JPMorgan Chase CEO Discusses Q2 2013 Results - Earnings Call Transcript

Executives

Jamie Dimon - Chairman and CEO

Marianne Lake - CFO

Analysts

John McDonald - Sanford Bernstein

Brennan Hawken - UBS

Betsy Graseck - Morgan Stanley

Matt O'Connor - Deutsche Bank

Mike Mayo - CLSA

Erika Penala - Bank of America Merrill Lynch

Andrew Marquardt - Evercore Partners

Matt Burnell - Wells Fargo Securities

Gerard Cassidy - RBC

Jim Mitchell - Buckingham Research

Paul Miller - FBR Capital Markets

Guy Moszkowski - Autonomous Research

Chris Kotowski - Oppenheimer

Moshe Orenbuch - Credit Suisse

Nancy Bush - NAB Research

Chris Whalen - Carrington

Eric Wasserstrom - SunTrust Robinson Humphrey

Christopher Wheeler - Mediobanca

David Hilder - Drexel Hamilton

JPMorgan Chase (JPM) Q2 2013 Earnings Call July 12, 2013 8:30 AM ET

Operator

Good morning, ladies and gentlemen. Welcome to JPMorgan Chase's second quarter 2013 earnings call. This call is being recorded. Your line will be muted for the duration of the call. We will now go live to the presentation. Please stand by.

At this time, I would like to turn the call over to JPMorgan Chase's Chairman and CEO, Jamie Dimon, and Chief Financial Officer Marianne Lake. Ms. Lake, please go ahead.

Marianne Lake

Thank you, operator. Good morning everyone. I'm going to take you through the earnings presentation, which is available on our website, and please refer to the display regarding forward looking statements at the back of the presentation.

So turning to page 1, we carried strong momentum into the second quarter, with net income of $6.5 billion and an EPS of $1.60 a share, on revenue of $26 billion, up 13% year on year and flat versus the seasonally strong first quarter, with a return on tangible common equity of 17%.

And you can see on the page that we've highlighted several significant items up front here: A $950 million reserve release in mortgage, and this quarter we saw net chargeoffs less than half of what they were a year ago; a $550 million reserve release in cards, with chargeoffs remaining historically low; and $600 million of expenses for additional litigation reserves in corporate. In addition, the results for the quarter included a $355 million DVA gain in the corporate and investment bank.

Outside of these four items, we had a number of other small items, both positive and negative in the quarter, which offset each other, many of which I'll call out as we go through the presentation. And we want to be very transparent with you. We don't count items like reserve releases and other noncore items when we think about our own performance, so if we adjust for all of these items both big and small, our return on tangible common equity would have been about 15%, reflecting strong underlying core performance.

This quarter, a couple of important themes: The market's environment in June, as well as several capital developments. So just a quick note on each. Rising long term rates and higher levels of volatility in June had an impact both on the quarter as well as in terms of our mortgage outlook guidance.

Our market businesses held up well in June, and our asset management platform outperformed during the backup. And importantly, remember that given the firm's positioning, rising rates will drive significant benefit in higher NII over time, but during the near term, higher long term rates and wider spreads drove a significant reduction in the unrealized gains in our securities portfolio, or a reduction in AOCI, which did impact Basel III capital negatively.

Despite that impact, we were able to add to our capital and improve capital ratios as we began to realize some of the runoff and model benefits that we'd previously guided you to. And finally, higher rates will have a significant impact on mortgage refi volumes and margins in the second half of the year.

On capital, we've added a new page in the deck on leverage, which I'll cover in a moment, but our headline capital number is a Basel III tier one common ratio of 9.3%, including the impact of the final Basel III capital rules approved this month by our regulators.

In general, the approvals are the same or similar to the NPRs, and in that sense, we're broadly in line with our expectations, including the confirmation of no exception to AOCI. The estimated impact on our ratio was a modest benefit.

So on page three let me take you through the details. We ended the quarter with Basel III tier one common of $148 billion, up from the prior quarter. We set a Basel III capital walk here on the page in the blue callout box, which steps you through each component of the change quarter on quarter.

Our Basel III tier one common ratio before the impact of final U.S. rules increased to 9.1% from 8.9%, even after the 20 basis point impact from the change in AOCI. This impact is offset by a $40 billion reduction in risk-weighted assets, reflecting the impact of portfolio runoff as well as lower levels of risk.

So then adding in the benefit of final rules, which were principally related to changes in MSR rules and securitization benefits, our ratio at the quarter end was estimated at 9.3%. And as you know, although we reflect our best understanding of all the rules in our ratio, we don't pull forward the impact of passive runoff or model enhancements, some of which we saw this quarter.

Together, these will deliver approximately an additional 75 basis points of benefits by the end of 2014. And we remain committed to reaching a 9.5% Basel III tier one common ratio by year-end.

Briefly on liquidity, in addition to building our capital, we accelerated compliance with the proposed Basel III liquidity coverage rules. And not only did we become compliant with the rule during the quarter, but at quarter end our estimated ratio was 118%, and we feel great about the progress we've made. Although there can be short term volatility in the number, you should expect that we will run around this level going forward.

And to finish on page three, in the bullets, the board increased the quarterly dividend to $0.38 a share from the previous $0.30, and during the quarter we repurchased $1.2 billion of common equity, as a reminder, that $1.2 billion of the $6 billion CCAR authorization.

So turning to page four, we've added this page to help walk you through our current thoughts on the new proposals regarding Basel III leverage. Let me start with two things. We believe the leverage ratio is an appropriate complement to our tier one common ratio if properly calibrated, and our holding company leverage ratio is estimated at 4.7% at the end of the quarter, based upon the U.S. proposed rules. To be clear, these rules do not reflect the most recent Basel proposal which would further increase our leverage balance sheet.

Just a few comments on the proposal in the U.S.: the denominated bills on GAAP assets with add-ons for derivative potential future exposures and off-balance sheet commitments resulting in a gross up for us and approximately $1 billion. And remember, included on our balance sheet is over $450 billion of cash and other high-quality liquid assets, which we think there's a strong argument that they should not attract capital at these levels.

So I'm going to take you through the analysis on the page. We started with analysts' estimates for net income, and we held our dividends flat and assumed repurchases generally consistent with our current levels. Given those assumptions, we would be able to add approximately 60 basis points to the leverage ratio by the end of 2014.

Additionally, we will continue to recalibrate our tier one capital through the issuance of preferreds. And finally, we will take appropriate actions to reduce our leverage assets, which may include some of the points on the slide. For example, repricing or restructuring our commitments or unwinding certain derivative positions.

And if you take those together, this could add another approximately 100 basis points over time, for a total of up to 160 basis points. So we will adjust our business, but we do expect the holding company to be able to be compliant in early 2015, with the bank to follow. Of course, a caution that this timeline could be impacted if there are significant changes to the rules, which are not yet final.

Changing gears, let's turn to the business performance, starting on page five, with consumer and community banking. The combined consumer businesses generated $3.1 billion of net income for the quarter, on $12 billion of revenue, with an ROE of 27%.

Just a quick look at the franchise. We ended the quarter with over 5,600 branches, over 19,000 ATMs, and we now have nearly 1,700 Chase private client locations.

We continue to see really strong growth in the underlying drivers of the consumer businesses. Deposits were up over $40 billion year on year, an increase of 10%; customer attrition levels remain historically low; and our active mobile customer base grew by 32% year on year. So we're adding customers, we're retaining them through superior customer experience, and we're deepening our relationships with them.

Also, mortgage and auto originations showed strong growth, up 12% and 17% year on year, respectively, and we had record credit card sales volume of $105 billion, up 10% year on year and record client investment assets of $172 billion, up 16%.

Turning to page six, consumer and business banking, net income of close to $700 million, and an ROE of 25%, on net revenue of $4.3 billion, down 1% year on year and up 3% quarter on quarter. While we continue to see pressure on deposit margins, 5 basis points down in the quarter, this continues to be largely offset by very strong growth. And on the noninterest revenue side, we're seeing strong growth in both debit and investment revenue.

Expenses are up year on year, reflecting the investments we're making in the business, including branch builds, as well as the absence of some one-time items that benefited the prior year.

