WELLS FARGO

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November 12, 2003

To: Addressees

Re: Advanced Notice of Proposed Rulemaking

Wells Fargo & Company appreciates the opportunity to participate in the ongoing dialogue on the Basel capital reform proposal. We are a diversified financial services company, providing banking, insurance, investments, mortgage and consumer finance from more than 5,600 stores, as well as through the Internet and other distribution channels across North America. As such, we have a keen interest in the framing of the Basel Accord and hope that the comments that we offer in this paper will be of assistance in providing solutions to the issues that exist in the current proposal.

Sincerely,

Howard I. Atkins

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Executive Vice President and Chief Financial Officer

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

Docket No. 03
Communications Division
Third Floor
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

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

Enclosure Attached

Wells Fargo & Company appreciates the opportunity to participate in the ongoing dialogue on the Basel capital reform proposal. While we respect the tremendous amount of time and effort that has gone in to shaping the proposal, we find that we still have some fundamental differences of opinion with the path on which the Basel Committee and the U.S. banking supervisors are proceeding and feel that certain aspects of the proposal must be changed in order for it to be acceptable.

We will direct our comments here to the Advanced Notice of Proposed Rulemaking ("ANPR") published in the Federal Register on August 3, 2003. We have drafted separate comment letters for the related Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit and the Draft Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital, although we may allude to some of that commentary in the course of this dialogue.

We expect that there will be a relatively uniform set of concerns that are communicated to the U.S. banking supervisors with respect to the ANPR – excessive conservatism, undue prescriptiveness, questionable treatment of expected losses and the loan loss reserve in the capital calculations, and inadequate recognition of risk mitigation actions, to name a few. We share and support these concerns, and will offer similar comments in the course of this letter.

However, these issues relate primarily to the risk-based capital calculation itself. In the final analysis, this calculation is not critical to Wells Fargo, insofar as our pricing decisions are based not on regulatory capital, but rather on internal economic capital analyses. Moreover, we are convinced that, if any risk-weighting concessions are granted by the Basel Committee and the U.S. banking supervisors in reaction to the comments received on ANPR, they will shortly thereafter be reclaimed through a new calibration of the risk-weighting formulas present in Pillar 1, or through different Pillar 2 requirements. How else will the Basel Committee manage to keep the overall level of capital in the banking system unchanged, particularly if the only banks in the U.S. that are subject to the Accord will be those with a tendency toward diminished capital requirements under the new system?

Therefore, the primary points that we will emphasize, and where we feel that we must be successful in helping the Basel Committee and the U.S. regulatory authorities implement a more appropriate regulatory capital regime, are in those areas where we believe that the Accord has ventured beyond its intended scope.

1. First and foremost, we believe that **the Accord has become entirely too prescriptive and inflexible in its vision of the risk management *processes* to which banks must adhere**. This is in stark contrast to the original supposition of Basel II -- that each bank would be allowed to continue the use of its existing risk management practices, so long as they could be shown to have been effective over time. The Accord should only aspire to establish a more risk-sensitive framework for constructing minimum bank regulatory capital requirements. It cannot, and should not, attempt to dictate how banks actually manage risk. For those institutions, like Wells Fargo, with proven risk management processes in place, it would be imprudent, and perhaps dangerous, for them to make significant changes to their risk management systems in the absence of quantifiable and validated data that clearly demonstrates that an alternate system is more robust and accurate, and could be successfully inculcated into their risk management process.

Do the Basel Committee and the U.S. banking regulators really intend to force the migration of well-functioning, customized risk management processes into an untested, complex framework with the potential to actually confuse, or undermine, the control and understanding that banks currently have of their credit portfolios?

2. The decision of the U.S. banking regulators to require only 10 U.S. banks to comply with the Accord increases the likelihood of creating an **uneven playing field for major competitors in the U.S. financial services industry**. Wells Fargo is large. However, our credit portfolios, customers, and risk profile more closely resembles that of smaller regional and community banks than larger, internationally-active, money center institutions. The deliberate creation of a bifurcated capital regime sets the stage for instances where direct competitors will not be subject to the same capital standards. It is likely that these inequities will be particularly meaningful to those institutions, like Wells Fargo, that are widely diversified by line of business and geography and, consequently, faced with a wider variety of smaller, heterogeneous competitors.

3. The **Pillar 3 disclosure requirements of the Accord remain overly prescriptive, inappropriate, and unnecessary**. We believe that the Pillar 3 requirements are not appropriate because public disclosure requirements ought to be set solely by those agencies that safeguard the interests of investors (i.e., the SEC, the FASB, and the rating agencies), not by banking supervisors who have neither the responsibility, the focus, nor the expertise to take on that role. Furthermore, such requirements seem unnecessary to us, because, quite outside of Basel, the market will dictate those elements of bank risk management disclosure that are most necessary to improve transparency.

We feel compelled to raise these issues, and others that we will enumerate, not only because they are important to us, but because we are concerned that the support that may exist for the Basel proposal within the banking community today stems not from a philosophical agreement with the direction of the Accord, but either from the fact that many may view the Accord as a *fait accompli* and are "jumping on the bandwagon" or, more narrowly, from the standpoint of whether or not a particular bank anticipates that it will receive a lower regulatory capital requirement under the new system. After all, if one accepts that all banks are, in principle, trying to maximize return on internal economic capital, subject to the constraint that economic capital be less than regulatory capital (in total), then regulatory capital becomes inconsequential to the risk/return proposition, *except* for the fact that banks will always argue for a less binding constraint (that is, lower regulatory capital). With Basel II, there is a further consideration in this equation, in terms of the considerable compliance costs that the Accord will impose on the banking system, an additional sunk cost without compensatory return. We feel that the Basel Committee and the U.S. banking regulators should take the time required to resolve many of the issues that the banking industry is raising at this critical juncture, rather than attempting to force such a controversial system into premature implementation.

We have organized our comments so as to respond to the questions on which the ANPR requested specific feedback and which are most significant for Wells Fargo. Other issues that we feel are important to raise are included at the end of our letter.

Question #1 pp 23-24
Competitive Considerations

What are commenters' views on the relative pros and cons of a bifurcated regulatory framework versus a single regulatory framework? Would a bifurcated approach lead to an increase in industry consolidation? Why or why not? What are the competitive implications for community and mid-size regional banks? Would institutions outside of the core group be compelled for competitive reasons to opt-in to the advanced approaches? Under what circumstances might this occur and what are the implications? What are the competitive implications of continuing to operate under a regulatory ca ital framework that is not risk sensitive?

If regulatory minimum capital requirements declined under the advanced approaches, would the dollar amount of capital these banking organizations hold also be expected to decline? To the extent that advanced approach institutions have lower capital charges on certain assets, how probable and significant are concerns that those institutions would realize competitive benefits in terms of pricing credit, enhanced returns on equity, and potentially higher risk-based capital ratios? To what extent do similar effects already exist under the current general risk-based capital rules (e.g., through securitization or other techniques that lower relative capital charges on particular assets for only some institutions)? If they do exist now, what is the evidence of competitive harm?

Apart from the approaches described in this ANPR, are there other regulatory capital approaches that are capable of ameliorating competitive concerns while at the same time achieving the goal of better matching regulatory capital to economic risks? Are there specific modifications to the proposed approaches or to the general risk-based capital rules that the Agencies should consider?

The ANPR proposes that only banks with total banking assets of $250 billion or more or total on-balance-sheet foreign exposure of $10 billion or more be required to comply with the Advanced IRB and AMA approaches of the Accord. We understand that this will limit the extent of U.S. compliance to roughly 10 U.S. banks, although others may be allowed to "opt-in." We believe that this decision increases the likelihood of creating an uneven playing field for major competitors in the U.S. financial services industry. Activities that, we feel, receive particularly onerous treatment in the Accord, such as retail lending and operational risk (e.g., transaction processing and asset management), would gain an undue advantage when offered outside of the Accord, either by non-bank competitors or other large banks.

Although we have not seen a list of the 10 mandatory "Basel Banks" in the U.S., we estimate that many of the institutions that we compete with most directly in our various regional markets may not be subjected to Basel's strict compliance standards and costs. Wells Fargo competes directly against smaller regional and community banks within the geographic footprint in which our respective banking franchises operate, yet they would not be subject to the same capital standards simply because they do not have the same scale of business as we do <u>outside</u> of this geographic footprint, but within the U.S.

A number of banks that are as large or larger than Wells Fargo in terms of particular product lines, but smaller than our Bank in terms of total assets, would not be subject to the same capital standards merely because they are not as diversified as we. Other examples of potential competitive inequality include monoline non-bank competitors in the credit card and retail lending business, as well as some of the largest institutions offering personal and institutional asset management. Across the sphere of diversified financial services that Wells Fargo offers, there will be meaningful instances where our direct competitors will not be taxed to the extent that we will be, simply because they do not enjoy the business diversity and economies of scale that we do.

With respect to competition, our contention would be that size is not the same as risk, and that an arbitrary measure like total assets is not the only, or best, way to measure either size or risk. The only fair way to enforce the Basel standards is to apply them to all banks, using the full range of options (Standard, Foundation, Advanced) that Basel envisions. If the U.S. regulators deem it necessary to impose the Advanced IRB (A-IRB) approach to Credit Risk on the largest U.S. banking institutions, in light of credit risk being the predominant risk that banks undertake as a matter of course, we believe that in order to lessen the competitive equality issues, the managed asset size threshold for mandatory A-IRB compliance should be reduced so as to include the top 50 U.S. banks, and that smaller banks should be required to adopt either the Standard or Foundation approach. While such a bifurcated system might result in higher credit capital requirements for smaller banks, it is the smaller banks that historically have had the greatest frequency of failure and the less-developed risk management processes. This approach is the only way, we feel, to adequately address both competitive equality and safety and soundness considerations.

In contrast, because there is no accepted methodology for quantifying Operational Risk, we also believe that the AMA approach to Operational Risk should not be the sole option that is made available to U.S. banks. We will expand on this thought in our commentary below that is specific to Operational Risk.

Question #2 pp 26-27
US Banking Subsidiaries of Foreign Banking Organizations

> *The Agencies are interested in comment on the extent to which alternative approaches to regulatory capital are implemented across national boundaries might create burdensome implementation costs for the US. subsidiaries of foreign banks.*

We believe that the home country capital rules should apply to U.S. subsidiaries of foreign banks, and vice versa, in order to minimize confusion and compliance costs within the parent holding company.

Question #3 p. 29
<u>Other Considerations - General Banks</u>

> *The Agencies seek comment on whether changes should be made to the existing general risk-based capital rules to enhance the risk-sensitivity or to reflect changes in the business lines or activities of banking organizations without imposing undue regulatory burden or complication. In particular, the Agencies seek comment on whether any changes to the general risk-based capital rules are necessary or warranted to address any competitive equity concerns associated with the bifurcated framework.*

We believe that the existing risk-based capital rules should be replaced by Basel II's Standard Approach for those banks not mandated, or electing, to adopt the Advanced IRB Approach.

Question #4 p. 30
<u>Majority-Owned or Controlled Subsidiaries</u>

> *The Federal Reserve specifically seeks comment on the appropriate regulatory capital treatment for investments by bank holding companies in insurance underwriting subsidiaries as well as other nonbank subsidiaries that are subject to minimum regulatory capital requirements.*

We do not understand the rationale for deconsolidating insurance subsidiaries from the New Accord. To do so would ignore the diversification benefit that insurance businesses bring to traditional commercial banking operations. Furthermore, the isolation of insurance subsidiaries might promote the practice of bank holding companies arbitraging the different capital standards of their insurance and banking entities.

