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December 9, 2003

Basel Committee on Banking Supervision
Bank for International Settlements
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Via Email: *bcbs.capital@bis.org*

cc:

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Re: October 11, 2003 Press Release (Basel II: Significant Progress on Major Issues)

Dear Sirs and Madams:

Wachovia appreciates the consultative process that has characterized the development of the new Accord. Banking regulators have clearly worked hard to understand the concerns expressed by the banking industry and to improve the Accord in response. The Basel Committee's October 11, 2003 announcement of additional revisions in response to comments on the third consultative paper illustrates the point perfectly. We commend the Committee for its diligence and look forward to continuing a constructive dialogue as we work toward implementing the new Accord. We find the improvements outlined in the press release to be a step in the right direction with room for even further improvement.

There is near unanimity in the industry that capital is intended to cover unexpected losses only. Furthermore, we applaud the attempt to streamline the rules surrounding securitizations, which we agree were too complex and prescriptive. We also agree that the approach for credit risk mitigation requires revision and that recognition of double default is needed.

The press release identifies four major areas of focus. Although several proposals were not described in detail, we offer the following comments covering all four issues. We hope that our input will lead to an Accord that is more risk sensitive and more closely aligned with banks' internal practices.

I. CHANGING THE OVERALL TREATMENT OF EXPECTED VERSUS UNEXPECTED CREDIT LOSSES

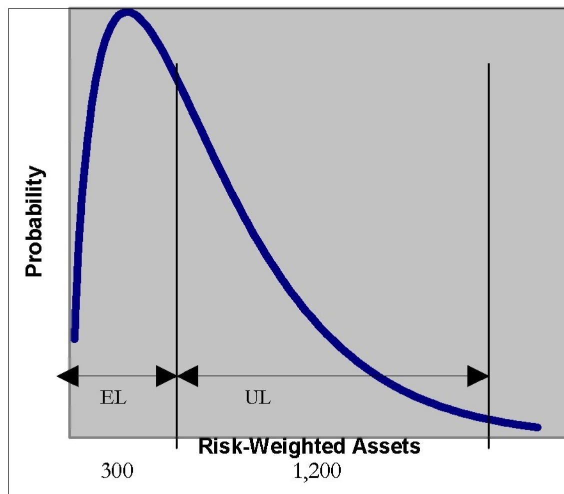
Assessment Criteria & the Proposed Approach

As we consider how to address the shortcomings of the previous treatment of EL, we look for a new proposal to satisfy three criteria: it should work well across the range of accounting practices employed in countries that will adopt the Accord, including approaches that may be required in the future; it should provide relief to lenders with high but predictable losses; and it should satisfy concerns about safety and soundness.

The current proposal, with adjustments outlined in the press release, will result in more risk-sensitive capital ratios for all lenders and provide relief to banks with high but predictable losses. Consider the following example with two banks, Bank H and Bank L. Each bank has reserves of $40 and other forms of capital of $110 for a total $150 in capital. Each bank also has $1,500 in RWA, so the capital ratio for each is 10% ($150/$1,500).

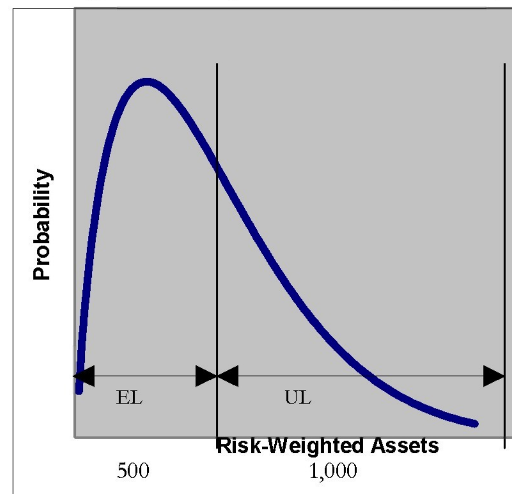
As illustrated in Figure 1 below, Bank H has a higher-EL portfolio with EL of $40 and Bank L has a lower-EL portfolio with EL of $24.

Figure 1a: Low-EL Bank (Bank L)



EL Portion of RWA	300
Minimum Capital Requirement	8%
EL (to deduct from Reserves)	24

Figure 1b: High-EL Bank (Bank H)



EL Portion of RWA	500
Minimum Capital Requirement	8%
EL (to deduct from Reserves)	40

As Table 1 below shows, the new methodology for calculating capital more accurately reflects the amount of resources available to each bank relative to its level of uncertain losses. While both banks have $30 of capital above their minimum requirement, that excess is a larger percentage of Bank H's minimum requirement. Including the high EL amount in the numerator and denominator of the old formula diluted the benefit of the excess capital.

