerance of new products or businesses prior to implementation. The Risk Committee would also be required to annually review previously approved significant business lines and products to determine whether each line or product has created any unanticipated liquidity risk, and to determine if still within established liquidity risk tolerance. The proposal requires the Risk Committee review of the independent validation of stress tests. The Risk Committee would also be required to establish procedures which govern the content of senior management reports on the liquidity risk profile.

As aptly described in the joint trade association comment letter, it is generally recognized that the board of directors is responsible for oversight of a company, and management is responsible for the day-to-day operations. "One of the fundamental features of corporate governance is the distinction and balance between the role of a company's board of directors and the company's management. It is generally recognized that the board is responsible for oversight of a company, and management is responsible for the day-to-day operations of the company. This distinction and balance is embedded in state law, federal corporate law, international standards, as well as prior guidance issued by the Federal Reserve."[18] The

[17] Federal Reserve Governor Tarullo recently stated that the current CCAR disclosures "have struck about the right balance between providing useful information to investors, counterparties, and the public, on the one hand, and protecting proprietary information whose release might result in competitive harm to firms, on the other." "Developing Tools for Dynamic Capital Supervision," Remarks by Daniel K. Tarullo, April 10, 2012.

[18] Joint trade association comment letter page D-4, which cites:

Clearing House also recently issued guiding principles for banking organization corporate governance, which endorsed the distinction between the board's responsibility for "making certain statutorily identified decisions and for conducting oversight of the business and affairs of a banking organization and its management" versus management's responsibility for "the day-to-day operations of the banking organization."[19]

A recent G-30 Report similarly emphasized the importance of respecting "the distinction between the board's responsibilities for direction setting, oversight, and control, and management's responsibilities to run the business."[20] The G-30 Report warned of the danger of conflating the responsibilities of management with those of the board.[21] The G-30 working group believes that the board's primary responsibilities include:

- reaching agreement on a strategy and risk appetite with management,
- choosing a CEO capable of executing the strategy,
- ensuring a high-quality leadership team is in place,
- obtaining reasonable assurance of compliance with regulatory, legal, and ethical rules and guidelines and that appropriate and necessary risk control processes are in place,
- ensuring all stakeholder interests are appropriately represented and considered, and
- providing advice and support to management based on experience, expertise, and relationships.[22]

The proposed rule would require an amount of involvement by the directors in the operational management of the company that is inconsistent with their traditional oversight role. While we think it is appropriate to have directors approve policies with respect to risk management, we do not think directors should have responsibility for practices or approving specific risk limits. We think that approving policies, as described in the joint trade association comment letter, is

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- *In re Caremark International Inc. Derivative Litigation*, 698 A. 2d 959, 971 (Del. Ch. 1996) and *Schoonejongen v. Curtiss-Wright Corp.*, 143 F. 3d 120 (3rd Cir. 1998) (state law);
- SEC Regulation S-K, Item 407(h) (federal corporate law);
- Principals for Enhancing Corporate Governance, Basel Committee on Banking Supervision, October 2010, page 7 (international standards);
- Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles, SR 08-8 (October 16, 2008) (Federal Reserve guidance).

[19] The Clearing House exposure draft, "Guiding Principles for Enhancing Banking Organization Corporate Governance," March 13, 2012, page 3.

[20] "Toward Effective Governance of Financial Institutions," Report of the Working Group on Corporate Governance for the G-30, Page 20.

[21] Toward Effective Governance of Financial Institutions," Report of the Working Group on Corporate Governance for the G-30, Page 20.

[22] Toward Effective Governance of Financial Institutions," Report of the Working Group on Corporate Governance for the G-30, Page 20.

the appropriate level of oversight by the board of directors.[23] We support the suggestion in the joint trade association comment letter that the board of directors approve a liquidity risk management program, which would address the company's liquidity risk tolerance, liquidity stress testing, liquidity buffer, the contingency funding plan, and the consideration of the liquidity costs of new lines of business or products.[24]

* * *

We thank you for your consideration of our comments.

Sincerely,

Barry L. Zubrow

[23] Joint trade association comment letter page D-5.

[24] Joint trade association comment letter page B-7.

Annex A

Within the portfolio of a broker/dealer it is common to have offsetting trades with the same counterparty. The table below presents a simple example of such trades showing the exposure at default computed using Current Exposure Methodology ("CEM"), which does not recognize full benefits of netting.[25] It is assumed that maturity, coupons, and other trade terms are identical, except for signs, and that the trades are done with the same counterparty with a legally enforceable master netting agreement.

