March 26, 2007

WACHOVIA

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Docket No. R-1261

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219

Re: Docket Number 06-09

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Re: RIN 3064-AC73

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

Re: No. 2006-33

via Email

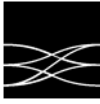
Subject: Comments on Joint Notice of Proposed Rulemaking for Risk-Based Capital Standards: Advanced Capital Adequacy Framework, 71 FR 55830, and

Comments on Joint Notice of Proposed Agency Information Collection Activities, 71 FR 55981 (both of the above dated September 25, 2006)

Preliminary 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

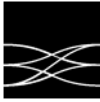
Comments on Joint Notice of Proposed Rulemaking for Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications (Basel IA), 71 FR 77446, December 26, 2006

Dear Sir or Madam:



Wachovia welcomes the opportunity to comment on these proposals. Our views are summarized below and discussed in more detail on the following pages.

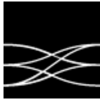
- Wachovia strongly supports the move toward risk-sensitive minimum capital rules and the international Basel framework as a path to improved safety and soundness.
- In response to premature conclusions from QIS 4, the U.S. agencies have backed away from an appropriate risk-sensitive capital system.
- The U.S. capital rules should include an AIRB approach harmonized with the international Basel framework so the rules are neither more harshly calibrated nor more prescriptive.
    - The prescriptiveness of the currently proposed rule significantly reduces its effectiveness and relevance and greatly increases the burden of compliance.
    - Pillar II provides all necessary controls to ensure that banks will hold adequate capital for their risks, particularly with full-time examiners engaged in continuous supervision at large banks.
    - Our concerns about prescriptiveness include not only credit risk, but the operational risk standards, too.
- The general capital rules for non-Basel II banks also should be updated and calibrated in harmony with the Basel II rules.
- The U.S. capital rules should allow banks to implement either the AIRB approach or the Standardized approach, with both aligned to the international Basel framework.



- U.S. domiciled banks should not be placed at a competitive disadvantage if they engage in low risk activities; current leverage ratio requirements should be revisited and relaxed as confidence develops in Basel II.
- Meaningful public disclosure requirements cannot be sufficiently defined or understood absent experience gained in the transition period; final details including the scope of public release should be developed at that time.
- The Basel II and Market Risk implementation schedules should be aligned.
- The repeated delays and uncertainties around this effort have added to the already high cost of implementation; we encourage the agencies to move ahead without further undue delay.

Wachovia welcomes this opportunity to comment on the Joint Notice of Proposed Rulemaking ("NPR") for implementing the Basel capital rules in the United States and related proposals. We have been a longstanding participant in the consultative process in the United States and internationally, and we are convinced that constructive dialogue produces better regulation. Financial institutions and regulators have a strong, shared interest in developing and maintaining effective regulation. It is important that regulators discuss their initiatives with the industry to improve the quality and effectiveness of regulatory policy, and this is especially true with complex regulations such as the proposed Basel capital rules.

However, the consultative process for Basel has fallen short of these objectives in the U.S. over the past two years. The agencies have not made adequate use of the experience found inside banks as they have moved toward a final rule. From our vantage point, the NPR has been developed without sufficient industry involvement to address the challenges that naturally occur along the road to significant advances.

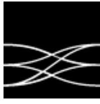


The NPR has, unfortunately, moved away from many of the principles contained in the Advanced Notice of Proposed Rulemaking published in 2003. It contains many changes from the international Basel framework, even though the need for such alteration is not clear. As then-FDIC Chairman Powell told the Senate Banking Committee in November 2005, "committing to specific changes to the framework at this time, without the benefit of further experience and industry systems development, would be premature."

Our response comprises several sections. First, we reaffirm our continued support for risk-sensitive capital requirements and for Basel II as a reasonable step in that direction. Second, we describe how U.S. capital rules under the NPR would veer from this objective (and from the framework that was agreed to in Basel and is being implemented around the world) in two vital areas: overall calibration and prescriptiveness. We also present recommendations as to how the U.S. capital rules could better move toward the promise of a risk-based framework. Finally, the appendix to this letter contains detailed responses to the questions asked in the NPR and related issues arising in the proposed rules.

Our concerns extend to the Supervisory Guidance for the NPR. Although we have not completed our analysis of the Guidance, our preliminary review raises further concern around prescriptiveness. We will file additional comments on the guidance at a later date, and we ask that those comments be considered alongside this material.

Wachovia has also filed a joint comment letter dated February 7, 2007 with other banks describing additional concerns with the NPR. We include those comments here by reference, although we will not repeat the discussion for the sake of brevity.



Wachovia strongly supports the move toward risk-sensitive minimum capital rules and the international Basel framework[1] as a path to improved safety and soundness. A risk-sensitive capital rule will require that capital is available where needed to protect against the risk of bank failures. Without a risk-sensitive system, the industry may appear to be well capitalized, even though some banks could be significantly undercapitalized for the risks they are taking.

A risk-sensitive capital system also recognizes that firms can as effectively enhance safety by taking less risk as by holding more capital. Less capital should be required for banks that choose a less risky business model and employ internal processes that show risks are identified, assessed, and well managed. As Comptroller Dugan said recently, "In cases where we can achieve an appropriate level of comfort that risk is truly reduced, then lower capital is warranted." [2]

Holding more capital spreads earnings over a larger base, lowering the return on each dollar of capital. Requiring excessive capital makes it more difficult for banks to earn an adequate return on their capital, with the risk that investors will move their capital to other countries or industries. Safety and capital efficiency are not trade offs: healthy banks are the best route to a safe banking system.

Risk is likely the more important focus in ensuring safety and soundness. In a study of bank failures in the late 1980s and 1990s[3], the FDIC's research department states, "As emphasized repeatedly in this chapter, however, bank capital positions are poor predictors of failure several years before the fact. If regulatory action were based solely on capital positions, in many cases such action might come too late to do much

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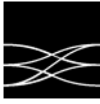
[1] All references to the international Basel framework refer to *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version*, found at http://www.bis.org/publ/bcbs128.htm

[2] Speech to Global Association of Risk Professionals, New York, February 27, 2007

[3] *An Examination of the Banking Crises of the 1980s and Early 1990s*, FDIC Division of Research, 1997. Available at http://www.fdic.gov/bank/historical/history/vol1.html

good."[4] The researchers identify the problem: "The ability of regulators to curb excessive risk taking on the part of currently healthy banks was (and continues to be) limited by the problem of identifying risky activities before they produce serious losses."[5] Basel II provides a key part of solving this problem through its risk-sensitive quantification.



A risk-based measure – where the degree of imprecision is limited by continuous on-site supervision in place at large U.S. banks – provides a better indicator of the need for capital than a fixed percentage that does not attempt to measure risk.

In response to premature conclusions from QIS 4, the U.S. agencies backed away from an appropriate risk-sensitive capital system. The Quantitative Impact Study performed in 2004 was described by the agencies as being on a best-efforts basis; it was performed before complete guidance was released to explain what information was being collected; there was little supervisory support to assist institutions in understanding whether they had interpreted the limited available guidance correctly; and banks were all in the midst of multi-year projects to adapt their internal systems to their best guess as to what the regulatory systems would ultimately require. Further, QIS 4 did not consider the practical implications of the credit cycle on Pillar II, which we discuss below.

Senior regulators themselves have publicly recognized that the need for rule changes will only become clear when banks and regulators can look at real results. For example, Comptroller Dugan told the Senate Banking Committee in November 2005, "We believe that certain of the concerns identified in QIS 4 will only be fully understood and resolved as the Basel II framework is implemented through a final rule, final supervisory guidance, and rigorous examiner scrutiny."

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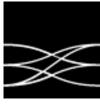
[4] FDIC, p 79
[5] FDIC, p 84



Unfortunately, the U.S. agencies reacted to QIS 4 with numerous changes, retreating from an appropriate risk-sensitive capital system and the international Basel framework. To correct this, the U.S. should return to the blueprint agreed to in Basel that is being put in place around the world.

The U.S. capital rules should include an AIRB approach harmonized with the international Basel framework so the rules are neither more harshly calibrated nor more prescriptive. Rules that set U.S. minimum capital requirements higher than those faced by other banks throughout the world will make it harder to compete with foreign-domiciled institutions. Prescriptive rules resulting in redundant systems used for compliance alone will raise costs for U.S. institutions compared to firms based in countries whose rules allow the use of internal systems, as envisioned in the international Basel framework. A recent study cited the regulatory environment – specifically an increasingly heavy regulatory burden and a complex, cumbersome regulatory structure – as a key factor in shifting business away from U.S. markets.[6]

The competitive consequences of overly harsh capital rules were described in the FDIC study cited above and are still true:

> If capital requirements are set too high, entry into the industry will be discouraged, competition within the industry will be weakened, and credit flows through bank and thrift intermediation will be reduced. A trade-off exists between the objective of restraining risk through regulatory capital requirements and the consequences of reduced competition among, and credit flows through, depository institutions. [7]

Aligning the overall calibration with the international Basel framework will ensure

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[6] *Sustaining New York's and the US' Global Financial Services Leadership*, pages 1:17 and 1:80, available at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf

[7] FDIC, p 80

that U.S. banks have a level playing field when competing against both investment banks and foreign banks.

The NPR contains several specific provisions that raise input parameters or even change the risk-weighted asset computations. Among the worst of these is the introduction of a formula for downturn LGDs, which appears to be a surcharge with particularly harsh consequences for loans that are well-secured and low risk. The bulk of our comments on specific provisions can be found in the appendix to this letter. As we consider these elements together, we are concerned that the goal for calibrating the input parameters has shifted from getting the numbers right to making sure the inputs are whatever is needed to produce no decrease in capital requirements compared to the current regime.

We are equally disturbed by the provision that the U.S. implementation will be made to produce even higher numbers relative to the international calibration if Pillar I numbers are more than 10 percent below Basel I requirements. The comparison is stated without regard to the business cycle, although a risk-sensitive framework ought to produce lower Pillar I requirements in the best parts of the credit cycle. Various studies[8] indicate that credit capital requirements will vary by 25 percent or more over the cycle. If the system is calibrated so that the minimum requirement will fall only a little in the best part of the cycle, it follows that capital requirements will actually rise in even a modest downturn in credit quality. Since banks do not want to raise new capital during a downturn, this situation effectively increases capital requirements for U.S. banks throughout the cycle. Setting capital requirements to be significantly higher than the current standard could lead banks in future recessions to take risk-reducing actions that are more stringent than indicated by their own analyses, exacerbating the economic cycle. In contrast to U.S. actions, the Basel Committee has

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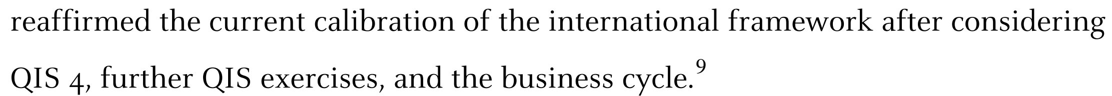
[8] Ervin & Wilde., *RISK*, October 2001; Catarina-Rabell, Jackson & Tsornocos. Bank of England, 2003; Jordan, Peek and Rosengren. FRB Boston, 2003; Rosch. University of Regensburg, 2002; Kashyap and Stein.FRB Chicago, 2004; presentation by large U.S. banks to regulatory agencies, 2005



reaffirmed the current calibration of the international framework after considering QIS 4, further QIS exercises, and the business cycle.[9]

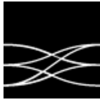
Wachovia, like other banks, operates with capital above regulatory minimums. This practice should in no way be taken to indicate that there would be no effect from setting the minimum at a level in excess of what is justified by risk, as long as the requirement remains below actual capital levels. In determining how much capital is appropriate for our business, we consider – among other things – the flexibility and other benefits produced by holding capital in excess of our regulatory minimum. This capital has significant value and should not be claimed by excessive regulatory capital rules.

The prescriptiveness of the currently proposed rule significantly reduces its effectiveness and relevance and greatly increases the burden of compliance. While the apparent objective of these many detailed rules is to ensure that results are comparable by mandating how banks should construct their processes and analyses, we believe this is the wrong approach, especially for the long run. Banking is a dynamic business, and risks constantly take on new characteristics as products evolve. The international Basel framework is designed to ensure that capital requirements respond to such developments by putting the onus on banks to develop and validate effective analyses for any new risks they take on.

Prescriptive rules will at best handle the risks that exist today. They will not keep up as innovations occur. The proposed rules are in some cases already out of date. Mandating their use will mean that banks will have to maintain two sets of analyses: one that remains current and is used to manage risk, and a second, outdated (but still expensive) system used solely for compliance. We must avoid the trap described by former Comptroller Hawke, who said, "We need to be cautious that Basel II does not stultify private-sector innovation by forcing banks to invest prematurely in a single

[9] *Basel Committee maintains calibration of Basel II Framework* at http://www.bis.org/press/p060524.htm

government-dictated approach that may not reflect the best practices that might otherwise evolve."[10]



Some believe that prescription is a price that must be paid for comparability. However, true comparability comes after the Pillar I numbers are reviewed in Pillar II, not before. Differences in approach will produce Pillar I numbers that legitimately differ from one bank to another. As written, the NPR requires banks to spend excessive amounts to comply with prescriptions that in many cases will have only a third- or fourth-decimal-place impact on the Pillar I capital requirement, while these other differences remain. The prescription adds significantly to cost while doing little to achieve precise comparability.

This is ***not*** to argue for more prescription. Mandating that every bank perform every analysis in exactly the same way would require rules so comprehensive and complex as to be unworkable. Innovation would be stifled, and since the key to effective risk analysis is matching the analysis with each bank's risk management processes, rules would have to extend to all the details of how banks conduct business.

Pillar II provides all necessary controls to ensure that banks will hold adequate capital for their risks, particularly with full-time examiners engaged in continuous supervision at large banks. Wachovia and numerous other financial institutions have been working for a decade or more to implement risk-based measurements for internal purposes. Banks have been diligent in applying these concepts to the real world, developing practical ways to deal with situations that often don't fit neatly into simple analyses. We use these systems to manage our businesses every day. Concurrently, supervisors monitor our risk management processes from end to end with large on-site examination teams, complemented by specialists from Washington and other sites who routinely visit banks and can compare practices and parameters

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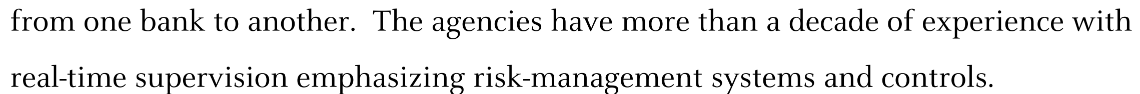
[10] John D. Hawke Jr., "The Road to Basel II: Good Intentions and Imposing Challenges," Remarks Made at the Risk Management Association's Capital Management Conference, Washington, June 6, 2002, available at: www.occ.treas.gov/ftp/release/2002-49.doc



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 ongoing review of risk and capital adequacy with senior management, they can ensure that banks are responding quickly to emerging problems. Each bank's Pillar I numbers must be interpreted during this process in light of the choices made in their development. The capital rules do not end with the Pillar I calculation; each bank's internal capital adequacy process is needed to complete the picture.

Aligning the Basel numbers with economic capital and other internal risk assessments – as envisioned during the development of the international framework – will complement and enhance discussions among regulators and banks. Disconnects between internal processes and the regulatory capital numbers will diminish the value of this review and will represent an important missed opportunity.

Our concerns about prescriptiveness include not only credit risk, but the operational risk standards, too. Given the maturity of the operational risk measurement discipline, we think the level of precision currently proposed for some standards is inappropriate and impractical. There is a notable lack of flexibility in the rules to allow for acceptance of viable modeling approaches to determine Units of Measure; the expectations for measuring Dependence seem unrealistic; and the restrictions on allowable offsets for Expected Operational Losses are too narrowly defined. Taken together, these three issues have the potential to produce capital estimates that are not defensible. That would be a troubling and unintended outcome. The Advanced Measurement Approach was meant to allow flexibility as banks develop internal models that most reflect their operational risks. A recent study by the AMA Group of the Risk Management Association confirms that a range of viable practices currently exists among banks subject to the rules. No consensus has yet developed on whether models should be "top down" or "bottoms up." Adding restrictions and unrealistic

expectations at this stage limits necessary flexibility and establishes a standard that may be beyond practical industry application at this stage of model development.

The general capital rules for non-Basel II banks also should be updated and calibrated in harmony with the Basel II rules. Fair capital rules are important to the health of the domestic banking industry; capital flows do not stop at national borders. Our domestic markets are accessible to firms that will operate under the Basel II rules implemented in their home countries. Capital rules should be equitable between large banks and smaller U.S. institutions, as well as with our international competitors. We support the proposal to update the general capital rules to make them more risk sensitive. The best way to do this would be to make the Standardized approach available to banks that do not adopt the AIRB approach. If the agencies decide instead to pursue the Basel IA approach described in the recent NPR[11], we urge that the agencies continue to adjust these rules as an internationally harmonized Basel framework is implemented for large banks in order to maintain fairness across the system.

The U.S. capital rules should allow banks to implement either the AIRB approach or the Standardized approach, with both aligned to the international Basel framework. Wachovia, along with other banks, several industry associations, and other interested parties, has requested that regulators provide U.S. banks – including those for which the Basel II rules would be mandated – the option to implement on a permanent basis either the AIRB approach or the Standardized approach. We repeat that request, noting that the NPR proposes a system whose impact diverges from the international Basel framework while being excessively expensive to implement and operate. It is difficult to justify spending a great deal of money on systems used for nothing but compliance when better information is available and used to manage the bank, especially when the leverage ratio – not risk-based capital requirements – will be the binding constraint for banks with low- to medium-risk portfolios. Supervisors

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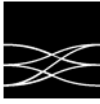
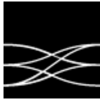
[11] *Joint Notice of Proposed Rulemaking for Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications*, 71 FR 77446, December 26, 2006



already have authority to review the better information, which would be used for internal risk management purposes, the internal capital adequacy assessment process, and supervisory discussions. The Pillar II processes will ensure that banks hold appropriate capital for the risks they take when using either the AIRB or Standardized approach.

