May 29, 2007

WACHOVIA

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Subject: Comments on Proposed Supervisory Guidance For Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar II) Related to Basel II Implementation, 72 FR 9084, February 28, 2007

Ladies and Gentlemen:

Wachovia welcomes the opportunity to comment on the proposed Supervisory Guidance for implementing the Basel capital rules in the United States. We have participated throughout the development of updated capital requirements in the United States and internationally, and we believe that constructive dialogue improves regulation. This is especially true with complex regulations such as the proposed Basel capital rules.

Our NPR response provides context for this document. Wachovia filed a comment letter in March on the Notice of Proposed Rulemaking for this topic. Since the Guidance provides details in support of those proposed rules, many of our comments in that letter apply to this document. We ask that our NPR comments be considered alongside this document.

Basel II should increase consistency and advance a common understanding of risk. Besides the benefits of greater risk sensitivity in the capital framework, one of the primary advantages of the Basel capital framework is the consistency of the regulatory capital regime with the way we run our business and manage risk. Its use will improve the common understanding of a bank's risk shared by the institution, its regulators and the marketplace. Aligning the Basel numbers with economic capital and other internal risk assessments will facilitate more focused and meaningful discussions between regulators and banks. By contrast, disconnects between internal processes and the regulatory capital numbers will diminish the value of these discussions and will represent an important missed opportunity. Likewise, disclosures of Basel numbers under Pillar III that are inconsistent with internal risk assessments will likely confuse and frustrate the marketplace.

The regulatory view of risk should evolve and take advantage of developments through which banks gain better insight into their risks in order to achieve these benefits. **Regulation that freezes understanding** by mandating processes and analyses **cannot keep up with innovations** in either analyses or the measurement and mitigation strategies for the underlying risks at which those analyses are aimed. Over time, the regulatory capital rules will become more and more outdated and less aligned with banks' own views of their risks. There will then be two sets of analyses: one that remains current and is used to manage risk, and a second system used solely for compliance. The Guidance should support the objective of greater consistency and thus encourage improvement in risk processes and analyses.

The Guidance falls short of this goal as written. The Guidance would be more effective if it avoided prescribing details of exactly how things should be done. Such statements become stopping points in the evolution of risk processes and analyses. The Guidance should instead be the starting point for discussions among banks and regulators and for improved understanding of risk. The Guidance should indicate the kind of analyses that would satisfy the rule's requirements, while encouraging banks to perform the tasks better with their own approaches. This does not advocate an "anything goes" approach to compliance, but rather a shared desire for genuine improvement.

The U.S. supervisory system is particularly well suited to provide oversight to a principles-based framework. Banks have been developing systems to manage risk for many years, and supervisors monitor banks' risk management processes from end to end. On-site examination teams are complemented with specialists from Washington and other sites who routinely visit banks and can compare practices and parameters from one bank to another. The agencies have more than a decade of experience with real-time supervision emphasizing risk-management systems and controls. Supervisors have continuous access to management and risk information, and through periodic review of risk and capital adequacy with senior management, they can ensure that banks are responding quickly to emerging problems. External oversight is made more effective by enhanced control and validation requirements specified in the capital rule. These mechanisms make prescriptive rules not only unnecessary, but also counterproductive.

Prescription May Distract From The Real Issue. Prescriptive rules may well divert attention from the real issue: whether a bank has realistic parameters expressing forward-looking expectations, considering a full business cycle. Instead, the focus could shift to simply whether the bank performed the steps necessary to comply with the standards. The Guidance should not lead anyone to conclude that all is fine once

the boxes are checked, and **principles are more likely to succeed here than detailed rules.**

Some parts of the Guidance avoid these pitfalls. Although we have specific comments on some provisions within the Pillar II Guidance, we find it to be written so that it can provide effective guidance not only when the rules are implemented, but also in the future. "Musts" are limited to broad objectives to be satisfied rather than details of how to do things. "Shoulds" are in a form that encourages thoughtful compliance and embraces the possibility of using better approaches. Many of the particulars are qualified with "generally," and others indicate that the appropriate solution should be tailored to the bank's situation. **The Pillar II approach should be extended throughout the Guidance.**

I. *Summary of Key Issues*

The majority of our comments on specific items can be found in Section II of this letter below. We highlight several key issues here, some of which expand on positions we stated in our NPR response:

- **The U.S. rules should be aligned with the international framework.** In particular, the specifications for a separate ELGD needlessly diverge from the International Accord. Nor should a function be mandated to specify ELGD as a function of LGD, with the harshest capital penalty applied to the least risk portfolio segments. The definition of default should likewise be aligned with the international framework. The wholesale definition should not include loans sold at a price of 95 unless the loans are already defaulted. A unique U.S. definition of default for retail loans does not have significant benefits to justify the expense of a second definition.

- **Some rules pertaining to the grading system are internally inconsistent.** Rules that specify which characteristics can be used to differentiate default rates in some cases contradict the standard requiring grading systems to rank order risks. If rank ordering is explained by factors that may not be considered in grading, banks cannot comply with both requirements. The principle (rank order) should be retained while the prescription (which factors should be included in the empirical analysis) should be removed.
- **Other rules are inconsistent with risk management practices.** For example, the distinction between eligible and ineligible guarantees seems appropriate for credit default swaps and other guarantees from unrelated parties, but they do not work for guarantees from related entities like owners. Likewise, the regulatory requirement to use unit- or account-weighted default rates (as opposed to dollar-weighted default rates) is an example of prescriptive rules that could force a bank toward an inappropriate number. Banks should identify and apply whichever method produces the most accurate result under the circumstances. Further, the securitization rules should not be applied to all tranching of credit risk – only those transactions where there may be multiple correlated defaults. In other cases, we may simply have different LGD expectations and a single PD.
- **Operational requirements** listed in the Guidance **for securitizations go far beyond the scope of regulatory capital measurement**, are overloaded with detail and would impede banks' continuing leadership in this business. It is important that this Guidance does not become a checklist of additional operational, regulatory and other burdens placed on banks outside of regulatory capital measurement. Some examples of additional burden that go well beyond what is needed for Advanced IRB measurement include prescriptive policies, procedures and documentation requirements, numerous eligibility tests, IAA qualification hurdles, and a litany of expectations throughout the securitization chapter.

- The Pillar II Guidance states that "Generally, material increases in risk that are not otherwise mitigated should be accompanied by commensurate increases in capital." While it would be generally reasonable to align capital levels with risk when a bank changes its portfolio through the introduction of a new product or by targeting a different risk profile, **banks may** in other cases **quite reasonably vary their excess capital consistent with their ICAAP.** For instance, banks have historically held excess capital in good times to reduce the need to raise capital in times of stress.
- **We oppose the requirement to separately quantify pre-CRM parameter estimates** (as well as the regulatory reporting requirements upon which we commented in our NPR response). This requirement – not found in the International Accord – is operationally quite burdensome, particularly for institutions that recognize the benefit of CRM in their grading process and, accordingly, will have to grade (and report) each loan twice. Further, if they use scorecards or other automated grading tools, they will have to maintain two sets of scorecards, one set with and one without the CRM.
- The Guidance includes a number of specific requirements of a bank's board of directors. **Banks should be able to implement their respective frameworks and/or systems consistent with their organization's existing governance policies and practices.** For example, a bank's board should be permitted to delegate these functions to senior executive management or a non-board committee thereof.

II. Discussion of Key Issues

Chapter 1. Advanced Systems for Credit Risk

S 1-1 An IRB system must have five interdependent components that enable an accurate measurement of credit risk and risk-based capital requirements.

The broad scope of this standard and chapter covers a wide range of matters upon which we comment more specifically below. Please see, e.g., our comments on internal LGD estimates, effects of economic downturn conditions, and related matters in our comments on Standard 4-22 below.

