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From: James.Johnson@wachovia.com [mailto:James.Johnson@wachovia.com]
Sent: Wednesday, June 07, 2000 2:06 PM
To: regs.comments@federalreserve.gov; comments@fdic.gov;
regs.comments@occ.treas.gov; public.info@ots.treas.gov
Subject: Comment Letter for Proposed Risk-Based Capital Standards

Attahached is a comment letter from Wachovia Bank, N.A. regarding the proposed risk-based capital standards for recourse and direct credit substitutes. I will also mail a hard copy of this letter to each of the regulatory agencies via U.S. mail. If you have any trouble with this transmission, please call me at (336) 732-7332. Thank you for your consideration of these comments.
James V. Johnson, III (See attached file: fedcom2.doc)

June 7, 2000

Jennifer J. Johnson, Secretary
Docket No. R-1055
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Robert E. Feldman, Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Communications Division, Third Floor
Docket No. 00-06
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Manager, Dissemination Branch, Records Management and Information Policy
Attention: Docket No. 2000-15
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Re: Risk-Based Capital Standards; Recourse and Direct Credit Substitutes

Ladies and Gentlemen:

This letter is submitted on behalf of Wachovia Corporation and Wachovia Bank, N.A. (hereinafter collectively referred to as "Wachovia"). Wachovia Corporation is an interstate financial holding company with dual headquarters in Atlanta, Georgia and Winston-Salem, North Carolina, serving regional, national and international markets. Its member companies offer personal, corporate, trust and institutional financial services. Wachovia Bank, N.A., the principal subsidiary of Wachovia Corporation, has more than 700 offices and 1,300 ATMs in Florida, Georgia, North Carolina, South Carolina and Virginia.

Wachovia has reviewed the proposed rule for "Risk-Based Capital Standards; Recourse and Direct Credit Substitutes" (the "Proposal") issued by the member agencies (the "Agencies") of the Federal Financial Institutions Examination Council dated March 8, 2000. Wachovia appreciates this opportunity to comment on the proposed framework, and we hope that this letter will help to further clarify the Proposal and answer questions raised therein. Overall, Wachovia strongly supports the concept of updating the risk-based capital requirements to better reflect the underlying risks associated with securitized transactions and to encourage the reduction of risks taken in this activity.

Definitions and Scope of the Proposal

Recourse and Direct Credit Substitutes
Wachovia agrees with the premise that the underlying risk for "recourse" and "direct credit substitute" is essentially the same and should carry the same risk-based capital treatment. Also, we agree with the proposed definitions of recourse and direct credit substitute, and we believe that an equal capital charge for each will reduce anomalous use of direct credit substitutes. However, we caution the Agencies that the Proposal is different from the proposed Basel Capital Adequacy Framework, which continues to assign a 100% risk weighting to direct credit substitutes. Therefore, the Proposal would put U.S. banks on an unequal footing with international banks if the Agencies' efforts to convince Basel to conform with the Proposal are unsuccessful. While we appreciate the Agencies' efforts to persuade Basel to conform with the Proposal, we are nevertheless concerned about the uneven playing field that may result.

We believe that the 200% risk weighting is too high for recourse obligations, direct credit substitutes and traded asset-backed securities that are rated BB. First, the increase from a risk-weighting of 100% for BBB to a risk-weighting of 200% for BB does not accurately reflect the increased amount of risk between these two rating categories. Second, the 200% risk weighting does not conform with the 150% risk-weighting that has been proposed by Basel. We urge the Agencies to consider a lower risk-weighting for BB exposure that is based on empirical analysis, not an arbitrary number such as 200% or 150%.

Credit Derivatives
Wachovia agrees that credit derivatives should be included in the definitions of recourse and direct credit substitute. We agree also with the definition of credit derivatives that is contained in the Proposal.

Risks Other Than Credit Risks
Wachovia agrees that a capital charge should be assessed only against arrangements that create exposure to credit or credit-related risks. We note that this concept is very important in the discussion later in this letter regarding the Managed Assets Approach. As discussed below, the proposed capital charge for early amortization is related to risks other than credit or credit-related risk.

