WACHOVIA

November 3, 2003

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551
Attention: Docket No. R-1154
Via EMail: *regs.comments@federalreserve.gov*

Office of the Comptroller of the Currency
250 E Street, SW.,
Public Information Room, Mailstop 1-5,
Washington, DC 20219
Attention: Docket No. 03-14
Via EMail: *regs.comments@occ.treas.gov*

Robert E. Feldman,
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC 20429
Attention: Comments
Via EMail: *comments@FDIC.gov*

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW.
Washington, DC 20552
Attention: No. 2003-27
Via EMail: *regs.comments@ots.treas.gov*

Re: Advance Notice of Proposed Rulemaking – Internal Ratings-Based Systems for Corporate Credit and Operational Risk Advanced Measurement Approaches for Regulatory Capital (68 FR 45900)

Dear Sirs and Madams:

Wachovia appreciates the opportunity to comment on the Advance Notice of Proposed Rulemaking (ANPR) regarding the implementation of the new Basel Capital Accord. We likewise appreciate the consultative process that has characterized the development of the new Accord. U.S. and international banking regulators have clearly worked hard to understand the concerns expressed by the banking industry and to improve the Accord in response. The Basel Committee's October 2003 announcement of additional revisions in response to comments on the third consultative paper illustrates the point perfectly. We commend the U.S. regulatory agencies for their diligence and look forward to continuing a constructive dialogue as we work toward implementing the new Accord.

Although several key areas within the new Accord require further revision, the proposed rules significantly improve the regulatory capital framework by aligning capital requirements with risk. Most notably, the proposed rules incorporate advances in risk measurement and management practices that have been developed in the years since the adoption of the 1988 Accord. ***We firmly believe that the key to success is the continued convergence of regulatory capital standards and continually improving sound risk management practices***.

We note our strong agreement with the ANPR's proposed use of internal models to compute capital for market risk, operational risk, and equity investments. This approach builds on the work banks are doing – and must do – to better understand the risks they are taking. It recognizes that banks

have considerable incentives to develop analyses tailored to their risks and their approach to managing those risks, and that no single set of formulas can capture the range of practices in this ever more complex industry.

We believe that the Agencies should take the additional step of permitting full use of internal models to determine minimum capital levels for credit risk. Internal models can produce a more careful consideration of diversification effects than can be achieved with a single factor model. Using internal models for credit risk would be consistent with the handling of market and operational risk.

A similar approach is needed for implementation. Even carefully crafted capital rules will fall short of success if not implemented and executed properly. We believe that much more flexible implementation interpretations are needed, or the new framework will impose substantial new costs and regulatory burdens on banks that will obstruct improved risk management.

Implementation must be built on top of continually improving risk management processes and systems. Minimum standards should be expressed in terms of principles and results, not in terms of methodologies and narrow definitions. Banks would then be encouraged to find the best techniques to explain how their loans and other risks behave given their approach to risk management and the latest best practices. ***The value of empirical evidence is paramount when developing internal practices***, and should take precedence over preconceived ideas of what "ought to be." Mandating how banks structure their analyses will stifle innovation and slow the development of better risk management practices.

Further, imposing definitions or methodologies instead of building on banks' well-founded decisions will trigger enormous, unnecessary costs. For example, nearly all U.S. banks use non-accrual as their definition of default. The supervisory regime currently addresses which loans should be placed on non-accrual; banks take appropriate steps to identify these loans. If regulators impose a separate default definition, banks will have to modify all their loan accounting systems to accommodate another default definition, modify data feeds and warehouses to gather this information, train operations personnel throughout their organizations to understand the difference between non-accrual and default, track both results, develop audit procedures to ensure the accuracy of both measures, and convert their historical default data measured in terms of non-accrual to estimates of what their rates would be with the new definition. If not consistent with banks' risk management practices, these expensive actions will have few, if any benefits beyond regulatory compliance. If such decisions are common, Basel will be a huge drain on the banking system.

Choices like this will be repeated hundreds of times for both credit and operational risk as we move toward implementation. In these situations, supervisors should allow – and encourage – banks to develop and employ ever more effective risk management and modeling approaches. True soundness is understanding the risks we are taking and having controls in place to ensure that those risks are considered appropriately, not just having capital to cover losses. A superior regulatory framework will build on today's best practices and accelerate the development of better risk management.

Where necessary, the ANPR should acknowledge that risk quantification is in the early stages of development. Operational risk is a prime example. Standards, including validation requirements, need to recognize this. We believe that a practical implementation of Pillar I that includes operational risk will serve as a catalyst for the development of management and measurement practices in this area. Over time, this will lead to more consistency, greater transparency, better comparability, and more effective industry practices. The state of the art in credit risk will advance, too, if the regulatory climate supports it.

The adoption of these rules may lead to lower levels of minimum required capital, especially as banks respond to the opportunity to improve their capital ratios by holding lower risk assets on their balance sheets. This will not necessarily lead banks to reduce their actual capital levels. ***The Agencies should state that lower Pillar I minimums are acceptable if sophisticated risk assessments and risk sensitive capital formulas produce that result. The new framework will not achieve its goals if lower risk is offset by recalibration simply to maintain current minimum capital levels.***

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The enclosed document includes Wachovia's comments on many aspects of the ANPR. Men and women throughout our firm collectively have spent hundreds of hours analyzing the proposals and recommending useful comments. We hope that their work will lead to further improvements to the Accord and contribute to a successful regulatory capital regime for the United States.

Our comments include many recommendations for improving the proposed rules. In our view, significant changes are necessary in several areas. We are pleased to note that the Basel Committee has announced its intention to revise many of the rules we believe are most problematic. These include the rules for securitized assets, the substitution approach for credit derivatives, and the rules requiring that credit capital be held for both expected loss (EL) and unexpected loss (UL). We believe that the latter concept should be extended to operational risk, so that capital would cover only unexpected losses. Additional comments concern the relative capital rates among retail products; the excessive conservatism required for some input estimates; and the voluminous, prescriptive disclosure rules that we believe would create uncertainty and misinformation among analysts and investors; among other issues. Without revisions to the proposal, these areas are likely to create significant distortions and inhibit sound risk management practices.

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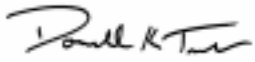
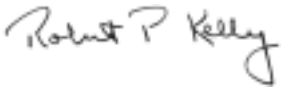
Wachovia is absolutely dedicated to understanding and managing risk in order to create value for our shareholders. We look forward to a regulatory capital regime that complements our efforts. We would oppose, however, implementation mandates that divert tens of millions of dollars from productive uses to regulatory compliance activities that produce no marginal benefits for our owners or other stakeholders.

Wachovia is committed to this process and to an improved regulatory capital framework. We have committed countless hours to this task over several years, and we are willing to invest additional resources to further improve these proposals. The efforts of U.S. regulators in this process provide clear evidence of their intent to produce rules that will improve the U.S. banking system, as well. We look forward to working with you toward this result.

Sincerely,



Donald K. Truslow
Chief Risk Officer



Robert P. Kelly
Chief Financial Officer

cc (by electronic mail):
Mark C. Treanor, Senior Executive Vice President and General Counsel
Michael A. Watkins, Senior Vice President and Deputy General Counsel

ANPR RESPONSE TABLE OF CONTENTS

I. OVERVIEW OF THE NEW ACCORD & COMPETITIVE IMPLICATIONS

The capital framework proposed in the ANPR is far more risk sensitive than the rules now in place. This change parallels the efforts of many banks to attribute economic capital in proportion to risk in order to align behavior with shareholder interests – improving the efficiency with which capital is deployed. The current framework induces some banks to hold fewer low-risk loans on their balance sheets and also leads some to devote resources to managing regulatory capital through securitizations and other devices. The banking system will benefit if the resources now applied to managing ratios can be redirected toward managing risk. Consequently, the new framework may in some ways contribute to improved efficiency of capital deployment among banks, a healthy development for the banking system.

The proposed framework incorporates advances in risk measurement and management practices that have developed in recent years. But not all banks have adopted these approaches, and indeed many smaller, less complex banks can reasonably choose to operate without the latest risk modeling techniques. **The two-tiered approach described in the ANPR does not *create* a bifurcated system; it merely *recognizes* that a two-tiered system exists.**

Cost & Competition

The concern that some may express about competitive effects between Basel banks and non-Basel banks is misplaced. Variations in minimum capital levels are minor differences compared to the distinction between banks that have invested in systems and processes that enable them to better understand the risks they are taking and those that have not. The cost of developing such capabilities is significant, but for complex banking organizations, these expenditures are needed to understand risk, Basel or no Basel. If implemented properly, the ***incremental*** cost to be a Basel bank above what needs to be spent to develop valid estimates of PDs, LGDs, and other measures is not so large.

Reasonable regulatory capital rules will not alter the way that credit is priced, but economic capital attribution has and will continue to influence pricing. Again, no bank will realize benefits from this activity because it is a Basel bank; any advantage will come from having a better understanding of risk.

However, disadvantages may arise for the mandatory Basel banks if implementation is too prescriptive and compliance costs excessive. To the extent that these rules do not use the best practices of today *and tomorrow*, banks will be forced to choose between doing things twice or doing them with less than best practices. Additionally, if compliance is prohibitively expensive, few banks will choose to opt in even if they have built best-practice systems. The rate of industry acceptance and opt-in is in the hands of the U.S. Agencies.

Non-Basel Banks & Competition

Although the real solution to the shortcomings of the current capital framework is the adoption of risk-sensitive capital rules –including the adoption of banks' internal models – several steps could be taken to lessen the problems of today's rules for non-Basel banks. A good approach would be to replace the current rules with a version of the Basel

Standardized or Simplified Standardized approach, particularly as they relate to residential mortgages. Such a change would reflect the less complex process necessary to measure risk at non-Basel banks while at the same time making that process more risk sensitive than the current rules. Such an approach would also reduce the differential between required capital for key portfolios at Basel and non-Basel banks.

The fact that some products require more capital under the IRB approach than under the general approach could lead some banks to avoid moving to a more risk sensitive approach. This could involve securitizing additional loans or otherwise slowing the growth of their loan portfolios to avoid falling under the rules. Supervisors should require banks to hold additional capital when it is clear that they would have to do so if they calculated risk-weighted assets under a more advanced, IRB approach. Such authority should only be used for blatant under-assessments. But without such a safeguard, non-Basel banks could find it too easy to grow high-risk portfolios.

The market won't press non-Basel banks to opt in simply so that they can wear the Basel tag or even so that they can enjoy improved regulatory capital ratios. Rating agencies have stated as much. Over time, however, the market ***is*** likely to press large, complex banks (i.e., large regional and specialty banks) to develop risk assessment practices that can reliably determine the risks in their portfolios whether or not regulatory capital rules change. This adoption will be facilitated as the software and processes currently in place at A-IRB institutions become more affordable for non-Basel banks. Such banks would then have the information needed to opt in, and would be likely to do so. Unreasonable regulatory requirements would hinder this natural market development.

Industry Consolidation

The introduction of a new capital framework will not by itself create winners or losers. Nor will it alter the dynamics of industry consolidation. There is no reason to believe that Basel banks will be any more likely to use the "excess" capital freed up by lower regulatory minimums to purchase other non-Basel banks than to believe that they will use the capital generated by any other activity – including normal profits – for this purpose.

It is possible, though, that non-Basel banks that are not prepared to opt in could be deterred from acquiring other non-Basel banks if the additional assets or foreign exposure would put them over the threshold requiring them to become Basel compliant. Regulators can minimize the risk of such an impact by implementing the new Accord in ways that keep compliance costs reasonable and by creating an environment where the gap between internal economic capital models and Basel compliance is minimal.

