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November 21, 2005

Ms. Suzanne Q. Bielstein
Director—Major Projects and Technical Activities

Mr. Lawrence W. Smith
Director—Technical Application and Implementation Activities

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position *Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133*

Dear Ms. Bielstein and Mr. Smith:

JP Morgan Chase & Co. (“JPMorgan Chase” or “the Firm”) appreciates the opportunity to comment on the Financial Accounting Standards Board’s (“FASB” or “the Board”) draft of the FASB Staff Position (“Proposed FSP”) No. 133-a, *Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133*. We have been actively involved in and endorse the November 21, 2005 submission prepared by the American Securitization Forum (“ASF”), the International Swaps and Derivatives Association (“ISDA”) and the Securities Industry Association (“SIA”), collectively, the Joint Industry Working Group (“JIWG”).

In addition to the comments provided by the JIWG, we have serious concerns about (1) the proposed accounting for what is deemed to be the measurement error component of a Level 5 derivative valuation, and (2) the proposed disclosure of gross unrealized gains and losses at inception for all derivative contracts. We have outlined our concerns and the basis for such below.

Level 5 Valuations

Background – Current Accounting

EITF Issue 02-3 states that, in the absence of observable data, the transaction price represents the best information available with which to estimate fair value at the inception of an arrangement. As such EITF 02-3 can be interpreted to implicitly require a dealer to “re-calibrate” its valuation models to transaction price at the inception of derivative trades considered to be unobservable. Subsequent changes to the inputs to the valuation model would then be made when there is available evidence indicating that there has been a change in such factors. While re-calibration

may be theoretically required, dealers cannot do so, as re-calibration would significantly and inappropriately impact their risk positions and risk management activities. In addition, dealers manage and value their risk on a portfolio/parameter basis, which renders calibration at the individual transaction level not operationally feasible.

Therefore, many dealers, including JPMorgan Chase, address the concept of marking to transaction price or re-calibration through a two-step process. First, profit estimated based on existing valuation models is manually deferred outside of the model. Second, the deferred profit is amortized into income on a systematic and rational basis, supported by the risk profile of the underlying derivative transactions. It is the combination of both manual deferral and amortization that effects a reasonable approximation of the results of model re-calibration.

Amortization is not simply assumed, but rather an evaluation of the transaction is performed to ensure that the chosen amortization approach creates a better estimate of fair value than deferral until maturity. In many cases, deferring the dealer profit until maturity would not result in more closely approximating the fair market value in a re-calibrated model, but would, in effect, structure a balloon payment of the profit at maturity, when its risk is zero. From an economic perspective this result does not make sense.

Proposed FSP

Paragraph 3b indicates that if a derivative transaction is executed outside of the reference market, then the transaction price presumption is rebutted. However, paragraph 4b states that if the minimum reliability threshold is not met at inception, dealer profit (loss) is deferred. The Board elected to require entities to record the model value of a Level 5 derivative as an asset (consistent with derivative trades categorized in Levels 1 through 4 of the fair value hierarchy) and to establish a deferred credit for an offsetting amount as the minimum reliability threshold has not been met. Therefore, profit for a Level 5 transaction is deferred until the minimum reliability threshold is met. We understand that the deferred credit accounting model was a compromise to address the Board's conflicting concerns regarding measurement of derivatives at fair value and possible measurement error in the initial estimate.

We respectfully disagree with the conclusions reached by the Board related to both the presentation of the deferred credit balance and the subsequent recognition of that deferred balance in earnings.

With respect to the presentation of the deferred credit balance, we do not understand how the Board justifies recording a deferred credit on the balance sheet related to a derivative asset that the Board has concluded is subject to sufficient measurement error risk to preclude profit recognition. It appears to us that the Board is implicitly indicating that transaction price is the best indicator of fair value for earnings recognition but is inconsistently requiring the balance sheet to be presented gross for a single transaction (although the net effect of the two entries is to record the transaction at transaction price). We do not see how the presentation of a single transaction or contract as a separate and distinct asset and liability on the balance sheet is either a faithful representation of the future cash flows to be received under that single contract or an improvement in financial reporting.