During the quarter, we had record investment sales of $9.5 billion, up 53% year on year, and I'll note that approximately 70% of those sales are managed money, driving strong recurring revenue for the business, up 13% year on year.

Average business banking loan balances are flat quarter on quarter, up 4% versus last year. And you can see here in the drivers that the loan production stabilized just above the very low levels we saw in the first quarter. We believe that we're maintaining share despite increased competition, and the pipeline is up relative to the first quarter, which should support origination levels in the second half of the year.

Turning to page seven, and mortgage banking, overall mortgage banking net income was $1.1 billion, with an ROE of 23%. At the top of the table, looking at the first blue highlighted lines, production pretax income was $582 million. Top line production revenue, excluding repurchases, was up slightly quarter on quarter, with a higher reported gain on sale pretax margins of 116 basis points, more than offsetting lower closed loan volumes, down 7%.

$49 billion of mortgage production saw a change in mix this quarter as the purchase market continued to recover. Our purchase volumes increased over 40% quarter on quarter, and contributed 36% to volumes, up from 23% last quarter. And despite the strong start in April, the environment in late May and June drove mortgage rates up significantly, around 100 basis points.

This pressure continued into July, and we expect it could have a significant impact on the refinance market side in the second half of the year. So if mortgage rates stay at or above current levels, the market could be reduced by an estimated 30% to 40%. Although we will adjust capacity, expense reductions will lag volume reductions, and will challenge profitability and production.

Moving down to servicing, pretax income of $133 million, up quarter on quarter and year on year, on lower expenses and modest gain in the MSR. Servicing expenses of $715 million decreased quarter over quarter in line with our expectations, and we continue to see servicing or expect servicing costs to decrease to $600 million by the fourth quarter.

At the bottom of the table, real estate portfolio pretax was $1.2 billion. Runoffs of the legacy portfolio continued, although in the quarter, given the positive economics of retaining certain loans, we added close to $5 billion of mortgage loans to our portfolio, which is up $1.3 billion quarter on quarter, and we expect to be able to sustain these levels in the second half.

On credit, delinquencies and foreclosure in our portfolio were each down around 10% quarter on quarter. Net chargeoffs continue to come down less than $300 million this quarter, which was in line with our guidance, and we released $950 million of reserves. The majority of this release related to to impact of lower severities, reflecting real and sustainable HDI improvements. Going forward, we expect quarterly net chargeoffs of less than $250 million, and as credit trends continue to improve, expect additional reserve releases in the next several quarters.

Turning to car merchant services and auto, on page eight, net income of $1.2 billion, up 21% year on year, with an ROE of 32%, or 23% if you exclude reserve releases, reflecting excellent underlying performance in the business. Revenue of $4.7 billion was up 3% year on year, and despite strong volumes, down slightly quarter on quarter as a result of spread compression.

In cards, year on year growth in both sales and merchant processing volumes was both strong and consistent at 10% and 15% respectively. And importantly, we saw a stabilization of outstandings at the end of the second quarter, after 15 quarters of net runoff. And we believe we've reached an inflection point and expect some modest growth from here.

Expenses are down year on year, primarily driven by lower remediation expenses on our legacy product. And the net chargeoff rate continues to be very low, and we released $550 million of credit card loan loss reserves this quarter. This reflected both the continued improvement in early stage roll rates as well as higher than expected levels of paydowns on modified loans.

The net chargeoff rate was 3.31%, down over 100 basis points year on year. And if we continue to see favorable roll rates, as well as our modified loans continuing to pay down, we will see incremental reserve releases in the second half of 2013.

And before we move on, a few words on auto. Originations up 17% year on year, reflecting market share gains and driving loan balances up 5%.

Moving on to slides nine and 10, and the corporate investment bank, a strong second quarter performance, which included a DVA gain of $355 million. This was versus a gain in the same quarter of last year of $755 million, both of which are shown in the credit adjustments line. As usual, we'll focus on the numbers excluding DVA. $2.6 billion of net income was the highest second quarter net income since 2009, up 37% year on year and 3% quarter on quarter.

Revenue of $9.5 billion was up 16% year on year, and the business delivered an ROE of 19%. Total banking revenue of $3.1 billion, up 17% year on year, on higher IBCs of $1.7 billion, up 38%, primarily driven by strong debt and equity underwriting.

We continue to be bank number one year to date in IBCs, and despite weaker credit markets toward the end of the quarter, we had near record debt underwriting fees in the first half of 2013. And equity capital markets, we have the number-one wallet share for the first half of the year.

Moving on to markets revenue, which was up 18% year on year, in line with our guidance, a very strong performance, particularly given the challenging environment in June, reflecting strong client flows throughout the quarter, the diversification of the business, and trading risk discipline.

Fixed income markets revenue of $4.1 billion was up 17% year on year, with credit and spread related products benefitting from less Euro Zone uncertainty and a stronger U.S. housing market. Equity markets of $1.3 billion was up 24% year on year, with strong client flows in [pass] and equity derivatives.

And before we leave markets, just a quick update on OTC clearing. The implementation of phase II in June went very smoothly. Although volumes were relatively light at launch, we have seen activity pick up, and we feel we have the right level of participation.

Securities services revenue of $1.1 billion was up 1% year on year, and within this number you should note growth in custody fees is in line with asset growth, but is offset by declines in agent lending as well as lower volumes in clearance and capital management.

Just a comment on credit. Trends are stable at low levels, with small net recoveries for the quarter. Loans are down 6% quarter on quarter, driven by lower balances in trade and conduits, and expenses were up 8% year on year, driven primarily by higher comp on higher revenues, with a comp to revenue ratio, excluding DVA, of 31% for the quarter.

Finally on this page, at the bottom of the driver section you see CIB average VAR, which continued to decline to $40 million, reflecting generally lower levels of risk, but also lower volatility across asset classes. I'll note that the increased volatility in June did, however, drive spot VAR up higher, to over $60 million.

Before we skip over page 10, just a comment. If you take a look at the numbers for first half of 2013, you can see we continue to make great progress in the international space, and had particular strength in Asia during this quarter.

Turning to page 11, commercial banking saw net income of $621 million on revenue of $1.7 billion, with an ROE of 18%. Revenue was up 3% quarter on quarter, despite the softer lending environment, driven by higher average loan balances, stable spreads, and positive momentum on cross-sell and IBCs.

Although end of period loans were flat this quarter, we saw very strong growth in commercial real estate, up 3% and gaining share, offset by lower corporate lending. Our clients have excess cash, and are keeping their utilization rates low, but we've also seen the continuation of competitive pricing and aggressive structuring. We're holding the line and choosing quality over growth, and this of course is reflected in our strong credit performance. But we're still adding very good clients, and doing more business with existing clients.

As we look forward, we expect continued strong growth in the real estate business, given our competitive position, and for C&I loans, pipelines are up from the first quarter and deal activity feels like it may be turning. We are expecting a more constructive second half, and therefore should see some growth, but the environment remains competitive.

Turning to page 12, and asset management, an excellent quarter, and despite challenging markets in June, we saw net income of $500 million, up 28% year on year and 3% quarter on quarter, with an ROE of 22%.

$2.7 billion of revenue, up 15% year on year, reflects an increase in management fees, driven by strong long term net inflows, $25 billion this quarter, marking the 17th consecutive quarter of long term inflows, and higher equity and fixed income markets, up 12% based on our business mix. We also saw higher performance fees driven by strong fund returns, and record loan balances, up $16 billion year on year across products and geographies.

A moment on expenses. Growth and performance in the business led to 11% year over year expense growth, but as our investments season, the business is delivering positive operating leverage, which you can see in the pretax margin, which is 30%, up from 27% last year.

We ended the quarter with assets under management of $1.5 trillion, up 9% year on year, and client assets of $2.2 trillion, up 10%, despite small net outflows in June. However, the breadth of our platform should enable us to continue to gather net new assets globally, looking forward, and we delivered strong relative performance in both fixed income and equities.