Reduction in Capital

The proposed changes in capital rules will not directly lead to reductions in Basel banks' capital levels. Essentially all banks operate today with capital levels above regulatory minimums, even above the "well capitalized" level. Banks determine the amount of capital they need to hold based on internal assessments of risk (economic capital), and most choose confidence levels that are above those in the Basel formulas. Unless regulatory capital requirements severely overstate risk, **regulatory capital will not constrain banks' behavior – economic capital will**.

Furthermore, rating agencies have clearly stated that they will be skeptical of banks that reduce capital in response to more favorable risk-weight functions. Over time, some banks may respond to rules that require less capital for less risk and reduce their risks and required capital. Investors, rating agencies, and regulators themselves can be satisfied with lower capital for these banks. Not only do the new capital rules demonstrate for some banks that their mix of loans holds less risk, but these banks have also demonstrated that they have the rigorous risk assessment processes in place to ensure that they understand the risks they are taking. Additional safeguards remain in place to ensure that capital minimums will not fall unreasonably. Examples include regulatory measures such as the leverage ratio and rating agency measures like the tangible equity ratio.

II. APPLICATION OF THE ADVANCED APPROACHES IN THE UNITED STATES

A. Home/Host Treatment

There will be significant differences in the rules between countries and one broad approach may not suffice. Regulators should be flexible and reasonable on this topic; perhaps it will best be handled under a Pillar II-type framework.

When considering the treatment for foreign subsidiaries of U.S. banks, we recognize that each jurisdiction will have its own regulatory framework based on the new Basel Accord. We urge the regulators to create a structure where the U.S. Agencies play the lead role in the overall supervision of American banks' foreign subs. Likewise, this treatment could be reciprocated so that U.S. regulators coordinate with their foreign counterparts when supervising foreign subsidiaries in this country.

One area in particular that concerns us is the structure of the operational risk database. AMA rules require that measurement methodologies be developed around the way we do business, a flexibility we applaud. However, we do not consider legal entities (or international boundaries) in the way we measure risk or assign economic capital. Therefore the situation could lead to confusion or burden. We urge all regulatory bodies to consider these contrasting forces when analyzing the operational risk of a foreign subsidiary.

B. Timing of Implementation

Whether banks can have data and analyses in place for the scheduled implementation depends on the prescriptiveness of the implementation rules. The good news, of course, is that banks have been building systems to quantify the credit risk in their portfolios for several years in support of economic capital systems. If regulators wisely build on what is in place, most of the credit risk data should be available. If, however, regulators require needless modifications or the development of essentially redundant systems by narrowly specifying definitions and methodologies rather than stating desired principles, it is unlikely that such changes can be accomplished in time to meet the schedule laid out in the ANPR. Further, since the rules are not yet finalized, it is unwise for banks to invest in systems other than those needed to support their economic capital work (and principles-based regulatory capital implementation). The delays associated with continuing to work out definitions and methodologies that satisfy regulators and banks will further reduce the time available for systems work. This is yet another reason a principles-based implementation approach is preferred.

Even so, it is likely that some portions of banks' portfolios will not be fully represented in data warehouses at the target date. Fortunately, it is almost certain that banks have prioritized their systems efforts to capture the risky loans and larger portfolios first, since these are most critical for economic capital purposes. One exception to this generalization could be those areas where best practices are evolving rapidly, such as credit derivatives. Even if systems are in place today to satisfy current best practices, new developments will lead to a steady evolution of systems requirements. Transition plans should acknowledge this reality.

Likewise, because industry practices are evolving rapidly in the operational risk arena, we believe additional time and/or transition measures are required there. The ANPR requires supervisory approval of advanced approaches (AMA and A-IRB) by December 31, 2005 to qualify for the January 1, 2007 target implementation date. This timeframe does not allow sufficient time for effective implementation as currently outlined by the ANPR and Supervisory Guidance. The organizational, cultural, technological, process, and measurement changes necessitated by the requirements are too significant to be achieved in such a short timeframe, particularly when considering regulations will not be final until 2004.

Additionally, wherever operational rules require processes that differ from today's practices, transition plans should allow sufficient time for existing exposures to mature and be renewed in compliance with these capital rules. For example, current liquidity exposures to ABCP programs may not comply with the requirements for favorable treatment, but standards will change once the rules become clear. Some time will be needed to roll these facilities over.

C. Treatment for Subsidiaries

Insurance Subsidiaries

The ANPR comments appear to offer two options for insurance subsidiaries. One is "deconsolidation" in which neither the assets of the insurance subsidiary nor any of the sub's equity is included in the holding company's consolidated ratios. Inherent in this approach is the assumption that the regulatory framework governing the insurance subs is acceptable. We know of no reason this would not be a good assumption. Our only concern with this proposal is that equity held in the sub over and above the minimum statutory capital requirements does represent equity of the holding company but could not be included in its ratios.

The second option seems to be a "partial consolidation" which, as we interpret the ANPR, seems unfair. Under this approach, all the insurance sub's assets would be consolidated, but only excess equity receives this treatment. In other words, all assets are included in RWA but not all of the sub's equity is counted in the ratios. While this somewhat addresses our concern with the first option (see above), it seems unfair to include all assets in the denominator and only a portion of the equity in the numerator. If this option were to be adopted, we would hope a RWA exclusion of some type would be allowed.

These comments are based on our interpretation of the limited discussion on the subject found in the ANPR. We urge the Agencies to provide more specific information on the treatment of these types of subsidiaries. Included in this information should be clarification on how to interpret the Agencies' definition of "excess" capital in the insurance subsidiary.

Other Subsidiaries

The efficacy and burden of the proposed framework on other subsidiaries of an institution – whether wholly or partially owned, individual banks or foreign subs – depend on the manner of implementation by the Agencies. Our current capital allocation process for these types of subsidiaries does not consider legal entity or foreign border. If supervisors implement the new Accord so this process can be maintained, then we will not have a concern in this arena.

III. ADVANCED INTERNAL RATINGS-BASED APPROACH (A-IRB)

A. Conceptual Overview

The EL/UL question and the role of reserves

Many of the ideas on this topic enumerated by industry participants in their CP3 responses seem to have been embraced by the Basel Committee at its Madrid meeting in early October. At this point, we will say that the Committee's approach is a step in the right direction, and we look forward to analyzing their proposal and discussing it further with U.S. regulators. Wachovia Bank plans to respond to the Committee on this issue by the requested December 31st deadline, but for the sake of going "on the record," we comment here on the proposed rules as they were written in the ANPR.

The primary problem with the rules surrounding offsets to the EL portion of risk weighted assets is a conceptual disagreement with the definition of capital. There is near unanimity among practitioners that capital is for unexpected loss only. Consequently, reserves should cover expected losses within the regulatory capital framework. In normal times, spread income will replenish reserves as losses are realized, since banks price their loans to cover EL, other costs, and a profit for the shareholders. In distressed situations, where losses unexpectedly exceed those anticipated at origination, banks will have to increase provisions or replenish reserves from capital accounts.

A solution should also consider that accounting rules vary around the world. Fair results are obtainable for a range of treatments for reserves. To begin, regulators must realize that reserves are resources available to absorb losses, just as capital is available to absorb losses. Indeed, it is to reserves that banks *first* turn to cover losses. The use of reserves to keep a bank solvent is more akin to retained earnings and other Tier 1 capital accounts than to subordinated debt and other Tier 2 accounts. Consequently, the first step is to include ***all*** reserves in Tier 1 capital. There should be no limitations on the amount of reserves that can be counted as capital, since all reserves can be used to absorb losses.

Once we have this foundation in place, we can consider how to remove EL from risk weighted assets. If at this point we simply deduct EL from the numerator of the capital ratio and subtract the EL portion of risk weighted assets, up to the level of reserves, from the denominator, we get a capital ratio more in line with industry practices. This approach will result in a truer comparison of available capital to the need for capital. It will not dilute the benefit of holding capital above minimum requirements for banks with higher expected losses with low volatility (e.g., consumer lenders) by including EL in the capital ratio.

We also see that this approach does not reduce system wide capital levels, since the resources in the system are essentially the same as they are today. We believe it would be a mistake for the U.S. to exchange a portion of the current capital

requirements for which banks should be adequately reserved for some unknown new capital requirement from a recalibration of the A-IRB capital functions.

We anticipate that the U.S. Agencies will adjust their proposals in light of recent announcements by the Basel Committee. Again, their press release indicates a step in the right direction, but we remain concerned about several aspects of their announced plan:

- The language indicating that "re-calibration" may be necessary is troubling since a re-classification will not cause a change in system-wide resources to guard against losses.
- Limits are included that appear to cap how much of "excess" reserves will be counted as capital, even though all reserves are available to absorb losses.
- Portions of the reserve will be counted as Tier 2 capital. We believe that all excess reserves should count as Tier 1 capital.

The use of internal capital models

Not only has the industry advanced considerably its risk measurement and management abilities since the publication of the initial Basel Accord in 1988, but analytical approaches have also converged significantly. This shift is occurring at more than just the largest institutions, as senior managers at an increasing number banks are recognizing and increasing their efforts to estimate and use economic capital in risk management and resource allocation.

We applaud the Basel Committee and U.S. Agencies for recognizing this as a driving motivation for revising the Accord and bringing regulatory capital more in line with economic capital. We view the proposed rules as a giant step toward the goal of internal regulatory capital calculation for all risks. We urge the Agencies to take the remaining step of allowing banks to use internal models to determine the regulatory capital for credit risk as well. Such a process would be consistent with the current practice for market risk and the proposed approach for operational risk and equity exposures. It would also be consistent with the framework already in place (as outlined in SR 99-18 and OCC 2000-16) for supervisors to ensure that internal models cover the full range of risks faced by the bank, that capital levels are adequate to support those risks, and that there is a formal policy in place describing model validation.

If under these authorities the Agencies determine that models for some credit risks (e.g. securitizations) have not yet developed to the point where they can be used for this purpose, such areas could be excluded for a time. These exclusions should be the exception rather than the rule, so that as the industry continually develops improving models, fewer exclusions would be needed.

B. A-IRB Capital Calculations

1. Wholesale

Definitions & Quantification
We applaud the decision to allow banks to use their own credit risk parameters. Plugging numbers that are already calculated for economic capital models into a regulatory formula is a minimal additional step. And because asset correlation is now the only major risk parameter *not* contributed by banks, we view this as a major step toward an internal regulatory capital model approved by supervisors.

Given this progress, we believe that the input definitions – PD, LGD, and EAD – are too prescriptive. The overriding principle here is that the product of these factors must equal expected loss. Small alterations in the definition of PD, for instance, will produce offsetting changes in measured PDs and LGDs. Moving a few zero loss defaults from one measure to another will have an ***insignificant*** effect on capital rates, but may have a ***significant*** effect on the ability of banks to organize their data in the most meaningful way. Standards should be expressed in terms of principles and results, not in terms of methodologies and definitions.

The evolution of regulatory capital modeling is at an important decision point. Tight specifications – even if well intended – will produce a framework that lags best practice by the time it is implemented. Rules based on principles can remain current as best practices evolve. The first approach will leave us needing a major update in a few years, just as Basel I requires an overhaul today. The latter approach, however, can put the industry on the path to ever more meaningful capital requirements based on internal models that are more sensitive to each banks' risks.

