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Written Statement By Chief Risk Officer of JPMorgan Chase & Co, Barry Zubrow, Before the FCIC

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Chairman Angelides, Vice-Chairman Thomas, and Members of the Commission, my name is Barry Zubrow. I am the Chief Risk Officer of JPMorgan Chase & Co., and have served in that role since I began working for the bank in December 2007. I thank the Commission for the invitation to appear, and I hope that my testimony will assist the Commission in its efforts to examine the causes of the financial crisis.

The Commission has asked me to address several topics related to JPMorgan, including its triparty repo program generally and its relationship with Lehman Brothers specifically. This is an important topic of inquiry for the Commission, as the triparty repo market is of vital importance to broker-dealers and others in the financial industry. It contributes significantly to the liquidity and efficiency of the securities markets in the United States. Indeed, the average daily volume of the triparty repo market grew to *$2.8 trillion* in 2008. The importance of the U.S. triparty repo market is underscored by the fact that it facilitates the financing by dealers of their U.S. Government and Agency securities inventories, an important source of liquidity through which the Federal Reserve operationally implements U.S. monetary policy.

JPMorgan is one of two major banks providing triparty repo clearing services in the United States. In its role as clearing bank, JPMorgan serves as the agent between a broker-dealer, on the one hand, and repo investors, such as money-market funds, on the other. In a typical transaction, the broker-dealer sells securities to repo investors in the evening with a promise to buy them back at a slight premium in the morning. JPMorgan provides services such as obtaining prices for the collateral pledged by the broker-dealers, applying and enforcing specific rules dictated by the investors regarding collateralization, and moving cash and collateral among accounts belonging to the broker-dealers and the investors.

JPMorgan served as triparty agent for Lehman's broker-dealer subsidiary, Lehman Brothers Inc. ("LBI"). At the beginning of each trading day, in a process known as the "unwind," JPMorgan would repay LBI's triparty repo investors the cash they had provided overnight, and move LBI's securities into accounts on which JPMorgan held a lien. JPMorgan thus would advance for LBI the large amounts of cash needed to buy back the securities LBI had sold the night before. These advances always were entirely discretionary, as JPMorgan was not contractually obligated to make them. In addition, as LBI's principal clearing bank, JPMorgan typically made substantial discretionary advances on LBI's behalf in connection with other repurchase agreement and financing activity, as well as advances in connection with the clearance and settlement of other LBI securities trading activity. Before LBI's final week, JPMorgan's intraday advances typically exceeded $100 billion daily.

JPMorgan's intraday exposure from the triparty repo program would last until the triparty investors and other financing sources returned in the evening for a new round of repos. During the day, JPMorgan thus faced the risk that the securities it held as collateral would drop in value, that the broker-dealer would default, and that the triparty investors and other financing sources would not re-invest with the broker-dealer in the evening to allow the broker-dealer to repay JPMorgan.

As of late 2007, JPMorgan took no margin on the large discretionary loans it made each morning in connection with the triparty repo unwind. Whereas the triparty investors would take a "haircut" overnight — paying less that 100 cents for each dollar of securities — JPMorgan took no such haircut when it took over the investors' position each morning. This enhanced the risk that JPMorgan would be unable to recoup the full amount of its advances through the liquidation of collateral, since it was advancing 100 cents on the dollar to LBI intraday.

In consultation with the Federal Reserve, JPMorgan decided in early 2008 to begin mitigating this risk by taking haircuts on its intraday advances to broker-dealer clients, including Lehman. JPMorgan determined that it would be appropriate to take, at a minimum, the same haircuts during the day that the triparty repo investors took overnight. However, in order to allow its clients time to adjust to this change, JPMorgan implemented the haircuts gradually. On March 17, 2008 — shortly after the near-collapse of Bear Stearns — JPMorgan began by increasing the margin it required from Lehman by 20 percent of the haircut that the triparty investors had been requiring, with an expectation that it would ramp up to 100 percent by the end of June.

Increasing margin requirements, however, still did not protect JPMorgan fully from the risks it faced in extending tens of billions of dollars of credit to broker-dealers each morning as part of the unwind. JPMorgan, unlike any single triparty investor, took on a broker-dealer's *entire* triparty repo book each day. This meant it would face far greater risks in a liquidation scenario. Furthermore, JPMorgan had no assurance that investors would return to fund the broker-dealer in the evening, such that the broker-dealer would be provided with the cash necessary to repay JPMorgan's intraday advances. Moreover, the haircuts negotiated between investors and the broker-dealers did not, in many cases, fully reflect the liquidation risk for the increasingly large amount of structured, difficult-to-value securities that were being financed through the triparty repo program.

