WACHOVIA

January 19, 2007

Office of the Comptroller of the Currency
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Attn: Public Information Room,
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Washington, DC 20219
Attention: Docket No. 06-10;
OMB Control No. 1557-NEW
Via E-mail: regs.comments@occ.treas.gov

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Attn: Comments
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Attention: RIN 3064-AD10
Via E-mail: comments@FDIC.gov

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Board of Governors of the Federal Reserve System
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Attention: Docket No. R-1266
Via E-mail: regs.comments@federalreserve.gov

Regulation Comments
Chief Counsel's Office
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1700 G Street, NW
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Attention: No. 2006-34; also Market Risk Framework Regulatory Reporting Requirements [1550-NEW]
Via E-mail: regs.comments@ots.treas.gov

Re: Comments on Joint Notices of Proposed Rulemaking (NPR) -
- **Risk-Based Capital Standards: Market Risk, 71 FR 55958, and**
- **Market Risk Framework Regulatory Reporting Requirements, 71 FR 55986 (both dated September 25, 2006)**

Ladies and Gentlemen:

Wachovia appreciates the opportunity to comment on the Joint Notice of Proposed Rulemaking containing the Agencies' planned revisions to the Market Risk Capital Rule (the "NPR"). The NPR stated that the objectives of the changes were:

- To enhance the rule's sensitivity to risks not adequately captured in the current rule.
- To enhance modeling requirements in a manner consistent with advances in the field since the adoption of the original rule.
- To modify the definition of covered position to better capture positions for which the market risk rule is appropriate.

The Need for Liquidity Based Principles – *Not* Prescriptiveness. While the proposed rule would partially fulfill these objectives, it will in many cases not do so while being unnecessarily burdensome, costly and inefficient. Most of the problems are due to the **prescriptiveness** of the proposals and **could have been avoided by proposing them as part of a comprehensive, principled approach**. While we agree that some risks may not be appropriately captured by the current rule, the proposed rule attempts to address these problems with specifics rather than a set of principles to be followed in order to ensure that a firm's internal model is adequate. At best, this approach could work at a point in time – not over the life of the rule.

Liquidity – the True Boundary Between Trading & Banking Books. This is particularly problematic in the definition of the trading book/banking book boundary. As the market evolves, we fully expect more and more types of risk to become traded, which should be viewed positively since it will reduce risk. To fixate upon either the accounting rules surrounding a particular instrument or the legal form of the risk, as the NPR does, is to move away from **the true separation between trading and banking books – which is the ability and intent to mitigate risks in an expeditious manner.** We urge the agencies to embrace an approach that recognizes that ***the key mitigant of market risk is...market liquidity.*** Put another way, banks' modeling of risks and economics are likely to keep up with new product development while fixed rules will lag. We feel quite strongly that the rule could be made both simpler and more effective if it relied on these ideas rather than upon the more rigid definitions in the current proposal. This is most glaring in the NPR's discussion surrounding Questions 2 and 3, but also is evident in the discussions surrounding incremental default risk.

Disjointed Implementation Puts U.S. Banks At A Competitive Disadvantage. We are also concerned about the proposed timing for implementing the proposed revisions to the rule. As a conceptual, logical and interpretive matter, the new market risk rule references and depends on aspects of the Basel II NPR for the banking book that will not be implemented until a later date. At a minimum, this will lead to confusion regarding how to compute regulatory capital during the transition period. The problem is particularly acute in the area of securitizations (See Wachovia's response to Question 5 below).

The agencies' plan to proceed unilaterally – reforming regulatory capital in two separate stages and with uniquely U.S. timing and versions of the rules - will be out of step with the rest of the world's regulatory and financial community and put U.S. banks at a competitive disadvantage. Internationally, refinements to the market risk capital rules and Basel II's advanced approaches are being implemented simultaneously in a coordinated fashion. International financial institutions can more easily address both sets of changes on an integrated basis with a single capital management strategy. Separate, staggered implementation dates in the U.S. will be burdensome and impose higher real costs on our banks, particularly in the short term, and require different capital management strategies, all of which will put U.S. banks at a competitive disadvantage to their international counterparts.

Responses to Enumerated Questions. Wachovia's responses to the agencies' specific enumerated questions in the NPR are set forth below.

Question 1: The agencies seek comment on the thresholds for the application of the market risk capital rule and, if they should be changed, on what appropriate thresholds might be.

The proposed thresholds are acceptable.

Question 2: The agencies request comment on all aspects of the proposed definition of covered position. The agencies are particularly interested in comment on additional safeguards that the agencies might implement to prevent abuse of the hedge component of the definition of covered position and increase transparency for supervisors.