Questions # 5 pp 32
<u>Transitional Arrangements</u>

> *Given the general principle that the advanced approaches are expected to be implemented at the same time across all material portfolios, business lines, and geographic regions, to what degree should the Agencies be concerned that, for example, data may not be available for key portfolios, business lines, or regions? Is there a need for further transitional arrangements? Please be specific, including suggested durations for such transitions.*
>
> *Do the projected dates provide an adequate timeframe for core banks to be ready to implement the advanced approaches? What other options should the Agencies consider?*

The Agencies seek comment on appropriate thresholds for determining whether a portfolio, business line, or geographic exposure would be material. Considerations should include relative asset size, percentages of capital, and associated levels of risk for a given portfolio, business line, or geographic region.

We believe that the transitional arrangements should be modified as follows:

- There should be a push-back in starting date equal to the amount of time after 12/31/03 that the U.S. finalizes its rule.
- Each core bank should be able to work with supervisors to have a staggered start time (after the pushed back time) for certain business lines for which data problems exist that cannot be expeditiously solved.
- Each core bank should be permitted to use a Basel Standardized capital allocation for those business lines that are in a transition – again, as determined by supervisory review.
- We see no reason for having different historical data requirements for different business lines or for different types of risk parameters (e.g., PD versus LGD). Five years of data for everything would seem an appropriate minimum standard after the transition period.
- The ANPR appears to omit a *data* transitional period as provided for in CP3, implying that the 5 years of data (or 7 years) are necessary at the beginning of the parallel calculation period. For some business lines, gathering of data retroactively is simply not possible. Rather, regulators might require at least 2 years of data at the beginning of 2006 (the beginning of the parallel calculation period, assuming no push back), with additional years of data to be added as time progresses. Full implementation with at least 5 years of data would then imply a 3-year transitional period beginning with the start of the parallel calculation period. This would permit banks to begin compiling data early in 2004 (or later, if the final U.S. implementation plans are delayed beyond the end of this year) on those business lines that had not been adequately documented previously.

Question #6 p. 40
<u>Expected Losses vs. Unexpected Losses</u>

The Agencies seek comment on the conceptual basis of the A-IRB approach, including all of the aspects just described. What are the advantages and disadvantages of the A-IRB approach relative to alternatives, including those that would allow greater flexibility to use internal models and those that would be more cautious in incorporating statistical techniques (such as greater use of credit ratings by external rating agencies)? The Agencies also encourage comment on the extent to which the model's necessary conditions of the conceptual justification for the A-IRB approach are reasonably met, and if not, what adjustments or alternative approach would be warranted.

With respect to the conceptual basis for the A-IRB approach, we believe that Pillar 1 contains **excessive conservatism** that would, in aggregate, significantly overstate banks' need for capital and would propose that either Pillar 1 be modified to be more consistent with bank risk estimation practices or that Pillar 2 be expanded to create a forum for banks to present evidence in support of their contradiction of the Pillar 1 formulae. Examples of the proposed Accord's conservatism include the following:

1) **No capital relief is given for credit portfolio diversification** - At Wells Fargo, we believe that we have consciously crafted a distinct competitive advantage by virtue of the diversity of our underlying businesses. Between mortgage banking, commercial banking, insurance, retail deposit taking, and asset management services (to name a few of our over 80 businesses), along with the significant economies of scale that we have in each of these businesses, we feel that Wells Fargo has created a portfolio of risks (both credit and non-credit) whose worst-case loss potential is substantially less than the sum of its parts. In fact, when we have simply modeled portfolio losses across all of our various credit portfolios in the past, we typically have concluded that the worst-case overall credit portfolio result is roughly 65-75% of the raw summation of the individual sub-portfolio worst-case events – a significant impact. We also understand that the capture of such capital benefits may be allowed under the AMA modeling of operational risk. If this is, in fact, the case, then why would this logic not extend to the modeling of capital for credit risk, where the impact is more substantive and more empirically justifiable?

2) **99.9% confidence level as a minimum standard** – The Accord employs a 99.9% confidence level (roughly a single-A debt rating for a one-year horizon) as the minimum capital requirement before potential Pillar 2 and "well-capitalized" increments are taken into account. We would recommend either setting the minimum standard closer to a level associated with a low investment grade rating, or employing the 99.9% level as the well-capitalized standard (after stress tests and FDICIA prompt corrective action provisions have been take into account).

3) **Unrealistic asset correlation assumptions** - The Accord employs unrealistically high asset correlation assumptions in the risk-weighted asset calculations, which make the estimated 99.9th percentile loss level arbitrarily high in the first place. These assumptions result in an exaggerated view of worst-case loss levels across all of the retail lending product categories, and are particularly misrepresentative in the case of high-EL/high-FMI (non-prime) retail lending.

4) **Stress testing requirements** - The Accord requires stress tests to the 99.9th percentile calculations, which may translate into required capital in excess of the 99.9th percentile. We do not understand the need for such a required incremental capital buffer, if so high a minimum confidence level has already been assessed.

5) **Omission of the tax consequences of losses** - The Accord fails to recognize the fact that worst-case losses should be supported by capital on an after-tax, rather than pre-tax, basis, thereby reducing the amount of capital required. After all, the actual drain on retained earnings occasioned by most losses is inclusive of the tax benefit associated with those losses. The omission of this benefit effectively overstates the required capital support for a business by 30-40%!

6) **Treatment of Goodwill as Capital** – Subsequent to the inception of the existing Risk-Based Capital Accord in 1988, the accounting principles (GAAP) that affect the treatment of the Goodwill asset on the balance sheet have changed. Under GAAP today, Goodwill must be revalued to its fair market value on a quarterly basis. As such, we believe that Goodwill now represents an asset with an accepted value equal to its recorded balance sheet amount, and should no longer be a required deduction from Tier 1 Capital in the regulatory capital calculations. In contrast to other banking assets that, by GAAP standards, are subjected to similar impairment analyses on an ongoing basis, the capital treatment of Goodwill is disproportionately harsh.

7) **Additional capital for "well-capitalized" standard** - As we understand it, in the U.S. the well-capitalized standard under the FDICIA prompt corrective action provisions may impose an additional 2.00% total capital requirement on banks, on top of the conservatism already built into the assumptions above.

Question #6 p. 40 (continued)
<u>Expected Losses vs. Unexpected Losses</u>

> *Should the A-IRB capital regime be based on a framework that allocates capital to EL plus UL, or to UL only? Which approach would more closely align the regulatory framework to the internal capital allocation techniques currently used by large institutions? If the framework were recalibrated solely to UL, modifications to the rest of the A-IRB framework would be required. The Agencies seek commenters' views on issues that would arise as a result of such recalibration.*

As a separate issue from the use of the ALLL in the capital calculation, Wells Fargo supports the widely held industry belief that capital is not needed to cover EL because bank pricing practices are generally constructed such that pricing covers expected losses, other expenses, and a targeted minimum return on economic capital. Stated differently, risk does not emanate from losses that are expected and priced for; it is created by uncertainty, in terms of unexpected credit events or mis-managed operating leverage.

Consequently, we would suggest that EL be excluded from the computation of required capital. If this treatment is not adopted, it seems to us that the only fair approach is to permit consideration of those elements that act as offsets to EL in practice – the full amount of the loan loss reserve and an appropriate portion of Future Margin Income. We believe that excluding EL from the capital calculation would be the simpler and, actually, more conservative, in terms of resulting in a higher capital requirement when compared to the alternative of subtracting Future Margin Income.

We would also point out that, in its current form, the Accord is internally inconsistent in its treatment of EL. It permits Future Margin Income to offset EL in the case of qualifying revolving retail exposures and operational risk, but does not allow it for any other banking risks. We find this illogical, and would suggest that a consistent treatment of FMI (as an offset to EL) be used across <u>all</u> banking products.

Question # 7 p. 46
Wholesale Exposures: Definitions and Inputs

> *The Agencies seek comment on the proposed definition of wholesale exposures and on the proposed inputs to the wholesale A-IRB capital formulas. What are views on the proposed definitions of default, PD, LGD, EAD, and M2 Are there specific issues with the standards for the quantification of PD, LGD, EAD, or M on which the Agencies should focus?*

Of the proposed inputs to the wholesale A-IRB capital formulas, the only one that Wells Fargo has a significant issue with is the **definition of default,** itself. We believe that the definition of default outlined in CP3 and the ANPR should be simplified to correspond more closely to what is more commonly used by risk practitioners. That is, loans that fall under the corporate and specialized lending models should define default to coincide solely with the incidence of non-accrual or charge-off status (to exclude the 90 days past due and other isolated conditions present in the Accord's current definition), and loans that fall under the retail model should define default to coincide with the Uniform Retail Credit Classification standards published by the FFIEC.

With respect to retail lending, the ANPR presents an updated point of view from the U.S. banking supervisors that the FFIEC definitions of loss recognition for retail credit will prevail. However, the ANPR goes on to state that retail default will also include the occurrence of any of the following events: 1) full or partial charge-off, 2) a distressed restructuring or workout involving forbearance and loan modification; or 3) notification that the obligor has sought or been placed in bankruptcy. We believe that the retail charge-off and bankruptcy conditions are addressed in the FFIEC guidelines, and, as such, would be appropriately triggered as defaults by those procedures. However, the distressed restructuring criterion is outside of the scope of FFIEC and should be excluded from the Basel definition of default.

Our comments here will address primarily the application of the default definition to corporate and specialized lending portfolios. We are concerned that, in the absence of moving the Basel default definition for wholesale loans to be based solely on the occurrence of non-accrual or charge-off status, **banks will be forced to track two separate measures of default – one for internal risk assessment and a second for regulatory capital purposes.** This would seem to be a meaningless, yet costly, exercise, since the ultimate driver of risk is loss, and **these fine lines of default definition will only serve to shift the mix of PD and LGD in an offsetting fashion, without significantly affecting ultimate loss.**

Non-Accrual status already subsumes the more detailed definitions of default. Generally, an asset is placed on non-accrual when it is 90 days past due or when reasonable doubt exists about a loan's collectibility. And, a declaration of bankruptcy would almost certainly trigger the condition of reasonable doubt regarding collectibility.

An exception to these general rules occurs when a loan is well secured and in the process of collection, in which case it will not necessarily be placed on non-accrual status. However, this exception only applies in limited situations. To be well secured, the asset must be secured by lien or pledge of collateral with realizable value sufficient to fully meet the obligation or guaranteed by a financially responsible party. An asset is in the process of collection if the collection through legal or other means is in due course. Generally, an asset can only remain that status for 30 days unless it can be demonstrated that the amount and timing of the payment is sufficient and reasonably certain.

There are already internal controls, internal audits, external audits and supervisory processes to ensure that non-accrual and charge-off policies are applied correctly. These policies, which govern whether banks continue to recognize income on their financial statements, should be sufficient to satisfy the Basel definition of default. **The broader IRB definition of default, which includes bankruptcy, selling at a loss, distressed restructuring (either wholesale or retail), and 90 days past due, is likely to arrive at virtually the same overall conclusion regarding the frequency of defaults, once consideration is given to materiality and purely technical defaults are excluded**.