Table 1: A More Risk Sensitive Capital Ratio

	Bank L	**Bank H**
<u>Old Methodology</u>		
$Capital_{EL+UL}$	150	150
RWA_{EL+UL}	1,500	1,500
Capital Ratio	10%	10%
<u>New Methodology</u>		
$Capital_{EL+UL} - Capital_{EL}$	150 – 24 = 126	150 – 40 = 110
$RWA_{EL+UL} - RWA_{EL}$	1,500 – 300 = 1,200	1,500 – 500 = 1,000
Capital Ratio	10.5%	11.0%
<u>Capital Relative to Minimum</u>		
Minimum Capital Requirement	8% of RWA = 96	8% of RWA = 80
Capital above minimum ($)	126 – 96 = 30	110 – 80 = 30
Capital above minimum (%)	30/96 = 31.25%	30/80 = 37.5%

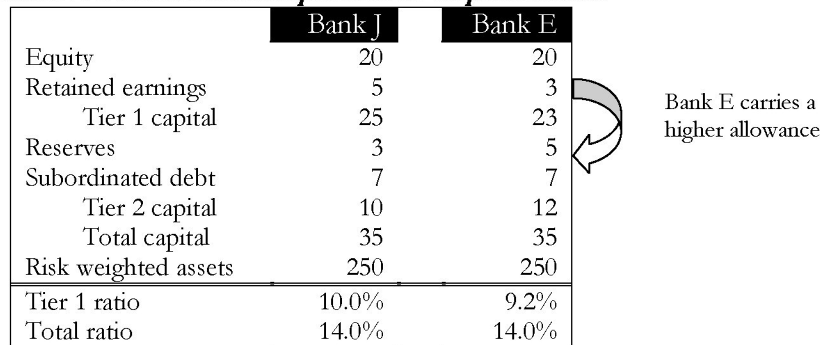
Considering the second criteria, minimum system-wide resources will remain unchanged under the new proposal, so concerns about safety and soundness should also be satisfied.

Finally, however, banks operating in different accounting environments will continue to see significant differences in their capital ratios when there is no real difference in their ability to cover potential losses. Further revisions to the proposal can level the playing field in these situations.

<u>Excesses & Shortfalls</u>

The treatment of excesses and shortfalls is troubling for several reasons. For one, banks will see differences in capital ratios depending on locally accepted accounting practices. Ignoring tax effects, consider a simple example of Banks J and E. Bank J operates in a country where accounting practices are such that just enough reserves are kept to match the Basel Accord's measure of expected loss. Bank E operates in a country where accounting practices are in place so that reserves are in excess of the Basel Accord's level of expected loss. If the allowance is included as Tier 2 capital only (as currently proposed) additional provisioning such that retained earnings are reduced and reserves increased will penalize banks operating with the rules used in Country E. This example is illustrated in Table 2 below.

Table 2: Potential Discrepancies in Capital Ratios



	Bank J	Bank E
Equity	20	20
Retained earnings	5	3
Tier 1 capital	25	23
Reserves	3	5
Subordinated debt	7	7
Tier 2 capital	10	12
Total capital	35	35
Risk weighted assets	250	250
Tier 1 ratio	10.0%	9.2%
Total ratio	14.0%	14.0%

Our second concern with excesses and shortfalls is a matter of symmetry. The proposed rules in the press release indicate that a shortfall of reserves relative to the amount of expected loss must be deducted partially from Tier 1 capital and partially from Tier 2, while excesses of reserves over EL are given credit only as Tier 2 capital. At the very least, excess reserves should be treated the same way, making adjustments to both Tier 1 and Tier 2.

A better solution would be to make ***all*** adjustments in the Tier 1 account. ***The use of reserves to keep a bank solvent is more akin to retained earnings and other Tier 1 capital than to subordinated debt and other Tier 2 accounts.*** There should be no limitations on the amount of reserves that can be counted as capital, since all reserves can be used to absorb losses. Returning to the example illustrated in Table 2, counting reserves as Tier 1 would increase the observed Tier 1 ratio for both banks to 11.2% (28/250), and negate any discrepancies related to classification.

Limits to the Recognition of Reserves

Another problem related to excess and shortfalls is the imposed cap limiting excess reserve recognition to 20% of Tier 2 capital. If a bank's Tier 2 capital balance is small, excess reserves may not benefit the bank at all!

Furthermore, the proposed limitation could potentially lead to level-playing-field problems across countries with different accounting practices. Firms like Bank E (above) that reserve conservatively will eventually reach the threshold where their Tier 2 Ratios – and Total Ratios – are reduced as capital is shifted from retained earning to reserves.