Moving on to page 13, and corporate and private equity, a net loss of $552 million for the quarter. Private equity generated net income of just over $200 million, which included over $400 million of gains in part driven by investments that are in active sales discussions. Treasury and CIO net loss was $429 million, driven by negative NII due to continued low rates and slower reinvestment, as well as a change in portfolio mix, shifting from higher yielding securities to [LTR] eligible securities and cash.

The result also included net securities gains and a modest loss on [unintelligible] redemption, which we guided to last quarter. Excluding the net of these two items, CIO Treasury would have been a net loss of about $350 million, which is generally in line with our guidance. And our quarterly guidance remains unchanged.

Finally, other corporate. A net loss of $335 million includes the $600 million of pretax expense for additional litigation reserves in the quarter. Excluding litigation, other corporate was around $100 million net income, in line with our guidance. And again, our guidance, which does include litigation and significant items, remains unchanged for other corporate.

Turning to page 14 and net interest margin, net interest income was down slightly and core NIM was down 23 basis points quarter on quarter. We acknowledge this is larger than you may have expected, but let me give you some color. Importantly, it was principally the result of actions we took to build liquidity to comply with Basel requirements more quickly, which we believe is a strong positive. And to the degree it was also a pull forward of compression we guided to over time.

So with that in the table on the slide, which shows our cash balances and how they progress over time, and what you can see circled is that our cash was up more than $100 billion quarter on quarter, with other interest earning assets being broadly flat. This changed the relative mix and also the size of our interest earning assets, and drove core NIM down the 18 basis points we circled on the page.

While the increase in cash does reflect accelerated LTR compliance, it does also reflect very strong deposit growth and slower reinvestments, and a little less robust loan growth. The balance of the reduction in NIM relates to loan yield compression, partially offset by the lower cost of debt.

So going forward, all else being equal, what we expect from here is relatively stable NIM in the second half of the year and net interest income to increase modestly next quarter. So finally on slide 15, here's our outlook. I covered these items as we went through presentation, so in wrap up, overall a very strong quarter, returning 17% on tangible common equity with excellent underlying performance across businesses, while making significant progress on capital and liquidity ratios. And the firm overall is positioned to benefit from a higher rate environment.

Thank you for joining us. Operator, you can open up the call for Q&A.

Question-and-Answer Session

Operator

[Operator instructions.] Our first question comes from John McDonald with Sanford Bernstein.

John McDonald - Sanford Bernstein

Do you have any sense that you could give us to where you stand on the leverage ratio at the bank level today relative to the 6% requirement?

Marianne Lake

We don't disclose the bank leverage ratio, but it is lower than the holding company, so we would have a further way to go. We've said we intend to be compliant at the holding company level by the beginning of 2015, and work on bank compliance shortly thereafter.

John McDonald - Sanford Bernstein

Maybe within a quarter or two? Can you give us any feel there?

Marianne Lake

Obviously the rules are fairly new, and still a proposal and not final, so there's work to do before they get finalized. We're working through all of the things we need to do to comply. I would say we would aim to be compliant by the end of 2015, but we need to go do more detailed plans, and we'll get back to you with more specifics.

John McDonald - Sanford Bernstein

Okay, and you mentioned the mitigation you can do at the holding company. Is there mitigation you can also do to help specifically the bank level ratio in terms of maybe assets that could be shifted to the parent, or equity that could go from the hold company to the sub and things like that?

Marianne Lake

Yes, all of those things could be considered, and would be considered.

John McDonald - Sanford Bernstein

And then on the liquidity ratio, why have you decided to run with this level of cushion to LTR, and why the acceleration in getting there now? Anything driving that in particular?

Marianne Lake

Yes, so in terms of the cushion, while it's not scientific, there is a volatility in that number inherent in actual deposit flows. So we do see some things in deposit flow, particularly wholesale flows, and that could span a quarter end and drive the ratio up or down some. So it's prudent to run that ratio above 100%, and at around about this level. And just in terms of acceleration, we just wanted to get there more quickly. The opportunity presented itself, so nothing more than that.

John McDonald - Sanford Bernstein

Okay, and could you give us some of the assumptions behind your outlook for stable net interest margin and modest net interest income growth in the back half of the year, just in terms of maybe what you're assuming on rates and loan growth, and what are the puts and takes in your outlook?

Marianne Lake

That's a great question, John, because as you alluded to in the question, there's a large number of moving parts in terms of the forecast, including points of view on rates, which as you know have been choppy over the last several weeks. So we base our projections on modest loan growth and on our understanding of the implied rate curves, and they could change.

Also, deposit flows, as you've seen, have been very, very strong. So we accelerated our LTR compliance back, the majority of the NIM compression we were previously expecting and guiding you to, forward, and consequently we expect to be more stable, with some loan yield compression being offset by lower cost of debt.

John McDonald - Sanford Bernstein

And finally, I'm not sure if I saw it in here or not, but can you remind us how much you benefit from higher rates? And which rates in particular are most helpful for you? If you can delineate between kind of the 10-year and the shorter based rates?

Marianne Lake

I'll just give you two data points and then you can maybe go and have a look at them. But I think in the Q we disclose a couple of things. The first is a bit of a [unintelligible], which says that over 12 months it would deliver about $900 million of additional NII. 10 year going up 100 basis points, I'm sorry. And that's not exactly what we've seen, but it's the closest thing to what we've seen right now.

And then the other thing we've disclosed is on a parallel shift of 100 basis points. So if you saw short rates go up too, and that would deliver just over $2 billion over 12 months. And don't forget that recurs, but it takes time to build up to that.

Jamie Dimon

And that's interest rates only, not mortgage volume, investment banking volume. That's just isolating interest rates only, assuming the company invests the way we're planning to.

John McDonald - Sanford Bernstein

And then that's the current numbers? That's last Q, or that's as of right now?

Marianne Lake

Those were the numbers from the last Q, and they are not meaningfully changed right now.

John McDonald - Sanford Bernstein

On reserve release, how can we gauge, if it is possible at all, how long this can go on for? Are there any base metrics that you think you can't go below that we can kind of look at as a percentage of loans or a percentage of normalized chargeoffs? Any help you can give us to kind of gauge how much might be left on the reserve release front?

Marianne Lake

I would point you to - and I can't remember the page, so I apologize - but we put a page in investor day that talked about what we thought through the cycle chargeoff rates were for each of our businesses, and so what I would do is take NCI loans and a reserve balance at the end of the period of $3.3 billion, take a look at that page and figure out what a more normal chargeoff rate and therefore reserve balance would be, and that will be in large part our reduction over the course of the next several quarters. So we expect it to be a journey to get to that level throughout 2014.

Jamie Dimon

So wholesale, kind of where we should be, we shouldn't expect much different. Credit card, maybe a little bit more, but then the 100s of millions. And on mortgage, I think we said at investor day, eventually it will a billion to a billion and a half. [cross talk] couple of years.

And KPI, if we have home improvement, we may see some reductions in [PCI] loan loss reserves, purchase credit reserve.

John McDonald - Sanford Bernstein

You haven't done that yet in terms of taking the PCI out yet, right?

Jamie Dimon

No.

Marianne Lake

We haven't done that yet, John, but the reserve release we've got in NCI was driven in large part by lower severity, so it would just continue. You might see some of that.

Operator

Our next question comes from Brennan Hawken of UBS.

Brennan Hawken - UBS

Another quick question on leverage. Could you help me understand why it takes until 1Q '15 for the bank holding company to add the 30 basis points necessary to the leverage ratio? It looks like what you laid out puts you kind of well above that earlier.

Marianne Lake

What we laid on the page was an illustration. And you're absolutely right, what it shows you is that we ought to be able to close that gap much more quickly. And so that might very well be what happens. We just aren't going to come out now with a target of achieving it over the course of the next one or two quarters, because we have other objectives, including the continuation of being able to have some capital distribution to you guys that we want to be able to decide when we do CCAR at the end of the year.

Jamie Dimon

We'll be able to do it pretty quickly when we know what it actually is. We don't want to start making actions that affect customers way in advance of knowing the real, final rules.

Marianne Lake

But what you took away from the page is absolutely right. Closing that gap should not be difficult, and could be more quick than this, but we want to be cautious.

Brennan Hawken - UBS

Understood. And was there a change in the securities portfolio during the quarter? And maybe could you give us an update on where that duration stands?