S 1–3 The board of directors or its designated committee must at least annually evaluate the effectiveness of, and approve, the bank's advanced systems.

Undue Board Involvement and Burden. As Wachovia stated in its response to the NPR, banks should be able to implement this and similar provisions referenced below consistent with their organization's existing governance policies and practices. For example, consistent with its oversight role, a bank's board should be permitted to delegate these functions to senior executive management or a non-board committee thereof. The agencies should not mandate escalation to the board of matters more appropriately delegated to and performed by executive management. Board involvement, if any, should be limited to receiving and discussing a report from senior executive management or a non-board committee thereof on the effectiveness of the bank's advanced systems.

The Guidance extends the NPR's imposition of a "one-size-fits-all" view of corporate governance by failing to provide the flexibility necessary to adapt the Basel II rules to the wide variety of organizations and modes of governance used by today's banking organizations. Please see Wachovia's further comments on other provisions of the Guidance that repeat this theme elsewhere in this letter as follows:

- **Operational Risk Standard 4** – mandating annual bank board evaluation and approval of the effectiveness of the AMA System (like Standard 1-3 above), but further adding "including the strength of the bank's control infrastructure", as well as additional duties regarding the framework and operational risk computations
- **Operational Risk Standard 5** – imposing obligations to integrate operational risk processes into bank decision-making processes and related resource needs
- **Operational Risk Standard 10** – prescriptively prescribing board and management operational risk management MIS including its frequency
- **Operational Risk Standard 32** – imposing prescriptive board reporting requirements on verification and validation functions

- **AIRB Standard 7-6** –mandating annual board reporting by internal audit in a manner similar to the preceding item

Chapter 2. Wholesale Risk Rating Systems

S 2-1 Banks must identify obligor defaults in accordance with the IRB definition of default.

We generally agree with the commercial default definition, with the exception of designating a borrower as defaulted if any of its loans are sold at 95 or less; detailed comments on this proposal are provided below. Depending on bank processes, there are likely to be some small differences among banks regarding when loans are moved to non-accrual or charged off. There are likewise some relatively minor differences between U.S. non-accrual rules and the default definition used in other countries. These differences should produce immaterial or at most relatively small differences. Supervisors should take a common sense approach to such differences, particularly as it applies to U.S. subsidiaries of foreign banks that have built systems to comply with home country default definitions. Any differences can be analyzed through sensitivity testing and compensated for under Pillar II.

Loan Sales at 95 – A Flawed, Arbitrary Principle. Loan sales below 95% of initial value are clearly not always indicative of default. We believe this rule is a result of poor specification of principles around loans that leave the portfolio through sale or other means. A value of 95 does not indicate default because:

1. credit deterioration is only one of several factors that affect the valuation of a loan, and one can show that the relationship of these many factors is such that no single value equates to an expectation that a borrower is unlikely to repay the loans as agreed. Numerous loan-specific factors will produce different valuation changes for the same change in credit quality or default risk. These include remaining maturity, initial rating and spread, expected LGD, line usage, and liquidity. Depending on these other factors, relatively low risk loans may be valued at 95 or less and higher risk loans could be valued near par. The link between value and whether a loan is defaulted is too complex to be approximated by a single value.

2. the market regularly assigns values of 95 and below to non-defaulted loans. One can use the Lehman speculative grade index to show that many non-defaulted instruments trade below 95 in certain periods.

3. the market illustrates that no single value is indicative of default. Our NPR response contains examples of different exposures to the same borrower trading below 95 and above par on the same day.

Using this rule would severely distort PD and LGD rates. It would create results that could not be fairly compared to external benchmarks and for which back testing would be consistent only if the rate at which non-defaulted loans were sold at a price of less than 95% remained stable. Furthermore, this rule would have harmful effects on risk management practices (e.g., discouraging active portfolio management, loan sales and other risk reducing measures), thereby likely resulting in an increase in risk.

S 2-3 IRB risk rating systems must have two dimensions — obligor default and loss severity — corresponding to PD (obligor default), and ELGD and LGD (loss severity).
S 2-4 Banks must assign discrete obligor rating grades.
S 2-5 The obligor rating system must rank obligors by likelihood of default.
S 2-6 Banks must assign an obligor to only one rating grade.

The overarching principle should be common sense with accompanying flexibility. Loans should be graded based on the reality of who will repay and their risks, and the mandate for identical grades should depend on whether there would be cross defaults. The foundation for this should be good underwriting practices, confirmed by supervision.

PD and Default Definition Inconsistency. We call attention to a serious inconsistency between the default definition and the rules around assigning default grades and PDs. The definition is based on what the bank experiences, not on some global concept of "whatever happened to the borrower" that would require tracking each client over the remainder of the year if the client leaves the portfolio, even if the bank's loan is paid in full. Yet the grading system described in the wholesale rule and Guidance requires banks to differentiate default risk based solely on borrower characteristics – one must ignore default mitigation achieved through loan structuring, liquid collateral, and the like.

An "Omniscient" View of Obligor Risk is Problematic. The rule defines default as being in default to the bank; this is necessary, as the bank cannot always know if the borrower defaults on other obligations, especially if those defaults occur after a borrower repays all its obligations to the bank.

If all creditors had equal priority with regard to claims on the borrower's cash flows and assets in the period leading to default, default risk would be the same for all. However, a goal of good loan structuring and credit risk management is to avoid default by establishing some priority on these cash flows and assets in order to be repaid before the borrower defaults on any obligation. In many cases, this means that the borrower will not default ***to the bank***. (Some advice has been offered from agencies that PD should be the PD of the riskiest exposure to the obligor.) Yet the assignment of PDs is to be made ***without*** considering the factors that differentiate the risk of default ***to the bank*** (consistent with the NPR's default definition) from the borrower's generalized default risk.

In cases where the only exposure to the bank has the characteristics that mitigate default risk and indicate a low PD, the bank should use this information to assign the PD. The bank does not expect to observe a default, and assigning a PD based solely on borrower characteristics will result in significant differences between attributed and actual behavior. However, even though the bank will "fail" the back test, the rules prohibit it from correcting the error by recognizing that factors other than the borrower's generalized default risk should be used to assign the PD.

Real World Examples. The following example highlights this inconsistency. The definition of a non-recourse loan is one in which the remedy available to the lender in the event of the borrower's default is to foreclose on the collateral; the borrower is not personally liable for repayment. In effect, the rule as written says that one can consider only that which is not relevant for repayment when assigning default risk.

The rating process must consider the facts of each specific case, not simply use one-size-fits-all rules that do not always apply. If a high net worth borrower took out a non-recourse loan with a 99% LTV, this rule would say that we must assign a very low PD based on the borrower's creditworthiness. This would be incorrect.

Similarly, if a loan to a municipality is to be repaid solely from the cash flows from, say, a parking deck and there is no recourse to the city, the borrower should be recognized as the parking deck even if the legal entity on the loan agreement is the city. Given the terms of the agreement, the city would clearly not be in default on all of its obligations if the loan to support the parking deck defaulted, and it would be terribly confusing for the Basel system to report the other loans as being in default. In cases such as this, it would be appropriate to assign different PDs to the various entities responsible for the loans, even if a common legal entity is on paper as the "borrower."

Further, commercial real estate borrowers are typically entities that own only the property being financed (the collateral). But the rule states, "a bank may not consider the value of collateral pledged to support a particular wholesale exposure (or any other exposure-specific characteristics) when assigning a rating to the obligor." Without considering the existence of the collateral and its ability to generate the cash flow to repay the loan, the resulting grade would indicate far higher risk than is appropriate. We note that one should not assign PDs based on a ***secondary*** repayment source of selling illiquid collateral, because the delay in repaying the loan in such cases would produce a clearly observable default, but the rule as written is far broader than this reasonable case.