While we agree with the basic principle of symmetry, we do not agree with the idea of forcing the trading book to be a subset of trading positions under GAAP. Rather, we would prefer that any asset held with intent to trade should be eligible for trading book treatment provided that the bank can demonstrate

1. Liquidity
2. Intent to trade
3. Ability to maintain a shadow mark to market account

The regulators have accepted the concept of liquidity in their definition of the incremental default charge in the specific risk calculation and they should be willing to apply the same principle in the definition of the trading book.

Applying these rules to the example provided in the NPR text, mortgage loans held in the bank's credit and investment portfolios would be placed in the banking book because they are not managed as trading exposures. However, mortgage loans originated for securitization would be classified in the trading book because they will be traded and are managed as trading exposures, with market risks actively mitigated. The proposed rule as written would mean that vertical integration in the mortgage business will be treated as being more risky (and therefore expensive) from a regulatory capital standpoint than purchasing identical third-party originated loans – even though a bank should know its own loans better than those of a third party.

Question 3: The agencies request comment on whether there is a better approach that matches more effectively the true economic impact of these transactions.

As with our response to Question 2, we agree in principle that symmetry is important when looking at two different sides of the same position. However, as stated previously, we believe that banks should have the option to classify both sides of the position as either trading book or banking book as long as they can meet the tests of liquidity and intent to trade. While this is most important for mortgages, it is also important for corporate loans in the large corporate space where firms with strict sell-down policies may well be able to demonstrate trading intent and liquidity. In addition, some developing products, such as contingent credit default swaps ("CCDS"), cross the line between the trading book and the banking book as they would be, under the current rules, trading book assets, while the perfectly offsetting risk, a swap with the counterparty underlying the CCDS, would have its credit risk restricted to the banking book under the proposed NPR.

Question 4: The agencies request comment on the extent and materiality of any distortion of the VaR-based measure due to the inclusion of some, but not all, offsetting transactions, and on any appropriate approaches to address this distortion in the final rule, including, subject to certain restrictions, (1) permitting a bank to include in its VaR-based measure the interest rate risk associated with certain non-covered positions that are hedged by covered positions (while remaining subject to a credit risk capital requirement for the non-covered positions) or (2) permitting a bank to include in its VaR-based measure certain internal interest rate derivatives hedging non-covered positions. The agencies also request comment on any operational considerations such approaches would entail.

We fully support both suggestions made in this question. That is

1. We believe that a bank should be allowed to include the market risk of a loan in the trading book and that classification should follow the new fair value accounting framework. In accordance with our comments in the responses to Questions 2 and 3, above, we think symmetric treatment is an important driver of bringing regulatory capital in line with economic capital.
2. Including internal interest rate derivatives that hedge non-covered positions in the trading book would provide two benefits. First, it would allow a firm the efficiency of trading internally when its own swaps desk is the best price in the market for a particular hedge. Second, it would force regulatory capital to equal economic capital.

Question 5: The agencies seek comment on the proposed definition of residual securitization position, and on the market maker exception and the conditions to use that exception. With respect to positions that do not qualify for the market maker exception, the agencies request

comment on the treatment of those positions under the credit risk capital rules and whether such treatment could give rise to any operational or other issues.

This is similar to the Basel/IOSCO Trading Book Review[1] of July 2005, which stipulated that securitization positions subject to deduction would generate Risk Weighted Assets for market risk at least equal to the RWA calculated under the securitization approach. However, the Trading Book Review allowed the securitization positions to be included in VaR so long as the incremental RWA of such positions were at least equal to their value under the securitization approach. In contrast the NPR proposes excluding such positions from VaR. Both of these approaches are problematic. As long as an institution can demonstrate that the risk of these positions can be properly captured in its VaR and specific risk models then there should be no special treatment for securitizations.

Furthermore, as indicated above, the proposed split in the effective dates of the proposed market risk rules (January 1, 2008) and the credit/securitization/operational risk rules (January 1, 2009} would create a material operational and interpretative problem, because the securitization rules under Basel I are different than the securitization rules under Basel II.

Question 6: The agencies seek comment on these requirements and on whether different or additional policies and procedures would be beneficial for ensuring appropriate identification of positions to which the market risk capital rule should be applied and appropriate risk management of covered positions.

In general, most of the rules around marking to market, liquidity and intent are reasonable and we have no objection. There are two sections of the proposed new rule that are either unclear or extremely difficult to comply with.