The proposed method for subsequent recognition of the deferred credit for revenue recognition purposes (e.g., recognition when the minimum reliability threshold is met) is even more problematic. While we acknowledge the theoretical attractiveness of proposing a single standard of reliability for revenue recognition over the life of the contract, we believe that the Board is in this case disproportionately weighting theory over economic reality. This approach is inconsistent with the economic behavior exhibited by many Level 5 derivative instruments, which

in many cases involve the realization of cash flows over the terms of the contracts. The single standard of reliability approach also ignores that the risk of measurement error in the initial estimate (the original conceptual basis for recording the deferral) decreases as cash is realized and as predicted events such as interest rate resets occur over the life of a contract. Finally, the proposed approach does not necessarily enhance comparability amongst reporting entities.

The concept of decreasing risk of measurement error over the life of a derivative is intuitive, as (keeping other inputs constant), vanilla swap and option values decrease as time to maturity decreases. We believe that from a revenue recognition perspective, the deferred revenue should be recognized as the risk of initial measurement error decreases. As previously noted, we struggle with the conceptual basis for a requirement to recognize revenue as a balloon payment that does not reflect that the risk decrease has occurred over time. We believe that amortization is a better reflection of the timing of the decrease in the risk of measurement error. Examples of the concepts described above have been included in Attachment I.

Additionally, we do not believe that the single standard of reliability will necessarily aid comparability. Under the single standard of reliability, two entities recording the same Level 5 transaction may not recognize the initial profit at the same time during the life of the trade. This is because the initial value of the same Level 5 transaction calculated by two different parties may differ if each entity's inputs differ. For example, an entity that utilizes more conservative inputs in its valuation model may estimate less inception profit than another entity. Both entities will record the same amount of revenue by the maturity of the transaction, however the more conservative entity will record some revenue over the life as predicted events occur and cash is realized. The less conservative entity will not record this revenue until the minimum reliability threshold is met. We believe that amortization based upon the risk profile of the transaction achieves greater comparability than the single standard of reliability, as it more closely mirrors the economic profile of the transaction.

Conclusion

Given the Board's continued concerns regarding measurement error, we believe that the only conceptually sound solution that is reflective of economic reality is to consistently follow the fair value hierarchy and the guidance provided in paragraph 15 of the Draft FVM Standard which states that in "a transaction in which the entity acquires an asset or assumes a liability, the transaction price (the price paid for the asset or received to assume the liability) is presumed to represent fair value...at initial recognition, absent persuasive evidence to the contrary." In the absence of persuasive evidence, the transaction should be initially recorded at transaction price for both balance sheet (i.e. netting the model fair value and the deferred and unamortized day one profit in a single balance sheet line item) and income statement purposes. Subsequent changes in fair value and decreases in the initial risk of measurement error should be recorded based on the risk profile of the transaction. This is consistent with the application guidance in AG76A of IAS 39 which states that "a gain or loss shall be recognized after initial recognition only to the extent that it arises from a change in factor (*including time*) that market participants would consider in setting a price" (emphasis added). Accordingly, we recommend that the Board eliminate the Proposed FSP's requirement of a deferred credit as well as its amortization prohibition.

Disclosure

Paragraph 6a of the Proposed FSP requires disclosure of gross unrealized gains and losses at initial recognition of a derivative instrument recognized in income during the period.

We believe that current financial statement disclosures, coupled with the disclosures proposed in paragraph 6b of the Proposed FSP and certain disclosures included in the Fair Value

Measurement Standard, are sufficient. JPMorgan Chase currently discloses trading revenues separated between fixed income and equity products, and after adoption of the FSP and the Fair Value Measurement Standard, will disclose a roll-forward of deferred profit balances for Level 5 transactions in addition to total gains/losses recognized for derivative transactions. Additional qualitative disclosures are also currently provided to explain broad trends in client versus non-client (e.g., portfolio management/trading) revenues. It is our opinion that this level of information should satisfy the Board's objective of providing the reader of the financial statements with the effect of such derivative transactions on JPMorgan Chase's financial statements.