Marianne Lake

We're not going to disclose the duration, but there was some changes in the portfolio as we moved out of noneligible into eligible securities for LTR and also maintain more cash. So there were some changes. We also [saw] making gains on sale, and we were doing that.

Brennan Hawken - UBS

So would the bias be to assume that it would be towards shorter?

Jamie Dimon

No.

Marianne Lake

No.

Jamie Dimon

When rates go up, certain mortgages lengthen, and a whole bunch of different things take place. But in general, the portfolio is several year duration, and a couple of year duration, AA-plus, and obviously it changes over time, so it manages shared exposures.

Brennan Hawken - UBS

And then just a quick follow up on John's question. Is it generally right, given what you guys have disclosed, and you guys just verified, and what we've seen in rates, if we assume that rates kind of stay where they're at, that you would get about 75% of that $900 million in additional NII in 2014, if we kind of stay status quo to where we are now?

Marianne Lake

That's not a bad assumption.

Brennan Hawken - UBS

And then last one, just trying to think about maybe the potential to avoid some of the really big distraction that we saw this quarter around what is sort of becoming an annual event at the shareholder vote. Have you guys considered maybe articulating some kind of plan or a blueprint, or a map or what have you, to get people comfortable with the future state of CEO/Chairman roles way down the line when there is sort of a secession that is in place?

Jamie Dimon

We're not going to say what board deliberations are, but the board obviously has talked about a bunch of ideas. Also, we think we have some of the best corporate governance out there, including what I think is more important than the separation of chairman and CEO, that the board should make decisions based on the circumstances at the time. They know the company, the strategy, the people. That the board always meets without the CEO, the board in total sets the agenda, the board is completely engaged in CEO compensation, the board can hire and fire the CEO at will. And those practices, some are in our charters, some are not, but hopefully it won't be the distraction it was last year.

Operator

Our next question comes from Betsy Graseck with Morgan Stanley.

Betsy Graseck - Morgan Stanley

One more question on page four. Your 4.7 is really close. We were looking for 4.5, so very much in line with what we were looking for. I'm just wondering why no bank sub disclosure. I realize that it's different. And I heard your answer earlier, but I'm just wondering why not just give us a number? Is it that there's too much uncertainty in estimating that denominator? You need understanding from the regulators, what they're looking for. Could you just help us out on a little bit of the qualitative reasons?

Marianne Lake

There's nothing [sinister] underlying it. Let me just give you hopefully enough. It is a little bit lower than 4.7, and given that the ratio for the bank holding company is 6%, then the gap is a little bit bigger. But measured in small tens of basis points, not more.

Jamie Dimon

A lot of it's historical. JPMorgan Chase got built through mergers over time, [unintelligible] in the bank, [unintelligible] broker-dealers. We're going to have to change our legal entities a little bit overseas. So we'll just have to modify legal entities to accomplish our objectives, and we'll be able to do that over time.

Marianne Lake

And over time, you know, [unintelligible] will help.

Jamie Dimon

The only [unintelligible] constraint is the 5%.

Betsy Graseck - Morgan Stanley

Yeah, I get that. If possible, I'd love to show you what our assumptions are, and maybe we could understand where we differ?

Marianne Lake

Yes, of course.

Betsy Graseck - Morgan Stanley

And then separately, you put on here, on this page, the potential further add-ons for the Basel proposal. You're talking about the Basel's consultative document that came out a couple of weeks ago. Is there any sense as to what kind of basis point hit that is?

Marianne Lake

We're not going to disclose it today, and we can reconsider that. Because we think there are some pretty fundamental issues with some of those proposals, not least of which is the absence of [unintelligible] or [unintelligible] on [max] securities financing, which we believe and are hopeful is going to be resolved. But it is an add-on, and it's not insignificant.

Jamie Dimon

One of the things I stress [is derivative] receivables and not taking benefit for collateral, which we know we get. So there are a lot of issues in there that need to be looked at and analyzed.

Betsy Graseck - Morgan Stanley

As to Brennan's earlier question, I think in the context of what we laid out as [illustratively] being achievable, then timelines would solve the problem.

Jamie Dimon

The other important point is one of the things that Basel and all this stuff is supposed to do is harmonize global rules. This is clearly no longer harmonization. We have one part of the world that's talking about two times what another part of the world is talking about. And I don't think there's any industry out there that would be comfortable with something like that in the long run. But in the long run, that has a lot of effects you can't determine quarter by quarter.

Betsy Graseck - Morgan Stanley

And part of the challenge is a higher denominator on one side and a higher ratio on the other side, right?

Marianne Lake

Right.

Betsy Graseck - Morgan Stanley

Just on HPI, HPI obviously rose significantly in the quarter. Could you give us an indication as to how much that helped RWAs? Was that a big piece of the driver?

Marianne Lake

The HPI [unintelligible] on RWA has a bit of a lag to it. So while it did contribute to the reduction in our RWA, our reduction was principally runoff, and some model enhancement and some lower risk. But in part that lower risk was driven by better HPI.

Betsy Graseck - Morgan Stanley

So can you give us a sense as to given where HPI is today, what kind of benefit that would have on RWAs, if there wasn't a lag?

Marianne Lake

It's a great question, and we will get back to you after the call.

Operator

Our next question comes from the line of Matt O'Connor with Deutsche Bank.

Matt O'Connor - Deutsche Bank

Just drilling down to some of the businesses here. Obviously June, as you had mentioned, we've all seen it was very volatile in the credit markets and the fixed income markets in general, and I guess kind of a basic question. Like, how did you do so well in fixed income? I know you guys had commented early part of the month, but things have deteriorated quite a bit, and I think some of us were surprised at how good it was back in the quarter.

Marianne Lake

June was a bit more challenging, and so it wasn't as strong as April and May, but it really comes down to the fact that we really do have a client-driven business model, and the client flows, they held up. And so if you surround that with robust and strong trading risk discipline, that's pretty much how it turned out.

Jamie Dimon

I think our folks in emerging markets also did a spectacularly good job, because I think you might see some real differentiation there from some other folks when all their numbers come out.

Matt O'Connor - Deutsche Bank

And is that just from managing a smaller inventory while the spreads were widening?

Jamie Dimon

A little of everything.

Matt O'Connor - Deutsche Bank

And I guess on the other side, when we look at the comp rate at the investment bank, it was down I think 2-3%, both linked quarter and year over year. What's driving that? Is it mix? Is it streamlining of the business lines that you announced about a year ago fully coming together? Or just paying people less?

Jamie Dimon

I think we've been very consistent how we look at comp and how we accrue it and things like that, after capital charges and by line of business, type of business. So it's just a change of mix and change of capital, etc.

Matt O'Connor - Deutsche Bank

And I think you've been guiding toward 35%. So do you think that maybe it's the lower end of that? That this is more sustainable?

Jamie Dimon

Possibly.

Operator

Our next question comes from Mike Mayo with CLSA.

Mike Mayo - CLSA

First, I just want to follow up on the comment. So, over the next 12 months, NII should benefit by 75% of the $900 million? In other words, in 2014 you should benefit by about $700 million?

Marianne Lake

All other things being equal, that's not an unreasonable assumption. But as we said, all things are never equal.

Mike Mayo - CLSA

No, I understand. It's more art than science. So I guess your run rate of net interest income, that would be about 1.5% of that? Is that in the ballpark of how you think about it?

Marianne Lake

Yes, I guess that's about right. Or maybe a little less.

Mike Mayo - CLSA

And when you say the benefit, the benefit of the 10-year increasing 100 basis points? I didn't fully hear how you explained that.

Marianne Lake

Yeah, I think we disclose all of the assumptions in the earnings [at risk] tables in the 10-Q, but yes, it's short rates staying low and the 10-year going up 100 basis points, I think.

Jamie Dimon

Yes, that's what drags up the 5-year to 7 [unintelligible]. Because if you use 1 point, it's the 10-year, but it's the yield curve going up [unintelligible].

Mike Mayo - CLSA

The reason I ask that is it seems as though maybe the 10-year's not as relevant as perhaps the 5-year, or am I mistaken?