Implicit Recourse
Wachovia agrees with the historical position of the Agencies that when a banking organization provides implicit recourse, it generally should hold capital in the same amount as for assets sold with recourse. Because of the complexity of implicit recourse arrangements, we continue to support the view that implicit recourse is best handled on a case-by-case basis, guided by the general rule that actions demonstrating retention of risk would trigger recourse treatment of affected transactions.

Subordinated Interests in Loans or Pools of Loans
Wachovia agrees that holders of purchased subordinated interests are exposed to risks that are comparable to the risks retained by holders of retained subordinated interests. Under the current guidelines, a purchased subordinated interest receives the same capital treatment as an off-

balance sheet direct credit substitute while a retained subordinated interest is treated as a recourse obligation. We believe that this difference should be corrected in order to prevent banking organizations from taking advantage of the different capital treatment by swapping subordinated interests.

Representations and Warranties
Wachovia agrees that if representations and warranties function as credit enhancements to protect asset purchasers or investors from credit risk, then the representations and warranties should be treated as recourse or direct credit substitutes. Also, we agree with the Proposal, which focuses on whether a warranty allocates credit risk to the banking organization, rather than whether the warranty is standard or customary in the industry. However, we caution that representations and warranties are negotiated provisions, and that there are significant differences in the representations and warranties provided by various banking organizations. Therefore, a case-by-case approach to evaluating the credit risk assumed under representations and warranties may be appropriate. In addition to the case-by-case approach, standard guidelines are needed.

Reservation of Authority
Wachovia agrees with the proposal to clarify the authority of the Agencies to determine appropriate risk-weights, on a case-by-case basis, for novel transactions that do not fit well into the risk weight categories as set forth in the Proposal. We believe it is important for the Agencies to have this authority given the increasing complexity of securitization structures. We urge the Agencies also to use this authority to assign either higher or lower capital charges depending on the risk in a particular structure, and not simply use the authority to increase capital requirements. The proper use of this authority will encourage banking organizations to create structures that reduce risk. Finally, the Agencies need to take necessary steps to insure that similar transactions are treated similarly by all banking organizations.

Proposed Treatment for Rated Positions
Wachovia agrees strongly with the proposed use of external credit ratings to reflect more accurately the risk in recourse obligations, direct credit substitutes, and senior and subordinated securities held in asset securitizations. We believe that the Proposal represents a positive step toward providing banking organizations with a more accurate measure of the risks that are held, and it may also provide incentive to banking organizations to hold lower risk assets. We appreciate the Agencies' efforts to increase the number of rating categories from three, as proposed by the Agencies in 1997, to the five categories contained in the Proposal. However, we believe that the five rating categories still lack sufficient granularity to reflect accurately the true underlying risk in these assets. For example, the use of finer distinctions between rating levels would avoid anomalies where a small distinction between AA- and A+ would create a large (30%) difference in risk-based capital requirements. This shortcoming is readily apparent whether measuring risk by historical bond default rates, bank loan loss experience or market pricing practices. Therefore, we urge the Agencies to differentiate risk further than is suggested in the Proposal.

Based on the historically low level of losses realized in securitizations, it appears that the proposed risk weightings are somewhat high. We would encourage the Agencies to consider further the risk weights to be applied for each ratings level. Also, a further reduction in minimum capital requirements would achieve better the Agencies' goal of aligning capital requirements with the relative risks associated with a particular position. Wachovia will not comment further on this issue here because we will participate in the more extensive comments to be provided in the "*Multi-Seller Conduit Comment Letter*" dated June 7, 2000 to be submitted to the Agencies.

Wachovia believes that the rating agencies possess the independence, long-term track record and strong empirical data that is necessary for the use of credit ratings in assigning risk weightings. Also, the definition of "nationally recognized statistical rating organization" appears to provide adequate control over the qualifications of the rating agencies. However, we would caution that the exclusive use of external ratings may encourage increased rating agency shopping and could jeopardize the independence of the rating agencies, particularly when the single highest rating is applied.

