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January 25, 2005

WACHOVIA

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Docket No. OP - 1215
Via EMail: *regs.comments@federalreserve.gov*

Office of the Comptroller of the Currency
250 E Street, SW.,
Public Information Room, Mailstop 1-5,
Washington, DC 20219
Attention: Docket No. 04 - 22
Via EMail: *regs.comments@occ.treas.gov*

Robert E. Feldman,
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC 20429
Attention: Comments
Via EMail: *comments@FDIC.gov*

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW.
Washington, DC 20552
Attention: No. 2004 - 48
Via EMail: *regs.comments@ots.treas.gov*

Re: Advance Notice of Proposed Rulemaking – Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital

Dear Sirs and Madams:

Wachovia appreciates the opportunity to comment on the Proposed Supervisory Guidance on Internal Ratings-Based Systems for Retail Credit Risk. We are likewise appreciative of the consultative process that has characterized the development of the proposed rules. In many ways the proposal reflects the concerns expressed by the industry during development. We look forward to continuing a constructive dialogue as we work toward implementing the new Accord.

While we are generally satisfied that the document describes good retail risk management and quantification practices, we believe it can be improved in several areas. The majority of our comments deal with the quantification of default rates and LGD rates. A few additional comments follow.

Default Rate Measurement

The document states that "For segments containing unseasoned loans, a bank should assign a higher PD estimate that reflects the annualized cumulative default rate over the segments' expected remaining life." This partition of loans into seasoned and unseasoned pools appears straightforward, but we find it raises some problematic computational issues.

Our practice for computing an annualized remaining life default rate is as follows:

$$Rate = \frac{PV(defaults)}{duration \times current\ portfolio}$$

We discount both defaults and balances to reflect the greater certainty around near-term default estimates. The key point, however, is that we reflect declining portfolio size in the denominator. Defaults decline in seasoned segments in large part because the portfolio shrinks. Computing the default rate as a percentage of a declining balance matches the EL charge with the spread income that will offset losses. The loss of good loans that leave the portfolio can significantly raise default rates.

Under the definition in the guidance, however, default rates for seasoned segments are to be computed using the *current* portfolio as the denominator. The instructions rightly prohibit dilution of the loss rate through the inclusion of new loans, but appear disconnected with the computation for annualizing default rates of unseasoned segments. Segments treated as "seasoned" will benefit from a larger denominator computed without considering that some loans will leave the portfolio during the next year. A segment with a constant default rate and significant prepayment activity will have a lower PD if it is handled under the "seasoned" rules than if it is handled under the annualized remaining life default rate rules.

Wachovia has the data and capability to compute default rates either way. We seek clarification or correction so that there is no "jump" in rates when transitioning from the unseasoned treatment to the seasoned approach. An easy solution would be to have all segments use the same approach.

The computation of annualized rates requires valid estimates of prepayments. In many institutions different groups forecast prepayments and credit losses. In any case, the guidance pays little attention to prepayment estimation, which will present significant challenges for anyone not now performing this analysis. These problems would be avoided by using a one-year default rate. With that approach, banks would plan for increases in capital as loans seasoned (if originations did not keep pace to maintain a steady mix of loans in the portfolio). Such considerations seem to fit Pillar II better than Pillar I.

LGD Issues

Attributed Costs Included in LGD

The Guidance requires that workout and collection costs for defaulted loans are to be included in computing LGD rates. Determining which costs should appropriately be attributed to credit losses requires that we look at how the rate is used. The LGD rate is multiplied by the default rate coming out of the capital computation. The LGD's contribution to loss varies with defaults. Therefore, it would be appropriate to include in the LGD rate those costs that vary with defaults. Direct costs, including the costs of a workout or recovery group apparently meet this criterion. Allocated overhead costs, on the other hand, do not vary with defaults. More defaults will simply spread overhead over more loans, lowering the unit "cost" of such allocations. Allocated overhead costs should therefore not be part of the LGD computation.

LGDs for Defaulted Loans

The Guidance distinguishes between the LGD for a defaulted loan and the "best estimate of expected loss" (BEEL) for the same assets. The latter concept appears to align with the write-down US banks take on defaulted retail loans per the FFIEC Retail Policy cited in paragraph 98. We interpret the former to be similar to the more general LGD rate computed at a pool or segment level. The proposed approach will require significant developmental work, and the benefit of this effort is unclear. LGD rates are to be developed at a pool level based on characteristics of the loans in the pool. When a particular loan defaults a partial charge-off is taken in accordance with accounting and regulatory rules based on an analysis of the specific collateral and other characteristics of that loan. Further analysis would be needed by all banks in order to determine Basel-compliant LGD estimates *given* the individually assessed write-downs already taken. Applying static, pool-level rates to loans without regard to their actual write-downs seems to have the perverse effect of yielding lower capital rates for the loans that needed higher charge-offs.

A more practical approach may well be to simply require a fixed capital charge for defaulted loans net of charge-offs already taken. We suggest using a 100 percent risk weight since the loans have already been written down to reflect the BEEL.

Stress LGDs

LGD estimates are to reflect economic downturn conditions. The guidance mentions several approaches for doing this, including using the average of loss severities during periods of high credit losses and making conservative assumptions to adjust severities taken from periods with no economic downturn.

We recognize that LGD estimates should consider the likelihood that losses during an economic downturn will be higher than in good times. We are, however, aware of no

generally accepted practice for making such an adjustment to observed LGD rates. We understand that the Basel Committee has established a working group to address the issue and that the working group will investigate ways of promoting consistency in LGD estimation. We hope that this process surfaces ideas worth pursuing. We intend to participate in this effort both through US regulators and through contact with the working group via industry associations, and we have recently submitted comments on the topic to the agencies.