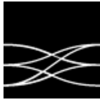
We are not making this request in lieu of asking that the agencies correct the NPR's problems. It is essential that the AIRB be aligned with the international Basel framework. A harmonized advanced option is vital to maintaining a level playing field with the industry's international competitors.

U.S. domiciled banks should not be placed at a competitive disadvantage if they engage in low risk activities; current leverage ratio requirements should be revisited and relaxed as confidence develops in Basel II. Despite the advantages of using a risk-sensitive approach to set capital requirements, the U.S. rules impose a second minimum requirement based on assets rather than risk. The consequence is to require excessive, inefficient capital levels for low-risk assets. As a result, some banks will turn away from low-risk credit opportunities so as not to dilute their return on capital. Others will balance their low-risk business with more high-risk lending so that their risk-based capital requirements are not materially lower than their leverage requirements. A third option for some banks is to bear the expense of removing assets from the bank without removing the risk. While securitization will continue to be a valuable tool for numerous purposes, including risk transfer, liquidity, and funding, the benefit of inducing banks to securitize solely for the purpose of regulatory capital arbitrage is unclear. All of these alternatives mean changing a bank's business model to take more risk. We see no public policy benefit of using regulation to lead banks to adopt higher risk profiles than they would otherwise choose.



We believe that the retention of the current leverage ratio requirement places U.S.-based banks at a competitive disadvantage to foreign firms. Foreign banks generally will not operate with a leverage ratio requirement in their home countries, making the acquisition of low-risk assets – or even entire financial institutions – less expensive for them. U.S. capital rules are not relevant in these cases, because U.S. capital can be funded with debt at the consolidated level. Capital is needed for risk, and comprehensive risk-based rules are sufficient to ensure that banks are safe and sound, especially in the U.S., where permanent examination teams monitor credit quality and capital adequacy. The leverage ratio rules should be revisited and relaxed as confidence develops in Basel II.

Meaningful public disclosure requirements cannot be sufficiently defined or understood absent experience gained in the transition period; final details including the scope of public release should be developed at that time. We support public disclosures that will allow the market to gain better insight into a bank's risk profile and confidential disclosure to assist regulators in their supervisory role. However, we believe the volume, content and timing of the proposed public disclosures would hinder the U.S. banking industry's ability to meet those goals. We believe that certain of the proposed items will not be well understood or provide useful information to the marketplace, given the proposed granularity and complexity. We suggest that Pillar III and the reporting templates be scaled back to focus on clarity and usefulness so as to better meet investor needs. We believe that this will help ensure the banking industry is not impacted by marketplace confusion, or worse, disruption, because of excessive, misunderstood disclosures. In addition, we believe that all reporting should be considered confidential by the regulators until the U.S. implementation of Basel II has gained some maturity. Deferring the start date of public disclosures allows regulators and the banking industry to ensure the comparability, and thus the usefulness, of this information.

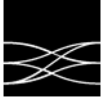


The Basel II and Market Risk implementation schedules should be aligned. The international Basel framework provides for the simultaneous implementation of the changes for credit, market and operational capital measurement; this is not so for U.S. domiciled institutions. As such, the international community enjoys the capital management synergy of planning for the impact of all capital changes simultaneously. Conversely, U.S. domiciled banks would be forced to first manage potentially higher minimum capital requirements related to the market risk rules only to have to subsequently manage a possible reduction in minimum capital requirements associated with Basel II. This may impact liquidity and pricing of capital during this period. If there are current issues in the market place regarding market risk capital levels, we believe that existing regulations and the current supervisory regime provide adequate tools to manage safety and soundness until the simultaneous implementation of all the new capital measurement rules.

The repeated delays and uncertainties around this effort have added to the already high cost of implementation; we encourage the agencies to move ahead without further undue delay. Given the extensive effort that has gone into this endeavor over the past decade, we ask the agencies to move ahead promptly with these recommendations. Operating under Basel I while most of the world moves to Basel II exposes U.S. banks to the same competitive problems we describe above.

We look forward to a reinvigorated 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 NPR. We invite you to contact us with any questions regarding the views expressed in this letter.

Sincerely,



Donald K. Truslow	Thomas J. Wurtz
Chief Risk Officer	Chief Financial Officer

cc

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Richard Westerkamp, Central Point-of-Contact, Federal Reserve Bank of Richmond

Michael E. Finn, Regional Director, Office of Thrift Supervision

Encl

Appendix to Basel II NPR Comment Letter Dated March 26, 2007 of Wachovia Corporation

Containing

Wachovia's Detailed Responses to the U.S. Federal Banking Agencies' Joint Notices of Proposed Rulemaking (NPR)

- **Risk-Based Capital Standards: Advanced Capital Adequacy Framework, 71 FR 55830, and**

- **Proposed Agency Information Collection Activities [Basel II Regulatory Reporting Requirements], 71 FR 55981 (above both dated September 25, 2006)**

- **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)**

- **Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications [Basel IA], 71 FR 77446 (December 26, 2006)**

Editorial Note:
For the convenience of the Agencies' staff, this Appendix contains
(1) A detailed Table of Contents (with hyperlinks) -- beginning on the following page, and
(2) An Index – appearing as the last page of this Appendix -- showing the location in this Appendix of the Agencies' 62 Questions, certain other enumerated Questions for which formal comment was requested, and Wachovia's response(s) thereto.

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Appendix to Basel II NPR Comment Letter Dated March 26, 2007 of Wachovia Corporation

I. General Questions and Issues

A. NPR General Questions for Formal Comment

1. ***Question 3:***
   The agencies seek comment and supporting data on the appropriateness of this limit. **(Refers to the 0.6% credit RWA cap on the inclusion of excess reserves in Tier 2 capital.)**

We believe that all excess reserves should be counted as Tier 1 capital. After ongoing profit, reserves are the *first* resource to absorb losses and maintain solvency. As such, they should be included with retained earnings and other Tier 1 capital elements. This will better accommodate the diverse accounting treatments of international Basel participants. We urge U.S authorities to address this with the Basel Committee in upcoming work on the definition of capital.

In any case, there is no question that *all* reserves can be used to absorb losses, so there should be no restriction on the amount of reserves counted as capital. Not doing so penalizes low risk banks. We therefore urge that the limit on the "excess" ALLL that may be included in Tier 2 capital be removed from the current U.S. rules.

We believe this position is consistent with our overall position that it is important to have harmonized global rules. U.S. accounting practices lead to higher reserves in the U.S. that are far more likely to exceed the cap than practices in other nations. The legitimate role of national discretion is to adapt the Basel framework to unique local situations. We note, however, that the rationale behind our position holds true internationally as well as domestically, even though the practical problem is in the U.S. We therefore urge U.S. regulators to also address the exclusion of reserves from capital through the Basel Committee.

2. ***Question 5:***
   The agencies seek comment on this approach to ensuring that overall capital objectives are achieved. **(Refers to the agencies' proposal to reevaluate the capital framework at the end of the transitional floor period given an aggregate industry regulatory capital decline of at least 10% from Basel I levels.)**

As stated in Wachovia's cover letter accompanying this Appendix, we are very troubled by the potential to have aggregate capital requirements increased in the event of a 10% aggregate decline in Pillar I minimum requirements. This would further deviate from the standard used internationally. It is imperative that U.S. implementation be consistent with international rules as a means of continuing to promote fair competition among banks from different countries. Basel II has been calibrated internationally with safeguards to ensure that significant minimum capital requirements decline only as a result of lower inherent risk.

It is important to clarify what factors might constitute low risk, and hence lower capital minimums. Low measured risk may result from two key drivers. First, a bank may be operating at a favorable point in the business cycle. However, this is a temporary condition and does *not* yield a relevant number to consider for the actual minimum capital requirement. Clearly, banks must have sufficient capital to operate with an acceptably low insolvency probability during a downturn. With a risk sensitive framework, regulators should not look solely at the Pillar I requirement in favorable parts of the business cycle to assess the impact of the proposed rule.

Second, a bank may choose to pursue a low risk strategy. If large U.S. banks pursue a low-risk path to ensuring their safety, they should not be penalized with a capital bar set artificially high. Such low risk banks should not be required to hold capital appropriate for high-risk banks. Regulation should not discourage low-risk activities.

It is understandable for regulators to be concerned about overly optimistic estimates driving industry capital lower. Yet addressing this concern with a formulaic recalibration is inappropriate. Rather, regulators should utilize Pillar II to target individual banks warranting capital adjustments. U.S. regulators championed the inclusion of Pillar II for the very purpose of addressing perceived shortfalls in Pillar I regulatory capital. In fact, the supervision envisioned under Pillar II has been an important feature of the U.S. regulatory environment for some time. Internal validation and benchmarking are just some of the advanced practices used by core banks to ensure accurate risk measurements and to demonstrate capital adequacy to local regulators, who are very familiar with banks' risk via continuous, on-site supervision. We believe such interactions should continue in the U.S. without extra conservatism or safeguards added to Pillar I processes.

Various studies[1] indicate that credit capital requirements will vary by 25 percent or more over the cycle. If the system is calibrated so that the minimum requirement will fall only a little in the best part of the cycle, the consequence must be that capital requirements will actually rise in even a modest downturn in credit quality. Since banks do not want to raise new capital during a downturn, **this situation effectively increases capital requirements for U.S. banks throughout the cycle.**

Further, the cyclical effect described above could exacerbate business cycle effects. Banks will naturally become more cautious about lending in a downturn because their internal measures will warn them that economic capital needs are increasing. However, if regulatory capital minimums are set too harshly, the latter will become a constraint before the internal measures. Since it is expensive to raise new capital in a downturn, banks may well dramatically reduce lending and/or sell loans aggressively, potentially causing further market disruptions.

[1] Ervin & Wilde. *RISK*, October 2001; Catarina-Rabell, Jackson & Tsornocos. Bank of England, 2003; Jordan, Peek and Rosengren. FRB Boston, 2003; Rosch. University of Regensburg, 2002; Kashyap and Stein. FRB Chicago, 2004; presentation by large U.S. banks to regulatory agencies, 2005

Rather than mandating overall industry floors, a better approach is to 1) rely on the bank-by-bank floors specified for the transition period and 2) confirm changes in capital requirements as part of the Pillar II dialogue between banks and regulators by reviewing the credit quality makeup of AIRB banks and comparing the reasonableness of results across banks. This form of benchmarking should complement the work banks are doing internally and through industry associations and should satisfy regulators that capital requirements are matched to risk levels.

Along with the competitive harm that could come to U.S. banks if our global competitors are permitted to be more efficient with their capital than we, the indicated recalibration creates issues around planning and fairness. As written, it appears that a bank's capital requirement will depend not only on its own risks, but also on the risks other banks hold. Even if many banks have Pillar I results that are within the stated tolerance, another bank that chooses to hold a very low risk portfolio could bring the aggregate below the targeted level and force a recalibration for everyone. We do not understand how such indeterminate rules would be good for the U.S. financial system.

Overall calibration should be undertaken in concert with the Basel Committee and should consider cyclical effects. The committee has already reaffirmed the current calibration[2] and will continue to monitor capital requirements during the period of implementation. The U.S. experience should be an important part of future assessments of the effectiveness of the international framework.

3. ***Question 6:***
The agencies seek comment on all potential competitive aspects of this proposal and on any specific aspects of the proposal that might raise competitive concerns for any bank or group of banks.

The U.S. version of this framework raises minimum capital requirements and compliance costs for U.S. domiciled banks above that of foreign competitors and is consequently likely to harm the competitiveness of U.S. banks with respect to foreign domiciled banking institutions. It may also influence ownership of U.S. banking assets.

Differences in risk sensitivity and conservativeness between the U.S. and International framework will affect pricing, product focus, and overall competitiveness. These differences, which are addressed in more detail throughout this letter, include the U.S. downturn LGD parameter requirement, elimination of the small- and medium-size enterprise ("SME") benefit, the U.S.-only leverage ratio requirement, and the indicated recalibration if minimum capital requirements decline materially - even if driven by benign business conditions or decisions to hold low-risk exposures. The AIRB framework available to foreign competitors is more appropriately risk sensitive than the U.S. version. This is particularly true with low risk loans, where required capital for U.S. domiciled banks will be significantly higher than for foreign competitors.

[2] See *Basel Committee maintains calibration of Basel II Framework*, May 24, 2006, available at http://www.bis.org/press/p060524.htm

The result is that U.S. domiciled banks may be forced to avoid holding low risk loans unless they balance them with higher risk exposures. Rather than promoting a safe and sound U.S. banking system, the additional conservatism in the U.S. rules could induce banks to take on more risk than they would choose to without an increase in capital.

The higher investment and compliance costs associated with the U.S. AIRB framework places core U.S. banks at a competitive disadvantage to foreign competitors. Foreign competitors will utilize rules that more closely align with the international AIRB framework and their internal measurements of risk. This minimizes required changes to their existing risk management processes and avoids the substantial one-time and recurring costs inherent to the proposed U.S. AIRB framework. The U.S. framework, on the other hand, entails a number of prescriptive rules (elaborated on in more detail throughout this letter) that are not aligned with how the banks currently manage risk. As such, core banks find themselves having to build redundant risk rating and risk management systems merely to comply with the U.S.-specific framework. The costs of these duplicate systems would be significant. It is the fact that the U.S. version is so far from how we run our business that makes this a compliance exercise; not that advanced banks lack adequate risk management systems.

Having foreign-owned U.S. banking subsidiaries comply with U.S. rules does not eliminate these inequities. Foreign bank holding companies can structure their investments in U.S. banks so that the underlying capital is consistent with home-country requirements.

Another competitive inequity stems from the U.S.-specific transition floor rules, which will result in the AIRB framework being adopted at least 1-year later in the U.S. with smaller capital reduction “steps”. Barring differences in the frameworks’ capital rules, the U.S. transition floor schedule enables foreign competitors to realize capital reductions sooner and potentially grow market share; we have already received reports of more aggressive competition from foreign banks operating under AIRB capital rules on some low-risk exposures.

Our discussion of “Competition” does not simply mean that foreign banks will have a pricing advantage for low risk assets. A more fundamental issue is that foreign firms can hold or buy U.S. banking assets for less capital than it takes for U.S. firms to hold or buy them. Acquisitions of U.S. assets could be financed, in part, by the “excess” capital freed up by the lower capital requirements. For example, suppose that there are three banks of equal size:

- Bank A has a low-risk strategy and requires capital of 3.
- Bank B has a high-risk strategy and requires capital of 7.
- Bank C is a moderate-risk institution with a capital requirement of 5.

Suppose bank A and B operate under a leverage-based rule that say capital requirements will be at least 5, no matter the result of the risk-based computation. So A holds 5 and B holds 7. A’s returns are spread over 5 units of capital, lowering the return for the capital

investor. This gives bank B an opportunity. B can acquire A. The combined firm needs capital of 10. B need only raise 3 in new capital to buy A, but A needs 5 to stay in business.

Alternately, suppose C operates under rules that have no artificial leverage constraint. C also has an opportunity. If C were to acquire A, the combined firm would need 8 units of capital. Again, C could raise 3 in capital to acquire A, while A needs 5 to remain in business.

A does have another choice. It can abandon its low-risk strategy, raise 5 in capital, add its 'extra' 2, and purchase B for 7. It survives, but not as a low-risk institution.

This case illustrates that constraining some banks in a risk sensitive system while others are not constrained creates problems. A too-high floor puts banks that pursue a low-risk strategy at a competitive disadvantage. The lower their risk, the greater the disadvantage they suffer. The rule intended to provide an "extra" measure of safety actually discourages banks from pursuing the low-risk strategy that would enhance safety.

This is, of course, a simplified illustration. Many other factors go into acquisitions. Nevertheless, the examples illustrate an important part of the analysis.

Note that these facts hold true even if the banks are profitable. Those who point to the profitability of U.S. banks as a reason not to worry that U.S. rules create the problems described above miss the important point. The profitability of U.S. banks makes them desirable investments not only for U.S. investors, but for potential foreign acquirers, too.

4. ***Question 7:***
The agencies request comment on whether U.S. banks subject to the advanced approaches in the proposed rule (that is, core banks and opt-in banks) should be permitted to use other credit and operational risk approaches similar to those provided under the New Accord. With respect to the credit risk capital requirement, the agencies request comment on whether banks should be provided the option of using a U.S. version of the so-called "standardized approach" of the New Accord and on the appropriate length of time for such an option.

The U.S. capital rules should allow banks to implement either the AIRB approach or the Standardized approach, with both aligned to the international Basel framework. Wachovia, along with other banks, several industry associations, and other interested parties, has requested that regulators provide U.S. banks – including those for which the Basel II rules would be mandated – the option to implement on a permanent basis either the AIRB approach or the Standardized approach. We repeat that request, noting that the NPR proposes a system whose impact diverges from the international Basel framework while being excessively expensive to implement and operate. It is difficult to justify spending a great deal of money on systems used for nothing but compliance when better information is available and used to manage the bank, especially

when the leverage ratio – not risk-based capital requirements – will be the binding constraint for banks with low- to medium-risk portfolios. Supervisors already have authority to review the better information, which would be used for internal risk management purposes, the internal capital adequacy assessment process, and supervisory discussions. The Pillar II processes will ensure that banks hold appropriate capital for the risks they take when using either the AIRB or Standardized approach.

Since the rationale for adopting the Standardized approach would be driven by a cost-benefit analysis rather than the inability to implement the Advanced approaches, there should be no deadline to migrate to a more advanced framework; any decision to transition should be the bank's own.