We reiterate our point that there should be no arbitrary limit on the amount of reserves counted as capital.

Future Margin Income

Wachovia has stated that it is not equitable to allow an FMI offset for certain products but not for others. We oppose product-specific rules for FMI.

Conceptually, expected losses should be covered by future margin income. For rational lenders, this should always be true when loans are originated. However, as time passes, circumstances may develop such that FMI does not cover EL:

- The current estimate of EL may be greater than originally expected.
- Prepayments and balance transfer programs can reduce the good loans and shrink FMI so that it no longer covers losses. This seems especially likely if pricing is increased dramatically to cover higher than expected losses.

Under accrual accounting there is no change in balance sheet figures as EL and/or FMI change. Therefore, it is unclear that margin income will continue to cover EL with certainty. It seems reasonable then to require that reserves cover EL.

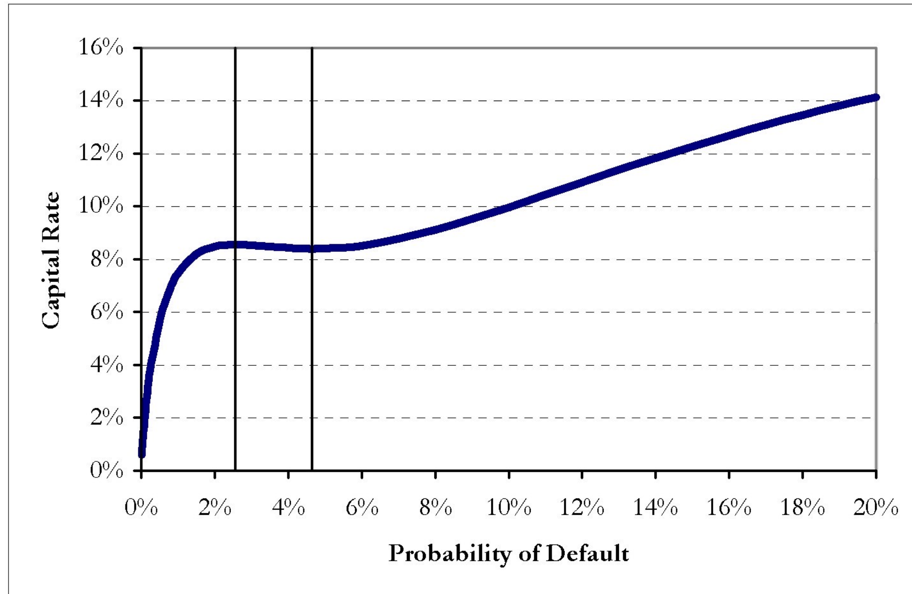
Since the proposed changes do not lower total resources in the system available to absorb losses, no recalibration is necessary.

Technical Issues

Several technical issues require attention as the EL/UL rules are finalized.

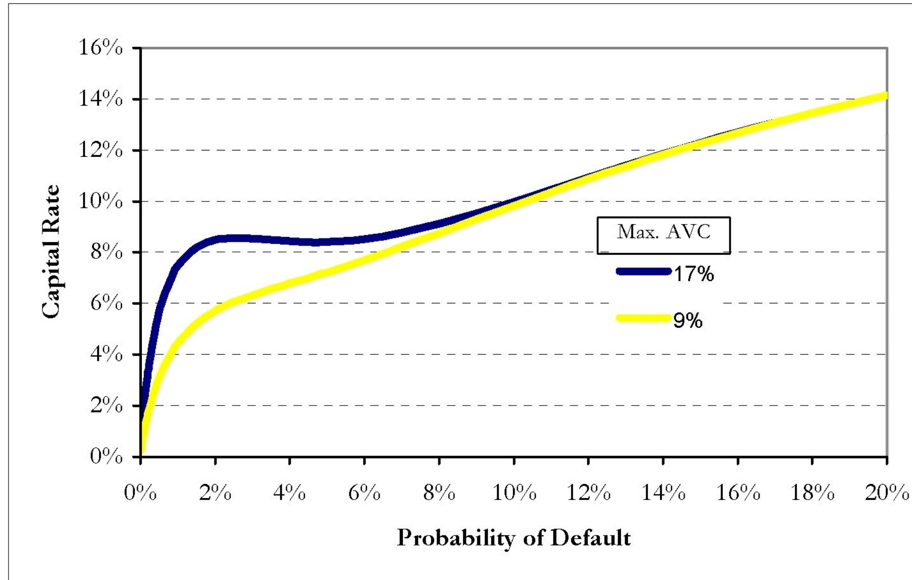
- Removal of EL from required capital further highlights the problems with the retail capital functions that we and other banks have discussed in our previous letters. Assuming a 100% LGD for the "other retail" category, capital actually *decreases* after removing EL from the capital formula when PD increases from 2.6% to 4.6%, as shown in Figure 2 below. The correlations decline so rapidly that they more than offset the increase in PDs.