In addition, throughout the spring and summer of 2008, JPMorgan participated as a member of the Counterparty Risk Management Policy Group III ("CRMPGIII"), an industry-led group of large bank, broker-dealer and investor firms, formed to discuss best practices and structural risks in the market. CRMPGIII specifically addressed the issues inherent in the triparty repo marketplace and articulated a series of best practices to be adopted by broker-dealers, investors, and agent banks — including practices relating to clearing bank intraday margin. JPMorgan discussed these best practices with each of its broker-dealer clients, including Lehman, and strongly recommended to its clients the importance of conforming to the recommendations. These recommended best practices were discussed with the Federal Reserve Bank of New York and other regulators.

Around June 2008, JPMorgan held high-level meetings with its large broker-dealer clients to discuss these risks. For Lehman, such a meeting was held on June 2, 2008. JPMorgan explained the unique risks it faced and pointed to an approximately $6 billion dollar margin shortfall. In response, Lehman executives agreed to pledge additional collateral. Meanwhile, JPMorgan agreed at Lehman's request to begin taking only 40 percent of investor margin by the beginning of July, and not to reach 100 percent until mid-August.

In mid-June 2008, Lehman pledged various structured securities (not cash) — which it valued at approximately $6 billion — in response to JPMorgan's request for additional margin. Because LBI's corporate parent, Lehman Brothers Holdings Inc. ("LBHI"), was the source of these additional securities, LBHI entered into appropriate documentation in late August 2008 to grant JPMorgan a security interest in the collateral.

By late August and early September 2008, Lehman's deteriorating financial condition was becoming increasingly apparent. It became widely recognized by market participants that Lehman was encountering large losses and would face serious problems over the coming weeks absent a significant transaction. In addition, it came to light that many of the securities Lehman had pledged to JPMorgan in June were illiquid, structured debt instruments that appeared to have been assigned overstated values. Nevertheless, JPMorgan was determined to remain supportive of Lehman. It continued to unwind the triparty repo book each morning and otherwise act on a business-as-usual basis.

But JPMorgan's exposure to Lehman was growing. This included exposure in areas unrelated to triparty repo clearing. For example, JPMorgan faced Lehman entities as a counterparty to derivatives transactions, and in each instance where JPMorgan held a position that was "in the money," it incurred the risk of a Lehman default. This included not only derivatives transactions for JPMorgan's own account, but also derivatives transactions between JPMorgan and Lehman entered into for their respective prime brokerage customers, for which JPMorgan shouldered the credit exposure in the event of a Lehman default. Furthermore, JPMorgan continued to accept "novations" in favor of Lehman's counterparties to derivatives transactions: when a counterparty held an "in the money" position but did not want to take on the attendant Lehman exposure, it could request a novation, and JPMorgan, at its sole discretion, would step into the counterparty's shoes and take on the derivative contract and the Lehman exposure itself.

JPMorgan and Lehman understood that Lehman's credibility in the markets could collapse instantly if JPMorgan declined to take on this additional exposure for prime brokerage customers and novations. JPMorgan therefore searched for a way to protect itself without triggering a run on Lehman. After taking all factors into account — including its current derivatives exposure, its potential derivatives exposure in the event Lehman defaulted and the several days it would take for JPMorgan to close-out its open derivatives transactions, the expectation that novations would continue to rise, and its continuing triparty repo and clearance and settlement-related exposures — JPMorgan determined that it could continue to face Lehman in the market if it had $5 billion in additional collateral.

A primary impetus for the decision to request additional collateral was JPMorgan's growing derivatives exposure. The $5 billion figure was far from sufficient to cover all of JPMorgan's potential exposures to Lehman — including triparty repo and clearance and settlement-related exposures — but JPMorgan believed that it was an amount that Lehman reasonably could provide. When JPMorgan conveyed its request to Lehman on September 9, 2008, Lehman executives agreed to pledge additional collateral, and delivered approximately $3.6 billion worth of collateral to JPMorgan over the next few days. Lehman did not indicate that JPMorgan's request was putting undue pressure on Lehman.

