May 29th, 2007

To:

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Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., NW
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Docket # OP-1277
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Robert E. Feldman
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Regulation Comments
Chief Counsel's Office
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Attention # 2007-06
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Re: Supervisory Guidance for Basel II Implementation

Dear Sir or Madam:

Wells Fargo & Company appreciates the opportunity to comment on the Supervisory Guidance for Basel II Implementation. We are a diversified financial services company, providing banking, insurance, investments, mortgage and consumer finance from more than 6,000 stores. On behalf of our employees, customers, and shareholders we have a keen interest in the framing of the domestic implementation of the Basel II Accord and hope that the comments that we offer in this letter will be of assistance in providing solutions to the issues that exist in the current proposal.

Prior to commenting on details of the Guidance, we would like to emphasize our position on major points that we have articulated in the past. These fundamental principles remain unchanged in the context of the recently released guidance. We are generally supportive of introducing a more risk-sensitive regulatory capital scheme in the United States; we agree with the Agencies' assessment that the current scheme is outdated for many reasons. However, we continue to have several fundamental differences of opinion with the path on which the Agencies are proceeding and feel that certain aspects of the overall guidance must be changed in order for it to be acceptable.

In summary, we believe that:

- U.S. Implementation Should Return to the Principles-Based Intent of the Basel II Accord;
- The Agencies Should Conform U.S. Regulations to International Standards;
- Pillar II Disclosure Requirements are Onerous and Based Upon an Objective that is Unlikely to Succeed;
- Pillar III Disclosure Requirements are Inappropriate and Unnecessary; and
- The Agencies Should Resolve Inter-Agency Differences and Issue Comprehensive, Final Guidance as Soon as Possible.

These points are articulated in more detail below. Following these comments in **Appendix I** are detailed comments of a more technical nature on the Guidance.

U.S. Implementation Should Return to the Principles-Based Intent of the Basel II Accord

The original intent of Basel II was to allow banks to use flexible, risk-based approaches to identify the requisite capital for activities. To prevent this from being abused, Pillar II and Pillar III are intended to act as counter-balances. However, with over 500 pages of guidance to date, the Agencies' implementation of Pillar I has become entirely too prescriptive and is in stark contrast to the original supposition of Basel II – that each bank would be allowed to continue the use of its existing risk management practices, so long as they could be shown to have been effective over time. We believe the philosophical shift is unnecessary and counter-productive.

It is unnecessary because the Agencies continue to have significant powers under Pillar II that can be used to ensure that banks respond quickly to emerging problems and to any other concerns that may arise. The process of carefully evaluating a bank's approach to and execution of calculating required capital under a risk-based, principle-based approach is certainly challenging. However, with on-site examiners that are engaged in continuous supervision, complemented by specialists throughout the system, it is no more challenging than the ongoing supervision work done today. In addition, the limited number of mandatory and opt-in banks makes this an achievable task.

It is counter-productive because no matter how well-intentioned, a rules-based approach will always lag market innovations. Further, the broad scope of evaluating capital adequacy does not lend itself to a rules-based approach. In essence, calculating requisite capital for a firm is the distillation of the risks arising from all of its activities. This is a significant task for a single firm, but it is immense to contemplate specifying the process by which this will be done for an entire industry. Success in that endeavor would require that regulators comprehensively identify and specify the calculation methods for every activity undertaken by the top U.S. financial institutions – essentially every financial instrument in existence. In addition, it would require continual updating to reflect market innovations. We believe such an effort cannot be successful and will result in a series of rules that are incomplete and/or inadequate, will be made obsolete very quickly, and will not result in a risk-based framework. Doing so will cause banks to perform

two different calculations: a "regulatory" calculation based upon the rules, and an internal calculation, based upon industry best-practices, for business purposes. Divergence between these calculation methods is not in the best interest of a scheme that seeks to be risk-based.

Instead, we believe that within broad guidelines, approaches for calculating required capital should be left to market participants, who are in the best position to understand the myriad of risks they face. This approach has worked well in the past. For example, interest rate risk, similar to capital in that it is pervasive in a firm's activities, is now considered a well-managed risk in the Industry. This was accomplished through principle-based regulations and a close, interactive examination process between Industry and Regulators.

We urge the Agencies to simplify the U.S. implementation of the Basel II Framework and move forward under a principles-based approach.

