In last year’s shareholder letter, I referred to the “turbulence” and “unprecedented”

nature of events that had taken place during the preceding months. We did not know

when the cycle would end or the extent of the damage it would cause. But we did know

that we had to “prepare for a severe economic downturn.” Collectively, we resolved to

navigate through the tough conditions, to help our clients in every way we could and to

show leadership in the industry, as has been our legacy during times of crisis.

It is now a year later. What transpired was largely unprecedented and virtually inconceivable.

Our firm tried to meet every challenge, and, in the process, we distinguished

ourselves in our service to clients and communities. Although our financial results

were weak in absolute terms (but fairly good in relative terms), reflecting terrible

market conditions, I believe—and I hope you agree—that this year may have been one

of our finest.

The way forward will not be easy. We do not know what the future will bring, but we do

know that it will require everyone— the banks, the regulators and the government — to

work together and get it right. As we prepare for a very tough 2009, with most signs

pointing to continued deterioration of the economy, we still remain long-term optimists

about our future and that of our country. Whatever may come, we will meet the challenge.

In this letter, I will describe our 2008 performance by line of business and review the

many critical events of the previous year. I also will focus on where the industry went

wrong and what the implications for the future may be. I hope, after reading this letter,

you will share my confidence in our ability to build a stronger, more vibrant company

for the future.

I. REVIEW OF 2008 FINANCIAL

PERFORMANCE AND BUSINESS RESULTS

JPMorgan Chase earned nearly $6 billion in 2008,

down 64% from the $15 billion we earned in the prior

year. During a “normal” credit cycle and environment,

we should earn more than $15 billion. So clearly, this

was not a great year financially. Essentially, the year’s

financial results were marred by two issues, both of

which were highlighted as major risks in last year’s

letter. The first related to increasing credit costs, mostly

for consumer and mortgage loans. The second

resulted from Investment Bank write-downs of more

than $10 billion, primarily from leveraged lending and

mortgage exposures.

Throughout this financial crisis, we have benefited

from a fortress balance sheet. We started this year

with Tier 1 capital of 8.4% and ended it with 10.9%.

We increased credit loss reserves to $24 billion (up

almost $14 billion, including $4 billion related to

Washington Mutual (WaMu)). Even without the infusion

of government capital in the year’s final quarter,

our Tier 1 capital at year-end would have been 8.9%.

Across all other measures of capital, we have remained

relatively conservative. Although we did not anticipate

all of the extraordinary events of the year, our strong

balance sheet, general conservatism and constant focus

on risk management served us well and enabled us to

weather this terrible environment.

While we are disappointed with our 2008 financial

results, we have not lost sight of our important

achievements. We are extremely gratified that we were

able to grow and gain healthy market share in virtually

all of our businesses. And we never stopped investing

in our systems and infrastructure and adding bankers,

branches and products.

Regardless of what 2009 will bring, this emphasis on

serving clients and growing our businesses will drive

our results for years to come.

A. Results by Line of Business

*The Investment Bank reported a loss of $1.2 billion*

Our Investment Bank (IB) had disappointing financial

results on an absolute basis but performed relatively

well compared with most of our competitors. The

results reflect a tough operating environment and suffered

from the aforementioned $10 billion in write-downs

on leveraged lending and mortgage-related

assets, partially related to the acquisition of Bear

Stearns. While those write-downs were painful, they

were among the lowest in our industry. Moreover, our

underlying business performed solidly, and in some

notable areas, it outperformed. Several core businesses

– Rates and Currencies, Commodities, Emerging

Markets and Credit Trading – reported record results.

We also were able to make significant progress across

our IB business. At the end of May, we closed our acquisition

of Bear Stearns, which I will discuss in more detail

later in this letter. Throughout the year, we stayed completely

focused on servicing our corporate and investor

clients, and in spite of the credit crisis, we continued to

be there for our clients when they needed our advice and

responsible capital support. J.P. Morgan was engaged in

nearly all of the largest and most complex deals of the

year, and we solidly established ourselves as the first call

for clients on their most important challenges.

We try not to overemphasize market share tables or

awards, but years of focus and discipline did lead to

some extraordinary industry recognition that is worth

noting. We earned our best rankings ever across the

league tables, finishing first in global investment banking

fees; mergers and acquisitions; global syndicated

loans; debt; equity; and debt and equity-related transactions

– the only firm ever to finish No. 1 in all of

these categories in a given year. In our Markets businesses,

client revenue increased 40% year-over-year, as

clients shifted more of their business to us in uncertain

times. In addition, J.P. Morgan received top awards

from International Financing Review, Risk and Financial

News and received a leading number of distinctions in

the Greenwich Associates’ 2008 Quality Leader survey

– a record number of industry honors for us.

As we move into 2009, we are not resting on our

laurels. We know we operate in a risky business with

many tough competitors who inevitably will come

back strong – even if some currently are distracted.

We also know that the investment banking business,

in many ways, will never be the same. Leverage will be

lower, and certain structured financial products will

likely cease to exist. But the fundamental business will

remain the same: advising corporations and investors,

raising capital, executing trades, providing research,

making markets, and giving our clients the best ideas

and the financing to make those plans a reality.

*Retail Financial Services reported net income of*

*$880 million with an ROE of 5%*

With $880 million in earnings, Retail Financial

Services (RFS) had a poor year overall. For its two

primary businesses – Retail Banking and Consumer

Lending – it was a tale of two cities.

On the plus side, Retail Banking, which includes

Consumer Banking and Business Banking, earned

$3 billion and, more important, grew its franchise –

both organically and through the acquisition of

Washington Mutual. We expect the WaMu acquisition

to contribute more than $2 billion in annual earnings,

and it has extended our branch network to more than

5,000 branches in 23 states, adding 7,200 bankers and

increasing our ATMs to 14,500, the second-largest ATM

network nationally. In Retail Banking, since the Bank

One merger and the addition of The Bank of New York

and WaMu branch networks, we have exponentially

grown our footprint, adding 4,400 branches through

acquisition and 500 organically. This five-year expansion

is reflected in more checking accounts (from 2.3

million to 24 million), more deposits (from $89 billion

to $342 billion) and more states in which we operate

(from four to 23).

On the negative side, Consumer Lending, which

includes the Mortgage, Home Equity, Student Loan

and Auto Finance businesses, reported a loss of $2.1

billion, driven by a 274% increase, to $9.5 billion, in

the provision for credit losses, primarily in the home

lending businesses. Despite these losses, Consumer

Lending remains core to what we do. It enables us

to serve customers across many products and extend

$352 billion in loans. However, continued pressure

on home prices, the effects of past poor underwriting

standards and the deepening recession have pushed

up, and, unfortunately, will continue to push up, credit

costs. Our current expectation is that quarterly charge-offs

for the Mortgage and Home Equity portfolios

could range from $1.8 billion to $2.4 billion (an

extremely high annualized loss rate of 3.5% to 5%).

By the end of 2008, we had reserves of more than $8

billion across all of RFS, and, with the expectation of

higher charge-offs, we also expect to build additional

reserves in 2009. However, there is one area that has

shown an improving trend: third-party mortgage

servicing. This business relies on scale and efficiency

and, including the addition of the WaMu portfolio,

it grew 91% to $1.17 trillion of loans.

We believe we have corrected for the underwriting

mistakes of the past. Essentially, by the end of 2008,

we saw a return to old-fashioned home lending standards

(a maximum of 80% loan-to-value, with fully

documented income). In addition, we closed down all

business originated by mortgage brokers. My worst

mistake of the past several years was not doing this

sooner. In general, the credit losses in the broker originated

business are two to three times worse

than that of our own directly originated business.

Unfortunately, approximately 30% of our home loans

were originated through the broker channel. Although

we will be paying for this bad underwriting for years

to come, we will continue to build the Consumer

Lending business with new standards in place.

We have always loved the Retail Banking business and

believe that the exceptional economics of the branch-based

businesses will fuel growth and earn a return on

equity (ROE) of more than 30% over time. As for the

Consumer Lending business, it should produce returns

of 15%-20%, especially as we capitalize on the benefits

of cross-selling and cross-underwriting.

*Card Services reported net income of $780 million with*

*an ROE of 5%*

Card Services’ full-year net income was $780 million,

down 73% year-over-year as charge-offs increased from

$5.5 billion in 2007 to $8.2 billion in 2008 (up 48%).

The net charge-off rate was approximately 5% of loans.

In 2008, Card Services increased net revenue by 8%

and grew managed loans by 3% (excluding WaMu).

In 2008, we added 14.9 million new credit card

accounts. By investing in activities to further engage

current cardmembers and attract new customers, we

continued growing the business. These activities

included renewing contracts with important partners

(AARP, Continental, Disney, Marriott and United) and

enhancing our customer service. Equally important,

Chase kept credit open and available to customers and

businesses in a safe and sound manner and extended

more than $84 billion in new credit.

With the WaMu acquisition, Chase became the largest

credit card issuer in the nation, with more than 168

million cards in circulation and more than $190 billion

in managed loans. Yet, being the biggest does not

mean we are the best. We will continue to invest in

areas that will make us the best in the business.

Specifically, our focus will be on responsive customer

service, valued loyalty and rewards programs, and

upgraded systems and infrastructure. In addition, our

ability to do a better job underwriting and to give our

customers added value through cross-selling is a huge

competitive advantage in both the card and retail

banking businesses.

Our focus on sound risk management extends to the

card business. Early in this crisis, we responded quickly

to leading indicators of change and made considerable

risk management improvements. This included:

raising the credit-score threshold for direct-mail marketing

and increasing the number of applications that

are subject to our thorough review process. We regularly

manage our customers’ credit lines, based on

their willingness and ability to pay. While we are

lowering credit lines for customers who show signs

of increased risk or inactivity, we also are raising lines

for our most creditworthy customers. In addition, we

are closing accounts that have been inactive for long

periods of time because we know from experience that

these accounts are extremely risky.

Looking ahead, we expect losses will continue to

increase from 5% to 9%, essentially tracking the rate

of unemployment. To prepare for higher losses, we

increased our reserves from $3 billion to $8 billion and

are intensifying our collections efforts. At the same

time, we have expanded our use of flexible payment

programs to help those customers experiencing financial

distress: In 2008, we saw 600,000 new enrollments

in payment programs, and we anticipate, and are

prepared for, that number to increase.