This is not to argue that one should assign PDs based solely on the cash flows from a "specialized lending" asset ***if*** the borrower carries ***additional*** default risk. In such a case, the borrower PD would be relevant, because a borrower bankruptcy would typically trigger a default. In practice, however, a single purpose entity would typically own the property and borrow the money, insulating it from the sponsor's risk. The

wholesale rules show some realism on this matter when dealing with borrowers operating in multiple jurisdictions. A "country" event could provoke a default on part of the borrower's exposure that is dependent on the country for repayment – a currency freeze, for example. Different PDs are permitted in this case. This thinking should be used when considering other situations wherever the borrower risk associated with individual credits is not the same for all the borrower's exposures.

A further example of the rules being applied too mechanically, even when they don't apply, would be situations in which all the borrower's loans were secured by liquid financial collateral. These cases are similar to margin loans but do not meet the technical requirements as "eligible margin loans." In such cases, empirical analysis shows that the bank will not experience default at a rate close to the rate assigned to a borrower whose loans are not secured by liquid financial collateral. The borrower will – before becoming 90-days delinquent – almost always ask that the collateral be liquidated to repay the loan. Even if a borrower were to become 90-days delinquent, since the bank will by that point act to sell the collateral (and the borrower cannot prevent it), the loan is unlikely to be put on non-accrual, since the bank is in process of liquidating the collateral and collecting what is owed. Without a recorded default, the bank cannot measure these situations as defaults. Default is avoided because the bank has structured the loan to mitigate default risk. Still, the bank is prohibited from reflecting this behavior in assigning PDs. Back-testing will not validate rates assigned as if the default risk were not mitigated.

Yet another case concerns implicit support as described in Standard 2-11. Rather than prescribing that ***all*** of the conditions in Paragraph 35 be met in order to recognize a benefit for implicit support, a bank should simply be required to demonstrate that it has complied with the principle that, "In determining an obligor rating, a bank should consider key obligor attributes, including both quantitative and qualitative factors that could affect the obligor's default risk,[1]" and that it has exercised judgment prudently. Factors to consider include the items listed.

S 2-7 A bank's rating policy must describe its ratings philosophy and how quickly obligors are expected to migrate from one rating grade to another in response to economic cycles.

Rating Policies Should Emphasize Principles. Wachovia advocates an emphasis on principles over prescription in this area. Accordingly, we would expect to satisfy the Standard with a high level discussion such as that ordinarily deemed suitable for a broad policy statement. However, if the agencies expect the Standard to require a bank's rating policy to provide quantitative analysis of ratings migration, we would consider that inappropriate. Moreover, diversity of borrower industries, geographies, and risk mitigants creates a wide range of migration outcomes in the face of shifting economic conditions. It would be impractical to gauge and validate how any single segment of borrowers would migrate under such circumstances.

[1] *Federal Register*, Vol. 71, No. 185, September 25, 2006: p. 55845.

S 2-12 Banks must have a loss severity rating system that is able to assign loss severity estimates (ELGD and LGD) to each wholesale exposure.
S 2-13 Banks should have empirical support for their loss severity rating system and the rating system should be capable of supporting the quantification of ELGD estimates (and LGD estimates if approved for internal estimates).
S 2-14 Banks must have a sufficiently granular loss severity rating system to group exposures with similar estimated loss severities or a process that assigns estimated ELGDs and LGDs to individual exposures.

There are multiple problems with the approach proposed in the NPR.

ELGD Plus Downturn LGD – Too Complicated, Burdensome and Costly for No Benefit. The need for a separate downturn LGD brings added cost without commensurate benefit and is not required by the International Accord. The Basel formulas compute a total capital requirement that separates the total into an EL component, covered by ALLL, and a minimum required capital component, covered by Tier 1 and Tier 2 capital. The proposal exacerbates the problem of disallowed ALLL. With EL computed based on the smaller ELGD, the portion of the ALLL used to offset EL is smaller. This leaves a larger excess ALLL, raising the likelihood that some will exceed the limit and be excluded from Tier 2 capital.

Virtually no bank tracks both LGD and ELGD, and it appears that neither parameter corresponds to what banks use internally. The consequence is that banks will be forced to track several LGD parameters: internal LGD, Basel LGD, Basel ELGD, and another Basel LGD without certain credit risk mitigants, etc. The resulting multitude of risk grading computations will be onerous and expensive.

Further, **the definition of downturn LGD is sufficiently vague as to make it unlikely that any two institutions will interpret it the same way**. We seek clarification as to the degree of severity embedded in this measure. If the intended downturn is too severe the measure will not be reliable – modeling of periods outside of a reasonable range is unreliable given anyone's data. Such extrapolations require a strong assumption about the shape of the relationship beyond the observed range, which is simply conjecture. However, if the intended downturn is reasonable (*e.g.*, at the 80th to 90th percentile of annual LGD rates) then our default-weighted average measure is already appropriate, as it is matched to this level of defaults.

Supervisory Mapping Conundrum. Another concern with the ELGD to LGD mapping formula is that no bank can "prove" that its internal measure is consistent with the downturn point because the target downturn point is not clearly defined. Consequently, the mapping function will likely be automatically required. This is a problem because the mapping formula disproportionately penalizes low ELGD exposures. For example, a loan with a 10% ELGD will have a mapped LGD of 17%, representing an increase of 72%. Meanwhile, a 45% ELGD loan will require a mapped

LGD of 49%, reflecting only a 9.8% increase. This is true even when the driver of the low LGD is not related to cyclical factors, such as being secured with high-quality assets that show no logical connection to the business cycle (such as government receivables, CDs, etc.). The formula is another instance of the U.S. rules rendering it more difficult for U.S. banks to undertake low–risk business than foreign competitors.

If applied inappropriately, the proposed LGD derivation rule may result in excessive cyclical effects for some banks. If a bank uses point-in-time characteristics (such as loan-to-value) in assigning ELGDs, the values for that parameter will be cyclical. On the other hand, LGD as defined in the NPR should not be cyclical, as it represents the value expected during a downturn. (We believe it is more appropriate to simply use a single, conservative, default-weighed average LGD for what the NPR divides into LGD and ELGD.) Yet if a bank applies the LGD ***formula*** to ELGD to get LGD, LGD will be just as cyclical as ELGD.

In a similar way, the downturn LGD parameter will also create inequities across banks that employ different grading practices. For example, a bank using a point-in-time grading policy will regrade a loan during a downturn and raise the LGD (and PD) because of the higher LTV. It would then need to apply the stressed LGD (likely from the mapping function) on top of this. A bank that employs a through-the-cycle grading policy with a constant default-weighted average LGD would have a fixed relationship between ELGD and LGD. Unless regulators permit the point-in-time bank to set LGD approximately equal to ELGD in a downturn, it is likely that the point-in-time bank will receive an unfavorable treatment (higher LGD) in a downturn than the other bank.

Again, **benchmarking among institutions will be important** to ensure that the application of the rules across firms with different grading approaches does not result in inequitable capital requirements.

Where data is scarce, banks should be permitted to use loss history and make reasonable judgments to decompose it into PDs and LGDs. **The focus of the rule should be getting the number right rather than pure mechanics.**

General Wholesale Comment – Inclusion of Small- and Medium- Enterprise Benefit.

The SME treatment should be aligned with the international Basel rules. All else held constant, smaller firms are relatively more susceptible to idiosyncratic factors than larger ones. For example, an SME would likely have less geographical diversification in its customer base and have less product diversification than a much larger firm. There is more idiosyncratic risk to be diversified away. As a consequence, a portfolio of loans to a large number of SMEs would likely have more diversification than a portfolio of loans to larger firms of similar rating.

As we recommended in our NPR response letter, issues such as this should be aligned with the international rules to maintain a level playing field among banks domiciled in different countries.

Chapter 3. Retail Segmentation Systems

S 3-1 Banks must use the IRB definition of default when identifying defaulted retail exposures.

