Testimony of Barry Zubrow
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Hearing before the House Financial Services Committee
June 16, 2011

Chairman Bachus, Ranking Member Frank, Members of the Committee, thank you for the opportunity to testify before you today on the international context for regulatory reform. My name is Barry Zubrow, and I have been the Chief Risk Officer of JPMorgan Chase since 2007.

Introduction

Let me begin by describing the current competitive landscape. It is not one of American dominance, as some may believe, but rather considerable competitive challenges. None of the world's five largest banks is a U.S. bank. U.S. banks represent 24 percent of the market share of the 50 largest global banks, down from over 50 percent only eight years ago; Chinese banks now hold 22 percent. These trends are likely to continue as emerging markets continue to expand.

History teaches that a vibrant economy requires a vibrant financial sector. There is simply no way to sustain economic growth without a strong financial sector providing loans, debt and equity financing, and risk management services to growing companies, and useful and innovative services to consumers. For over a century, the U.S. economy has benefited from having the most sophisticated and innovative finance system in the world.

The growth of the largest U.S. banks, like JPMorgan Chase, has mirrored the growth in U.S. corporations and the globalization of business and financial markets. A corporate treasurer for a Fortune 500 U.S. company relies on global banks like JPMorgan Chase to raise billions of dollars of debt or equity on short notice, and to raise that debt and equity in whatever capital market and currency in the world is currently offering the most advantageous terms; to offer a wide range of derivatives products to manage the company's currency, interest rate and other risks; to manage the company's pension plan; and to the extent that company intends to expand into an emerging market, to be there waiting, ready to provide treasury and custody services, trade finance and a host of other services. By the same token, a foreign company looking to establish operations (and jobs) in the United States will retain JPMorgan Chase to fund and manage that expansion. And it is worth noting that Chase also is the largest Small Business Administration lender in the United States.

Those of us who regularly meet with corporate managers take this connection for granted, but I fear that this connection is not widely appreciated. If large U.S. banks are hobbled by uneconomic capital levels or risk restrictions, a U.S. company is not going to turn to smaller U.S. banks to underwrite a €1 billion debt offering paired with a euro/dollar swap, or to lend it $200 million, or to provide custody services for a new overseas subsidiary; rather, it is going to turn to our foreign bank competitors.

Certainly, the financial crisis exposed serious flaws in the U.S. regulatory system, particularly the dangers of unchecked leverage and regulatory arbitrage. Most of the reforms imposed in the

wake of the recent financial crisis – by market participants, accounting authorities, supervisors, regulators and the Congress – will improve the soundness of our system while allowing U.S. firms to remain competitive. Most importantly, leverage has been reduced by applying bank holding company capital standards broadly across firms, and originators of mortgage and other products now cannot escape regulation by changing their legal structure or charter. We at JPMorgan Chase and others in the financial services industry have been supportive of these measures. Indeed, we worry that the lack of controversy around these important measures has left them underappreciated.

That said, the regulatory pendulum clearly has now begun to swing to a point that risks hobbling our financial system and our economic growth. We believe that U.S. policymakers should focus on:

- how much the regulations they have proposed *collectively* reduce risk taking by financial firms;
- how this collective impact is likely to result in reduced U.S. economic and job growth, because funding business growth requires someone to take a financial risk;
- how many of these regulations are being rejected or deferred by other countries, providing their banks at least a temporary competitive advantage in the marketplace, and in many cases a permanent one.

I will focus today on the two most stark cases – a capital surcharge on U.S. banks and extraterritorial application of margin requirements – where regulation currently risks doing more harm than good, and putting U.S. firms at a distinct and unnecessary competitive disadvantage globally. Regulators have different levers to reduce the risk of a bank's failure, particularly a large bank's failure: high capital to protect against unexpected losses; liquidity to allow continued operation under stress; regulation to discourage risk taking; supervision to discourage risk taking; recovery and resolution regimes that allow banks to fail without causing systemic crises or imposing costs on taxpayers. U.S. regulators have dramatically increased scrutiny on all these fronts, but now are considering a capital surcharge above Basel III levels that does not adequately account for the changes that have been made, and proposed margin requirements for derivatives transactions that risk doing extraordinary and unnecessary damage to the ability of U.S. firms to serve their clients.

Before turning to those two issues, I will review the current state of regulation, and its competitive impact on U.S. banks.

The Regulatory Landscape Post Dodd-Frank Act

It is critical not to underestimate the collective impact of Dodd-Frank and numerous other regulatory and supervisory initiatives designed to reduce risk at U.S. financial firms, and ensure that failed firms can be resolved without creating systemic risk or imposing loss on taxpayers.

Diminishing the Risk of Financial Institutions

Numerous regulatory initiatives are making U.S. financial institutions less risky, both by limiting the risk of the activities they undertake, and by dramatically increasing the amount of capital and liquidity firms must hold.

A Quick Inventory of Risk Reduction

Let me briefly highlight the host of recent initiatives designed to reduce risks taking by U.S. financial firms.

- All large U.S. financial institutions are now subject to Federal Reserve supervision and capital requirements.

- Off-balance-sheet activity has been reduced dramatically by heightened risk management practices, a FASB requirement that such structured products be consolidated on the firm's balance sheet, and dramatically higher capital and liquidity requirements for such obligations. Dodd-Frank's credit risk retention requirements for asset-backed securitizations are designed to improve the quality of the underwriting of the assets underlying such securities, and the SEC's Regulation AB overhaul will require a new and robust disclosure regime (including loan-level data) at issuance and on an ongoing basis.

- All large participants in derivatives markets – be they dealers or participants – are subject to supervision, reporting and margin requirements.