Proposed Treatment for Non-traded and Unrated Positions

Wachovia commends the Agencies for proposing to permit banking organizations to utilize internal risk rating systems to apply the ratings-based approach to unrated direct credit substitutes in asset-backed commercial paper programs. We view this proposal as a positive step toward reflecting more accurately the true economic risks in securitized assets and in improving capital efficiency. However, the Proposal is very limited in allowing the use of internal risk rating systems only for direct credit substitutes and only for risk weights of 100% and 200%. The Proposal seems to be contradictory in that it defines direct credit substitutes and recourse obligations as having equal risk, but does not allow internal ratings of recourse obligations because they are deemed less likely to be of investment grade quality. We urge the Agencies to expand the allowed uses of internal risk rating systems.

An expansion of the allowed uses of internal risk rating systems would limit potential market disruptions caused by overloading the rating agencies. In addition, it would alleviate the risk of total dependence on the judgement of privately owned external rating agencies. Although additional work needs to be done in the banking industry in order to rely on internal risk rating systems, the industry will close the gap quickly once the new risk-based capital standards are adopted. We note that internal models already are well developed for the calculation of capital required for market risk in the trading portfolio.

The use of internal risk rating systems for allocation of capital will require enhanced regulatory oversight to ensure that internal systems are appropriate and consistent. Because of the complexity of models to be used for internal risk rating systems, the Agencies will need to provide sufficient and well trained resources for the initial validation and ongoing monitoring. The validation process should recognize strong internal processes, appropriate stress testing and strong management. Finally, the risk-based capital standards need to be responsive to change. In this regard, regulators will need to provide support for financial innovations that will enable banking organizations to reduce risk.

Because of the complexity inherent in the use of internal risk rating systems and the different approaches used by various banking organizations, Wachovia supports the concept of providing the Agencies with the flexibility to adjust capital requirements based on the quality of a bank's risk management. Internal models represent a tool for the management of risk; however, risk management is very dependent upon the quality of management and the underlying credit culture.

Effective use of regulatory oversight would allow the Agencies to decrease capital requirements for banks that demonstrate a strong credit culture and have proven risk management processes.

Managed Assets Approach

Wachovia disagrees strongly with the proposed 20% risk weighting for securitized assets that contain an early amortization feature. Our opinion is based primarily on the fact that the early amortization feature does not present credit risk to the seller. We agree that early amortization does provide a certain amount of liquidity risk to the seller; however, we do not believe that this liquidity risk should be handled through the risk-based capital framework. Any well-run banking organization has several alternatives available to it for managing its liquidity, and it also will have extensive contingency plans in place. Therefore, an automatic capital charge is inappropriate for these institutions that are well prepared for liquidity risks.

The Proposal raises the concern that the seller's interest in the securitized assets is effectively subordinated to the interests of the investors through the payment allocation formula applied during early amortization. We believe that the current regulatory treatment, to treat retained residual interests and subordinated interests as sold with recourse, is adequate for this risk. As a result, the securitizing bank must hold capital against the carrying amount of the retained interests as well as the outstanding amount of all senior interests, subject to the low-level recourse rule. There is no need for an additional capital charge on the seller's interest.

Finally, the Proposal raises the concern that the risks of early amortization can create incentive for the seller to provide "implicit recourse" to prevent an early amortization. We believe that the current regulatory authority, to impose a capital charge against banks that provide credit enhancement beyond any pre-existing contractual obligation, is sufficient to cover this risk. Wachovia will not comment further on this issue here because we will participate in the more extensive comments to be provided in the "*Master Trust Comment Letter*" dated June 7, 2000 to be submitted to the Agencies.

Wachovia appreciates the opportunity to comment on the proposed risk-based capital standards, and we compliment the Agencies on their efforts to date. Thank you for your consideration of these comments. We look forward to seeing the Agencies' revisions to the Proposal based on these and other comments.

Sincerely Yours,

James W. Smith, Jr.
Executive Vice President