Use The International Accord's Definition of Default for Retail Exposures. We believe the agencies should utilize the International Accord's definition of default for retail exposures where the obligor is past due more than 90 days. This would provide consistency regarding the definition of default (and align EAD and LGD, notwithstanding the U.S. LGD / ELGD treatment) among U.S. banks and those based internationally. The proposed criteria of utilizing the FFIEC definition of 120 days past due for closed-end retail exposures and 180 days past due for mortgages and open-end revolving exposures would create this inconsistency (despite instances of loss recognition or partial charge-offs of interest or fees at earlier times). If non-accrual is removed from the definition of default for retail exposures, banks' practice of writing-off accrued interest when placing a loan on non-accrual status would be ignored unless principal was concurrently charged off. Using events where the obligor is past due more than 90 days would provide a consistent definition that includes all components of EAD.

Chapter 4. Quantification

S 4-3 Banks must separately quantify wholesale risk parameter estimates before adjusting the estimates for the impact of eligible guarantees and eligible credit derivatives.

We oppose the requirement to separately quantify pre-CRM parameter estimates. This requirement is operationally quite burdensome, particularly for institutions that recognize the benefit of CRM in their grading process rather than through a simple substitution or adjustment at the last stage of the quantification process. For such institutions, this requirement means that they will have to grade each loan twice, once with and once without the CRM. If they use scorecards or other automated grading tools, they will have to maintain two sets of scorecards, one set with and one without the CRM. This is a uniquely U.S. requirement not found in the International Accord.

S 4-4 Banks may take into account the risk-reducing effects of guarantees in support of retail exposures when quantifying the PD, ELGD, and LGD of the segment.
S 4-5 Banks may only reflect the risk-reducing benefits of tranched guarantees of multiple retail exposures by meeting the definition and operational criteria for synthetic securitizations.

We oppose the interpretation of this requirement, as presented at the April 18, 2007 RMA Guidance Clarification Meeting with the agencies, as it mandates that all retail loans with tranched guarantees must be analyzed under the securitization treatment. Such tranches will not have direct or inferred ratings and would be subject to the more

operationally burdensome Supervisory Formula Approach. Instead, an option to ignore the guarantee should be granted so that they may be treated under the basic retail rules.

Wachovia also opposes the approach of recognizing only PMI guarantors. Other loan products, such as privately insured student loans, have comparable guarantor structures that have the same benefits as PMI. We do not agree that PMI should be treated as having NO counterparty risk while other guarantees are treated as having NO double default benefits. This treatment results in, for instance, privately insured student loan rates computed as if a guarantor default would result in a default ***for every single guaranteed loan***. It is unreasonable to assume that all or even a large portion of a guarantor's underlying exposures would default in the event of a guarantor default.

S 4-18 Effects of seasoning, when material, must be considered in the PD estimates for retail portfolios.

We generally agree with the approach described in the NPR to use an annualized PD as the input parameter for retail loans. Annualizing PDs avoids the understatement of risk that would result if temporarily low PDs were assigned to new loans when higher default rates are expected after the seasoning period. In that case, any slowdown in originations would result in a predictable but unaccounted increase in the portfolio's default rate. Further, among segments with the same next-12-month loss rates, negative migration will produce greater value declines for those with higher lifetime loss expectations.

We note that **the Guidance on immaterial seasoning appears to overlook key risks.** Stating that seasoning effects may not be material if a retail subcategory's age distribution remains stable could mask significant seasoning effects. In such cases, the unseasoned loans could use their initial, low, PD while remaining loans use their seasoned PD. The same unseasoned loans in another bank's portfolio will have to use their annualized PD – with the only difference being a judgment about whether the age distribution is stable enough or whether the portfolio mix is "too concentrated" in new loans, both of which terms are undefined. The latter bank could have a materially higher overall PD. Further, a bank could find that it makes "too many" new loans or has "too many" prepayments of old loans in some period, resulting in a concentration of unseasoned loans. It seems odd that the bank would have to switch methodologies based on what may be a modest shift in its loan mix. The exclusion should be limited to immaterial portfolios.

It would also be reasonable to permit the use of default rates computed with only seasoned loans as an approximation for annualized remaining-life default rates.

S 4-19 ELGD and LGD estimates must be empirically based and must reflect the concept of "economic loss."

S 4-23 Estimates of additional drawdowns must reflect net additional draws expected during economic downturn periods.
S 4-24 Estimates of additional drawdowns prior to default for individual wholesale exposures or retail segments must not be negative.

We can structure our analyses to align with this requirement. We note, however, that banks should have the flexibility to reflect additional drawdowns in either LGD or EAD, but not both, as this would be double counting. LGD estimates already take into account potential losses from additional draws. Both LGD and EAD have a linear effect on capital, such that a slight increase in EAD will be offset by a slight decrease in LGD. Again, we ask that supervisors apply a flexible, commonsense approach to this requirement, especially where there are few instances of post-default draws. In particular, many foreign-domiciled banks must comply with home country rules requiring EAD to be the balance ***at*** the time of default. Flexibility will allow them to avoid building systems around a second process that has little material effect on their results. Differences can and should be addressed in Pillar II.

In addition, there should be no mandate to include purchase accounting adjustments and similar amounts that may affect the loan carrying value to EAD. Banks should have the option to hold 100% RW for such adjustments.

S 4-20 ELGD estimates must reflect the expected default-weighted average economic loss rate over a mix of economic conditions, including economic downturn conditions.
S 4-21 LGD estimates must reflect expected loss severities for exposures that default during economic downturn conditions, and must be greater than or equal to ELGD estimates.
S 4-22 A bank may use internal estimates of LGD only if supervisors have previously determined that the bank has a rigorous and well-documented process for assessing the effects of economic downturn conditions on loss severities and for producing LGD estimates consistent with downturn conditions. The process must appropriately identify downturn conditions, identify the impact of economic downturn conditions on loss rates, identify any material adverse correlations between drivers of default and LGD, and incorporate any identified correlations and/or downturn impact into the quantification of LGD.

As stated in our NPR response, we believe that a single LGD parameter should be specified as in the international rules. A requirement to stress LGD parameters beyond a prudently conservative forward looking default-weighted average adds unnecessary conservatism beyond the international rule set. Wachovia's existing LGD parameter is a conservative default-weighted average measure that already reflects downturn conditions. Furthermore, since the rules for calculating internal downturn LGDs are ambiguous, regulators could err on the side of caution and disallow a bank's downturn LGD in favor of the mapping function, which fails to distinguish between situations where LGD varies with the cycle and those where it does not.

If applied inappropriately, the proposed LGD derivation rule may result in excessive cyclical effects for some banks. If a bank uses point-in-time characteristics (such as loan-to-value) in assigning ELGDs, the values for that parameter will be cyclical. On the other hand, LGD as defined in the NPR should not be cyclical, as it represents the value expected during a downturn. (We believe it is more appropriate to simply use a single, conservative, default-weighed average LGD for what the NPR divides into LGD and ELGD). Yet if a bank applies the LGD ***formula*** to ELGD to get LGD, LGD will be just as cyclical as ELGD.

S 4-25 Quantification of the risk parameters should appropriately recognize the risk characteristics of exposures that were removed from reference data sets through loan sales or securitizations.

We agree that recognition of removed exposures is important, as it has a significant impact on historical default rates. We believe that some of the inappropriate prescriptions would be unnecessary if one actually follows this Guidance for all loans that leave the portfolio, not only those that leave through a sale. Consider, for example, a case of 1,000 borrowers recognized as being high risk. Over a one-year period, 100 default, 400 leave the bank without defaulting, and 500 remain at the end of the year. (As borrowers seek to avoid default, it is not unusual for a high proportion of risky borrowers to pay down their loans and exit the portfolio; a 40 percent withdrawal rate is reasonable.) One could make several assumptions about the default rate of such borrowers in order to compute an annualized default rate for the entire cohort of borrowers. One could assume during the remainder of the year:

- none of them defaulted after leaving the portfolio
- they defaulted at the same rate as those who could be observed because they remained in the portfolio
- they defaulted at some other imputed rate.

