J.P.Morgan

13 March 2016

The European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA

Re: Draft RTS on market risk model assessment (EBA/CP/2015/27)

Dear Mr. Enria,

J.P. Morgan (JPM) is grateful for the opportunity to comment on the EBA draft Regulatory Technical Standards (RTS) on assessment methodology on the use of internal models for market risk and assessment of significant share under Article 363(4)(b) and (c) of Regulation (EU) No 575/2013.

We acknowledge the mandate established in the CRR for the EBA to develop draft regulatory standards specifying both the assessment methodology under which competent authorities permit institutions to use internal models, and the conditions under which the share of positions covered by the internal model within a risk category shall be considered significant. Harmonisation of approaches across EU member states, and more broadly across regulatory authorities globally, is an objective we would support. However we share wider industry concerns over some of the approaches proposed by the EBA in this RTS as set out in the joint ISDA/AFME response. We believe alternative approaches can be presented to fulfil the CRR mandate without these issues.

We are concerned that certain aspects of the EBA proposal are unnecessarily inconsistent with the final FRTB standards agreed by the Basel Committee[1]. The RTS should represent an opportunity to align towards these global standards and avoid any contradiction that may need to be dismantled once the FRTB is implemented. Whilst we acknowledge the limit to which the EBA can align with these proposals in advance of implementation in Europe, any approach not explicitly required under the CRR mandate that would result in divergence from the FRTB final standards seems difficult to justify. The key areas of divergence include:

- A definition of "significant" that is extremely high, both relative to a parallel threshold in the FRTB framework, and on a standalone basis, and which does not allow for the differentiation by business area envisaged in the FRTB
- A sequencing of model approvals by risk type (general prior to specific) which is not required under the CRR, nor the FRTB final standards, and does not appear to provide any additional mitigation of risk

[1] http://www.bis.org/bcbs/publ/d352.htm.

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- A back-testing requirement of 250 days prior to application submission, whereas the FRTB final standards accommodate a time period which is both shorter and which includes the period between submission and approval of the model

For all of these areas (on which more detailed rationale is provided in the annex to this letter) we believe EBA should converge towards the FRTB final standards. We are highlighting these particular aspects of the EBA proposal as we believe they create unnecessary restrictions that could impede firms from gaining new model approvals.

We consider that the proposals make the model approval process – generally already a multi-year endeavour, requiring a great deal of resource from both firm and supervisory authority – challenging to the point of becoming impractical. The proposed standards do not allow supervisors the flexibility to, for example, sequence approvals by product complexity or business area, and effectively force a 'big bang' approach to the approval process. Whilst we understand the desire for harmonisation of approaches, we consider that sufficient consistency could be achieved in the end result of the approval process, whilst allowing greater flexibility over the course of that process. This would, of course, be regulated by the expert judgment of supervisors themselves.

The prescription of the proposed requirements, and their lack of flexibility, presents a significant barrier to firms seeking new model approvals, whilst having a much lower impact on those firms which already have such approvals in place (for whom many of the requirements will only have an effect if there is a material change in the firm's position). This represents a significant competitive issue, effectively penalising new entrants.

We discuss these key concerns in greater detail in the annex to this letter, where we answer a selection of relevant questions.

Yours sincerely,

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Annex

Q4: Do stakeholders agree with the General-Specific model application hierarchy introduced by the RTS?

The requirement for General approval before Specific approval is not required under FRTB and we believe that there is nothing in CRR Art.367 or Art.370 that makes specific risk permissions contingent on general permissions. The consultation paper (CP) does suggest that the CRR requires this sequencing. However, we consider that the CRR merely applies standards for specific risk modelling which include all those required for general risk. This does not logically require that a firm has to have both approvals, but rather means that both sets of standards need to be met for specific risk approval to be granted.

Further, we do not believe that the requirement for sequencing is conceptually necessary. For example, Debt-General and Debt-Specific risk categories are not variants of the same asset class, but essentially represent different asset classes (Interest Rate and Credit Spread, respectively), which are often traded on different systems, by different lines of businesses, using different risk and valuation methodologies. This means, for example, that it would be impossible under the proposed standards for a firm to seek model approval for a credit trading business (using mostly credit derivatives, with little general interest rate risk) without also having approval for its rates business – because the credit business would fail the significance test for general risk, but would be unable to seek specific risk approval without it.

Lastly, there would seem to be no downside in allowing firms to seek specific risk approvals in the absence of general risk – it would not appear to present an opportunity to 'game' the approval process and, as noted above, the CRR already requires firms seeking specific risk approval to have in place risk measurement and modelling standards super-equivalent to those for general risk.