- Most derivatives trades will be centrally cleared, eliminating counterparty risk with other firms, and some will be exchange traded. The systemic impact of the failure of a derivatives dealer will thereby be reduced, provided that clearing houses are properly capitalized and managed.

- Originators of mortgages and other consumer products are now all subject to the same rules, and to federal supervision.

- Banks are prohibited from engaging in proprietary trading.

Thus, as a result of these post- financial crisis changes, Lehman Brothers would have been subject to the same Federal Reserve capital and prudential supervision as JPMorgan Chase, including extremely high capital charges for collateralized debt obligations (CDOs) and other exotic securities. AIG would have been required to register as a major swap participant, report on its positions, and subject itself to federal supervision. Countrywide and Washington Mutual would have been subject to the same mortgage underwriting standards as national banks, and would have been either significantly limited in making subprime loans or required to retain the risk of those mortgages. And the Financial Stability Oversight Council (FSOC) and the Office of Financial Research would have been gathering data on concentration risk and counterparty exposure, and empowered to act on their findings. These are very important changes.

Capital

Nowhere has change been more profound than with respect to capital. In addition to expanding the application of such requirements to all large financial institutions, U.S. regulators have agreed with other supervisors, through the Basel Committee on Banking Supervision's Basel III process, to a dramatic increase in regulatory capital requirements. I wish to be clear that JPMorgan Chase strongly supports the Basel III capital requirements, and believes that they will bring additional stability to the financial system without causing adverse consequences that outweigh these benefits. As I will discuss in a moment, it is a potential surcharge on Globally Systemically Important Financial Institutions (G-SIFIs) that is a bridge too far, and creates costs that risk exceeding the diminishing benefits of higher capital requirements above Basel III minimums.

As a frame of reference for how stringent capital standards are at this point, our analysis shows that at the Basel III 7 percent minimum, the nine likely U.S. G-SIFI banks, in aggregate, could absorb an instantaneous loss equal to two years of their average losses during the financial crisis – $203 billion – and *still* maintain a 5 percent Tier 1 Common capital ratio.[1] (The two-year time frame and 5 percent ratio were the standards required by the Federal Reserve under CCAR. The average two years of losses include losses both for the nine banks and the institutions they acquired during the crisis.)

As another frame of reference for current capital levels, consider that JPMorgan Chase entered the financial crisis with a ratio of tier 1 common equity to risk-weighted assets of 7 percent under the applicable capital rules (Basel I). (In other words, we held $7 in common stock or instruments of similar quality for every $100 of loans or other assets we had at risk.) Starting at that level, we were able to weather the financial crisis, *and* to acquire both Bear Stearns and Washington Mutual, and the chairman of Congress's Financial Crisis Inquiry Commission has stated that JPMorgan Chase would have survived the crisis without assistance. So, if the question is, "How much capital is necessary to weather the worst financial crisis in U.S. history?" the answer should be "about what JPMorgan Chase held."

With this in mind, note that the Basel III rules effectively would require JPMorgan Chase to hold approximately ***45 percent*** *more capital than it did during the crisis.* This is because the new 7 percent tier 1 common equity minimum standard under Basel III corresponds to more than 10 percent under its Basel I predecessor requirement in effect in 2007, particularly for banks having meaningful counterparty exposures and that are engaged in trading activity. This includes, through an interim measure called Basel II.5 that focuses on market risk – a 100 percent capital charge against high-risk securitization structures, including certain high risk CDOs, which contributed to losses in the recent crisis. It also includes a narrowing of the definition of what instruments count as capital, which we strongly support.

Liquidity

In addition to dramatically increasing capital requirements, Basel III also establishes an entirely new regime for liquidity requirements. There is no doubt that this was an important and

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[1] These nine are C, JPM, BAC, WFC, GS, MS, BK, STT and USB. Acquired companies whose losses are included are Bear Stearns, Wachovia, Countrywide and Washington Mutual.

necessary step, and will reduce systemic risk and increase safety and soundness once implemented. We do have serious concerns about some aspects of the liquidity coverage ratio and other initiatives, but these are beyond the scope of my testimony today.

Supervision

While regulatory changes are the part of oversight that the public sees, supervision by examiners occurs under the waterline but is every bit as significant. It is worth remembering that one reason national banks generally avoided subprime lending – and one reason unregulated entities were able to occupy that field – was pressure from the OCC to exit this business.

At any given time, we at JPMorgan Chase have 75-135 on-site, full-time examiners from the OCC, Federal Reserve and FDIC; the U.K. FSA and other regulators have still more examiners overseeing our overseas operations. We underwent 218 examinations in 2010, and will see more this year. It is difficult to overstate the increase in supervisory oversight for large financial firms.

Ensuring Resolution and Thereby Ending Too Big to Fail

Just as the examples above demonstrate that critical steps have been taken to reduce the likelihood of a large bank failure, other measures have been taken in the United States to lessen the impact on the financial system should a failure occur.

- The largest firms must draft recovery and resolution plans (also known as a "living will"), detailing the actions it would take to survive a crisis and its plan for liquidation, sale or recapitalization in an insolvency scenario. Supervisors oversee this process.

- Under Dodd-Frank, each large firm also must submit a recovery and resolution plan under the Bankruptcy Code.

- Under Dodd-Frank, in the event resolution under the Bankruptcy Code proves unworkable, the FDIC can be granted authority to resolve a financial services holding company in much the same way it has resolved banks.

- In the event it becomes receiver for a financial company, the FDIC is permitted to provide liquidity support to enable an orderly liquidation or recapitalization, with any losses borne by surviving companies.