The differences are material. In the example, assuming that none default produces an observed default rate of 100 / 1000 or 10 percent. Alternately, one could assume that the censored borrowers left evenly throughout the year. On average, 200 were not available to default, so the effective denominator would be 800. Assuming that the censored borrowers defaulted at the same rate as the others produces an annualized default rate of 100 / 800, or 12.5 percent. ***The difference is 25 percent.***

We are ***not*** asking that regulators prescribe a single approach to handling withdrawn borrowers, but we do ask that the agencies state principles around withdrawn observations consistent with accepted statistical methods.

Further, the regulatory requirement to use unit- or account-weighted default rates (as opposed to dollar-weighted default rates) is **an example of prescriptive rules that could force a bank toward an inappropriate number.** While we agree that unit-weighted rates are generally preferable (since a few large exposures could disproportionately influence dollar-weighted results), this is not always true. For

instance, if there is a size-related bias in the rates, the dollar-weighted answer may be a better estimate of future portfolio losses than the count-weighted result. **Banks should identify and apply whichever method produces the most meaningful result under the circumstances.**

A simple example illustrates the point – assume two segments with loans having the same exposure amount in each segment, but no observable characteristics to indicate a credit quality difference:

1st segment has 1,000 loans, each having $100K of exposure. Total exposure = $100M. 30 loans ($3M) are bad.
Unit and $ based PD = 3%.

2nd segment has 1,000 loans, each having $10K of exposure. Total exposure = $10M. 10 loans ($100K) are bad.
Unit and $ based PD = 1%.

Combining the two segments results in different unit vs. $ based PDs:
(30+10)/(1000+1000) = 2% unit based PD
($3M+$0.1M)/ ($100M+$10M) = 2.82% dollar based PD

If a bank utilized a unit-based approach for measuring PD in this example, it would understate its Expected Loss and ALLL needs.

Expected loss = PD x LGD x EAD

$ based PD ($ default/EAD) ($ loss/$ default) (EAD)

Unit-based PD (# defaults/# loans) ($ loss/$ default) (EAD)

Chapter 5. Wholesale Credit Risk Protection

S 5-2 Banks must ensure that credit protection for which risk-based capital benefits are claimed represents unconditional and legally binding commitments to pay on the part of the guarantors or counterparties.

Underwriting processes will be slowed significantly if all guaranteed exposures first require a full legal compliance review. An onerous legal review process may discourage banks from relying upon this proven risk mitigant – clearly an undesirable outcome from a policy perspective. Such credit protection should be allowed so long as banks can demonstrate its sufficiency.

Chapter 7. Controls and Validation

S 7-5 The systems and processes used by a bank for risk-based capital purposes must be consistent with the bank's internal risk management processes and management information reporting systems.

We fully support this fundamental Basel II concept, but in our view the Guidance itself contradicts it. We prefer that the systems and processes used for risk-based capital be the same as those used internally. However, if the regulatory rules diverge significantly from best practice then Basel becomes merely a compliance exercise.

We believe the NPR rules and Guidance have become too prescriptive to allow any bank to conform to them for everyday risk and capital management. The NPR rules deviate from internal practice and are in many cases outdated or otherwise less than standard industry practice. Deviations include the detailed methodology for grading assignments, use of stressed LGD parameters, and exclusion of important credit risk mitigants. We believe that the regulatory community should encourage the use of better methodologies for risk rating and segmentation and then permit the use of these internal numbers, as envisioned in the international framework. This concept was the very basis behind developing the AIRB approach. Over time, the role given to internal systems should grow. Imposition of prescriptive rules works against this objective because regulatory systems won't improve and evolve; internal systems will improve, and the gap between them will grow over time.

S 7-6 Internal audit must, at least annually, assess the effectiveness of the controls supporting the IRB system and report its findings to the board of directors (or a committee thereof).

The requirement to annually assess the effectiveness of controls supporting the IRB system is unduly prescriptive and burdensome. Internal Audit should be allowed to use a risk-based approach to determine the frequency of control assessment. Controls should be assessed on a periodic basis according to an audit cycle established based on underlying risks.

Please refer to our responses to Operational Risk Standards 4, 5, 10 and 32 where we discuss this and related concerns.

S 7-14 Banks should establish ranges around the estimated values of risk parameter estimates and model results in which actual outcomes are expected to fall and have a validation policy that requires them to assess the reasons for differences and that outlines the timing and type of remedial actions taken when results fall outside expected ranges.

Practices to implement this Standard will develop over time. One needs to distinguish between idiosyncratic errors (which are to be expected), cyclical variation (which will systematically raise or lower rates compared to long-term averages), and bias (which must be identified and corrected).

Chapter 8. Stress Testing of Risk-Based Capital Requirements

S 8-1 Banks must conduct and document stress testing of their advanced systems as part of managing risk-based capital.

We support stress testing as a prudent form of risk management, but requiring it in the Pillar I Standards and Pillar II is redundant. Keeping stress testing under Pillar II – as part of the ICAAP – will better accommodate banks' different approaches without adding unnecessary prescriptiveness and burden.

Chapter 9. Counterparty Credit Risk Exposure

S 9-1 All transactions with a counterparty subject to a qualifying master netting agreement constitute a netting set and may be treated as a single exposure, otherwise each transaction shall have its risk-based capital requirement calculated on a standalone basis.

Wachovia asks that regulators refer to the comments delivered by Wachovia as well as the IIF, ISDA and LIBA on the NPR associated with this Guidance. Wachovia wishes to emphasize the following point:

- Firms should be permitted to calculate effective EPE at the counterparty - rather than netting set - level, as it is consistent with most firms' practices. Implementing the effective EPE calculations at the netting set-level will require significant investments by many firms, and is not likely to result in materially different parameter estimates.

S 9-3 Banks must use the same method for determining risk-based capital requirements for all similar transactions.

While this Guidance somewhat clarifies rules from the associated NPR, firms using IMM should be able to implement alternative models for select portfolios, such as complex structured transactions, new portfolios, etc. Output from such models could be conservatively applied to matrix-type netting sets as appropriate, including prior to the calculation of Effective EPE. The rules should not mandate that these constitute additional netting sets, particularly as the application of collateral across multiple regulatory netting sets, even though legally constituting one netting set, will become complex.

Chapter 10. Risk-Weighted Assets For Equity Exposures

S 10-1 Banks must apply the same methodology to like instruments.

Wachovia believes that this standard for banking book equity exposures is overly prescriptive and potentially narrows the applicability of internal models. We recommend a change that allows different methodologies to be used for different business units or legal entities, depending upon business model and materiality. For example, all private equities or all public equities can use either an internal model or a SRWA. However, the treatment must be consistent for all equity exposures of each category, they cannot be mixed. We believe that **there is value in having the option to assess capital in a different manner for different portfolios**, particularly if managing equity exposures represents a core business strategy for a given business unit as opposed to a tangential portfolio for another. We understand the regulators' concern with "cherry picking" beneficial capital treatment for one or more, but not all, portfolios, but this concern should be managed through the supervisory review process contemplated by Pillar II. The "all or nothing approach" of this Standard (as it is coming to be known) is unnecessary and in some cases inappropriate.

General Equity Comment – Inappropriate Treatment of Hedge Funds

As noted in our NPR response, Wachovia continues to object to the proposed treatment of hedge funds, described in the NPR as "fund investments with material liabilities." The proposed exclusion of investment funds with any material liabilities from the equity rules is not found in the international framework. Wachovia believes that hedge fund investments should be explicitly included in the equity exposure rules. We strongly oppose the treatment of hedge funds under the securitization rules, believing that this treatment will result in punitive capital charges and a misalignment of risk and capital.