The Agencies Should Conform U.S. Regulations to International Standards

The rule proposed by the Agencies is substantially different from the Basel II Capital Framework (the "Framework") agreed upon by U.S. and International Regulators in June 2004. In addition to the numerous prescriptions described above, we remain concerned that the NPR imposes a cumulative conservatism that is unwarranted given the substantial powers present in Pillar II. Ultimately, this will place U.S. banking institutions at a competitive disadvantage to foreign banks. Our major concerns include:

- A longer phase-in period (3 years in the U.S. vs. 2 years in Europe)
- Higher phase-in floors (95/90/85% in the U.S. vs. 90/80% in Europe)
- The imposition of a minimum leverage requirement
- Aggregate reduction in capital of no more than 10%
- Numerous prescriptive requirements that dramatically increase complexity and that always opt for a conservative approach (e.g. multiple definitions of LGD, no distinction for SME vs. Large Corporate Loans, etc.)

These differences will result in higher U.S. capital requirements for identical activities. Since capital is not restrained by national borders, the imposition of an uneven regulatory burden will cause business to flow outside of the U.S., threatening the prominence of U.S. Banking organizations among the world's largest and most profitable banks.

The intended purpose of many of these requirements seems to be the mitigation of unanticipated declines in capital levels. While certainly something to be mindful of, we think it important to make several key points:

- The results of QIS-4 are not a valid basis for implementing changes to the framework. This study was done with systems that were not fully developed, limited data and with limited oversight and guidance by the Agencies.
- We believe that in Pillar II, U.S. Regulators already have sufficient latitude to require higher levels of capital if needed. The use of this existent structure is preferable to continuing to promulgate rules-based, non-risk-based measures of capital adequacy.

- Imposition of a leverage floor seems prudent during the transition process, but in the long-term it should be evaluated based upon actual results. If the risk-based systems are functioning as intended, then this floor will not be necessary.
- The 10% aggregate limit is arbitrary. Therefore, breeching this limit is not a valid indication that the Framework is fundamentally flawed. Additionally, administration of this rule, given the wide latitude firms have in which to enter the parallel and transition phases, is very challenging and has not been specified by the Agencies.

In summary, we recommend that the Agencies conform the U.S. approach to the Framework, and rely on existing controls under Pillar II to ensure capital levels are not reduced below a prudent threshold.

Pillar II Disclosure Requirements are Onerous, and Based Upon an Objective that is Unlikely to Succeed

The Pillar II disclosure requirements seem to be designed to facilitate detailed comparisons across institutions. While this is conceptually sound, it is very difficult to implement practically, and we believe it is unlikely to succeed.

Many activities not contemplated by the Basel II Framework impact capital levels. For example, it is well understood that a firm's collection activities dramatically impact the performance of a portfolio. If two firms had an identical portfolio of loans, but substantially different collection practices, we would expect that while PDs would be identical, the LGDs would be different. No amount of comparative activities of capital data between the two institutions would be able to describe why the LGDs were different. This same concept extends to other practices as well, including portfolio management activities, operational processes, etc. Even if calculated using the same framework, results between and across banks could be materially different for justifiable reasons that could not be identified by detailed comparisons. Accordingly, we contend that detailed comparisons are of little or any value.

Historically, meaningful comparisons across institutions have been very challenging, both to the Agencies and to the Industry. Outside of very limited areas such as the Shared National Credit process where exposures are identical, we can think of few examples where gathering and analyzing cross-industry data has yielded practical results.

This comparison becomes further complicated should the Agencies follow our recommendation to become more, not less, principles-based. We urge the Agencies to dramatically scale back their plans for disclosure for the purposes of performing detailed comparisons across Banking organizations.

Pillar III Disclosure Requirements are Inappropriate and Unnecessary

We believe that the Pillar III requirements are not appropriate because public disclosure requirements ought to be set solely by those agencies that safeguard the interests of investors (i.e. the SEC, the FASB, and the rating agencies), not by Regulators who have neither the responsibility, nor the expertise to take on that role. Furthermore, such requirements seem

unnecessary to us because, quite outside of Basel, the market will dictate those elements of bank risk management disclosure that are most necessary to improve transparency.

