March 27, 2013

Department of the Treasury
Office of the Comptroller of the Currency
250 E Street SW
Mail Stop 2–3
Washington, DC 20219

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation,
550 17th Street NW
Washington, DC 20429


Dear Ladies and Gentlemen:

Better Markets appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System ("Board"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") in response to the request for public comment in connection with the above-captioned Notices of Proposed Rulemaking ("Proposed Rule") published on August 30, 2012, in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

A recent Senate Committee Report, *JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses*, provides compelling evidence of how JPMorgan Chase manipulated its calculations of Value-at-Risk ("VaR") and other model-based measures of

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1 Better Markets is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular in the rulemaking process associated with the implementation of the Dodd-Frank Act.
loss exposure and risk for an extended period of time. In addition to the enormous evidence made plain by the recent financial crisis, this new evidence of manipulation, combined with recent examples of reduced risk estimates following changes to models at Deutsche Bank and Morgan Stanley, raises serious questions about whether banks can be trusted to accurately determine their risk exposures and how financial regulatory rules should be drafted and implemented to achieve compliance with the law.

In particular, this evidence calls into question a key element of existing and proposed risk-based capital rules. Those capital rules rely heavily on bank calculations of VaR and other measures of loss exposure. The bank calculations are important inputs to overall measures of risk-weighted assets, which are used to determine bank compliance with the risk-based capital requirements.

When bank risk and exposure calculations are subject to manipulation and gaming, as most recently evidenced by JPMorgan Chase, the effectiveness of capital requirements is, at best, undermined. One necessary conclusion is that the Proposed Rule referenced above needs to be strengthened to counter this observable weakness.

1. The Senate Permanent Subcommittee on Investigations report shows that JPMorgan manipulated VaR calculations and other metrics to reduce measured bank exposure to loss and risk-weighted assets.

The Senate Report describes the developments leading up to the CIO model manipulations as follows:

"In 2005, JPMorgan Chase spun off as a separate unit within the bank its Chief Investment Office (CIO), which was charged with investing the bank's excess deposits, and named as its head Ina Drew who served as the bank's Chief Investment Officer. In 2006, the CIO approved a proposal to trade in synthetic credit derivatives, a new trading activity. In 2008, the CIO began calling its credit trading activity the Synthetic Credit Portfolio [SCP].

"Three years later, in 2011, the SCP's net notional size jumped from $4 billion to $51 billion, a more than tenfold increase. In late 2011, the SCP bankrolled a $1 billion credit derivatives trading bet that produced a gain of approximately $400 million. In December 2011, JPMorgan Chase instructed the CIO to reduce its Risk Weighted Assets (RWA) to enable the bank, as a whole, to reduce its regulatory capital requirements. In response, in January 2012, rather than dispose of the high risk assets in the SCP - the most typical way to reduce RWA - the CIO launched a trading strategy that called for purchasing additional long credit derivatives to offset its short derivative positions and

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lower the CIO’s RWA that way. That trading strategy not only ended up increasing the portfolio’s size, risk, and RWA, but also, by taking the portfolio into a net long position, eliminated the hedging protections the SCP was originally supposed to provide.”

To reduce the contribution of the SCP to JPMorgan’s risk-weighted assets, the CIO employed two strategies. First, in 2012 it implemented, on an “expedited” basis, a new VaR model, which lowered the SCP’s loss exposure “by 50%,” and thereby lowered its contribution to the bank’s risk-weighted assets. According to the Senate Report:

“On January 30, 2012, the CIO won bank approval of its new VaR model. The impact of the new model was even greater than the 44% described in the emails to firm management: it immediately reduced the CIO’s VaR by 50%, from $132 million to $66 million.

“JPMorgan Chase told the Subcommittee that the change in the CIO VaR model was not motivated by a desire to give the CIO traders more room to take risk. However, the evidence is clear that the January 2012 pressure to expedite approval of the model change was motivated by the CIO traders’ desire to end the CIO’s VaR breach and produce a much lower VaR, which then enabled them to take on more risk. An OCC model expert told the Subcommittee that it was ‘no coincidence’ that the CIO’s new VaR model was implemented at the same time the CIO traders were increasing their acquisitions; rather, instituting the new VaR model was part of the trading strategy. Mr. Dimon acknowledged as much during his testimony before Congress when, in discussing the SCP losses, he stated: ‘In January, the new model was put in place that allowed them to take more risk and it contributed to what happened.’

“JPMorgan Chase has acknowledged to the Subcommittee that the internal approval process for the new CIO VaR model was ‘hurried.’ All of the bank’s VaR models were supposed to be reviewed and approved by its internal Model Review Group, which was part of its risk division. When the bank’s Model Review Group undertook its evaluation of the CIO’s new VaR model, it found a number of operational and mathematical problems and asked the developers to provide action plans to address the problems as well as provide dates for when the actions plans would be completed. No dates were set for completing the action plans, however, and the action plans were, in fact, never completed. A later OCC internal review described the action plans as identifying essential requirements that should have been completed before the model was placed into use.”