Chapter 11. Securitizations

S 11-1 Banks must use the securitization framework for any exposures that involve the tranching of credit risk (with the exception of a tranched guarantee that applies only to an individual retail exposure).

A standard that requires utilization of the securitization framework for any exposure that involves the tranching of credit risk is highly inappropriate. Non-securitized tranched credit exposures risk rated by banks should be measured as credit risk. Some syndicated loan deals would technically trigger the securitization definition because of risk tranching, even though no special purpose entity exists and all creditors would experience default at the same time. For example, given a single loan agreement with A and B participations, the lenders would have identical default risk even if they will be repaid on different schedules or have different LGDs. The securitization approach is NOT appropriate in such a case. The securitization framework deals with correlated defaults and so should be applied where the underlying will have multiple possible defaults.

S 11-4 Banks that provide implicit support to securitization transactions must hold risk-based capital as if the underlying assets had not been securitized, and must deduct from Tier 1 capital any after-tax gain-on-sale resulting from the securitization.

We agree with the Standard, but it should not be taken to introduce new conditions that would alter the industry's current understanding of what qualifies for sale treatment.

S 11-6 The maximum risk-based capital requirement for all securitization exposures held by a bank associated with a single securitization transaction is the amount of risk-based capital plus expected losses that would have been required had the underlying exposures not been securitized.

We understand the requirement that gains on sales be deducted for regulatory capital purposes. However, credit-enhancing I/Os ("CEIOs") that are created through a bank's securitization activities without gains should not result in an overall increase in required capital compared to holding the exposures on balance sheet. Actual risk does not increase, and the process should not result in a punitive result. Regulatory guidance should limit the capital requirement, including the CEIO, to the risk-based capital plus expected losses that would have been required had the underlying exposures not been securitized.

The example below shows that capital held for a CEIO beyond the gain results in very uneven regulatory capital levels. In some instances, significantly more capital is required for the bank holding the securitization. In other scenarios with essentially the same economic risk, the bank is required to hold far less regulatory capital.

Suppose $1.0 million in loans is securitized and the CEIO is valued at $30,000. Once the securities are created, the bank adjusts its basis in accordance with FAS 140. The value of all combined interests is equal to that of the loans transferred into the trust. Since the CEIO is 3.0% of the total, the value of all the trust interests is adjusted to 100/103. As bonds are sold at par, the bank realizes gains. In this case, where everything except the CEIO is sold, the CEIO's value is essentially equal to the gain on sale, which has been added to capital. The gain would then be deducted from capital under the rule. Because all bonds are sold, no further capital charges or deductions are required.

However, if the bank chooses to sell only a senior tranche and thereby retain many of the bonds, little of the future margin income in the CEIO is realized and turned into capital. Yet the rules still require the bank to deduct the entire value of the CEIO from capital AND hold capital equal to k-irb. The total capital required is greater than if the loans were simply held on the balance sheet. The transaction is designed only to enhance liquidity, not to transfer risk, so little or no capital relief should be realized. However, the transaction should not increase required capital either.

If additional bonds were sold at a later date, the deduction of additional gains would offset the corresponding increases in actual capital, but the portion of the CEIO that was ***not*** a gain would go away, and the remaining capital requirement would be reduced, back to the level of k-irb. This reduction occurs with no reduction in risk, but the bank sees a reduction in the net capital requirement. We do not take issue with the requirement to hold dollar-for-dollar capital against the unrated CEIO, but we do believe it should count toward the maximum capital charge.

S 11-7 Banks must follow the specified hierarchy of approaches to determine risk-weighted asset amounts for all securitization exposures.

We have no issue with the hierarchy (RBA, IAA, SFA) beyond the issue identified in S 11-1. However, operational requirements listed in the Guidance for securitizations go far beyond the scope of regulatory capital measurement, are overloaded with detail and would impede banks' continuing leadership in this business. It is important that the Guidance does not become a checklist of additional operational, regulatory and other burdens placed on banks outside of regulatory capital measurement. Some examples of additional burden that go well beyond what is needed for Advanced IRB measurement include prescriptive policies, procedures and documentation requirements, numerous eligibility tests, IAA qualification hurdles, and a litany of expectations throughout the chapter, including the following requirements from Standard 11-2:

> **S 11-2 Banks should develop written implementation policies and procedures describing the allowed approaches, methods of application, and designated responsibilities for complying with the securitization framework.**
>
> *In addition to the IRB requirements, originating banks should maintain specific securitization policies and procedures including the appropriate accounting treatment for the securitization exposure (FASB 140, FIN 46R), pooling and servicing agreements for each securitization exposure...The central component is a full written description, or implementation guide, detailing each step in the process. The guide should include all key processes, such as identifying exposures, selecting approaches, documenting approvals and data elements, and establishing responsibility for oversight and quality control.*

(Further requirements and expectations are listed throughout the Securitization chapter.)

We request less prescription around these rules. It would be excessively burdensome to produce full documentation for each deal solely for regulatory purposes when comprehensive deal documents (for investors, not regulators) are already produced. We ask that program-level documentation in combination with deal documents be deemed sufficient for compliance.

S 11-9 The securitization transaction must have an external rating assigned by an NRSRO that fully reflects the credit risk associated with timely repayment of principal and interest.

Standard 11-9 makes sense; however, we oppose the two rating requirement for originated transactions (as opposed to one rating on purchased transactions), as the operational burden far outweighs any marginal benefit.

It is not necessary to have two ratings for every tranche. The rating agencies are completely independent entities whose ratings are relied upon publicly. Rating agency models do not contemplate who retains or holds a security, tranche, or other instrument; they simply use their resources to rate the risks of the underlying collateral and how that risk is structured to individual instruments. If one rating from a reputable agency is acceptable for securities held by investors, it should likewise be acceptable if the investor is also the sponsor or transferor. There are numerous structures where specific risk transference is the goal of the transaction. In these structures, because only one tranche is likely to be sold, the investor may be very comfortable in having only one rating. The added cost of another rating agency in these structures can significantly increase the overall cost to sell the risk since the true cost can only be spread over one investor.

Operational Risk

Supervisory Objectives and Approach

The Guidance states: "In performing their evaluation, the Agencies will exercise supervisory judgment in evaluating both the individual components and the overall AMA System. The NPR provides that the primary Federal supervisor may require a bank to assign a different risk-weighted asset amount for operational risk, to change aspects of its operational risk analytical framework (for example, distributional or dependence assumptions), or to make other changes to the bank's operational risk management processes, data and assessment systems, or quantification systems if the supervisor determines that the risk-weighted asset amount for operational risk produced by the bank is not commensurate with the bank's operational risk profile...."

Wachovia understands that a primary supervisor has the option of requiring a different risk-weighted asset amount for operational risk. However, Wachovia believes that the specific changes to a bank's operational risk analytical framework, processes and systems referenced in the text might be extremely disruptive. The full implementation of a bank's AMA System may take years. Once set in place, and approved during the Qualification phase, a bank cannot easily change components of its analytical framework, processes and/or systems, nor should it be expected to do so. Instead, changes that a bank's primary supervisory believes are warranted, to ensure the risk-weighted asset amount produced by the bank is commensurate with the bank's operational risk profile, should be limited to Pillar II. Thus, Wachovia requests deletion of the following language:

> *"... to change aspects of its operational risk analytical framework (for example, distributional or dependence assumption), or to make other changes to the bank's operational risk management processes, data and assessment systems, or quantification systems ..."*

"Systematic Process" and "Demonstrate"

The words "systematic process" and/or "demonstrate" are used throughout the Guidance for the AMA. If interpreted in the most conservative sense, these words can suggest a level of rigor and/or maturity of the operational risk discipline far beyond its actual stage in the evolutionary path. For example, "to demonstrate" could entail proving and providing clear and certain evidence. Operational risk measurement and management is still evolving and, in many cases, the best that can be reasonably achieved at this time is well-reasoned, thoughtful and well-documented consideration, rather than definitive demonstration.

