WELLS FARGO

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February 8, 2005

To: Addressees

Re: Draft Supervisory IRB Retail Guidance

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 6,000 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
Executive Vice President and Chief Financial Officer

Addressees: Docket No. OP-1215
Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Docket No. 04-22
Office of the Comptroller of the Currency
250 E Street, SW
Public Reference Room, Mail Stop 1-5
Washington, DC 20219

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
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. We will direct our comments here to the Draft Supervisory Guidance on Internal Ratings-Based Systems for Retail Credit dated October 27, 2004.

There has been a relatively uniform set of concerns communicated to the Basel Committee in response to past publications on the topic of prescriptiveness. 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. To reiterate a point made in our previous responses to the Basel Committee, 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 or consistency is **not** required, and where Basel II steps into the realm of unwarranted prescriptiveness, comes from its attempts to dictate how banks actually **manage** risk. Basel II 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 related 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. Indeed, in our view, this prescriptiveness could diminish the real value to the banking system that comes from diversity in risk management practices and if pushed could actually increase system's risk.

We point this out again as background toward commending the Committee on the more flexible approach to bank risk management processes that it has incorporated in the Supervisory IRB Retail Guidance. In many of the areas of retail risk segmentation architecture, implementation of retail model validation, and retail model data maintenance, the Committee has permitted banks an appropriate amount of flexibility to conform the Basel capital requirements to those policies that individual banks may employ for internal risk management purposes.

In particular, we support the philosophy outlined in Paragraph 10 of the Retail Guidance, dealing with its scope of application. Wells Fargo manages many of its credit portfolios in a relatively centralized fashion, even though the exposures may be held by multiple legal entities. We are in full agreement with the concept that PD, LGD, and EAD estimates may be applied at the portfolio segment level, with capital requirements for each relevant legal entity being based on the proportionate share of each segment owned by such legal entity, subject to the assurance that the resulting capital calculations accurately reflect the risk profile of each individual entity.

We strongly urge that a concomitant degree of flexibility be infused into the final version of the Supervisory Guidance on Corporate Credit, particularly in the areas of rating system transparency, front-end validation, and data warehousing requirements

In keeping with our earlier point that clarity is required in relation to definitional issues within the Accord, we would offer the summary recommendation that the IRB Retail Guidance could benefit greatly from the compilation of a **Glossary of Terms**. There are many terms in the Supervisory Guidance that are left to interpretation. If an institution's interpretation turns out to be at odds with the interpretation of their banking supervisors, the solution may prove very costly both in manpower and financial resources.

It is extremely important that all the parties involved have the same understanding of the basic terms. The way things are currently configured, there cannot only be differences in how each financial institution interprets the Guidance, but how each regulator interprets and applies the standards in determining compliance.

It would make sense to try and keep things as simple as possible. The introduction of a Glossary of Terms would take the guesswork out of what the Guidance means when it uses terms that might have multiple interpretations. Examples might include the periodicity of model validation, meaning of "best available data", and classification of accounts as seasoned versus unseasoned, to name a few.

Once these terms have been agreed upon, financial institutions can truly understand where their issues lie and concentrate on working on complying with the requirements, as opposed to constantly trying to comply with what they "think they mean". Wells Fargo would be happy to work with the Banking Supervisors to present our views on these definitions, with a goal of crafting a consensus document.

We have organized our remaining comments into the same chapters presented in the Supervisory Guidance.

Quantification of IRB Systems

1) **SME Risk Weight Function** -- 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 at so granular a function of sales size as is suggested by the Accord. We do not understand why a 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. Ideally, this function could also be made to eliminate the arbitrage possibilities that currently exist between corporate and retail SME risk weightings.

2) **Treatment of Small Business Lines as QRE** -- Paragraph 150 states that "revolving exposures to an individual can be treated as QRE's, even if used for business purposes." For the avoidance of doubt, we believe that this phrasing should be expanded to include business entities as well as individuals, as long as the other criteria in Paragraph 150 are satisfied, namely that individual exposures cannot exceed $1 million and that the loans be managed on a segmented basis, with credit scoring being a key component of the underwriting process.