We also welcome an improved approach for measuring credit capital for OTC derivatives. We agree with the general concept of applying the wholesale exposure approach to OTC derivatives and agree that EAD (as opposed to PD or LGD) is the appropriate variable to reflect derivatives-specific factors. However, we believe that there should be symmetric treatment for OTC derivatives and repo-style transactions. ISDA/TBMA/LIBA[1] and Michael Gibson[2] at the Fed have delivered important work on the topic. We understand that the Models Task Force of the Basel Committee is considering the issue, and echo the point raised by ISDA/TBMA/LIBA in their October 6th letter to Mr. Caruana that the newly proposed delay will be an opportunity to revisit this important issue. We also hope the U.S. Agencies will continue to work with the industry on this front.

[1] "Counterparty Risk Treatment of OTC Derivatives and Securities Financing Transactions," June 2003.
[2] "Regulatory capital for counterparty credit risk: A response to ISDA's proposal," Michael S. Gibson.

Within the confines of the proposed rules on all wholesale exposures, we see room for even further improvement in the following areas:

- Definition of Default

  We continue to disagree with the definition of default on two levels.

  We were pleased to read in the ANPR that the definition of default will be generally consistent with non-accrual. We were quite confused, however, when the Supervisory Guidance document detailed a much more restrictive definition that included bankruptcy, loan sales at a loss, and so called "silent defaults." Not only is there already an extensive regulatory framework around non-accrual, it is the most common element across the industry. As detailed in the cover letter to this document, a definitional difference such as this will have a ripple effect throughout the company requiring an unnecessary use of resources.

  We note the following concerns about the default definition in the documents:

  Loan sale at a discount
  As detailed in our CP3 response letter, selling loans at a discount does not always constitute default and at many institutions is a standard portfolio management practice. We also provided an illustration of how including loan sales in the default statistic can distort both PD and LGD rates.

  Silent defaults (including bankruptcies)
  It is essentially impossible to clearly identify these defaults. If a borrower liquidates a CD (or has us do it), did he default? If a guarantor steps in and injects equity into a firm that has borrowed, has that borrower defaulted? If our brokerage operation sells stocks to satisfy a margin call, did the owner default on all of her obligations to the bank? If an asset-based lending customer files for bankruptcy but his closely monitored accounts receivables continue to be converted into cash that pays down our loan balances (with court approval), has a default occurred? Is a debtor in possession in default at origination?

  Secondly, even if we could clearly identify all these situations so we could call them defaults, we would have to build redundant systems at a high cost for no benefit other than regulatory compliance. We argue it is better to use these resources to actually improve risk management.

  But the problem goes beyond the specifics of the default definition. Banks and regulators could continue to work toward a definition that addresses everyone's concerns (including the ones raised above), but we

are convinced that such efforts would be horribly misguided. The definition of default that is most effective for our bank has already been determined after much internal debate and analysis, a project we are certain has also been completed at our peer institutions around the world. The guiding philosophy for the capital framework should be that the regulations express the principle (e.g., bank needs a policy defining default), and then banks determine the best way to achieve it, subject to validation.

- Probability of Default

  When measuring our default experience, our historical results clearly show that facility-specific factors affect the default rates, as shown in our confidential Attachment 1. With the value the Agencies place on empirical evidence and the importance of producing default estimates with as much accuracy as possible, we strongly believe that grading systems should be able to take into account factors that have been shown to differentiate among observed default rates.

  Additionally, it has been our experience that the presence of a guarantee improves an exposure's PD, but not to the level of the guarantor itself. Separately, we found that for loans that do default, the presence of a guarantee improves the LGD. From these empirical results we have concluded that the effect of a guarantor is felt not wholly on one risk parameter, but partly on two.

  Before accepting these numbers, we attempted to adjust our analysis so that benefit was recognized in only one area, to match the specified regulatory framework. We ultimately realized that distorting reality for the sake of compliance would lessen the value of these measurements as risk management tools.

  Additionally, we understand that industry practice is mixed in this regard, with some banks adjusting PD and others adjusting LGD. Conversations with our peers also revealed that several banks give credit to both parameters. Therefore, we urge the Agencies to reconsider the proposal that such benefit be realized in only one risk parameter.

- Loss Given Default

  We continue to disagree with an overly conservative loss given default calculation that considers only the periods of highest default. Taking a default-weighted average would serve as a better method for calculation and would fulfill the principle of conservatism by over-weighting periods with high defaults. For example, the LGD for our entire commercial portfolio for the business-cycle-trough years of 1999-2001 was only 1% more than the entire history spanning from the second half of 1996 until the end of 2002; this proves that a default-weighted

average effectively over weights years with more defaults and slightly higher LGDs. (Reference confidential Attachment 2 for more details.)

- Exposure at Default

  For loan exposures, our method – based on empirical results – defines the defaulted amount as the amount that goes to workout. This method presents a much clearer picture of what happens, as the benefit of collateral is often realized during workout before the balance is moved to non-accrual. Again, we urge the Agencies to let the data determine the most appropriate framework so as to minimize the regulatory burden of duplicate calculations.

  For OTC derivatives, specifying EAD using the existing add-on factors significantly misstates the position at risk. For single transactions, the add-on factors do not generally reflect market risk factors or trade specific terms. More importantly, the add-on approach does not take into account portfolio effects, which result in significantly lower risk. Such effects are seen whether measured on a gross basis (given the existence of trades with mutually exclusive exposure profiles, and coherent adding of time buckets when measuring aggregate risk), or on a net basis (which reflects offsets present in most financial institution portfolios). Finally, a significant portion of outstanding OTC derivatives is collateralized in a manner consistent with repo-style transactions, and we believe EAD should be measured consistently between the products. The proposed rules for repo-style transactions include a PFE that is portfolio-based recognizing market volatilities, correlations, and cash-equivalent controlled collateral. This approach better represents the risk of OTC derivatives.

- Maturity

  We agree that risk does not decline linearly as maturity approaches. Maturity itself may trigger default. However, to maintain that all loans should hold at least as much capital as if they had a full year until maturity essentially assumes that loans are risk free for much of their last year. The true picture is somewhere in between, with more conservatism appropriate for higher PD borrowers. Although applying the current maturity adjustment to loans with less than one year remaining until maturity is neither analytically derived nor empirically driven, the relationship produces results that are quite reasonable. Consequently, we urge that the maturity adjustment be extended to remaining maturity under one year, with a one-month minimum.

  Following the same logic the Basel Committee used in permitting the maturity exceptions for exposures with an original maturity of less than three months, we suggest that short term credit extensions such as repos are less risky than commitments with a longer original term but short remaining lives. ISDA describes several alternative formulas for

determining the appropriate maturity adjustment for short dated facilities in its CP3 response. A reasonably conservative approximation of their recommendation could be achieved simply by using a 50 percent CCF to facilities with an original term of no more than 3 months/90 days and then applying the standard maturity adjustment.

Further, for derivatives we argue that M should *not* be the notional-weighted average remaining maturity. Such an estimate does not reflect the risk profile of the positions in terms of EAD or credit risk. For example, consider the impact of maturity on two simple un-netted portfolios, each comprised of a $10mm at-market interest rate swap and an equivalent EUR-USD forward transaction:

Table 1: One Problem with a Notional-Weighted Maturity

Portfolio A	M	Notional	PFE	CEA	K (%)	K ($)	K (Net $)
IR Swap	5	$10,000,000	0.5%	$50,000	5.99%	$2,996	
FX Forward	2	$10,000,000	5.0%	$500,000	3.66%	$18,310	$21,305
Portfolio	3.5			$550,000	4.83%	$26,548	$26,548

Note: PD=.25%, LGD=45%

Portfolio B	M	Notional	PFE	CEA	K (%)	K ($)	K (Net $)
IR Swap	2	$10,000,000	0.5%	$50,000	3.66%	$1,831	
FX Forward	5	$10,000,000	5.0%	$500,000	5.99%	$29,959	$31,790
Portfolio	3.5			$550,000	4.83%	$26,548	$26,548

Note: PD=.25%, LGD=45%

As can be observed in Table 1, portfolio capital is the same in both cases despite the significantly higher risk profile of Portfolio B; portfolio capital is +25% and -16% different than summed single transaction results. A notional-weighted M leads to questionable results.

These rules differ even more significantly with industry risk management practices. Time impacts credit risk both in terms of the EAD profile (which is dependent on terms of the underlying trade(s)) and the slope of the PD curve. Under the proposed rules, M mis-characterizes risk on two fronts: by measuring EAD for the full term of the trade (whereas risk typically occurs on the shorter end) and then applying too high a PD to that exposure (driven by positively sloped PD curves). Further, when the purpose is to provide capital protection over only a 1-year horizon we question the application of a positively sloped PD maturity adjustment (based on M) to derivative exposures which, relative to loans, are insensitive to credit spreads. We believe a risk-weighted measure of M or the approach outlined by ISDA/BMA in their July 31st letter to Mr. Caruana would be more appropriate.

- Diversification

Most capital allocation formulas include a benefit for diversification. This is true for both commercially available and internally developed models. To the extent that the regulatory formulas do not grant as much benefit for diversification as our internal models do, a distinct gap between economic and regulatory capital will continue to exist. This is yet another reason to adopt our internal practices for regulatory requirements.

High-Volatility Commercial Real Estate

Consistent with our theme that empirical evidence is valuable and most relevant, supervisors were wise to allow banks that have the data on defaults and losses to use that data to estimate the risk parameters for specialized lending. We do not consider it a practical scenario that any American bank that qualifies for the A-IRB methodology would simultaneously need to use the Supervisory Slotting Criteria (SSC) for this type of lending. Regardless, the RMA[3] shows that the SSC produces capital rates that are considerably more than A-IRB and internal rates. Thin data should lead to more stringent rates, but not this stringent.

Furthermore, high-volatility real estate is just another segment of a broadly diversified portfolio; we do not believe that validation requirements should be any more rigorous for these exposures than any other. To echo earlier comments on the calculation of LGD, we believe it is overly conservative – even to the point of bias – to measure LGDs only in recessionary periods. Real estate should not be singled out any more than any other industry. Similar thinking would require extremely high LGDs for all future telecom loans because of recent problems. This approach will always protect against the last problem rather than prepare for the next.

We *do* acknowledge that speculative construction and development projects are more sensitive to the economy than stabilized properties. But any dividing line between high-volatility from the rest of commercial real estate will be an arbitrary assignment. The Agencies have suggested making such a distinction based on pre-leasing and equity levels. While we agree those factors are important, we note that the dynamic nature of those levels would complicate the HVCRE identification process. We also believe there are other important factors not considered, such as market conditions, recourse structure, a guarantor's level of unencumbered liquidity and prior demonstration of support (i.e. willingness to increase the level of recourse or write a check for deficiency), the developer's track record, and cash vs. appraised equity contributions.

Our experience only illustrates that no two banks are likely to manage commercial real estate risks in exactly the same way and that implementation costs to separate HVCRE from other CRE could be significant. Consequently, we recommend a simplified approach where HVCRE is

[3] "Measuring Credit Risk and Economic Capital in Specialized Lending – Best Practices," March 2003.

synonymous with the definition of Real Estate Construction Loans in the Call Reports with exceptions justified by bank experience and approved by supervisors.

We call attention to the fact that even elevated capital rates for HVCRE will not prevent future speculation nor eliminate the risk of future bubbles in real estate or any other area. Banks employ a range of techniques to guard against overly optimistic assessments of risks. Regulators should address such concerns under their supervisory authority.

Finally, we also note that treating defined classes of commercial real estate differently will not have significant competitive implications. As explained in our section on "Cost & Competition," we believe the noteworthy distinction is between banks that have and have not invested in systems to better understand their risks.

Leases
Because residual risk to the lessor varies by product type, a reworked and more individual treatment for residual risk is warranted.