We do not expect 2009 to be a good year for the credit

card business. In fact, we do not expect to make any

money in Card Services this year. However, once this

crisis is over, we believe that our ongoing investments

in service quality, rewards programs and enhanced

infrastructure will ultimately make us one of the best

credit card companies in America.

*Commercial Banking reported net income of $1.4 billion*

*with an ROE of 20%*

Commercial Banking delivered strong results, outperforming

its peer group and even exceeding our 2008

plan in a tough year. Strong credit quality, risk

management, client service, operational efficiency,

expense control and effective pricing all contributed to

the strong result: a 27% increase to a record $1.4 billion

of net income, on a record $4.8 billion in revenue.

And instead of relying on lending to be the key driver

of revenue, Commercial Banking achieved record

results in gross investment banking revenue of $966

million (up 9%), treasury services revenue of $2.6

billion (up 13%), average liability balances of $103.1

billion (up 18%) and average loan balances of $82.3

billion (up 35%). It also is notable that only 36% of

Commercial Banking’s revenue relates to loans.

In addition to ranking among the top three commercial

banks nationally in market penetration and lead

share and being the No. 2 large middle-market lender

in the United States, Commercial Banking maintained

a favorable market position relative to peers in risk

management and deposit growth. We also are encouraged

by the prospects for the Commercial Term

Lending business we acquired from WaMu and the

expansion of our middle-market model across the

West and Southeast footprints. As ever, client selection

is critical to our success, and Commercial Banking has

not only created more than 1,800 new relationships but

also has expanded nearly 10,000 existing relationships

– a sign of the continued vitality of our business.

That said, due to our clients’ waning loan demand and

higher credit losses, 2009 will be a tough year for the

Commercial Banking business. While we expect problems

in commercial construction and real estate to

worsen for the rest of this year, we are fortunate to

have limited exposure and strong reserves. The turbulence

in the economy and its anticipated impact on the

broader Commercial Banking portfolio have led us to

shift into a recession-management mode and dedicate

many of our best resources into critically important

workout units, where expert senior managers are

involved on a daily basis.

Commercial Banking is a business with excellent long-term

value for us. We play a critical role in serving so

many great companies across this nation. And as this

important and vibrant sector of the economy grows,

so will we.

*Treasury & Securities Services reported record net income*

*of $1.8 billion*

Treasury & Securities Services (TSS) delivered exceptional

financial results in 2008. Its net income has more

than doubled since 2005. For 2008, it stands at $1.8 billion

(up 26%), with a 47% return on equity, on record

revenue (up 17%). We value this business tremendously

and appreciate how it has grown consistently over

time, produced good margins, and maintained great

global scale and long-standing client relationships.

The business maintains a leading position in holding,

valuing, clearing and servicing securities and providing

cash management, corporate card and liquidity products,

and trade finance services to the world’s leading

companies and institutional investors. We now serve

more than 2,800 clients around the world. In 2008,

TSS brought in more than 250 significant new client

relationships, representing more than $80 million in

annualized revenue. In a business with global scale,

50% of TSS’ revenue is from business outside the

United States, and in 2008, this revenue grew by

15%. TSS further strengthened its international

presence, expanding services in more than 20 countries

throughout Europe, the Middle East, Africa,

Asia and Latin America – we now do business in

more than 45 countries.

Notably, TSS also broke its single-day U.S. dollar-clearing

volume record – by clearing a staggering $5

trillion in a single day, 59% over its average. Due to

market conditions, TSS assets under custody decreased

by 17% to $13.2 trillion. Yet, at the same time, average

liability balances were up 22% to $280 billion, reflecting

a flight to quality as clients were drawn to the

stability of J.P. Morgan.

TSS is preparing for continued stress in the equity

markets in 2009, declining securities lending balances

and the negative impact of 0% interest rates.

Nevertheless, it remains an excellent business, serving

clients from all five of our other businesses, and we

expect it to produce strong results for years to come.

*Asset Management reported net income of $1.4 billion*

*with an ROE of 24%*

Asset Management, with assets under supervision of

$1.5 trillion, experienced a turbulent year in 2008. As

anticipated in this letter last year, earnings dropped

(by 31%). But overall, the year’s results were the result

of three trends: continued strong growth in Private

Banking, a small reduction in assets under management

(but a large change in the mix of asset types)

and a rigorous management of risk.

Private Banking had an exceptional year, bringing in a

record number of new clients and a record level of net

new assets (approximately $80 billion, for a total of

$538 billion). Earnings grew 12%. Over the past two

years, more than 235 new bankers have joined the

Private Bank and promise to contribute significantly

to its future growth.

Assets under management were $1.13 trillion at the

end of 2008 versus $1.19 trillion in 2007. Net new

inflows were a healthy $151 billion, up 31% from the

prior year. Unfortunately, this was more than offset by

the declines in market values. In addition, there was a

large change in the mix of assets. The cash we manage

for all our clients increased dramatically, with liquidity

balances growing by $210 billion to reach $613 billion

by year-end, as clients globally sought safety away

from higher-risk investments. Equities and alternatives

went in the opposite direction, with a 49% decline to

$240 billion from $472 billion, largely due to a 41%

drop in the value of equity markets. Finally, alternative

assets dropped 17% to $100 billion from $121 billion.

The current turmoil has reinforced the importance of

managing risk. Our culture of strong risk management

(proper due diligence, documentation, auditing, among

other measures) is consistent with our philosophy of

putting clients’ interests first and has enabled us to

avoid many of the negative developments that surfaced

last year.

We anticipate another difficult year in 2009, with

earnings continuing to be affected by market conditions.

But this is a great business, and we intend to

keep it that way by focusing on helping our clients

through the current environment.

*The Corporate sector reported net income of $557 million*

In 2008, we reported a net loss of $700 million in

Private Equity – a different story from 2007, when we

reported pre-tax private equity gains of more than $4

billion. We love the private equity business, but as we

indicated in prior years, private equity returns are by

their nature lumpy, and we did not expect the stellar

2007 results to be repeated in 2008. We will remain

patient and still expect this business to deliver in

excess of 20% return on equity for us over time.

Aside from Private Equity, our Corporate sector,

excluding merger-related items, produced $1.5 billion

in net income. This includes unallocated corporate

expense of approximately $500 million, which we

expect to continue at approximately the same level

in 2009, as well as a myriad of other items that are

disclosed in detail in our financial statements.

B. Strong strategic positions of all our businesses

One important and critical point to highlight is that

each of our businesses now ranks as one of the top

three players in its respective industry. As ever, our

goal is to be the best, not necessarily the biggest. That

said, we know that size matters in businesses where

economies of scale – in areas such as systems, operations,

innovation, branding and risk diversification –

can be critical to success. The only reason to get

bigger and gain economies of scale is when doing so

enables you to do a better job for your clients; i.e., by

giving them more, better and faster at a lower cost.

Ultimately, this is also the only real reason to do a

merger – the client gets something better. If this isn’t

the case, big can be bad. If bureaucracy, hubris, lack of

attention to detail – or other ailments of large corporations

– overwhelm the benefits of size, then failure will

ultimately result.

We are also keenly aware of the value added at more

detailed levels in our businesses. For example, in

Retail Financial Services, we gained share with small

businesses as we expanded our brand footprint. Our

Investment Bank has become a top player in both

Prime Brokerage and Energy, previously two of our

weak spots. Commercial Banking added WaMu’s

Commercial and Community Lending businesses

to its portfolio, representing $44.5 billion in loans.

And Private Banking’s record in net new asset flows

showed the strength of the J.P. Morgan franchise, as

high-net-worth individuals worldwide chose us to manage

their investments. We also continue to upgrade

our infrastructure by improving systems, data centers,

products and services.

Suffice it to say, we like our market position and

believe that each business is strong and getting

stronger. Even in tough years like 2008 and 2009,

we did not – and will not – stop doing all the things

that make our businesses better.

II. REVIEW OF CRITICAL EVENTS OF

THE YEAR

In this section, I want to review some of the critical

events for us this past year:

• The purchase of Bear Stearns

• The purchase of Washington Mutual

• The gathering storm that arrived with a vengeance

• The acceptance of government TARP

A. The purchase of Bear Stearns

On May 30, 2008, we closed our acquisition of Bear

Stearns – a deal completed in record time under truly

extraordinary circumstances.

Over the weekend of March 15, we were asked by the

U.S. government to assist in preventing Bear Stearns

from going bankrupt before the opening of the Asian

markets on Monday morning. The possibility was real

that if Bear Stearns had been allowed to go bankrupt,

it could have had a cataclysmic effect on the financial

markets. (Many believe that later experiences with

Lehman Brothers essentially proved this to be true.) To

a person, our Board of Directors felt JPMorgan Chase

had a special obligation to do all we could to help, especially

knowing that we were among the few companies

– if not the only one – in a position to do so. However,

this deal posed more risks and threatened to be more

backbreaking than any other acquisition we had done in

the past. And it had to make sense for our shareholders.

Going into this deal, we had two things in our favor:

the strength of our balance sheet and capital base and

the skill of our people.

Our first priority was to quickly reduce our downside

risk. This required us to massively de-risk Bear Stearns

quickly and in potentially dangerous markets. Bear

Stearns had approximately $400 billion in assets that

we needed to consolidate into our financial and risk systems

and reduce quickly to approximately $200 billion

of assets. We had to manage this reduction so that the

remaining risk was manageable and well-controlled. The

potential downside – given the treacherous markets –

was enormous. We asked the government to finance

and assume the risk on approximately $30 billion of

mortgage assets (compared with our $370 billion of total

assets acquired from Bear Stearns). The portion that

the government agreed to take comprised the less risky

mortgage assets (we kept the most risky mortgage

assets). We simply could not and would not take on

any more mortgage risk – it would have been extremely

irresponsible. And remember, the government could

finance the assets much more cheaply than we could

and could hold them as it saw fit, whereas we would

have been forced to sell them immediately.

Under normal conditions, the price we ultimately paid

for Bear Stearns would have been considered low by

most standards. But these were not normal conditions,

and because of the risk we were taking, we needed a

huge margin for error. We were not buying a house –

we were buying a house on fire.