Consider two identical, perfectly offsetting interest rate swaps with 5 years left to maturity, $100 million notional long and short, and $1 million and -$1 million current mark to market. Since these trades can be legally netted, the net exposure they present is 0 at all times. Therefore, a risk measure of these trades should reflect full netting, and respective exposures should be 0. IMM would follow this approach. However, the CEM calculates exposure at default equal to $1,200,000.

CEM Exposure at Default (EAD)

Maturity Swap 1 & 2	5 Yrs
Add On Factor	1.5%

	Perfectly Offsetting Trades		
	Swap 1**	**Swap 2****	**CEM Netted Positions**
Mark-to-market	1,000,000	(1,000,000)	0
Notional	100,000,000	100,000,000	200,000,000
Net to Gross Ratio	100%	100%	0.00%
EAD	**2,500,000**	**1,500,000**	**1,200,000**

** Non nettable calculation

On a portfolio-wide basis, CEM results are typically seven to eight times higher than results under IMM.

[25] For OTC derivatives contracts subject to a qualifying master netting agreement, CEM requires that an institution calculate exposure at default as the sum of (1) Net Current Credit Exposure and (2) Adjusted Potential Future Exposure. Net Current Credit Exposure is the greater of the net sum of all positive and negative mark to market values of each contract under a qualifying master netting agreement or zero. To calculate the Adjusted Potential Future Exposure, the institution must first calculate the Net to Gross Ratio for the contracts subject to the agreement. This is the ratio of the net current credit exposure for all such contracts to the gross positive current exposure for all such contracts. The Adjusted Potential Future is equal to (40% * gross notional of all contracts under the agreement * a mandated conversion factor) + (60% * such gross notional amount * a mandated conversion factor *Net to Gross Ratio).

Annex B

The following four examples, all involving credit protection bought or sold on Greece, demonstrate an important flaw in the proposed rule. In each case, a hypothetical U.S. bank is both selling and buying protection on Greece with the same counterparty, either a Greek bank or a U.S. SIFI. Such offsetting trades are commonplace in the market, as traders making markets in these instruments stand ready to buy and sell at any time, and so tend to have significant amounts of offsetting positions on their books. The examples demonstrate clearly how the treatment of such positions in the proposed rule dramatically overstates the exposure of the U.S. bank to both Greece, as the reference asset, and to the U.S. bank's various counterparties to the credit protection contracts. The examples also support the methodology articulated in question 56 and give examples of how to combine that methodology with the prudent treatment of wrong way risk.

Background:

Prior to the restructuring of the Greek debt, the markets have already priced in the expectation that Greece's long term debt will be restructured, and as a result the long term debt is already trading at 25% of face even though the restructuring has not yet taken effect.

These examples use the following two transactions:

Transaction name	Notional	Maturity	Coupon	Current PV (% of face)	Equivalent bond price
A	$100mm	20 March 2022	100 bps	75%	25%
B	$40mm	20 December 2021	100 bps	75%	25%

The examples consider varying combinations of these trades facing either:

- A U.S. SIFI (the "SIFI"), the financial condition of which is insensitive to Greek sovereign risk.
- A Greek bank, the financial condition of which is highly correlated to Greek sovereign risk.

Example 1

Transactions:

Sold protection on transaction A and bought protection on transaction B, both with the SIFI. Note that the present value of a CDS contract after a credit event when the final recovery on the reference asset is zero simply equals the notional amount because the contract pays (1-Recovery)*Notional. This produces the following position:

Transaction Name	Transaction direction	Notional	Current unrealized PV	Realized PV after default with 0 recovery	Difference ("DE Zero", or question 56 methodology)
A	Sell protection	$100mm	($75)mm	($100)mm	($25)mm
B	Buy protection	$40mm	$30mm	$40mm	$10mm
Total Net	Sell protection	$60mm	($45)mm	($60)mm	($15)mm

If the bonds recover at zero, consistent with the question 56 methodology, and absent a default by the SIFI as counterparty, the covered company would suffer a net trading book loss of $15 million across the two positions. The protection sold will result in the covered company making a payment of $100 million, but $75 million of the loss had already been recognized in the mark to market account, so the mark-to-market loss is $25 million. The protection bought will result in a payment to the covered company of $40 million, but $30 million of this has already been recognized in the MTM account. As a result, the gain is only $10 million. All of the relevant payments would be netted in line with the auction protocols and the legally enforceable netting agreements, and so the result would be a net loss of $15 million. This result would be consistent with the calculation methodology summarized in question 56.[26]

[26] Discussions of collateral movements are ignored above for simplicity, but the changes in the unrealized value of the contracts would be reflected in the corresponding posting of variation margin by the US bank to or from either the SIFI or the Greek bank counterparty, recognizing that all bank participants in the CDS market have daily variation margin collateral agreements in place.