1. In stating that a portfolio must have well defined trading and hedging strategies the regulators oversimplify the distinction between proprietary trading and market making, and add a third category, customer flow, that would seem to be the same as market making. While it is relatively easy to define proprietary-only desks, banks often take substantial proprietary positions on desks that are categorized as market making. As long as this is clearly stated in the business mandate for such a desk it should be allowed to engage in both types of activities. In addition, the new rule states that the hedging strategy must clearly state which positions are being hedged and which positions serve as hedging instruments. This is not possible in practice and would lead to a massive record-keeping burden in any good faith attempt to comply with such a requirement. We believe the following phrases (and any comparable) should be stricken from the rule as proposed.
    a. "to accommodate customer flow"
    b. "the hedging strategy should clearly articulate which positions are being hedged and which positions serve as hedging instruments"
2. Policies and procedures are supposed to address "assessing on a daily basis the bank's ability to hedge position and portfolio risks and the extent of market liquidity". In practice, we will be able to accumulate daily data but this type of assessment is not meaningful on a daily basis. Accordingly, we ask that the word "daily" to be changed to "regular", and that the term "regular" when used in this context be interpreted to mean "quarterly or more frequently than quarterly only upon a significant move in the relevant market".

Question 7: The agencies request comment on all aspects of prepayment risk, including the extent and materiality of prepayment risk, whether material prepayment risk may warrant a further explicit requirement that banks hold capital against prepayment risk over a one-year horizon

footnote [1] "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects", Basel / IOSCO Working Group, July 2005.

under both the internal models and standard approaches to specific risk, and the interplay between prepayment risk and default risk for purposes of determining the bank's overall measure for market risk. The agencies also seek comment on how an explicit capital requirement for prepayment risk could be designed.

In some trading portfolios prepayment risk is material. However, it is not clear why the regulators would want banks to hold capital to the one-year horizon for prepayment risk where they have accepted the idea that the positions may be disposed of within the standard 10-day period. If any additional capital charge for prepayment is assessed, then it should be based on the same liquidity framework as the incremental default charge for specific risk. However, we feel that even this would be extreme. Many firms already include sensitivities to prepayment risk model parameters in their internal models. As such, we see no reason to have an explicit requirement for prepayment risk in the internal models approach. We have no comment on the standard approach.

Question 8: The agencies request comment on the exclusion of fees, commissions, reserves, and net interest income for the trading profit or loss used for regulatory backtesting, including the appropriateness and feasibility of these exclusions, and whether additional items should also be excluded. The agencies also request comment on the role of hypothetical backtesting--specifically, whether hypothetical backtesting is feasible as part of model validation; whether other forms of backtesting should also be used; and whether regulatory backtesting should be based on hypothetical backtesting.

The agencies wish to exclude fees, commissions, reserves and net interest income from trading profit and loss. While we agree that most of these factors lead to biased estimates of "clean P&L", we do not feel that net interest income should be excluded. We give three examples,

1. In a credit trading portfolio, spread income (or loss in the case of short positions) is an important part of the daily profit and loss and is part of the economic compensation earned (paid) by the firm for taking on these positions.
2. In any options position, carry/theta is the economic offset to gamma. Excluding this type of net interest income would mean that short gamma positions showed systematically biased losses in backtesting
3. In evaluating the risk on an interest rate position, excluding net interest income would force firms to base VaR on forward rate risk only rather than on the more intuitive spot yield curve. This would make the models much less understandable to non-technical personnel

With regard to the subject of hypothetical backtesting, it is not clear how the phrase "hypothetical changes in portfolio value that would occur if there were no intra-period changes" differs from the definition of clean P&L. In addition, while hypothetical backtesting is both feasible and desirable as a part of model validation, it is not at all clear how it could be used to transform VaR into capital. Capital charges should be based on a firm's actual portfolio performance in real market conditions.

Question 9: The agencies request comment on the proposed timeframe for phasing out partial modeling of specific risk and on whether it would allow banks enough time to implement the proposed changes.

We have no problems with this proposed timeframe.

Question 10: The agencies seek comment on the extent and materiality of specific risk for commodities and foreign exchange positions and on whether and how a specific risk capital requirement for those positions could be developed under both the internal models and standard approaches.

We assume that the proposal for specific risk modeling for commodities refers to the site-specific risk inherent in the trading of certain physical commodities. As such we would think that this is already covered in the requirement to adequately measure basis risk.

The only obvious places that the measurement of foreign exchange specific risk might make sense are in the cases of pegged currencies and non-convertible currencies. In all other cases, we feel that the foreign exchange market adjusts quickly enough to new information and is liquid enough to ensure that existing models are more than adequate. It may make sense to add some sort of charge for these positions but there is little historic data on how currencies trade when they begin to float.