We paid $1.5 billion for Bear Stearns, a company that

had reported a little more than $11 billion in common

equity. We knew that most – but we hoped not all – of

the common equity we were buying would be used for

close-down costs, litigation expenses, severance costs

and, most important, quickly eliminating the risk on the

balance sheet. We have largely completed this task, but,

unfortunately, all of the equity was used up in this

process, and several billions more in losses ran through

our income statement in the second half of 2008.

Despite these additional costs, we still believe that

Bear Stearns has added significantly to our franchise.

In particular, it completed our franchise in two

areas where we were weak, Prime Brokerage and

Commodities, and it enhanced our broader equity and

fixed income businesses. Ultimately, we expect the

businesses we acquired to add approximately $1 billion

of annual earnings to the company.

The truly impressive part of the Bear Stearns deal was

the human side – seeing our people rise to the challenge

under a great deal of strain. On Thursday night,

March 13, I called our investment banking heads, Steve

Black and Bill Winters, who then called our finance,

audit, tax, trading and banking professionals as well as

legal, real estate and systems teams around the world –

many of whom got out of bed and went back to work. Soon, hundreds returned to work that night. By the

weekend, thousands of people from around the world

were working around the clock. These professionals

ably managed the due diligence work and gave us the

confidence we needed to complete the deal. Their

Herculean effort over that weekend and the next several

months made it possible for us to sign and close the

deal in about 75 days. If you could have seen what I

saw during that intensely stressful time, you would

have been very proud of the team at JPMorgan Chase.

B. The purchase of WaMu

On September 25, the Federal Deposit Insurance

Corporation (FDIC) seized the banking assets of

Washington Mutual in the largest bank failure in

history. Moments later, we acquired the deposits,

assets and certain liabilities of Washington Mutual

for approximately $1.9 billion. We now know that

JPMorgan Chase was the only bank prepared to act

immediately. We acquired WaMu’s 2,200 branches,

5,000 ATMs and 12.6 million checking accounts, as

well as savings, mortgage and credit card accounts.

Importantly, we did not acquire the assets or liabilities

of the bank’s holding company or assume the $14

billion of senior unsecured debt and subordinated

debt of Washington Mutual’s banks.

The deal was financially compelling – it was immediately

accretive to earnings, and it will add an estimated

$2 billion or 50 cents per share to our 2009 results and

increasingly more thereafter. To achieve these anticipated

earnings, we did not rely on heroic revenue

assumptions. Instead, we mostly relied on expected

cost savings (net of the large investments in the

technology and refurbishment of the branches) of $1.5

billion. We now expect to achieve cost savings of more

than $2 billion. We also plan to complete all rebranding

and system conversions by the end of this year.

With the acquisition of WaMu, we purchased approximately

$240 billion of mortgage and mortgage-related

assets, with $160 billion in deposits and $38 billion in

equity. We immediately wrote down most of the bad

or impaired assets (approximately $31 billion), properly

reserved for the remaining assets, and established

reserves for severance and close-down costs. After

recognizing all of these costs, we believe that we now

have a relatively “clean” company that came with

approximately $4 billion in “good” common equity.

Our due diligence on WaMu’s assets was extensive,

and our assumptions were conservative. We assumed

that home prices would go down another 10% (from

the day we closed), providing a healthy margin for

error. However, if home prices go down more than

expected, say 20%, all other things being equal, this

could cost us $5 billion-$10 billion more. Even under

these circumstances, we think the transaction will

remain a great deal, at a great price for our shareholders.

We are confident that it will add enormous value

to JPMorgan Chase in the future.

Given our conservative nature, we sold $11.5 billion in

common stock the morning after the deal announcement

to maintain our strong capital base. The capital raise –

upsized due to strong response from investors – was the

largest U.S. common stock follow-on offering ever executed.

In addition, WaMu’s retail deposits contributed

to our stable funding base and liquidity position.

In prior years, we consistently expressed our desire to

broaden our retail footprint to attractive regions such

as the West Coast and Florida – as long as the plan

made good sense financially and we could execute the

transaction effectively. The WaMu transaction aligned

perfectly with this criteria. Specifically, it expands our

retail franchise into fast-growing new markets with

established branches; bolsters our presence in our

significant footprint states; and, over time, will allow

us to extend the reach of our commercial banking,

business banking, credit card and wealth management

efforts. These additional businesses were not heritage

strengths of WaMu but, in effect, can be built on top

of the WaMu branches and we hope eventually will

add another $500 million to our earnings (this will

take many years and was not built into our original

assumptions). An expanded product line, together

with enhanced systems, will benefit former WaMu

customers tremendously.

Our people across the business – together with our

experts in systems, marketing, legal, finance, audit and

human resources – did an outstanding job executing

this transaction, making it possible for us to take this

important strategic step.

C. The gathering storm arrived with a vengeance —

and how JPMorgan Chase fared

In 2008, Bear Stearns collapsed; Lehman Brothers

declared bankruptcy; Fannie Mae and Freddie Mac

were placed into government conservatorship; the

government assumed majority ownership of AIG;

Merrill Lynch sold itself to Bank of America; Wells

Fargo took over a struggling Wachovia; IndyMac and

WaMu went into receivership by the Federal Deposit

Insurance Corporation; Countrywide and the U.S.

mortgage business virtually collapsed; the two remaining

major investment banks, Goldman Sachs and

Morgan Stanley, became bank holding companies;

around the globe, French, British, Swiss and German

banks were rescued by their governments; and the

world entered the sharpest, most globalized downturn

since the Great Depression.

As for JPMorgan Chase, we had large credit and operational

exposures in virtually every situation mentioned

above, affecting nearly every line of business. Our

firm’s management teams, credit officers, risk officers,

and legal, finance, audit and compliance teams worked

tirelessly to protect the company. We believe it is a

considerable sign of strength that we could manage

through such extraordinary problems with minimal

losses to the company.

*We avoided many critical problems that would have*

*made things far worse*

In last year’s letter, we focused on our problems –

including mortgage issues in Retail Financial Services

and write-downs in the Investment Bank of leveraged

loans and mortgage securities. Those issues cost us a

considerable amount of money in 2008 and will continue

to cost us money in 2009. But it also is instructive

to focus on how we were able to avoid certain problems,

control the damage and minimize the cost.

In 2008:

• We essentially stayed away from sponsoring structured

investment vehicles (SIV) because we viewed

them as arbitrage vehicles with plenty of risk and a

limited business purpose. We also minimized our

financing to SIVs for the same reasons, and back in

2005, we sold the only small SIV we had sponsored.

• We didn’t write option ARMs (adjustable rate

mortgages) because we did not think they were a

consumer-friendly product. Although we made

plenty of mistakes in the mortgage business, this

was not one of them.

• We substantially cut back on subprime early in the

crisis. While subprime mortgages cost us nearly $1

billion in 2008, we avoided far worse results because

we had significantly reduced our exposures in 2006.

This was true both in the mortgage business and in

the Investment Bank.

• We never built up the structured finance business.

While we are a large player in the asset-backed

securities market, we deliberately avoided the structured

collateralized debt obligation (CDO) business

because we believed the associated risks were too

high. Structured finance in its most complicated

forms, such as “CDO-squared,” has largely disappeared

after unleashing a myriad of problems on

the financial system. They will not be missed.

• We did not unduly leverage our capital, nor did we

rely on low-quality forms of capital. We always had

high targets of 8% to 8.5% Tier 1 capital. We always

believed in “high-quality” capital, which, among

other things, means conservative accounting, strong

loan loss reserves and a high component of tangible

common equity. The higher the quality of capital,

the more prepared one is for tough times.

• We maintained a high level of liquidity – and were

always prepared for unexpected draws (i.e., collateral

calls). Strong liquidity is a constant for us. The fact

that we have total deposits of $1 trillion across our

retail and wholesale businesses positions the firm

advantageously overall and has helped us weather

the worst of the crisis. We will do whatever it takes

to ensure that our liquidity remains a strong part of

our fortress balance sheet so that we can maintain

flexibility during challenging times to be in a position

to support our clients.

• We avoided short-term funding of illiquid assets,

and we essentially do not rely on wholesale funding.

(Of our $1 trillion of deposits, approximately $300

billion is referred to as “wholesale,” but it essentially

is comprised of deposits that corporate clients leave

with us in the normal course of business – i.e., they

are “sticky” and not like brokered certificates of

deposit or “hot money” that move on a whim for one

basis point.) Simply put, we still follow the financial

commandment: Do not borrow short to invest long.

D. The acceptance of government TARP

On October 13, 2008, I went to Washington, D.C., with

eight chief executives of other financial firms. There,

we were asked by the Secretary of the Treasury, the

Chairman of the Federal Reserve, the Office of the

Comptroller of the Currency (OCC), the FDIC and the

New York Federal Reserve Bank to agree to accept a

package of capital from the government. As part of its

Troubled Asset Relief Program (TARP), the U.S. government

was proposing some powerful measures to

help fix the collapse in the credit and lending markets.

They prevailed upon the nine of us to set an example

for others by accepting this capital infusion as a sign

of our unanimous support of these measures. The logic

was that a massive infusion of capital into the U.S.

banking system would pave the way for the industry

as a whole to extend more credit than they otherwise

would have provided. The government’s view was also

that if any of the banks declined the TARP funds, then

many of the additional banks might not want to be

tainted by their acceptance of the TARP money

because it might be viewed as a sign of weakness.

*We felt then that accepting the TARP funds was the right*

*thing to do for the U.S. financial system – even though it*

*may not have been as beneficial for JPMorgan Chase as*

*it was for some of the others*

In short, we did not ask for the TARP capital infusion,

and we did not feel we needed it (our Tier 1 capital at

year-end would have been 8.9% without it). In fact,

the TARP program had asymmetric benefits to those

accepting it; i.e., it was least beneficial to strong companies

like ours and vice versa. That said, we believe

that accepting the TARP funds was the right thing to

do for the U.S. financial system – and that JPMorgan

Chase should not be parochial or selfish and stand in

the way of actions that the government wanted to take

to help the whole financial system.