Marianne Lake

You're not mistaken, which is why if you actually get more of a parallel shift and rates go up, numbers go up by multiples.

Mike Mayo - CLSA

Separately, the investment banking backlogs, where are they versus the first quarter, at the end?

Marianne Lake

The pipeline?

Mike Mayo - CLSA

Yeah.

Marianne Lake

Activity levels picked up some, and we expect that to carry into the third quarter, so a little better.

Jamie Dimon

You saw a real slowdown when we had the volatile markets in June, but we don't think that's actually… You know, the market's kind of opening up again. You see a bunch of IPOs and [unintelligible] deals, and M&A chatter.

Mike Mayo - CLSA

And the leverage ratio, you said under the U.S. rules it's 4.7%. Under the proposed Basel rules, if adopted, where would the leverage ratio be?

Marianne Lake

We didn't disclose that, Mike, for a couple of reasons. One is that, as we said, the proposals, we think, have some fundamental issues to them. But it would be lower. The growth up to our balance sheet on top of the 3.5 sitting on the page would not be insignificant. But we didn't disclose it.

Mike Mayo - CLSA

Can you give us a ballpark? Or is that one reason you're being so conservative? You have 160 basis point potential benefit, but you're still saying wait until early 2015. Is that part of your thought process?

Marianne Lake

Yes, that is definitely one of the reasons, and that's one of the reasons why we said and of course the timeline could be impacted if there are significant changes to the rules. And that would be one of those changes.

Mike Mayo - CLSA

And then last question relates to the processing business, which to me looks like it's lagging for the second quarter in a row. And I'm asking a more broad question, for eight years since BankOne merged with JPMorgan and I think for a few decades before that, it was run as a separate business, and the fourth quarter last year it was merged into the investment bank, and now we have two quarters in a row of what looks like performance that will lag peers.

So my question is, how is the management and organizational restructuring going? Is it impacting the processing bus, or is there something else taking place there?

Jamie Dimon

I think it's going great, and the folks in the field will tell you that they're seeing huge benefits from putting together the corporate global investment bank, the corporate investment bank, treasury services. But you are right, there's been a flattening out a little bit in treasury services and investor services, which is mostly custody. Some of that's spread, some of that's margins. So some of that will benefit also a little bit from rising rates. But we don't what the peers will show yet. Maybe you do, but I don't know yet.

Mike Mayo - CLSA

Yeah, I'm guessing it's going to lag. I mean, you have assets under custody down 2% linked quarter, when markets are up as much as they are. Is there anything else that's one-time or unique?

Jamie Dimon

Mike, I don't know, and obviously if we lag our peers, we'll be as disappointed as you are.

Operator

Our next question comes from Erika Penala with Bank of America.

Erika Penala - Bank of America Merrill Lynch

My first question really has to do with some of the initial questions asked on capital. What is the priority here on capital distribution versus leverage ratio? Is it compliance to the 5% at the hold co? Or is it accelerating capital distribution over the next two years relative to what you announced out of this year's CCAR? Or can JPMorgan both be compliant with the leverage ratio over time and accelerate buybacks and dividends?

Jamie Dimon

Your last one.

Marianne Lake

Yeah, it's balancing both, Erika, which is why in response to the earlier question, we said we've been conservative on the timeline because we want to preserve the flexibility to consider capital distributions when we do our CCAR in 2013, and it will be a factor we consider.

Erika Penala - Bank of America Merrill Lynch

And a follow up question on what you mentioned, Marianne, in the beginning of the call, on mortgage. You mentioned that if rates stay where they are, that could mean the market shrinks by 30% or 40%. What is the proportion in expense in that scenario that you could take out of the business? And how long typically is the lag until you can take those expenses out?

Marianne Lake

The truly variable, as in transaction variable, portion of the business is some, but the majority of it is related to people and systems. So there's usually a several-month lag to be able to get that out of the system.

Erika Penala - Bank of America Merrill Lynch

And proportionately, if the revenues are down, let's say, origination revenues are down 30-40%, what's the efficiency ratio that we can think about as we think about the variable costs that can be taken out?

Marianne Lake

Think about it this way, I think that revenue margins will be down on competitive pressures. Volumes are down, and expenses may go up, because volumes are down for a couple of quarters. Sorry, expense margins would go up.

Jamie Dimon

In other words, a dramatic reduction in profits.

Marianne Lake

Yeah, we're trying to be clear with you that this would be a significant event if mortgage rates stay where they are or go higher.

Operator

Our next question comes from Andrew Marquardt with Evercore Partners.

Andrew Marquardt - Evercore Partners

I wanted to ask on expenses. Can you talk about how you're still feeling about the full year target? You had previously talked about down a billion year over year, ex-legal. Does that still stand?

Marianne Lake

Let me just walk you through it. This quarter our expenses adjusted for litigation were $15.2 billion. For the first half, adjusted corporate litigation and foreclosure-related matters was 30.7, which would be against the $59 billion target, which is running a little high, but there are two important factors.

One is in our definition of adjustment, we only adjusted out corporate litigation, so there's other litigation in the firm. That's several hundred million dollars disclosed in our [unintelligible] and you can see that. And also, in the first half of the year, we did see outperformance in terms of the investment bank or CIB revenues, and clearly we pay compensation on that, which is a good expense, and we would waive it in all day long.

So if you take the combination of those two things that we don't technically adjust out, our underlying core expenses are on track for that number, yes.

Andrew Marquardt - Evercore Partners

And the additional litigation costs this quarter, somewhat elevated. How do we think about them going forward? Staying elevated but similar rate? Or a little bit lower? How do we think about that?

Marianne Lake

You can't really think about a run rate trend in litigation costs, because they are somewhat lumpy. So we don't have a forecast for you and they will go up and down.

Andrew Marquardt - Evercore Partners

And then in terms of the rates, obviously impact a lot of different businesses, mortgage, the balance sheet, NII, NIM discussion. And also, can you walk through how we should think about it in terms of the fixed business? Heightened volatility, maybe more volume, but then obviously softer environment in June. How do we think about this current environment kind of playing out for the back half of the year in terms of trading?

Jamie Dimon

You're absolutely right. When you separate NIM you try to tease it out, and [you're making them] interest rate, because you've got to look at the underlying results, underlying volumes, and things like that. There's no reason to think that we're not going to have a good trading going forward, because if the economy is strengthening, and our view is that it is, and that capital markets are going to kind of open up again, and people get adjusted to slightly higher new rates. And yeah, volatility helps certain trading areas. Higher [unintelligible] certain mortgages, they can help other areas. So it's a whole potpourri. It's impossible almost to separate it out. We try to do that for you, but I think it's a little bit of a mistake to look at the whole company.

Andrew Marquardt - Evercore Partners

And then my last question was just a clarification on there's been a lot of regulatory issues, capital, liquidity, buffers on buffers, OLA, etc. I think it's this quarter that you're resubmitting your CCAR plan. Is it fair to assume that despite all these things that have been coming out, and still some hurdles need to be met, that one shouldn't expect the change in capital deployment? Or should we?

Marianne Lake

We're working really hard on the CCAR resubmission, and you're right, we're going to resubmit that before the end of the third quarter. We're in constant dialog with the regulators, although we won't receive any formal feedback until we're in the fourth quarter. And so we're doing everything we can to be able to be successful in remediating any of the issues they identify for us. And if we're able to do that, then there should be no impact.

Jamie Dimon

It won't be for lack of trying. You have a thousand people now who are devoted…

Marianne Lake

We have 500 people that are dedicated, and thousands of people working on it.

Operator

Our next question comes from Matt Burnell with Wells Fargo.

Matt Burnell - Wells Fargo Securities

First of all, you mentioned servicing costs in the mortgage business being down by about $600 million in the fourth quarter. Is that largely coming out of the default side of things? Or do you think that will be more evenly spread between default and more regular servicing?

Marianne Lake

Just a point of clarification if it wasn't clear. Our guidance was that we're expecting to get our expenses down to $600 million in the fourth quarter from the level that they're at now which is $715 million for this quarter. So to be very clear. And to remind you, our longer term on rates for that business is $325 million a quarter. So it is dominated by the default side, but there is some core performance obviously in there too.