The United States is ahead of the rest of the world: the FDIC's new authorities are already in place, while most countries have no plans for orderly resolution, and some have effectively acknowledged that their banks would be bailed out at taxpayer expense should a crisis occur. The United States is doing the hard work to make orderly resolution of large financial institutions a viable option, and JPMorgan Chase and other banks are devoting extraordinary resources to this unheralded project.

The European Union is debating a legal framework for resolution that is similar in approach to the U.K. Banking Act of 2009 and, if adopted and implemented, would be a useful step forward. Even then, however, such plans would be unproven and run against recent history. In contrast, the United States during the financial crisis allowed one of its largest depository institutions, Washington Mutual, and largest broker dealers, Lehman, to fail, with Washington Mutual being resolved through the FDIC process that has now been extended to non-banks. Hundreds of smaller banks have been closed by the FDIC. U.S. policymakers need to understand how unique this history is: most nations around the world have never allowed a bank of any size to fail in modern times.

This point is important because a country expecting to bail out its largest banks in the event of crisis might rationally insist on higher capital levels *ex ante* than one committed to orderly resolution at no expense to the taxpayer. The same might be true for a country still establishing its resolution framework or unsure of its practicality. U.S. banks should not suffer the worst of both worlds: preparing at extraordinary expense and dislocation for an orderly resolution, and suffering a capital charged premised on all recovery and resolution planning having been for nothing.

Further Insulation for Taxpayers

Aside from decreasing the risk of trouble at large financial institutions, Dodd-Frank also reduces the risk that a large institution's failure would impose costs on taxpayers. Under Dodd-Frank, if the FDIC suffers losses on liquidity support to a large financial institution in the course of resolution, other large firms must pay for those losses. It is worth noting that the Deposit Insurance Fund (DIF) and its predecessor, the Bank Insurance Fund, have never imposed a loss on taxpayers. JPMorgan Chase alone has paid approximately $3.5 billion in special assessments and prefunding of future assessments in order to recapitalize the DIF. Under the FDIC's new assessment scheme, JPMorgan Chase pays approximately $1.3 billion in deposit insurance premiums that cannot be justified based on the risks we pose to the deposit insurance fund, and are effectively used to pay for small bank failures.

The Limits of Regulation

All of these new requirements will substantially increase the safety and soundness of large U.S. financial institutions and decrease the risk of their causing systemic risk or economic harm. That said, no amount of regulation, or even overregulation, can guarantee that there will never be another financial crisis. So long as a financial system requires one group of people to lend money to another group of people for short periods of time – and any useful financial system must – there will always be the possibility of panic, and there will always be the need for the government as lender of last resort to provide liquidity to solvent institutions suffering a short-term liquidity crisis. This is why the Federal Reserve's discount window has existed since 1913. As well capitalized as JPMorgan Chase was during the financial crisis, we benefited from the liquidity programs provided by the Federal Reserve when short-term funding became unavailable to any firm at any price, regardless of credit quality.

Thus, at some point regulatory changes reach the limits of their utility, and the costs they collectively impose in terms of economic activity and growth and competitive harm outweigh diminishing marginal benefits. We have reached that point in U.S. regulatory reform.

The Shape of the Regulatory Playing Field Thus Far

As we near the one-year anniversary of the Dodd-Frank Act, European Union and individual countries in the EU are considering over a hundred different legislative initiatives, including a European Commission proposed European Market Infrastructure Regulation (EMIR) and a revision to the Markets in Financial Instruments Directive (MiFID). At this point, the European proposals are very complex and different from the U.S. approach in many areas, and their final form is very difficult to predict. We know enough, however, to be concerned that the regulatory landscape that emerges from the European political process may differ from that in the United States. Put another way, U.S. policymakers should not assume that a level playing-field will emerge from whatever European or Asian regulatory initiatives eventually take shape. The new regulatory environment has the potential to hasten rather than reverse the long-term competitive decline of the U.S. financial services sector, vis-à-vis our international competitors. For example:

- The Volcker rule has been rejected by every country to have considered it, and is not the law in any other country in the world in any form.

- U.S. banks are subject to among the highest level of supervisory scrutiny in the world, particularly when one recognizes that we are subject to supervision by multiple regulators (for example, Federal Reserve, OCC, FDIC, CFPB, SEC, CFTC, FTC, and state attorneys general and securities regulators) whereas most foreign financial institutions have only one or two.

- At this point, U.S. regulators have proposed draconian margin requirements, and proposed to apply them to U.S. firms operating abroad, which would effectively end their overseas business. We are hopeful that these proposals will be rationalized, but at this stage, the U.S. approach is an outlier compared to the rest of the world.

- Similarly, the European Commission appears to have decided to permit derivative trades within a banking group without the posting of margin, which we believe is appropriate, but only for transactions within a Member State of the European Union. Asian regulators have no plans for similar restrictions. The corresponding U.S. provisions require affiliates to post margin to one another, and would needlessly put U.S. financial services companies at a significant disadvantage.

- U.S. regulators subject U.S. institutions to stress tests of their capital that are, by all accounts, the most stringent of any country in the world.

- While U.S. securitization markets remain moribund and risk concentrates in Fannie Mae and Freddie Mac, European banks continue to fund their mortgage market through a multi-trillion dollar covered bond program that proved resilient through the crisis. (Fortunately, this

Committee has passed at a subcommittee level a bipartisan bill sponsored by Representatives Garrett and Maloney that would remove legal obstacles to establishing a similar market here in the United States.)

- With respect to capital, it is fair to note that European supervisors implemented Basel II in 2008, whereas U.S. regulators are still in the process of implementation. We believe, however, that the delay by U.S. regulators reflects a desire to ensure that the models necessary to implement it – the same models that will be necessary for Basel III – fully reflect risk. As I discuss below, there is evidence that implementation around the world has not always been consistent. In any event, the stress testing under Federal Reserve's recent Supervisory Capital Assessment Program (SCAP) and Comprehensive Capital Analysis and Review (CCAR), which required banks to demonstrate how they will meet Basel III standards, clearly represents an extraordinarily rigorous capital standard, and can fairly be seen as having leapfrogged Basel II to impose the toughest current capital standard in the world.