Question 11: The agencies request comment on how a bank should adjust the incremental default risk capital requirement to adjust for the impact of liquidity, concentrations, hedging, and optionality.

The agencies have asked for comment on four issues – liquidity, concentrations, hedging and optionality. However, there are really only two issues, liquidity and optionality.

Liquidity is simply a measure of how long it takes a firm to hedge the specific risk in a given position. Any model for liquidity should take into account the size of a firm's position relative to the market liquidity available to hedge risk. In other words, liquidity and concentration are really the same thing. Firms should be free to model liquidity using any reasonably testable statistical framework as long as they take into account liquidity in both normal and stressed markets. Optionality is an operating assumption; any adequate model should always take into account the optionality characteristics of a risk position

Question 12: The agencies request comment on all aspects of the proposal to reflect in the market risk capital requirement a measure of incremental default risk. Specifically, the agencies seek comment on the feasibility of measuring incremental default risk at a one-year, 99.9 percent confidence level and the appropriateness of the assumption of a constant level of risk

The time horizon for the confidence level should be based, like all other trading book charges, on the assumption that a firm will liquidate a risk that is deteriorating. If liquidity is taken into account in a model then it should be done at the position level and the time horizon for each position should reflect its liquidity. The existing proposal allows this to be taken into account but still forces a constant level of risk. This last requirement is flawed in that it ignores the fact that firms take action to reduce risk when crises occur. A firm should be able to assume a non-constant level of risk if it can demonstrate policies and procedures that will lower the level of capital available to risk takers after large losses. While market making activities will be more constant over the year, proprietary books tend to be run with hard stop loss limits.

Question 13: The agencies request comment on the extent to which banks, at present, measure incremental default risk and the prospects for development of methodologies to capture this risk fully in internal models by the proposed January 1, 2010 deadline. The agencies also request comment on the fallback methods proposed for banks unable to develop an internal model to capture incremental default risk by January 1, 2010.

Like most firms, Wachovia does not presently have an incremental default risk model. We have allocated headcount and other resources towards the development of such a model and believe that it is feasible to develop such a model by Jan 1, 2010. However, we are concerned that, given the fact each firm will be taking its own unique theoretical approach towards this modeling, it will be difficult to obtain approval of such a model by the proposed deadline. In our experience, the regulatory approval process for specific risk models is difficult and protracted, and, at current staffing levels, the regulators

lack the personnel to work with all impacted firms in a timely manner. Therefore, if such a deadline is imposed, the proposed rule should include some kind of commitment by the regulators, such as self-imposed maximum response times on applications, and concrete steps to address these concerns should supplement the rulemaking process.

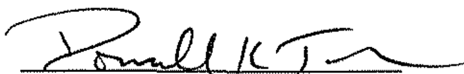
Question 14: The agencies seek comment on all aspects of the proposed public disclosure requirements.

We have no objection to the proposed requirement of a formal disclosure policy to be adopted by a bank's Board of Directors or the Quantitative Disclosures for Internal Models set forth in Section 8(c) of the NPR, however, Wachovia strongly opposes adoption of the new Qualitative Disclosures for Internal Models. While we currently report all of the required information to our regulators, public disclosure of this information is both burdensome and competitively disadvantageous. Specifically, we feel providing public disclosure of the composition and valuation policies for our Covered Position Portfolios would offer potentially damaging and inappropriate insight to a bank's proprietary investment tactics and strategies. *We continue to believe the current disclosures made in the annual report process provide* investors the needed insight into Wachovia's market risk management and this additional reporting would not be an incremental benefit to shareholders or the marketplace.

Market Risk Regulatory Reporting NPR. Please consider the preceding paragraph as Wachovia's response to the agencies' Joint Notice of Proposed Rulemaking - Market Risk Framework Regulatory Reporting Requirements, 71 FR 55986 (September 25, 2006), to which we do not otherwise object.

Wachovia appreciates the opportunity to share our views on the proposed revisions to the Market Risk Capital Rule and related Regulatory Reporting requirements. The proposals raise several concerns outlined above. If the agencies will adopt a more open posture and engage in a diligent consultative process with the industry, the final rules can be modified to address these concerns. We look forward to working with the agencies to achieve the intended objectives. We invite you to contact Adam Litke, Managing Director and Head of Market Risk, at 212/214-6105, with any questions regarding the views expressed in this letter.

Sincerely,



Donald K. Truslow
Chief Risk Officer

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