BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

Date: April 1,2004 (Revised)

To: Myron Kwast

From: Paul Calem, Mark Flood (OTS), and Jim Follain

Subject: Report on Visit to Wachovia Corporation on November 20, 2003

Attendees: Wachovia representatives: Russell Playford; David Brooks; Chris Livingston; Gary Wilhite; and Kathy McDonough. Fed of Richmond representatives: Dave Swett and Perry Mehta. FRB representatives: Paul Calem and Jim Follain. OCC representatives: Thomas Berkoben, Geoffrey White, and Rantch Isquith.

Purpose: To seek feedback on the potential competitive affects of Basel II on bank investments in mortgages and amplification of some issues discussed in the official ANPR Comments submitted by Wachovia Bank.

Perspective: Wachovia is a bank holding company with a large national bank. Total earnings for the corporation in the 12 months ending at 2003:Q3 were $4.3 billion, 57 percent of which was generated by the General Bank. It maintains a large "footprint" in the southeastern market. Retail businesses produce approximately 70 percent of revenues. They report a cost of capital of 11 percent and have $2.5 billion in annual excess capital. Their debt is rated Aa3, **A,** and A+ by Moody's, S&P, and Fitch, respectively. Wachovia held over $50 billion in consumer loans secured by real estate at the end of 2003:Q3. See http://www.wachovia.com/inside/page/1,,13205_303,00.html and its 2003:Q3 SEC 10-Q report for details.

Key Points Discussed Regarding Competition.

1. *The two-tiered approach to be applied in the U.S. does not create a bifurcated system; it merely recognizes that a two-tiered system exists.*

   This is a quote from pg. 2 of their comments, but it summarizes an important part of the view of Wachovia on the issue of competitive effect. The key to success is a bank's knowledge of risk and it requires much expertise and expense to build an organization capable of measuring such risk and acting upon the information. In this sense and if implemented properly, the incremental cost of Basel II for such banks is not so large.

2. *It is difficult at this time topredict the impact of a continuation of a two tiered system on competition since so many othersfactors will affect the outcome.*

   These include:
   a. Variation among banks in their understanding and management of mortgage credit risk;
   b. The nature of competition in particular markets and sectors;
   c. Differences among banks in cost structures and competitive strategies;

   Wachovia maintains that competitive effects are likely to be modest, although they acknowledged that it is difficult to predict the impact of a two tiered system on competition and so one cannot say with certainty that there will be no effect on competition. Nevertheless, they believe that the effect will be ***at most*** small.

3. *Regulatory and economic capitalplay important roles in strategic decisions, while economic capital has more influence on tactical decisions. Strategic decisions include whether to hold a large portion of the bank's balance sheet in particular asset classes, while tactical or marginal decisions include whether or not certain mortgages should be held on the balance sheet.*

4. *Pricing tends to be "drivenby the market."*

5. *The decision to hold or sell a mortgage is dependent upon a number offactors.* This issue came up in a discussion of empirical work being considered to estimate the sensitivity of a bank's decision to invest in mortgages. A substantial number of factors other than regulatory capital considerations were mentioned. These include: relative returns on economic capital, the leverage ratio, the rating agencies' tangible equity ratio, liquidity needs, accountingconsiderations,and diversificationwithin the entire portfolio. At the margin, Wachovia is quite willing to invest in mortgage assets, and they have purchased Alt-A loans as investments.

6. *Returnsfrom investing in credit riskfor nonconforming and, inparticular, AltA and low-doc loans, tends to exceed what isfound in the conforming market.*

   This assumes, of course, that the investing banks manage the costs of this business properly.

7. *One option to mitigate potential competitive effects on Non-AIRB banks is to offer them the Basel Standardized Approach.* This would lessen any Competitive affect in the mortgage market and also bring about a better alignment between regulatory and economic capital.

8. *General agreement on estimates of economic capital.* Wachovia indicated general agreement between internal models of credit risk economic capital for mortgages and the output of the Basel II rule. As noted in their ANPR response, they get to these numbers with different inputs (e.g., correlations) than in the Basel formulas.

9. *Interest rate risk capital is considered at the macro-level; it is not allocated on a product-by-product basis because interest rate risk is removed from the business units and managed centrally. There are some product-specific allocations for operating risk capital.*

Key Points Related to Implementation

1. *PMI:* Wachovia believes that the benefits of PMI should be included in the computation of LGD, but they did not offer a view regarding its materiality or empirical significance. See pg. 17 of its ANPR comments for further elaboration.

2. *Maturity adjustment:* Wachovia points out a number of differences between the results of its internal models and the capital requirements of Basel 11 for several types of retail loans. A contributing factor is the difference in treatment of expected maturity between its internal models and Basel 11. Expected maturity is embedded in the Basel 11 asset correlation for residential mortgages. Wachovia believes this leads to a mismatch between Basel II capital and its internal estimates, particularly for second-lien mortgages. Adding a maturity factor would result in much better alignment between the proposed Basel Il rule and its internal models. Pages 17-19 of their ANPR comments discuss this point.

3. *Operational risk vs. credit risk.* Wachovia argues that the ANPR AMA guidance is too prescriptive by its requirement that credit losses due to operational errors be assigned to credit losses. Instead, they encourage supervisors to make sure that all elements of risk – market, credit, and operational – are assigned "owners" within the firm and not insist on a particular form of ownership.