The U.S. banking supervisors seem overly concerned regarding the potential for "silent defaults;" that is, instances where the well secured and in the process of collection exceptions to non-accrual policies are triggered. Capturing this data is a meaningless exercise for two reasons. First, **these are exceptions precisely because there is a strong expectation of zero loss**. And, second, as we previously stated, the net result of tagging such events as defaults would be negligible, since increased PD estimates would be offset by lower LGD estimates.

The same thought process around silent defaults also seems to have driven the additional criterion to include loan sales at material credit related discounts as defaulted assets. We oppose this criterion on both practical and conceptual grounds. Loan sales are a part of the portfolio management function. Portfolio management strategies differ significantly across banks, with some institutions being much more active than others. Even within a single institution, loan sale strategies will vary across time depending on overall balance sheet management and liquidity issues. Clearly, **including performing loan sales in the definition of default would introduce comparability problems**. Further, discounts on loan sales can be due to a variety of factors unrelated to credit such as interest rates, liquidity or technical supply and demand issues. It would be quite difficult, and ultimately arbitrary, to disentangle these effects.

Finally, on a more fundamental level, the loss in a loan's value due to credit deterioration is migration risk and not default risk. **Migration risk is already included in the framework through the maturity adjustment portion of the IRB formula. To be consistent with the derivation of the formula, the default probability that is estimated should not be artificially inflated for downgrades, and then only for those that are "realized" through discretionary loan sales. Such regulation could create perverse incentives for bank credit portfolio management and actually add to risk in the portfolio.**

One final issue that we would like to point out with the definition of default is its interplay with paragraph 366 of CP3. Paragraph 366 prescribes that banks must have one point on their borrower rating scales that is reserved solely for defaulted loans. We see no reason why it should be necessary to create a risk rating bucket that, by design, has a 100% PD, so long as a bank would always be able to identify what the actual default rate is for each of its rating buckets. While it is highly likely that defaulting borrowers would congregate at the lower end of a rating scale, we do not think that a unilateral default rating construct should be prescribed to banks. However, the mandate for a single default bucket becomes a potentially bigger issue when added to the fact that we disagree with the proposed definition of default in the first place. **Without some change in the default definition, banks would be faced with the unnecessary cost of actually creating parallel risk rating methodologies – one for internal risk assessment and a second for regulatory capital purposes, with no value added to the risk management process, and, indeed, the potential to create confusion among those responsible for identifying and managing risk in the portfolio.**

Of secondary, but still meaningful, importance to Wells Fargo is the language in the ANPR which suggests that conservatism be built into the estimates provided for EAD and LGD by limiting, for example, the underlying observation set to recessionary periods. We believe that EAD and LGD should be estimated using a "default-weighted" process that is naturally weighted toward periods with high defaults. Stressed parameters, such as recessionary EAD's and recessionary LGD's, should be used separately in stress analyses.

Question # 8 p. 52
Wholesale Exposures: SME Adjustment

> *If the Agencies include a SME adjustment, are the $50 million threshold and the proposed approach to measurement of borrower size appropriate? What standards should be applied to the borrower size measurement (for example, frequency of measurement, use of size buckets rather than precise measurements)?*
>
> *Does the proposed borrower size adjustment add a meaningful element of risk sensitivity sufficient to balance the costs associated with its computation? The Agencies are interested in comments on whether it is necessary to include an SME adjustment in the A-IRB approach. Data supporting views is encouraged.*

The capital formulation for SME's (small and medium-sized enterprises) should be simplified so that it is not so complex and, potentially, costly for banks to comply with, in terms of assembling the required data. There is little theoretical support for modeling borrower asset correlation as so granular a function of sales size as is suggested by the Accord. We do not understand why a **single**, lower asset correlation specification could not be devised, using the same functional form, but lower parameter settings, as the Corporate risk weight function, while simply stipulating a maximum sales size for a borrower to be considered an SME (we believe that $50 million threshold suggested is reasonable). Ideally, this function could also be made to eliminate the arbitrage possibilities that currently exist between corporate and retail SME risk weightings.

Question # 9 p. 54
<u>Wholesale Exposures: Specialized Lending</u>

> *The Agencies invite comment on ways to deal with cyclicality in LGDs. How can risk sensitivity be achieved without creating undue burden?*

We do not believe that cyclicality in minimum regulatory capital requirements is a problem, so long as minimum regulatory capital is somewhat below the economic capital levels that banks' internal risk models would suggest. In this way, banks would naturally be led to hold a cushion for volatility in their capital-setting policies. Therefore, using long-run average LGD estimates that incorporate periods of recession is preferable to using recession-only LGD estimates (which would introduce a bias for regulatory capital to be too high throughout the rest of the cycle). This point applies to all forms of lending, not just Specialized Lending.

With respect to Specialized Lending (and, specifically, investor/developer real estate lending), it should be noted that the cyclicality mentioned in the ANPR with respect to LGD will spill over into the PD estimates for such a portfolio, given the correlation between PD and LGD. As a result, certain scenarios can occur in which different obligations for a given borrower may have different PD's. This outcome is counter to one of the Supervisory Guidance's prescribed principles for obligor rating scales. We offer a possible solution to this issue in our response to the following question.

Question #10 p. 55
<u>Wholesale Exposures: Specialized Lending</u>

> *The Agencies invite comment on the merits of the SSC approach in the United States. The Agencies also invite comment on the specific slotting criteria and associated risk weights that should be used by organizations to map their internal risk rating grades to supervisory rating grades if the SSC approach were to be adopted in the United States.*

Paragraph 362 of CP3 describes an exemption from the two-dimensional rating system design requirement that is available to banks using the supervisory slotting criteria. It states that "given the interdependence between borrower/transaction characteristics in Specialized Lending, banks may satisfy the requirements under this heading through a single rating dimension that reflects EL by incorporating both borrower strength (PD) and loss severity (LGD) considerations." We agree about the presence of significant correlation between PD and LGD in commercial real estate lending, and feel that Advanced IRB banks should be allowed the same flexibility to use a single rating scale to assess risk in investor/developer real estate lending. We believe that this would be a much more reliable manner in which to capture the collateral-intensive nature of that business and its correlation with borrower PD.

Question #11 p. 57
Wholesale Exposures: HVCRE

> *The Agencies invite the submission of empirical evidence regarding the (relative or absolute) asset correlations characterizing portfolios of land ADC loans, as well as comments regarding the circumstances under which such loans would appropriately be categorized as HVCRE.*
>
> *The Agencies also invite comment on the appropriateness of exempting from the high asset correlation category ADC loans with substantial equity or that are pre-sold or sufficiently pre-leased. The Agencies invite comment on what standard should be used in determining whether a property is sufficiently pre-leased when prevailing occupancy rates are unusually low.*
>
> *The Agencies invite comment on whether high asset correlation treatment for one-to four-family residential construction loans is appropriate, or whether they should be included in the low asset correlation category. In cases where loans finance the construction of a subdivision or other group of houses, some of which are pre-sold while others are not, the Agencies invite comment regarding how the "pre-sold" exception should be interpreted.*
>
> *The Agencies invite comment on the competitive impact of treating defined classes of CRE differently. What are commenters' views on an alternative approach where there is only one risk weight function for all CRE? If a single asset correlation treatment were considered, what would be the appropriate asset correlations to employ within a single risk-weight function applied to all CRE exposures?*

We agree that certain forms of commercial real estate lending have historically exhibited higher volatility than traditional forms of corporate lending. It is also true, we believe, that over the years those commercial real estate lenders that have experienced several real estate cycles have developed underwriting strategies to dampen the potential impact on their portfolios of recessionary real estate environments.

Our perspective is that there is no "right" answer to what is "high volatility" commercial real estate lending. Such a definition would certainly be multi-dimensional, rather than subscribing to a simple, product-based focus. And, a multi-dimensional alternative would assuredly present compliance and data maintenance burdens to reporting banks. We would support the alternative of selecting a simple, directionally correct, definition of "high volatility" commercial real estate, such as any loans that meet the Call Reporting definition of Real Estate Construction Lending.

Question # 12 p. 58
<u>Wholesale Exposures: Lease Financings</u>

> *The Agencies are seeking comment on the wholesale A-IRB capital formulas and the resulting capital requirements. Would this approach provide a meaningful and appropriate increase in risk sensitivity in the sense that the results are consistent with alternative assessments of the credit risks associated with such exposures or the capital needed to support them? If not, where are there material inconsistencies?*
>
> *Does the proposed A-IRB maturity adjustment appropriately address the risk differences between loans with differing maturities?*

We agree that the proposed formulae result in a reasonable representation of the relative risk of positions with varying PD's and LGD's. There are two issues that we have with the formulation. First, we believe that the asset value correlation function for corporate SME borrowers has been set too high, is overly complex, and encourages a capital arbitrage between retail SME and corporate SME (as we discussed above).

Secondly, we believe that the formulaic capital treatment of very short-term maturities under one year is excessive. If an obligor has a given probability of default over, say, the next quarter, the cumulative probability of default over 4 quarters, even assuming no credit quality deterioration, must be higher than the one-quarter probability of default. Therefore, unexpected losses must be less for the short-dated facility. Implicit in this conclusion is the requirement that the bank have the unquestioned right to cancel the facility at the end of the current term.

Question # 13 p. 60
<u>Retail Exposures: Definitions and Inputs</u>

> *The Agencies are interested in comment on whether the proposed $1 million threshold provides the appropriate dividing line between those SME exposures that banking organizations should be allowed to treat on a pooled basis under the retail A-IRB framework and those SME exposures that should be rated individually and treated under the wholesale A-IRB framework.*

We believe that the line of demarcation between SME exposures treated as retail and those treated as wholesale could reasonably be certified under Pillar 2, rather than codified under Pillar 1. Each bank would be required to show how it manages certain SME exposures as relatively homogeneous "retail" assets. A threshold such as $1million may become quickly outmoded, either due to inflation or due to the way in which risk management and measurement is carried out at individual banks.

More importantly, we believe that this question should really be moot. A better alternative, we believe, would be to establish a single risk-weighting function for SME that eliminates the arbitrage possibilities that currently exist between the corporate and retail SME sub-portfolios.

Question # 14 p. 65
Retail Exposures: Undrawn Lines

> *The Agencies are interested in comments and specific proposals concerning methods for incorporating undrawn credit card lines that are consistent with the risk characteristics and loss and default histories of this line of business.*
>
> *The Agencies are interested in further information on market practices in this regard, in particular the extent to which banking organizations remain exposed to risks associated with such accounts. More broadly, the Agencies recognize that undrawn credit card lines are significant in both of the contexts discussed above, and are particularly interested in views on the appropriate retail IRB treatment of such exposures.*

We do not see anything wrong with the concept of holding capital against undrawn lines of credit. Most retail risk management practitioners would acknowledge that there is risk is such commitments that may materialize in the event of default. However, practitioners would also maintain that there is an interplay between PD and EAD and, for some products, LGD, such that the sensitivity of the "bottom-line" losses (EL) cannot be modeled as an uncorrelated response to one of the latent variables.