*We think the government acted boldly in a very tough*

*situation, the outcome of which could have possibly been*

*far worse had it not taken such steps*

The government acted quickly and boldly – taking

unorthodox steps to try to right the ship. It had to act

with urgency while dealing with complex and rapidly

changing problems that did not lend themselves to

simplistic solutions. While we will never actually

know, we believe, as many economists and analysts do,

that without these and other actions the government

has taken to date, things could have been much worse.

So while it is easy to criticize the timing, marketing or

consistency of the effort – we also recognize how hard

it is to act boldly in difficult and dangerous times. We

should remind ourselves of what President Theodore

Roosevelt expressed nearly a century ago:

“It is not the critic who counts; not the man who points

out how the strong man stumbles, or where the doer of

deeds could have done them better. The credit belongs

to the man who is actually in the arena, whose face is

marred by dust and sweat and blood; who strives

valiantly; who errs, who comes short again and again,

because there is no effort without error and shortcoming;

but who does actually strive to do the deeds; who

knows great enthusiasms, the great devotions; who

spends himself in a worthy cause; who at the best

knows in the end the triumph of high achievement, and

who at the worst, if he fails, at least fails while daring

greatly, so that his place shall never be with those cold

and timid souls who neither know victory nor defeat.”

We hope that our leaders will continue to be bold

and brave in seeking solutions to these once-in-a-generation

problems.

*Banks are lending, and the TARP is probably helping*

It is important to recognize that TARP capital is only

14% of our total capital. It is also important to recognize

that to the extent we use the money and lose it,

the risk is 100% ours because we still owe the money

back to the government. Despite that, we, and other

banks, are trying to use TARP capital to benefit shareholders,

clients and communities. In the fourth quarter

of 2008 alone, we extended more than $150 billion in

new credit to consumers, businesses, municipalities

and not-for-profit organizations, including nearly $30

billion in home lending and $2.8 billion in auto lending.

We increased loans and commitments to government

units, health care companies and not-for-profits

by 33% in 2008 and plan to increase lending to these

groups by $5 billion in 2009. We also completed several

major syndicated leveraged finance loans, and, in

one critical instance, we bought the entire $1.4 billion

bond issue from the state of Illinois when no one

else would bid for it, giving Illinois the financing for

payroll and other important needs. Finally, we remain

very active in the interbank market (where banks lend

to each other) and have had on average $40 billion to

$50 billion out in the interbank market each night.

While total lending by banks fluctuates according to

the markets and changing credit conditions, we do

believe that TARP has enabled many banks to increase

their lending in certain key areas – more than they

otherwise would have done.

While we clearly understood that there might be

potential (mostly political) unintended consequences

of TARP, we believed that it would help the U.S.

financial system at that critical moment.

III. FUNDAMENTAL CAUSES AND

CONTRIBUTIONS TO THE FINANCIAL

CRISIS

After Lehman’s collapse, the global financial system

went into cardiac arrest. There is much debate over

whether Lehman’s crash caused it – but looking back,

I believe the cumulative trauma of all the aforementioned

events and some large flaws in the financial

system are what caused the meltdown. If it hadn’t

been Lehman, something else would have been the

straw that broke the camel’s back.

The causes of the financial crisis will be written about,

analyzed and subject to historical revisions for decades.

Any view that I express at this moment will likely

be proved incomplete or possibly incorrect over time.

However, I still feel compelled to attempt to do so

because regulation will be written soon, in the next

year or so, that will have an enormous impact on our

country and our company. If we are to deal properly

with this crisis moving forward, we must be brutally

honest and have a full understanding of what caused

it in the first place. The strength of the United States

lies not in its ability to avoid problems but in our

ability to face problems, to reform and to change. So

it is in that spirit that I share my views.

Albert Einstein once said, “Make everything as simple

as possible, but not simpler.” Simplistic answers or

blanket accusations will lead us astray. Any plan for

the future must be based on a clear and comprehensive

understanding of the key underlying causes of –

and multiple contributors to – the crisis, which

include the following:

• The burst of a major housing bubble

• Excessive leverage pervaded the system

• The dramatic growth of structural risks and

the unanticipated damage they caused

• Regulatory lapses and mistakes

• The pro-cyclical nature of virtually all policies,

actions and events

• The impact of huge trade and financing imbalances

on interest rates, consumption and speculation

Each main cause had multiple contributing factors.

As I wrote about these causes, it became clear to me

that each main cause and the related contributors

could easily be rearranged and still be fairly accurate.

It was also surprising to realize that many of the

main causes, in fact, were known and discussed abundantly

before the crisis. However, no one predicted

that all of these issues would come together in the

way that they did and create the largest financial and

economic crisis of our lifetime.

Even the more conservative of us, and I consider

myself to be among them, looked at the past major

crises (the 1974, 1982 and 1990 recessions; the 1987 and

2001 market crashes) or some mix of them as the worstcase

events for which we needed to be prepared. We

even knew that the next one would be different – but

we missed the ferocity and magnitude that was lurking

beneath. It also is possible that had this crisis played

out differently, the massive and multiple vicious cycles

of asset price reductions, a declining economy and a

housing price collapse all might have played out differently

– either more benignly or more violently.

It is critical to understand that the capital markets

today are fundamentally different than they were after

World War II. This is not your grandfather’s economy.

The role of banks in the capital markets has changed

considerably. And this change is not well-understood – in

fact, it is fraught with misconceptions. Traditional banks

now provide only 20% of total lending in the economy

(approximately $14 trillion of the total credit provided

by all financial intermediaries). Right after World War II,

that number was almost 60%. The other lending has

been provided by what many call the “shadow banking”

system. “Shadow” implies nefarious and in the dark, but

only part of this shadow banking system was in the dark

(i.e., SIVs and conduits) – the rest was right in front of us.

Money market funds, which had grown to $4 trillion of

assets, directly lend to corporations by buying commercial

paper (they owned $700 billion of commercial paper).

Bond funds, which had grown to approximately $2 trillion,

also were direct buyers of corporate credit and securitizations.

Securitizations, which came in many forms

(including CDOs, collateralized loan obligations and

commercial mortgage-backed securities), either directly or

indirectly bought consumer and commercial loans. Asset

securitizations simply were a conduit by which investment

and commercial banks passed the loans onto the

ultimate buyers.

In the two weeks after the Lehman bankruptcy, money

market and bond funds withdrew approximately $700

billion from the credit markets. They did this because

investors (i.e., individuals and institutions) withdrew

money from these funds. At the same time, bank lending

actually went up as corporations needed to increasingly

rely on their banks for lending. With this as a

backdrop, let’s revisit the main causes of this crisis in

more detail.

A. The burst of a major housing bubble

U.S. home prices have been appreciating for almost

10 years – essentially doubling over that time. While

some appreciation is normal, the large appreciation,

in this case, and the ultimate damage it caused were

compounded by the factors discussed below.

*New and poorly underwritten mortgage products*

*(i.e., option ARMs, subprime mortgages) helped fuel*

*asset appreciation, excessive speculation and far higher*

*credit losses*

As the housing bubble grew, increasingly aggressive

underwriting standards helped drive housing price

appreciation and market speculation to unprecedented

levels. Poor underwriting standards (including little or

no verification of income and loan-to-value ratios as

high as 100%) and poorly designed new products (like

option ARMs) contributed directly to the bubble and

its disastrous aftermath.

*Mortgage securitization had two major flaws*

In many securitizations, no one along the chain, from

originator to distributor, had ultimate responsibility for

the results of the underwriting. In addition, the poorly

constructed tranches of securitizations that comprised

these transactions effectively converted a large portion

of poorly underwritten loans into Triple A-rated securities.

Clearly, the rating agencies also played a key role

in this flawed process. These securitizations ended up

in many forms; the one most discussed is CDOs.

Essentially, these just added a lot more fuel to the fire.

*While most people are honorable, excess speculation and*

*dishonesty were far greater than ever seen before, on the*

*part of both brokers and consumers*

The combination of no-money-down mortgages, speculation

on home prices, and some dishonest brokers

and consumers who out-and-out lied will cause damage

for years to come. This, in no way, absolves the poor

underwriting judgments made by us and other institutions,

and it certainly doesn’t absolve anyone who

mis-sold loans to consumers.

B. Excessive leverage pervaded the system

Over many years, consumers were adding to their

leverage (mostly as a function of the housing bubble),

some commercial banks increased theirs, most of the

U.S. investment banks dramatically increased theirs

and many foreign banks had the most leverage of all.

In addition, increasing leverage appeared in:

• Hedge funds, many using high leverage, grew dramatically

over time. Some of that leverage was the

result of global banks and investment banks lending

them too much money.

• Private equity firms were increasingly leveraging up

their buyouts. Again, some banks and the capital

markets lent them too much money.

• Some banks (and other entities) added to their leverage

by using off-balance sheet arbitrage vehicles, like

SIVs and leveraged puts.

• Nonbank entities, including mortgage banks, CDO

managers, consumer and commercial finance companies,

and even some bond funds, all increased their

leverage over time.

• Even pension plans and universities added to their

leverage, often in effect, by making large “forward commitments.”

Basically, the whole world was at the party, high on

leverage – and enjoying it while it lasted.

C. The dramatic growth of structural risks and the

unanticipated damage they caused

I believe there are four structural risks or imbalances

that grew and coalesced to cause a “run on the bank.”

But this was not a traditional bank run – it was a run

on our capital markets, the likes of which we had never

experienced. After Lehman’s bankruptcy, many parts

of our capital markets system stopped providing any

capital to the market at all. If the crisis had unfolded

differently, then perhaps the events that followed

would not have occurred. Surely no one deliberately

built a system with these fundamental flaws and imbalances.

Clearer heads will understand that much of this

was not malfeasance – our world had changed a lot and

in ways that we didn’t understand the full potential

risk. But when the panic started, it was too much for

the system to bear.

*Many structures increasingly allowed short-term*

*financing to support illiquid assets*

In essence, too much longer-term, non-investment

grade product was converted into shorter-term Triple

A-rated product. Some banks, hedge funds, SIVs and

CDOs were using short-term financing to support illiquid,

long-term assets. When the markets froze, these

entities were unable to get short-term financing. As a

result, they were forced to sell these illiquid assets.