Jamie Dimon

And just to keep it really simple, we hope to get it to a run rate of $500 million the year after that, $400 million the year after that, and $325 million, where we should be. And we have a lot of work to do in systems, etc. to get all that done. And obviously the costly foreclosure, delinquent stuff is also coming down.

Matt Burnell - Wells Fargo Securities

So it's about a three to four year run rate to get down to ultimately where you want to be?

Jamie Dimon

Three years.

Marianne Lake

Three years, and know that we're actively working the portfolio to be able to do what we can more quickly. So you would expect that we're looking at either sales or subservicing in defaulted loans, and [capacitizing] our performing servicing. So we're working on all of that.

Matt Burnell - Wells Fargo Securities

Just a further clarification question on gain on sale margins. You mentioned those were 118 basis points this quarter. You mentioned last quarter that they were 100 basis points and about 180 basis points on a normalized basis in the fourth quarter. Are all those calculated in the same way? Are those quarterly averages? Or are those the gains at the end of the quarter?

Marianne Lake

They're all calculated the same way, based upon the disclosed closed owned volumes that we have to use. So if you take the revenues and expenses and use the closed loan volume for the quarter, that's how we drive the margins, which is why you see some short term noise quarter over quarter and the increases to actually 116 basis points, because we actually got revenues when we lock loans, but we report them closed.

Jamie Dimon

Which is different than you guys do at Wells.

Matt Burnell - Wells Fargo Securities

Fair enough. And then one final question. You mentioned deal activity appears to be turning. I think that was with respect to the commercial banking business. Could you provide a little more color on that? Did June's volatility in the interest rate scenario slow down business activity in the commercial banking business? And I'm not really specifically talking about the investment bank, but more on the commercial banking side of things.

Marianne Lake

I will tell you that it's more of what we're seeing and feeling in discussions and activity with our clients, that we feel like deal activity levels have picked up and may be turning. And the pipeline feels a little better, and solid, but not strong. So we're expecting that to translate into the second half and obviously as the economy continues to recover and confidence continues to grow, hopefully that will get even better.

Matt Burnell - Wells Fargo Securities

And just finally, there's been a lot of talk, obviously, in the last couple of days, about a potential reassertion of Glass Steagall. And I guess I'm just curious, given your current business model, if that were to come to pass, would that be a meaningful negative in terms of your ability to maintain your cross-sell opportunities across the businesses? Or is that perhaps less of a challenge given how you currently have the businesses structured?

Marianne Lake

My comment on that is that Glass Steagall didn't have anything to do with the crisis, and our business model allowed us to be a port in the storm. Our customers like doing business with us in the model that we have now, so we don't spend time thinking about it.

Operator

Our next question comes from Gerard Cassidy with RBC.

Gerard Cassidy - RBC

I just want to be clear, when you talk about, on page four, that you're going to hold your capital distributions flat, is that for all of 2014 relative to '13?

Marianne Lake

Yes, just to be really clear, and you look at the title there, to be clear, illustrative. We just, for the purposes of this analysis, we just held everything flat. That's not to imply anything about what our capital distributions will be going forward, but rather to imply we can continue to do some.

Gerard Cassidy - RBC

And then second, you put in here the tier one capital actions could add possibly 30 basis points. Could you give some color behind what you're thinking there?

Marianne Lake

It's just optimizing our mix between common and preferred.

Gerard Cassidy - RBC

And with the total leverage impact of 60 to 160 basis points, clearly that's over the 5%. I assume, then, that you're going to be comfortable running something north of 5% when you finally get there?

Marianne Lake

It's too early for us to talk about [unintelligible] on that level.

Gerard Cassidy - RBC

In your investor day, you gave us the ROEs for the different lines of business and then, in the total firm, you fell 15-16%, 16% was your target ROE. Will that change now that you've got to carry the higher leverage numbers?

Jamie Dimon

This just came out, so we're trying to share information with you, and it might, but give us a little bit time and we'll give you a deeper feel how this might affect different businesses, different products. Because obviously when you do something like this, this will be pushed down, at one point, not just to the line of business, but to the client, and the product, and the country. And then we can answer that question for you.

Gerard Cassidy - RBC

You guys have had some great C&I loan growth in the middle market space over the last four, five, six quarters. It seems like it's really slowed down this quarter. Anything in particular happen?

Marianne Lake

Nothing in particular. Just demand. And I should tender that with demand and the continuation that we talked about of very, very strong competition. And we are, as I said, prioritizing quality over growth. We would tactically underperform rather than chase a deal we were uncomfortable with.

Gerard Cassidy - RBC

And finally, can you give us any color on how the shared national credit exam has gone? And are those results in your second quarter results? Or will they be in third quarter results?

Marianne Lake

The results are in our second quarter results.

Jamie Dimon

Not that material.

Operator

Our next question comes from Jim Mitchell with Buckingham Research.

Jim Mitchell - Buckingham Research

Just a couple of quick follow ups. I hate to focus on the leverage ratio, but just one question on the cash component. I think by my calculation if you were to exclude cash from the denominator, that would add almost 70 basis points to your leverage ratio. Do you think that has any legs, or any sticking with regulators in terms of logic around excluding that?

Jamie Dimon

You've got to ask them.

Jim Mitchell - Buckingham Research

And then maybe just getting to the [unintelligible] business, you alluded to it a little bit. Some businesses benefit from volatility. Is it fair to assume that in June we saw things like foreign exchange and interest ratings do better, and credit and mortgages do worse? Is that the best way to think about it?

Jamie Dimon

We're not going to give you monthly specific… I think our folks did a very good job in June. Obviously when spreads widen out, certain businesses are more at risk than others. I already mentioned that in emerging markets we probably saw the most volatility, both in terms of spread volatility and equity [unintelligible] did a very good job.

Operator

Our next question comes from Paul Miller from FBR.

Paul Miller - FBR Capital Markets

On your reserve ratios, rate around 2%, and you had a lot of reserve releases in the quarter, with credit improving, can you continue to do this type of releases in the next couple of quarters, or is that reserve ratio going to stick around 2%?

Marianne Lake

If you think about mortgages having some [more releases] because we continue to see delinquencies and severities improve, particularly HPI improvement. And so you should expect that to continue, maybe not at the level that we saw this quarter, because we had a big revision to HPI, as you know, during the last several months. And in card, we've had a billion fifty of reserve releases in the first half. Given what we're seeing, we expect more releases in the second half, but not at that level.

Jamie Dimon

Think of it as several hundred million. It's near the end, for card. And home sale is kind of where it should be, and we'll bounce around.

Operator

Our next question comes from Guy Moszkowski with Autonomous Research.

Guy Moszkowski - Autonomous Research

Just looking at the hit to the OCI at $3.1 billion, it actually seems like it's less than would have been implied by the guidance that you gave at the investor day. Obviously that was for a more severe shock, but just calibrating it relative to the number of basis points that the 10-year went up, etc. Any comment on that?

Jamie Dimon

You've got it exactly right. At investor day we gave you something far more dramatic than 100 basis points. And we've already said the duration of this thing is not 10 years, it's a lot less than 10 years. So obviously the effect will be less.

Guy Moszkowski - Autonomous Research

And is part of the reason why, besides the fact that it was 100 basis points, not a 230 basis point move or whatever, is part of the reason linked to the derisking of the treasury portfolio that you were talking about as you prepared for the LCR?

Jamie Dimon

Not really.

Marianne Lake

Not really.

Guy Moszkowski - Autonomous Research

Okay. But is there validity to the idea that if we recalibrated for 100 basis points move versus a 230 basis points move that I think is implicit in that $15 billion number that you gave us in February, was the $3 billion in line with that? Or was it actually materially better? And if so, maybe if it wasn't related to the LCR derisking, why did you have a better outcome?

Marianne Lake

The investor day scenario was a more severe scenario than the 230 basis points you're implying.

Jamie Dimon

What number did we give at investor day?

Marianne Lake

It was 300, plus or minus. And this is in line with our expectations.