As part of JPMorgan's attempt to obtain appropriate protection for the entirety of its exposure to Lehman, on the morning of September 10, LBHI executed new documentation granting JPMorgan a security interest in the new collateral to cover all obligations of all Lehman entities to JPMorgan. This protection allowed JPMorgan to continue making tens of billions of dollars in advances to Lehman, to continue trading with Lehman on its own behalf and for prime brokerage customers, and to accept novations.

JPMorgan meanwhile continued to evaluate its margin position with respect to Lehman. Its daily margin requirements for triparty repo clearance were rising as Lehman was increasing the amount of illiquid securities in its triparty repo book. During the second week of September 2008, JPMorgan analysts conducted a broad review of Lehman's collateral securities. This review indicated that some of the largest pieces of collateral pledged to JPMorgan were illiquid, could not reasonably be valued and were supported largely by Lehman's own credit. This was inappropriate collateral — essentially, claims against Lehman pledged to secure other claims against Lehman. When the true nature of Lehman's collateral came to light on September 11, 2008, it became apparent that JPMorgan was holding a substantial amount of inappropriate collateral, and that it would need additional collateral if it were to continue supporting Lehman. JPMorgan decided that $5 billion in cash was an appropriate request, even though its potential collateral shortfall was greater, as it was a number that JPMorgan believed Lehman could handle.

On the evening of September 11, 2008, JPMorgan representatives made a series of phone calls informing Lehman that JPMorgan wanted to continue to be supportive of Lehman through the extension of credit and other services, but that $5 billion was needed for JPMorgan to continue to support Lehman in as stabilizing a way as possible. JPMorgan explained that it preferred to have Lehman post cash collateral rather than reducing lines of credit or ceasing trading, which would be more visible to the market. Lehman agreed to honor this request. Later that night, JPMorgan sent Lehman a letter stating that, if Lehman did not post the collateral by the open of business the next day, JPMorgan would exercise its right to decline to extend credit to Lehman. On the morning of September 12, 2008, JPMorgan unwound Lehman's triparty repo book, and Lehman delivered $5 billion of cash collateral during the morning and early afternoon. JPMorgan continued to extend credit to Lehman throughout that critical period and thus never had to assess its options concerning further extensions of credit in the face of a failed collateral request.

Despite JPMorgan’s constant efforts to support Lehman and not do anything to frighten the market, a run on the bank eventually ensued for reasons unrelated to JPMorgan. Throughout early September, investors raised their haircuts substantially. By September 12, hedge funds and other major customers were withdrawing their assets from Lehman and some of the largest investors pulled back entirely, refusing to provide Lehman with the overnight financing it desperately needed to keep operating.

During the weekend of September 13 and 14, 2008, I and other senior JPMorgan executives — along with representatives from other financial institutions — participated in discussions at the Federal Reserve Bank of New York concerning the financial crisis generally, and Lehman’s difficulties in particular. Government representatives made it clear to everyone present that the government would not provide financial assistance to save Lehman, and that discussions should focus on either a strategic transaction for Lehman or a funding package provided by a consortium of banks. After a potential deal with Barclays Capital fell through due to regulatory issues in the United Kingdom, LBHI filed for bankruptcy in the early morning hours of September 15, 2008.

Throughout all of this, JPMorgan did not cut and run but stood by our client. As other parties withdrew from Lehman, JPMorgan continued to make enormous — discretionary — extensions of credit to the ailing bank, and it continued to trade with Lehman and perform novations. JPMorgan never turned its back on its client, even as others did.

Even *after* LBHI filed for bankruptcy on September 15, 2008, JPMorgan continued, at the urging of LBHI and the Federal Reserve Bank of New York, to extend many tens of billions of dollars of credit to LBI on a daily basis, without imposing any additional collateral requirements. JPMorgan's willingness to continue making clearing advances to LBI during those tumultuous days, when it had no obligation to do so, allowed LBI to keep operating and made possible the sale of LBI's business and assets to Barclays Capital, as well as the loss-free transfer of more than 100,000 customer accounts.

As a result of JPMorgan's willingness to extend credit to Lehman in reliance on the collateral it had been provided, JPMorgan ended up with nearly $30 billion in claims against Lehman's bankruptcy estate. The overwhelming majority of those claims — more than $25 billion — arose out of clearing advances made to LBI *after* LBHI's bankruptcy filing. In addition, more than $3 billion of JPMorgan's claims arose from its exposure under derivative agreements, many of which JPMorgan entered into — or assumed through novations — as part of JPMorgan's efforts to support Lehman in increasingly distressed markets.

I appreciate this opportunity to share my views, and I look forward to your questions.