It is important that **reasonability** be incorporated into the implementation of the AMA in the U.S., to reflect the complexity involved, stage of development, and the qualitative judgment that will be necessary in a number of areas. We believe that a practical implementation of Pillar I can serve as a catalyst for the development of operational risk management and measurement practices. Over time, this could lead to more consistency, greater transparency, increased comparability between institutions, improved disclosure, and more effective industry practice. Initially setting the bar beyond attainable reach, however, could lead to undesirable outcomes.

S 3 The bank must maintain effective internal controls supporting its AMA System.

The supporting text requires that internal audit assess the effectiveness of internal controls annually, continuing with "…Sound internal controls, assessed annually for effectiveness by internal audit, should also reduce the possibility of significant human errors and irregularities in internal processes and systems, and should assist in their timely detection when they do occur. The audit function's annual assessment is not required to assess all operational risk controls, but the scope of the assessment should be sufficient to assess the effectiveness of the controls supporting the bank's AMA System…."

The effectiveness of controls is assessed by internal audit on an ongoing basis and reported to senior management, based on approved audit plans. The requirement for a specific annual assessment of controls supporting the AMA system would be burdensome, with no discernible benefit.

The audit review schedule should be risk based and may occur more or less frequently than annually, as appropriate to the risk. Wachovia requests that the word "annually" be replaced by "periodically, as appropriate."

Please refer to our response to AIRB Standard 7-6, above, where we discuss this concern in the credit context.

S 4 The bank must ensure that the effective framework is in place to identify, measure, monitor & control operational risk & to accurately compute the bank's operational risk component of the bank's risk-based capital requirement. The board of directors must at least annually evaluate the effectiveness of, and approve, the bank's AMA System including the strength of the bank's control infrastructure.

S 5 The board of directors and management should ensure that the bank's operational risk management, data and assessment, and quantification processes are appropriately integrated into the bank's existing risk management and decision-making processes and that there are adequate resources to support these processes throughout the bank.

These standards entail significant changes from the ANPR Supervisory Guidance.

The expectation for the board of directors to annually evaluate and approve the effectiveness of the bank's AMA system, including the review of detailed supporting information, is too burdensome. In addition, inclusion of the newly defined term "AMA System" is far reaching and places an unreasonable burden of detailed involvement by the board. The Guidance should provide flexibility so the role of implementation monitoring can be balanced with current board duties and responsibilities.

S 10 The board of directors and management must receive reports on operational risk exposure, operational risk loss events, and other relevant operational risk information. The reports should include information regarding firm-wide and business line risk profiles, loss experience, and relevant business environment and internal control factor assessments. These reports should be received quarterly.

The supporting text states: "Comprehensive management reporting, geared toward the firm-wide operational risk management function and line of business management, should include…" several bullet points, among them: "changes in factors signaling an increased risk of future losses and …operational risk causal factors."

Practically speaking, this requirement cannot be met at this point in time or in the near future. In many instances, operational risk factors that led to a particular event cannot be uniquely determined retrospectively, let alone factors signaling an increase in future losses. Today, management relies on a series of diverse information such as RCSA and audit results, past loss experience, external events or scenario analysis to arrive at a judgment on the level of and change in risk. A change in the level of risk may signal future loss or it may signal a change in the frequency and severity of future losses. A direct relationship between a change in risk and future losses cannot be shown except for highly predictable routine losses where the amount of available and relevant data supports such a relationship.

Wachovia requests that the two bullet points referenced above under S 10 (i.e., *"changes in factors signaling an increased risk of future losses and …operational risk causal factors"*) be combined and replaced by *"where possible, changes in factors signaling an increased risk of future losses (for example, changes in causal factors)"*.

S 24 The bank's operational risk quantification system must use a combination of internal operational loss event data, relevant external operational loss event data, business environment and internal control factor assessments, and scenario analysis results. The bank should combine these elements in a manner that most effectively enables it to quantify its operational risk exposure. The bank should choose the analytical framework that is most appropriate to its business model.

The explanatory detail goes on to state "…Banks should be able to demonstrate (see Standard 30) the effect of each element on the operational risk exposure estimate. In cases where this is not possible, or where an element is not used as a direct input into

the quantitative model, the bank should calculate a benchmark estimate using that element individually."

The expectations outlined in the detailed language following S 24 exceed the current state of industry practice and are, thus, impractical. Because the four elements are used in combination to generate an estimate of exposure, the isolation of the impact of any single element is not always feasible or relevant. For instance, external data may be used in the model directly in order to generate a reasonable capital number and/or to bring stability to the exposure calculation. In this case, while it may be technically possible to model without external data, the results would not be meaningful. Similarly, the requirement to calculate a benchmark from an element not directly input into the quantitative model may not be feasible or relevant. For instance, if the result of a scenario analysis process is a set of stress losses, or the use of "well-reasoned, external data" as allowed for in S 20, the results cannot be used as a benchmark without employing some type of model to generate an aggregate loss estimate.

It would be reasonable to expect that banks can adequately explain the rationale for directly including or excluding each of the four elements in/from the calculation, without specifically requiring irrelevant calculations and/or the creation of benchmarks. Wherever the effects of a given element can be shown with relevance and without a benchmark, this could be required (e.g., an ex post facto adjustment of an initial exposure calculation to reflect Business Environment and Internal Control Factors).

S 26 In calculating the risk-based capital requirement for operational risk, management may deduct certain eligible operational risk offsets from its estimate of operational risk exposure. To the extent that these offsets do not fully cover expected operational loss (EOL), the bank's risk-based capital requirement for operational risk must incorporate the shortfall. Eligible operational risk offsets may only be used to offset EOL, not UOL.

The supporting text continues with "...While additional eligible operational risk offsets may be considered in the future, the Agencies' review of the implementation of AMA Systems indicates that banks so far have only been able to demonstrate that losses resulting from external credit card fraud or securities processing errors may meet the test of being highly predictable and reasonably stable..."

Wachovia believes that the eligibility for operational risk offsets should be allowed in all circumstances that conform to the criteria defined in the rule, and not limited to only the two examples identified.

S 27 The bank must employ a unit of measure that is appropriate for the bank's range of business activities and the variety of operational loss events to which it is exposed, and that does not combine business activities or operational loss events with different risk profiles within the same loss distribution.

Unit of measure is defined as "The level (for example, organizational unit or operational loss event type) at which the bank's operational risk quantification system generates a separate distribution of potential operational losses."

Wachovia interprets this standard to essentially preclude the use of top-down (i.e., single unit of measure) approaches due to the difficulty of demonstrating that a loss distribution estimated on a firm-wide basis does not combine business activities or operational loss events with different risk profiles within the same loss distribution. This implies that only "bottoms-up" approaches will be allowed. Greater flexibility and a willingness to consider a wide variety of modeling approaches should be the norm as the industry progresses along the requisite maturity curve. Currently, we do not believe "bottoms-up" (i.e., multiple units of measure) approaches should be a requirement for AMA approval.

A number of U.S. banks face significant challenges in selecting the "...appropriate (unit of measure) for their range of business activities and the variety of operational loss events to which they are exposed..." due to insufficient instances of operational risk loss events required for determining homogeneous distributions.

Focus on the Loss Distribution Approach in combination with unit of measure, as written, could place an undue weighting on the sample sizes of historical operational loss events. That is, unit of measure will be defined both on homogeneity of loss distributions and sample size, with the result that two banks with similar risk profiles, but dissimilar loss histories, could have different units of measure. In addition, the role of individual loss events in determining the statistical properties of these units of measure may be inadvertently and unwisely emphasized.