Jamie Dimon

Unfortunately, the OCI, I hate to say, is not that big a deal. We all know about it, we're all prepared for it. Rates can go up, OCI gains are going to down. There are 20 basis points, you're going to see this happen elsewhere. It's asynchronous. You know, we have OCI going to capital, and the benefits going to earnings in the future.

So if it were up to us, we wouldn't have actually had this asynchronous [unintelligible]. And we're prepared, we're going to have buffers that can repair that. We know how the conservation buffer works, but it's not that big a deal. And the duration of our portfolio, and you guys could do it yourself, AA-plus, couple year duration, you could almost calculate those numbers yourself, with one caveat. The losses are less as rates go up, because of the [unintelligible] of the portfolio, currently.

And the other thing about this, you can change it overnight at any time.

Guy Moszkowski - Autonomous Research

Fair enough. As I think about the changes that you can make to the business that you referred to on page four to mitigate the impact of the leverage ratio changes, you talk about optimizing the use of central clearing, and yet there's also all these concerns about the disallowance of additional derivatives collateral. How comfortable are you that the way the rules are written right now, moving your derivatives business more towards central clearing really does, because of the collateral, give you a lot of relief on those leveraged assets?

Jamie Dimon

If you move a trade from central clearing house, it has no charge here, and it has nothing to do with the margin that they put up at the clearing house. If the trade is bilateral with cost, you have the receivable gets [unintelligible], you can't take benefit from the fact that you're going to get collateral against it. That's the way the calculations are done. So any trade you move to a clearing house eliminates that exposure. The margin for the clients at the clearing house is not with us, it's with the clearing house.

Guy Moszkowski - Autonomous Research

Right. So I guess the logical next question for that is given the central clearing mandate, which has started to be implemented recently, as we think about leverage ratio going forward, should we be thinking about a large part of that derivatives add in to the denominator of the ratio as basically being in runoff?

Jamie Dimon

You know, we had already added in our forecast to you guys some stuff moved to derivatives, how to look at capital. So I do think at the margin this will [unintelligible] things at the clearing houses, but we don't have an analysis to tell you about that right now. Will it be material? We don't really know yet. Remember, a lot of the client business, they are also going to determine what they want. It won't be just up to us.

Marianne Lake

And remember, that derivative add-on calculation is a calculation that is currently being rethought by the Basel committee, because of some of the issues with it. So it could also, in and of itself, improve.

Guy Moszkowski - Autonomous Research

When you think about those leverage asset actions you're talking about, is there any linkage of taking those actions that further benefits LTR?

Marianne Lake

We haven't done that analysis.

Jamie Dimon

It's hard to tell.

Marianne Lake

I mean, to be honest, we were trying to be very transparent and give you some ideas about the sorts of things that we're considering. We haven't translated these into detailed plans yet. So we don't know the second order impact of this yet.

Jamie Dimon

I think Marianne gave numbers that showed that we could handle this, but also, you have to be very cognizant of [fine] effects. We have a client business, and we have to make sure that we continue to have a client franchise, and so over time, we'll adjust the businesses and we'll meet LTR, we'll meet Basel III, we'll meet whatever the leverage ratio is. And think of it in some ways as alternative minimum taxes. So for every client we'll be running what's the return on Basel III capital? And then what's your return on leveraged capital?

Marianne Lake

And stress capital.

Jamie Dimon

And so you try to manage all those as fair to the client and kind of fair to the company.

Guy Moszkowski - Autonomous Research

As I've talked with clients over the last couple of days about this leverage ratio issue, one of the questions that has come up is wouldn't it be possible to downstream more capital to the banks in order to deal with the 6% requirement there? Obviously that incurs a double leverage issue, potentially. Your double leverage ratio right now is just over 1.05. Is there any room there?

Jamie Dimon

Obviously there will be stuff like that. Give us a little time. I mean, we're showing you that we can get to the consolidated pretty easily. Maybe we have to restructure some things and change the capital structure a little bit, move businesses out of the FDIC insured bank and all that. I don't think any of that's going to be critical to the future function of our business. We'll adjust those things to accomplish what we need to accomplish. Give us a little more time. This just came out a couple of days ago.

Operator

Our next question comes from Chris Kotowski with Oppenheimer.

Chris Kotowski - Oppenheimer

It just seems the thrust of the whole leverage ratio is that it's going to penalize the businesses that have the highest ratio of leveraged ratio assets to risk weighted assets. And can you give us an idea where that gap is the biggest? And in particular, also, are any of these global businesses where this would give European banks a leg up?

Jamie Dimon

Let me do the second question first. If you have a world where some businesses have to have twice as much capital as other companies, that obviously over time can create huge competitive disadvantages. I don't know of any industry in America who would want to compete globally on that basis. We have an interest in a safe and sound system, so we're not against the leverage ratio, but we're not for a hugely unbalanced competitive playing field.

So put that aside. The regulators know that. We thought [unintelligible] Basel and all that to kind of harmonize these kind of things. And as you asked about, we show here, anything which is a low RWA asset, including HQLA, revolvers, certain types of derivatives, those things obviously you'll look at a little bit differently, because of this leverage ratio asset. And we don't have to do it by business yet. We'll give you more detail later.

Like, even Marianne had mentioned that we take huge deposits in from countries, and from money funds, etc., that you may not take in because you can't afford capital against a deposit of a billion dollars that you're getting from a money fund, that you park at the Fed for 25 days, just waiting to pay the FDIC 10 basis points. You pay the client 5 or 6 or 7 basis points. You've got to put 6% capital against it. A whole bunch of things we've got to figure out how we're going to do it, but we want to make sure we manage the client franchise properly. We'll figure out the other stuff over time.

Operator

Our next question comes from Moshe Orenbuch with Credit Suisse.

Moshe Orenbuch - Credit Suisse

Jamie, following up on that, it just seems like even the $100 billion of increase in deposits this quarter probably cost you 15 basis points in that leverage ratio. And so is there any movement, do you think, during the comment period, towards exclusion of any of the risk-free assets at all?

Jamie Dimon

Separate the type of deposit, okay? So if it's a consumer deposit, it has a completely different LTR, how you can invest, the kind of spread you can make. If it's what we would call, like, big wholesale short term deposits, you're absolutely correct. We would probably restrict some of that over time.

Moshe Orenbuch - Credit Suisse

And maybe just to follow up on the mortgage business, you talked about some of the financial impacts. Can we talk a little bit just about strategically what you're doing as you kind of look at that business and the competitive environment in a kind of weaker refi environment?

Marianne Lake

This back up, although sharp, is not entirely unexpected. So every thought about our longer term plans, and when we outlined all of that in the strategy for the mortgage business at investor day, that medium to long term plan does not change. So it may accelerate some of the activities that we have, and have, as we said, some impact on our next couple of quarters results, but the long term strategy hasn't changed. We're working the portfolio, optimizing services, trying to take cost out as quickly as possible and grow share. And actually we should be able to grow share even more strongly in a more difficult market.

Operator

Our next question comes from Nancy Bush with NAB Research.

Nancy Bush - NAB Research

Two questions. First, on the branch banking network, I know this back up in rates has been primarily at the longer end, and we have not yet had a corresponding rise in short term rates. But do you see any needs at this point to reprice products, etc., at the branch level due to consumer perspective of rising rates?

Marianne Lake

No. Not yet. And as you know, traditionally that would, in any case, lag. Of course that doesn't mean it will, but that's traditionally what happens.

Nancy Bush - NAB Research

Secondly, Jamie, you talked about the asynchronous nature of OCI with OCI getting dinged now with the benefits in the future. Something else asynchronous is sort of staring us in the face, and that's this loan loss reserve methodology possible change to expected lifetime loss. What are your thoughts about that? Where does that stand in an implementation process, and would you really get dinged by that?

Jamie Dimon

This is what the issue is with all this. You spend all this time talking about accounting as opposed to business. The business is deposits, serving clients, doing things, and now we're talking all of a sudden about AOCI. And we have a lot of asynchronous accounting. And pro-cyclical accounting and stuff like that. We try to explain, but we try to look through all of that and build a business. More clients, more bankers, more branches, happier clients, and so all of our business, that's how we look at it. We'll work through the asynchronous accounting.