3) **Retail Leases** -- Paragraph 152 describes the fact that an 8% capital requirement will be imposed on the residual value of leased assets, to recognize a bank's exposure to loss arising from potential decline in the fair market value of a leased asset below the estimate used at the time of lease inception. We believe that recognition should also be given to the risk mitigation that a bank may have put in place to dilute this risk through the purchase of residual value guarantees against such potential declines.

4) **Minimum 10% LGD for Mortgages** – Paragraph 133 states the widely-debated rule that residential mortgages will be subject to a 10% floor on LGD. As mentioned in previous comment letters, we continue to believe that this floor is unnecessary, and potentially obscures the risk-mitigating effect of private mortgage insurance for residential mortgages.

5) **Floors for EAD on Installment Loans --** Paragraph 137 states "For fixed exposures such as term loans and installment loans, each loan's EAD is no less than the principal balance outstanding." For many installment loans, the contractual principal reduction to be recognized in the near-term is insignificant. However, there are also instances where the remaining term to maturity is relatively short, and, therefore, the likelihood that significant principal reduction may take place prior to an event of default is quite high. Such conditions are easily tracked and modeled, so we believe that estimated reduction of principal should be a permitted practice for estimating EAD on retail installment loans. This would give recognition to what actually occurs in practice and properly account for the balance at risk.

6) **Seasoning Requirement** -- Paragraph 110 states that "for segments containing unseasoned loans, a bank should assign a higher PD estimate that reflects the annualized cumulative default rate over the segments expected remaining life."

We think that this requirement needs further explanation. If the intent is that seasoned loans and unseasoned loans have, essentially, the same PD's (all other things being equal), we would object to that. If the intent is that the PD's assigned to unseasoned loans reflect the fact that it will take a period of time for them to ratchet up to the steady state level of seasoned loans, then this interpretation is more in line with our beliefs. However, we would note that the latter interpretation is really nothing more than a means to estimate a long-run average PD; and, therefore, any specialized treatment of unseasoned loans is really, in our minds, unnecessary.

Banks must use the long-run average of one-year PD's to document the probability of default for all accounts. The database for the long-run average PD's already contains and accounts for the unseasoned loans. It is a mixture of both seasoned and unseasoned loans taken together that create long-run average one year PD's. Accounts move from an unseasoned state to a seasoned state as time goes on. If the issue is one of too much new business (unseasoned) at any one time that issue is already addressed because the amount of capital required will increase over time using the existing process in recognition of the aging of those accounts.

In short, we believe that the use of long run average PD's should continue for all accounts and the requirement to address unseasoned accounts separately should be removed.

7) **Stress Condition LGD's** – Paragraph 127 requires that LGD be measured based on "economic downturn conditions, where necessary". We believe that such an approach is flawed on several fronts:

- No definition of "downturn condition" is provided, nor is any standard with respect to "necessary". Clearly, different users could have very different interpretations of these definitions.

- We would imagine that few banks have the data to credibly estimate the impact of severe economic conditions on their retail portfolios in a manner consistent with their existing processes, since much of the model development has taken place only in recent years.

- The introduction of a downturn LGD parameter into the capital equation is inconsistent with the manner in which PD's are specified in the Accord (i.e., long-run averages). If there is concern over the validity of single-factor models in properly estimating worst-case losses, then we would prefer some arbitrary add-on to the current capital equation.

Fundamentally, however, we believe that LGD should simply be estimated using a long-run "default-weighted" process that is naturally weighted toward periods with high defaults. Stressed parameters, such as recessionary LGD's, should be used separately in stress analyses.