Exposure treatment under the proposed rules:

Transaction Name	Transaction direction	Notional	Reported reference asset exposure to Greece	Reported reference asset exposure to the SIFI under mandatory shifting
A	Sell protection	$100mm	$100mm	0
B	Buy protection	$40mm	($40)mm	$40mm
Total Net	Sell protection	$60mm	$60mm	$40mm

The covered company's initial $100 million notional of protection sold referencing Greece as reference obligor will be reduced by the purchase of $40 million of protection from the SIFI, but this reduction will also require the reporting ("shifting") of $40 million of exposure to the SIFI as the counterparty on the covered company's bought protection contract. As a result, despite the fact that there would be a loss of only $15 million in the trading book due to the Greek restructuring event, the covered company shows $60 million of exposure to Greece in its concentration limits. At the same time, despite the fact that the restructuring will produce a net loss, and therefore payments will be due *to* the SIFI instead of payments being owed *from* the SIFI, the shifting rule requires showing $40 million of exposure to the SIFI.

Exposure treatment under JPMorgan's proposal:

Transaction Name	Transaction direction	Notional	Reported reference asset exposure to Greece	Reported counterparty exposure to SIFI
A	Sell protection	$100mm	$25mm	See below
B	Buy protection	$40mm	($10)mm	See below
Total Net	Sell protection	$60mm	$15mm	Calculated under IMM or CCAR-like approach, on a net basis

The covered company shows exposure to Greece as a reference obligor after giving effect to netting for the offsetting position as contemplated by question 56. This methodology shows $15 million of net exposure to Greece consistent with the economic trading loss. The exposure to the SIFI is calculated pursuant to a Stressed IMM (or CCAR-like) exposure calculation on a net basis across the two trades, and aggregated with all other exposure to the SIFI.

Note that the approach in the proposed rule would overstate the reference asset exposure by a factor of four, while showing $40 million of counterparty exposure to the SIFI where in reality the exposure under any reasonable IMM would show a much smaller amount.

Example 2

Transactions:

Example 2 reverses the direction of example 1. Instead of net selling protection, the covered company is net buying protection:

Transaction Name	Transaction direction	Notional	Current unrealized PV	Realized PV after default with 0 recovery	Difference ("DE Zero", or question 56 methodology)
A	Buy protection	$100mm	$75mm	$100mm	$25mm
B	Sell protection	$40mm	($30)mm	($40)mm	($10)mm
Total Net	Buy protection	$60mm	$45mm	$60mm	$15mm

These transactions produce a potential net trading gain of $15 million. As in example 1, each transaction has an unrealized present value of 75% of face, and so the incremental change in each transaction's value as a result of assuming a zero recovery is only 25%.

Exposure treatment under the proposed rules:

Transaction Name	Transaction direction	Notional	Reported reference asset exposure to Greece	Reported reference asset exposure to SIFI under mandatory shifting
A	Buy protection	$100mm	($40)mm	$40mm
B	Sell protection	$40mm	$40mm	0
Total Net	Buy protection	$60mm	0	$40mm

The covered company shows no reference asset risk to Greece, and reports $40 million notional of exposure to the SIFI under the shifting requirement.

Exposure treatment under JPMorgan's proposal:

Transaction Name	Transaction direction	Notional	Reported reference asset exposure to Greece	Reported counterparty exposure to SIFI
A	Buy protection	$100mm	($25)mm	See below
B	Sell protection	$40mm	$10mm	See below
Total Net	Sell protection	$60mm	($15) mm netted against bond or loan exposures	Calculated under IMM or CCAR-like approach, on a net basis

In light of the SIFI's lack of correlation to the reference asset, the potential net trading gain is automatically netted with any other reference asset exposures to Greece (for example, from Greek bonds or loans) in line with the question 56 methodology. The exposure to the counterparty is calculated pursuant to a Stressed IMM (or CCAR-like) exposure calculation on a net basis across the two trades, and aggregated with all other exposure to the SIFI. Note that although the proposed rules produce an accurate value for the reference asset exposure in this case, the maximum possible exposure to the SIFI is the net change in value of the contracts (i.e., the gain as a result of the restructuring) which is $15 million. Therefore, the shifting requirement in the proposed rule overstates the maximum exposure to the SIFI by a factor of nearly three, and by a considerably higher amount when compared to exposure as measured by an IMM approach that recognizes the lack of correlation between the counterparty and the reference asset.

Example 3

Transactions:

Example 3 is the same as example 2, but substitutes the Greek bank for the SIFI as counterparty to the transactions.