Requiring derivative revenues to be further delineated between client value (i.e., profit on client-related transactions) versus non-client revenues for external disclosure purposes poses two problems: 1) such disclosures presume that ongoing portfolio management revenues are totally separable from client value, which is not the case; and 2) disclosing this level of granularity could put individual firms at an informational disadvantage versus their competitors.

First, we acknowledge that a derivative dealer's ability to take risk is dependent on its ability to support a client franchise, and for that reason dealers may make internal estimates of client versus non-client revenue trends over a reasonable timeframe. However, it is difficult to estimate a delineation of portfolio management revenues from day one client value in the analysis of the broad trend. It would be extremely difficult to perform such an exercise with the precision required for financial statement disclosure, especially over a short time horizon such as a quarterly reporting period.

For example, over time a dealer pays for risk management positions or hedges of client transactions in its portfolio. Estimates of such hedge costs to be incurred by a dealer are incorporated into the transaction pricing offered to a client at the inception of the transaction. However, the reporting or tracking mechanisms that would be required to monitor actual hedge costs incurred over time, potentially in different reporting periods, and to allocate them to client value reported in a given interim financial reporting period would be significant. (Note that we believe such tracking is necessary to give an indication of retained client value.) This analysis is further complicated by the dynamic trading of portfolio risk on an ongoing basis. It is for these reasons that dealers such as JPMorgan Chase do not typically disassociate portfolio management results from client value.

Secondly, segregating portfolio management revenues from client value, particularly on a quarterly basis, could result in a level of transparency for portfolio management activities that dealers are not comfortable disclosing to competitors. Depending on relative market issues, such transparency of portfolio management activities could lead third parties to an understanding of how an individual dealer's portfolios are positioned.

Finally, we note that the difficulties in segregating portfolio management results from client value will naturally lead to inconsistent disclosures amongst dealers. Current systems are not configured to capture this information in a systematic manner; in addition, calculations of client value incorporating hedge costs may vary between dealers. We therefore question the incremental value gained by providing such information.

For all of the reasons noted above, we do not believe this disclosure requirement will increase the usefulness of dealer financial statements to third party users and have significant reservations about the implementation costs and the level of portfolio detail that it could require a firm to provide. Given the quality of earnings represented by Level 1-4 derivative transactions, disclosure of total gains and losses should be sufficient. Such disclosure could be complemented

by a qualitative narrative regarding broad trends in client versus non-client results as necessary (depending on market conditions and an individual firm's performance). At a minimum, we think that this particular disclosure requirement would be more appropriately addressed in the Board's broader Derivative Disclosure Project.

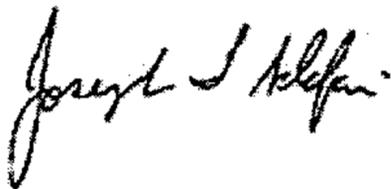
Amendment to Statement 133 Implementation Issue B6

We support the Board's efforts to ensure that the recognition of embedded derivatives is consistent with that of freestanding derivatives. However, we have concerns with the current drafting of the amendment, as we do not believe that it reflects the Board's intent in all circumstances.

We believe that there are unintended consequences associated with the inability to rebut the transaction price in one's reference market where persuasive evidence is available. We do not believe that the Board intended, within all reference markets, to imply that day one gains and losses would not be recognized for Levels 1 through 4. The amendment, as drafted, may also lead to recognition, not deferral, of day one profit (loss) on Level 5 derivatives embedded in hybrid instruments transacted in one's own reference market. The November 21, 2005 submission from the JIWG provides further analysis supporting our concerns, as well as drafting recommendations that we urge the Board to consider.

We appreciate the opportunity to submit our views and would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact me at 212-270-7559 or Shannon Warren at 212-648-0906.