The Agencies Should Resolve Inter-Agency Differences and Issue Comprehensive, Final Guidance as Soon as Possible.

We are sensitive to the size and complexity of this endeavor. However, we encourage the Agencies to redouble their efforts to effectively implement Basel II in the U.S. by addressing two issues that have contributed to the Industry's overall concern about this effort:

- First, we ask the Agencies to move forward quickly with clear, comprehensive, and final guidance. The repeated delays and uncertainties around implementation have added to the already high cost of implementation, and have placed us behind other Countries implementing the Framework.
- Second, while we appreciate the difficulties in harmonizing the different perspectives of each Agency, we urge the Agencies to commit their senior leadership to resolving differences in a clear and timely manner.

Sincerely,

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APPENDIX I – Detailed Comments on Guidance

In the following section, we elaborate on comments of a more technical nature.

1. Supervisory Mapping Function (ELGD/LGD)

S2–3 IRB risk rating systems must have two dimensions obligor default and loss severity corresponding to PD (obligor default), and ELGD and LGD (loss severity).
S4–21 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.
S4–22 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.

The assumption that ELGD*PD reflects expected losses (versus the Accord's LGD*PD) not only increases RWA, but also leads to a reduction in the applicability of ALLL (which can only be used to cover EL). The increase in RWA results in reduced ratios, thus a need for greater capital; the reduction of ALLL can lead to a slight increase in capital, but not sufficiently to counteract the RWA growth.

The resultant dissimilarity between the calculations of RWA and ratios (between the US Basel II rules and the Basel II Accord) negates any benefit of using Pillar III to compare US and non-US banks.

Our objections to the SMF are as follows:

1. The SMF is extremely punitive at lower ELGDs. For example, a 10% ELGD results in a 17.2% LGD. This difference is far more at ELGDs below 10%.
2. The all-or-none approach proposed in the US regulations hampers any model development. Internal LGDs can be used only if we have data for all the products in that loan sub-category. If not, the Supervisory Mapping Function needs to be used. This causes a disincentive to collect data to further model development.
3. The Basel II proposal specifies that LGD be computed at a high (99.9 percent) confidence level. This is already a stressed environment, so the reduction of Expected Losses through ELGD is unnecessary.

We, therefore, recommend that the regulators simplify the AIRB calculation by eliminating the ELGD/LGD difference.

2. Wholesale definition of Default

S2–1 Banks must identify obligor defaults in accordance with the IRB definition of default.
S2–9 Banks must have at least seven discrete obligor rating grades for non-defaulted obligors and at least one rating grade for defaulted obligors.
S3–1 Banks must use the IRB definition of default when identifying defaulted retail exposures.
S4–2 Risk parameter estimates must be based on the IRB definition of default. At least annually, a bank must conduct a comprehensive review and analysis of reference data to determine the relevance of reference data to the bank's exposures, quality of reference data to support risk parameter estimates, and consistency of reference data to the IRB definition of default.

We object to the 5% credit related loss in the definition of default. If a loan is sold at a 5% credit related loss, all the loans to the obligor must be marked as defaulted. However, the sale of the loan at a discount could be due to a variety of reasons. This is another situation where there is a divergence from the Accord. This will increase compliance costs for banks with international presence. This problem could be fixed by reverting to the definition of default in the international Basel II agreement.

3. Segmentation in Retail

S3–2 Banks must first place exposures into one of the three retail exposure subcategories (residential mortgage, QRE, and other retail). Banks must then separate exposures into segments with homogeneous risk characteristics.

While not articulated in the NPR or the Guidance, we understand that "regulatory preference" cites this section to prohibit calculating capital at the loan level. Although this is regulatory preference, we believe loan level risk measurement and capital attribution is a best practice. The Guidance only specifically mentions that a bank should have a clear and well-documented policy on aggregation of risk parameter estimates from individual exposures. Borrower level details and business decisions such as loan approvals, line increases and collections are available at the individual loan level. In addition, every major bank in the US uses retail credit scoring for retail default probability estimation, borrower by borrower. In a scenario where granular data was not available, we could perhaps understand the preference to aggregate loan attributes and then calculate capital. Furthermore, economic capital for a bank is calculated at the most granular, individual exposure level. We feel that this approach is the most accurate and representative form of capital measurement.