- As a general matter, Asian regulators appear to be waiting to see the judgments of both the United States and Europe before deciding whether and how to increase regulation.

Given this background, I would now like to discuss two areas that pose the greatest danger to U.S. competitiveness, and U.S. economic and job growth.

The Proposed Imposition of a Capital Surcharge on Large Financial Institutions

Let me first turn to proposals for imposing a capital "surcharge" on certain large banks – so-called global systemically important financial institutions, or G-SIFIs – including our own. For comparison, please note that the Basel III capital requirements were the product of a process that was transparent, thoughtful, deliberate and professional. A series of proposals were made public, their quantitative impact studied, and the proposals refined; this was done by experts in their fields. By contrast, the process for producing the G-SIFI surcharge does not at this point appear to share these attributes. The Dodd-Frank Act directed U.S. regulators to impose a capital charge on large banks, but only after notice and comment rulemaking, which has not occurred. Furthermore, there is no indication that Congress expected such a charge to be as large as some suggest some supervisors are considering, in the range of 100-300 basis points on top of Basel III minimums.

Too Much

Leaving aside procedural issues, there are several reasons to question the substance of such a charge:

- As described above, the 7 percent minimum already set by Basel III would effectively require JPMorgan Chase to hold 45 percent more capital than it took to weather the crisis. In the context of all the other changes being made, it is difficult to understand how one could justify a surcharge for U.S. banks in addition to this Basel III requirement.

- The results of the stress tests included in the Federal Reserve's recent CCAR process demonstrated that leading U.S. banks are appropriately capitalized under highly adverse stress scenarios. The results of the CCAR are particularly significant given their methodology, which included a replay of the financial crisis and recession over a two-year stress period.

- Basel III minimums were designed to apply only to large, internationally active banks, including G-SIFIs. And, as I have noted, the market risk charges of Basel II.5 – an increase in capital requirements of approximately 400 percent for many positions – apply primarily to large, internationally active trading banks – that is, G-SIFIs.

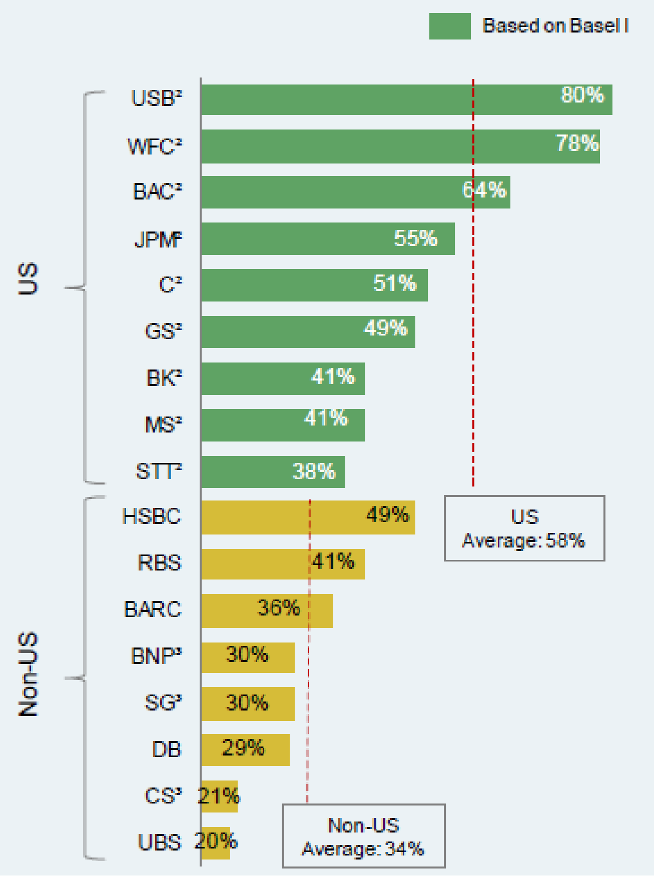
- Requiring capital at a level significantly above Basel III requirements will diminish investor appetite for large bank equity, which will require large banks to abandon more capital-intensive businesses, increase prices to earn a sufficient return on equity, or push banks to reduce the size of their balance sheets. Any of these options will have impacts on the U.S. economy.

  Commentators have argued that the delay of any surcharge until 2019 will mitigate adverse affects. We believe the truth is exactly the opposite. The market and banks will immediately gravitate to the new standards, at exactly the same time the financial system is adjusting to all the other regulatory impacts, further exacerbating pressure on the fragile economic recovery. Over the past few weeks, we have observed significant volatility on rumors of relatively larger or smaller surcharges.

Too Inconsistent

While current capital rules are consistent as written, there are strong reasons to believe that U.S. regulators are applying them far more strictly than other supervisors. The risk weighting of an asset has a direct effect on its capital requirement: an asset with a 100 percent risk weight requires twice as much capital as a less risky asset with a 50 percent risk weight. Whereas measuring a bank's qualifying capital is an objective and relatively simply process, determining the appropriate risk weight for a given asset is a complicated and increasingly subjective process, heavily reliant on modeling. One can gain a sense for how conservatively or liberally a bank is applying its models by comparing its risk-weighted assets to its total assets, as reported in financial statements (which is an objective number). Doing so, we observe large differences between U.S. and foreign firms.