Very truly yours,



Joseph Sclafani

EXAMPLE

To demonstrate our concerns regarding the proposed revenue recognition model for Level 5 derivatives, we have focused on an example of a long-dated over-the-counter interest rate swap with its variable leg based on a specific bank's prime rate. The bank-specific prime rate forward curve is significant to the estimate but will not become observable throughout the life the trade. Therefore the minimum reliability threshold will not be met until year ten. However, the risk of initial measurement error will decrease over the life of the swap since (1) the variable leg of the swap resets to the spot prime rate each reset period and (2) cash is exchanged each reset period, each resulting in the realization of previous estimates. At the last reset date (which occurs prior to maturity), the risk of initial measurement error is zero, since all of the remaining fixed and floating rates are known.

Background

- 10 year swap with annual reset at the end of each year
- The dealer receives floating rate cash flows. The rate is the bank specific prime rate and is therefore unobservable
- The dealer pays fixed rate cash flows.
- The dealer believes that the swap is worth \$1 million based upon its valuation model. [The dealer believes that the prime floating rate will be greater than the fixed rate such that each reset is worth \$100,000 on a present value basis and in the aggregate the present value of the cash settlement of all 10 resets is \$1 million.]
- Deferred profit or loss is recognized under the requirements of the Proposed FSP

EXAMPLE 1.a.

The example below assumes that the dealer's estimate of fair value was accurate (Dealer Profit=\$1M). The model value decreases as the cash underlying the initial estimate of fair value is received. Even though the initial estimates are realized at each reset date and cash payment date over the life of the transaction, the deferred profit associated with those initial estimates is not recognized until the final year.

Year	Net Cash flow	Change in MTM	Model Value (B/S Asset)	Deferred Balance (B/S Liability)	Net P/L
Day 1			1,000,000	1,000,000	0
1	100,000	(100,000)	900,000	1,000,000	0
2	100,000	(100,000)	800,000	1,000,000	0
3	100,000	(100,000)	700,000	1,000,000	0
4	100,000	(100,000)	600,000	1,000,000	0
5	100,000	(100,000)	500,000	1,000,000	0
6	100,000	(100,000)	400,000	1,000,000	0
7	100,000	(100,000)	300,000	1,000,000	0
8	100,000	(100,000)	200,000	1,000,000	0
9	100,000	(100,000)	100,000	1,000,000	0
10	100,000	(100,000)	0	0	+1,000,000

EXAMPLE 1.b.

The example below assumes that the dealer's initial estimate of fair value was incorrect (Dealer Profit= \$0, not \$1M). The model value decreases as the swap's prime floating rate resets and the initial estimates are proved incorrect. As this decrease in model value is driven by the correction of the estimate and not a cash receipt, a loss is recognized. Even though the initial estimates are corrected at each reset date, the associated correction of the initial estimate of profit in the deferred credit balance does not occur until year ten. We fail to see how a \$900m profit in year ten offset by losses over the life is an improvement in financial reporting.

Year	Net Cash flow	Change in MTM	Model Value (B/S Asset)	Deferred Balance (B/S Liability)	Net P/L
Day 1			1,000,000	1,000,000	
1	0	(100,000)	900,000	1,000,000	(100,000)
2	0	(100,000)	800,000	1,000,000	(100,000)
3	0	(100,000)	700,000	1,000,000	(100,000)
4	0	(100,000)	600,000	1,000,000	(100,000)
5	0	(100,000)	500,000	1,000,000	(100,000)
6	0	(100,000)	400,000	1,000,000	(100,000)
7	0	(100,000)	300,000	1,000,000	(100,000)
8	0	(100,000)	200,000	1,000,000	(100,000)
9	0	(100,000)	100,000	1,000,000	(100,000)
10	0	(100,000)	0	0	+900,000

Conclusion

In both potential outcomes of the bank-specific prime rate swap, the entity delays recognition or correction of the initial estimate of profit or loss in spite of objective evidence to support recognition. We believe that in most cases, amortization is a better reflection of the decreasing risk of measurement error in the initial estimate of fair value. We acknowledge that an amortization of the deferred credit is not appropriate under all circumstances or for all products. For example, products such as digital options that are sensitive to significant changes in inputs that can occur close to maturity may not exhibit a decreased risk of measurement error. For that reason, we believe that decreases in the initial risk of measurement error should be recorded based upon the risk profile of the transaction.