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3 Ibid, 4, footnotes in the text omitted.
4 Ibid, 180, footnotes in the text omitted and emphasis added.
The CIO also adopted a strategy of gaming another measure of loss exposure, called the CRM, which also contributes to the calculation of risk-weighted assets. The CRM had flagged the SCP as a source of $6.3 billion in risk to the bank. Had the CRM been used with integrity, it would have raised the SCP's contribution to risk-weighted assets significantly. However, the CIO was determined to reduce its impact, not accurately reflect it. According to the Senate Report:

"The CIO's efforts to question the CRM results were not limited to challenging the accuracy of the $6.3 billion risk projection. The CIO also sought to game the method used to determine which assets in the Synthetic Credit Portfolio would be subjected to CRM analysis as well as to analysis using another key risk measure known as the Incremental Risk Charge or IRC. Like CRM, the IRC risk metric is used to calculate a bank's Risk Weighted Assets (RWA) and its capital requirements." 5

To reduce the impact of the CRM on RWA, the CIO decided to reclassify the SCP positions in a manner that reduced the associated capital requirements:

"Over the next two weeks, Mr. Hagan worked with the QR analysts to come up with a way to categorize the CIO's trades in a way that would reduce its CRM and IRC results. Ultimately, the bank reached a compromise with Mr. Hagan over how to split the portfolio between the tranche and index books. At the end of March, Mr. Hagan was allowed to design the initial split of the portfolio as it existed in order to optimize RWA, but once a trade was placed in either the tranche or index book, it had to stay there. As new trades were made, the CIO would be allowed to categorize them in order to optimize RWA, but existing trades could not be recategorized.

"The CIO's efforts to understand and influence the CRM, IRC, and RWA models continued into April 2012. In an email dated April 3, 2012, Achilles Macris informed Ina Drew that a QR analyst 'is now in our office and he is 100% involved with the RWA projections of our book and ways to bringing it lower.' Ms. Drew forwarded the email to the CIO's Chief Financial Officer John Wilmot who responded: 'I don't get the sense of clarity that we know what is driving the RWA (economic risk versus VaR, stress VaR, CRM and IRC) or the p&l [profit and loss] – or more importantly that either will be manageable going forward.' Mr.Wilmot also wrote: 'We haven't made the case of how this book runs off and whether risk can be managed effectively.' 6

The JPMorgan strategy of manipulating risk estimates for the CIO portfolio continued until the losses became so great that they were transparent to derivatives market participants and ultimately to the Comptroller of the Currency.

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5 Ibid, 192, footnotes in the text omitted.
6 Ibid, 196-197.
2. Other large banks have recently adjusted their risk calculations and thereby reduced risk-weighted assets.

In 2012 both Deutsche Bank and Morgan Stanley announced changes to their risk models, and in both cases the changes reduced the value of risk-weighted assets. Changes to Deutsche Bank's risk models reportedly reduced assets by €13 billion, and the changes at Morgan Stanley reportedly reduced calculated VaR by a third. Do these changes reflect a better measurement of risk, or do they, as in the case of JPMorgan, reflect an intent to reduce regulatory capital requirements by manipulating models? Can anyone outside these banks answer this question with any confidence?

3. The proposed Risk-based Capital Rule and the Market Risk Capital Rule rely heavily on accurate bank calculations of VaR and other model-based risk measures to determine risk-weighted assets and risk-weighted capital requirements.

The above referenced Notice of Proposed Rulemaking for the Advanced Approaches Risk-based Capital Rule and Market Risk Capital Rule, notes that:

“As a general matter, a banking organization subject to the market risk capital rule will not include assets held for trading purposes when calculating its risk-weighted assets for the purpose of other risk-based capital rules. Instead the banking organization must determine an appropriate capital requirement for such assets using the methodologies set forth in the final market risk capital rule.”

The methodologies used under the Market Risk Capital Rule include calculations of VaR, described in §§ .201 to .207 of the Proposed Rule, and calculations of Comprehensive Risk, using model-based techniques described in § .209.

In addition, under the Advanced Approaches Rule, banks may, under certain conditions, calculate capital requirements for repo-style transactions, eligible margin loans, and over-the-counter derivatives using VaR or internal model methodologies (IMM), as described in §.132.

These sections of the Proposed Rule make bank calculations of VaR and other model-based exposure measures central to the successful identification and implementation of risk-based capital requirements.

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8 Federal Register, Volume 77, No. 169, August 30, 2012, 52995.
9 Ibid, 53044 – 53048.
10 Ibid, 53011 – 53020.
4. The Proposed Rule needs to be strengthened to counter the demonstrated vulnerability of VaR and other model-based calculations to manipulation and gaming.

The evidence from the Senate Report illustrates the ease with which a bank can manipulate its estimates of its exposure to loss, and thereby reduce a significant component of its overall risk-weighted assets under the Proposed Rule. As Better Markets has pointed out in a previous comment letter, banks have the incentive to do this and regulators have limited ability to monitor what they are doing. In addition, model-based measures of loss exposure, such as VaR, performed poorly in the run-up to the financial crisis. These are unacceptable weaknesses in a regulatory regime intended to reduce financial instability.

CONCLUSION

If the Proposed Rule is to be effective, then simpler, more robust, and more easily monitored measures of exposure to loss need to replace VaR and other model-based measures. Failure to do so will embed measures that are inherently weak and easily manipulated by banks into a very important part of banking regulation. Such an outcome should be intolerable to rulewriters.

We hope these comments are helpful in your consideration of the Proposed Rule.

Sincerely,

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