WELLS FARGO

December 31, 2003

Basel Committee on Banking Supervision
Bank for International Settlements
2 Centralbahnplatz
CH-4002, Basel, Switzerland

1154

Re: The Proposed Treatment of Expected and Unexpected Losses Under the New Basel Capital Accord

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

Sincerely,

George Wick

George D. Wick
Senior Vice President, Credit Risk Architecture

cc: Basel 2003 Capital Proposal
Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Basel 2003 Capital Proposal
Office of the Comptroller of the Currency
250 E Street, SW
Public Information Room
Mailstop 1-5
Washington, DC 20219

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments, Basel 2003 Capital Proposal
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Enclosure Attached

Wells Fargo & Company appreciates the opportunity to participate in the ongoing dialogue on the Basel capital reform proposal. Our comments here will address the October 11, 2003 proposal ("Proposal") by the Basel Committee for a modified treatment of Expected and Unexpected Losses under the new Basel Capital Accord.

Referring back to some of our earlier comment letters, we have always tried to make two basic points regarding EL:

1. Wells Fargo thinks of the loan loss reserve (ALLL) as another form of capital. We see no reason why banks should not be able to effectively count their entire ALLL as capital, regardless of the proposed treatment of EL in the risk-weighted asset formulae. Usage of the ALLL as capital should not be capped at 1.25% of risk-weighted assets (RWA), or aggregate expected losses (EL).

   The proper risk-based capital treatment for the ALLL, we believe, is to consider the entire reserve as part of Tier 1 capital. Such treatment would recognize the fact that the ALLL possesses the same ability as equity capital to absorb losses and avoid insolvency. This property separates the ALLL from other Tier 2 capital components, such as subordinated debt. Furthermore, were the entire ALLL to be included within Tier 1 capital, the effect of cross-border differences, or cross-time differences, in the accounting standards for the ALLL would, we feel, be eliminated, given the parity imparted to equity and the ALLL in the risk-based capital ratio computations.

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

   The internal capital generation created by Future Margin Income (FMI) acts as a primary buffer against losses in the portfolio, even before loan loss reserves and equity capital are drawn upon. While this concept has long been valued by bank debt rating agencies in their evaluation of bank capital structures and securitizations of pools of assets, it has been virtually ignored in the Accord. Furthermore, it should be acknowledged that Future Margin Income is found throughout a diversified bank holding company and, regardless of its source, serves as a component of internal capital generation. Wells Fargo's position has always been that some fraction of <u>all</u> FMI, not just the FMI found in higher-margin retail lending portfolios and businesses characterized by operational risk, should serve as a deduction to required Pillar 1 capital.

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

While there are various ways in which the risk-based capital rules could reflect the accumulation of different forms of capital to provide a buffer against expected and unexpected losses, we believe that the most effective solution is to simply exclude EL and FMI from the computation of required capital. We elaborate on this thought below.

Wells Fargo believes that the new Proposal, while moving in the right direction, still has several shortcomings. The Proposal effectively removes EL from <u>both</u> the computation of *required* capital and the identification of *actual* capital, with only modest additional changes to the capital formulae. Under this approach <u>the resulting risk-based capital ratios are left essentially unchanged</u>. This treatment effectively presumes that the purpose of the ALLL is to "cover" expected losses. Although there would be recognition given to ALLL in excess of EL (up to a proposed cap of 20% of Tier 2 capital) in the computation of Tier 2 capital ratios, Future Margin Income would no longer have any presence in the risk-based capital calculations.

As mentioned in our introduction, we believe that it is inappropriate to establish such a tight linkage between the ALLL and EL. The ALLL is just one form of capital that can be drawn upon to cover EL. However, in practice, internal capital generation (a derivative of FMI) would offer the "first line of defense" against such losses and equity capital also offers similar protection, but would probably be the last form of capital called upon. As there is no direct correspondence between any one element of bank capital and any one source of a bank's losses, it should also be evident that there should be no arbitrary limits set on a bank's capital, such as the 20% cap for the excess ALLL outlined in the Proposal.

It should also be evident that, by demoting the ALLL to the rank of Tier 2 capital (on par with subordinated debt), the Accord is seriously mis-representing the relative worth of those two accounts, in terms of their ability to ensure the solvency of a banking organization.

We believe that excluding EL from the computation of required capital offers a simple solution to a problem that, otherwise, can become quite complex. The presumption of this solution is that FMI, in aggregate, covers Expected Losses, in aggregate. Given the fact that sound bank pricing practices require that pricing cover expected losses, associated non-interest expenses, and a targeted minimum return on economic capital, there is actually a "buffer" in this assumption - the FMI increment attributable to providing a minimum return on required capital.

If banking regulators are concerned that FMI is not known with certainty and could fail to cover expected losses under certain scenarios, one should consider the power of diversification within a portfolio and its tendency to reduce the volatility of FMI across a collection of imperfectly correlated businesses. Furthermore, given that management of banking products takes place at a sub-portfolio level, most banks would have incentive systems in place to re-price products that were performing so poorly as to be unable to at least provide FMI in excess of expected losses. Such products would not only detract from shareholder value, but would actually be producing a negative RAROC. If necessary in certain circumstances, banking supervisors could always make use of Pillar 2 as a forum to require additional capital of a bank whose FMI was judged to be insufficient to offset its expected losses.

We believe that the arguments in support of eliminating EL from the capital calculation on theoretical grounds are persuasive. However, having said this, we are concerned about the impact that such a change would have on the proposed Accord. It is clear that, by removing EL from the equation, all banks' capital ratios will increase. If the current formulation produced a global banking system capital requirement that met the goals of the Basel Committee, how will the Committee react to a proposal which detracts from that level?

There would seem to be two potential answers to this question. The Committee could either recalibrate the risk-weighting equations (most likely through the use of higher asset value correlation (AVC) assumptions), which we think would be compounding a pre-existing flaw in the process (the retail AVC's being too high to begin with). Or, the Committee could choose to live with higher capital ratios.

The alternative of higher capital ratios seems innocuous. However, in the United States, a well-capitalized leverage requirement (Tier 1 to Total Assets ratio) is imposed in addition to the risk-weighted standards. As risk-weighted capital ratios become higher, the leverage ratio may become more binding for certain banks. And, having a leverage ratio as the more binding constraint would undermine the purpose of a risk-sensitive capital framework. In fact, one could envision a scenario where banks priced in a risk-sensitive framework, *subject to* the constraint that their internally allocated capital always exceed the minimum leverage standard. In this scenario, those assets that would suffer most directly would be the least risky assets (for which risk-based capital was lower than the minimum leverage standard). If banks were to divest such assets in efforts to meet minimum regulatory leverage standards, the risk in the system would increase - exactly the opposite result that would be desirable from a safety and soundness standpoint.

As a result, we believe that the Basel Committee and the U.S. banking regulators should attempt to reach a consensus on the exclusion of EL from the required capital calculation, but also set out a more extended time frame to attempt to address some of the other issues that might be accentuated by this solution to an isolated problem. Among these issues, we would include: the classification of the ALLL as Tier 2, rather than Tier 1, capital; the value of having a Tier 2 capital ratio; the use of 99.9% as a confidence level for minimum (as opposed to well-capitalized) capital standards; and, the appropriateness of a leverage ratio standard that could dominate the impact of the risk-based standards.

We appreciate the opportunity to engage in a continuing and constructive dialogue, and look forward to further iterations of the new Accord.