Even 100% risk weighting does not protect against overly optimistic assignment of residual values by the lessor. At the same time, a 100% risk weight is harsh for lessors with conservative residual valuation policies that nearly always result in gains – not losses – at maturity. Alternatively, some leases are not even exposed to residual risk.

Therefore, banks need (and most have) internal policies on valuation and a process to validate the reasonableness of assigned residual values depending on the type of lease arrangement. As with equity exposures, banks should have the option to use internal models – approved by regulators – to determine capital requirements for lease residuals. Regulators could also address the risk of overly optimistic residual valuations through their supervisory authority.

Loans Purchased at a Discount
We agree with the Agencies that the rules in CP3 produce incorrect results when loans are purchased at a discount greater than EL. However, we believe that the solution proposed in the ANPR is too conservative. Many loans from among a group purchased at a significant discount will pay off at par, realizing gains, so that the group requires less capital than the same loans purchased or originated at par.

2. Retail

Definitions & Quantification
We find the categorization of retail loans into three distinct categories a reasonable attempt to differentiate between types of exposures that inherently have different drivers of risk. And while the categories themselves

are reasonable, we continue to find fault with the relative capital rates, as discussed below in more detail. We also offer the following comments on the definition and quantification of retail exposures:

- Unused Commitments
  Holding capital to protect against the risk of unused retail commitments is conceptually sound. Properly estimating exposure at default by segment so that low-risk segments are recognized as such is quite challenging. We are convinced, however, that if a culture is created that allows banks to innovate that the industry will eventually reach a consensus on the issue, as it has on other risk parameters. The fact that most banks can and do freeze lines when borrowers become significantly delinquent will show itself in the numbers if this practice reduces risk. No "solution" should be imposed.

- Private Mortgage Insurance
  We view PMI as a valid risk mitigate and believe it should be allowed when calculating a mortgage's LGD. To the extent that it is or is not a material factor will be seen in the empirical results of the portfolio. Separately, recognizing this product for Basel banks under the proposed framework will not have significant competitive implications.

- Size Boundaries
  We agree conceptually that at some point very large individual exposures should no longer be considered retail borrowers. We believe, however, that the threshold should be determined based on risk management practices and materiality instead of being mandated. Having several small business loans with balances over $1 million in an SME retail portfolio is likely immaterial. Further, the implementation burden of pulling a few such loans out of a retail pool will outweigh the benefit of separate treatment.

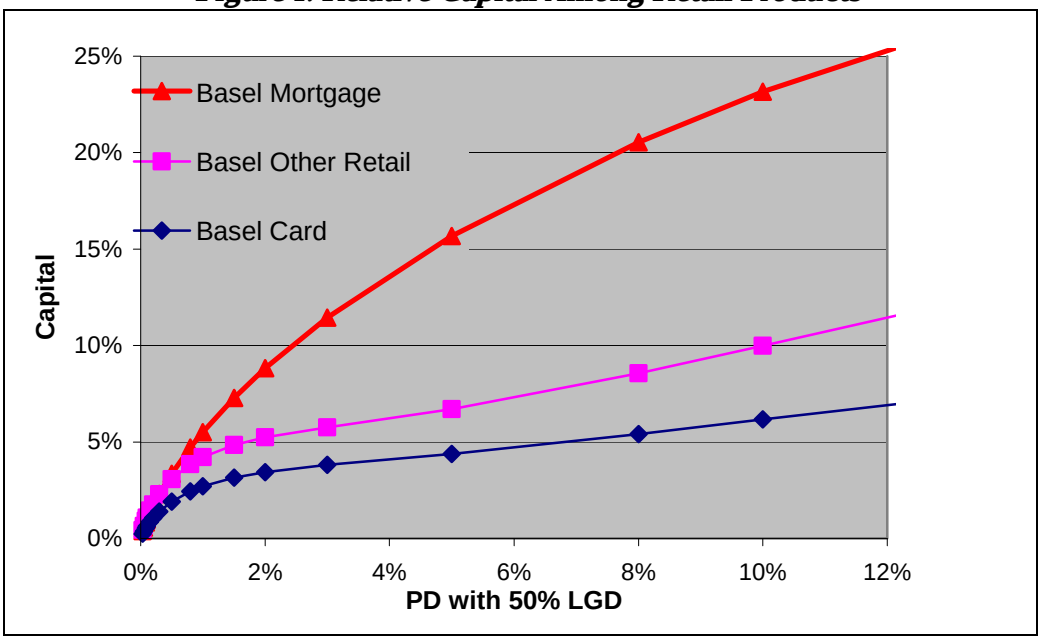
Relative Capital among Retail Products

The ANPR suffers from the same lack of differentiation between high-quality consumer loans and sub-prime non-mortgage loans as Basel CP3. The problems with the relative risk weights are illustrated through the relationship between a credit card loan with an 8% PD and a home equity loan with a 1% PD, as shown in Figure 1. All other things equal[4], the credit card loan requires less capital than the mortgage.

[4] Although only some second mortgages have LGDs approaching those of credit cards, the formulas should produce reasonable results.

The main problem lies with the asset correlations. The RMA[5] shows that banks uniformly use much lower correlations for high quality retail loans. We understand that asset correlations in the retail risk-weight functions are not conceptually identical to asset correlations in industry models because the proposed correlations also include a maturity effect, which is not otherwise

Figure 1: Relative Capital Among Retail Products



captured for retail credits. With this adjustment for maturity, the mortgage function is reasonably consistent with available data and our usage for economic capital modeling. However, for high quality non-mortgage exposures, the high correlations cannot be justified by the maturity effect because the average life of other retail credits (including home equity loans and lines of credit) is generally shorter than first mortgage loans.

We are likewise surprised at the extremely low asset correlations and risk weights for the highest risk sub-prime non-mortgage borrowers. The RMA paper cited above also shows that the industry's median asset correlation for nearly all the non-mortgage retail products is higher than the Basel value when PDs are above about 5%.

Therefore, we believe a better approach would be to deal with maturity explicitly. Such treatment would overcome the shortcomings of the proposed treatment.

Further, we are aware of no solid evidence that consumer asset correlations decline as default probabilities increase. The decline in asset correlations for non-mortgage products is far, far steeper than that used in any commercial

[5] "Retail Credit Economic Capital Estimation – Best Practices," February 2003.

risk-weight function, with no apparent justification. At the same time, no reduction at all is attributed to asset correlations for the mortgage and home equity portfolios. It is no surprise, then, that we get the odd relationships described above.

Some have argued that they can manage high-loss consumer portfolios with little volatility. Unfortunately, not all banks have had that experience. U.S. industry data shows considerable volatility in credit card loss rates.[6] It seems imprudent to assume that all banks can manage sub-prime portfolios well, or even to assume that low correlations estimated during low-to-moderate stress periods will hold in the event of a recession that hits consumers especially hard. But those banks that *can* do so successfully *should* be rewarded. The only realistic way for these banks to receive credit for a practice that materially differs from the majority of the industry is for supervisors to evaluate each bank's internal models separately.

Others have claimed that the lives of non-mortgage retail loans are quite short, so less capital is required in the same way that less capital is required for short-maturity commercial loans. When measured at the portfolio level, it may be true that the duration of revolving consumer loans is low. It is the many *low-risk* borrowers, however, who pay off their accounts quickly and shorten the portfolio's average life. The riskiest consumers do not amortize their loans nearly as fast. U.S. regulators have in fact expressed considerable concern about extreme amortization periods being applied to high-risk borrowers – even finding cases of negative amortization. This maturity effect would point to ***increasing*** the asset correlation values as PDs rise, not decreasing them.

The paper[7] by Roberto Perli (FRB) and William Nayda (COF), published in the Journal of Banking and Finance and submitted as an Appendix to Capital One's CP3 response, addresses the relative risk of high- and low-PD credit card loans. Their multi-factor model quantifies, using real data, what we know by experience and common sense: high PD segments are much riskier than low PD segments. The implied asset correlations and capital rates for the highest risk segments are materially higher than correlations generated using the current formulas. Meanwhile, low PD assets are treated harshly due to the too-high asset-value correlations tied to these loans. As those authors conclude, this anomaly could lead banks to favor more risky loans.

A second problem with the currently proposed rules is that high-EL credit card loans can offset significant portions of their required capital with

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[6] Per the U.S. FRB quarterly statistical release of charge-off rates for the top 100 banks, the average charge-off rate for credit cards for 1986QI through 2003QI was 4.25%. Assuming a constant LGD of near 100%, the capital charge for this thoroughly diversified "portfolio" would be about 8.0%, using the correlations in the Basel formula. This is far too close to the highest observation of 7.8% for 2002QI. The industry is more volatile than implied by the low asset correlations in the current formula.

[7] "Economic and Regulatory Capital Allocation for Revolving Retail Exposures," July 2003.

anticipated margin income. Fairness would require that if revolving products get credit for anticipated margin income – even partial credit – then income from other products should receive equal treatment. Based on its October 11th press release, the Committee appears to have also recognized this inequity.

Market Response to Mortgage Capital Rates
As discussed in our section on competitive effects, we do not believe that changes in regulatory capital rates will have a material effect on the mortgage market. For one, the deep secondary market sets pricing and terms for mortgages, and bank decisions are driven by economic capital, not regulatory capital. Additionally, we do not believe that reduced capital requirements for mortgages will result in a credit induced housing bubble any more than we believe increased capital requirements for high-volatility real estate will prevent irrational exuberance.

We recognize, however, that the difference in mortgage capital requirements for Basel and non-Basel banks may be a controversy and a distraction. As noted earlier, we support adjustments to the current regulatory capital rates for residential mortgages (in line with the Basel Standardized approach).

3. Credit Risk Mitigation

Repo-style Transactions
We agree with the conceptual approach to be used for repo-style transactions, which recognizes that portfolio dynamics significantly impact EAD (as opposed to PD) with a given counterparty when subject to a valid netting agreement. We also agree with applying collateral against the EAD subject to the criteria proposed.

While more specific comments are listed below, we are concerned with the level of complexity introduced through the proposal. While notional amounts and volumes are high, the short time horizon of transactions and operational practices such as netting, over collateralization, and collateral management make the relative risk of most repo-style transactions relatively small. The formulas in the proposal should produce lower capital numbers but the processes and calculations required seem excessive (in particular the VAR back-testing framework).

- Netting
  For transactions that do not qualify for netting treatment, we agree theoretically that reasonable results can be obtained by adjusting the LGD. However, the volume of repo-style transactions executed each day by our institution makes it impractical to manually assign LGDs to specific transactions. We believe the only practical way we could do this is to have systems calculate LGDs based on formulas and trade details. Here again we prefer the approach in which the Agencies articulate the

principle and the banks supply a methodology. Otherwise, we would like clarification on how the Agencies propose handling the issues.

For example, the proposed rules state "LGD estimates would have to be grounded in the historical recovery rates on the collateral and could not be based solely on the collateral's estimated market value." What type of LGD would we be expected to apply to a repo on U.S. Treasury Note or agency collateral? Could we use VaR-type calculations on the collateral to then derive an LGD on the repo, which we expect would lead to a result for the single deal similar to the EAD adjustment approach? Could proxies be used for certain types of collateral and, if so, would these be validated through regulatory supervision?

Also with respect to transactions that do not qualify for netting treatment, we believe counterparty credit risk should be based on portfolio effects (as discussed above with respect to OTC derivatives) which are not reflected in the proposed rules.

Finally, the criteria for recognizing netting appear to be slightly different from the rules currently applicable to OTC derivatives. We would like clarification about the requirement to possess written supporting legal opinions, the impact of walkaway clauses, and other documentation requirements.