One of the functions of banking and the capital markets

is to intermediate between the needs of investors

and issuers. This triggers a normal conversion, either

directly or indirectly (through securitizations) of

longer-term, illiquid assets held by the issuers, who

need to finance the business into the shorter-term,

higher-grade product that most investors want. Clearly,

over time, this imbalance had grown too large and

unsupportable.

*Money market funds had a small structural risk, which*

*became a critical point of failure*

Money market funds promise to pay back 100% to the

investor on demand. Many money market funds invested

in 30- to-180-day commercial paper or asset-backed

securities that under typical circumstances could be

sold back at par. In normal times, investors demanded

their money in fairly predictable ways, and funds were

able to meet their demands. Over time, money market

funds grew dramatically to exceed $4 trillion. After

Lehman collapsed, one money fund in particular,

which held a lot of Lehman paper, was unable to meet

the withdrawal demands. As word of that situation

spread, investors in many funds responded by demanding

their money. In a two-week period, investors pulled

$500 billion from many money funds, which were

forced to sell assets aggressively. To raise liquidity,

these money funds essentially were forced to sell

assets. As investors moved away from credit funds and

into government funds, the banks simply were unable

to make up the difference. This became one more huge

rupture in the dike.

*Repo financing terms got too loose, and too many illiquid*

*assets were repo’ed*

Over time, in those markets where financial companies

financed their liquid assets, financial terms had

become too lax. For example, to buy non-agency mortgage

securities, financial institutions only had to put

up 2%-5% versus a more traditional 15%-25%. The

repo markets also had begun to finance fairly esoteric

securities, and when things got scary, they simply

stopped doing so. In the two weeks after Lehman’s

bankruptcy, more than $200 billion was removed from

this type of financing, by both investors and banks.

Once again, financial institutions had to liquidate

securities to pay back short-term borrowing – thus,

another rupture in the dike.

*Investors acted wisely to protect themselves, but the system*

*couldn’t handle them all doing it at the same time*

Individual investors, corporations, pension plans, bond

and loan funds, money market funds and others – all

acted in their own self-interest, and all individually

acted wisely. But collectively, they caused enormous

flows out of the banking and credit system. Regardless

of whether the funds came out of a bank, a money

fund, or a bond or loan fund, the fact remains that the

cumulative result was a severe shortage of necessary

credit that was removed from the system. Clearly, things

had changed. In the past, regulators had

focused on preventing a systemic collapse of the main

intermediaries in the financial system; i.e., the banks.

In this new world, however, we need to discuss how to

protect ourselves not only from runs on banks but also

from runs on other critical vehicles in the capital and

financial markets.

D. Regulatory lapses and mistakes

With great hesitation, I would like to point out that

mistakes also were made by the regulatory system.

That said, I do not blame the regulators for what happened.

In each and every circumstance, the responsibility

for a company’s actions rests with us, the CEO and

the company’s management. Just because regulators

let you do something, it does not mean you should do

it. But regulators have a responsibility, too. And if we

are ever to get this right, it is important to examine

what the regulators could have done better. In many

instances, good regulation could have prevented some of

the problems. And had some of these problems not happened,

perhaps things would not have gotten this bad.

*Unregulated or lightly regulated parts of the market*

*contributed to the crisis*

I’ve already discussed some of the flaws with money

market funds and hedge funds – the latter were not

regulated, and the former were lightly regulated. In

addition, there are two large segments, among others,

that – had they been regulated – could have helped the

system avoid some problems.

• Much of the mortgage business was largely unregulated.

While the banks in this business were regulated,

most mortgage brokers essentially were not. In fact,

no major commercial bank that was regulated by the

OCC wrote option ARMs (possibly the worst mortgage

product). A very good argument could be made

that the lower standards of the unregulated parts of

the business put a lot of pressure on those players

in the regulated part of the business to reduce their

standards so they could compete. In this case, bad

regulation trumped good regulation.

• Insurance regulators essentially missed the large

and growing one-sided credit insurance and credit

derivative bets being made by AIG and the monoline

insurers. This allowed these companies to take huge

one-sided bets, in some cases, by insuring various

complex mortgage securities.

*Basel II, which was adopted by global banks and U.S.*

*investment banks, allowed too much leverage*

It is quite clear now that the second of the Accords by

the Basel Committee on Banking Supervision (known

as Basel II), published in 2004, was highly flawed. It

was applied differently in different jurisdictions,

allowed too much leverage, had an over-reliance on

published credit ratings and failed to account for how a

company was being funded (i.e., it allowed too much

short-term wholesale funding). In 2004, the five independent

U.S. investment banks adopted Basel II under

the jurisdiction of the Securities and Exchange

Commission (this was not allowed by the banks regulated

by the Federal Reserve or the OCC, which

remained under Basel I). The investment banks jettisoned

prior conservative net capital requirements and

greatly increased their leverage under Basel II. And the

rest is history.

*Perhaps the largest regulatory failure of all time was the*

*inadequate regulation of Fannie Mae and Freddie Mac*

The extraordinary growth and high leverage of Fannie

Mae and Freddie Mac were well-known. Many talked

about these issues, including their use of derivatives.

Surprisingly, they had their own regulator, which clearly

was not up to the task. These government-sponsored

entities had grown to become larger than the Federal

Reserve. Both had dramatically increased their leverage

over the last 20 years. And, amazingly, a situation was

allowed to exist where the very fundamental premise

of their credit was implicit, not explicit. This should

never happen again. Their collapse caused damage to

the mortgage markets and the financial system. And,

had the Treasury not stepped in, it would have caused

damage to the credit of the United States itself. *Too many*

*regulators – with overlapping responsibilities*

*and inadequate authorities – were ill-equipped to handle*

*the crisis*

Our current regulatory system is poorly organized and

archaic. Overlapping responsibilities have led to a diffusion

of responsibility and an unproductive competition

among regulators, which probably accelerated a

race to the bottom. Many regulators also did not have

the appropriate statutory authority (through no fault

of their own) to deal with some of the problems they

were about to face. One large, glaring example revealed

by the collapse of Bear Stearns and Lehman was the

lack of a resolution process in place to deal with failure

of investment banks. If commercial banks fail, the

FDIC can take them over. This was not the case with

investment banks. In addition, a resolution process

needs to be in place for large, global financial companies

that operate in many jurisdictions and use many

different regulatory licenses.

E. The pro-cyclical nature of virtually all policies,

actions and events

In a crisis, pro-cyclical policies make things worse. I

cannot think of one single policy that acted as a counterbalance

to all of the pro-cyclical forces. Although

regulation can go only so far in minimizing the impact

of pro-cyclical forces in times of crisis, we still must be

aware of the impact they have. For example:

• Loan loss reserving causes reserves to be at their

lowest level right when things take a turn for the

worse. Therefore, as a crisis unfolds, a bank not only

faces higher charge-offs but also has to add to its

level of reserves, depleting precious capital.

• Although we are proponents of fair value accounting

in trading books (a lot of the mark-to-market losses

that people complained about will end up being real

losses), we also recognize that market levels resulting

from large levels of forced liquidations may not

reflect underlying values. Certain applications of

fair value accounting can contribute to a downward

spiral where losses deplete capital, and lower capital

causes people to respond by selling more, at increasingly

lower values.

• The rating agencies made mistakes (like the rest of

us) that clearly helped fuel a CDO and mortgage

debacle. They also, in the midst of a crisis, continually

downgraded credits. Lower ratings, in turn,

required many financial institutions to raise more

capital, thus adding to the vicious cycle.

• In bad times, the market itself demands both an

increase in capital and more conservative lending.

We may not be able to change this phenomenon,

but there are steps we can take to ensure that the

system is better prepared for it.

• Financing arrangements allow the most leverage in

good times, but they force a dramatic reduction in

leverage in bad times.

• As capital markets volatility increases, Basel II

capital calculations and many risk management

tools, like Value-at-Risk, demand that more capital

be held to own securities or loans.

F. The impact of huge trade and financing imbalances

on interest rates, consumption and speculation

I suspect when analysts and economists study the

fundamental causes of this crisis, they will point to the

enormous U.S. trade deficit as one of the main underlying

culprits. Over an eight-year period, the United

States ran a trade deficit of $3 trillion. This means that

Americans bought $3 trillion more than they sold overseas.

Dollars were used to pay for the goods. Foreign

countries took these dollars and purchased, for the

most part, U.S. Treasuries and mortgage-backed securities. It also is likely that this process kept U.S. interest

rates very low, even beyond Federal Reserve policy, for

an extended period of time. It is likely that this excess

demand also kept risk premiums (i.e., credit spreads)

at an all-time low for an extended period of time. Low

interest rates and risk premiums probably fueled excessive

leverage and speculation. Excess consumption

could be financed cheaply. And adding fuel to the fire,

in the summer of 2008, the United States had its third

energy crisis – further imbalancing capital flows.

There have been times when large imbalances – such as

those in trade – sort themselves out without causing

massive global disruption. However, it is bad planning

and wishful thinking to assume that this will always be

the case. These imbalances shouldn’t be allowed to get

that large – they create too much potential risk.

Many other factors may have added to this storm – an

expensive war in Iraq, short-selling, high energy prices,

and irrational pressure on corporations, money managers

and hedge funds to show increasingly better

returns. It also is clear that excessive, poorly designed

and short-term oriented compensation practices added

to the problem by rewarding a lot of bad behavior.

The modern financial world has had its first major

financial crisis. So far, many major actors are gone:

many of the mortgage brokers, numerous hedge funds,

Wachovia, WaMu, Bear Stearns, Lehman and many

others. Some of the survivors are struggling, particularly

as we face a truly global, massive recession – and it

still is not over.

IV. THE FUTURE OF OUR SYSTEM

The extent of the damage and the magnitude of the

systemic problems make it clear that our rules and regulations

must be completely overhauled. Such changes

to the regulatory system could have huge implications

on the long-term health, and strategies, of our business.

While unprecedented actions have been taken by both

the Federal Reserve and the Treasury, my hope is that

new policies are grounded in a thorough analysis of what

happened and what we need to do about it. Political

agendas or simplistic views will not serve us well.