5. ***Question 8A:***
The Board seeks comment on the proposed BHC consolidated non-insurance assets threshold relative to the consolidated DI assets threshold in the ANPR. **(Refers to revised BHC consolidated asset threshold, which has been expanded beyond depository institutions to include total BHC consolidated assets excluding insurance underwriting subsidiary assets.)**

This BHC asset threshold could force BHCs whose assets primarily fall under the market risk rules to apply the Basel rules when their DIs – on their own – are far under the threshold. We understand that some institutions have claimed that this would be overly burdensome. If required to implement a unique U.S. version of the AIRB approach, this treatment may indeed be inappropriate. Rather than lowering the threshold, **the better solution would be to permit all U.S. banks to implement the international Standardized approach as we advocate elsewhere.** In this case there should be no excessive burden.

6. ***Question 8B:***
The agencies seek comment on the proposed scope of application. In particular, the agencies seek comment on the regulatory burden of a framework that requires the advanced approaches to be implemented by each subsidiary DI of a BHC or bank that uses advanced approaches.

We believe (iii) is intended to apply when a U.S. bank or holding company (including those that are subsidiaries of foreign banks or holding companies) meets criteria (i) or (ii) and also has subsidiaries, which subsidiaries would then be required to operate under the same rules. We believe this rule is overly broad and recommend that this part of the rule be dropped or changed to permit subsidiaries to use **another** approach as appropriate to the subsidiary's materiality. Further, with respect to a DI, the passage stating, "[a] DI also is a core bank if it is a subsidiary of another DI or BHC that uses the advanced approaches" should be deleted.

7. ***Question 9:***
The agencies seek comment on the application of the proposed rule to DI subsidiaries of U.S. BHC that meets the conditions in Federal Reserve SR letter 01-01 and on the principle of national treatment in this context. **(Refers to requirement to have U.S.-chartered DIs that are subsidiaries of foreign banks be subject to same U.S. capital requirements as U.S. DIs.)**

SR 01-01 exempts qualifying foreign-owned BHCs from having to comply with the Federal Reserve's capital adequacy guidelines. Throughout this letter we have called for a level playing field both domestically and globally. That principle should be applied here.

The same capital adequacy guidelines should be applied to all BHCs, whether U.S. or foreign-owned. The inequality in current regulation provides yet another reason to align the new rules with the international framework and to relax or remove the leverage ratio requirement for U.S. banks to level the field with foreign banks in this country, as we have stated elsewhere. Equal treatment is imperative for promoting fair competition among the varied players competing for U.S. market share.

As a practical matter we note that the true underlying capital requirements for foreign BHCs are their home country rules, since they can use leverage to capitalize their U.S. subsidiaries.

8. ***Question 10:***
The agencies seek comment on this approach, including the transitional floor thresholds and transition period, and on how and to what extent future modification to the general risk-based capital rules should be incorporated into the transitional floor calculations for advanced approaches banks. **(Refers to transitional period protocol and the feasibility of basing capital floors on a modified Basel I framework.)**

We believe that the transition rules are a reasonable means of building confidence in a new capital system. But the need to build confidence should be balanced with the objective to remove floors in a timeframe that minimizes competitive effects. The proposed transition floor break points place U.S. banks at a competitive disadvantage to foreign competitors, who are allowed to transition earlier and utilize larger floor decrements.

Our preference is to have the same floors and transition periods as banks in the rest of the world.

Further, the NPR's language about moving through the transition periods troubles us. If a bank was at one point in compliance and approved to begin the transition period, but is later found to no longer be in compliance, it is quite sensible that the bank would not be

able to move forward to the next transition period. However, the statement, "[a] bank's primary Federal supervisor would determine when the bank is ready to move from one transitional floor period to the next period" seems to present a new, undefined hurdle not part of the international framework. We ask that the rule simply permit banks to move to the next transition floor as long as the primary Federal supervisor does not notify the bank that it is no longer in compliance.

Finally, we note that the calculation for the floor ratio is different in the NPR than that used in the international framework. We ask the agencies to align the transitional capital floor calculation with the Basel II Framework, in particular with respect to inclusion of ECL and UL.

9. ***Question 11:***
The agencies seek comment on what other information should be considered in deciding whether those overall capital goals have been achieved **(The agencies are asking for other specific information that should be considered, in addition to AIRB capital and corresponding Basel I capital, to determine whether the agencies' capital goals have been met.)**

We believe the issue here is how one interprets and assesses the stated goal that "The agencies do not expect the implementation of the New Accord to result in a significant decrease in aggregate capital requirements for the U.S. banking system." This statement must, of course, be read alongside the earlier statement, "The framework outlined in this proposal (IRB framework) is intended to produce risk-based capital requirements that are more risk-sensitive than the existing risk-based capital rules of the agencies (general risk-based capital rules)."

It would be overly simple to read these two statements and maintain that they must both be absolutely true without qualification in all cases, at all times. A risk-based system will produce capital requirements that rise and fall as business conditions and credit quality change over the business cycle. When compared to a starting point that does not vary over time, there will inevitably be periods in which the new metric is relatively higher and others where it is lower.

System wide comparisons of capital requirements must therefore consider the entire business cycle and total capital requirements, not just the Pillar I number reported at a point in time. Since banks will not want to raise new capital in a recession they will keep their capital levels high enough in good years that they will remain safely capitalized in periods where minimum capital requirements rise. Further, the Basel rules themselves require banks to consider their capital requirements in stress scenarios and to maintain adequate excess capital to meet the needs of such stress periods. A bank would not be permitted to operate near their reported minimum capital level in a good period even if it wanted to. Severely limiting the *potential* capital reductions in the best part of the cycle is therefore equivalent to *raising* capital requirements. Since Pillar II requires

banks to have sufficient capital to handle the cyclical downturns that occur from time to time, it is redundant to include it in the Pillar I computation.

Calibration of a risk-sensitive system to a fixed point must consider credit quality. Under Basel I, banks have been required to hold more capital for low-risk assets than has been needed for the risk. Banks have therefore generally not held large proportions of very low risk assets, since the capital rules make it difficult to earn sufficient returns on the uneconomic levels of capital required to support the low-risk assets. A risk-sensitive capital requirement (*e.g.*, the international Basel framework) will enable a low-risk business model since it permits banks to earn a fair return on the capital needed to support low-risk assets. As more banks pursue a low-risk model, overall capital requirements could fall, triggering the recalibration. Reducing risk in the industry should not be a trigger for increasing capital.
Any capital rule that aims to maintain capital levels without considering the risk in banks' portfolios and the need for capital will discourage a move toward holding more low risk exposures.

The agencies must consider whether these rules create competitive problems for U.S.-domiciled institutions. Elsewhere (Question 6) we discuss potential competitive issues raised by these rules. The agencies should clearly consider if these fears are becoming reality in considering if the goals of the NPR are being met. However, if we wait until competitive issues are so clearly affecting the U.S. industry that everyone agrees that it is a problem, we will then have lost valuable time needed to fix the situation.

We fully support the principle that U.S. banks should be well capitalized. We would be negatively affected by credit problems at any large bank, and we want to know that we are being held to the same standards as our competitors. But we believe the international Basel framework provides the best path to knowing that banks are adequately capitalized, and we believe that the safeguards provided in the international framework – particularly in combination with real-time, on-site supervision at large banks – are the most effective and efficient means to ensure that the rules are being applied prudently.

10. *Question 12:*

The agencies seek comment on this proposed timetable for implementing the advanced approaches in the United States.

The agencies have correctly tied the timetable to the date a final rule is published. A 36-month implementation window is reasonable.

As noted in our cover letter, we encourage the agencies to move ahead without further undue delay. Given the extensive effort that has gone into this endeavor over the past decade, the U.S. agencies should be able to implement the international Basel framework without investing significant time reworking the rules.

11. ***Question 20:***
The agencies seek comment on the appropriateness of the 24-month and 30-day time frames for addressing the merger and acquisition transition situations advanced approaches banks may face.

The 24-month merger period appears to be a generally reasonable approach to the implementation issues raised by acquisitions. The12-month extension will usually provide flexibility for complex, large transactions (*e.g.*, time to identify surviving systems and processes prior to developing an implementation plan), or mergers where neither participant is an AIRB institution. There may, however, be some situations with unusual circumstances, and we recommend that an extension period of as much as 24 months or more be permitted.

The 30-day post-consummation deadline for an implementation plan, however, is not appropriate. The rule as stated is not size or complexity dependent. Depending on the circumstances, it may be quite difficult to furnish a thorough plan in this time frame. We recommend that a 90-day time frame be used.

12. ***Question 21:***
Commenters are encouraged to provide views on the proposed adjustments to the components of the risk-based capital numerator as described below. Commenters also may provide views on numerator-related issues that they believe would be useful to the agencies' consideration of the proposed rule. **(Refers to new adjustments to Tier 1 and Tier 2 capital, including elimination of the nonfinancial equity investments deduction and the change in the ALLL treatment).**

Changes from Basel I include several instances where exposures with 1250% risk weights are now deductions. We support this as a universally applied change.

However, the adjustments to the leverage ratio capital number are inappropriate. Because the leverage ratio is not a risk sensitive calculation, it is inconsistent to use risk-based deductions in its calculation. ***We strongly urge that risk-based capital deductions be removed from the leverage ratio calculation.***

Further, as described below in our discussion of securitizations, we find that non-gain residual interests that are deducted should be counted toward the capital cap for the securitization of the capital that one would hold if the loans were held in the bank's portfolio. (See issue VII.B.2 under Securitizations.)

Covering EL with ALLL is consistent with the international Basel framework, and we do not ask U.S. regulators to deviate. We do, however, ask that U.S. rules be changed with regard to the cap on the ALLL that is counted as capital, since U.S. reserving practices differ from those used in other parts of the world (see Question 3).

13. __Question 22:__

The agencies seek comment on the proposed ECL approach for defaulted exposures as well as on an alternative treatment, under which ECL for a defaulted exposures would be calculated as the bank's current carrying value of the exposure multiplied by the bank's best estimate of the expected economic loss rate associated with the exposure (measured relative to the current carrying value), that would be more consistent with the proposed treatment of ECL for non-defaulted exposures. The agencies also seek comment on whether these two approaches would likely produce materially different ECL estimates for defaulted exposures. In addition, the agencies seek comment on the appropriate measure of ECL for assets held at fair value with gains and losses flowing through earnings. **(Proposed treatment is to use a bank's ALLL impairment estimate for defaulted exposures to determine defaulted exposure ECL. ECL for non-defaulted exposures will be different from that of defaulted exposures).**

The proposed ECL approach is adequate. The alternative adds complexity with little value. The difference in calculated ECL between the proposed and alternative treatments should be minimal.

Assets held at fair value should not have an assigned ECL or allowance because these measures are already embedded in the balance sheet valuation such that value losses have been removed from actual capital.

14. __Question 23:__

The Board seeks comment on this proposed treatment and in a particular on how a minimum insurance regulatory capital proxy for tier 1 deduction purposes should be determined for insurance underwriting subsidiaries that are not subject to U.S. functional regulation. **(Refers to consolidation and deduction approach for functionally regulated consolidated insurance underwriting subsidiaries).**

We believe the capital deduction described in the "consolidate and deduct" approach is not as sound as the "deconsolidation" method described in the International Accord. The NPR's approach not only puts U.S. banks at odds with their international counterparts, it also fails to appropriately calculate capital on insurance subsidiaries' risks. The NPR will in some cases double count the capital requirement for the same risks that are being covered by the insurance regulators' requirements. We believe the banking industry is better served by aligning the U.S. rules with the International Accord, which recognizes that insurance exposures can be better measured by the various insurance regulatory bodies. However, we also seek clarification on what criteria the Federal Reserve views as satisfying its requirements for "comparable" supervision and minimum capital requirements.

In line with our response to Question 21, we strongly urge that any risk-based capital deductions such as the one proposed for the insurance entities be removed from the leverage ratio calculation.

15. ***Question 27:***

The agencies seek commenters' perspectives on other loss types for which the boundary between credit and operational risk should be evaluated further (for example, with respect to HELOCs).

The boundary between credit and operational risk should be aligned with banks' internal systems and not prescribed in detail. Requirements to do things differently than internal practice will materially affect compliance costs. The prominent boundary-area issues have already been identified, so smaller categories are not likely to materially affect numbers. Banks should be allowed to classify other gray-area losses as operational. Examples include retail credit card fraud, losses stemming from identity theft, and losses due to the failure of a servicer or intermediary to perform. The option to classify these losses according to banks' policies should extend to situations where banks choose to create a loan as the means of recovering the loss.

16. ***Question 28:***

The agencies generally seek comment on the proposed treatment of the boundaries between credit, operational and market risk.

On the broader issue of risk-based capital standards for market risk, please refer to our Market Risk NPR comment letter dated January 19, 2007 for commentary on a number of concerns we have with the proposed rules, including excessive prescriptiveness, the distinction between trading and banking book assets, and the disjointed implementation schedule.

Concerning boundary losses between operational risk and market risk, we do not oppose having "trading error" type losses treated as operational losses for calculating risk-based capital requirements. Examples include sells executed as buys, errors in executing stop loss orders, exchange rate errors and trading fraud. Unlike credit risk boundary losses, there are no existing standards that prescribe how boundary losses between market risk and operational risk are to be handled for risk-based capital purposes. Industry participants are not likely to have developed identical systems and processes for capturing such data.

While we do not object to the treatment outlined in the NPR, we request that reasonable principles be established with respect to market risk and operational risk boundary issues, as this is new to the industry. Any solution should consider materiality. Losses below some level should be permitted to stay in the trading book to avoid having to track innumerable small events.

B. Comments on Other Issues Identified by Wachovia

1. ***Board Approval***

The NPR states that a bank's board or designated committee must evaluate and approve at least annually the effectiveness of the bank's advanced systems. Banks should be able to implement this provision 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.

2. ***Use Test***

We agree with the premise of the use test; there are significant benefits to both the bank and supervisors when internal views of risk are aligned with those used for regulatory purposes. Benefits include sizeable cost savings and increased confidence for the regulatory parameters, as internal usage functions as a form of validation and benchmarking. Disconnects between internal processes and the regulatory capital numbers will diminish the value of this review and will represent an important missed opportunity.

However, 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 AIRB 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, and the gap between them will grow over time.

3. ***Pillar II Methodologies to Ensure Consistency***

As discussed in our cover letter, the U.S. supervisory process has and will continue to provide great assurance that banks are properly identifying, assessing, and managing risk

and that capital levels are sufficient for the risk a bank chooses to hold. 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 ongoing review of risk and capital adequacy with senior management, they can ensure that banks are responding quickly to emerging problems.

Further, to the extent that the agencies are concerned about consistency in the application of the AIRB approach, on-site supervisors and specialists from across the system routinely visit banks and can benchmark practices and parameters from one bank to another. Benchmarks can identify areas warranting further review in calculating Pillar I numbers without being used mechanically (*e.g.*, to override the Pillar I parameters). Even though banks may segment their portfolios somewhat differently, benchmarks can be adjusted or interpolated appropriately to compare banks' numbers. As the state-of-the-art improves and practices converge, benchmarks can evolve in ways that prescriptive rules cannot. Aggregate benchmarks for typical portfolios could be compared to the general capital rules to provide the agencies and the banking industry with a fair comparison from bank to bank, regardless of approach. Because they are used in Pillar II, benchmarks should not be hard and fast capital requirements.

It is important that the process of comparing processes and parameters be done in consultation with the industry. Differences in portfolio makeup, risk management processes, and analytic approaches will result in differences from bank to bank. Such differences are not "bad" and should not result in a regulatory mandate to adopt the most conservative approach among acceptable alternatives. Basel implementation in other jurisdictions gives an important role to working groups comprising bankers, industry associations, and regulators. Such mechanisms should be part of the U.S. process, too. Consultation should result in both better results and a more efficient process.

4. Precision of Capital Requirements

Some have been troubled that an AIRB system uses parameters generated from banks' internal data through analyses performed by banks themselves. Because the parameters are expected values and other forward-looking numbers instead of precise measurements of currently observable facts, the argument has been made that they are not fit for use as the basis for capital requirements.

In reality, risk-based capital requirements, even with some uncertainty around the measurements, are better indicators of the need for capital than fixed percentages that make no attempt to quantify risk or the need for capital. If the latter provides an appropriate level of safety, it is only because a bank's business model happens to equate to the fixed percentage.

The overly simple rules would not require a bank that chooses a riskier portfolio to hold sufficient capital. It may be easy to get a precise answer with such a rule, but precision alone does not make an answer correct. Notwithstanding measurement and estimation

error, a rule based on risk will virtually always require more capital for higher risk activities.

Imprecision will be kept in check through several processes within the second Basel pillar. Some of the most important internal constraints will be the link to historical performance; the rigorous validation requirements: and management's responsibility to ensure that all system components function effectively, are in compliance with the qualification requirements, and – most importantly – produce appropriate numbers. If the agencies can avoid overly-prescriptive rules so that banks can use internal systems to produce the Basel parameters, the fact that banks use the numbers to run their organizations will be crucial evidence that the parameters are the best expressions of expected results.

Further, supervisors monitor banks' risk management processes with large on-site examination teams. The agencies have more than a decade of experience with real-time supervision that aims to develop a deep understanding of a bank's processes, its risks, and how those risks are managed. With the support of specialists from Washington and other centers of expertise and the insights gained from visiting banks across the system, supervisors should be able to judge whether parameters are reasonable and if changes in a bank's capital requirements truly correspond to changes in risk.

Aligning the Basel numbers with economic capital and other internal risk assessments – as envisioned during the development of the international framework – will complement and enhance discussions among regulators and banks. Dialogue between supervisors and bankers using a common language about risk will enhance risk management and the regulatory process. Disconnects between internal processes and the regulatory capital numbers will diminish the value of this review and will represent an important missed opportunity.

II. Parameter Estimation Questions and Issues

A. NPR Parameter Estimation Questions for Formal Comment

1. ***Question 15:***
   In light of the possibility of significantly increased loss rates at the subdivision level due to downturn conditions in the subdivision, the agencies seek comment on whether to require banks to determine economic downturn conditions at a more granular level than an entire wholesale or retail exposure subcategory in a national jurisdiction.