Under certain modeling assumptions, this would not be an insurmountable problem. However, the Basel risk-weight function uses an assumption of declining asset correlation in relation to PD, which produces the unintuitive outcome that the EAD assumption for low PD accounts has an outsized impact on the 99.9^{th} percentile losses for such accounts. It is these low PD accounts that would have the lowest usage in the first place. The result is that those accounts that are most sensitive to EAD also receive the highest asset correlation in the A-IRB formulation, with the result that their 99.9^{th} percentile losses are exaggerated. In order to make the modeled probability density function of losses for credit cards and unsecured revolving lines of credit more realistic, we believe that the declining asset correlation function in the A-IRB capital formulation must be replaced by a constant asset correlation function.

Question #15 pp. 66-67
Retail Exposures: Future Margin Income

> *For the QRE sub-category of retail exposures only, the Agencies are seeking comment on whether or not to allow banking organizations to offset a portion of the A-IRB capital requirement relating to expected losses by demonstrating that their anticipated FMI for this sub-category is likely to more than sufficiently cover expected losses over the next year.*
>
> *The Agencies are seeking comment on the proposed definitions of the retail A-IRB exposure category and sub-categories. Do the proposed categories provide a reasonable balance between the need for differential treatment to achieve risk-sensitivity and the desire to avoid excessive complexity in the retail A-IRB framework? What are views on the proposed approach to inclusion of small-*

business exposures in the other retail category?

The Agencies are also seeking views on the proposed approach to defining the risk inputs for the retail A-IRB framework. Is the proposed degree of flexibility in their calculation, including the application of specific floors, appropriate? What are views on the issues associated with undrawn retail lines of credit described here and on the proposed incorporation of FMI in the QRE capital determination process?

The Agencies are seeking comment on the minimum time requirements for data history and experience with segmentation and risk management systems: Are these time requirements appropriate during the transition period? Describe any reasons for not being able to meet the time requirements.

a) On the topic of EL, see our response to question #6.

b) We believe that the retail capital formulation could be made to coincide more closely with industry best practices by doing away with the three retail formulations that have been proposed and allowing the asset correlation parameter in the basic Merton formula to be a variable, rather than hardcoded to have three distinct values. Banks could then employ asset correlation assumptions that were customized to the traits of each heterogeneous retail portfolio.

c) As it stands, the Accord employs unrealistically high asset correlation assumptions in the risk-weighted asset calculations, which make the estimated 99.9^{th} percentile loss level arbitrarily high. These assumptions result in an exaggerated view of worst-case loss levels across <u>all</u> of the retail lending product categories, and are particularly misrepresentative in the case of high-EL/high-FMI (non-prime) retail lending.

d) As indicated above, the definition of default used within retail categories should align with reporting practices of banks. Thus, the FFIEC standard should be used without embellishment.

e) The proposed approach to estimating the inputs to the regulatory retail capital models is generally appropriate. However, no floors should be placed on any estimated parameter input. The proposed 10% floor on LGDs for single family mortgages is simply another example of arbitrary and cumulatively conservative rules. Rather, the appropriateness of PD, LGD, and EAD estimates is strictly a Pillar 2 issue. That is, the banking supervisors retain the ability under Pillar 2 to require any AIRB bank to use a higher PD or LGD input into the regulatory capital models than the bank would use in the absence of supervision.

f) We also wish to point out that actual implementation by banks of some of the data gathering aspects of risk measurement for retail products cannot begin in earnest until the regulators release their supervisory guidance document regarding retail credits. The requirement for 3 years worth of experience with the segmentation and risk management systems are too stringent, especially since the agencies have not yet published supervisory guidance for retail credit risk. We recommend that this requirement be softened.

g) On the topic of portfolio segmentation of retail exposures, page 61 of the ANPR states that one of the "specific limitations" that the Agencies would propose is that banking organizations would need to separately segment "delinquent retail exposures". While Wells Fargo's primary position on the topic is that no specific requirements should be imposed on retail portfolio segmentation, we still view the ANPR's statement as being somewhat vague. We would recommend that the language be modified to make it clear that, in this context, delinquency can be recognized either through explicit segmentation (that is, past due versus not past due, or some variation on the theme) or through the incorporation of delinquent characteristic(s) in the credit scoring models which a bank might use to form the basis for its retail product PD estimation.

Question # 16 p.70
Retail Exposures: Private Mortgage Insurance

The Agencies also seek comment on the competitive implications of allowing PMI recognition for banking organizations using the A-IRB approach but not allowing such recognition for general banks. In addition, the Agencies are interested in data on the relationship between PMI and LGD to help assess whether it may be appropriate to exclude residential mortgages covered by PMI from the proposed 10 percent LGD floor. The Agencies request comment on whether or the extent to which it might be appropriate to recognize PMI in LGD estimates.

More broadly, the Agencies are interested in information regarding the risks of each major type of residential mortgage exposure, including prime first mortgages, sub-prime mortgages, home equity term loans, and home equity lines of credit. The Agencies are aware of various views on the resulting capital requirements for several of these product areas, and wish to ensure that all appropriate evidence and views are considered in evaluating the A-IRB treatment of these important exposures.

The risk-based capital requirements for credit risk of prime mortgages could well be less than one percent of their face value under this proposal. The Agencies are interested in evidence on the capital required by private market participants to hold mortgages outside of the federally insured institution and GSE environment. The Agencies also are interested in views on whether the reductions in mortgage capital requirements contemplated here would unduly extend the federal safety net and risk contributing to a credit-induced bubble in housing prices. In addition, the Agencies are also interested in views on whether there has been any shortage of mortgage credit under general risk-based capital rules that would be alleviated by the proposed changes.

With respect to the question on PMI, we are puzzled as to why the Basel Committee has even envisioned an LGD floor for mortgages. It seems out of context with the approach that is suggested for LGD estimation elsewhere in the Accord. We commented above on our point of view on cyclicality in LGD's. Residential mortgage loans with PMI should be no different than any other loan class. Banks should be required to provide realistic, long-run average estimates of their LGD's that are default-weighted averages of their experience across an economic cycle, and not subject to any artificial floors. Under the Accord's current wording, we would acknowledge that the proposed LGD floor could have public policy implications, with respect to its impact on banks who actively use PMI insurance as a tool to facilitate the granting of loans at attractive rates to borrowers who have not accumulated a 20% down payment.

On the broader topic of the capital requirements that result from the proposed A-IRB capital formulation for mortgage products, we believe that the regulatory asset value correlation assumptions should be adjusted downward for both first and second mortgage products. While we acknowledge that the current proposal provides capital for prime mortgages at a rate significantly below the old Accord, it should also be noted that the A-IRB formulation addresses credit capital only. Our internal models would suggest a reasonable amount of operational risk to the mortgage production and mortgage servicing businesses, which needs to be aggregated with the credit capital associated with the mortgages held in portfolio in order to provide a valid basis for assessing overall capital required by a mortgage banking business.

Question #17 p. 72-73
<u>Retail Exposures: Future Margin Income Adjustment</u>

> *The Agencies are interested in views on whether partial recognition of FMI should be permitted in cases where the amount of eligible FMI fails to meet the required minimum. The Agencies are also interested in views on the level of portfolio segmentation at which it would be appropriate to perform the FMI calculation. Would a requirement that FMI eligibility calculations be performed separately for each portfolio segment effectively allow FMI to offset EL capital requirements for QRE exposures?*

We believe that internal capital generation acts as a primary buffer against losses in the portfolio, even before loan loss reserves and equity capital are drawn upon. While this concept has long been valued by bank debt rating agencies in their evaluation of bank capital structures and securitizations of pools of assets, it has been virtually ignored in the Accord. Even recent amendments to the Accord with respect to Future Margin Income are fundamentally understated, by virtue of restricting their focus to higher-margin retail lending portfolios and operational risk. Margin income is found throughout a diversified bank holding company and, regardless of its source, serves as a component of internal capital generation. Stated simply, it is not the risk alone of extending credit that creates a requirement for capital outlay at a financial institution. It is this risk absent a compensatory reward that raises capital requirements. We would argue that some fraction of Future Margin Income should be deducted from <u>all</u> Pillar 1 capital formulations – wholesale lending, retail lending, and operational risk. FMI excesses in certain areas should be allowed to subsidize FMI shortfalls in other areas, since it is the holding company's solvency that is being evaluated.

Question #18 p. 75-76
<u>Retail Exposures Formula: Other Retail</u>

> *The Agencies are seeking comment on the retail A-IRB capital formulas and the resulting capital requirements, including the specific issues mentioned. Are there particular retail product lines or retail activities for which the resulting A-IRB capital requirements would not be appropriate, either because of a misalignment with underlying risks or because of other potential consequences?*

As mentioned earlier, we believe that the Accord employs unrealistically high asset correlation assumptions in the risk-weighted asset calculations, which make the estimated 99.9th percentile loss level arbitrarily high. These assumptions result in an exaggerated view of worst-case loss levels across <u>all</u> of the retail lending product categories, and are particularly misrepresentative in the case of high-EL/high-FMI (non-prime) retail lending.

Question # 19 p. 77
<u>A-IRB: Other Considerations: Loan Loss Reserves</u>

> *The Agencies recognize the existence of various issues in regard to the proposed treatment of ALLL amounts in excess of the 1.25 percent limit and are interested in views on these subjects, as well as related issues concerning the incorporation of expected losses in the A-IRB framework and the treatment of the ALLL generally. Specifically, the Agencies invite comment on the domestic competitive impact of the potential difference in the treatment of reserves described.*

> *The Agencies seek views on this issue, including whether the proposed US. treatment has significant competitive implications. Feedback also is sought on whether there is an inconsistency in the treatment of general specific provisions (all of which may be used as an offset against the EL portion of the A-IRB capital requirement) in comparison to the treatment of the ALLL (for which only those amounts of general reserves exceeding the 1.25 percent limit may be used to offset the EL capital charge).*

We believe that banks should be allowed to effectively count their entire loan loss reserve (ALLL) as capital, rather than having its usage capped (at 1.25% of risk-weighted assets (RWA), or aggregate expected losses (EL)). If usage of the ALLL is capped, a major portion of three primary buffers against loss volatility – portfolio diversification, margin income, and part of the loan loss reserve – will effectively have been ignored. It would also be the case in this instance that banks with low expected losses would receive an arbitrary capital advantage, since it is more likely that their ALLL would "fit" under the 1.25% of RWA cap.

Wells Fargo thinks of the loan loss reserve as another form of capital. We see no reason why banks should not be able to effectively count their entire ALLL as capital, regardless of the proposed treatment of EL in the risk-weighted asset formulae. It is particularly objectionable to us that the current proposal gives an arbitrary advantage to some banks in terms of their ability to make full use of their ALLL.

Question #20 p. 82
A-IRB Other: Treatment of undrawn receivables purchase commitments

> *The Agencies seek comment on the proposed methods for calculating credit risk capital charges for purchased exposures. Are the proposals reasonable and practicable?*
>
> *For committed revolving purchase facilities, is the assumption of a fixed 75 percent conversion factor for undrawn advances reasonable? Do banks have the ability (including relevant data) to develop their own estimate of EADs for such facilities? Should banks be permitted to employ their own estimated EADs, subject to supervisory approval?*

The agencies should clarify whether the purchased receivables approach applies to all credit exposures purchased from third parties or a more limited set of transactions of trade receivables. We support the flexibility to apply top down methods for purchased exposures.