Often we hear the debate around the need for more

or less regulation. What we need is better and more

forward-looking regulation. Someone has famously said

that a crisis should not go to waste. But what is also true

is that it shouldn’t take a crisis to solve our problems.

During a crisis, people panic. This can make it harder,

not easier, to do the right thing. From our perspective,

certain improvements would make a big difference. We

would like to share with you some of our suggestions.

A. The need for a systemic regulator with much

broader authority

We agree with our leaders in government that we

should move ahead quickly to establish a systemic regulator.

In the short term, this would allow us to focus

attention on correcting some underlying weaknesses

in our system and filling the gaps in regulation that

contributed to the current situation. It also is clear that

U.S. policy must be coordinated with the proper set of

international regulators. When the crisis emerged, the

actions of individual countries had a critical impact on

numerous other countries. International coordination

is essential in resolving this kind of crisis.

*There should be procedures in place to deal with*

*systemically important institutions – failure is fine*

*as long as it’s orderly and controlled and* ***doesn’t cause***

***systemic failure***

Size is not the issue; rather, it is when institutions are

too interconnected that an uncontrolled failure has the

potential to bring the whole system down. What we

need is a resolution process that allows failure without

causing damage to the whole system. In the case of BearStearns or Lehman – both investment banks – regulators

did not have this protocol. They do have it, however,

for commercial banks. Even more important, regulators

are going to need a resolution process for large,

global corporations that operate in many jurisdictions

around the world.

The first goal should be to regulate financial institutions

so they don’t fail. If they do fail, a proper resolution

process would ensure that action is swift, appropriate

and consistent. The lack of consistency alone

caused great confusion in the marketplace. For example,

when some of the recent failures took place, there

was inconsistent treatment among capital-holders (preferred

stock and debt holders were treated very differently

in different circumstances). It would have been

better if the regulators had a resolution process that

defined, a priori, what forms of aid companies would get

and what the impact would be on capital-holders. The

FDIC resolution process for banks provides a very good

example of how a well-functioning process works.

Various liquidity and “lender of last resort” facilities,

like some of those put into place during this crisis, also

could be in place on an a priori basis. These controls

would reduce risk and maximize confidence.

*Regulation needs to be administered by product and*

*economic substance, not by legal entity*

We have experienced the unintended consequences of

redundant regulation; i.e., different agencies regulating

the same product in the mortgage business, in the derivatives

business and in lending overall. If, on the other

hand, similar products were overseen by a single regulator,

that regulator would have much deeper knowledge

of the products and full information that extends across

institutions. The “regulatory competition” that could

have caused a race to the bottom would be eliminated.

*Hedge funds, private equity funds and off-balance sheet*

*vehicles must be included in our regulatory apparatus*

*without compromising their freedoms and positive attributes*

Certain vehicles like hedge funds and private equity

funds need to be regulated but only to protect the system

against risk. These vehicles do not need to be heavily

regulated like a deposit-gathering bank. We should

consider requiring hedge funds over a certain size

(say, $1 billion of equity) to register, provide quarterly

audited reports, disclose total leverage and certain risk

attributes – like volatility and investment categories –

and outline operational procedures. They also could be

required to show their regulators (not their competitors)

any concentrated “trades” that could cause excessive

systemic risk. This all could be done without compromising

flexibility or disclosing confidential positions

while allowing these vehicles to move capital –

as freely and aggressively – as they see fit.

*The systemic regulator needs the ability to anticipate risk*

*and do something about it if necessary*

There, undoubtedly, are financial products in the market

today that – if unchecked – could have a destabilizing

effect. A systemic regulator, had it been closely

watching the mortgage industry, might have identified

the unregulated mortgage business as a critical point

of failure. This regulator also might have been able to

limit the leverage of Fannie and Freddie once they

were deemed to pose major systemic risks. Such a

regulator might have been in the position to recognize

the one-sided credit derivative exposures of AIG and

the monoline insurers and do something about it.

A systemic regulator also should be on the lookout

for new or potential structural risks in our capital

markets, such as the structural flaw that grew in

money market funds.

B. The need to simplify our regulatory system

Everyone agrees that the existing system is fragmented

and overly complex. We have too many regulators and

too many regulatory gaps. No one agency has access to

all the relevant information. Responsibility often is

highly diffused. This problem could be relatively easy

to fix but only if we have the political will to fix it.

C. The need to regulate the mortgage business —

including commercial mortgages — in its entirety

Many of the same gaps in regulation that helped lead

us into this mess still exist today – for example, in the mortgage business. Mortgages are the largest financial

product in the United States, and while we do not want

to squelch innovation, the entire mortgage business

clearly needs to be regulated. This is not the first time

that mortgages and real estate have led this country

and many of its financial institutions into deep trouble.

Proper regulation would go a long way toward standardizing

products, testing new ones, improving customer

disclosure and clarifying responsibility.

D. The need to fix securitization

We believe that securitization still is a highly effective

way to finance assets. But some securitizations, particularly

mortgage securitizations, had an enormous flaw

built into them: No one was responsible for the actual

quality of the underwriting. Even mortgage servicing

contracts were not standardized such that if something

went wrong, the customer would get consistent resolution.

We cannot rely on market discipline (i.e., eliminating

bad practices) alone to fix this problem.

We have heard several reasonable suggestions on

how the originator, packager and seller of securitizations

could be appropriately incentivized to ensure good

underwriting. For example, requiring the relevant parties

to keep part of the securitizations, much like we do with

syndicated loans today, would help manage resolution if

something were to go wrong and could go a long way to

re-establish market confidence and proper accountability.

E. The need to fix Basel II — leading to higher capital

ratios but a more stable system

As discussed earlier, Basel II has many flaws – it has

taken too long to implement, it responds slowly to

market changes and it is applied unevenly across

global borders. Perhaps its worst failing is that, in its

current construct, Basel II does not include liquidity,

which allowed commercial and investment banks to

buy liquid or illiquid assets and fund them short.

While this practice did not appear quite so dangerous

in benign times, it created huge issues for many financial

institutions during the market crisis. Basel II also

has relied too heavily on rating agencies and, by its

nature, has been highly pro-cyclical in its capital

requirements for assets. It would be easy to make these

capital requirements less pro-cyclical and require Basel

II to recognize the risk of short-term funding, particularly

that of wholesale funding. Finally, Basel II should

be applied consistently, reviewed continuously and

updated regularly. The world changes quickly.

F. The need to get accounting under control

We at JPMorgan Chase are strong believers in good,

conservative accounting. Accounting should always

reflect true underlying economics, which actually is

how we run the company. However, accounting practices

are not widely understood, are changed too frequently

and are too susceptible to interpretation and

manipulation. Sometimes, they even inadvertently

determine U.S. government policy.

*We generally like fair value accounting*

For assets that are bought and sold, fair value accounting

creates the best discipline. Fair value accounting

(often referred to as mark-to-market accounting)

already provides for some flexibility if recent prices are

under highly distressed conditions. In such cases, good

judgment and sound fundamental cash flow-type evaluations

can be employed to value certain assets.

However, in our opinion, the application of fair value

accounting for certain categories needs to be reconsidered.

For example:

• We now have to mark to market our private equity

investments by using potentially artificial benchmarks.

These investments, by their nature, are very

illiquid and are intentionally held for several years.

To mark them to market, proxies made up of comparable

companies are used, and appropriate discounts

and judgments are applied. Essentially, we write

these investments up when markets are good and

write them down when markets are bad. But I am

fairly confident that this approach is not always

right. In many instances, cost is the best proxy for

fair value. We would rather describe our investments

to our shareholders, tell them when we think these

investments might be worth more and, certainly,

write them down on our financial statements when

they have become impaired. A new mark-to-market rule addresses “debit valuation

adjustments.” Essentially, we now have to mark

to market credit spreads on certain JPMorgan Chase

bonds that we issue. For example, when bond spreads

widen on JPMorgan Chase debt, we actually can

book a gain. Of course, when these spreads narrow,

we book a loss. The theory is interesting, but, in

practice, it is absurd. Taken to the extreme, if a company

is on its way to bankruptcy, it will be booking

huge profits on its own outstanding debt, right up

until it actually declares bankruptcy – at which point

it doesn’t matter.

• It is becoming increasingly more difficult to compare

mark-to-market values of certain instruments across

different companies. While it’s too involved to go into

detail here, different companies may account for similar

mark-to-market assets differently. This needs to be

addressed by ensuring that companies adhere to consistent

valuation principles while applying the rules.

• Fair value accounting does not and should not apply

to all assets. Investments or certain illiquid assets that

are intended to be held for the longer term (like real

estate or plant and equipment) or loans and certain

assets that are shorter term (like receivables or inventory)

all could actually be marked to market. There

are, in fact, markets for some of these assets, and others

could be calculated based on reasonable assumptions;

for example, a farm would be worth more

when corn prices go up, and a semiconductor plant

would be worth less when semiconductor prices go

down. However, if we marked these assets in this

way, they would have wildly different prices depending

on the health of the economy or the swings in

prices for their output. While accounting should

recognize the real impairment in the value of assets,

marking the aforementioned assets to market every

day would be a waste of time. Under this scenario, it

would be quite hard for companies to invest in anything

illiquid or to make long-term investments.

*New accounting rules that have the potential to*

*inadvertently affect how the capital markets function*

*or change fundamental long-term U.S. government*

*policies should be made thoughtfully, deliberately*

*and with broad input*

For example, we all believe that companies should

have fully funded pension plans; i.e., the actual assets

in the plan should be enough to meet a fair estimate of

the liabilities. Years ago, if this wasn’t the case, companies

were allowed to maintain a “deficit” and fund it

over several years. That deficit was not recorded on the

financial statement of the company.

A change in accounting rules dictated that the deficit

should not just be a footnote in the financial statements

but that it should be reflected directly in the

equity account of the corporation. Clearly, in very bad

markets, these deficits grow dramatically, thus depleting

the increasingly precious capital that companies

have. (This is just another example of a pro-cyclical

force). When companies realized they were getting

enormous volatility in their capital account, they began

to curtail or eliminate their pension plans in favor of

401(k) plans (where the individual bears all the investment

risk). This was a rational, precautionary step. But

it, in effect, transferred the risk from the company to

the individual. No longer did the large corporations

assume the risk of providing a steady income stream to

retired employees. Instead, the risk was passed to the

individuals – many of whom could not afford it.