Wachovia's existing LGD parameter is a conservative default-weighted average measure that already reflects downturn conditions. This is because the data are dominated by downturn observations, rendering a more granular level of analysis unnecessary and not meaningful. As an example, consider three business regions where each, in turn, experiences a downturn period. (The table is constructed as if there is a clear correlation

between default rate and LGD. Actual data does not necessarily support this. See Question 17.) The number of defaults per region during the downturn is 10 times the number the number during other cycle periods; each region's downturn LGD is 15 percentage points higher than during normal economic conditions.

		Region			
		A	B	C	Total
Year 1	LGD	31%	30%	33%	31.4%
	# defaults	45	50	55	150
Year 2	LGD	45%	35%	32%	43.0%
	# defaults	500	45	60	605
Year 3	LGD	30%	50%	32%	46.3%
	# defaults	50	450	60	560
Year 4	LGD	30%	35%	47%	45.0%
	# defaults	50	45	600	695
Year 5	LGD	28%	30%	31%	29.6%
	# defaults	55	50	45	150
Year 6	LGD	32%	31%	30%	31.0%
	# defaults	45	50	50	145
Total	LGD	40.1%	43.8%	42.2%	42.0%
	# defaults	745	690	870	2,305

Figure 1: Hypothetical LGDs with subdivisions

As shown in Figure 1, the defaulted weighted-average LGD is 42.0%. It is also comparable to the stressed years' LGDs of 43% to 46%. The downturn LGDs from each region has a dominating effect on the overall weighted average, while periods or regions with low LGDs have a small effect. The worst LGD for each region is higher, at 45% to 50%, but for a bank to experience such a rate would require that all regions simultaneously experience their worst LGD. Banks construct diversified portfolios to reduce the risk that all segments will experience stress at once. The suggested approach would be excessively conservative by assuming away diversification benefits for LGD. For a bank with a diversified portfolio, it is unlikely that all subdivisions of a bank's portfolio would experience extreme LGDs at the same time.

We believe that a requirement to stress LGD parameters beyond a prudently conservative forward looking default-weighted average adds unnecessary conservatism beyond the international rule set. 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.

2. ***Question 16:***

The agencies seek comment on and supporting empirical analysis of (i) the proposed rule's definitions of LGD and ELGD; (ii) the proposed rule's overall approach to the LGD estimation; (iii) the appropriateness of requiring a bank to produce credible and reliable internal estimates of LGD for all of its wholesales and retail exposures as a precondition for using the advanced approaches; (iv) the appropriateness of requiring all banks to use a supervisory mapping function, rather than internal estimates, for estimating LGDs, due to limited data availability and lack of industry experience with incorporating economic downturn conditions in LGD estimates; (v) the appropriateness of the proposed supervisory mapping function for translating ELGD into LGD for all portfolios of exposures and possible alternative supervisory mapping functions; (vi) exposures for which no mapping function would be appropriate; and (vii) exposures for which more lenient (that is, producing a lower LGD for a given ELGD) or more strict (That is, producing a higher LGD for a given ELGD) mapping function may be appropriate (for example, residential mortgage exposures and HVCRE exposures). **(Downturn LGD = 0.08 + 0.92 x ELGD)**

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

The need for a separate downturn LGD brings added cost without commensurate benefit. The Basel formulas compute a total 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 combined requirement, EL + capital, is determined based on LGD. The result of the LGD/ELGD approach is to shift more of the requirement from EL – which can be covered by ALLL – to required capital; the total seems to remain the same. However, the shift only appears to be benign (*i.e.*, the only true result being the added expense for tracking both parameters).

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. We have addressed this issue separately.

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 not terribly severe (*e.g.*, 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.

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.

Another weakness with the mapping function relates to the unclear correlation between default rates and LGDs. According to a recent study[3] by Standard & Poor's, the correlation between default risk and recoveries for a portfolio of secured loans is negligible. The paper states that secured loans are typically structured to ensure lower LGD at higher PDs. Moreover, our internal research suggests that the relationship is weakest where the primary and secondary repayment sources are least related. Examples include a guarantor with independent resources and collateral with alternate uses. On the other hand, the relationship is strongest where the secondary repayment source is identical to the primary, *e.g.*, a building foreclosure where rents were the primary source of repayment, a business whose sale is the secondary source of repayment, or liquidation of equipment whose output generated the primary repayment source. These relationships should be appropriately captured in attributing default-weighted average LGDs, not automatically increased by the formula.

3. ***Question 17:***

The agencies seek comment on the extent to which ELGD or LGD estimates under the proposed rule would be pro-cyclical, particularly for longer-term secured exposures. The agencies also seek comment on alternative approaches to measuring ELGDs or LGDs that would address concerns regarding potential pro-cyclicality without imposing undue burden on banks.

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

[3] Chew, William H. "Benign Leveraged Market or Credit Amnesia? Recovery Ratings Three Years On." New York, NY: Standard & Poor's Ratings Services, January 2007.

expected during a downturn—see figure 2. (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; see question 16 for our critique of this concept.) Yet if a bank applies the LGD ***formula*** to ELGD to get LGD, LGD will be just as cyclical as ELGD. Consequently, regulators should emphasize that the LGD formula is to be used only when a bank cannot estimate LGD. The formula should be applied only to a long-run average ELGD and not a point-in-time LGD based on current characteristics.

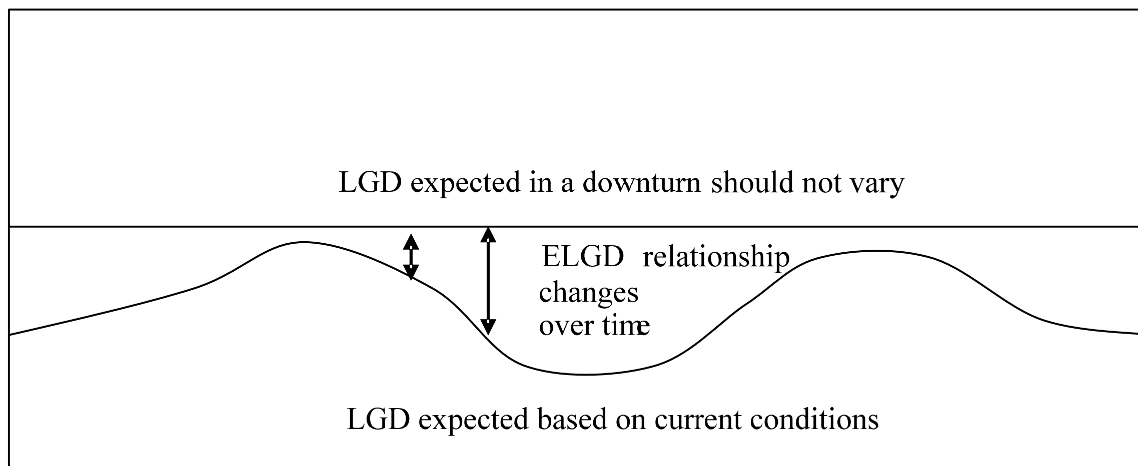

Figure 2: Cyclicality of ELGD

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 / or 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.

4. ***Question 30:***

The agencies seek comment on wholesale and retail exposure types for which banks are not able to calculate PD, ELGD, and LGD and on what an appropriate risk-based capital treatment for such exposures might be.

It is important to note that one can never calculate parameters -- they are all estimates, no matter how much historical data one has. When data is scarce, one can still make an estimate, even if one has to be conservative to compensate for added uncertainty.

Where data is scarce, banks should be permitted to use loss history and make reasonable judgments to decompose it into PDs and LGDs. The rule does discuss the use of external data, which may be the best available information for new products and other areas where internal data is insufficient to make solid estimates.

Judgment is required in both making estimates and reviewing their appropriateness. Furthermore, the focus of the rule should be getting the number right rather than pure mechanics. The proposed rule contains too little discussion of benchmarks, consideration of the business cycle, or assessment of credit risk relative to other risks, etc. The focus is on the math, not the thinking around the math. The only advantage to a purely mechanical approach is that it is easier to recalculate the numbers and to (perhaps erroneously) conclude they are right.

B. Comments on Other Issues Identified by Wachovia

1. ***EAD Definition***

We have several issues with the proposed EAD definition, primarily related to prescriptiveness.

First, we urge the agencies to apply a flexible, commonsense approach to the handling of interest and fees. In many cases these are capitalized and included in a loan's balance, but in others they are carried (and charged off) separately. The choice of including these in the EAD (so that the loss cannot exceed 100 percent) or not (so that the loss could be somewhat more than 100 percent) has no practical effect on the parameters and the capital requirement. Both have linear effects on capital, and the slight increase in EAD (if included) will be precisely offset by a decrease in the LGD rate. Flexibility will not only make compliance less burdensome for U.S. banks that have different internal practices, it will also enable foreign-domiciled banks that must comply with different home country rules to avoid building systems around a second calculation that has no material effect on the result.

Second, the potential draw "over the remaining life of the exposure" is somewhat ambiguous. One meaning could be that the analysis around EAD estimates must cover the entire lifetime of all defaulted loans and understand the probability of future usage whenever a loan may default, even if many years in the future. This presents

considerable burden and is inconsistent with defining PD over an annual horizon, as a methodology for estimating with a 1-year horizon is already established. Rules should be clarified to make plain that this meaning is not intended.

The phrase could also mean that EAD is the exposure a bank stands to lose given that a borrower defaults, even if the point at which this exposure materialized occurs after default. U.S. workout practices make advancing additional funds after default possible:

1. as a means to secure a greater recovery at a later date, for example by funding the completion of a unfinished building or
2. because the bank may place a loan on non-accrual before the borrower has violated covenants, and the bank cannot cut off future draws.

In these cases, including the future draw in EAD produces observations that generally keep LGDs between 0 and 100 percent. We believe this practice makes sense. However, we again 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. At a high level, such adjustments would be immaterial. Banks should have the option to hold 100% RW for such adjustments.

The EAD rules should also be changed for exposures such as trade finance that behave like loan commitments. For trade finance, performance letters of credit and some other credit instruments, the EAD should not be mandated to be 100%, as these are not always drawn. Banks would not collect the data this way, and the cost of retrofitting analysis is unreasonably high.

2. *Handling Borrowers that Leave Before the End of the Period*

The NPR and the guidance are ambiguous as to principles for handling borrowers who leave the portfolio during an annual period when computing historical default rates. The retail guidance (Standard 27) says that risk parameters must be adjusted appropriately to recognize the risk characteristics of exposures that were removed from reference data sets through loan sales or securitizations. The commercial rules are silent. The little guidance received from individual regulators has been inconsistent.

This is an important issue, having a significant impact on historical default rates. Consider, for example, a case of 1000 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. 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.***

Based on several discussions to date, it appears that these first two approaches are equally acceptable under the guidance, with the "use test" requiring that a bank use for regulatory capital purposes the same method it uses internally, even if that means that two banks would use parameter inputs that differed by 25 percent for exactly the same experience. This is troubling.

We believe that some regulators were uncomfortable with the implication that every single borrower that leaves a portfolio would not default, so a "patch" was attempted for commercial loans. The NPR appears to say that banks can assume that the default rate on all borrowers who leave the portfolio during the year is zero percent, except for borrowers who leave through a loan sale at a price of 95 or less, in which case one must assume a default rate of 100 percent. This overly simplistic handling of withdrawn observations will clearly produce distorted results. Further discussion around mandating that a 100 percent default rate be assumed for all borrowers who have any exposure sold at a price of 95 or lower can be found below (Question 14).

The Guidance does state,

> "Upwardly adjusting risk parameter estimates to account for sales or securitization would be particularly important for a bank that sells off primarily exposures that are performing poorly (for example, delinquent loans). … When risk parameter estimates use internal historical data as reference data sets and the potential bias created by loan sales and securitizations is material, the bank should identify, by detailed risk characteristics, the loans sold out of the pool or portfolio. Any potential bias caused by removing these loans should be corrected."

It is unclear, however, that this statement addresses the problem adequately.

The treatment of withdrawn (or censored) observations is a standard part of survival analysis. 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.

A bank's choice on how to handle withdrawn observations should be part of assessing the overall conservatism of their risk quantification. For instance, it is conservative to assume that all the borrowers who repaid their loans before the period end default at the same rate as borrowers who do not pay their loans. For troubled borrowers, the bank has successfully worked out the loan without a default. For other borrowers, payment indicates that they had sufficient resources to pay off the loan when they did, which may imply that they were less likely to default during the remainder of the year (if observed) than borrowers that do not pay off their loans. A bank that chooses a less conservative assumption here could either make more conservative assumptions in other areas or would need a greater cushion over their computed Pillar I number than the more conservative bank.

III. Wholesale Exposure Questions and Issues

A. NPR Wholesale Questions for Formal Comment

1. *Question 1:*

The agencies seek comment on and empirical analysis of the appropriateness of the proposed rule's AVCs for wholesale exposures in general and for various types of wholesale exposures (for example, commercial real estate exposures).

Commercial real estate and other wholesale AVCs were studied and debated over several years and then agreed upon internationally. The proposed correlations are generally consistent with internal bank methodologies, with some minor differences. We believe it is important to maintain consistency with the international framework's AVCs since U.S. banks compete with banks from foreign jurisdictions. Changing correlations in the U.S. rules would make it terribly difficult for international implementation.

2. *Question 13:*

The agencies seek comment on this aspect of the proposed rule and on any circumstances under which it would be appropriate to assign different obligor ratings to different exposures to the same obligor (for example, income-producing property lending or exposures involving transfer risk). **(Refers to requirement to assign a single grade to a wholesale obligor, render all bank exposures to obligor as defaulted in the event of single exposure default, and not consider collateral when assigning obligor rating.)**

There is a serious logical inconsistency in the rule. 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 his obligations to the bank.

If all creditors had equal priority with regard to claims on the borrower's cash flows and assets, 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 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. (See also Question 14: for further discussion of the inconsistency between the default definition and the rules for differentiating PDs.)

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.

The following example highlights this inconsistency. The definition for 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 in the 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 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 collateral, these borrowers would not be bankable. 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.

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.

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. (One can still impute a default rate. See Issue II.B.2) 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.

The retail rules recognize that collateral can affect default risk, since loan-to-value and similar collateral-based characteristics can be used to segment a bank's portfolio and assign different default rates.

Whenever the rules force a predetermined framework on a broad set of results without regard to whether the circumstances around those results fit the assumptions underpin-ning the framework, one is likely to distort the data or to produce results that cannot be

validated. It would be better to grant additional flexibility in interpreting the rules and to let banks' validation processes and on-site supervision determine whether they match reality.

3. ***Question 14:***
The agencies seek comment on this proposed definition of default and on how well it captures substantially all of the circumstances under which a bank could experience a material credit-related economic loss on wholesale exposure. In particular, the agency seeks comment on the appropriateness of the 5 percent credit loss threshold for exposures sold or transferred between reporting categories. The agencies also seek commenters' views on specific issues raised by applying different definitions of default in multiple national jurisdictions and on ways to minimize potential regulatory burden, including use of the definition of default in the New Accord, keeping in mind that national bank supervisory authorities must adopt default definitions that are appropriate in light of national banking practices and conditions. **(Wholesale definition is 1. non-accrual, 2. full / partial charge-off, or 3. a 5% or more credit-related loss upon sale or relevant account transfer.)**

General Comments:

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. We do note that, depending on bank processes, there are likely to be some small differences among the details of when loans are moved to non-accrual or charged off. There are likewise some (relatively small) 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.

We have been troubled to hear reports that some banks find material differences between the guidance they have received around U.S. non-accrual rules and the international default definition as it pertains to loans that are 90-days delinquent but so well secured that the realization of the collateral will eventually repay the loan. Others have reportedly been instructed that these situations should not be placed on non-accrual. Our experience is that such a situation would be a non-accrual (unless repayment was in process) and would therefore be a default, consistent with the international framework.

We call attention to a serious inconsistency between this default definition and the rules around assigning default grades and PDs. As discussed in Question 13 (see above), this 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.

Loans Sold at 95:

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. We will discuss this problem, which is also described above (see II.B.2).
We will then present analyses in several sections to illustrate problems that arise from the current proposal.

1. We show that a value of 95 does not indicate default:
    a. We will first show that credit deterioration is only one of several factors that affect the valuation of a loan, and we will 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.
    b. The practical reality is that the market clearly assigns values of 95 and below to non-defaulted loans. We use the Lehman speculative grade index to show that many non-defaulted instruments trade below 95 in some periods.
    c. The market also illustrates that no single value is indicative of default. We show market data from 2007 where certain loans from a borrower are traded at less than 95 while others are priced above par on the same date.
2. We show that using this rule would severely distort PD and LGD rates and create results that cannot be fairly compared to external benchmarks.
3. We discuss the harmful effect that this rule would have on risk management practices, likely resulting in an increase in risk.
4. We present an appropriate alternative that would accurately record defaults.

Accurately reflecting loan sales in other parameter measures. The NPR states that the agencies expect banks to assess carefully the impact of *retail* exposure sales in quantifying the risk parameters calculated by the bank for its retained retail exposures. It is not reasonable to assume that every loan that leaves the bank – particularly those that leave through a sale – would not have defaulted if it had remained in the portfolio throughout the year. The loans may have defaulted at the same rate as similar loans that remained in the portfolio and whose behavior was observable, or the bank may impute a different default rate based on the characteristics of the loans at the time they were sold. By attributing a realistic default rate to borrowers who leave during the year, a bank can develop more accurate estimates of the default rate to be attributed to remaining and new borrowers.

The commercial rules use an oversimplified approach to imputing a default rate to borrowers who leave the portfolio. The NPR is silent on how to treat all of them except

those that leave through a sale at a price of 95 or worse. Presumably, a bank could assume that none of the withdrawn borrowers defaults during the remainder of the year. However, for borrowers that leave by a sale at or below 95, the rules require a bank to assume that 100 percent of these borrowers default before the year ends. As described below, this produces clearly incorrect parameters.