8) **Best Estimate of Expected Losses (BEEL)** – Paragraph 128 introduces the concepts of best estimate of expected losses and potential loss given default (PLGD) for defaulted assets. We believe that these concepts are unnecessary, given the array of parameters already present in the Accord and the fact that these particular parameters would apply to such a small fraction of a bank's assets. Another complicating feature is the fact that these estimates are to be applied to the gross amount of a defaulted asset, rather than the current book value, which necessitates additional bank tracking expense, with little value added. We would advocate a simpler approach whereby the current book value of defaulted assets (gross of any specific loan loss reserves) were treated consistently with other asset classes, in terms of the use of long-run average PD's, LGD's, and EAD's.

9) **Quarterly Updates of Risk Parameters** -- Paragraph 78 of the Supervisory Guidance states that, "At a minimum risk parameters estimates must be updated at least quarterly". This paragraph requires some clarification. We believe that the proper intent is to require that the *explanatory variables* in any PD, LGD, or EAD estimating function must be updated quarterly so as to come up with new PD's, LGD's, and EAD's that can be applied to the updated portfolio account data. We would strongly urge that the intent of this paragraph not be construed to require banks to rebuild and/or update estimating model *coefficients* on a quarterly basis before applying those models to the quarterly data. We would suggest that it would be more practical to expect that models be rebuilt and validated on a yearly basis with the most recent portfolio account information.

10) **Interest Receivables** -- We believe that the balance sheet item called "Accrued Interest & Fees Receivable" should receive a 0% risk weight, since the credit risk associated with this account is captured in the economic loss measured for the associated asset portfolios as part of the LGD parameter estimation methodology. This logic may also be applicable to "Other Real Estate & Other Collateral Owned," depending on the time horizons used by banks in estimating LGD's for the underlying asset portfolios. The conditions under which a 0% risk weight could be justified for these asset classes should be made clear in the final rules.

Control and Oversight Mechanisms

1) **Independence of Rating Assignments -** Paragraph 235 and RS-53 of the Supervisory Guidance state that "banks must have a comprehensive, independent review process that is responsible for ensuring the integrity of the IRB risk segmentation system and quantification process and that reviews should be conducted annually."

   The OCC currently requires that internal bank examination functions use a risk-based approach to scheduling the frequency of their examinations, with higher-risk functions scheduled for more frequent review and lower-risk functions scheduled for less frequent review. Wells Fargo has structured its examination process accordingly. Only the highest-risk operations are reviewed once in each calendar year. Consequently, it would be impractical for the Bank's Risk Asset Review department to meet the annual review requirement set forth in the proposed guidelines.

   The only practical way for the Bank examination function to meet the literal requirement for annual review in Paragraph 235 would be for it to increase its examination frequency. In addition to the added costs such a change would impose, it would mean that we would have to abandon the OCC-mandated, risk-based approach to examination scheduling.

   We suggest that the Supervisory Guidance be modified to allow for a risk-based approach to scheduling the comprehensive, independent reviews of the IRB risk segmentation system and quantification process. If minimum frequencies must be mandated in the guidance, we suggest that a more practical interval for lower-risk, less volatile businesses would be 24-to-36 months, and that only the highest risk businesses require a review on a strict, annual cycle.

2) **Use of Risk Estimates** -- Paragraphs 239 of the Supervisory Guidance states that "IRB risk parameter estimates of PD, LGD, and EAD should be incorporated in credit risk management, internal capital allocation, and corporate governance." We believe that the starkness of this language was unintended by the regulators, as it conflicts with both the associated RS-55, which states only that "Retail IRB risk parameter estimates must be consistent with risk estimates used to guide day-to-day retail risk management activities", and with the absence of a "use test" for AIRB risk parameter estimates in CP4 and the Supervisory Guidance on Corporate Credit.

   Paragraph 239 of the Supervisory Guidance should be re-worded to make it less rigid and more consistent with the principle of RS-55.

In conclusion, we would like to acknowledge the work done by the Basel Committee and its support staff in incorporating an appropriate amount of flexibility into the Supervisory IRB Retail Guidance. We are hopeful that our thoughts expressed here are helpful not only in terms of pointing out issues with the proposed Guidance, but also in suggesting solutions.