4Q10 RWA % of Total Assets adj. for netting[1]



[1] Non-US banks total assets adjusted (when applicable) for disclosed derivative and repurchase agreement netting for purposes of comparability with US banks, which are subject to FIN 39 & FIN 41 US GAAP requirements.
[2] Based on Basel I 4Q10 disclosed data. Under Dodd-Frank US banks must continue to calculate Basel I and Basel III capital ratios and then use whichever of the two ratios requires a higher level of capital.
[3] Netting adjustments not disclosed

Of course, it is theoretically possible that U.S. firms simply hold more risky assets than their foreign competitors. But this seems unlikely given that we compete in the same markets and tend to hold similar assets, and in some cases opposite sides of the same trade. The more plausible explanation is that our competitors apply a more favorable risk weighting. This means, though, that the effective capital rate for a large U.S. bank already is considerably higher than its foreign competitors.

The Basel Committee has recognized the need for peer review to ensure that its standards are implemented consistently, and U.S. regulators have stressed the importance of including risk-weighted asset calculations in any such review. It is premature, however, to impose a surcharge on U.S. banks that could substantially exacerbate an existing competitive disparity; U.S. regulators should withhold judgment on any surcharge until they are convinced that the playing field is level.

Too Different

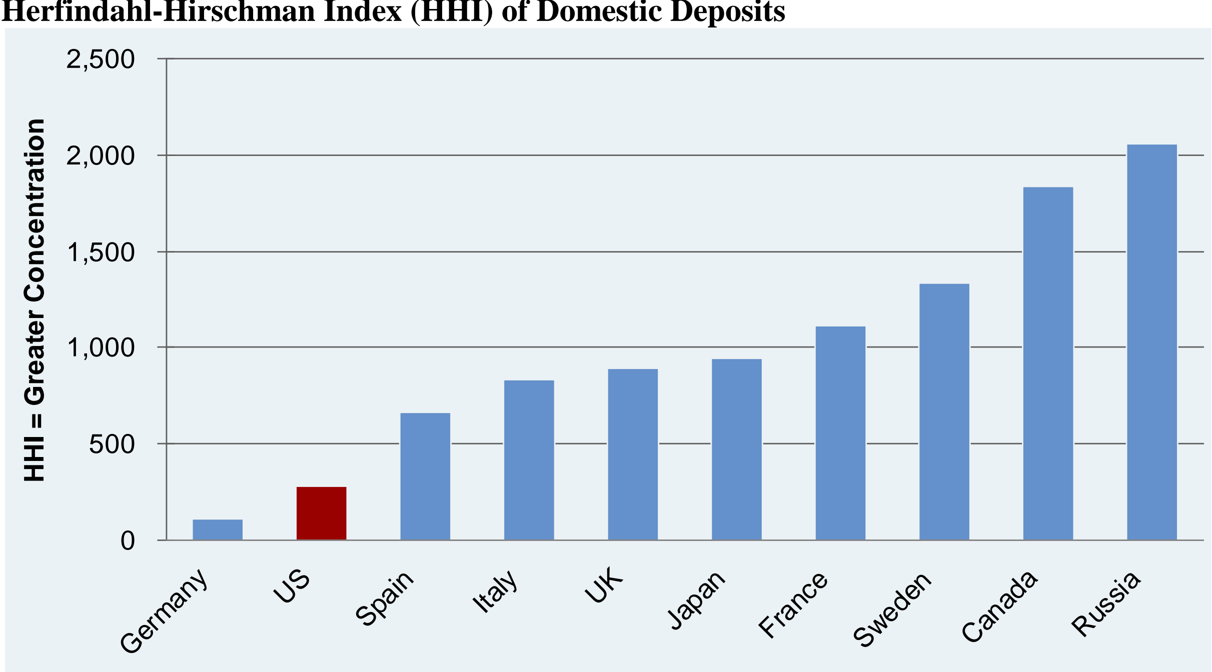
Even leaving aside implementation of Basel III, it is striking how differently the United States has responded to the financial crisis from almost all other major countries. As I have outlined,

every other country has rejected the Volcker rule; almost every country has failed to adopt plans for orderly resolution of SIFIs; no country has yet to propose margin requirements, and none is likely to adopt a scheme like the one here. No other country has both the present intent and long history of surviving banks covering the losses of failed banks; many have neither. Other national differences provide additional legitimate reasons why one country might impose a capital surcharge while another might refrain. As Secretary Geithner recently noted, the three largest U.S. banks account for 32 percent of total banking assets in the United States, in comparison to 46 percent for the three largest in Japan, 58 percent in Canada, 63 percent in the UK, 63 percent in France, 70 percent in Germany, 71 percent in Italy, and 76 percent in Switzerland.

Higher capital requirements may be more necessary in countries where the size of the banking sector rivals (or exceeds) the size of the economy, and thus where banks are "too big to save." For example, Switzerland, which has chosen to implement minimum capital requirements above Basel III levels, has a much higher concentration in its banking system than the United States; the same is true for the United Kingdom, which has advocated a high G-SIFI charge. (That said, it is worth noting that the ratio of risk weighted assets to total assets for Swiss banks is among the lowest of those measured, so a higher ratio tends to correct for that imbalance.) There are also serious concerns in the United Kingdom regarding oligopolistic pricing, and that the removal of a competitor would leave consumers without meaningful choices and with higher, oligopolistic prices, which is not the case here. (The U.K. government has established an Independent Banking Commission to consider issues of competition and stability.)

U.S. deposits are much less concentrated compared to most other countries, at least in part because of a federal law prohibiting any bank from making an acquisition that would leave it with more than 10 percent of U.S. insured deposits.

Herfindahl-Hirschman Index (HHI) of Domestic Deposits



Sources: Celent report "Too Big to Bail? Bank Concentration in the Developed World" (June 22, 2009).