Transaction Name	Transaction direction	Notional	Current unrealized PV	Realized PV after default with 0 recovery	Difference ("DE Zero", or question 56 methodology)
A	Buy protection	$100mm	$75mm	$100mm	$25mm
B	Sell protection	$40mm	($30)mm	($40)mm	($10)mm
Total Net	Buy protection	$60mm	$45mm	$60mm	$15mm

Exposure treatment under the proposed rules:

As in example 2, the reference asset exposure to Greece is reported correctly as zero, and $40 million of exposure to the Greek bank is reported as a result of the shifting requirement.

Transaction Name	Transaction direction	Notional	Reported reference asset exposure to Greece	Reported reference asset exposure to Greek bank under mandatory shifting
A	Buy protection	$100mm	($40)mm	$40mm
B	Sell protection	$40mm	$40mm	0
Total Net	Buy protection	$60mm	0	$40mm

In this case, the shifting requirement appears more reasonable due to the obvious high correlation between the Greek bank and the Republic of Greece. However, note that the amount required to be reported as exposure to the Greek bank is overstated by a factor of nearly three relative the maximum possible exposure to the Greek bank.

Exposure treatment under JPMorgan's proposal:

Transaction Name	Transaction direction	Notional	Reported reference asset exposure to Greece	Reported counterparty exposure to Greek bank
A	Buy protection	$100mm	($25)mm	See below
B	Sell protection	$40mm	$10mm	See below
Total Net	Sell protection	$60mm	None, or ($15) mm available for netting against bond or loan exposures	If $15mm gain is used to reduce other exposures, then $15mm of exposure to the Greek bank is reported. Otherwise, no exposure under IMM.

The relatedness between the reference asset and counterparty in this case is addressed under policies and procedures instituted by the covered company. Application of the question 56 methodology would show that the covered company has a theoretical gain of $15 million, subject to the performance of the Greek bank. The covered company has a choice:

- If this position were the only reference asset exposure to Greece, it could report no exposure, since the potential failure of the counterparty to perform would only result in forfeiting a potential future gain, rather than experiencing a loss. The covered company would not be required to show any exposure to the Greek bank.
- If the covered company has other reference asset exposure to Greece, for example by being long $30 million of Greek bonds, then would have the option to reduce the reported reference asset exposure from the bonds by claiming the potential gain from the protection. This would result in reported exposure to Greece of $15 million ($30 million - $15 million). In order to do so, it would be required to show (i.e., "shift") $ 15 million of exposure to the Greek bank.

Example 4

Transactions:

Example 4 reverses the direction of example 3, and mirrors example 1 but with the Greek bank as counterparty.

Transaction Name	Transaction direction	Notional	Current unrealized PV	Realized PV after default with 0 recovery	Difference ("DE Zero", or question 56 methodology)
A	Sell protection	$100mm	($75)mm	($100)mm	($25)mm
B	Buy protection	$40mm	$30mm	$40mm	$10mm
Total Net	Sell protection	$60mm	($45)mm	($60)mm	($15)mm

Exposure treatment under the proposed rules:

As in example 1, the proposed rules misstate the exposure in two respects: first, they overstate the reference asset exposure to Greece by a factor of 4. Second, they require reporting $40 million of exposure to the Greek bank when the true exposure under any reasonable IMM would be negligible.

Transaction Name	Transaction direction	Notional	Reported reference asset exposure to Greece	Reported reference asset exposure to SIFI under mandatory shifting
A	Sell protection	$100mm	$100mm	0
B	Buy protection	$40mm	($40)mm	$40mm
Total Net	Sell protection	$60mm	$60 mm	$40mm

Exposure treatment under JPMorgan's proposal:

Transaction Name	Transaction direction	Notional	Reported reference asset exposure to Greece	Reported counterparty exposure to Greek Bank
A	Sell protection	$100mm	$25mm	See below
B	Buy protection	$40mm	($10)mm	See below
Total Net	Sell protection	$60mm	$15 mm	Calculated under IMM or CCAR-like approach, on a net basis

As in example 1, under JPMorgan's proposal, the covered company shows exposure to Greece as a reference obligor after giving effect to netting for the offsetting position as contemplated by question 56. This methodology shows $15 million of net exposure to Greece consistent with the economic trading loss. The exposure to the Greek bank is calculated pursuant to a Stressed IMM (or CCAR-like) exposure calculation on a net basis across the two trades, and aggregated with all other exposure to the Greek bank. Although the wrong-way risk policies would have noted the high correlation between Greece and the Greek bank, the policies would not require any shifting, because the Greek restructuring would produce an incremental payment *to* rather than *from* the Greek bank. Nonetheless, the IMM would show *some* exposure to the Greek bank as counterparty, recognizing that the probability of a failure of the Greek bank that is simultaneous with a sharp recovery in the creditworthiness of the Greek sovereign, while negligible, is not zero.