We believe that several points deserve attention. First, the meaning of LGDs-from-a-period-of-high-credit-losses must be clear enough that it will be consistently applied from bank to bank. Second, the value of this LGD should truly be an expected value – even if it is an expectation conditioned on a part of the cycle. It should not be set so conservatively as to be a "worst case" outcome.

Further, to the extent that "stress" LGDs are intended to compensate for LGD estimates that are not risk sensitive, they should not be applied in the same way to both banks that have risk-sensitive LGD estimates and those that don't. For example, a bank that considers loan-to-value in assigning LGDs for real estate lending will likely see their estimated LGDs rise in a period of high losses as property values fall and they refresh the inputs to their model. Such a bank needs little or no additional adjustment for stress LGDs, while a bank using a single LGD rate that does not vary with loan-to-value would need to be more conservative relative to their observed average when assigning LGDs.

We also note that periods of high credit losses primarily produce more defaults – not only defaults with high losses but also more defaults for which there are low losses. Regulators should not necessarily expect that LGDs from periods of high credit losses would be significantly higher than default-weighted average LGDs. The latter, after all, are more heavily weighted with observations from periods with more defaults.

PMI and Other Guarantees

Private mortgage insurance is a guarantee to mitigate losses suffered on defaulted residential mortgages. Banks are instructed to reflect the benefit of PMI in LGDs for mortgages. For the QIS, no counterparty risk charge is to be assessed for the guarantor.

We note that private insurers also occasionally guarantee other retail products. One example of this is found in student lending. Wachovia's practice is to substitute the guarantor's default risk for the default risk of all the retail borrowers, and to assign an LGD based on a stressed EL for the underlying loans as if unguaranteed. Assigning an LGD based on the underlying loan (which might near 100 percent) would in effect assume that if the guarantor were unable to perform ***all*** the underlying loans would default and suffer near-total losses. Such a result is clearly far from reality. It is also completely inconsistent with the treatment offered for PMI, and we see no justification offered for the disparate treatment.

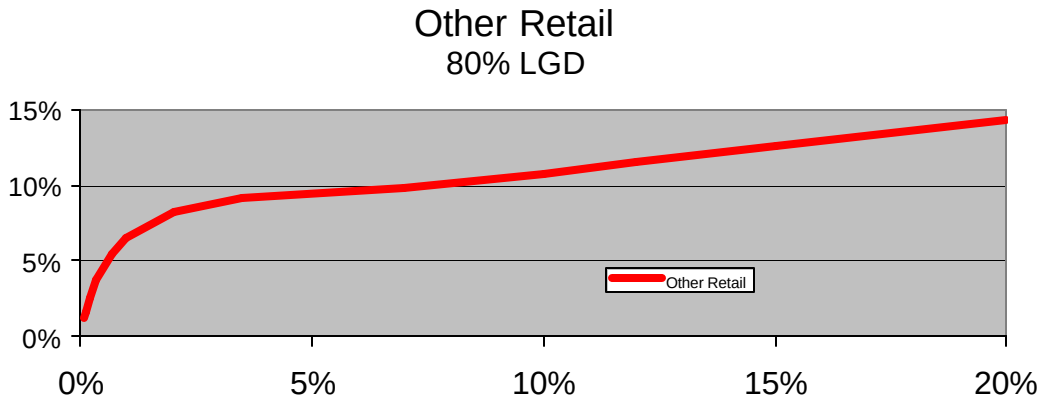
Additional Matters

Accrued Interest and Fees

As a practical matter, the way banks account for accrued interest (and fees) depends on the loan in question. For revolving credits, accrued interest is capitalized into the principal balance, while closed end loans typically maintain accrued interest in a separate account. Consequently, it would create a computational burden on banks to always account for accrued interest as a balance within the capital calculation. This is not to say that interest reversals should be ignored in computing LGD. Where accrued interest is not included in the defaulted balance, discounted recoveries should be reduced by any (undiscounted) interest reversals. (Losses for such loans could reasonably be more than 100 percent of the balance outstanding at default, not including interest.)

"Other Retail" formulas

While the capital formulas themselves are taken from the Basel Committee's capital framework, we cannot refrain from commenting on an obvious problem with the risk-weight function for "other retail" loans. The way that asset-value correlations decline with increasing PDs means that capital levels for this category is quite *in*sensitive to risk.



The declining AVC formula creates a misshapen capital function. The capital rate for loans with a 10 percent PD is little more than that capital rate for a loan with a 2 percent PD. Banks are in some ways encouraged to take on high-risk loans rather than low-risk loans. It is unclear why this class of loans would be both more volatile than mortgages at one PD level and less volatile than credit cards at another. The minimum and maximum AVC values should be brought much closer together.

Some of the difficulty around exposure assignment is a direct result of this anomaly. If a small business credit card receives an AVC of 15 percent while the owner's credit card gets a 4 percent AVC, the capital difference is significant although the risk difference is modest.

Again, Wachovia appreciates the opportunity to comment on this proposal, and we look forward to additional discussion about these matters.

Sincerely,

Russel Playford,
Executive Vice President
Credit Risk Management

Gary Wilhite
Senior Vice President
Credit Risk Management

cc:

Don Truslow, Chief Risk Officer, Wachovia Corporation
Dave Nole, Chief Risk Officer, Consumer
Bill Dawson, Chief Risk Officer, Capital Management and Wealth Management
David Brooks, Basel II Implementation Program Sponsor
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