- Haircuts

  We believe using own-estimate haircuts is reasonable, particularly given the regulatory framework existing for VaR calculations. However, we believe that the minimum holding period for collateral haircuts and M should be consistent with contractual liquidation periods, rather than specified, to acknowledge improved risk management practices when demonstrated.

- Back-testing

  The Agencies should permit greater flexibility around the back-testing approach, both in terms of the sampling methodology and the penalties, which should be established in consultation with supervisors and consistent with a firm's portfolio and risk management framework. We agree conceptually with the sampling approach, but are concerned about the operational requirements needed to support it. We believe reasonable results could be obtained by testing a representative portfolio. The back-testing multipliers are inconsistent with market risk rules and are unnecessarily high.

Guarantees & Credit Derivatives

We believe that the matter of guarantees and credit derivatives should be divided for effective analysis. Let us first consider guarantees from interested parties – owners, parent companies, investors, etc. For middle market

lenders, such guarantees are everyday business. Here we believe the guiding principle is obvious: let the data rule.[8] The degree to which such guarantees affect default rates, LGD rates, *or both* needs to be empirically determined. It is wrong to impose rules that restrict these effects by fiat, without regard to actual behavior.

The rules for credit derivatives, on the other hand, can legitimately be developed based on more conceptual analyses. The historical data around credit derivatives is thinner than for guarantees by interested parties. Further, the credit quality of essentially all counterparties is quite good. Defaults are rare, so it is difficult to develop tight estimates of default effects from empirical studies. But not all conceptual frameworks are equally valid.

The proposed framework for derivatives has several shortcomings:

- Substitution

  We find the substitution approach inconsistent with other provisions in the proposed rules and prudent risk management practices. By only recognizing the better of the PD and LGD estimates of the obligor or guarantor (credit derivative counterparty), ***the rules do not encourage the hedging of higher quality assets*** that tend to be the larger exposures in the portfolio. We believe it is especially these large exposures that require capital protection and question the appropriateness of the regulatory framework in this regard. We also question the desirability of effectively supporting the selling of protection by only highly rated institutions, from both the standpoint of equitable treatment of market participants and continued concentration of the product among relatively few financial institutions. We believe fully hedged underlying exposures should get full capital relief, and that capital should be measured against the credit derivative counterparty. Under the current rules, a firm that hedges highly-rated exposure with a highly-rated counterparty must hold more capital than if no hedging occurred (as a result of the substitution approach and a counterparty risk charge – as illustrated in the "Day 1" column of Table 2 below).

- Double Default

  Wachovia believes both double default and double recovery effects should be reflected in the treatment of credit derivatives for regulatory capital purposes, just as they are in pricing and internal economic capital attribution. The existence of a credit derivative market for high grade credits supports this view: if substitution of guarantor grades for underlying obligor grades reflected the risk of fully hedged obligations, a credit derivatives market would only exist for low grade credits.

[8] Of course we know that randomness will produce results that differ from expected. Recurring "unexpected" results beg for deeper analyses to understand the patterns. Improved risk management calls for the uncommon wisdom that challenges conventional thinking and uncovers more complex relationships.

When Wachovia buys protection with credit derivatives, our internal ratings of the underlying facility are not changed because we do not believe that underlying loss characteristics are affected by the existence of a credit derivative. (The PD and LGD of XYZ Corp. obligations are inherent to XYZ Corp. obligations.) We create a separate facility for the credit derivative and designate it as a short position with its own ratings. For example, if we have $10mm exposure to XYZ Corp., which is then fully hedged by a CDS with ABC Bank, we reduce our exposure, however measured, to XYZ Corp. to $0; we then recognize counterparty risk of X% based on double effects (as discussed below) of $10mm to ABC Bank. Adopting an approach which treats the hedge as a short position in its own right also allows for automatic recognition of any mismatches in amounts, amortization, seniority, maturity, etc.

- Double Default Paper

  We offer the following comments with respect to some of the issues raised in the Federal Reserve's double default white paper:

  Correlation of the Guarantor vs. Correlation of the Obligor (ϱ_g vs. ϱ_o)
  We believe a company is affected consistently by systematic risk, whether borrowing on its own behalf or extending a guarantee or credit derivative. Accordingly, we do not believe ϱ_g should be specified differently than ϱ_o for the same entity.

  Furthermore, the proposed capital formulas already incorporate asset correlations to capture systematic risk, so any attempt to adjust ϱ for systematic risk would be double-counting the effect.

  Correlation Between an Obligor and Guarantor (ϱ_{og})
  We agree with the Agencies' focus on asset correlation between an obligor and guarantor, and recognize that this area is currently receiving significant focus in the financial markets. Expansion of the collateralized debt obligation market and credit index and basket products are leading to rapid development of observable data and commercially available technology.

  We also believe that each sector has its own intricacies so that a single measurement approach for correlation and wrong-way risk would be inadequate. Sometimes those effects manifest themselves in unexpected ways. The most appropriate way to capture them would be through the combination of objective (market statistics) and subjective (institutional judgment) measures.

  Concentration
  We agree with the Agencies' concern with respect to historic concentration of credit derivatives with the largest "dealer" financial institutions. However, we question the assumption that these organizations are holding large amounts of undiversified or

undistributed risk – as further described by Fitch[9]. While we remain cautious about over-reliance on collateralization, we note industry practice among dealers, and increasingly between dealers and clients, to require collateral for significant risk positions. Accordingly, net unsecured risk will typically occur as a result of event risk (such as fraud), which causes rapid pricing/risk gaps that trigger large collateral calls. We believe broader implementation of VaR-type and stress testing regimes would adequately address many of these situations.

Other market practices

With respect to market practices and other questions raised in the double default white paper, we participated in a survey of market participants performed by ISDA, TBMA, LIBA, and IACPM, and accordingly refer the Agencies to the comments submitted jointly by such associations.

- Additional Requirements for Recognized Credit Derivatives

  Restructuring

  We believe restructuring should remain a required credit event for *full* recognition of capital benefits from credit derivatives. However, we believe credit derivatives without the restructuring provision still provide significant protection, and that the losses the capital standards seek to cushion will typically be those associated with other credit events. (A Fitch study[10] showed that only 3% of CDS calls were due to restructuring.) Accordingly, we agree with the Agencies that a discounting approach can produce a reasonable pro-ration of full capital relief. ISDA, S&P, and the RMA have all contributed valuable research on this topic, and we continue to support their efforts to better understand the true value of a restructuring clause (that goes beyond observing differences in market pricing). The ultimate discount percentage should be based on this type of empirical analysis rather than imposed by Agency fiat.

  Unrealized Gains and Losses

  We agree with the Agencies that unrealized gains should be deducted from Tier 1 Capital for total return swaps and credit default swaps where the credit derivative is accounted for in the trading book and the hedged obligation is accounted for in the banking book – so that an increase in risk does not result in an effective decrease in required capital. For example, consider capital requirements of a $10mm 5-year loan (booked in the banking book) fully hedged with a credit default swap (booked in the trading book):

[9] "Global Credit Derivatives: A Qualified Success," September 24, 2003.
[10] "Credit Events in Global Synthetic CDOs: 2000-2003," May 12, 2003.

Table 2: Multiple Negative Effects of Substitution

	Day 1	Day 2	
	$PD_{obligor}$=.15% $PD_{counterparty}$=.15%	**Scenario A $PD_{obligor}$=.25% $PD_{counterparty}$=.15%**	**Scenario B $PD_{obligor}$=.05% $PD_{counterparty}$=.15%**
Base Capital for Loan	$472,000	$599,000	$274,000
Capital for Loan with CDS (using substitution)……	$472,000	$472,000	$274,000
Capital for CDS Counterparty…….	$23,600	$24,544	$23,600
Total Capital	$495,600	$496,544	$297,600
Additional Capital	$-	$944	$(198,000)
Tier 1 Capital (via income statement)	$-	$20,000	$(20,000)

Note: LGD for obligor & counterparty = 45% both days

In addition, the table shows that to ensure symmetric treatment, unrealized losses should be added back to Tier 1 capital.

Finally, we would like to restate our position discussed earlier and illustrated in the first column of Table 2 that fully hedging a loan with a credit default swap may require more capital than an unhedged exposure. *This makes no sense.*

Maturity

We believe that credit derivatives with a remaining maturity of less than one year still provide significant protection against loss on the underlying obligation. Similarly, we agree with the Agencies concern that the proposed formula (Pa) does not address amortization distinctions, but also wish to note that it does not appear to be consistent with proposed rules. The stated goal is to provide "an estimate of the amount of credit losses over a one-year period…" In the case of default risk, credit losses following default on the underlying obligation are generally measured as the product of EAD and LGD – that is they are generally the same regardless of the tenor of the instrument. Accordingly, a credit derivative with a term greater than one year, regardless of a mismatch with the underlying obligation, addresses this risk. However, the Agencies have also included a maturity factor (M) in the capital algorithm to capture market value/migration losses in addition to default losses. We believe it would be more appropriate to recognize maturity mismatches consistent with the M adjustments, since the market value changes affect underlying obligations and credit derivatives in a similar manner. To be consistent with the one-year horizon goal, we believe credit derivatives with remaining maturities of less than one year could be measured using the proposed formula (Pa) or, as proposed in the rules, recognized only when the maturity of the credit derivative is not less than that of the hedged obligation.

Counterparty Risk

We note inconsistency between the approach for credit derivative counterparty risk and the rules for repo-style transactions. While the credit derivatives rules remain based on PFE factors, the repo-style rules base EAD on net unsecured exposure. As noted above in our comments with respect to repo-style transactions, we believe ISDA/TBMA/LIBA and the Federal Reserve have delivered important work on the topic of derivative counterparty risk measurement.

With respect to the ASRF approach, we believe the Federal Reserve has identified key risk drivers, but that the approach should be coordinated with the OTC derivative work. Accordingly, we believe it is important to consider the three correlation factors of ϱ_g, ϱ_o, and ϱ_{og}, but believe it is more important to focus our efforts on the portfolio effects of multiple exposures to a given counterparty. This will help us more accurately arrive at a coherent EAD.

More specific comments on counterparty risk include:

- Double default and double recovery

For CDS hedge counterparty risk, we believe it is appropriate to incorporate double default and double recovery effects, since actual credit loss is the result of joint default and joint LGD. For repo-style transactions, EAD is a function of market value (which under the proposed rules reflects default and recovery factors), risk sensitivities, correlations, and collateral. The product of EAD (which already contains default and recovery factors on the underlying), PD and LGD (both of the counterparty) reflects double default and double recovery effects.

- Correlation between an obligor and guarantor (ϱ_{og})

We agree conceptually with evaluating ϱ_{og}, but are currently focusing on the correlation between exposures with a given counterparty. For example, a significant portion of our credit derivative exposures are executed with large dealer institutions. We typically also have other credit derivatives, interest rate derivatives, equity derivatives, and other exposures with such dealers, in each case subject to a valid netting agreement supported by a collateral agreement. Properly assessing our counterparty credit risk requires properly assessing EAD for the portfolio (consistent with applying the netting benefits supported by the Agencies), which requires understanding for each counterparty all the exposures and correlations between those exposures, as well as documentation and collateral terms as noted above. There are typically offsets and diversification benefits within each counterparty portfolio, the effects of which can be significant.