The problem can be avoided by using an approach similar to that presented in the retail rules. In all probability, some of the borrowers will default. It is up to the bank to apply valid techniques to impute an annualized default rate to sold loans and other borrowers whose behavior cannot be observed throughout the year.

Many factors affect a loan's value when sold. One can create many examples of moderately downgraded loans that are valued at 95% or less using standard valuation models. There are many reasons why loans may be sold at 95% or less, including changes in interest rates, non-conformance to market demand or standards, portfolio liquidation, concentration reduction, and a variety of loan-specific factors.

The NPR does say that default is triggered by a five percent *credit-related* discount. However, it would be onerous and impractical for banks to separate "credit related" discounts from non-credit related value changes for each loan sale, not to mention the debates that would be raised by such sorting.

Even if it were possible to isolate a credit-related value change, numerous loan-specific factors will produce different valuation changes for the same change in credit quality /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.

To demonstrate, we cite the following examples. The example shown in Figure 3 demonstrates how differences in remaining maturity influence the discount. As shown, a longer contractual term produces a larger value drop as default risk increases. Consider a borrower with a variety of debt priced to produce a par valuation at a BBB rating. If the borrower's PD rises to 8.5 percent, a loan with a one-year remaining life will lose less than 5 percent of its value, although another loan with 5 years remaining until maturity would lose nearly 15 percent of its value.[4] The borrower, of course, has a less than 1-in-10 chance of actually defaulting. The chart shows that 95% is not the proper cutoff, but neither is 90% or 85%. Addressing this issue with a "line in the sand" is not the proper approach.

[4] Valuations computed with a commonly used valuation model, which is also used in Wachovia's economic capital model to assess the cost of credit migration.

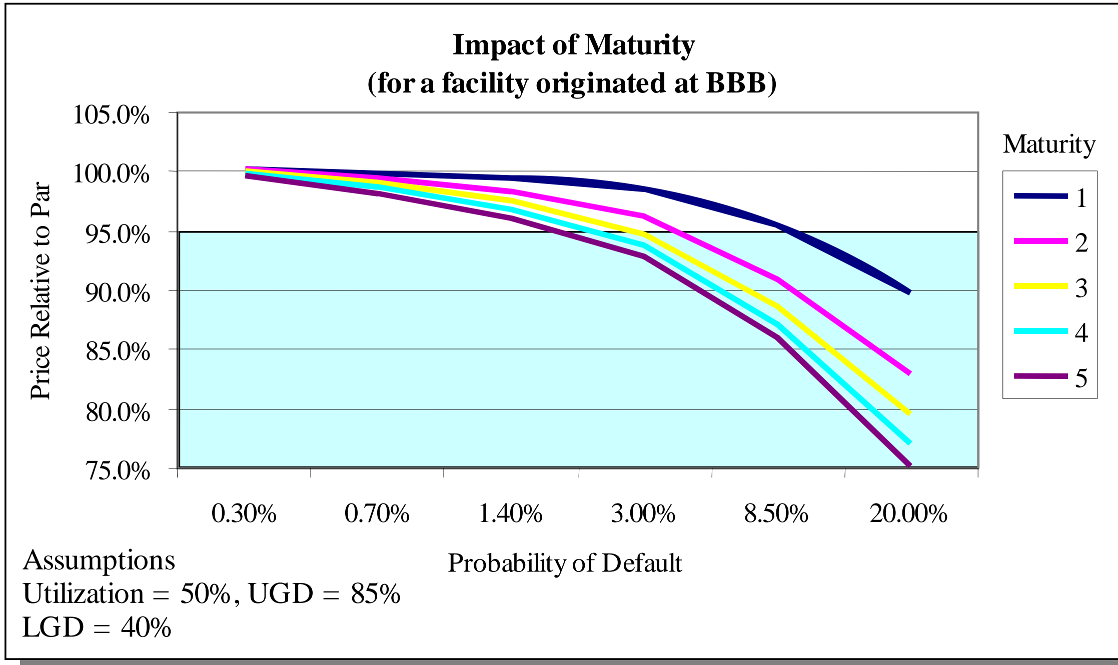

Figure 3: Remaining maturity and value

Figure 4 depicts negative migration with two loans having different initial ratings. As PD increases the loan values decrease, but the impact of negative migration is more pronounced for names that originate as investment grade. If both loans deteriorate, the loan initially at investment grade will reach a 95% discount first, and per the proposed rule be technically in default. The example loan originated with investment grade pricing reaches this point with a PD of only 3%. Yet this credit rating and risk of default is the same as the other loan trading well above 95%.

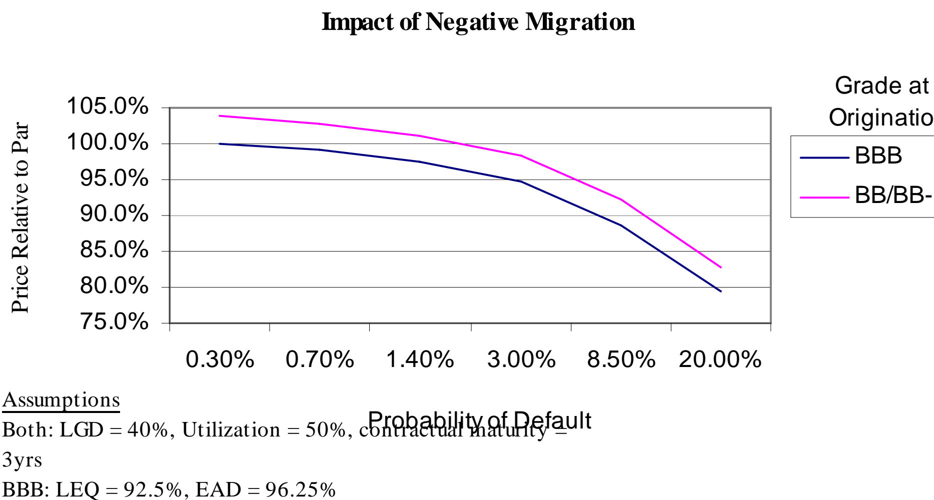

Figure 4: Original Price and Value

The market prices many non-defaulted assets at less than 95. Figure 5 shows the Lehman high yield index. The index contains no defaulted bonds yet the overall index fell below 95 for the entire period from August 1998 to May 2003, going as low as 75. Since these are fixed rate bonds, one could ask if rates (a non-credit factor) produced the change, but the lower graph shows that spreads (a credit-related factor), not general rates, produced the change.

A dramatic decrease in value and increase in spreads occurred in August of 1998. That was the month when the index value first fell below 95, but it was also the same month of the Russian currency and default crisis. The index excludes debt issued from countries designated as emerging markets, but yet the market still witnessed an increase in U.S. credit spreads in sympathy to world events.

For both of the reasons outlined above, requiring banks to put all debt to firms with loans or bonds trading below 95 into default would produce misleading, disruptive statistics.

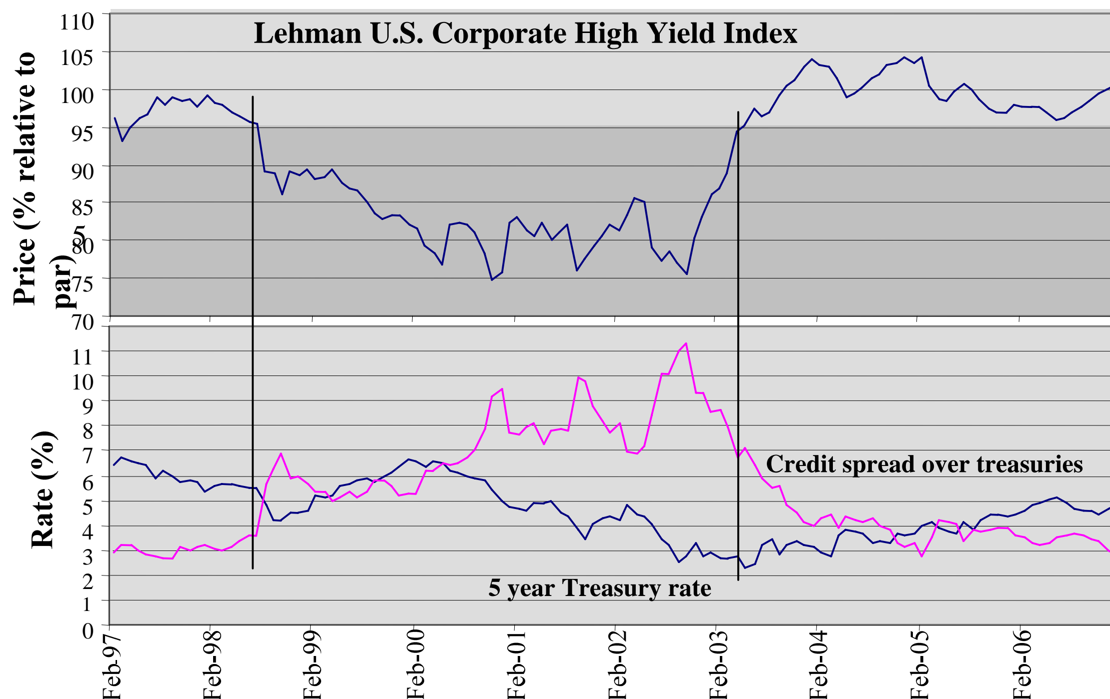

Figure 5: Lehman High Yield Index

The market also illustrates that an entity's loans may trade at several different values, and no single value is indicative of default. Figure 6 shows the illogic of supposing that a single value of one credit exposure indicates whether a borrower is in default. On the same day, one loan to Ford traded at more than 101, while another was

priced at about 94. The rule would require that a bank that traded the latter to put all Ford exposures into default, including the loan trading at 101. This would cause considerable confusion and disruption in the secondary market.

		Term Loan	Revolver
Ford	Bid/Ask*	101.25 / 101.625	93.625 / 94.25
		Note: same security package and credit agreement, with term loan two years longer.	
	Funding	Funded	Unfunded
	Effective Coupon	L+300	L+50
	Market	Deep	Shallow
	Tranche Rating (Moody's)	Ba3	Ba3

*Quotes from Morgan Stanley's par loan desk on the morning of 1/24/2007.

Figure 6: Is Ford in Default?

Using this rule would severely distort PD and LGD rates. Labeling loans sold below the proposed threshold as having defaulted results in many undesirable consequences in developing accurate parameters. For example, in 1994 one of Wachovia's predecessor institutions considered all loans sold at a material discount to be defaults. This practice was discontinued once we recognized the distortions caused by this approach. Secondary trading is common for large, unsecured corporate loans. Suppose 10 such loans actually defaulted and had an LGD of 50 percent. Suppose another 10 were sold at 95 and that there were a further 10 loans repaid in full by the borrowers with sales at 95. If forced to call the second and third group defaults, the bank would have experienced an LGD of 18.33 percent for large corporate unsecured loans. It would be a mistake to assign this low rate as the LGD for large corporate unsecured loans when the appropriate experience is that the truly defaulted loans lost 50 percent.

	Count	LGD
Actual Defaults	10	**50%**
Loan Sales	10	5%
Repaid (others sold)	10	0%
Overall	30	18.3%

Further, since this characteristic is unequivocally not a generally acknowledged definition of default, comparing PDs computed with this definition may well produce default rates

that cannot be compared to external benchmarks. This is particularly true for low default portfolios, such as investment grade corporate borrowers.

This rule would have a harmful effect on risk management practices, and would likely result in an increase in risk. Best practice in portfolio management includes reducing exposure – often via loan sales – as a borrower's default risk increases. The reduction is usually gradual with acceptable position sizes decreasing as PDs move higher and higher.

This rule would likely disrupt this activity. Suppose a bank has a large position in a credit whose price has dropped to 94.9 (which could occur with a PD of only 3 percent, as shown in Figure 3 above). It may choose to reduce its position by 10 percent. But with this rule it would have to disclose that the entire remaining position has defaulted. This gross overstatement of the defaulted loans in its portfolio would make the bank appear much riskier than it is, and a bank may well desire to avoid making this misleading disclosure to the market. Consequently, it may elect to forego the loan sale and hope that the riskier portfolio will not have adverse consequences. If the deterioration continues, the bank would naturally continue to reduce its position, but the appearance of a large default could continue to inhibit sound practices.

The risk management profession has worked hard to move best practices to the point where banks actively manage risk and sell loans. It would be quite unfortunate if capital regulation were to undo some of the progress made to date.

Banks should accurately reflect the status of loans that are being sold. If the agencies are concerned that banks could understate defaults by selling loans that would otherwise be in default, the solution is to require that banks accurately record defaulted loans from among those that are being sold. It is reasonable to require banks to assess whether a loan would be put on non-accrual (or would be 90 days or more delinquent) if it were not sold. These loans are, in fact, in default, and a bank should record them as such even if it then immediately sells them. This accurate accounting of defaults is necessary for analyses, including that which imputes a default rate to the sold loans.

Flexibility is needed as this rule is applied to derivatives and related exposures. While clarified by the supervisory guidance, the wholesale default definition in the proposed rules is not consistent with the definitions of default used in master netting agreements (*e.g.*, ISDA, GMRA, MSLA, etc.) for OTC derivatives and Repo-style transactions. As a consequence, actual defaults will differ from regulatory defaults, causing firms to implement duplicative tracking mechanisms and potentially distorting empirical PD and ELGD/LGD parameter data collected. The definition of default in the proposed rules should specifically include defaults applicable to OTC derivatives and Repo-style transactions, particularly where these are the only exposures to the borrower. In doing so, the rules should also differentiate between non-credit-related termination events (*e.g.*, tax events) and credit-related default events (*e.g.,* bankruptcy*),* with only the latter included in the regulatory definition.

In addition, to the extent that there are still differences, regulators should be flexible and permit use of the home regulator's default definition when the U.S. is the host country. A single PD should be applied to the borrower wherever the loan is booked, and a single view of default should support the analysis. If the difference caused by this approach were material (and we do not expect it to be), the effect on capital requirements should be addressed in Pillar II. U.S. regulators should encourage reciprocal treatment when U.S. banks operate in other jurisdictions.

4. ***Question 18:[Part 1]***
The agencies seek comment on the feasibility of recognizing such pre-default changes in exposure in a way that is consistent with the safety and soundness objectives of this proposed rule. The agencies also seek comment on appropriate restrictions to place on any such recognition to ensure that the results are not counter to the objectives of this proposal to ensure adequate capital within a more risk-sensitive capital framework.

We believe the proposed rule is a correct means of recognizing this important risk management practice. For example, suppose a $1 million loan sent to workout has the balance reduced to $100,000. When the bank realizes the loan will not be repaid in full, it moves the remaining balance to nonaccrual. It eventually recovers another $50,000 and writes off $50,000. The industry would recognize this as a 95% recovery, and not a 50% loss.

Granted, this proposed rule creates a situation where it is incumbent on the bank to keep the LGD estimate up to date. One cannot realize the full collateral value (at the $100,000 point) and still grade an LGD as though the $1 million resources are still available.

No restrictions should be placed to limit recognition for exposures where the pattern of predefault paydowns is common, measurable, and significant. The benefit is as real for occasional cases as for commonly occurring paydowns. Moreover, it would introduce a data management nightmare to discern what individual transactions are acceptable. Compliance costs are compounded when one must also differentiate between material and immaterial paydown adjustments. The rule seems to require costly special treatment to ensure that immaterial amounts are handled in a special way.

We agree, however, that it would be prudent to exclude partial loan sales from this proposed rule. Consider a $2 million dollar loan sent to workout, with $1 million sold at 95% of initial value, and the remaining $1 million is moved to non-accrual. The bank then charges off $400,000 and recovers the rest. The part sold before default was not "recovered" from the customer. The LGD is 40 percent (ignoring discounting) for the part not sold before default. Note, however, that if default had to be declared when the first piece was sold at 95%, LGD would be 22.5 percent.

5. ***Question 18:[Part 2]***
In addition, the agencies seek comment on whether, for wholesale exposures, allowing ELGD and LGD to reflect anticipated future contractual paydowns prior to default may be inconsistent with the proposed rule's imposition of a one-year

floor on M (for certain types of exposures) or may lead to some double-counting of the risk-mitigating benefits of shorter maturities for exposures not subject to this floor.

We do not understand why the 1-yr floor on M would affect the proposal to permit recognition of certain predefault paydowns.

6. ***Question 24:***

The agencies seek comment on how to strike the appropriate balance between the enhanced risk sensitivity and marginally higher risk-based capital requirements obtained by separating HVCRE exposures from other wholesale exposures and the additional complexity the separation entails. **(HVCRE exposures have a different (more conservative) capital correlation factor to reflect their higher asset value correlations.)**

Wachovia has three general concerns with the proposed HVCRE definition. Overall, our concerns with this rule can be addressed through closer alignment with FDICIA rules.

- Exclusion "B" to the HVCRE definition is very problematic for the following reasons: (i) while we agree with the importance of having "skin in the game," especially for development and construction loans, there are numerous factors banks consider when determining an appropriate level of minimum cash equity (property type, pre-leasing, tenant creditworthiness, etc.) and a standard benchmark of 15% does not consider all of these factors (for example, less than 15% may be reasonable for a single credit tenant project and more than 15% may be reasonable for a speculative office building); (ii) lenders typically think about cash equity as a percent of total project cost, not as a percent of "as completed" value; (iii) the rule would require significant changes to internal systems for monitoring and tracking; and (iv) it's unclear how this exclusion would be applied to phased projects. Therefore, we suggest that Exclusion "B" be removed.

- Exclusion "C" will also be problematic to track. Clarification is requested regarding the definition of a withdrawal and the potential complexity this may place on exposures that continually straddle the 15% contributed capital threshold.

- We note that renovations present particular problems for the determination of cash equity, since equity is already in the property being redeveloped. Again, we agree with the importance of having "skin in the game," but we believe that grading systems and risk management processes are the appropriate tools to address these risks.