The approach in CP3 applies dollar for dollar capital reduction for the purchase discount. The U.S. agencies are not comfortable with this approach because it would result in a zero capital charge for assets where the discount is equal to or greater than the estimated LGD. In the ANPR, the AIRB formula is applied to the cost basis of the exposures using either bottom-up or top down estimates of the parameters. As a result, the dollar capital charge is reduced only by the amount of the discount times the capital ratio. We believe this approach is too conservative and not sufficiently risk sensitive. A better approach would be to scale the LGD in relation to the discount. We recommend a floor of 25% on the scaling factor be set to assure non-zero capital assignments.

If the top-down approach applies to portfolio acquisitions, mergers, whole loan purchases, and secondary market transactions, the qualifying criteria for this approach are too stringent. In particular, the requirement that the receivables be limited to maturities less than one year, unless fully collateralized, would exclude most retail assets.

With regard to estimated EADs, we see no reason to have a separate treatment of committed revolving purchase facilities (i.e., an arbitrary 75% "conversion" factor for undrawn lines). The Pillar 2 supervision process should govern acceptable EAD estimates made by individual AIRB banks, as is the case for the other risk parameters (PD and LGD). Only if supervisors find the internal process unacceptable should the internal EAD estimate be replaced with a supervisory requirement for EAD.

Question # 21&22 p. 84
<u>A-IRB Other: Capital Charge for Dilution Risk - Minimum Requirements</u>

> *The Agencies seek comment on the proposed methods for calculating dilution risk capital requirements. Does this methodology produce capital charges for dilution risk that seem reasonable in light of available historical evidence? Is the corporate A-IRB capital formula appropriate for computing capital charges for dilution risk?*
>
> *In particular, is it reasonable to attribute the same asset correlations to dilution risk as are used in quantifying the credit risks of corporate exposures within the A-IRB framework? Are there alternative method(s) for determining capital charges for dilution risk that would be superior to that set forth above?*
>
> *The Agencies seek comment on the appropriate eligibility requirements for using the top-down method. Are the proposed eligibility requirements, including the $1 million limit for any single obligor, reasonable and sufficient?*
>
> *The Agencies seek comment on the appropriate requirements for estimating expected dilution losses. Is the guidance set forth in the New Accord reasonable and sufficient?*

No specific comment.

Question # 23 p. 91
<u>Credit Risk Mitigation Techniques</u>

> *The Agencies seek comments on the methods set forth above for determining EAD, as well as on the proposed backtesting regime and possible alternatives banking organizations might find more consistent with their internal risk management processes for these transactions. The Agencies also request comment on whether banking organizations should be permitted to use the standard supervisory haircuts or own estimates haircuts methodologies that are proposed in the New Accord.*

We concur with the broadened recognition of collateral in the new Accord. This revised treatment of collateral will better align industry and regulatory practice for this critical credit risk mitigation tool.

We support the use of collateral haircuts that are determined internally. Large, highly rated banks tend to be net collateral receivers, and as such, their incentives to use fiscally sound haircuts are aligned with those of the U.S. banking supervisors. Conversely, it would be difficult for large banks to change collateral arrangements that are already in place, especially since the majority of counterparties will not be Basel II compliant entities.

In addition, we would like to point out that certain requirements in CP3 are not in line with large, complex banks' internal collateral policies.

- Paragraph 125 of CP3 implies that non-investment grade or unrated corporate bonds would not be eligible collateral, even for banks that qualify to use their own haircuts. At the same time, Paragraph 129 of CP3 requires banks using their own haircuts to take into account the liquidity of lower quality assets – an issue that is a key consideration in the assignment of our internal haircuts. Thus, the exclusion of non-investment grade corporate debt altogether (as opposed to the use of a larger haircut) is unduly harsh in light of standard haircut practice.

- CP3 requires a separate assessment for foreign exchange risk even for banks under the AIRB that will be setting their own haircuts. The separate assessment of foreign exchange risk presents problems from an implementation standpoint given that most large, complex banks apply a *portfolio view* to collateral. It appears that the CP3 proposal essentially requires banks to look at each transaction separately to determine whether there is a currency mismatch. For large portfolios with large counterparties involving multiple positions, this approach may involve thousands of transactions -- which would make such an approach both impractical and not best-practice from a portfolio management standpoint. Typical practice is to agree with a large counterparty on a schedule of eligible collateral assets and applicable haircuts. Eligible collateral can include US dollar cash and securities and certain non-US dollar cash and securities. Most non-US dollar collateral positions are in euros, yen, and pounds, where there is generally low volatility over the short period of the exposure. The counterparty can cover its collateral requirements for its <u>net</u> exposure by delivering any of the eligible assets. For a portfolio of such low-volatility currency, short duration positions, currency risk is negligible and is often not measured for this reason (and if it were to be measured it would be done on a portfolio basis).

- CP3 requires banks to use a 99% confidence level in setting their own collateral haircuts. Many banks may not use such a high confidence level in setting internal haircuts. To do so would imply an exceedingly low joint probability that the obligor will default and the collateral value will decline to insufficient levels. Given the cumulatively conservative prescriptions elsewhere in the new Accord, including the overall confidence interval for capital purposes, we believe that the confidence interval for internal haircuts should be a Pillar 2 (supervisory guidance) issue.

- We believe that there should be significant conformity in the capital calculations for products that exhibit similar economic risks, notably repo transactions and OTC derivatives. Paragraph 149 of CP3 appears to restrict use of the VaR approach to repo-style transactions. It is not clear from a theoretical or empirical perspective why supervisors would impose such a restriction. We also see no reason why repos would be allowed to adjust EAD in order to reduce exposure for collateral, while derivatives are required to adjust LGD.

- In addition, any modifications to the current approach should properly recognize the risk-reducing effects of *collateral support agreements*, which require the delivery of collateral upon the breach of pre-agreed thresholds, thereby reducing potential future exposure.

- Finally, supervisors should permit VaR modelling for all transactions, not just repo transactions, that are marked to market and remargined daily, and meet high standards of legal enforceability (i.e. transactions that comply with paragraphs 88 and 89 of CP3).

Question #24 p. 93
Guarantees and credit derivatives

> *Industry comment is sought on whether a more uniform method of adjusting PD or LGD estimates should be adopted for various types of guarantees to minimize inconsistencies in treatment across institutions and, if so, views on what methods would best reflect industry practices. In this regard, the Agencies would be particularly interested in information on how banking organizations are currently treating various forms of guarantees within their economic capital allocation systems and the methods used to adjust PD, LGD, EAD, and any combination thereof*

Page 92 of the ANPR states that "the adjusted risk weight for [a] hedged obligation could not be less than the risk weight associated with a comparable direct exposure on the protection provider". While this application of the "substitution approach" may be roughly appropriate to certain forms of guarantees in which the financial condition of the borrower and guarantor are closely linked (say, a proprietor who provides a personal guarantee against the performance of his business), there are other forms of guarantees (such as credit derivatives), where this approach does not adequately recognize the lower risk of joint default or the benefit of double recovery associated with guarantees.

Failure to recognize the risk mitigation effect of double default in credit derivatives would send inappropriate signals to banks about the use of guarantees and credit derivatives -- financial instruments that have provided enormous value in the active management of portfolio credit risk.

As one illustration of the proposal's inadequacy, consider the case where a AA-rated counterparty is used to enact a hedge on an unrelated AA-rated exposure in the banking book. Using the substitution approach, there would be no capital benefit. Moreover, the bank would have to add a capital charge for the counterparty exposure associated with the hedge provider. In effect, the bank would be required to hold more capital than if it had not hedged at all.

As a solution to this situation, we would support the use of some form of the modified ASRF approach suggested in the recent Federal Reserve paper on guarantees and credit derivatives. Under this approach, regulators could (at least initially) assign the necessary 3 "types" of asset value correlation (AVC) in conservative fashion (e.g., obligor and guarantor AVCs according to the Basel AVC-PD equation for commercial credits, and a "wrong-way" asset-value-correlation of, say, 50%). This would produce significant reductions in the regulatory capital charges for a hedged transaction.

Question # 25 p. 96
<u>Additional requirements for recognized credit derivatives</u>

> *The Agencies invite comment on this issue, as well as consideration of an alternative approach whereby the notional amount of a credit derivative that does not include restructuring as a credit event would be discounted. Comment is sought on the appropriate level of discount and whether the level of discount should vary on the basis of for example, whether the underlying obligor has publicly outstanding rated debt or whether the underlying is an entity whose obligations have a relatively high likelihood of restructuring relative to default (for example, a sovereign or PSE). Another alternative that commenters may wish to discuss is elimination of the restructuring requirement for credit derivatives with a maturity that is considerably longer --for example, two years --than that of the hedged obligation.*

We agree with the position in CP3 that restructuring does not need to be included as a credit event in a credit derivative contract, provided the bank has control over the decision to restructure. At the same time, a contract with restructuring can provide greater credit risk coverage than one without it. Thus, the restructuring discount approach could be an attractive option. However, no restructuring discount should be implemented until a reasonable amount of credit protection has been recognized by the new Accord in the first place. Placing a discount on top of the meager benefit granted by the substitution approach would effectively eliminate the benefit of the credit hedge altogether.

We support ISDA's proposed methodology for determining the discount factor.

Question #26 p.96
<u>Additional requirements for recognized credit derivatives con't.</u>

> *Comment is sought on this matter, as well as on the possible alternative treatment of recognizing the hedge in these two cases for regulatory capital purposes but requiring that mark-to-market gains on the credit derivative that have been taken into income be deducted from Tier 1 capital.*

Supervisors are worried that banks may recognize too much regulatory capital as a result of the inconsistent treatment for a loan with accrual accounting versus its credit default swap (CDS) hedge with MTM accounting. We acknowledge the existence of an accounting asymmetry. However, we do not believe that regulators should attempt to solve what is essentially a FAS133 problem within the Basel II framework. Indeed, there are other significant instances in which GAAP policy differs from or is not based on best-practice risk measurement. Further, even if GAAP were to move to a purely MTM framework, such a framework would still not be always appropriate from a risk measurement perspective. For example, for a loan whose spread is risk related, a decline in credit quality (increase in risk rating) may result in little or no decline in market value (due to the contractual increase in margin), but additional economic capital should be assigned to the credit. In the case of MTM hedges coupled with accrual accounting loans, the right approach is to fix U.S. general accounting principals.

If Basel were to enact this proposal then virtually no capital benefit could be given to credit hedging utilizing CDS transactions, and the regulatory rule would be sending a very inappropriate signal to bank risk managers. Further, strictly from a safety and soundness perspective, we do not believe that there is a significant regulatory capital advantage being granted by the accounting asymmetry. That is, suppose the alternative U.S. proposal (embodied in the question on P. 61 of the ANPR) is <u>not</u> enacted. Then, when hedging a loan in the banking book with a CDS transaction in the trading account, additional regulatory capital may be needed for market risk, plus counterparty risk, in the trading book -- acting to offset the reduction in capital for the loan in the banking book. It is quite possible that the result will be higher regulatory capital than before the hedge (even though internal EC will uniformly decrease with a properly structured hedge).