Thus, even if U.S. regulators could ensure that the same capital standards would be adopted and applied consistently across the world, there are powerful, entirely legitimate reasons why the United States could and should decide to impose little or no surcharge on large banks.

Counterpoint

Let me now discuss some of the rationales we have heard offered for a G-SIFI surcharge.

Argument 1: Dodd-Frank and our existing regulatory regime focus only on firm-specific risks but not on the greater systemic risks posed by G-SIFIs, and a new surcharge is required for the marginally greater systemic impact of a G-SIFI failure.

We believe that this argument (1) seriously understates the impact of existing regulation and the Dodd-Frank Act's reforms; (2) draws the wrong lessons from the financial crisis; and (3) relies on unproven academic theories in claiming that an appropriate G-SIFI surcharge can be determined based on societal impact.

First, as described, an extraordinary amount of existing and ongoing financial regulation is designed to reduce the systemic risk of large financial institutions, particularly their wholesale operations, where there is the greatest chance of interconnectedness and therefore systemic risk. Central clearing of derivatives reduces systemic risk. Margin requirements reduce systemic risk. Reporting and supervision of positions reduce systemic risk. Subjecting all dealers regardless of charter to the same capital requirements reduces systemic risk. Basel II.5, which dramatically increases – often by 400 percent or more – the capital charge on trading positions held by large banks, decreases systemic risk, because it is in these positions that systemic risk resides. Basel III applies some of its highest capital charges for interbank trades, not because the firm specific risk is high but because their systemic risk is high. A new resolution procedure created especially for systemically important institutions, and modeled on proven methods for resolving large banks, reduces systemic risk. The creation of an FSOC specifically charged with identifying risks to financial stability should reduce systemic risk.

Certainly, no U.S. regulators objected to the Dodd-Frank Act on the grounds that it was not addressed to reducing systemic risk, and was myopically and inappropriately focused only on firm-specific risk. To the contrary, Congress was told, correctly, we believe, that Dodd-Frank would substantially reduce systemic risk.

Second, the worst moments of the financial crisis arose from a liquidity crisis. As in past crises, capital proved to be a poor and lagging predictor of failure; rather, firms that held long-term assets and short-term liabilities without a stable source of emergency liquidity were most likely to fail. While the TARP injection of preferred stock in the largest banks was an important step, the liquidity facilities and guarantees put in place to stem runs on money market funds and a complete breakdown in the commercial paper market were of at least equal importance. Higher capital levels alone would not have been an answer to this problem.

Third, attempting to quantify the impact of a firm's failure on the financial system as a whole is at this point neither art nor science. We understand that some academic papers attempting this

estimate have been published, generally by their own acknowledgement neither in final form nor peer reviewed, all extraordinarily hypothetical, and none grounded in a post-Dodd-Frank regulatory framework.

Argument 2: Recent academic papers assert that, under corporate finance theory, capital requirements can be increased ad infinitum without affecting demand for bank equity because investors will be indifferent to a loss of return in exchange for reduced risk. In other words, having regulators rather than investors determine the appropriate amount of capital required for one type of company (banks) – and having regulators make that determination based on factors different from those investors would consider – will make no difference in investor appetite.

Recent, actual, investor sentiment is quite contrary to this theory. Investors uniformly report that one of the greatest depressants on banks stocks currently is uncertainty about future capital requirements, and the G-SIFI surcharge in particular – the same capital requirements and surcharge that academic theory told us should be a matter of indifference to these investors. Equity analysts recently have downgraded large U.S. banks stocks based in part on potential higher capital requirements – while theory says they should be indifferent to increased capital requirements.

Argument 3: It is good to impose handicaps on large banks because small banks can meet the same needs for funding without imposing systemic risk.

It is worth noting what a radical change to banking supervision this argument implies. It would dictate that a loan to a given company should carry a different capital charge depending solely on who makes the loan. In short, it uses capital requirements – which have always been linked to safety and soundness in general and the risk of loss in particular – as instead a mechanism for imposing competitive change. We believe this would be an extraordinarily unwise step to take, and would represent a potential politicization of banking supervision that should greatly concern policymakers.

Furthermore, as noted at the outset, it is highly unlikely that small banks would replicate large bank functions for U.S. companies. Our commercial business with medium- and large-size companies – providing credit and liquidity – will flow to foreign banks who already serve such customers in the United States. Even to serve smaller companies, small banks would need to raise substantial amounts of equity to replicate large bank lending at a similar price.

Argument 4: SIFIs are the product of artificial growth due to a funding advantage, and therefore higher capital charges will simply offset this subsidy and return them to their "normal" economic size.