7. ***Question 25:***

The agencies request comments and supporting evidence on the consistency of the proposed treatment with underlying riskiness of SME portfolios. Further, the agencies request comment on any competitive issues that this aspect of

the proposed rule may cause for U.S. banks. **(Agencies are not granting preferential RWA treatment to SME exposures. International Accord offers a more favorable correlation function.)**

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 argue in our cover letter, issues such as this one ought to be aligned with the international rules to maintain a level playing field among banks domiciled in different countries.

8. *Question 31:*

The agencies seek comment on the appropriateness of permitting a bank to consider prepayments when estimating M and on the feasibility and advisability of using discounted (rather than undiscounted) cash flows as the basis for estimating M. **(M refers to effective remaining maturity.)**

Many banks are currently studying the effect of prepayments on commercial loans, especially prepayments by risky borrowers who are encouraged to prepay by covenants, fees, increased interest rates, etc. We do not know of any published work on the impact of these prepayments on future defaults, but we believe that prepayments do have an effect on effective remaining maturity and that banks will ultimately be able to model it. We encourage regulators to monitor this issue and to be ready to approve innovative approaches when validated.

One place where prepayment can be shown to effect parameters is in default behavior. Borrowers that completely prepay do not default. Default risk can be shown to vary with certain structures or covenants. In situations such as asset-based lending, one should not be forced to ignore factors that mitigate default, whether they are collateral, guarantors, or other structuring terms. We urge the agencies to permit banks to recognize characteristics that are related to the full payment of loans and the avoidance of defaults in differentiating PD rates. This is an important risk management tool and banks should recognize it when appropriate rather than being forced to spread the benefit across all loans.

We make the following additional recommendations concerning M.

- Banks should be allowed to use either undiscounted principal payments or discounted cash flows when calculating M.

- The proposed treatment (setting M equal to the greater of one day and M) for exposures with an original maturity of less than one year and are not part of a bank's ongoing financing of the obligor is operationally burdensome. It would be nearly impossible to administer a system to identify which loans do or don't meet the three criteria listed, particularly the third – that the bank has no substantial commercial incentive to continue its credit relationship with the obligor in the event of credit deterioration of the obligor. While the desire to avoid evergreen loans is understood, the proposed rule will result in a tick-box style of review that is not feasible for bank compliance. As an alternative, we recommend that the floor for M be the lesser of 1 year and the original maturity of the loan as long as the first 2 criteria are satisfied.

B. NPR Wholesale Credit Derivatives Questions for Formal Comment

1. ***Question 40:***
   The agencies request comment on the appropriateness of these criteria in determining whether the risk mitigation effects of a credit derivative should be recognized for risk based capital purposes. **(Refers to 8 criteria governing contract requirements [some of which deviate from the International Accord] income statement, and balance sheet treatment and valuation, all of which, in addition to a further 6 requirements, must be satisfied to qualify for treatment as an eligible credit derivative.)**

The proposed criteria are reasonable for determining eligible credit derivatives.

2. ***Question 41:***
   The agencies are interested in the views of commenters as to whether and how the agencies should address these and other similar situations in which multiple credit risk mitigants cover a single exposure.

The proposed rules are a major improvement from earlier Basel II drafts. The proposed bifurcation-type treatment for multiple mitigants hedging a single exposure is reasonable. We would appreciate clarification of how single mitigants hedging multiple exposures should be handled under the wholesale rules. Understanding that treatment under the retail exposure rules varies from the wholesale exposure-by-exposure approach, some firms may hedge multiple wholesale exposures (*e.g.*, multiple loans to the same borrower) with a single credit derivative. Section 33(d)(2) mentions multiple exposures and we believe that the eligibility criteria in the text could be revised to clarify bifurcation-type treatment for single mitigant-to-multiple exposure hedging.

C. Comments on Other Issues Identified by Wachovia

1. ***Rules for Wholesale Guarantees***

The rules for wholesale guarantees, as listed on page 55876 of Federal Register Vol. 71, No 185, appear to have been written for non-related guarantees such as CDSs or bank LCs. The rules present problems for many other types of guarantees, even some government guarantees. It is not unusual for such guarantees to be structured so that the bank would first find the obligor in technical default prompting the balance of the loan to become immediately due. This constitutes a demand for payment from the obligor. Criterion (iv) states that guarantees in these cases are not eligible for use as credit risk mitigation. We strongly recommend that these rules be clarified and that appropriate rules be written for related-party guarantees.

2. ***Wholesale Lease Receivables***

We agree with the proposal to treat net wholesale lease investments as a single exposure to the lessee. This reflects how banks treat this product today.

3. ***Capital for Defaulted Loans***

The proposed approach is somewhat unclear. If the 100% risk weight applies to the entire EAD (legal amount owed plus UGD), then the rule double counts the capital requirement for the charged off portion of the loan, since the charge off has been subtracted from capital through the income statement. It is reasonable to require a capital charge for the ***net*** balance of defaulted loans and to recognize that charged off amounts have already been deducted from capital. Since banks are required to reserve or write down expected losses – capital is only for potential additional ***increases*** in LGD.

It is excessively burdensome to require that banks track previous capital amounts to comply with the second part of the requirement. Further, it sets up perverse incentives to make big leaps rather than gradual risk rating changes.

If regulators are not satisfied that a 100 percent risk weight on net value plus the capital already deducted by writing down the loan provides sufficient coverage for defaulted loans, a simpler alternative would be to place a higher risk weight on the net book balance of the defaulted loan.

4. ***Collateral Rules***

The proposed collateral rules, as presented on page 55867 of Federal Register Vol. 71, No 185, appear reasonable for use as a starting point for analysis or when a bank has insufficient empirical data to determine how things work. Unfortunately, these rules are written as a stopping point, not a starting point. This ensures that, at least for regulatory capital purposes, banks will not be permitted to develop any deeper understanding of risk.

In reference to the second rule set, rule (i), the decision to spend money to perfect a lien should be justified from a cost benefit standpoint. A real benefit can be observed and measured – based on borrower historic behavior – for loans where the agreement states that the loan is secured, even without legal certainty around the lien. Regulators should not be permitted to demand legal certainty when it does not make economic sense, particularly when LGDs are low.

Under the second rule set, rule (iv), the need to regularly estimate collateral market values is particularly burdensome and of limited benefit. In estimating collateral market values, banks consider costs as well as benefits when deciding on whether to update collateral valuations. There are many circumstances where it's the proper business decision to obtain an updated collateral value, but it is operationally infeasible to do so regularly for all loans.

5. Wholesale Credit Derivatives

We would appreciate clarification of the scaling of the currency mismatch applicable to wholesale exposure hedging (Section 33(f)(2) and (3)).

In addition, we believe the rule should be expected to address the use of contingent credit default swaps (CCDS) to hedge counterparty risks inherent in OTC derivatives. In such cases, CCDS should be eligible hedges under substitution and double-default methods, subject to eligibility criteria generally consistent with those applicable to CDS. For CCDS hedging, the hedged obligation would be the OTC derivative exposure, as measured under the proposed rules. In recognizing this treatment, the rules would need to be revised to exclude restructuring requirements (as these are not applicable to the OTC derivatives) and incorporate a number of other conforming changes. In addition, as noted in our comments dated January 19, 2007 on the proposed market risk rules, trading book and banking book definitions need to be adjusted to support symmetrical treatment of the CCDS (a trading book instrument as proposed) used to hedge OTC derivatives (a banking book instrument as proposed).

Further, although the proposed rule is largely consistent with the Accord in the treatment of credit hedging, we encourage the agencies to reconsider the proposed treatment together with the Basel Committee. Improved capital treatment for double default, maturity mismatch and restructuring haircuts will provide more appropriate incentives for risk mitigation through the use of credit hedges.

IV. Retail Exposure Questions and Issues

A. NPR Retail Questions for Formal Comment

Appendix to Basel II NPR Comment Letter Dated March 26, 2007 of Wachovia Corporation

1. ***Question 2:***
The agencies seek comment on and empirical analysis of the appropriateness and risk sensitivity of the proposed rule's AVC for residential mortgage exposures - not only for long term, fixed-rate mortgages, but also for the adjustable-rate mortgages, home equity lines of credit, and other mortgage products -- and for other retail portfolios.

As with wholesale AVCs, this was studied and debated over several years. Though the chosen AVC differs from what banks use internally, the actual value appears to be a reasonable attempt to align the Basel formula, which lacks an implied maturity factor, with industry practice, which may include one.

2. ***Question 4:***
***The agencies seek comment on the use of a segment-based approach rather than an exposure-by-exposure approach for retail exposures.* (Refers to the requirement to segment retail exposures into groups of similar risk traits, versus requirement to evaluate exposures on an individual level.)**

Loan level modeling is in place at most advanced banks and is the most useful approach for risk measurement. After an individual exposure's risk is measured, the exposure is assigned to a risk segment. Subsequently, if an exposure's risk score changes over time, the exposure will dynamically migrate to a new risk segment. The Basel process should encourage loan level modeling and dynamic risk segmentation consistent with bank advancements in risk measurement.

In some cases, even banks that generally use loan level modeling will utilize a segment approach – with, for instance, small or simple homogeneous portfolios. Both approaches should be available to be used where appropriate.

3. ***Question 14:***
***The agencies seek comment on this proposed definition of default and on how well it captures substantially all of the circumstances under which a bank could experience a material credit-related economic loss on wholesale exposure. In particular, the agency seeks comment on the appropriateness of the 5 percent credit loss threshold for exposures sold or transferred between reporting categories. The agencies also seek commenters' views on specific issues raised by applying different definitions of default in multiple national jurisdictions and on ways to minimize potential regulatory burden, including use of the definition of default in the New Accord, keeping in mind that national bank supervisory authorities must adopt default definitions that are appropriate in light of national banking practices and conditions.* (Retail definition is partial / full charge-off or write-down or 120-180 days past due.)**

We encourage the agencies to 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 nonaccrual 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.

4. *__Question 29:__*
The agencies seek comment on this approach to tranched guarantees on retail exposures and on alternative approaches that could more appropriately reflect the risk mitigating effect of such guarantees while addressing the agencies' concerns about counterparty credit risk and correlation between the credit quality of an obligor and a guarantor. **(Tranched guarantees that apply to individual retail exposures will not be subject to securitization framework; banks may recognize recoveries from both obligor and guarantor for ELGD / LGD calculation).**

The retail approach to tranched guarantees of individual credits agrees with the way such guarantees actually perform; the wholesale rules should be conformed. As discussed below, securitization rules and formulas were designed to deal with the risk of correlated / uncorrelated defaults. Tranched exposure and guarantees to single loans will simply result in different EADs and LGDs.

Further, we discuss below that it is appropriate to recognize counterparty credit risk from guarantors, but that the NPR's treatment produces unreasonable results. We propose that the agencies permit a conceptually sound approach to recognizing a double default benefit, since a guarantor default will not result in the default of all guaranteed loans.

For additional comments about retail guarantees, see our full discussion following Question 42.

5. *__Question 32:__*
The agencies seek comment on whether the agencies should impose the following underwriting criteria as additional requirements for a Basel II bank to qualify for the statutory 50 percent risk weight for a particular mortgage loan: (i) That the bank has an IRB risk measurement and management system in place that assesses the PD and LGD of prospective residential mortgage exposures; and (ii) that the bank's IRB system generates a 50 percent risk weight for the loan under the IRB risk based capital formulas.

If a bank does not have the requisite IRB risk management system then regulators should not add qualifying criteria that will increase operational burden. In such circumstances

we recommend that the 50% risk weight be applied only to 1-4 family residential pre-sold construction loans.

In reference to requirement "ii", it does not seem logical to require a bank's IRB system to replicate an exact risk weight of 50%. Rather, this requirement should reference RW's of either $< 50\%$ or $\geq 50\%$.

6. ***Question 33:***
The agencies seek comment on all aspects of the proposed treatment of one-to four-family residential pre-sold construction loans and multifamily residential loans. **(Refers to 50% RW for 1-4 family presold construction loans, a 50% RW for multifamily residential loans meeting certain criteria, and a 100% RW for 1-4 family presold construction loans with a cancelled purchase agreement.)**

We would like to apply the Basel rules to as many exposure classes as is practical. Our preference is to minimize exception cases and keep carve-outs as simple as possible.

7. ***Question 42:***
The agencies seek comment on this alternative approach's definition of eligible retail guarantee and treatment for eligible retail guarantees, and on whether the agencies should provide similar treatment for any other forms of wholesale credit insurance or guarantees on retail exposures, such as student loans, if the agencies adopt this approach. **(Eligible retail guarantee definition requires PMI protection with senior unsecured long-term debt in one of two highest investment grade categories. Guarantee must be recognized in LGD, not PD.)**

Wachovia strongly opposes the approach of recognizing only PMI guarantors. Other loan products, such as 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.

For instance, if the guarantor disappeared and the underlying loans went through an event stressed to a "capital" level, the loss (*i.e.*, the LGD for guarantor default) would only be the capital on the underlying, NOT LGD on the underlying applied to the default of 100 percent of the guaranteed loans. In reality, an even smaller LGD should be applied, since even a "downturn" LGD is not specified as the LGD matched to a 99.9th percentile of defaults.

The agencies seem to have recognized that this overly harsh treatment would create a significant error, and they have avoided the problem for the largest category of retail guarantees – PMI – by permitting banks to ignore guarantor risk altogether. The problem of extremely overstated capital is just as real for non-PMI guarantees as it is for PMI, so we ask that the agencies either permit banks to estimate the risk for all retail guarantees (*i.e.*, permit a conceptually sound approach to recognizing a double default benefit since a guarantor default will not result in the default of all guaranteed loans) or to ignore guarantor risk for all retail guarantees provided by an A-rated or better guarantor.

8. ***Question 43:***
The agencies seek comment on the types of non-eligible retail guarantees banks obtain and the extent to which banks obtain credit risk mitigation in the form of non-eligible retail guarantees. **(Non-eligible guarantees are those without PMI backing. Alternative is to treat non-eligible guarantor as wholesale guarantor and model exposure as wholesale exposure.)**

Privately insured student loans are the principal type of non-eligible retail guarantee used in Wachovia's retail lending. Although this is not a large portion of the bank's overall loan portfolio, such loans may be significant to anyone engaged in this business.

We believe that the agencies should allow treatment for other retail guarantees, such as privately insured student loans. It is inappropriate to assume that all of the insured loans would default in the event of the guarantor's default; only a small portion of the guaranteed loans would be at risk, as shown in Question 42.

Any portion of a loan guaranteed by the U.S. government should be assigned a zero EAD, since the LGD is zero and we can assume no guarantor risk.

9. ***Question 44:***
The agencies seek comment on both of these alternative approaches to guarantees that cover retail exposures. The agencies also invite comment on other possible prudential treatments for such guarantees. **(Other alternatives encompass recognizing all retail guarantees but restricting retail segment capital to a floor of 2%- 6%.)**

We agree with the proposed treatment for eligible retail guarantors, but would like to see the scope broadened to include other high quality guarantors. The current treatment for ineligible guarantors is very harsh. Though we support the proposal to treat an ineligible guarantor as a wholesale direct exposure, the inability to recognize double default or recovery effects is punitive. The rule appears to assume that a default of such a guarantor would be accompanied by having 100% of the underlying loans default. In the instance of student loans, only a portion would be at risk of default in the event that the guarantor

defaulted. In this scenario the credit risk would revert to the bank since it already carries the exposures on its books.

We do not support the alternative proposal of subjecting a non-eligible guarantor-backed segment to a capital floor.

B. Comments on Other Issues Identified by Wachovia

1. ***Seasoning in Retail PDs***

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, not an entire subcategory.

It would also be reasonable to permit the use of default rates computed without newly originated loans as an approximation for annualized remaining-life default rates.

2. ***Retail Exposure Definition***

We agree with the proposed retail definitions for lease residuals and mortgages, as these are consistent with internal best practices. The decision to not impose an upper limit on 1-4 family residential exposures is also prudent. The retail small business definition should be expanded to include individually managed loans with immaterial exposure sizes.

V. Repos, Margin Lending & OTC Derivative Questions

A. NPR Repos, Margin Lending & OTC Derivative Questions for Formal Comment

1. *Question 34:*
For purposes of determining EAD for counterparty credit risk and recognizing collateral mitigating that risk, the proposed rule allows banks to take into account only financial collateral, which, by definition, does not include debt securities that have an external rating lower than one rating category below investment grade. The agencies invite comment on the extent to which lower rated debt securities or other securities that do not meet the definition of financial collateral are used in these transactions and on the CRM value of such securities.

These are reasonable broad-brush criteria, however, the rules should support a broader range of financial collateral. The rules should be consistent with applicable law and provide firms with the ability to recognize other collateral when they can demonstrate it is prudent to do so.

For example, the proposed rules appear to exclude mortgage loans (and other whole loans) that are expressly recognized under the U.S. Bankruptcy Code (and other relevant statutes) and are increasingly liquid and securities-like. Similarly, there is an active, liquid, and growing market for corporate securities rated lower than one grade below investment grade, which are readily taken as collateral for Repo-style transactions. There are also many securities that, while unrated (such as Treasuries and many agency issues), should be permitted. Related to the haircuts, the June 2004 international guidance provided a cap on haircuts for securities lent, at the level of "Other equities" (Para. 153). Standard supervisory haircuts could include additional asset classes with "Other publicly traded equities…". A more conservative alternative would be to provide a 50% haircut, scaled for less liquidity (a 1-month hold) and higher volatility.

Collateral practices are evolving, and the regulatory framework should evolve with risk management practices. Beyond general asset classes and issuer credit quality, there are other, sometimes issue-specific and more important, factors that should be considered when evaluating collateral: volatility, liquidity, currency risk, custody and settlement processes, varying international collateral management practices, price transparency, and legal considerations. Under the own-estimates approach (and other advanced approaches), a firm should be able to recognize any financial collateral that meets prudent collateral risk management practices.