For higher quality reference names, in which a VaR model may be used to estimate market risk capital, the initial saving on the regulatory capital against the underlying loan will not be fully offset by the increase in market risk and counterparty risk capital – which is as it should be, since the hedged loan is safer than the unhedged loan. After booking the hedge, if the credit quality of the reference name decreases, there will be a MTM gain in the trading book (and a corresponding gain in Tier 1 capital) – but this gain will be offset by a) an increase in counterparty risk capital since the CDS is more in-the-money, b) an increase in market risk capital due to an increase in VaR, and c) a possible increase in the ALLL due to a reassessment of the underlying credit's quality (even if there is no change in specific reserves, a lower risk rating would imply a higher estimated EL and thus an addition to the ALLL under current accounting practices). Thus, the alternative U.S. proposal – which would subtract the MTM gains on the derivative from Tier 1 capital – should not be implemented. Any regulatory capital asymmetries (which, in any event, are not matched by internal EC asymmetries) would best be eliminated through a MTM accounting treatment of the loan/hedge package.

Question # 27 p.98
<u>Treatment of maturity mismatch</u>

> *The Agencies have concerns that the proposed formulation does not appropriately reflect distinctions between bullet and amortizing underlying obligations. Comment is sought on the best way of making such a distinction, as well as more generally on alternative methods for dealing with the reduced credit risk coverage that results from a maturity mismatch.*

The essential problem with the Agencies view with regard to credit risk mitigation is that it is transaction-oriented, rather than exhibiting a portfolio perspective. Wells Fargo would address a counterparty hedging exercise by creating a credit exposure profile over time for the counterparty, with netting of all exposures to this name across the bank. Thus, the hedge profiles would be netted against the profiles of the underlying exposures, with any residual exposures converted into bullet loan equivalents and charged for internal EC. Additional EC would be assigned for credit derivatives that do not function as explicit guarantees (i.e., credit derivatives involving basis risk).

Under the ANPR proposal, it appears that banks would have to match each hedge to a particular underlying transaction. Thus, two completely offsetting (but individually mismatched) trades, rather than having a net capital allocation of zero, would have positive capital assigned to each "paired" trade. Furthermore, maturity mismatches would be treated on a transaction-by-transaction basis. Even worse, under the proposal a three-year hedge of a 5-year loan would receive only 60% of the benefit of a five-year hedge and, in the next year, the two-year hedge of the (remaining) 4-year loan would receive only 50% of the benefit of a matched maturity hedge. There would be no capital saving at all for a one-year remaining life hedge. This treatment is far more conservative than implied by the maturity adjustments embedded in the regulatory ASRF model itself.

This arbitrary treatment should be replaced by simply accounting for maturity mismatches as the difference between AIRB capital on the underlying (given its maturity) and the AIRB capital on the hedge (given its maturity). The bank would also have to hold capital for the counterparty exposure associated with the hedge provider.

Question #28 p. 99
<u>Treatment of counterparty risk for credit derivative contracts</u>

> *The Agencies are seeking industry views on the PFE add-ons proposed above and their applicability. Comment is also sought on whether different add-ons should apply for different remaining maturity buckets for credit derivatives and, if so, views on the appropriate percentage amounts for the add-ons in each bucket.*

No specific comment.

Question #29 p. 102
<u>Equity Exposures - Positions covered</u>

> *The Agencies encourage comment on whether the definition of an equity exposure is sufficiently clear to allow banking organizations to make an appropriate determination as to the characterization of their assets.*

No specific comment.

Question # 30 p. 103
<u>Equity Exposures - Zero and low risk investments</u>

> *Comment is sought on whether other types of equity investments in PSEs should be exempted from the capital charge on equity exposures, and if so, the appropriate criteria for determining which PSEs would be exempted.*

No specific comment.

Question #3l p. 104

Equity Exposures: Nationally legislated programs

> *The Agencies seek comment on what conditions might be appropriate for this partial exclusion from the A-IRB equity capital charge. Such conditions could include limitations on the size and types of businesses in which the banking organization invests, geographical limitations, or maximum limitations on the size of individual investments.*

The proposed materiality threshold designed to assess risk exposure for banks' higher risk equity holdings is 10% of Tier 1 plus Tier 2 capital. At a 10% Total Capital level, this is equivalent to a 1% of assets test. This seems like a very low materiality threshold – perhaps 3% or 5% of total assets might be more reasonable. In conjunction with this modification, we would recommend that certain lower-risk equity investments, such as CRA investments, be discounted when included in the materiality calculation.

Question #32 p. 104-105

Equity Exposures: Nationally legislated programs Con't.

> *The Agencies seek comment on whether any conditions relating to the exclusion of CEDE investments from the A-IRB equity capital charge would be appropriate. These conditions could serve to limit the exclusion to investments in CEDEs that meet specific public welfare goals or to limit the amount of CEDE investments that would qualify for the exclusion from the A-IRB equity capital charge. The Agencies also seek comment on whether any other classes of legislated pro gram equity exposures should be excluded from the A-IRB equity capital charge.*

No specific comment.

Question # 33 p. 109

Equity Exposures: Grandfathered Investments - Description of quantitative principles

> *Comment is specifically sought on whether the measure of an equity exposure under AFS accounting continues to be appropriate or whether a different rule for the inclusion of revaluation gains should be adopted.*

No specific comment.

Question #34 p. 115-116
Supervisory Assessment of A-IRB Framework: US Supervisory Review

> *The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the A-IRB requirements. If this balance is not appropriate, what are the specific areas of imbalance, and what is the potential impact of the identified imbalance? Are there alternatives that would provide greater flexibility, while meeting the overall objective of producing accurate and consistent ratings?*
>
> *The Agencies also seek comment on the supervisory standards contained in the draft guidance. Do the standards cover all of the key elements of an A-IRB framework? Are there specific practices that appear to meet the objectives of accurate and consistent ratings but that would be ruled out by the supervisory standards related to controls and oversight? Are there particular elements from the corporate guidance that should be modified or reconsidered as the Agencies draft guidance for other types of credit?*
>
> *In addition, the Agencies seek comment on the extent to which these proposed requirements are consistent with the ongoing improvements banking organizations are making in credit-risk management processes.*

There has been a relatively uniform set of concerns communicated to the Basel Committee in response to Consultative Paper 3 (CP3) on the topic of prescriptiveness. However, we fear that these criticisms have been too general in nature to be of much value as an agent of change. In fact, the Committee may be receiving mixed signals from the industry in terms of its requests to have more rigidity built into the Accord on some issues and less rigidity on others.

The areas where we feel that clarity is required relate primarily to definitional issues within the Accord – a common definition of default or future margin income, long-run average versus point in time PD or LGD estimates, and similar metrics or terms that are necessary to create an unambiguous foundation upon which the new, more risk-sensitive, regulatory capital calculations can be computed.

Where clarity is **not** required, and where the Supervisory Guidance steps over the line and into the realm of unwarranted prescriptiveness, comes from its attempts to dictate how banks actually **manage** risk. The Supervisory Guidance is too prescriptive and inflexible in its vision of the risk management ***processes*** to which banks must adhere.

This is in stark contrast to the original supposition of Basel II -- that each bank would be allowed to continue the use of its existing risk management practices, so long as they could be shown to have been effective over time. The Accord and Supervisory Guidance should only aspire to establish a more risk-sensitive framework for constructing minimum bank regulatory capital requirements. They cannot, and should not, attempt to dictate how banks actually manage risk. For those institutions, such as Wells Fargo, with proven risk management processes in place, it would be imprudent, and perhaps dangerous, for them to make significant changes to their risk management systems in the absence of quantifiable and validated data that clearly demonstrates that an alternate system is more robust and accurate, and could be successfully inculcated into their risk management process.

Please refer to our separate letter on the Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit for more specific comments on the supervisory standards for A-IRB.

Question #35 p. 118
Securitization - Operational Criteria

> *The Agencies seek comment on the proposed operational requirements for securitizations. Are the proposed criteria for risk transference and clean-up calls consistent with existing market practices?*

Banks should be permitted to exercise a clean-up call when the securitization exposures fall below 10% of either (i) the original principal amount of exposures issued or (ii) the original pool balance of all assets acquired to support such exposures. The purpose of the clean-up call is administrative convenience when the size of a transaction no longer justifies the servicing costs. We believe that, if appropriately exercised so as to not be implicit support, whether the 10% is based on the size of the pool or the size of the remaining balance of exposures should be irrelevant. We note that many clean-up calls are currently based on the size of the issued exposures and would have to be unnecessarily amended (which can be time consuming and costly in the term market) if our comment were not taken.

Question #36 p. 122
Securitization - Maximum Capital requirement

> *Comments are invited on the circumstances under which the retention of the treatment in the general risk-based capital rules for residual interests for banking organizations using the A-IRB approach to securitization would be appropriate.*
>
> *Should the Agencies require originators to hold dollar-for-dollar capital against all retained securitization exposures, even if this treatment would result in an aggregate amount of capital required of the originator that exceeded KIRB plus any applicable deductions? Please provide the underlying rationale.*

We support the currently contemplated cap on required capital for retained positions of an originator at the K_{IRB} of the underlying pool as if it had not been securitized. Assuming that the K_{IRB} of the underlying exposures is appropriately calibrated, it is inappropriate to hold more capital for a part of that risk as opposed to the entirety of that risk. Without the cap, total capitalization after a securitization could be multiples of capital prior to a securitization, a result that further evidences the miscalibration of the RBA and SFA for securitizations. We further advocate the ability to use assigned ratings to override positions within K_{IRB} that have true credit protection, either through the tranching of the K_{IRB} exposure or through the presence of credit risk mitigants not recognized in the SFA. We do not believe that the presence of one of these features should preclude the presence of the other. They address separate issues that should be separately considered on their merits.

Question #37 p. 125-126

Securitization - Positions below K_{IRB}

> *The Agencies seek comment on the proposed treatment of securitization exposures held by originators. In particular, the Agencies seek comment on whether originating banking organizations should be permitted to calculate A-IRB capital charges for securitizations exposures below the KIRB threshold based on an external or inferred rating, when available.*

We believe that originators should not be treated differently than investing institutions with respect to the capital treatment of retained or repurchased tranches of securitizations. Rather than being required to deduct from regulatory capital all positions below K_{IRB} regardless of rating, originators should be allowed to apply the same RBA risk weights used by investors for the subject tranches when performing the calculation, since the risk is the same.

Question #38 p. 126

Securitization - Positions above KIRB

> *The Agencies seek comment on whether deduction should be required for all non-rated positions above KIRB. What are the advantages and disadvantages of the SFA approach versus the deduction approach?*

No specific comment.

Question #39 p. 130
<u>Securitization - Ratings Based Approach (RBA)</u>

The Agencies seek comment on the proposed treatment of securitization exposures under the RBA. For rated securitization exposures, is it appropriate to differentiate risk weights based on tranche thickness and pool granularity?

For non-retail securitizations, will investors generally have sufficient information to calculate the effective number of underlying exposures (N)?

What are views on the thresholds, based on N and Q, for determining when the different risk weights apply in the RBA?

Are there concerns regarding the reliability of external ratings and their use in determining regulatory capital? How might the Agencies address any such potential concerns?

Unlike the A-IRB framework for wholesale exposures, there is no maturity adjustment within the proposed RBA. Is this reasonable in light of the criteria to assign external ratings?

We believe that the proposed risk weights in the Ratings-Based Approach to be used by Investing Banks in the mezzanine and senior tranches of securitizations are too high, and could lead to irrational incentives to trade securities. These weights could be made to coincide more closely with the weights generated by the corporate risk weight formula for assets with comparable PD's.