4. Timeline Schedule for Implementation

The transitional floors and the timing of the floors are a significant departure from the Accord. This divergence creates competitive inequities that favor non-US banks. We recommend that the US regulators adopt the international floors and periods.

5. Validation

S7–4 Validation activities must be conducted independently of the advanced systems' development, implementation, and operation, or subjected to an independent assessment of their adequacy and effectiveness.
S7–6 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).
S7–9 Validation processes for risk rating and segmentation systems, and the quantification process must include the evaluation of conceptual soundness, ongoing monitoring, and outcomes analysis.
S7–14 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.

The current proposal states that "A bank must have an internal audit function independent of business-line management that assesses at least annually the effectiveness of the controls supporting the bank's advanced systems. At least annually, internal audit should review the validation process, including validation procedures, responsibilities, results, timeliness, and responsiveness to findings. Further, internal audit should evaluate the depth, scope, and quality of the risk management system review process and conduct appropriate testing to ensure that the conclusions of these reviews are well founded. Internal audit must report its findings at least annually to the bank's board of directors (or a committee thereof)."

We believe that the use of the word "annual" as it relates to the review of the validation process is overly prescriptive and is not consistent with the accepted risk based audit approach executed by most Financial Services internal audit departments.

In our view, the word "periodic" would provide for greater flexibility in accommodating model validation reviews during business audits which are generally cycled based upon risk.

We are in agreement with the regulators on independent review of the system development, implementation and operation. We also understand the need for reviewing model development. However, we are of the opinion that the audit should be carried out comprehensively initially and thereafter in the case of significant changes. Auditing a system that has not changed significantly is an unnecessary overhead expense.

The path to a successful model needs to be documented in detail. We feel that every unsuccessful attempt to arrive at this model need not be documented though. For example, in one attempt, we

might want to exclude a particular dependent variable just to see the effect of this variable on the logistic regression. Subsequent models might include that variable. We shouldn't have to document this attempt. Risk parameterization is an iterative process, and only the rejection of the serious contenders should be documented. The standards should not specify how an institution models risk and validates its models, but instead should allow the institution to use its own processes – as long as it can demonstrate it has a reasonable approach.

6. Stress Testing

S8–1 Banks must conduct and document stress testing of their advanced systems as part of managing risk-based capital.

A clear distinction needs to be made as to whether Stress testing is a Pillar I or a Pillar II requirement. We strongly believe that this is a Pillar II issue. The purpose of including stress testing under Pillar I in addition to Pillar II should not be to artificially inflate capital levels. The guidance does not mention how capital is affected by the outcome of these stress tests. Stress testing under ICAAP should be sufficient to cover this requirement.

7. Equities

S10-1 Banks must apply the same methodology to like instruments.

Currently, the guidance allows banks with non-excluded, non-investment fund equity exposures to use either the (1) IMA for all equity exposures, (2) SRWA for all equity exposures or (3) IMA for public and SRWA for private exposures. This election is complicated by the fact that only the SRWA approach explicitly allows for non significant equity exposures to receive a risk weight of 100% (materiality test). If it is correct to infer that the IMA precludes materiality in its VAR-based approach, then the minimum risk weight that can be applied to any exposure under IMA would be 200%. Under this current menu of approaches, there are few advantages, due to the lack of materiality weighting, in choosing the IMA.

We propose that all non-investment fund exposures below the materiality threshold be risk weighted at 100%. The election of approaches should then only matter for those exposures above the materiality threshold. In lieu of this proposal, we would alternatively recommend that the minimum risk weight under the IMA calculation be changed to 100%. The goal is to bring the treatment under the different approaches in line.

S10-4 Internal models used to calculate risk-based capital requirements for equity exposures must be consistent with models used in the bank's risk management processes and management information reporting systems.

The current requirement that internal models be integrated within internal risk management is potentially limiting to the risk management process overall. It mandates that specific board resources (e.g. meeting minutes) be dedicated to assessing the models' role in risk management. These requirements would implicitly force the models' use rather than allow the use to be guided by the evolving needs of the bank. Furthermore, internal risk management is guided by a

confluence of other inputs and models. Therefore, any cause-effect relationship between the specific internal models and actual risk management decisions would be difficult to quantify. We recommend a more general set of guidelines as to how the models might best be used over time.

8. Securitization

S11-4 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.