If the loan loss reserve accounting changes, it would add obviously the loan losses, though probably not as much as people think. But we still would run the business for economics in the long run. It wouldn't change how we run the business, we'd just be holding more reserves, which would be fine with us.

Nancy Bush - NAB Research

I realize that you're going to run the business for the business, but do you have any sense if this is going to happen, and when it might happen?

Marianne Lake

I mean, as you know, the industry commented, we commented, in terms of the proposal, and we're generally in favor of it. We think a lifetime timeline is too long. Something shorter would make more sense. I think we need to work that through. It would be implemented over, you know, not the course of the next couple of quarters, but in a year or so. So we'll wait and see.

Operator

Our next question comes from Chris Whalen of Carrington.

Chris Whalen - Carrington

Marianne, could you go back to mortgage and talk a little bit about the quality of the demand you're seeing? At the beginning of the year, the industry was guiding down about 20% in terms of volumes, and for next year as well. Your numbers suggest that's basically doubled. In other words, instead of 20% we're looking at 30-40% given rates. Would it be fair to say that the two factors are equal?

Marianne Lake

First of all, the industry groups haven't fully reforecast the market, so we'll wait and see what they come out with. We're trying to be transparent with our guidance at that level. Hopefully we're wrong, and hopefully it will be better than that. I will say for our own business, we didn't expect volumes to be down this much throughout the year, had this not happened with this space.

Chris Whalen - Carrington

So you think there is definitely a price reaction out there among consumers?

Jamie Dimon

Well, mostly this is refi. So purchase we actually saw go up a little bit.

Chris Whalen - Carrington

But purchases are catching up, though.

Jamie Dimon

They're not going to make up for refi, but they may go up, yes.

Chris Whalen - Carrington

So Jamie, back to your point about harmonization, when you look at the totality of the way the regulators are treating mortgage, MSRs, for example, which have been rallying very strongly in the past few months, and your comments last year about Basel, should the U.S. withdraw from Basel II? I mean, it's so unfriendly to businesses that are very important to you and to the economy, particularly in mortgage. What are your thoughts on that?

Jamie Dimon

We're in favor of finishing. We've always believed in high capital, high liquidity, good regulation, things like that, and finishing it. Obviously, there are things that all companies have points of view about which would be different, but I think the closer you get to real harmonization, the better. And if you want to start all over again, we'll spend another five years debating every single thing out there.

Operator

Our next question comes from Eric Wasserstrom of SunTrust Robinson Humphrey.

Eric Wasserstrom - SunTrust Robinson Humphrey

Marianne, can we just go back to the sequential NII guidance? Can you help me understand how much of that is coming or what the attribution is between benefit to NIM versus loan growth?

Marianne Lake

As I said, we're expecting NIM to stay broadly flat from here. We do expect some modest loan growth, our outlook. I'm not going to tell you how much, but some. And then we also have the improving cost of debt, lower cost of debt, on actions that we've been taking throughout the first half.

Eric Wasserstrom - SunTrust Robinson Humphrey

Shouldn't presumably, then, the benefits to the funding cost show up through NIM?

Marianne Lake

Yes, but we also have yield compression, so there's puts and takes. So relatively flat on NIM, modestly up on NII.

Eric Wasserstrom - SunTrust Robinson Humphrey

And then just within the composition of loan growth, if you divorce out the credit card seasonality, it's been within a very stable range. What is it that, in your view, takes the loans out of the current range?

Marianne Lake

I'm sorry, I didn't understand.

Eric Wasserstrom - SunTrust Robinson Humphrey

In other words, your loan balances have been between $725 billion and $728 billion, very consistently, for many quarters, if you divorce out fourth quarter credit card seasonality. But it sounds like you have some expectation that starts to move out of that range in order to generate this improvement in NII. I was wondering what the driver of that is.

Marianne Lake

We're growing loans in asset management, we're growing loans in auto, we're adding more mortgage loans, we're expecting some growth in commercial. Our commercial real estate is already growing strongly. We're expecting some growth in middle market and corporate client banking space. Although, we've seen a reduction in CID, we're expecting that to remain relatively flat. So all other things being equal, that's net growth. And card, as I said, has hit that inflection point. So that will stop contributing to runoff, net.

Eric Wasserstrom - SunTrust Robinson Humphrey

And then just finally, on the third quarter guidance, is that consistent with or relatively better than your prior annual guidance of down 1%?

Marianne Lake

So, our annual guidance, if you look at the first half of the year, you'll see that obviously already we are down year to date by more than that amount. So this is relative to the third quarter we expect NII to go up. We're already down a little more than 1%.

Operator

Our next question comes from Christopher Wheeler of Mediobanca.

Christopher Wheeler - Mediobanca

On equity capital markets, clearly the volumes are up about 2% quarter on quarter, and I think we all expected you to outperform. But it was an extremely good performance, and I wondered if you could brag a little bit about how you achieved that and how much you thought was the market share and how much is down to geographic split. That's the first question.

The second still I go back onto leverage. I'm just intrigued by the comments on page four, which you touched on in an earlier question, on the tier one capital actions, which you sort of suggested would be perhaps issuance of some additional tier one capital. This is becoming called now AT1.

And I wondered if you actually had any indication yet - and I know it's very early - from the regulator or what the terms of that new capital would have to be to qualify for tier one under Basel III. And then perhaps talk about the $14-15 billion of current hybrids that you have within the tier one calculation, which obviously you're going to phase out, I think, in some cases, if not all, through to end of 2018, and what your strategy is for replacing those.

And then just perhaps finally, I know Jamie's talked a lot about level playing fields, and I've asked him that last year on Basel III capital, but I'm just wondering actually the leverage ratio that you're looking to have to achieve now, whether it actually gives you a competitive advantage as opposed to a disadvantage given 3% is pretty well considered too skinny.

Jamie Dimon

Well, thank you for bragging on our trading results. For years, the investment bank is building FX rates, securitized products, commodities, emerging markets, credit, and they're good. And obviously some go up and some go down.

I didn't see any regional effects. We trade around the world, and the books get handed off around the world, so it's hard to give it a region. But we build a lot of clients low businesses, and that was driving it. I think it's better for the world to have harmonized rules around what Basel's trying to do, etc., but you're absolutely correct, it doesn't have to be exactly the same to have a competitive marketplace, etc.

We always ran with higher capital liquidity than most of our competitors. I just think if one is 3% and one is 6%, that becomes just too big. And over time, you could have huge competitive effects. And the regulators are working out… We all want a fair, safe, sound financial system. That's in everyone's benefit, and there are huge capital requirements, liquidity requirements, leverage requirements, stress testing requirements, and among all of that, I think we're getting there. But at one point, it should be somewhat harmonized. And your middle two questions I now forgot.

Marianne Lake

Can we get back to you on some of that? We're running out of time.

Operator

Our next question comes from David Hilder with Drexel Hamilton.

David Hilder - Drexel Hamilton

To be clear, on page four, are you saying that your 4.7% leverage ratio is as of June 30 without any other assumptions or roll forward?

Marianne Lake

Yes, correct. Sorry, as of June 30 based on the U.S. proposed rules.

Jamie Dimon

Estimated to the best of our ability.

David Hilder - Drexel Hamilton

And congratulations for doing the work so quickly. But secondly, Jamie, how will you as a company respond to the proposal? Are you in favor of it largely? Are you against it? Will you have a lot of proposed changes to it?

Marianne Lake

We did say at the beginning that we do think that having a leverage ratio is an important part of our capital management toolkit or process, as long as it's properly calibrated. And so for us the two questions, and I think they're very important, and the industry does to, so we are participating in the discussions is, as Jamie's talked about, what should the quotient, or the ratio be, and making sure that that's not only appropriate but fair across the globe. And also, what should the calculation for the denominator be?

And we've alluded already to specific questions, but there are more. One is should high quality liquid assets, and most particularly cash and cash at central banks, be treated the same as other balance sheet items? And then in terms of some of the additional add-ons that are being proposed, we think they could have issued actual issues for the operation of the financing market.

So I think there's going to be a lot of work that takes place. There are comments due back on all of those proposals by mid-September call it, plus or minus. And I think this will all be worked through the fourth quarter.