We believe that it is important that the RBA be recalculated using the Perraudin and Peretyatkin model, but changing the key LGD assumption previously used for calibrating risk weights for granular highly rated tranches that qualify for risk weights calculated in column 1 of the RBA table. While the ideal would be different assumptions for different asset classes, we believe an appropriate LGD assumption that is workable across the board for these thick, granular positions is one between 5% and 10%, rather than the 50% LGD assumption that underlies the current RBA factors.

Question #40 p. 137
<u>Securitization - Supervisory formula approach (SFA)</u>

The Agencies seek comment on the proposed SFA. How might it be simplified without sacrificing significant risk sensitivity? How useful are the alternative simplified computation methodologies for N and LGD?

i. The floor capital charge is too high

With respect to liquidity and credit enhancement positions for Asset-Backed Commercial Paper conduits, we suggest that, rather than a floor for each transaction, the floor capital requirement under the SFA should be a floor for an overall portfolio. First, a portfolio-wide floor gives a bank continued incentive to continue to structure highly rated, very safe transactions on a transaction-by-transaction basis. Under the proposed deal by deal floor, there will be little incentive to structure tranches to ratings levels beyond which the floor overrides the actual risk of a position. Second, recognizing that any floor is arbitrary, a portfolio-wide floor imposes only one conservative assumption rather than the multiple conservative assumptions in a deal by deal analysis. We believe a portfolio-wide floor significantly reduces the distortions that are inevitable when any arbitrary floor is imposed but continues to provide a means for regulators to maintain an appropriately conservative minimum regulatory capital requirement.

If the Agencies were not to accept a portfolio-wide floor, we believe that the current floor proposal is so high as to cause great distortions between what are meant to be minimum capital requirements and economic capital held by a bank.

ii. Additional Credit for Future Margin Income

In the U.S. Proposal, the Agencies have recognized and given partial credit to the sizing of revolving retail asset securitizations to create an expected level of future margin income being available to cover expected losses on the portfolio. We note that securitizations of other interest-bearing assets have the same structure and expectation of available future margin income as retail exposures.

We believe the Agencies should give credit to all asset classes where the yield on the assets is used to cover expected losses. In securitizations with future margin income, transaction structures may differ significantly and in some cases the financing institution would not be entitled to any of the excess spread on the portfolio (for example in cases where the excess spread is returned to the seller of the receivable pool). Only that portion of the future margin income, if any, that exceeds ongoing transaction expenses (i.e., the excess spread) should be given credit as credit enhancement.

We also believe the Agencies should expand the credit given for the existence of future margin income to all transaction types structured to allow for excess yield (future margin income that exceeds ongoing transaction expenses) on assets to serve as credit enhancement to cover expected losses. We note that rating agency methodology, the cornerstone of the RBA, gives credit for the existence of such credit-enhancing excess spread structures. In fact, many times in transactions where excess spread is used to provide protection against losses, the second form of loss protection (e.g., overcollateralization) will be required to be sized much smaller than it would otherwise need to be in order to cover losses. For the SFA to accurately assess the risks of these transactions and provide consistency between the RBA approach and the SFA, the SFA must recognize this form of credit enhancement in all transactions where it exists.

iii. More Appropriate Treatment for Dilution Risk

The U.S. Proposal treats dilution risk extremely conservatively. The current proposal does not give any credit to contractual recourse to the seller for dilution in asset types such as trade receivables and credit card receivables where dilution risk is relevant. This is contrary to rating agency and industry practice that acknowledges that contractual recourse for dilution is the risk equivalent of an unsecured loan to the seller of the receivables. The U.S. Proposal dictates that when calculating capital for asset pools that have dilution risk, there is a requirement to use the expected loss from dilution as the PD and 100% for LGD, which results in a grossly overstated K_{IRB}.

The 100% LGD assumed in the U.S. Proposal for calculating dilution risk under the SFA is inappropriate. First, dilution risk, unlike most forms of credit risk, is not only mitigated by the presence of recourse to the seller of receivables to cover dilution losses but also, in many cases, by reserves sized as a multiple of expected losses to cover both EL and UL. This seller recourse is a meaningful and material risk mitigation tool and should be acknowledged as equivalent risk of an unsecured loan.

iv. More Appropriate Parameters for LGD

To apply the top down approach a bank must decompose expected loss ("EL") into its probability of default ("PD") and loss given default ("LGD") components. If these numbers cannot be derived in a "reliable" manner, extremely conservative proxies of PD and 100% LGD and EAD assumptions must be applied. It is likely that banks relying on the top down approach would be required to use these conservative assumptions. We suggest that a revised top down approach provide a table of LGD parameters for securitizations rather than an LGD being equal to 100%. We suggest that this table be delineated by asset class.

Question #41 p.138-139
<u>Securitization - The look-through approach for eligible liquidity facilities</u>

> *The Agencies seek comment on the proposed treatment of eligible liquidity facilities, including the qualifying criteria for such facilities. Does the proposed Look-Through Approach -- to be available as a temporary measure -- satisfactorily address concerns that, in some cases, it may be impractical for providers of liquidity facilities to apply either the "bottom-up" or "top-down" approach for calculating KIRB? It would be helpful to understand the degree to which any potential obstacles are likely to persist.*
>
> *Feedback also is sought on whether liquidity providers should be permitted to calculate A-IRB capital charges based on their internal risk ratings for such facilities in combination with the appropriate RBA risk weight. What are the advantages and disadvantages of such an approach, and how might the Agencies address concerns that the supervisory validation of such internal ratings would be difficult and burdensome? Under such an approach, would the lack of any maturity adjustment with the RBA be problematic for assigning reasonable risk weights to liquidity facilities backed by relatively short-term receivables, such as trade credit?*

Under the proposed Look-Through Approach, the risk weight applicable to unrated liquidity positions is the highest risk weight assigned to any of the underlying exposures covered by that position. We believe that the more appropriate measure is to look to the weighted average of the risk weights. This weighted average risk would reflect the true risks in the portfolio as opposed to an overly conservative estimation of the risks reflected by an assumption that the highest risk asset (regardless of size) is a valid estimate for the risk in the entire portfolio.

Question #42 p. 139
Securitization - Other Considerations - Capital treatment absent an A-IRBA Approach - the Alternative RBA

> *Should the A-IRB capital treatment for securitization exposures that do not have a specific A-IRB treatment be the same for investors and originators? If so, which treatment should be applied — that used for investors (the RBA) or originators (the Alternative RBA)? The rationale for the response would be helpful.*

We do not believe that an Alternate RBA Approach is appropriate for those asset classes for which an A-IRB Approach is unavailable to a bank. So long as a position has been rated, the bank should be permitted to use the RBA Approach regardless of whether it is an originator or an investor. We anticipate that it will be the exception rather than the rule that an A-IRB Approach will be unavailable to a bank for a particular asset class for the banks expected to be covered by the A-IRB in the U.S. In these limited circumstances, we believe that regulatory review and monitoring of the development of a particular A-IRB is more appropriate than requiring potentially distortive capital treatment for a position.

Question #43 p. 143
Securitization - Determination of CCFs for non-controlled early amortization structures

> *The Agencies seek comment on the proposed treatment of securitization of revolving credit facilities containing early amortization mechanisms. Does the proposal satisfactorily address the potential risks such transactions pose to originators?*
>
> *Comments are invited on the interplay between the A-IRB capital charge for securitization structures containing early amortization features and that for undrawn lines that have not been securitized. Are there common elements that the Agencies should consider? Specific examples would be helpful.*
>
> *Are proposed differences in CCFs for controlled and non-controlled amortization mechanisms appropriate? Are there other factors that the Agencies should consider?*

We support the Agencies' proposal recognizing early amortization risks and their associated capital requirements will vary based on both the asset type and the nature of the early amortization provisions. Nevertheless, there are a number of needed changes to the qualification conditions for controlled early amortization treatment. First, the U.S. Proposal should be clear that the amortization requirements would apply only to economic pay-out events and not normal amortization or accumulation periods. The early amortization capital charge represents a new capital requirement specifically targeting the credit and liquidity risks associated with early amortization events – when things go bad. As a result, the amortization requirements should only apply to the specific economic early amortization risk. During normal amortization periods, the loans, by definition, are performing well and liquidity requirements are incorporated into the bank's liquidity planning process.

Second, we believe that the requirements for when an amortization provision is considered "controlled" are too restrictive by requiring that there be a pro rata sharing of interest, principal, expenses, losses and recoveries based on the balance of receivables outstanding at the beginning of the month. We believe the two other requirements set forth for "controlled" amortization provisions clearly establish the fundamental principles for these amortization. Namely, they state that 1) the amortization period be sufficiently long so that 90% of the debt outstanding at the beginning of the amortization period is repaid or recognized as in default and 2) amortization occurs at a pace no more rapid than straight-line amortization. We believe that the U.S. Proposal should clearly articulate a guiding principle as it has done with the two provisions referred to in the preceding sentence, and not micro-manage the rules. Therefore, we believe the pro rata sharing requirement should be deleted in its entirety.

Third, we note that while the proposed amortization rules make sense in the credit card context, it is not clear that the same application should be used across the board for other revolving retail assets. For example, some securitizations early amortization provisions are linked to the size of the overcollateralization in a transaction. Therefore, the appropriate triggers in those securitizations should be to the level of overcollateralization rather than the level of excess spread. The final rules for amortization provisions should provide regulators with sufficient flexibility to apply appropriate modifications to the amortization rules when the context requires.

Question #44 p.145
<u>Securitization - Servicer cash advances</u>

> *When providing servicer cash advances, are banking organizations obligated to advance funds up to a specified recoverable amount? If so, does the practice differ by asset type? Please provide a rationale for the response given.*

No specific comment.

Question #45 p. 147
AMA Framework for Operational Risk

> *The Agencies are proposing the AMA to address operational risk for regulatory cap ital purposes. The Agencies are interested, however, in possible alternatives. Are there alternative concepts or approaches that might be equally or more effective in addressing operational risk? If so, please provide some discussion on possible alternatives.*

Certain operational loss events are relatively small and frequent. Such events can be successfully modeled through the use of statistical techniques applied to historical data sets. Because such losses are relatively predictable, they can effectively be priced into the product, in much the same manner as expected credit losses are priced into credit products, and we support the Committee's decision to allow Future Margin Income to offset the expected component of such losses.

However, we are doubtful that similar statistical techniques can be applied to historical data to reliably model extreme operational loss events. Truly catastrophic loss events cannot be predicted, and no amount of capital will protect an institution in such an instance. We believe that some form of qualitative (scenario analysis) modeling is more appropriate in assessing those types of loss events that are less predictable. Accordingly, we think that more development is necessary to finalize exactly what types of loss events ought, realistically, to be captured under AMA approaches to Operational Risk capital formulations.

The proposed AMA framework for Operational Risk leaves banks with the task of developing a complex and costly methodology for operational loss estimation. This choice begs the question of whether there may be an alternative approach that demonstrates that no capital is required for operational risk, given a particular bank's facts and circumstances, or whether there are alternative approaches to determining operational risk capital that are consistent with the way sound businesses actually operate, without being overly complex or costly to administer.

For example, we note that the well-known concept of operating leverage, or business risk, seems to be totally overlooked in the Basel Committee's operational risk capital deliberations. We feel that constructing a business-based approach to operational risk capital should be viewed as an acceptable alternative to the AMA track. We would encourage further discussions between the regulatory agencies and their regulated institutions along the lines of quantifying the main elements, definitions, and procedures of this type of framework.