The rules should be revised (i) to provide a broader definition of "Repo-style transaction", (ii) to specifically include a broader range of market- and legally-accepted collateral in the definition of "Financial collateral" and (iii) to provide a non-prescriptive option that evolves with prudent risk management practices.

2. ***Question 35:***

The agencies recognize that criterion (iii) above may pose challenges for certain transactions that would not be eligible for certain exemptions from bankruptcy or receivership laws because the counterparty—for example, a sovereign entity or a pension fund—is not subject to such laws. The agencies seek comment on ways this criterion could be crafted to accommodate such transactions when justified on prudential grounds, while ensuring that the requirements in criterion (iii) are met for transactions that are eligible for those exemptions. **(Criterion (iii) requires that the transaction is executed under an agreement that provides the bank the right to accelerate, terminate, and close-out the transaction on a net basis and to liquidate or set off collateral promptly upon an event of default (including upon an event of bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdiction.)**

Wachovia believes that criterion (iii) should be broadened in application so that financial transactions may qualify for the beneficial capital treatment even if the counterparty is not an entity falling within the scope of favorable netting / insolvency regimes, such as when the counterparty is a sovereign, central bank, insurance company, pension fund or other institutional counterparty. The risk of an insolvency of this type of counterparty is low and such risk is typically managed by robust risk management systems that monitor credit lines and trade tenors, daily marks and collateral call rights; the transactions also provide for termination rights upon a payment default, a credit downgrade or financial covenant event, or other early warning event.

Current regulations permit recognition of collateral in certain securities lending transactions absent a no-stay requirement.[5] The proposed rules could be prudently harmonized by adding to the existing provision an option to recognize collateral absent the no-stay requirement, provided the exposure is not part of the ongoing financing of the counterparty (as defined in the NPR at FR Page 55926).

3. ***Question 36:***

The agencies seek comment on the appropriateness of requiring that a bank have a perfected, first priority security interest, or the legal equivalent thereof, in the definition of financial collateral.

While it is Wachovia's risk management practice to ensure that it has a valid and perfected security interest in collateral, the requirement that collateral be subject to a perfected security interest can raise complicated legality issues where counterparties are organized in different jurisdictions, trading out of offices located in other jurisdictions, and posting collateral issued and traded through multiple jurisdictions. Because U.S. and EU countries have adopted laws that have eliminated registration and other formalities previously associated with perfection of security interests, Wachovia believes that favorable capital treatment should be recognized for all liquid, financial collateral where

[5] Federal Register, Vol. 71, No. 35, February 22, 2006, Final Rule, page 8932

the collateral is in the possession and control of the secured party and the secured party has a reasonable basis to believe it could promptly liquidate the collateral (in addition to other criteria required by the proposed rules).

4. ***Question 37:***

The agencies recognize that this is a conservative approach and seek comment on other approaches to consider in determining a given security for purposes of the collateral haircut approach. **(Refers to requirement, for netting collateral with the same counterparty, that only securities with the same exact CUSIP number qualify for netting treatment.)**

The approach of requiring identical securities, while conservative, is a reasonable way to establish clear and simple criteria on which to base the simplest calculation alternative. Measuring net collateral risk across different securities requires assessment of security-specific terms such as term structure, call features, etc. – the features of which are available in the more advanced approaches permitted under the proposed rules.

5. ***Question 38:***

The agencies seek comment on methods banks would use to ensure enforceability of single product OTC derivative netting agreements in the absence of an explicit written legal opinion requirement.

Firms should be permitted to rely on country-based grids (which would be prepared by in-house counsel based on review of the industry and commissioned opinions) that classify counterparties by jurisdiction, legal type, and other relevant factors (provided core documentation requirements are met), such that enforceability can be monitored at the broader classification level rather than counterparty-by-counterparty.

6. ***Question 39:***

The agencies request comment on all aspects of the effective EPE approach to counterparty credit risk, and in particular on the appropriateness of the monotonically increasing effective EE function, the alpha constant of 1.4, and the floor on internal estimates of alpha of 1.2.

IMM is a major improvement over CEM, and broadly consistent with leading practices. We are pleased that regulators have incorporated these provisions into the NPR, as they provide reasonable risk estimates that are much needed for this large and growing product segment.

ISDA, of which Wachovia is a member, has had extensive dialogue and written communication with regulators regarding IMM. A number of discrepancies remain between our preferred approach and the NPR. We ask that regulators refer to comments on this NPR delivered by the IIF, ISDA and LIBA. We wish to emphasize the following points:

- 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.
- While somewhat clarified by the supervisory guidance, 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.
- We believe firms should be permitted to recognize collateral required by deteriorations in counterparty credit quality, provided that subject to regulatory approval the internal model used models the coincidence of (i) the relevant attributes(*e.g.*, counterparty rating)and (ii)collateral required, or a conservative proxy thereof(*e.g.*, resulting from the highest applicable counterparty threshold under the collateral agreement).
- The definition of "Effective Maturity" (FR 55914) should also include M (EPE) (FR 55932).
- The proposed rules and guidance include a requirement to calculate "expected exposure" with and without the effect of collateral. We believe other measures of potential future exposure (*e.g.*, peak exposure) should also satisfy the requirement.

B. Comments on Other Issues Identified by Wachovia

1. <u>Margin Loans</u>

The rules around margin lending illustrate our concerns about prescriptiveness. The definition of an "eligible" margin loan is quite technical, even referring to various sections of the U.S. bankruptcy code, FDICIA, etc. In reality, the economics and borrower behavior associated with margin lending extend well beyond the narrowly defined bounds of "eligible" margin loans. It is not apparent why the line has been drawn between transactions eligible for this treatment and those that are economically equivalent but that may not meet a minor technical requirement. If the loan behavior is indistinguishable there should be no need to calculate a separate capital value. This is especially problematic when written in the rule rather than the guidance. The guidance could be a starting point or fallback in the absence of good numbers. In the rule, we are restricted to a single approach that may poorly represent reality. Such prescriptive rules do not fit with an empirical approach based on internal results, since empirical findings cannot be used directly to describe behavior, they must be force fit into a framework that may not apply.

As Wachovia wrote in a March 9, 2006 letter to the agencies (with three other banks), the problem is that margin loans outside of the definition for "eligible" facilities do not behave like traditional loans.

The key issue is that one cannot observe a borrower default in the same way that one does in other lending situations. One can see that in many cases collateral is liquidated at the time some portion of the loan is repaid. But most of these cases are clearly not defaults. These borrowers have the contractual right to instruct or allow the lender to sell a portion of the collateral and often choose to do so. The borrower may use the event of a margin call as a prompt to get a poorly performing security out of his portfolio. Even if the borrower has few other options for repaying the loan, he does have the resources in the form of the security to repay the debt and does so without defaulting.

In many cases (*e.g.*, where the borrower has additional loans with the bank) we can plainly observe that the borrower has not defaulted on the other obligations. But in cases where margin lending is the only credit one has extended a specific customer, we know little about whether the borrower would be in default on other exposures.

This repayment activity contrasts with other credit exposures. With most lending there is no mechanism for the bank or borrower to quickly convert a portion of the collateral to cash and bring the loan back within margin as a normal part of business.

In light of these facts, we recommend that banks be permitted to link default risk for the broader group of margin loans to collateral characteristics and margining policies. Several precedents already exist for making PD primarily dependent on collateral rather than the borrower or for permitting the use of collateral as one of several factors that determine PD.

The specialized lending rules in the international Basel framework cover several cases where the proceeds from converting collateral into cash are the primary expected source of repayment. In the same way, the relevant measure of risk for much margin lending is the relationship between the collateral and loan values rather than the underlying borrower risk. SEC regulations have allowed lenders to forgo individual borrower credit assessments for years.

Similarly, in the rules for residential mortgage lending, loan-to-value is seen as an acceptable driver for PD rates, even though it is a characteristic of the collateral rather than the borrower.

We urge that regulators acknowledge that in situations such as margin lending, the presence of margined collateral as a typical means of repaying loans (*i.e.*, not through the collections or workout process for troubled debt) can be used to differentiate default probabilities and that banks be permitted to reflect this effect in their grading systems if observed.

Permitting the use of margin lending concepts beyond the narrowly defined set of "eligible" margin loans would push others to examine their empirical results to find the best framework to describe borrower behavior. Prescribing a single approach will inhibit better understanding of risk in this area.

VI. Equity Exposure Questions

A. NPR Equities Questions for Formal Comment

1. *Question 55:*
   The agencies seek comment on this definition. **(Refers to publicly traded equity exposures.)**

Wachovia sees no issue with the current definition of a publicly traded equity. This definition is consistent with how the industry and Wachovia view and manage publicly traded equity investments held in the banking book.

2. *Question 56:*
   The agencies seek comment on the approach to adjusted carrying value for the off balance sheet component of equity exposures and on alternative approaches that may better capture the market risk of such exposures. **(Adjusted carrying value is effective notional principal amount minus the adjusted carrying value of the on-balance sheet exposure.)**

Wachovia believes that both the definition and the related issue of the separation of banking book and trading book equity exposures are unclear. We would look for principles (not prescription) involving investment intent to determine how the banking book / trading book division is implemented in order to classify exposures appropriately. Given this, Wachovia believes that the proposed off-balance sheet treatment is acceptable. Warrants, though not specifically mentioned in the rules, should be excluded from this treatment, as they carry no book value and have no risk of loss that would lead to capital consumption.

3. *Question 57:*
   The agencies seek comment on the proposed rule's requirements for IMA qualification, including in particular the proposed rule's use of a 99.0 percent, quarterly returns standard. **(IMA Qualification requirements include use of internal model that produces estimate of potential losses for modeled equity exposures that are not less than result yielded using 99% one-tailed confidence interval VaR methodology, using a distribution of quarterly returns for a benchmark equity portfolio.)**

Wachovia believes that the IMA qualification requirements are largely consistent with the existing VaR market risk requirements for the calculation of regulatory capital. However, Wachovia would like to point out that the quarterly time period is not consistent with the proposed Risk Based Capital Standards: Market Risk (FR 55958). A 10-day VaR is used in that document, but a quarterly time period is referenced in the draft NPR.

A 99.0% 10-day VaR multiplied by 3 will not provide the same results as a 99.0% 90-day (quarterly) VaR. It would only provide the same results if the returns were normally distributed, which they are not. However, it appears to be a reasonable compromise between the equity holdings outside of and inside the trading book. Wachovia has no issue using this definition as the standard for calculating regulatory capital on publicly traded equity exposures.

4. ***Question 58:***
The agencies seek comment on the operational aspects of these floor calculations. **(Refers to floors on supervisory risk weights.)**

Wachovia believes there are no issues with the operational aspects of these floor calculations.

5. ***Question 59:***
The agencies seek comment on the necessity and appropriateness of the separate treatment for equity exposures to investment funds and the three approaches in the proposed rule. The agencies also seek comment on the proposed definition of an investment fund.

Wachovia believes that the proposed separate capital treatment for investment funds is appropriate. The three approaches presented allow for varying levels of sophistication and should enable all banks to comply appropriately with the proposed rules. We firmly believe that the 7% risk-weighting floor should be applied on an aggregate, not fund by fund, basis.

One issue that Wachovia has with the current proposed rules involves the treatment of hedge funds. In the draft NPR, fund investments with material liabilities are excluded from the equity rules. 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 as has been previously suggested. We believe that this treatment will result in punitive capital charges and a misalignment of risk and capital.

Finally, Wachovia believes that the definition of an investment fund should be modified to read as follows:

> “A company in which all or substantially all of the assets are pooled financial assets that are collectively managed in order to generate a financial return, including investment companies or funds with material liabilities.”

VII. Securitization Exposure Questions and Issues

A. NPR Securitization Questions for Formal Comment

1. ***Question 26:***
The agencies request comment on the appropriate treatment of tranched exposures to a mixed pool of financial and non-financial underlying exposures. The agencies specifically are interested in the views of commenters as to whether the requirement that all or substantially all of the underlying exposures of a securitization be financial exposures should be softened to require only that some lesser portion of the underlying exposures be financial exposures.

The proposed regulatory definition appears too restrictive. Securitization activities continue to advance with new exposure types and market acceptance. When a NRSRO independently rates a securitization, or any tranche thereof, the RBA should be available for that exposure. Regulators should not limit asset types eligible for securitization recognition and the RBA. Leveraged leases and income producing real estate that have been formally securitized are examples of exposures that should be eligible for the RBA, provided they are independently rated by a NRSRO. The regulatory agencies should not establish arbitrary requirements regarding financial and non-financial underlying exposures for treatment under the RBA.

2. ***Question 45:***
The agencies seek comment on this differential treatment of originating banks and investing banks and on alternative mechanisms that could be employed to ensure the reliability of external and inferred ratings of non-traded securitization exposures retained by originating banks.

While the proposal is consistent with existing guidance and practice, 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.

3. ***Question 46:***
The agencies seek comment on whether they should consider other bases for inferring a rating for an unrated securitization position, such as using an

applicable credit rating on outstanding long-term debt of the issuer or guarantor of the securitization exposure.

Banks should justify their rationale for such grades rather than having blanket rules that may not be equally appropriate in all circumstances. If the exposure is liquidity to an ABCP conduit, allow the use of the IAA should the bank qualify to do so because the structure could be such that the conduit tranche would be rated higher than the inferred rating.

4. *Question 47:*
The agencies seek comment on the appropriateness of basing the risk-based capital requirement for a securitization exposure under the RBA on the seniority level of the exposure.

The seniority level of the exposure is a reasonable approach for determining the capital requirement under the RBA. Unrated claims (*e.g.,* servicing advances), senior to the highest rated tranche of a securitization ("AAA"), should qualify for the same rating as the senior tranche.

5. *Question 48:*
The agencies seek comment on how well this approach captures the most important risk factors for securitization exposures of varying degrees of seniority and granularity. **(Refers to methodology for assigning risk weights under the RBA and IAA that employs a 2-dimensional RW mapping table. One dimension is the applicable 3rd-party rating and the other is the number of underlying exposures.)**

The proposal has logic overall, but it is hard to comment on the arbitrary level of the granularity cutoff. Also, there are significant operational difficulties in tracking payoffs within a structure to determine if or when it crosses the granularity threshold, so the treatment should apply only based on the original number of underlying assets. That being said, the risk of an aged structure with fewer underlying assets is greater.

6. *Question 49:*
The agencies seek comment on suggested alternative approaches for determining the N of a re-securitization. **(N refers to the effective number of underlying exposures.)**

Appropriate modeling of resecuritizations depends on structure. The securitization approach is based on correlated defaults, so the appropriate N depends on the defaults that will affect a deal's performance. In some cases, the relevant event would be the default of a securitization tranche that went into the resecuritization, so N would be the number of such tranches in the resecuritization. In other cases, the relevant defaults are those of the underlying loans, which would then determine N. No single approach will always give a reasonable answer.

7. ***Question 50:***
The agencies have not included this concept in the proposed rule but seek comment on the prevalence of eligible disruption liquidity facilities and a bank's expected use of the SFA to calculate risk-based capital requirements for such facilities.

Since these facilities will generally require an asset to meet an AA or AAA level to be eligible to be drawn, the 20% risk weighting appears appropriate.

8. ***Question 51:***
***The agencies seek comment on the appropriateness of these additional exemptions in the U.S. markets for revolving securitizations.* (Refers to conditions under which banks are not required to hold regulatory capital. These include situations where securitization has replenishment structure in which underlying exposures do not revolve; securitization contains revolving assets that mimic term structures; or where investors remain fully exposed to future draws following early amortization.)**

We agree with the exemptions (i) and (iii). It is clear in those exemptions that the underlying principle requiring investors to be fully exposed to the underlying risk of the assets has been met and, conversely, the originating bank has transferred all such risk. The exemption in (ii) is clear in its statement that if the amortization mimics term structures, then the exemption is met.

To illustrate our understanding of the proposed exemptions we have described our Home Equity Line of Credit (HELOC) product below and how it meets these exemptions.

Before amortization begins, all payments and new draws of HELOCs in a securitization structure are paid to or funded by the trust. Once the structure enters amortization, all new draws are property of the originating bank and not the trust. However any draws that existed at the time the amortization began remain in the trust and therefore the underlying exposure of those draws is to the investors, NOT the originating bank--exactly like a term deal. During amortization any payments on the HELOC are paid in the same order the draws occurred, first to the trust until the individual HELOC is zero, and then to the originating bank.

The HELOC is best viewed as two assets during amortization. The original drawn portion remains with the trust and therefore all the underlying risk exposures remain with the investors. Once the amortization period begins, future draws are property of the originating bank.

9. ***Question 52:***
The agencies solicit comment on the distinction between controlled and non-controlled early amortization provisions and on the extent to which banks use

> ***controlled early amortization provisions. The agencies also invite comment on the proposed definition of a controlled early amortization provision, including in particular the 18-month period set forth above.***

While we agree with the concept of controlled versus non-controlled early amortization charges, the 18-month straight-line amortization period stated in the NPR (to be considered "controlled") appears to be intended for subprime credit card exposures, which have low payment rates. An 18-month straight-line amortization period requirement is too long for prime credit cards, which have much higher customer payment rates. A 4.5 percent excess spread trapping point for all collateral is not appropriate. For example, HELOC securitizations have lower excess spread requirements than credit cards. Banks should be permitted to utilize actual deal specific amortization triggers to determine capital requirements for early amortization, rather than an arbitrary regulatory established excess spread level

> ***10. <u>Question 53:</u>***
> ***The agencies seek comment on the appropriateness of the 4.5 percent excess spread trapping point and on other types and levels of early amortization triggers used in securitizations of revolving retail exposures that should be considered by the agencies.***

A 4.5% excess spread trapping point is arbitrary and much too high for prime home equity lines of credit. Stating a prescriptive requirement based upon excess spread levels would be difficult to implement and create unnecessary burden. To simplify the rules and meet the regulatory agencies' desire for a capital charge on undrawn lines of credit, which are not unconditionally cancelable, the agencies should utilize a 10% conversion factor. If the line of credit is unconditionally cancelable, a 0% capital charge is appropriate.