Figure 2: Other Retail Anomaly



Our proposed solution is to reduce the asset value correlations at the high quality (low PD) end of the spectrum. For example, the curve smoothes out if the maximum correlation is lowered to the .08 to .10 range. (See Figure 3)

Figure 3: Impact of Changing Correlation



- Other technical issues require further clarification from the Committee. Does the maturity adjustment multiplier change the EL that should be used for loans with maturities beyond one year? Additional clarity is also needed around the computation of EL for securitized assets and HVCRE when the supervisory slotting criteria are used.

II. SIMPLIFYING THE TREATMENT OF ASSET SECURITIZATION, INCLUDING ELIMINATING THE "SUPERVISORY FORMULA" AND REPLACING IT BY A LESS COMPLEX APPROACH

More details are needed to thoroughly analyze the simplification of the securitization methodology. As you develop these details, please refer to our July 30, 2003 letter to the Basel Committee in response to the third consultative paper and our November 3, 2003 response letter to the U.S. Agencies' Advanced Notice of Proposed Rulemaking (68 FR 45900). Our ANPR comment letter is on the public record and can also be accessed on many of the Agencies' websites.

The most critical points concerning securitizations from those letters include:

- We agree the RBA is more practical than the SFA.
- RBA should be applied without the 100% capital rule for positions under k-irb.
- Gains, not the entire residual, should be deducted from capital.
- Residual interests should count toward k-irb.
- The minimum capital rate should be reduced to more accurately reflect the very low risk in the most senior tranches.
- Unrated exposures for ABCP lines should be assessed based on banks' own processes for assigning PDs, LGDs, etc.
- For ABCP securitizations, higher AVCs would be reasonable, given the additional systematic risks inherent in portfolios.

III. REVISITING THE TREATMENT OF CREDIT CARD COMMITMENTS AND RELATED ISSUES

We likewise need more details to thoroughly analyze the treatment of credit card commitments. Again, we refer you to our CP3 and ANPR response letters for our current position.

Credit cards are just another form of revolving credit; special rules are not needed. A product specific usage-given-default percentage can be developed and applied. We believe that adequate analyses will show that unused credit card commitments have low EADs. We believe that the A-IRB EAD for credit cards should be based on banks' empirical analyses rather than regulatory decree.

IV. REVISITING THE TREATMENT OF CERTAIN CREDIT RISK MITIGATION TECHNIQUES

Again, we would need more details to thoroughly analyze the treatment of risk mitigation techniques.

As we have said in our CP3 and ANPR response letters, the current approach is too harsh. Its distortions include ignoring the benefit of hedging high quality exposures and requiring additional capital for a fully hedged loan under some circumstances. As we and other banks have said before, the best solution is to allow the use of internal models. Until that time, we would support an alternative such as the one outlined in the Double Default paper authored by Erik Heitfield and Norah Barger of the U.S. Federal Reserve Board. In particular we would support a simplified "haircut" approach that scales the unhedged capital requirement by a predetermined percentage based on the protection provider's PD. A version of that approach was presented by Mr. Heitfield at the November 4, 2003 meeting of the International Association of Credit Portfolio Managers, and is illustrated below.

CP3 Risk Weight Function

$$K_{hedged}(PD_o, PD_g, LGD) = h(PD_g) * K_{unhedged}(PD_o, LGD)$$

Guarantor PD	Average Ratio of $K_{hedged}/K_{unhedged}$ (across a range of obligor PDs)
0.03%	0.10
0.05%	0.14
0.10%	0.21
0.50%	0.48
1.00%	0.62
2.00%	0.76

In addition to our deep concerns about double default, we restate our major concerns with the proposed risk mitigation methodology:

- There should be consistency of treatment between OTC derivatives and repo-style transactions.
- The benefit of portfolio effects should be considered when measuring counterparty exposure.
- The proposed derivative PFE factors do not generally reflect market risk factors or trade specific terms.
- Maturity for derivatives should not be the notional-weighted average remaining maturity.

We would like to close by repeating our appreciation for making this process an iterative one, and hearing our concerns about the latest changes that were outlined in your October 11th press release. We look forward to continuing the mutually beneficial collaboration that will ultimately make the new Basel Accord a success.

Sincerely,

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