Because there is no accepted methodology for quantifying Operational Risk, we believe that the AMA approach should not be the only option made available to U.S. banks. All institutions subject to the Accord should be allowed to develop any risk measurement methodology (Basic Indicator, Standard, AMA, or an alternative such as a business-based approach) that is acceptable to their national banking supervisors, and to disclose their methodology and their key controls for managing operational risk in their public filings.

Question #46 p. 152
AMA Capital Calculation

> *Does the broad structure that the Agencies have outlined incorporate all the key elements that should be factored into the operational risk framework for regulatory capital? If not, what other issues should be addressed? Are any elements included not directly relevant for operational risk measurement or management? The Agencies have not included indirect losses (for example, opportunity costs) in the definition of operational risk against which institutions would have to hold capital; because such losses can be substantial, should they be included in the definition of operational risk?*

Wells Fargo has a basic difference of opinion with the Basel Committee with respect to the capital treatment of Operational Risk, insofar as we don't believe that capital should be required for Operational Risk at all. To understand this perspective, one must first bifurcate operational losses into two segments -- 1) high frequency/low severity losses that can be statistically assessed, expensed, and priced for, and 2) low frequency/high severity losses that cannot be reliably modeled.

We would argue that high severity losses should be outside the scope of a formulaic approach to minimum regulatory capital standards, because they are unpredictable and so remote as to be outside the statistical bounds of what should be captured in capital at risk formulae. We also feel that the more predictable forms of operational losses are 1) **simply a cost of doing business** to a bank and, therefore, routinely factored into the way that banking products are priced, 2) quite **stable over time**, because of their predictability and absence of correlation across businesses, and 3) **likely to be entirely offset by the Future Margin Income generated by a bank in aggregate**, across all of its operational businesses. Many of these losses are either expensed or accrued for by banks, and hence requiring capital charges as well would be a form of "double counting." Because the Advanced Measurement Approach (AMA) would allow for the recognition of imperfect correlation of risks and the impact of Future Margin Income, we feel that the aggregate outcome of such modeling of predictable operational losses would typically result in a zero capital requirement, and thus, such risks should simply be exempted from the minimum regulatory capital requirements in the first place, as they are today.

Notwithstanding this point of view, we have considered some of the questions on operational risk posed by the ANPR. With respect to the scope of operational losses addressed by the Accord, the ANPR defines operational risk to include "...exposure to litigation from all aspects of an institution's activities." This would appear to include settlements of baseless lawsuits as operational risk losses. In many cases, these settlements are made to control costs or to maintain customer relations and more appropriately represent strategic risk rather than operational risk. We believe that this language should be modified, so that banks would have some flexibility to exclude certain lawsuit settlements from the scope of operational risk capital.

We do not believe that the direct incorporation of external loss data should be a required component of a bank's operational loss modeling. While it is instructive for banks to be aware of external loss events, applying that information across all institutions in a formulaic manner seems problematic to us. The quality and consistency of external data would prove difficult to verify, especially given the lack of common data collection standards within the industry. Furthermore, each bank will have its own inherent and specific causes of risk depending on the diversification of its lines of business and appetite for risk. Without a relatively detailed awareness of the internal control conditions that led to those losses at other institutions, it is difficult, at best, to do much more than guess the impact of a seemingly similar event on a given bank. Accordingly, external data should only be one of several, optional considerations when performing scenario analysis, and not necessarily the most important.

Question #47 p. 149
AMA - Overview of Supervisory Criteria

> *The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the operational risk requirement. If this balance is not appropriate, what are the specific areas of imbalance and what is the potential impact of the identified imbalance?*
>
> *The Agencies are considering additional measures to facilitate consistency in both the supervisory assessment of AMA frameworks and the enforcement of AIVL4 standards across institutions. Specifically, the Agencies are considering enhancements to existing interagency operational and managerial standards to directly address operational risk and to articulate supervisory expectations for AMA frameworks. The Agencies seek comment on the need for and effectiveness of these additional measures.*
>
> *The Agencies also seek comment on the supervisory standards. Do the standards cover the key elements of an operational risk framework?*

At Wells Fargo, we believe that we have consciously crafted a distinct competitive advantage by virtue of the diversity of our underlying businesses. Between mortgage banking, commercial banking, insurance, retail deposit taking, and asset management services (to name a few of our over 80 businesses), along with the significant economies of scale that we have in each of these businesses, we feel that Wells Fargo has created a portfolio of risks (both credit and non-credit) whose worst-case loss potential is substantially less than the sum of its parts. We are encouraged to see that the capture of the capital benefits created by business diversification is permissible under the AMA modeling of operational risk. We believe that this logic should extend to the modeling of capital for credit risk as well, where the impact of portfolio diversification is more substantive and more empirically justifiable.

However, we are concerned by the language of the ANPR, which states that "Under a bottom-up approach, explicit assumptions regarding cross-event dependence are required to estimate operational risk exposure at the firm-wide level. Management must demonstrate that these assumptions are appropriate and reflect the institution's current environment". The requirement for institutions to demonstrate that explicit and embedded dependence (correlation) assumptions are appropriate needs to be clarified. It is important that reasonability be incorporated into this standard. Insufficient data will be available to statistically prove correlations across business lines and event types. Therefore, correlations most likely will be determined from qualitative reasoning based on the underlying nature of the risks. We suggest that the language in this section recognize the fact that qualitative judgment will be necessary and that flexible approaches need to be allowed, provided that institutions have a well - reasoned basis for their assumptions. It is important that overly conservative criteria not be applied regarding correlation assumptions so that banks using more risk-sensitive "bottoms-up" approaches to the quantification of operational risk capital are not penalized.

Please refer to our separate letter on the Draft Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital for more specific comments on the supervisory standards for the AMA.

Question #48 p. 156
AMA-Corporate Governance

> *The Agencies are introducing the concept of an operational risk management function, while emphasizing the importance of the roles played by the board, management, lines of business, and audit. Are the responsibilities delineated for each of these functions sufficiently clear and would they result in a satisfactory process for managing the operational risk framework?*

The ANPR appears to mandate that an independent, firm-wide operational risk management function exist, which is separate from line of business management oversight. We believe that such a directive is premature, given that a consistent, well-meaning definition of what operational risk comprises does not yet exist. Under these conditions, how can there be a central committee to oversee something that is not defined?

For similar reasons, we are concerned that banking supervisors may interpret the ANPR to develop unrealistic expectations for the board of directors' involvement in the oversight of operational risk management. Page 151 of the ANPR states that "the board of directors would have to oversee the development of the firm-wide operational risk framework, as well as major changes to the framework ... The board and management would have to ensure that appropriate resources have been allocated to support the operational risk framework." It is difficult to require board of directors oversight for something that is not well defined.

Rather than trying to devise a "one size fits all" central oversight function for operational risk management, we think that the Supervisory Guidance should be re-worded to simply require that there be a thorough governance process for overseeing what may be multiple types of operational risks, with the details left to the discretion of individual banks.

Question #49 p. 159
<u>Elements of an AMA Framework</u>

> *The Agencies seek comment on the reasonableness of the criteria for recognition of risk mitigants in reducing an institution ~ operational risk exposure. In particular, do the criteria allow for recognition of common insurance policies? If not, what criteria are most binding against current insurance products? Other than insurance, are there additional risk mitigation products that should be considered for operational risk?*

To the extent that extreme operational loss event modeling is deemed realistic, we see no reason why the recognition of insurance mitigation should be limited to 20% of the total operational risk capital charge, as suggested by Paragraph 66 of the Supervisory Guidance. To do so might lead to imprudent risk management incentives in the use of insurance programs. We recommend that the capital adjustment for insurance be based on the **full** amount of insurance protection provided by insurance policies, given that the policies meet the qualitative standards outlined in the ANPR.

Question #50 p. 164
Disclosure Requirements

> *The Agencies seek comment on the feasibility of such an approach to the disclosure of pertinent information and also whether commenters have any other suggestions regarding how best to present the required disclosures.*
>
> *Comments are requested on whether the Agencies' description of the required formal disclosure policy is adequate, or whether additional guidance would be useful.*
>
> *Comments are requested regarding whether any of the information sought by the Agencies to be disclosed raises any particular concerns regarding the disclosure of proprietary or confidential information. If a commenter believes certain of the required information would be proprietary or confidential, the Agencies seek comment on why that is so and alternatives that would meet the objectives of the required disclosure. The Agencies also seek comment regarding the most efficient means for institutions to meet the disclosure requirements. Specifically, the Agencies are interested in comments about the feasibility of requiring institutions to provide all requested information in one location and also whether commenters have other suggestions on how to ensure that the requested information is readily available to market participants.*

Wells Fargo believes that the Accord has ventured beyond its intended scope in its specification of the disclosure requirements in Pillar 3. The proposed Accord requires that a bank make extensive disclosures about its risk profile and risk management processes. We view the proposed requirements for Pillar 3 disclosure as excessive and costly to implement, with the resulting information being potentially confusing to the investment community, particularly with respect to efforts to compare the risk profile of one institution to another. Rather, we feel that market forces can act as a better policing authority for required disclosures, compelling companies to achieve a requisite level of transparency on topical issues. We believe that the proposed approach is flawed on several counts:

- First, we see no basic need for such disclosures. The market is sufficiently well informed already, as evidenced by the breadth of banks' securities issuance activities. Securities transactions require the market to constantly assess a financial institution's creditworthiness, risk profile, and capital structure. If the market needs more information in order to perform this assessment, it will demand it; and, it will penalize the reputation of those that cannot provide the necessary information. We do not believe that the Basel Committee can effectively, nor should it, determine the informational requirements of bank credit markets.

- Second, efforts to employ disclosures such as those proposed in order to make comparisons in the risk profiles of two financial institutions will invariably lead to mis-interpretations among readers of the information. We know well from our considerable experience in acquiring other banks how different two banks' approaches to risk rating loans can be. Without exception, we have come away from the due diligence efforts on potential acquisition candidates planning for the changes that we will have to make to the target company's reporting of its risk profile in order to make it comparable to our more conservative approach. This same issue will extend to a comparison of Probability Of Default, Loss Given Default, and other metrics across institutions, as each company will take a different approach to its parameter estimation process.

- Third, the Pillar 3 disclosure requirements may be duplicative to, and potentially inconsistent with, existing or future GAAP and non-GAAP accounting disclosures, and unnecessarily costly to compile and report within adequate standards of audit controls. We view the potential for lawsuits as being very high, and regard the provisions of Paragraph 765 of CP3 (which allows that Pillar 3 disclosures need not be audited externally, unless otherwise required) as an empty gesture, since no large issuer is going to be disclosing material public information without appropriate (but costly and time consuming) internal review.

- And fourth, the proposed disclosures will create an uneven playing field between banks and their non-bank competitors, who will be free to pursue their business activities unencumbered by supervisory capital rules and the excessive compliance costs that they will engender.

We recommend that Pillar 3 be eliminated or, at least, made voluntary, so that the market and those agencies that are appropriately tasked with safeguarding the interests of investors (i.e., the SEC, the FASB, and the rating agencies) could determine the need for any additional disclosure about a public company's risk profile and risk management practices.