Banks should also be required to hold capital for securitizations with an unplanned early amortization event (*e.g.*, performance reasons) that causes investors in a securitization to be repaid before the original maturity. Pillar II capital requirements should encompass this risk.

> ***11. <u>Question 54:</u>***
> ***The agencies seek comment on and supporting empirical analysis of the appropriateness of a more simple alternative approach that would impose at all times a flat CF on the entire investors' interest of a revolving securitization with a controlled early amortization provision, and on what an appropriate level of such a CF would be (for example, 10 or 20 percent).***

Please see response to question 53.

B. Comments on Other Issues Identified by Wachovia

1. Securitization-like Exposures

The definition of "securitization-like" remains somewhat confusing. The proposed securitization exposure definition could be interpreted as covering all situations with multiple loan classes, especially if executed through a single agreement with the borrower. 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. Likewise, leveraged leases should be treated as commercial loans rather than securitizations, since the underlying lease will either be in default or not. Securitization rules and formulas were designed to deal with the risk of correlated / uncorrelated defaults. Rules should not be the tool in search of a use.

2. Capital Requirement and CEIOs

The proposed securitization capital requirement (described in the first two full paragraphs in the middle column on Page 55857 of Federal Register Volume 71) may create incentives for regulatory capital arbitrage that does not reduce risk. Specifically, the creation of a credit enhancing I/O ("CEIO") does not increase economic risk compared to holding loans on balance sheet. We strongly believe that CEIO strips should be included in the capital that counts toward k-irb. The below example 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 was added to capital. The gain would then be deducted from capital. Because all bonds are sold, no other 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 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.

Many types of securitizations have this structure at some point in their lifecycle. Such transactions enhance the bank's portfolio liquidity and are economically valuable despite the retention of the credit risk. The currently proposed capital rules significantly increase required capital for transactions structured in this manner compared to the capital required for retaining the loans on its books – even though there is no increase in risk. In fact, it is arguably the case that the increased liquidity reduces risk.

We do recognize that residual interests are subject to value losses from factors beyond credit risk. For instance, prepayments may warrant a write down in residual value. We do not believe that this is a reason to increase capital, since the same factors affect the valuation of other bank assets, which do not incur an extra capital charge. We believe it is inappropriate to single out these assets for harsher treatment.

The uneven treatment of the capital rules is demonstrated by considering what would happen over time if the bank initially sold only a few of the bonds, and later sold more. In this case, we begin with the loans on the balance sheet and a required capital charge of $28,000 (k-irb). When the securitization is created and only the AA bonds are sold, the capital requirement would jump to $54,214 (plus the deduction of the gain, which equals the amount added to capital). If additional bonds were sold, the deduction of additional gains would offset the corresponding increases in capital, but the portion of the CEIO that was ***not*** a gain would go away, and the remaining capital requirement would come back to the $28,000 level (*i.e.*, k-irb). This reduction occurs with no reduction in risk; the factors that can reduce the value of the residual are the same whether or not the gain has been realized. (The latter two figures would be reduced by the difference between k-irb and the RBA capital amount if the former were higher.) 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.

Some regulators may be concerned that banks can use overly optimistic assessments of future margin income when valuing their residuals. Subtracting only the gain-on-sale rather than the entire residual would protect against this behavior. Consider the example again. Suppose that the bank valued the residual at $60,000 rather than $30,000. The trust interests would be adjusted to 100/106. As long as few bonds are sold, the bank continues to hold k-irb in capital for the interests it owns and to deduct only the small gain it realized on the sold position. The overly optimistic valuation need not be deducted, since it has not increased the bank's capital. If, however, most of the bonds were sold, the bank would still hold k-irb for the credit risk in its retained loans and deduct the larger gain-on-sale it realized when it sold the bonds.

Finally, we do not understand the rationale for assigning all non-credit-enhancing I/O strips a 100% risk weight instead of using the ratings-based approach based on their actual or implied rating. It would seem more consistent if these cash flows were assigned the same capital as if they were bundled with principal in one security. As a practical matter, the rule as written will simply induce firms to bundle interest with other securities to get an appropriate charge.

VIII. Operational Risk Questions

A. NPR Operational Risk Questions for Formal Comment

1. *Question 19:*

The agencies solicit comment on all aspects of the proposed treatment of operational loss and, in particular, on (i) the appropriateness of the proposed definition of operational loss (ii) whether the agencies should define operational loss in terms of the effect an operational loss event has on bank's regulatory capital or should consider a broader definition based on economic capital concepts; and (iii) how the agencies should address the potential double-counting issue for premises and other fixed assets. **(Proposed definition of operational loss encompasses events that result in loss and are associated with internal fraud; external fraud; employment practices and workplace safety; clients, products, and business practices; damage to physical assets; business disruption and system failures; or execution, delivery, and process management.)**

NPR Definition:

Wachovia supports the definition proposed in the NPR.

Expanded Definition:

We do not believe the definition should be expanded to include economic capital concepts. We believe the incremental amount of losses attributed to economic impacts does not significantly impact the AMA capital charge. While loss events can periodically have an economic impact beyond the GAAP accounting treatment, data collection is burdensome because record keeping systems are not designed to centrally capture this information. This may represent a "best practice" for management information purposes but should not be a requirement for regulatory capital purposes. Accordingly, Wachovia urges the regulatory agencies not to broaden the definition beyond the current scope of GAAP losses recognized in the current annual accounting period financial statements.

Premises and Fixed Assets:

Wachovia agrees that the regulations need to be changed to avoid double counting of capital required for premises and fixed assets. It appears the NPR is suggesting that, while economic capital concepts may not be needed in the definition of an operational loss on an overall basis (as quoted above), there may be a need to account for losses based on replacement cost (as opposed to book accounting cost) for premises and other fixed assets. It references the fact that some banks are currently using replacement cost in their economic capital analysis. Similar to the discussion on economic impacts above, we do not believe impairments to fixed assets should be treated on a replacement cost basis as this is inconsistent with GAAP accounting and not supported by internal accounting processes. Wachovia supports the use of the risk category "damage to physical assets" in

operational risk models to determine the amount of capital required for premises and fixed assets as opposed to the risk weighted asset approach now proposed.

2. ***Question 60:***
The agencies are interested in commenters' views on other business lines or event types in which highly predictable, routine losses have been observed.

Wachovia recommends the regulatory agencies adopt less restrictive wording in the rule to allow for banks with sophisticated risk management systems to present empirical data to qualify other types of losses as "highly predictable and routine." It is Wachovia's opinion that external check fraud losses in retail banking are both routine and predictable and should be allowed as an offset to expected operational losses ("EOL"). This category of losses has a high frequency, is highly predictable, is forecasted and reserved regularly, and is supported by detailed reporting. With further research, there may be other predictable, highly routine loss types that should qualify as an EOL offset.

B. Comments on Other Issues Identified by Wachovia

1. ***Overall Operational Risk Issues***

Unit of Measure: The NPR introduces and defines the concept of unit of measure 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. It requires the bank to demonstrate it has not combined business activities or operational loss events with different risk profiles within the same loss distribution.

A recent study completed by the AMA Group of the Risk Management Association confirms that a wide range of practices currently exists among banks subject to the rules. No consensus has yet developed on whether models should be "top down" or "bottoms up." Regardless of the particular approach chosen, each bank has expressed a high level of confidence in the viability of its methodology.

Wachovia interprets the NPR to essentially preclude the use of top-down 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 bottom-up approaches will be allowed. If this is not the agencies' intent, the NPR language around unit of measure should be clarified to remove any ambiguity over the permissible use of either a bottoms-up or top-down approach. This concern may be shared by the other banks that have developed top-down approaches.

Establishing a requirement that a bank must demonstrate that it has not combined business activities or operational loss events with different risk profiles within the same loss distribution is unrealistic. Not only does the limited amount of available data make this difficult to achieve at a business line and/or event type level, there has been no definition of homogeneity established with respect to risk (*i.e.,* there can be wide variation in risk profiles within individual business lines and/or types of events). We think the agencies should allow banks to utilize units of measure that make efficient use of the available data for the development of useful and defensible estimates of loss distribution and capital.

Requiring a "bottoms-up" approach at this early stage of industry maturity, in which both data availability and model development are in early stages, establishes a standard that is beyond practical application. Wachovia does not think it prudent to contradict the spirit of the Advanced Measurement Approach, which was meant to allow flexibility for banks to develop models most reflective of their operational risk.

There needs to be sufficient latitude as the industry (and especially an individual institution) progresses along the requisite maturity curve. Institutions should be permitted to progress to increased levels of granularity/homogeneity (*i.e.,* move from top-down to bottom-up approaches) as they believe this progression can be supported by the underlying data -- the desire to generate distributions at homogeneous levels involves one or more trade-offs. As data are disaggregated in the pursuit of homogeneity, less and less data become available to estimate or generate the actual, unique distributions, as well as to make "internal estimates of dependence among operational losses within and across business lines and operational loss event types."

Wachovia believes that in the long run bottom-up approaches may be an appropriate industry aspiration or "best practice," as the increased granularity in modeling may lead to more risk sensitive capital calculations. Currently, however, we do not believe this should be a requirement for AMA approval.

Operational Loss Dependence: Wachovia agrees there should be some measure of dependence, where appropriate, that is incorporated and documented into either "bottoms-up'" or "top-down" capital models; certain operational losses may be related across operational event types and business lines.

However, the current statistical techniques / approaches for how to determine dependence across operational risks are in the early stages of development. Also, it will require many years of loss data collection before sufficient data will exist to perform statistical tests of dependence based on empirical data. Until that time, dependence assumptions will be based primarily on management judgment. In addition, capital calculations under the two dependency extremes (*i.e.* zero correlation and 100% correlation) can significantly impact capital estimates. Due to the wide variation in capital results that dependence assumptions can cause and the heterogeneous characteristics of operational risk, we do

not agree with the standard that exposure estimates across units of measure should be summed if the proposed requirements around dependence assumptions are not met.

To address the agencies' concerns, Wachovia believes a more reasonable upper bound should be placed on dependence assumptions until sufficient data exists to support statistical tests of dependence

The draft rule states a bank must demonstrate that its process of estimating dependency meets several criteria. But the wording is ambiguous so that the requirement could be construed to require statistical proof (which is a high and impractical general standard at this juncture), or conversely, it could mean simple business judgment. For the latter, there is no explanation regarding the line of reasoning or the types of information the agencies would require to support these judgments.

To demonstrate that its process for estimating dependency meets the criteria, the bank should be allowed to use empirical evidence that can be made available at reasonable cost, whether it is statistical or anecdotal. Then the demonstration should be either based on established statistical techniques or on clear logical argument regarding the presence or absence of relationships between the causes of different risks and losses, or regarding the similarity of circumstance between the bank and a peer group for which acceptable estimates of dependency are available.

If no demonstration is forthcoming, then a conservative assumption of positive dependence is warranted, but not an assumption of perfect positive dependence. An appropriate assumption should be based upon a conservative statistical analysis of industry data.

For a bank that cannot demonstrate anything about independence, it seems excessively conservative to require the bank to sum operational risk exposures since it is very unlikely that loss distributions across all units of measure are perfectly and positively dependent.

Finally Wachovia does **not** believe that "*… top-down approaches inherently mask dependence and, under many circumstances, assume statistical independence across business lines and event types."* There is no inherent reason why a top-down approach has to mask dependence or assume statistical independence.

Expected Operational Loss (EOL): Wachovia supports the position of the NPR in allowing an offset to capital for expected operational losses. This is consistent with our internal economic capital principles which have been followed over the past 5 years.

However, Wachovia is concerned that the rules as presented will preclude: 1) the use of EOL offsets comprised of accounting reserves for specific legal cases or for a class of legal cases; and 2) the use of budgeted or forecasted losses as an EOL offset.

Legal reserves are a highly sensitive and confidential matter for Wachovia. Such reserves could at any point in time represent a substantial portion of the total reserves Wachovia has for operational losses and should be eligible for use as an offset.

Also, the amount of anticipated operational losses factored into the bank's annual financial plan should be eligible for use as an offset. As budgets and financial forecasts are created and maintained, amounts are entered and updated for certain predictable and recurring types of operational losses.

These amounts should be eligible for use an as offset to EOL. Wachovia urges the agencies to clarify the rules to allow the use of legal reserves and budgets/forecasts as EOL offsets to operational losses over a one-year time horizon.

IX. Public Disclosure & Regulatory Reporting Questions for Formal Comment

A. NPR Disclosure Questions

1. *Question 61:*
   The agencies seek commenters' views on all of the elements proposed to be captured through the public disclosure requirements. In particular, the agencies seek comment on the extent to which the proposed disclosures balance providing market participants with sufficient information to appropriately assess the capital strength of individual institutions, fostering comparability from bank to bank, and reducing burden on the banks that are reporting the information.

We agree with the agencies that the Basel II Accord warrants a certain level of public and private disclosure and thoroughly support the regulators in their approach of allowing banks flexibility as to where that disclosure takes place.
While we support the concept of disclosures that will assist the regulators in their supervision and provide the market place an adequate amount of data, we believe the volume and content of the proposed templates will go well beyond meeting these goals. Unfortunately, left as is, the Pillar III tables will contain a great amount of information that will not be comparable not only across U.S. banking organizations but also with our international counterparts. For example, by publishing any information on ELGD and LGD, which is a U.S. only concept, the market place will not have the ability to compare U.S. to international Pillar III reports.

We also believe that table 11.5, which requires the reporting of back testing information, will not be well understood by or useful to the market place; we continue to believe that Pillar II would be a much more appropriate vehicle for regulators to meet this conceptual need. We request that the Pillar III tables and the public reporting templates be scaled back to meet the need of investors. We believe this will help ensure the banking industry is not subject to market place confusion and potential disruption.

We strongly oppose the look-back concept mentioned in this NPR. While we understand the desire for look-back data, we are unsure that the regulators' desired objectives would be achieved, as the data would be very summarized. Given their limited value and burdensome compilation requirements, the look-back data is not worth the cost. Rather, we recommend the regulators use the Pillar II process and consult with the industry to identify a better way to understand credit migration.

We support the public versus private split of the reporting templates but request a longer period before requiring public disclosure of Schedules A and B. In particular we believe the information contained in Schedule B should be phased in during the transition periods after the regulators and the industry have gained experience and increased confidence in Basel II and are comfortable with consistent treatment across institutions.

We also believe that additional filing time is needed and appropriate for the information to be publicly disclosed pursuant to the Pillar III tables. The 30-day reporting cycle is filled with the current regulatory burden. Adding the detailed disclosures requested in Pillar III would be burdensome and inefficient for banks. Accordingly we propose a 60-day reporting period deadline as this would better allow banks to utilize existing staff for preparation.

The comments above encompass our general response to the Pillar III reporting and public disclosure requirements. Please reference The Clearing House Association's comment letter regarding Pillar III for detailed responses on individual line items of the reporting schedules and tables.

2. ***<u>Question 62:</u>***
Comments on regulatory reporting issues may be submitted in response to this NPR as well as through the regulatory reporting request for comment noted above.

Reporting Template NPR Q 1: ***The agencies seek comment from the industry concerning the feasibility of collecting certain additional information beyond that described in this proposal. What aggregate summary information might banks submit that best describes or characterizes period-to-period migration across internal rating grades or retail segments? If such information were required, are there particular formats or other considerations that would reduce the reporting burden for banks?***

While we understand the agencies' desire to help identify causes of the changes in credit risk regulatory capital requirements, we do not believe the "lookback" portfolio approach described in question 1 is an acceptable solution. Not only would the reporting process be overly burdensome and costly, we do not believe that reporting previous risk parameters provides any additional insight. On specific disclosures, we believe the market will have difficulty understanding and using information about the comparison of expected losses to actual losses--many factors can change over the course of a 12-month

period. Explanation of the changes can be cumbersome and difficult to summarize in a reporting document.

Reporting Template NPR Q 2: ***The agencies are considering another alternative reporting treatment with respect to the wholesale and retail portions of the above proposal (Schedules C-R). Would reporting burden be lessened if banks submitted data using internally-defined obligor grades or segments, rather than aggregating the grades or segments in supervisory reporting bands?***

Yes. We strongly support the proposal of allowing banks to submit data using internally-defined obligor grades or segments, given the operational ease of this approach.

Reporting Template NPR Q 3: ***The agencies request comment on the appropriateness of making the data items on Schedules A and B and data items 1 through 7 of the operational risk reporting schedule (Schedule V) available to the public for each reporting entity for data collected during periods subsequent to its parallel run reporting periods as currently proposed. Comments are requested on the extent to which banks are already providing these data to the public or are planning to make such data public as well as the timing of these disclosures. In addition, comments are requested on the perceived risks associated with public reporting of these data items.***

Please see our response to regulatory reporting template question # 1.

Reporting Template NPR Q 4: ***What changes in the proposed regulatory reporting requirements for the Advanced Capital Adequacy Framework, including additional data or definitions, would better assist the agencies in reaching their stated goals? In this regard, the agencies also seek input on possible alternative ways to capture the requested information and the appropriateness of the requested data given the stated purposes of the information collections and the associated reporting burden.***

Wachovia supports the method by which the regulators are allowing the reporting to be delivered. However, we request further guidance on some of the requests. Specifically, more detailed guidance on the Pillar III reporting will lend itself to more consistent reporting across institutions.

Appendix to Basel II NPR Comment Letter Dated March 26, 2007 of Wachovia Corporation

Index of Agencies' Questions Appearing in the NPR

For the convenience of the Agencies' staff, the following is an index showing the location in Wachovia's detailed Appendix of the Agencies' 62 Questions, certain other enumerated Questions and Wachovia's response(s).

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