- PFE add-ons

Regarding the proposed credit derivative PFE factors, we believe they do not generally reflect market risk factors or trade specific terms. For protection buyers, the value of protection purchased is first a function of the underlying asset and second a function of the credit quality of the counterparty. Consider protection purchased on a AAA underlying versus protection purchased on a BB underlying, both from the same counterparty. The cost of protection cannot be the same given differences in the underlying risk. Similarly, consider protection purchased on the BB asset, but in one case purchased from a AA entity and in another case from a BBB entity. The cost cannot be the same given the risk of obtaining protection from a BBB entity versus the AA entity. Similar analogies can also be made looking at correlations between the underlying asset and protection provider, where given comparable ratings, a protection buyer should only be willing to pay a lower premium for higher correlation between underlying asset and CDS counterparty. For instances of selling protection, the premium paid by the buyer should increase as their own credit quality declines. This premium is also impacted by correlation between the buyer and the underlying asset: the lower the correlation, the more valuable the premium. Given that the protection buyer's maximum risk to the counterparty is the loss given default (LGD) of the notional on the underlying, and the protection seller's maximum risk to the counterparty is the present value of the remaining premium payments, potential risk is higher for the protection buyer. Within the confines of the proposed rules, we believe the PFE add-ons for credit derivatives do not reflect the above considerations.

- Trading book vs. banking book

Also consistent with the OTC derivative rules, we believe capital treatment should be consistent regardless of whether credit derivatives are booked in the trading book or the banking book.

4. Equity

The definition of equity is sufficiently clear and we agree with the principles that are discussed in that section of the document. The ability for banks to use their internal data and models in consultation with supervisors is a theme of our response letter that cannot be emphasized enough. To the extent that the "methodologies used to compute the banking organization's estimated loss" are those "used by the institution for internal risk management" and "fully integrated into the banking organization's risk management infrastructure," equity exposures are no different from our loan portfolio at Wachovia Bank.

Furthermore, we agree that nationally legislated programs that support small business and community development are in the interest of the public

welfare. We are concerned that having such exposures included with other equity when calculating materiality thresholds may make banks reluctant to participate in these programs because to do so would push them over the imposed limit. Therefore we recommend removing CRA-type equity from the materiality trigger formula to prevent such a situation. Any equity given its own capital treatment should be taken out of a materiality formula for consistency's sake.

Finally, when determining capital treatment and materiality triggers, we encourage the Agencies to also consider other federal and state programs that promote public welfare but were not listed in the document. Examples include (but are not limited to) Low Income Housing Tax Credits, Historic Tax Credits, and New Markets Tax Credits.

C. Supervisory Assessment of A-IRB Framework

1. Conservatism

The 99.9% confidence interval embedded into the capital formulas is higher than necessary for a safe and sound banking industry. We understand this is largely due to the fact that the regulatory formulas do not separately cover all risks, such as business risk or interest rate risk in the banking book. The Basel rules published in CP3 describe how regulators can add on capital under Pillar II for a variety of reasons. U.S. regulators have indicated that Pillar II extends to the rest of the world authority that already exists in the United States and that supervisory add-ons should be no more common under the new rules than they are today. If this is not the case – if banks will have to hold additional capital under a Pillar II-type framework for many of the risks that are indirectly covered under Pillar I (and the leverage ratio) – then the Pillar I requirements contained in these rules are too harsh and the calibration of the formula will need to be revisited, specifically holding capital against losses at the 99.9% confidence interval.

Furthermore, if data is thin then we will be the first to support a degree of conservatism for prudent risk management. But if enough data exists and covers enough turns of the business cycle (as will be the case under the proposed framework), then the multiple layers of conservatism – recessionary LGDs and conservative parameter estimates – are unnecessary. We agree with the passage in the Supervisory Guidance indicating "margins of conservatism need not be added at each step." Compounding conservative estimates will produce a distorted, biased result.

2. Supervisory Guidance Document

We appreciate an advanced look at the more detailed guidance that supervisors will use when assessing a bank's compliance with the new Accord. We also recognize the Agencies' attempt to create a document that

is principles-based rather than overly directive. We find much of the document to be a collection of the best practices performed at institutions that are regarded as industry leaders in risk assessment and management. At the same time we find the document to be out of touch with some industry beliefs and too prescriptive about others. The differences are best expressed with a case-in-point.

Section II (Ratings for IRB Systems) includes the following principle:

> "Banks must adopt a ratings philosophy. Policy guidelines should describe the ratings philosophy, particularly how quickly ratings are expected to migrate in response to economic cycles."

This directive is followed by an explanation of what a "ratings philosophy" is, how a bank should consider the consequences of its decision, if it will be applied consistently across portfolios, and how the bank will account for capital fluctuations that may arise because of the ratings philosophy.

In short, the Agencies are instructing banks to analyze their internal data, make a decision, and think through the consequences of their decision. Fair enough.

Compare this to another principle that appears in the same section:

> "Banks must record obligor defaults in accordance with the IRB definition of default."

This directive is followed by a prescriptive discussion about what constitutes default and further instruction that data capture systems will have to be modified to accommodate this new regime of default definition.

Here, the Agencies are mandating a definition of default onto banks that is out of line with current industry practice and further mandating that banks create the necessary systems to accommodate the rule. This is a textbook example of regulatory burden.

These contrasting examples illustrate the tension in the Supervisory Guidance between principle and prescription that is found throughout the entire 101 pages. In many cases – particularly the principles themselves – the document takes the tone of the former: expressing a standard, explaining it, and leaving many of the specifics where they belong, with the bank's management. In many other cases – especially in the text surrounding the principles – the prescriptiveness of the latter example prevails. We believe this happens far too often and strongly believe that this and all future Supervisory Guidances would be more effective and less burdensome if the more prescriptive sections were re-written to be more principles-based. To do so would allow banks to build on risk management practices already in place as accepted regulatory procedures.

Where current practices are insufficient to achieve regulators' goals, the guidance should describe what is to be accomplished rather than specify the means to accomplish it.

We cite additional examples where the document could take a less prescriptive approach:

- We continue to disagree with the strict definition of default as outlined in the Supervisory Guidance. Please refer to the earlier "Wholesale" section of this document for elaboration.

- It goes without saying that an identifier or unique bucket for defaulted exposures will facilitate analysis of those crucial loans. However, to the extent that we already disagree with and do not match the Agencies' definition of default, adding such a default bucket will be a second layer of regulatory burden.

- Furthermore, separate exposures to the same obligor may not always deserve the same facility default grade, especially if some exposures are given special treatment. A perfect example is the asset-based lending environment where collateral is more closely monitored, even to the extreme of debtor in possession financing which includes the oversight of a bankruptcy court.

- We agree with the Agencies that granularity is an important attribute when analyzing default experience but we are concerned with the rules surrounding risk-rating modifiers. We recently innovated our grading system to include + & - because we thought such a practice would allow for better risk management. Years of results show that those buckets do indeed perform differently. (Reference confidential Attachment 3.)

  And while we have not written explicit descriptions of grades ***6+*** and ***6-***, we do have a policy about what differentiates ***"+"*** and ***"–"*** grades from a ***"base grade."*** We also have assigned each + and – bucket a unique PD consistent with historical performance. Therefore we believe it is the assignment of a PD and the empirical results that truly separate risk buckets, not the minimal differences that we would have to convey by adding finer gradations to a grading matrix with many subjective descriptions.

- As discussed in our sections on "Wholesale" and "Credit Risk Mitigation," the principle that risk-mitigating effects of guarantees can only impact PD *or* LGD is out of step with industry practice. This is another opportunity for the new rules to be flexible enough to match a variety of successful approaches by a variety of industry participants.

- The data history required for supervisory approval is generally reasonable, but transition measures are needed to ensure that the data is meaningful. Banks need ample time to develop such systems, especially for atypical parts of the portfolio. Banks should be encouraged to do this right rather than being forced into rushed implementation. If the grading inputs database, for instance, is done improperly, populating the database will require excessive amounts of unproductive time. It is easy to envision a process in which graders – having already made their decisions – go through a trial-and-error process until they get the database aligned with their risk assessment. The cost of an expensive grading process will be less accurate grading as resources are diverted to completing the forms rather than assessing the risks.

- Mandating the frequency of parameter estimate analysis and the audience for the exercise is to create a system at some banks that will not match the internal audit and control functions already in place. We agree that policies are needed, but believe that banks should be free to determine the appropriate governance structures for their own institutions.

- We believe the roles of the board and management are being blurred in some of the final principles and passages of the Supervisory Guidance. The depth and frequency of information that must be provided to the board of directors is out of line with current industry practice and not completely relevant for this group. Wachovia's shareholders care about the risk profile of the bank, so the board should be briefed on the corporation's risk management philosophy and structures in place to accomplish it. However, the managers of the firm are the ones that should deal with day-to-day specifics such as model assumptions and predictive accuracy.

IV. SECURITIZATION

A. Traditional Securitizations

Asset securitizations have more complex structures than most credit exposures. The proposed rules attempt to address their complexity but still contain several critical problems. The Basel Committee has recognized this and has announced that additional work will be performed in this area. We look forward to working with U.S. regulators to improve the rules in this critical area. Until then, we would like to comment on the rules *as they were written* in the August 4th Federal Register.

Deduction of Residual Interests

One notable problem is the current rule requiring a deduction of all retained interests representing capitalized future spread income. As we discussed in our CP3 response, we understand that this rule exists to prevent the "creation" of capital through the securitization process. However, as our illustration in the CP3 document shows, there are plenty of instances where the required deductions far exceed the capital added to the balance sheet in these transactions. Consequently, these rules inadvertently require more capital for securitized loans than for the same loans held on the balance sheet.

Two choices exist to correct the problem. The residual interests can be ignored, so that only that capital which is counted toward covering k-irb is required, or the residual can be counted toward k-irb. If a bank retains the riskiest tranches of the securitization and sells the least risky, both options are reasonable. However, if a bank holds the residual and sells mezzanine tranches, the former option would understate the bank's risk. We consequently recommend that residual interests be counted toward k-irb. Further, non-credit enhancing residuals contain little or no credit risk. We believe that no deduction should be required for these interests under the credit risk framework because it is repayment risk that makes the value of these interests uncertain; an internal models approach or a 100 percent risk weight may be the most reasonable charge for these assets.

Ratings-Based Approach

We believe that originating banks should be permitted to ***apply the Ratings Based Approach to all rated exposures they retain, not only those above k-irb***. Such treatment would better align the Basel requirements with both market practices and the capital that investing banks would be required to hold for the same exposure. An overall cap of k-irb is still appropriate. The Basel Committee has proposed eliminating the Supervisory Formula Approach, and we believe this additional step would solve several problems. First, applying RBA capital to positions below k-irb would be consistent with the market's view of the risks of these exposures. Banks that claim the Basel rules are treating them harshly – perhaps because their diversification and risk management have produced less volatile losses than assumed in the Basel formulas – would have recourse. They could take their claims to investors and rating agencies and potentially see a benefit in their capital

requirements by demonstrating that the risks of the underlying loans are adequately covered by subordinated tranches.

The application of the RBA without regard to k-irb would also solve some conceptual problems surrounding the proposed framework. A bank that sells all tranches down to k-irb surely transfers some risk to the senior investors. The investors have to hold capital for these risks, but no relief is granted to the seller. Our recommendation would provide relief to the seller if the positions below k-irb are rated to require less than 100 percent capital.

Further, permitting use of the RBA would simplify the MIS cost for banks that create securities to be sold in their entirety. The utmost example of risk transfer is a bank that packages loans and sells all tranches of a securitization. Banks often enhance the marketability of these securities by occasionally buying some of the securities in the secondary market, thus increasing liquidity. Such banks are not required to maintain complete risk information for these securitizations when they have sold everything. But all the Basel grading and MIS requirements would suddenly apply if a bank bought a security backed by these loans. Such a requirement would make these transactions prohibitively expensive and create a disincentive to engage in these risk-reducing activities. Holding capital for these exposures based on the RBA without regard to k-irb would keep compliance costs reasonable while still requiring originating banks to hold as much capital as an investing bank.