Wachovia believes this specific challenge demands more flexibility from the U.S. Regulators in reviewing the selection of the appropriate unit of measure for each bank and that bottom-up approaches should not be required for AMA approval. It would be an unrealistic expectation beyond practical application at this stage of industry evolution. Accordingly, we also suggest that the language of the NPR and Guidance be revised to reflect this flexibility.

In the definition of unit of measure, Wachovia believes the words "*distribution of potential operational losses*" should be replaced by "*measure for potential operational losses.*" In the text for Standard 27, Wachovia believes the word *"appropriate"* should be replaced by *"well reasoned given current data availability"* and that the phrase, "*...and that does not combine business activities or operational loss events with different risk profiles within the same loss distribution*", should be deleted.

S 28 The bank may use internal estimates of dependence among operational losses within and across business lines and operational loss events if the bank can demonstrate to the satisfaction of its primary Federal supervisor that the bank's process for estimating dependence is sound, robust to a variety of scenarios, and implemented with integrity, and allows for uncertainty surrounding the estimates. If the bank has not made such a demonstration, it must sum operational risk exposure estimates across units of measures to calculate its total operational risk exposure.

Wachovia believes this standard imposes a requirement that is unduly prescriptive, as well as unreasonably conservative (i.e., if a bank has not satisfied its primary Federal supervisor and must sum up all operational risk exposures). The current statistical techniques and approaches for determining dependence across operational risks are in the early stages of development, without the emergence of any commonly accepted approach or guidelines as yet. Industry practitioners continue to explore alternative approaches to modeling operational risk dependency. Given the available data, however, robust empirical tests that allow the differentiation between alternative approaches continue to be a challenge. The assessment of the appropriateness of dependency assumptions cannot simply and solely rely on empirical demonstration.

The specific proposal to sum the exposure estimates in the absence of required demonstrability has two fundamental drawbacks:

(i) It is unsupported by any empirical analysis and will result in a punitive and unrealistic increase in capital in almost any circumstance.

(ii) It provides the strongest disincentive for institutions to fully and appropriately investigate relevant units of measure. The potential for regulators to require the simple aggregation of capital across units of measure will drive banks to reduce units of measure to the lowest number possible consistent with the conditions outlined in S 27.

In the absence of sufficient sample of events (particularly tail events), the Guidance should permit banks to present theoretical or heuristic arguments for their individual views on dependence. Such arguments, if accepted, would constitute good use of sparse data and, simultaneously, be consistent with the original spirit of the AMA.

For these reasons, we strongly urge that the following language be stricken from the text: *"... the bank must sum operational risk exposure estimates across units of measure to calculate its operational risk exposure."* Instead, Wachovia believes a reasonable upper bound should be placed on dependence assumptions until sufficient data exists to support statistical tests of dependence.

S 30 The bank must document all material aspects of its AMA System. This documentation should include the rationale for the development, operation, and assumptions underpinning its chosen analytical framework, including the choice of

inputs, distributional assumptions, and the weighting across qualitative and quantitative elements.

The phrase "all material aspects" is too vague and places an unreasonable burden on the industry. Inclusion of all material aspects is implied in any event. Wachovia requests that this phrase, "all material aspects," be deleted. The ensuing language "...documentation should include ..." should suffice for the purpose of the Guidance.

S 32 The bank must validate, on an ongoing basis, its AMA system. The bank's validation process must be independent of the AMA System's development, implementation, and operation, or the validation process must be subject to an independent review of its adequacy and effectiveness.

The supporting text includes: "The verification and validation functions should annually assess and report to the board of directors on the adequacy of the overall AMA System ... The validation process should address model documentation, data sources, model assumptions, coding and mathematical computations, conceptual soundness of the approach, comparison of estimates to results of alternative quantitative and qualitative models, model performance evaluation, and out-of-sample testing. The validation process must also require the bank to periodically stress test its quantitative and qualitative models. Stress testing must include a consideration of how economic cycles, especially downturns, affect the bank's operational risk-based capital requirement...Appropriate reports summarizing the results of independent verification and validation of the bank's AMA System, including associated models, should be provided to the board of directors and appropriate management. The board of directors should ensure that senior management initiates timely corrective action where necessary."

The requirement to annually assess the adequacy of the overall AMA system is unduly prescriptive and highly burdensome. The verification and validation functions should be allowed to use a risk-based approach to determine the frequency of their assessment of the accuracy and integrity of the AMA system, control elements, as well as the scope and effectiveness of operational risk reporting. Assessment should be performed on a periodic basis according to a cycle established based on underlying risks.

Wachovia requests that *"ongoing"* be replaced by *"periodic and as appropriate."* Wachovia believes that there is no value in re-validating more frequently than annually when there has been no change or in the absence of change. Wachovia also recommends the addition of *"as appropriate"* to the sentence beginning *"The validation process should address..."* For example, given lack of data, robust out of sample testing may not be meaningful in most situations and therefore may not be appropriate under those circumstances. Additionally, Wachovia requests removing the requirement that stress testing include consideration of economic cycles. The maturity of operational risk management and measurement, even within industry leaders, does not make this requirement practicable at this time. Finally, Wachovia believes that the board of directors should have the discretion to delegate authority for the oversight of the

implementation and ongoing assessment of the AMA system to senior management, including analyzing the results of independent verification and validation of the bank's AMA system.

Pillar II

Wachovia supports the current flexibility and principle based approach of the Pillar II Guidance. The proposed ICAAP is generally reasonable, flexible and high-level. It is not, and should not be, overly prescriptive. We support the fundamental objectives of an ICAAP as laid out in the Guidance. However, the capital planning targets and goals developed under an ICAAP should address all meaningful measures of capital, e.g., economic, regulatory, tangible, and common. These capital targets should be determined by banks and discussed with supervisors.

Banks are expected to hold capital above minimum regulatory levels, commensurate with individual risk profiles. We recognize the need for a capital cushion, but note that it should depend in part on each bank's approach to setting its Pillar I numbers – the level of conservatism, philosophy around cyclicality, etc. Considerations should likewise include the relative magnitude of risks not explicitly measured (although implicitly included, at normal levels) in the Pillar I computations.

Banks should not be expected to perform a mathematical reconciliation between regulatory and economic (internal) capital, although they should have an understanding and ability to explain the differences.

The Pillar II Guidance states that "Generally, material increases in risk that are not otherwise mitigated should be accompanied by commensurate increases in capital." While it would be generally reasonable to align capital levels with risk when a bank changes its portfolio through the introduction of a new product or by targeting a different risk profile, banks may in other cases quite reasonably vary their excess capital consistent with their ICAAP. For instance, a bank's response to rising capital requirements due to a downturn in credit quality will likely include actions that lead to a smaller increase in risk than would occur without mitigation, but may also include managing the level of capital held over and above the minimum. One of the reasons for holding capital well above the minimum in times of good credit quality is to have adequate capital in stressed periods without having to raise additional capital under adverse market conditions. Further, excess capital may also be held for other strategic purposes (e.g., acquisitions), and banks may redeploy such capital from time to time consistent with safe and sound capital practices at a particular point in a credit cycle.

Finally, Wachovia believes that stress testing or scenario analysis should not be prescriptive and needs to be linked to risk management actions. We believe that stress-testing or scenario analysis should be bank specific, and not result in an identical set of stress tests across the industry.

We look forward to a renewed consultative process as we move toward an improved capital framework for all U.S. financial institutions. We are committed to working with the agencies to achieve our common objectives, and we appreciate the opportunity to comment on this Guidance. We invite you to contact us with any questions regarding the views expressed in this letter.

Sincerely,

Donald K. Truslow
Senior Executive Vice President
and Chief Risk Officer

cc

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