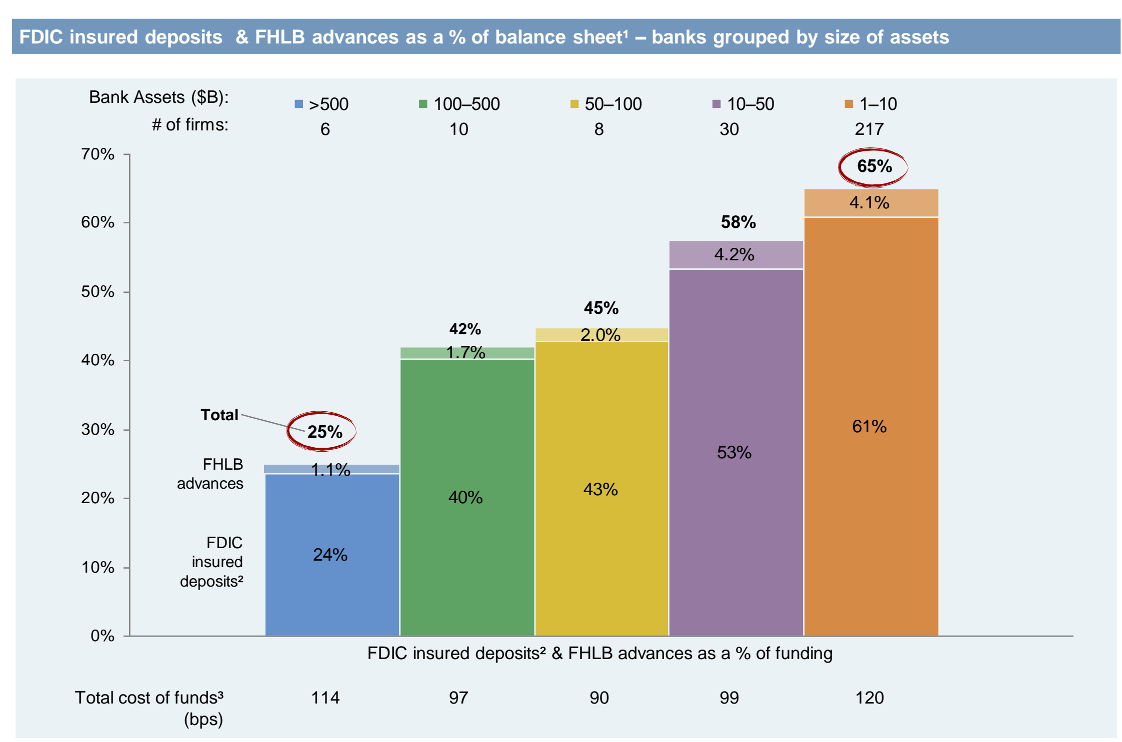
As previously noted, large global banks (U.S. and foreign) reflect a global economy where corporations require cross-border funding options, and the ability to raise significant amounts of funding very quickly.

The notion that large banks have a material funding advantage over small banks appears to be incorrect. Academic studies tend to attribute any funding advantage in debt markets to a belief

by debt holders that they will be bailed out in the event of default. However, these studies have not been updated to reflect recent changes to law and in any event failed to consider adequately whether larger firms' debt trades better because of liquidity or other factors.

Even leaving aside that question, however, the fact is that most small and mid-sized banks rely for their funding primarily on low-cost government guaranteed or government sponsored funds. As the chart below shows, using 2010 data, the average cost of funding for large banks is therefore *higher* than for small- or medium-sized banks. The reason is funding mix: large banks (over $500 billion in assets) derive only 22 percent of their funding from insured deposits and Federal Home Loan Bank advances; the equivalent number is 47 percent for banks between $100 and $500 billion; 53 percent for banks between $50 and $100 billion; 58 percent for banks between $10 and 50 billion; and 65 percent for banks below $10 billion.

Small banks are ~2.5x more reliant than the largest banks on government-insured and government-sponsored funding sources



Source: SNL, regulatory financials. Data as of 12/31/10. Includes all 282 listed US banks and broker / dealers with assets>$1B and available BHC financials.
1. Percentages based on a weighted average
2. Insured deposits based on banks' reported estimates where available; FDIC estimate used otherwise
3. Cost of funds equals interest expense divided by average interest-bearing liabilities plus average non-interest bearing deposits (interest-bearing liabilities include deposits, Fed funds, repos, subordinated debt, trust preferred securities and other borrowings)

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Derivatives Regulation

The Dodd-Frank Act takes numerous actions to reduce the systemic risks posed by derivatives. Many of those actions – position reporting, some margin requirements – are a prudent response to the financial crisis. There are two areas, however, where we have significant concerns.

Push Out

Under section 716 of Dodd-Frank, U.S. banks must push out credit, equity, and commodity derivatives into separately capitalized subsidiaries.

Most rules imposed by Dodd-Frank involve difficult trade offs – for example, between reduction of risk and preservation of market liquidity, between safety and soundness and credit availability. The push-out rule of section 716, however, decreases market liquidity, impairs safety and soundness; increases systemic risk; and makes large banks more difficult to resolve. The only justification offered for it has been to deprive banks of a marginally better cost of funding at the bank level than they could obtain in a holding company affiliate. Not surprisingly, this requirement has not been adopted by any other country in the world, and has been publicly opposed by Chairman Bernanke, Acting Comptroller Walsh, and FDIC Chairman Bair, among numerous others.

The implications of this requirement are profound:

- Operational risks increase, as positions must be managed in multiple units.
- Costs to customers increase.
- Risk management will be more difficult, because the requirement to book transactions in multiple legal entities will result in either a proliferation of trading books or numerous intercompany transactions to reconsolidate risk into a single entity.
- Because customers prefer to face a bank as counterparty, our foreign bank competitors, not subject to such a requirement, will receive a competitive advantage.

Also under section 716, affiliates within a bank holding company will be required to post margin to each other. We believe this provision will impair rather than assist safety and soundness, and is unwise. The European Union is so concerned about such an approach that it is actively considering a specific exemption from EMIR, to avoid the need for margining in intra-group transactions, at least where individual jurisdictions are concerned.

Congress should repeal or significantly amend section 716.

Margin Requirements

Margin is a means of reducing counterparty risk in derivatives transactions. Depending on the type of counterparty, its financial strength and a firm's credit policies, a counterparty might be required to post initial or variation margin. Variation margin is collateral that a party posts to cover credit exposure arising from market movements – that is, to the extent the trade moves against one party and the other party wants to secure its exposure. Initial margin is collateral posted at the outset of a transaction as protection against potential future market movements.