Capital Rate Calibration for Rated Securities

Several comment letters on CP3 noted that the capital rate assigned to the most senior securitization tranches is too high. The analysis in the paper submitted by the ASF, *et al,* concludes that the capital assigned to senior non-CDO tranches by the Perraudin-Peretyatkin model is always at least 3 times too high and often even more severe. Even with the thick/thin and granularity adjustments, which are conceptually sound, rates are too harsh for the least risky tranches.

We are very much in agreement with the ASF's recommendation that a much lower floor be used for the most senior tranches in a securitization. The complement to this conclusion is that subordinated tranches may need more conservative assumptions regarding LGD. We would not oppose more conservative rates for speculative grade tranches, especially if combined with an agreement to permit the use of the RBA for positions below k-irb.

Getting the capital right for senior positions is vitally important if banks are to use securitizations to transfer meaningful risks. A common structure has the originating bank holding a residual interest, investors owning the mezzanine tranches, and the originator retaining a large super senior position. If the charge for the super senior tranche is too high, banks will find no regulatory capital benefit from transferring the risky portion of such a structure to investors. While the economic capital benefits of such a deal would likely lead banks to do them even without the regulatory capital benefits, the regulatory capital framework should avoid such distortions.

B. Synthetic Securitizations

Synthetic securitizations are increasingly used to transfer risk. The excessively conservative substitution approach to credit risk mitigation could put an end to the use of these structures in favor of cash or collateralized deals. Such punitive treatment is not justified. All of our comments on credit risk mitigation through credit derivatives apply here. In addition, we ask that reasonable rules be developed to handle partially collateralized deals or other approaches that may develop in response to these rules.

C. Asset Backed Commercial Paper Programs

The proposed rules for ABCP conduit programs attempt to handle many aspects of managing the risks of these exposures – the credit risk of the underlying assets, whether that risk can be estimated using top-down or bottom up approaches, how to measure or control the risk of dilution, the risk of available commitments, etc. We believe that many of the proposed rules fall short of best practices. Banks consider all these issues ***and more*** in assessing the risk of their exposures to ABCP programs.

As noted by the ASF, *et al*, in their response letter, banks, rating agencies and market participants have already built methodologies around the way that records are kept in the real world so that performance data can be easily placed in to the context of a desired structuring result. Industry performance testifies to the fact that deals have been successfully structured for years with this approach, and validation systems are already in place that would be at the disposal of regulators.

Attempting to match ANPR rules to this current state, however, misses the real issue. As we have so emphatically said elsewhere, implementation must build on banks' dynamic risk management practices. Even if regulators can codify today's best practices, banks will advance their understanding of the risks involved with these conduits, possibly even before the new capital framework is even implemented.

We therefore strongly urge that banks be permitted to produce their own internal ratings for their liquidity and credit enhancement positions. The PD, LGD, and EAD estimates for these exposures can be validated as well as many other internal estimates. Since securitizations have more systematic risk than a single-borrower exposure, it would be appropriate to use a capital function with higher asset value correlations but much less complicated than the proposed framework.

V. AMA FRAMEWORK FOR OPERATIONAL RISK

Wachovia recognized the need to establish a distinct Operational Risk capital charge when we revised our economic capital models in 2000. Although this discipline is in the early stages of development, we believe that there is great value in quantifying these risks. Therefore, we strongly support the use of internally developed models that align regulatory capital with economic capital models, which are used to measure earnings volatility and evaluate performance on a risk-adjusted basis.

We appreciate the consultative process and notable improvements to the new Accord over the past three years. Operational risk measurement and management practices are still evolving rapidly. Ongoing dialogue and flexibility are therefore necessary to ensure that valuable disciplines evolve at large, complex financial institutions.

Increasing Specificity and Prescriptiveness

We recognize the need to achieve a balance between providing clarity and becoming overly specific and prescriptive. Where information is included to provide context, we suggest the guidance be referred to as **examples**, rather than **requirements**. This concept applies in the following sections:

- Firm-wide Risk Management Function – Supervisory Guidance/Paragraph 21 indicates the responsibilities of the independent firm-wide risk management function include periodically reviewing the institution's operational risk framework to consider the loss experience, effects of external market changes, other environmental factors, and the potential for new or changing operational risks associated with new products, activities, or systems. This review process should include an assessment of industry best practices. These are considered highly prescriptive requirements and we are not clear how an assessment of industry best practices would be conducted.
- Policies and Procedures – Standard 8/Paragraph 26 indicates policies and procedures should outline all aspects of the operational risk management framework. Paragraph 26 is very specific regarding the management and measurement information that should be included in the policies and procedures.
- Operational Risk Management Reports – Standard 9/Paragraph 29 specifically outlines what information management reports should summarize and requires reports to be produced at least quarterly. We disagree with the requirement to produce quarterly reports and believe the frequency of reporting should be based on need. Also, we are unclear of expectations regarding reports, which are referenced as *operational risk causal factors.*
- Internal Control Environment – Standard 11 requires an institution's internal control structure to meet or exceed minimum regulatory standards. The requirement to exceed minimum regulatory requirements is new and unclear.
- Internal Operational Risk Loss Event Data - Standard 15/Paragraph 41 indicates the level of detail of any descriptive information should be commensurate with the size of the gross loss amount. While agreeing it is important to understand large loss events, we do not agree the level of descriptive information about an

event should be determined by the size of the event. It is sufficient to document a clear description of the loss event.

- External Data – Standard 20/Paragraph 47 specifically outlines what external data should be collected. *Sufficient information about the reporting institution to facilitate comparison* may not be available from consortium or public databases.
- Documentation of Analytical Framework – Standard 26/Paragraph 61 requires extensive documentation for all assumptions embedded in the chosen analytical framework. Some of the documentation referenced in this standard may need to be based on qualitative assumptions rather than quantitative assumptions (e.g., dependence assumptions).
- Data Maintenance – Standard 31/Paragraph 73 requires comprehensive definitions for each data element used by the institution for operational risk loss events or risk assessment inputs.

Need for Clarification

Certain issues are discussed in the ANPR where we are unclear on the underlying principle and intended purpose. It is important to note that we are not seeking prescriptive guidance on these topics. Sections where additional clarification of principles or specific "terms" is requested include the following:

- Background – Supervisory Guidance / Paragraphs 5 & 6 indicate an expectation to develop an analytical framework that translates loss data and risk assessments into an operational risk exposure resulting in a capital number. A clear definition of risk exposure is requested.
- Board and Management Responsibilities – Standard 2 / Paragraph 17 and 19 reference several responsibilities:
    - Risk Tolerance – Responsibility to identify the institution's tolerance for risk.
    - Authority for Managing Operational Risk – Responsibility to identify the senior managers who have authority for managing operational risk.
    - Remuneration Policies – Responsibility to institute remuneration policies consistent with the appetite for risk and sufficient to attract qualified operational risk management and staff.
    - Management must communicate operational risk issues to appropriate staff that may not be directly involved in its management.
    - Management responsibilities include ensuring that risk issues are communicated with staff responsible for managing credit, market, and other risks.
- Internal Operational Risk Loss Event Data - Standard 15 indicates an institution must have at least five years of internal operational event loss data captured across all material business lines, events, product types, and geographic locations. We request clarification regarding the reference to product types and geographic locations.
- Business Environment and Internal Control Factor Assessments - Standard 15/Paragraph 50 indicates the business environment and internal control factor assessments should reflect both the positive and negative trends in risk management within the institution as well as changes in an institution's business

activities that increase or decrease risk. We would appreciate more clarity regarding the assessment and trend analysis of the business environment.

- Policies and Procedures - Standard 25/Paragraph 54 indicates the institution must have policies and procedures that define scenario analysis and identify its role in the operational risk framework.
- Analytical Framework - Paragraph 29 describes different capital approaches being used today as bottom-up (loss distribution for each business line/loss type) or top-down approaches (loss distribution on firm-wide basis with allocation methodology to assign capital to business lines). Paragraph 65 indicates institutions must carefully consider the conditions necessary for the validity of top-down approaches. We would appreciate more clarity regarding how top-down approaches can satisfy the requirements for a risk-sensitive AMA model.

Corporate Governance

The roles of the Board of Directors, management, operational risk management, lines of business, and audit are outlined sufficiently in the ANPR. We are not in agreement with the requirement for the Board of Directors to oversee the development of the firm-wide operational risk framework. We believe the Board should approve the conceptual framework but management should be responsible for developing the framework and approving the plan of implementation.

Roles and Responsibilities of Supervisors

Regulations should clearly delineate the respective roles of the different U.S. financial supervisory bodies. The interpretation and implementation of Sarbanes-Oxley, Basel II, FDICIA, and other legislation and regulation should be coordinated to remove potential duplications and contradictions, saving compliance costs.

Currently, it is unclear what the roles of the Fed, OCC, FDIC, NASD and SEC will be in supervision of operational risk management. The banking and other regulatory agencies concerned should review overlaps in their rules and regulations flowing from recent and established law and regulatory initiatives. This would reduce unnecessary regulatory burden and greatly help affected institutions plan their implementation of the necessary changes in the systems, organization and processes.

Supervisory Approach

The ANPR indicates supervisors will exercise considerable judgment in evaluating an institution's compliance with each of the standards and how well the individual standards complement and reinforce one another within the overall measurement and management framework. We believe financial institutions should demonstrate to regulators how their newly developed methods of managing and measuring operational risk comply with individual supervisory standards and are integrated to reinforce one another. Supervisory oversight should occur through validation of this process.

Home / Host Supervision

Provided it acts in accordance with international supervisory standards, the home country supervisor should have responsibility for reviewing and approving the soundness of the bank's AMA regulatory capital methodology, including the top-down apportionment of

capital to individual legal entities. Host supervisors should rely on the home supervisor to review the conceptual soundness of the AMA model; with the primary responsibility of ensuring the apportionment of capital in their jurisdiction is based on sound principles.

Analytical Framework

Supervisory Standard 27 indicates the institution's operational risk analytical framework must use a combination of internal operational loss event data, relevant external operational loss event data, business environment and internal control factor assessments, and scenario analysis. Paragraph 57 suggests these framework elements be included as inputs to the analytical approach. We believe it is useful to consider these elements in developing the analytical framework. We do not believe it is appropriate to require all of these components to be included as inputs and suggest incorporating clarifying language allowing flexibility regarding use of all components.

Expected Loss

Supervisory Standard 28 indicates the capital requirement for operational risk will be the sum of expected and unexpected loss unless the institution can demonstrate, consistent with supervisory standards, the expected loss offset. We believe the capital charge for operational risk should represent unexpected losses only. Expected losses for operational risk typically are budgeted and factored into the pricing for products and services. The Basel Committee recently indicated expected losses would not be included in credit risk capital. To be consistent, we recommend this approach also be adopted for operational risk capital.

Correlation

Standard 29 requires documentation of dependence (e.g., correlations) among operational losses across and within business lines. Institutions must demonstrate explicit and imbedded dependence assumptions are appropriate, and where dependence assumptions are uncertain, the institution must use conservative estimates. Paragraph 64 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 these assumptions are appropriate and reflect the institution's current environment.

The requirement for institutions to demonstrate the appropriateness of explicit and imbedded dependence (correlation) assumptions needs to be clarified. It is important that reasonability be incorporated into this standard. Insufficient data will be available to statistically estimate correlation across business lines and event types. Therefore, correlation most likely will be determined by qualitative reasoning based on the underlying nature of the risks. We suggest the language in this section recognize qualitative judgment will be necessary and flexible approaches be allowed, provided institutions have a well - reasoned basis for their assumptions and are actively working to better understand available risk data upon which to derive correlation assumptions. It is important that overly conservative criteria not be applied regarding correlation assumptions so those banks using more risk-sensitive, bottom-up approaches to the quantification of capital are not penalized. Also, given the problems inherent in derivation of correlation estimates, it will be very difficult to implement "non-constant" correlation. The requirements regarding correlation assumptions should be less stringent at this stage of operational risk capital quantification, should incorporate the concept of materiality, and should not be overly prescriptive and unrealistic.