This is a perfect example of how accounting inadvertently

sets policy. And, in my opinion, this was probably

the wrong policy for the country. There would have

been many ways to be true to the economic purpose

of accounting without making a detrimental policy

change. There are countless other examples, and we

hope regulators and accountants will eventually find

better ways to apply accounting principles.

G. The need for appropriate counter-cyclical policies

During this crisis, it became evident that our system

created enormous pro-cyclical tendencies. In fact, I

can’t think of one counter-cyclical policy at all (other

than emergency actions taken by the government). Accounting policies such as mark-to-market and loan

loss reserving are pro-cyclical. Basel II capital requirements

are pro-cyclical. Regulatory and legal requirements

are pro-cyclical. Repo and short-term financing

are pro-cyclical. The one pro-cyclical tendency we

probably can never correct is that of the market itself

(i.e., the cost of capital goes way up in a downturn or

investors refuse to finance less liquid assets). I have

heard many good ideas about how to create some

counter-cyclical policies and will focus on three here.

*Loan loss reserving can easily be made counter-cyclical*

I find it absurd that loan loss reserves tend to be at

their lowest point precisely when things are about to

get worse. As things get worse and charge-offs rise

dramatically, one must dramatically increase loan loss

reserves, thus depleting capital rapidly. This problem

would be solved if banks were allowed to estimate

credit losses over the life of their loan portfolios.

Reserves should be maintained to absorb those losses.

This would enable banks to increase reserves when

losses are low and utilize reserves when losses are

high. Transparency would be fully preserved because

investors and regulators would still see actual charge-offs

and nonperformers. This would require a rational

explanation about the appropriateness of the lifetime

loss estimates. It also would have the positive effect of

constantly reminding CEOs, management teams and

investors that bad times, in fact, do happen – and that

they should be prepared for such events.

*Repo and short-term financing can easily be made*

*counter-cyclical*

All banks now have access to the standard financing

facilities for securities and loans via the Federal

Reserve (i.e., the Fed will lend a specific amount of

money against specific assets). A suggestion is this:

If an institution provides financing to clients in excess

of what the Fed would lend to the bank for the same

securities, it would have to be disclosed to risk committees

and the company’s Board of Directors. The Fed

then would have two major tools to reduce leverage

and in a way that is counter-cyclical – it could charge

higher capital costs to a bank when the bank is lending

more than the Fed would lend or the Fed could reduce

the amount it would lend to the banks. Market players

would still be free to provide credit and leverage as

they see fit.

*Banks should have the ability to implement countercyclical*

*capital raising with rapid rights offerings*

Banks and possibly other companies would be aided

by having the ability to effect rights offerings at a

moment’s notice. Regulations should facilitate such

offerings – with the proper disclosure – in a matter of

days rather than weeks. This would allow a company

to raise capital and repair a balance sheet that might

have been stretched by unanticipated market events

and to do so in a manner that is fair and does not

dilute the company’s existing shareholder base.

H. The need for policies in health care, pensions,

energy and the environment, infrastructure and

education that will serve us well over time

Beyond the financial crisis, there are several important

issues that will dictate whether or not the United

States will continue to thrive over the next century. We

believe our nation can and should be able to provide

health care coverage for all. It is the right thing to do, it

will help us build a stronger nation, and, if done properly

and efficiently, we believe it ultimately will be

cheaper than the current course we are on. On energy,

we now have experienced our third major crisis, and

we, as a nation, still have not executed a sensible long-term

energy policy. Again, we believe that done right,

an energy policy could be economically efficient, create

great innovation, reduce geopolitical tensions and

improve our environment. Similarly, we need to

improve our nation’s infrastructure and develop an

education system that befits our heritage.

We can’t fall into the trap of institutional sclerosis –

now is the time to act. In the past, this nation has

shown the fortitude to work together to accomplish

great things, and we need to do that again. For our

part, we at JPMorgan Chase are doing everything we

can to be helpful to our leaders on all these issues. V. WHAT COMES NEXT FOR

JPMORGAN CHASE

Your management team is deeply engaged and is acting

with extreme caution in navigating these uncharted

waters. The U.S. Treasury and the Federal Reserve have

continued to take bold and dramatic action, as have

central banks and governments around the world. In

this next section, we will discuss some of the important

issues for JPMorgan Chase.

A. Our leadership in mortgage modifications and

support for the administration’s mortgage programs

JPMorgan Chase is at the forefront of foreclosure prevention

and mortgage modifications nationally. Our

foreclosure prevention efforts are intended to reach

both the $300 billion of loans that we own and the

$1.2 trillion of investor-owned loans that we service.

We already have helped keep 330,000 borrowers in

their homes and expect to help avert 650,000 foreclosures

by the end of 2010. We are committed to

keeping borrowers in their homes by making sustainable,

properly written loan modifications, in many

cases before a default occurs.

We believe it is in the best interests of both the homeowner

and the mortgage-holder to take corrective

action as soon as possible. Our re-default rates are half

the rates that the OCC has said are experienced by

national servicers. Re-default rates in the industry

generally will come down once modifications are

done with proper underwriting and as the economy

and home prices start to improve. If re-default rates

were extremely low, we probably should be doing

more modifications.

We strongly support the Obama administration’s

mortgage modification program. The plan’s features

are aligned with the program we already had implemented,

extending them to more struggling homeowners

and providing us and other servicers with more

options to keep families in their homes. We also support

the program because the guidelines establish a

clear, fair and consistent set of standards for all servicers

to follow. It is intended for borrowers with

mortgages below $729,750; and all borrowers must

fully document their income, clearly demonstrate

financial hardship and live in the home. We believe these mortgage modifications are economically

and morally the right thing to do and that the program

underscores the importance of mutual respect – by

treating others in the way that we would like to be treated

in the same situation – while upholding the essential

principle that individuals, businesses and corporations

should repay their loans if they can afford to do so. In

our view, its completeness eliminates the need for judicial

modification in bankruptcy proceedings. However,

if legislated, judicial modifications should be consistent

with this plan and focus only on borrowers who either

don’t qualify or have not been offered a modification.

Beyond that, it is time to quickly implement the mortgage

modification program – even if it is not perfect in

everyone’s view – and to move on.

B. Comments on the derivatives business

Derivatives have become an essential and widely used

risk management tool. The International Swaps and

Derivatives Association estimates that 90% of the

Fortune 500, 50% of mid-sized companies and thousands

of other, smaller U.S. companies use derivatives

to manage certain risks, including currency and interest

rate risk. As such, derivatives are a large business for

JPMorgan Chase and for firms around the world. It is

important to note that derivatives in and of themselves

did not cause this crisis. In fact, derivatives have performed

fairly well in this crisis environment. However,

it is clear that derivatives, at least in financial reporting,

are hard to understand, lack transparency and did contribute

somewhat to the crisis. At JPMorgan Chase, we

believe derivatives, when used properly, play an important

role in managing risk, and we are trying to address

the concerns about derivatives.

• We have been standard setters in bringing more

transparency to our financial reporting and will

continue to be. In this report, you will find extensive

details on our counterparty exposures and other risk

considerations that are central to understanding our

derivatives and other trading businesses.

• Some of the concerns about derivatives have to do

with the large notional amounts. But those figures

are reference measurements and do not reflect actual

counterparty credit risk. Actual risk is the mark-to-

market value of the contract after taking into

account netting of risk across all transactions with

a counterparty, collateral and hedging. Actual risk

projections also take into account the potential

future exposure coming from market moves.

• Our counterparty exposures net of collateral and

hedges are $133 billion, and the company manages

those exposures name by name – like a hawk. The

figure is large, but we get paid to take the risks, we

reserve and account for them conservatively, and we

manage them in conjunction with all of our other

credit exposures.

• As the overall amount of counterparty credit risk

has grown, so has the concern that this growth has

increased systemic risk. To address this issue, we

support the development of clearinghouses, which

we believe will reduce the counterparty risk and

increase transparency for standardized contracts. We

already clear a significant portion of our interest rate

and commodities derivatives through clearinghouses,

and we have been active in the development of a

clearinghouse for credit default swaps. Those derivatives

that are too customized to be cleared can easily

be monitored by regulators to ensure they do not

cause systemic risk.

• AIG’s downfall wasn’t due to its use of derivatives

per se but to its poor risk management practices.

The insurer took concentrated risks through credit

default swaps insuring mortgage-related assets. On

the other side of the equation, some dealers bought

this insurance from AIG without requiring them to

post collateral until such time as their credit rating

deteriorated. This is a case where bad risk management

on the part of AIG was compounded by bad

counterparty risk management by AIG’s counterparties.

The potential systemic impact was substantial.

JPMorgan Chase did business with AIG, but, in line

with our general policies, we kept our credit exposure

relatively small so that our firm would not be

compromised if AIG had been allowed to fail. With

hindsight, the problem itself could have been better

contained and dramatically mitigated had AIG been

properly regulated and required to provide collateral

(to a clearinghouse or its counterparties).

• There are regulatory gaps that need serious attention,

as was evident with AIG. A way to prevent a

future AIG is by empowering a systemic risk regulator

(as described earlier). Such a regulator would

have been in a position to see the risk piling up and

address it before the company failed.

• Recognizing upfront profits for derivative transactions

can be problematic. Even though it is not standard

accounting, we believe the profits relating to

the risk positions associated with derivatives should

be booked over the life of the transaction, proportionate

to the risk remaining.

With proper management, systemic risks created by

derivatives can be dramatically reduced without compromising

the ability of companies to use them in

managing their exposures.

C. The reasons for maintaining a fortress balance

sheet and cutting the dividend

Maintaining a fortress balance sheet will always be

essential to us. Our Tier 1 ratio is 10.9%, with tangible

common equity of $81 billion, and we will continue to

increase our loan loss reserves, as appropriate. With

$24 billion in allowance for credit losses at the end of

2008, we believe our loan loss reserves across all our

businesses are among the strongest in the industry.

Out of an abundance of caution to be prepared for the

future during this uncertain environment, we believed

it was prudent to reduce our quarterly dividend from

$0.38 to $0.05 per share, effective with our next scheduled

dividend payment.