Further clarification is needed as to what constitutes "implicit support". The current definition that "implicit support" is support that is outside the language of the original contract is too broad and appears to be a "catch all" of terms. More importantly, the requirement that in cases of implicit support, capital be held against the pool of underlying assets as if no securitization had occurred is too punitive. "Implicit support" allows for degrees of risk. In addition, the requirement would force banks to hold capital against assets from which they will have decoupled and transferred the benefits. Assuming that a more meaningful definition of "implicit support" is forthcoming, we would suggest a capital cap based on the quantified degree of implicit support provided.

S11-6 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 agree in principal that the capital treatment of securitization exposures should be no more than that of the underlying. The difficulty arises in allocating the forgone risk based capital of the underlying to an individual tranche. Though capital can be calculated for individual exposures-SFA-there is no subsequent link of underlying exposure to tranche. No guidance exists as to how to allocate the capital ceiling to each tranche held (i.e. most risky to least risky).

S11-7 Banks must follow the specified hierarchy of approaches to determine risk-weighted asset amounts for all securitization exposures.

The current hierarchy of capital approaches is restrictive. Banks should be given more freedom to choose approaches as long as the tenets of the chosen approach are adhered to. Consider the case in which a Bank has the underlying data to employ the SFA approach to all securitization exposures but can't because some of the exposures are sufficiently rated. The bank would then be forced to employ the RBA approach even though more granular exposure data was available. The rigidity of the hierarchy would move the bank to less granular information.

We suggest a selection, rather than hierarchy, to empower the bank to choose approaches that are both more appropriate and less burdensome.

S11-9 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.

The requirement that securitization ratings need to be routinely updated creates significant administrative burdens on banks to update the ratings on small and large exposures alike. The requirement-though obviously intended to force banks to periodically re-assess risk-is overly conservative since rating downgrades on smaller exposures would have less impact on the bank. Furthermore, no guidance has been provided as to how often these ratings must be updated.

We suggest that an exposure amount threshold be established below which rating updates would be deemed unnecessary. We also believe that early amortization triggers on smaller exposures will provide the necessary indicators of changes in the underlying portfolio, thereby mitigating the need for these routine updates.

S11-10 Banks should document the factors that support their use of the RBA.

We agree that banks should document the input factors for their RBA approach at the inception of the securitization. However, we disagree with the need to track this information throughout the securitization's life. Changes in the underlying inputs-for instance granularity, type of underlying exposure and name of NRSRO- will never be significant enough to materially impact capital.

We believe that the information provided at inception should be retained and not be subject to update.

9. Pillar II/ICAAP

With regard to the Pillar II/ICAAP guidance, the goal for regulators should not be to use these as a way to increase capital to a preferred level, but instead to aim for a review with respective banks as to what risks need to be addressed. There may be instances where Pillar II/ICAAP capital is less than Pillar I capital. The ICAAP requirements allow banks to identify risks unique to them and, as such, will lead to a better differentiation in the market. Nevertheless, the Pillar II/ICAAP guidance switches between open-ended guidance to very prescriptive requirements. As these are meant to guide banks, there must be discussion between the regulators and banks. Explicit statements of what has to be included should be removed from the Pillar II/ICAAP guidance.

Stress-testing of the ICAAP models is acceptable; however, as the models will already contain some stressed conditions, it is not believed that the (more) stressed ICAAP capital number needs to be reported as Pillar II/ICAAP capital.

The Pillar II/ICAAP requirements add to the prescriptive requirements of Pillar I, and may hinder acceptance on the part of the regulators, leading to a delay in parallel runs. The delay in getting the regulations (and guidance) finalized would put the U.S. banking industry at a further disadvantage to, say, the European banking industry.

Another issue is that some material risks assigned at the BHC level may be difficult to assign conclusively at the DI level. Furthermore, the expectation that not only will ICAAP influence *"...business decisions and overall risk management..."*, but also *"...be integrated with other*

management processes related to risk assessment, business planning and forecasting, pricing strategies and performance measurements" assumes that banks do not have successful processes in place; *"The primary use of an ICAAP is to provide an assessment of internal capital adequacy"* not to replace banks' processes. It is hoped that rather than adding ICAAP as another regulation on the U.S. banking industry, it replaces ICAAP-like banking regulations such as SR 99-18.