On this basis we consider there should be no requirement for general risk model approval automatically to precede or accompany an application for specific risk model approval.

Q7: What levels do stakeholders consider are appropriate for the proposed thresholds? Please provide your answer considering the calculation before and after positions have been excluded by the competent authority.

We believe that the threshold levels for assessing 'significant' and assessment method by Risk Category are too high, and go directly against the approach used in FRTB.

The threshold levels set for positions intended for IMA of a given Risk Category at 90%-95% are extremely high. The language used in the CRR requires a 'significant share' of positions in a risk category to be captured – this is not the same as the 'vast majority' or even 'most' of the positions, and would not appear to justify the 90-95% level proposed in the CP. Furthermore, the thresholds are much higher than the 10% of the bank's aggregated market risk capital coming from IMA-approved desks which is viewed as a 'significant share' under the equivalent FRTB requirement.

We also consider that allowing differentiation by, or exclusion of, positions by product complexity or business area (perhaps temporarily to allow phasing of the model application process) would not contradict the CRR text, whilst granting firms and supervisory authorities the flexibility required to manage the approval process. This would be more consistent with FRTB (which allows differentiation, subject to the 10% threshold, by trading desk), and is also consistent with current supervisory practice, for example in the case of the UK PRA, which differentiates model permission scope by broad classes of positions within each risk category (PRA Supervisory Statement 13/13 9.4).

Q9: What are stakeholders views regarding the proposed requirements on the internal committee structure?

We find the overall proposal to be reasonable and generally in line with the existing practices. However we would like to reinforce industry comments about the prescriptive nature of certain requirements as listed in their response. The overall governance arrangements that are in place for large financial institutions would make it impractical to implement a framework with just one 'committee' which this proposal seems to imply.

Q10: Do stakeholders agree that the internal validation requirements are relevant and capture all material risks?

While we agree with most of the proposed validation requirements, we would recommend that the standards recognise that elements of the validation process may be carried out by different functions. For example, the robustness of IT infrastructure is something which would often be carried out by a technology function, rather than the group primarily responsible for model review and validation.

Q12: Do stakeholders agree that the proposed requirements on limit structure, regular limit update and limit breach approval processes are appropriate?

We are supportive of industry response and the issues highlighted are largely in line with our findings. We would like to reinforce particularly the point regarding day to day management of limits by committee which we find impractical, and propose allowing delegation of limit authority to the appropriate individuals, under an agreed framework.

Q15: Do stakeholders agree that the model should have been working in a stable way during a minimum period of 250 days prior to application for permission to use the model?

We acknowledge that it is desirable from both a supervisor's and a firm's perspective that an internal model used for calculating own funds requirements have a proven track record of reasonable accuracy in measuring risks. That said, the requirement of 250 days is overly strict compared to the approach under FRTB which is interpreted to allow for discretion to observe model

performance post submission until the required 250 day observation period is reached. Our view is that three months, which in effect is the current standard applied by some regulators (e.g. PRA, SS13/13 para 9.10) should be a sufficient time to demonstrate stability of the systems and processes supporting IMA models. A longer period might be required prior to the model 'going live' for the purpose of capital calculation.

Q24: What are stakeholders' views regarding the relative merits of the inclusion of all risk factors for the actual P&L computation?

VaR is looking to capture the tail risk and as such should be benchmarked against all risk factors for the actual P&L computation.

Q25: What are stakeholders' views regarding the proposed definition of 'Net interest income'?

We support industry response and would like to reiterate that Net interest income (NII) exclusion should only be applied to an accrual book. However there is no reason to exclude NII from MtM securities where it presents a component of carry.

Q28: What are stakeholder's practices regarding adjustments computed less regularly than daily?

Where adjustments are calculated less frequently than daily, it may be hard to determine whether any movement occurred on a discrete date or more gradually over the readjusted period. As per the industry response, it should be a valid reason for removing the breach which is evidently caused by such adjustments.

Q29: What are stakeholders' views regarding the treatment of Theta in VaR and as a component of P&L?

VaR does not capture theta as a tail risk and to be consistent with this, Theta should also be removed from Hypothetical P&L for backtesting. While CRR may be not be clear on whether Theta should be included in VaR, FRTB specifically refers to applying 'instantaneous price shocks', implying that Theta should be excluded from both VaR and P&L.

Q30: Taking into account the CRR requirement to capture 'correlation risk' do you consider that the use of stochastic correlations should be required?

There are significant challenges around the use of stochastic correlations and so we do not feel that stochastic correlations should be required as long as there is sufficient monitoring around the actual correlations used.