External Data

Standard 21 indicates management must *systematically review external data to ensure an understanding of industry experience* and Paragraph 46 suggests external data may serve a number of different purposes in the operational risk framework. We agree that external data has the potential to serve a number of useful purposes, but have concerns about its appropriateness as a quantitative input due to its limited availability and uncertain relevance. Guidance on the use of external data needs strengthening. We suggest incorporating language acknowledging the need for ongoing industry dialogue on the effective use of external data during implementation.

Risk Mitigation

Standard 30 indicates institutions may reduce their operational risk exposure by no more than 20% to reflect the impact of risk mitigation. The 20% ceiling is arbitrary and an explanation is not provided for the basis of this ceiling. It may serve as a disincentive for financial institutions to fully utilize the protection that may be afforded by insurance and other risk mitigations. We believe the capital adjustment for insurance should not be restricted to 20%, but should be based on the amount of insurance protection provided. It is particularly restrictive when considering the criteria necessary for insurance to qualify as a capital offset. For example, most policies have exclusions or limitations based on regulatory actions. We also believe insurance provided by captive insurers should be allowed as a capital adjustment provided qualitative criteria is met, and regulations should provide flexibility allowing for recognition of other risk mitigation products that may emerge in the future. If securities products and other capital market instruments are analyzed and determined to be an effective offset to capital, we believe they should be allowed to be factored into the regulatory capital calculation.

Definition of Operational Risk Loss

Currently, operational risk losses must be "...recorded in the institution's financial statements consistent with Generally Accepted Accounting Principles (GAAP)". We are not in agreement that operational risk losses need to be balanced and reconciled to the general ledger. Many operational risk losses do not get posted to the general ledger as discrete losses, particularly in trading businesses. The supporting information for the loss is often found in the narrative of the incident description as opposed to in a general ledger-posting document. We do agree that losses in the Operational Risk databases need to be compared with the general ledger and difference noted.

The ANPR notes indirect losses (e.g., opportunity costs) have not been included in the definition of operational risk against which institutions would have to hold capital, but indicates such losses can be substantial. The ANPR also solicits comment on whether indirect losses should be included in the definition of operational risk. We oppose consideration of indirect losses such as opportunity cost in the definition of operational risk. Issues would emerge relating to the accuracy of measurement and uniformity in application.

The ANPR includes in the definition of Operational Risk Loss the requirement to capture all of the out-of-pocket expenses associated with an operational event. We recommend requiring the capture of material, rather than all, out-of-pocket expenses associated with an operational loss event.

Legal issues

Definitions of Operational Risk

The ANPR employs the definition of operational risk set forth in The New Basel Capital Accord (Basel II), that is, "the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events… include[ing] legal risk . . . ." *See* The New Basel Capital Accord (April 2003) at para. 607; 68 Fed. Reg. 45978 (2003). Whereas Basel II does not provide a definition, the ANPR defines legal risk as "*the risk of loss resulting from failure to comply with laws as well as prudent ethical standards and contractual obligations. It also includes exposure to litigation from all aspects of an institution's activities.*" 68 Fed. Reg. 45978 (2003) (emphasis added).

Legal Risk Should Not Be Classified as a Component of Operational Risk

Wachovia maintains that legal risk should not be classified as a component of operational risk. In most cases, legal risk is simply the realization of other forms of operational risk which the AMA already accounts for. Legal liabilities naturally arise from these risks. Notwithstanding the Basel Committee's recent conception of operational risk, the U.S. and international banking community's understanding generally has been that operational risks are those risks "associated with potential failures in a bank's operational processes, or in the systems that support them. Possible *adverse consequences of operating risk* range from financial loss to reputational damage, *hostile litigation, regulatory penalty*, and even enforced closure of the bank." E. Cade, Managing Bank Risks (Cambridge, UK: Woodhead Publishing Ltd./The Chartered Institute of Bankers, 1997) (emphasis added) at 191. Litigation expenses and related losses are clearly consequences of operational risk rather than its causes. Attempts to quantify the legal risk alongside the traditional types of operational risk will almost certainly result in categorical confusion and the double-counting of potential losses.

Attorney-Client Privilege

To include litigation exposure in the definition of operational risk threatens the attorney-client privilege. By including litigation exposure in the definition of operational risk, the definitional framework implicitly anticipates that an institution will collect and include in its risk calculations potential litigation exposure. Estimates of litigation exposure are among the most closely guarded confidential information within any financial institution or other company and historically have been protected from disclosure to third parties because they are subject to the well-established legal doctrine of "attorney-client privilege." Disclosure of this information to individuals beyond the small number who fall within the scope of the attorney-client privilege and must know the information for management or legal representation purposes can be deemed a waiver of the attorney-client privilege. A waiver of the attorney-client privilege would subject this highly confidential information to disclosure to opposing parties in litigation. The dire consequences to an institution resulting from the disclosure of its estimate of legal risk exposure on a case would make it practically impossible to reasonably settle or otherwise resolve that case and could result in catastrophic consequences to the institution. Wachovia views these consequences as so significant that we strongly oppose any requirement

that would result in the gathering or reporting of litigation exposure information as part of the operational risk assessment process.

Historic Litigation Data at a Case or Matter Level

The inclusion of historic litigation data at a case or matter level increases an institution's exposure to increased litigation losses by exposing information (which generally is kept confidential and used internally for management purposes) to the plaintiffs' bar. Data gathering at the matter level may disclose, for example, that an institution has several claims of a particular type. While management should surely be made aware and address the issues, such information would be harmful to the institution if publicly disseminated. If the capital charge for the legal risk component of operational risk, or if particular event level data are disclosed (which could become available through the discovery phase of litigation or be determined indirectly through the publicly available information), detrimental results would likely follow. The plaintiffs' bar would likely use any amounts identified for expected losses—and particularly the capital cushion for unexpected losses—as a proxy for commencing litigation against a financial institution. Financial institutions assessing the most conservative measures of legal risk would be the most penalized. To implement a system that increases risk to the institution would defeat the purposes for measuring operational risk and managing to reduce it. Loss data for litigation losses should be gathered at a business unit level rather than at an event level. Internal management should be informed of the events that compose the overall loss number, but it substantially increases risk to the institution to disclose such information at the case or individual matter level.

Recommendations

Wachovia recommends reconsideration of the concept that legal risk should be classified as a component of operational risk. Broadly speaking, legal risk is a consequence rather than a cause or component of operational risk. Specific forms of legal risk not endemic to other types of operational risk should be identified as such. In addition, should legal risk be classified as a component of operational risk, we recommend that the final rules provide a "safe harbor" provision, based upon the attorney-client privilege, to protect from disclosure to third parties information related to an institution's legal risks and litigation exposure.

VI. DISCLOSURE

We agree with the concept that market discipline is an appropriate force in evaluating comparative funding and capital costs of banking organizations. We also agree that proper disclosure of pertinent risk information is important in that regard. Clear, transparent, and understandable information is needed in all disclosures, and Wachovia continues to be a leader in this arena.

We strongly believe that the disclosure requirements should be principles-based rather than the prescriptive listing of requirements that is now part of the ANPR. We feel under a principles approach, the quality of the resulting disclosures and explanations will better allow the market to determine relative risk.

We believe the following situations will arise if the disclosure requirements are not modified from their current version.

- Specific disclosure requirements outside of those already mandated by the SEC may result in the publication of confusing or apparently contradictory numbers. A set of broad guidelines from the Agencies would be more appropriate, permitting banks to present data in ways that complement SEC rules.

- The current level of proposed disclosure will most likely be useful only to highly sophisticated financial statement users.

- The risk of misinformation through a prescriptive listing of disclosures is overly high, far outweighing potential benefits of transparency.

- Disclosure of detailed default and severity information on a quarterly basis can easily be misinterpreted by analysts and investors. For example, normal fluctuations of expected and actual results around defaults and recoveries can lead to unjustified negative reactions.

- True comparability of detailed data across institutions will not be possible without standardizing risk management practices. This includes parameters such as rating bands and each bank's quickness of re-grading in response to the business cycle. Since these practices go to the heart of risk management, they should be determined internally rather than imposed by regulators, thus leaving true comparability unattainable.

- Overly detailed disclosures may be meaningless to most investors, but with a few simple assumptions, may effectively disclose confidential information to competitors or potential acquiring firms.

Finally, we believe that the location and style of disclosures should be left up to management, within existing SEC guidelines. For example, there are already SEC disclosure requirements for market risk that provide ample information to the public. Again, a principles-based approach would be more appropriate and better achieve the spirit of a true market discipline.

VII. REGULATORY ANALYSIS

We appreciate the Agencies' willingness to comprehend the costs and other effects of all the requirements laid out in the new Accord.

As we noted earlier in this document, the new rules will not themselves change the competitive landscape because more and more banks use economic capital to guide decisions. Economic capital allows a deeper understanding of risk and that is a competitive advantage for which banks should be rewarded. Such an understanding also strengthens the entire system. These innovations will transpire with or without the new Accord, just as they did under the first Accord.

What is yet to be determined is the ***incremental*** cost to become a Basel bank. If regulators build on systems and processes already in place, that cost will be small. Alternatively, implementation rules that require additional or nearly redundant systems for compliance alone will result in costs so great that mandatory Basel banks will be at a competitive ***dis***advantage, despite the possibility of lower minimum capital requirements. An overly prescriptive approach will cost Basel banks dearly compared to non-Basel banks and unregulated competitors. A principles-based implementation can be accomplished without diverting funds from more productive uses.

Administrative Studies

Appropriate implementation should not require expenditure levels – beyond what banks will incur anyway in building systems to support the risk infrastructure they need to stay competitive – that would trigger the regulatory analyses described in the ANPR. But, as noted above, it is not clear how regulators will approach implementation. The ANPR and Supervisory Guidance are filled with an ambiguous mix of good intentions and ominous indications that regulators will impose their own definitions and methodologies that force innovative banks to duplicate systems and processes. Consequently, it would seem necessary for the Agencies to complete the analyses described in E.O. 12866 and the UMRA. It would, however, be premature to undertake such studies at this time. Banks cannot know if their compliance costs will be just a few million dollars or many tens of millions until the Agencies' intentions regarding implementation are much clearer. (Wachovia believes its costs will be in this range, depending on the manner in which the regulations are implemented.)

Understandably, banks are anxious to know the answer to this question. Banks can reasonably be expected to make the expenditures now that contribute to their risk management processes and that will provide the information needed for a Basel system that complements their work. But it is very difficult to invest today in special systems and modifications that will be needed *if* regulators insist on a different definition of default or some other practice whose only apparent benefit is compliance. Since the implementation deadline is approaching rapidly, the costs of the redundant systems will escalate in order to complete the work on a compressed schedule if the prescriptive approach is taken. We certainly urge the Agencies to embrace an implementation approach built on the industry's evolving best practices instead of one that standardizes too much.

CONTACT INFORMATION

For credit risk:

Gary Wilhite
Senior Vice President
(804) 697-6741
gary.wilhite@wachovia.com

For operational risk:

Richard Campbell
Senior Vice President
(704) 383-1452
richard.campbell@wachovia.com

For all other areas:

Chris Livingston
Senior Vice President
(704) 383-9760
chris.livingston@wachovia.com