While market practice has grown more conservative in the wake of the financial crisis, the margin rules proposed by the banking agencies are far more stringent. The banking agencies have recently proposed margin regulations for swaps that are not cleared. These regulations

were issued pursuant to section 731 of Dodd Frank, which directs the agencies to issue rules that are "appropriate for the risk associated with the non cleared swaps . . . ." The draft regulations that have been issued will have two consequences: first, as applied (uniformly) in the U.S. market, overly stringent margin requirements will make it more difficult for our clients to manage risk by increasing the cost and risk of doing so; second, if applied overseas, and if foreign banks are able to continue adhering to current market practice, the proposed margin rules will quite simply put us out of business overseas.

The draft rules impose a highly prescriptive margining regime to uncleared swaps between swap dealers and virtually all financial end users, which require all financial end users to post initial margin and variation margin with zero thresholds. By imposing the same requirement on all financial end users, the draft rules ignore the mandate of Section 731 that the margining regime be risk based. There are significant differences in credit quality between various classes of financial end users, ranging from hedge funds at one end of the spectrum (most hedge funds already post variation margin and initial margin under current market practice) to sovereigns and supranationals at the other; many entities do not currently post margin under current market practice due to their financial strength. Imposing a "one size fits all" margining regime on all financial end users violates the intent of the statute and will impose significant and unnecessary burdens on many financial end users that will inhibit their ability to manage risk.

The draft rules also impose a margining regime on non-financial end users, despite the absence of any evidence that swaps with non-financial end users create systemic risk or contributed in any way to the financial crisis. Congress acknowledged this when it provided for a broad exemption from the clearing requirement for non-financial end users using swaps to hedge commercial risk. By requiring all non financial end users to negotiate credit support arrangements with their swap dealers, the draft rules raise the specter of margin requirements applying to the hedging activities of thousands of Main Street American companies. This has the potential to divert scarce capital from the balance sheets of these companies, inhibit job creation and impact their international competitiveness. These are all results that the Congress was clear to avoid when it exempted swaps with non-financial end users from the clearing requirements of Dodd Frank; we do not believe it intended to allow the same outcome through margin requirements.

As noted above, the draft rules also provide for uniform extraterritorial application of the margin rules on uncleared swaps, despite the clear statement in Title VII that extraterritorial application of the statute should be permitted only in unusual circumstances. The potential impact of extraterritorial application of U.S. margin rules cannot be overstated, given that adoption of similar rules is at least 18 months away in Europe, with no assurance that the eventual rules will be equally stringent. Thus, for at least the foreseeable future, if a French pension fund, a Dutch company, or an Asian sovereign wealth fund wishes to enter in a derivatives transaction, European or Asian banks will not require them to post margin; if Dodd-Frank is read to require U.S. banks to do so, we will simply lose this business. Furthermore, since most companies seeking debt underwriting require a derivative as part of their funding plan – for example, a German firm may wish to issue debt in dollars and swap to euros – we would be unable to compete in those markets as well. The competitive impact of applying the margin rules to our swap activities overseas is exacerbated by very prescriptive and restrictive rules governing what

types of margin are eligible under the proposed regime. By restricting eligible margin to U.S. dollar cash, Treasuries and Agencies, the proposed rules will put U.S. banks in the position of demanding margin from our overseas clients when our competitors do not; in addition we are not permitted to accept margin in the form of, for example, Euro Cash and G7 Sovereign Debt, which are common forms of permitted collateral in European markets. The effect of this will be to kill our overseas swaps activities; even if Europe and other regulators were to subsequently adopt similar rules, it would be too late.

Congress could have passed a law prohibiting U.S. banks from operating an overseas derivatives business, but it did not. In fact, it never even considered doing so, and never would, given the vital importance of this business to U.S. financial firms. And yet the interplay of a CFTC/SEC registration requirement and a margin proposal from the bank regulators risks the same result. Under the terms of Dodd Frank, which include a specific mandate against extraterritorial application of rules in this area, the CFTC and SEC should not require a foreign branch or subsidiary of a U.S. bank to register as a U.S. swap dealer unless it is doing business in the United States. It should not be required to register if it is located overseas and only doing business with foreign companies or overseas offices of U.S. companies.

Meanwhile, European policymakers also have concerns about the extraterritorial application of Dodd-Frank. The European response appears to have been to add similar extraterritorial provisions to EMIR, in a form of quid pro quo. We understand that these issues were raised during the visit of Commissioner Barnier earlier this month, but we are concerned about the potential for an outcome in which both U.S. and EU legislation creates damaging extraterritorial effects. Such a scenario can only be to the detriment of both jurisdictions.

Role of FSOC & Congress

We are pleased that Congress has chosen to exercise oversight of these issues – particularly capital, where the stakes for our economy are so high and deliberate consideration is needed given the potential impact on U.S. competitiveness, credit availability and job creation. Clearly, the FSOC also has a role to play, given the systemic implications of these provisions, and the need to understand not just the rules of each agency but how those rules interrelate, and how they affect the competitiveness of U.S. firms.

Dodd-Frank requires regulators to provide the public – including the affected institutions and the clients they serve and, not incidentally, the Congress – notice and the opportunity to comment on a proposed rule *before* it is adopted, not after international negotiations have made its adoption a *fait accompli*. We believe that the FSOC's Volcker study was an important contribution, and believe that the FSOC should coordinate work in other areas as well.

Conclusion

Thank you very much for this opportunity to present the views of JPMorgan Chase, and I welcome any questions you might have.

United States House of Representatives

Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
Barry Zubrow	JPMorgan Chase & Co.
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☑ Yes ☐ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
JPMorgan Chase engages in a wide range of business with the federal government across various lines of business. For example, we are an SBA and FHA lender, and we provide various payment services for federal government agencies.	
7. Signature: [signature]	

Please attach a copy of this form to your written testimony.