We did not take this action lightly, and we recognize

our tremendous obligation to shareholders to seek to

maintain dividend levels. But extraordinary times

require extraordinary measures. So while our performance

and capital are solid, we have an even higher

obligation to ensure that our fortress balance sheet

remains intact. This will enable us to stay flexible to

seize opportunities and continue to build and invest in

our market-leading businesses, even in a highly

stressed environment.

We maintain a long-term commitment to the dividend

and still view a 30%-40% payout ratio of normalized

earnings as ultimately reasonable. We will continue

to review all relevant criteria to ensure the ongoing

strength of our capital base and will await a more stable

economic environment before increasing the dividend.

D. Comments on TARP

While the decision to reduce our dividend was not

directly related to accepting TARP, it does provide us

with additional capital – about $5 billion per year –

which could position us to repay TARP funds sooner

than otherwise would have been possible. We, of course,

would do this in consultation with our regulators.

Many people would like us to repay the TARP funds

as soon as we can; some are angry over the changing

government conditions relating to the acceptance of

TARP funds; and some would like to see swift repayment

as a matter of principle.

The reason we accepted TARP still stands – we believed

it was in the best interests of the United States and the

banking system overall. We will not react capriciously

or out of anger in determining when to repay the

TARP funds. We will repay them only if doing so is

consistent with the best interests of our country and

our company.

E. The impact of a deep recession, and the

government’s stress test

We have been forthright and consistent in letting our

shareholders know that a recession will impact our

financial results, a severe recession even more so. And

that’s if we do everything right. Last year, we noted

that the recession would have a significant impact

on credit and that in a difficult environment, “credit

losses could rise significantly, by as much as $5 billion

over time, which would require increases in loan loss

reserves.” Managed net charge-offs were $13 billion in

2008, up from $7 billion in 2007. Our current view is

that 2009 charge-offs will be even higher.

The recession will ripple through and affect all of our

consumer and commercial credit exposures – some

worse than others. In addition to higher charge-offs, it

will require substantial additions to reserves, which we

have increased from $10 billion at the end of 2007 to

$24 billion at the end of 2008. We already said last

year how bad we thought mortgage and home equity

losses might get, and, unfortunately, they have become

even worse. The severity of this recession also could

have a dramatic impact on credit card losses; we now

expect a 9% unemployment rate to lead to charge-offs

of higher than 9%. (In the past, we would expect

unemployment of 9% to lead to charge-offs of 7% or

more. Now, however, we believe that the combined

effect of unemployment with the major housing downturn

will lead to a higher charge-off rate.)

The Treasury, in conjunction with the OCC, FDIC and

Federal Reserve, has launched a stress test program to

ensure that the 19 largest banks (those with more than$100 billion in assets) have the capacity to remain

properly capitalized in a highly stressed environment.

The government’s adverse economic environment

envisions a two-year recession, where unemployment

reaches 10.4% and the housing price index declines

48% from peak to trough. While some banks may need

additional capital or support, a successful completion

of the stress test program should eliminate the need to

guess which banks are properly capitalized and which

are not. In the best case, it will affirm the banks’ capital,

accounting and reserve ratios, which will remove

uncertainty in the marketplace and increase financial

stability. (Unfortunately, the announcement of the

stress test, which is expected to be presented in late

April, is causing enormous consternation in the markets

that would have been better to avoid.)

We regularly do stress tests for our company, always

projecting forward our capital and liquidity. We think

our capital ratios will maintain their extremely strong

levels throughout the government’s “adverse economic

environment.”

You also should know that your company will be

prepared for an environment even worse than the one

just described.

F. Recent government actions and the potential

power of concerted efforts

Governments around the world have taken dramatic

actions during this crisis. The Federal Reserve and

Treasury of the United States have provided $5 trillion

of liquidity facilities to finance various types of

assets and – to stabilize individual companies and the

overall system – have guaranteed almost $1 trillion of

assets on the balance sheets of certain institutions

and injected $1 trillion of capital into the financial

system. In addition, the government is trying to

reduce the mortgage rate by buying mortgages,

making it easier to refinance; reducing consumer

payments; and aggressively pushing mortgage

modification programs. We believe the recent Term

Asset-Backed Securities Loan Facility, or TALF

program, which allows private investors to get nonrecourse

financing on asset-backed securities, will

aid the securitization markets. This program eventually

may lend up to $1 trillion to finance new securitized

loans. It can also be modified and extended

as appropriate. It should be noted that many of the

government’s programs are not only replacing bank

lending but are also filling the gaps left by many of

the nonbank lenders in the capital markets.

We know that these government actions will have

unintended consequences and can lead to political

interference and that we will need to remove these

forms of support over time, intelligently. All these

concerns add to our worries, particularly about potential

future inflation, but we’ll reserve such a discussion

for another time.

There is no silver bullet: We believe that all of these

actions, if implemented properly and executed – in a

timely way and in conjunction with the U.S. fiscal

stimulus program – could have an enormous positive

impact. The sum of the parts can be a lot more powerful

than each individual action.

We see that the largest global economic downturn is

being met with massive global government actions –

and while the specific outcome is uncertain, there is

good reason to think that the governments will eventually

win.

This country has had its defining moments: the Civil

War; the Great Depression; World War II. This may

also be one of them. President Abraham Lincoln said,

“A house divided against itself cannot stand.” Just as

our military acts in concert – across the Army, Navy,

Air Force and Marines, under one commander-in-chief

– now, so too, should we. This means coordination

across the House and Senate, Democrats and Republicans.

If we rise to the challenge now, we will prevail.

Vl. GETTING COMPENSATION RIGHT

IS CRITICAL

Looking back at last year, I continue to reflect on how

proud I am of the people in this company. It often is

in the toughest of times that one learns what people

are really made of. Our employees worked harder than

ever and performed admirably for the company, for

our clients and even for our country under enormously

challenging conditions. Throughout the unexpected

events and incredible pressure of 2008, it was hard

not to be impressed by the intellect, work ethic and

strength of character of the individuals at this firm.

I know many Americans are concerned about compensation

practices across the financial services industry,

and many of the concerns are quite legitimate. At

JPMorgan Chase, we believe we have been at the forefront

of sensible compensation practices. Our process

is disciplined and rigorous, and we have always sought

to reward the long-term performance of our employees.

Our practices reflect this:

• We pay our people for performing well over multiple

years and for helping to build a company with

long-term, sustainable performance.

• In looking at performance, we always try to properly

account for risk being taken. We are also mindful

that a rising tide lifts all boats, and we do not want

to pay people on that basis.

• Performance to us has never been simply a financial

measure. It has always included the broader contribution

a person brings to a company, such as maintaining

integrity and compliance; recruiting and

training a diverse, outstanding workforce; and building

better systems and innovation.

• We have had in place a bonus recoupment policy

beyond that required by Sarbanes-Oxley.

• We don’t have: change-of-control agreements, special

executive retirement plans, golden parachutes,

special severance packages for senior executives

or merger bonuses. We have always paid a significant percentage of

our incentive compensation in stock, approximately

50% for our senior management team. That stock

vests over multiple years.

• Our senior management team generally must retain

and hold approximately 75% of all stock ever

received from the company.

There are a lot of legitimate complaints about compensation

– not just at financial firms but at all types of

companies. Good companies know that compensation

can cause bad incentives. They know there is no magic

to a calendar year and that they must be careful not to

pay people too much in a current year – due to either

exuberance or real market pressures. Compensation is

one of the most complex issues we deal with because

it is important to the individuals and the company.

Improperly done, it can destroy a company. We strive

mightily to hire, train and retain the best talent –

smart, ethical, hard-working, entrepreneurial individuals

– and getting compensation right is a critical part

of this process.

VII. CORPORATE RESPONSIBILITY

We believe we have a deep responsibility to you, our

shareholders, and to our creditors, our clients and all

our employees. We work incredibly hard to uphold all

our obligations every day.

*Our commitment to corporate citizenship*

We have always been deeply committed to being good

corporate citizens. It is an essential part of what we

do – and who we are – as a firm. As such, we have

intensified our corporate responsibility efforts, directing

resources to make a meaningful difference to the

people who live and work in the communities in

which we operate.

While some may think of us as a Wall Street firm, we

also are very much a part of Main Street: We employ

225,000 people worldwide in 48 U.S. states and more

than 60 countries. Our 5,000 branches serve customers

in 23 states. We provide health care coverage for

400,000 people. On average, we pay more than $10

billion a year in taxes to the U.S. government, as well

as to state and local jurisdictions.

Last year alone, our firm and our Foundation made

charitable contributions of approximately $100 million

in our markets across the United States. And over the

past five years, we have given more than $600 million

to 13,500 organizations globally. These tremendously

important investments help inner-city young adults

get jobs, fund educational programs, build affordable

housing and support rebuilding efforts after a tsunami,

earthquake or hurricane hits one of our global communities.

Our people are devoted to the communities they

serve – and, in a mutually beneficial relationship, we

thrive when those communities are healthy, secure

and prosperous.

*The Way Forward: Stepping up our game*

We strive to help our clients and our customers in

every way – and especially during these difficult times.

This overall effort, part of an initiative called The Way

Forward, represents our commitment to the actions we

have taken and are willing to take to move America

and the global economy forward. Throughout our history, we have always believed that

our obligation extends beyond simply serving shareholders,

clients and employees. For us, public service

means working with government officials, in a nonpartisan

way, to fully identify, analyze and overcome our

problems. We believe the right solutions come only

when we participate in a constructive dialogue, get

beyond the words, “It’s not politically feasible,” and

take bold steps.

*Ensuring the health and vibrancy of this company for the*

*next 200 years is paramount*

The real measure of strength for a country – or a

company – is not whether we have problems but how

we learn from them, overcome them and emerge better

for it. For more than 200 years, the world has turned

to JPMorgan Chase in times of difficulty and turmoil,

counting on our people to support our country, our

clients and our communities around the world. We

feel that obligation more intensely than ever and are

focused on doing everything in our power to make

sure this company remains strong, healthy and vibrant

so that it can continue to do what it does best for the

next 200 years.

Jamie Dimon

Chairman and Chief Executive Officer

March 23, 2009