WELLS FARGO

Howard I. Atkins
Executive Vice President
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MAC A0101-121
420 Montgomery Street
San Francisco, CA 94104
415 396-4638
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November 12.2003

To: Addressees

Re: Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital

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,

Howard I. Atkins
Executive Vice President and Chief Financial Officer

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

Docket No. 03
Communications Division
Third Floor
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

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

Enclosure Attached

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Wells Fargo & Company appreciates the opportunity to participate in the ongoing dialogue on the Basel capital reform proposal. While we respect the tremendous amount of time and effort that has gone in to shaping the proposal, we find that we still have some fundamental differences of opinion with the path on which the Basel Committee and the U.S. banking supervisors are proceeding and feel that certain aspects of the proposal must be changed in order for it to be acceptable.

We will direct our comments here to the Draft Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital dated July 2, 2003. We have drafted separate comment letters for the related Advanced Notice of Proposed Rulemaking ("ANPR) and the Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit, although we may allude to some of that commentary in the course of this dialogue.

Wells Fargo has a basic difference of opinion with the Basel Committee with respect to the capital treatment of Operational Risk, insofar as we don't believe that capital should be required for Operational Risk at all. To understand this perspective, one must first bifurcate operational losses into two segments -- 1) high frequencyllow severity losses that can be statistically assessed, expensed, and priced for, and 2) low frequencylhigh severity losses that cannot be reliably modeled.

We would argue that high severity losses should be outside the scope of a formulaic approach to minimum regulatory capital standards, because they are unpredictable and so remote as to be outside the statistical bounds of what should be captured in capital at risk formulae. We also feel that the more predictable forms of operational losses are 1) **simply a cost of doing business** to a bank and, therefore, routinely factored into the way that banking products are priced, 2) quite **stable over time,** because of their predictability and absence of correlation across businesses, and 3) **likely to be entirely offset by the Future Margin Income generated by a bank in aggregate,** across all of its operational businesses. Many of these losses are either expensed or accrued for by banks, and hence requiring capital charges as well would be a form of "double counting." Because the Advanced Measurement Approach (AMA) would allow for the recognition of imperfect correlation of risks and the impact of Future Margin Income, we feel that the aggregate outcome of such modeling of predictable operational losses would typically result in a zero capital requirement, and thus, such risks should simply be exempted from the minimum regulatory capital requirements in the first place, as they are today.

In the event that the Basel Committee and the U.S. regulatory authorities deem it prudent to persist in their direction to assign regulatory capital to operational risk, the primary point that Wells Fargo will emphasize lies with the AMA itself. Although the draft supervisory guidance on the AMA approach is, in many ways, more enlightened that the Accord's credit risk capital formulations (in terms of its recognition of Future Margin Income and portfolio diversification benefits), it should be acknowledged that there is no accepted methodology for quantifying Operational Risk.

As such, we believe that the AMA approach should not be the only option made available to U.S. banks. All institutions subject to the Accord should be allowed to develop any risk measurement methodology (Basic Indicator, Standard, AMA, or other alternative) that is acceptable to their national banking supervisors, and to disclose their methodology and their key controls for managing operational risk in their public filings.

The proposed AMA framework for Operational Risk leaves banks with the task of developing a complex and costly methodology for operational loss estimation. This choice begs the question of whether there may be an alternative approach that demonstrates that no capital is required for operational risk, given a particular bank's facts and circumstances, or whether there are alternative approaches to determining operational risk capital that are consistent with the way sound businesses actually operate, without being overly complex or costly to administer.

For example, we note that the well-known concept of operating leverage, or business risk, seems to be totally overlooked in the Basel Committee's operational risk capital deliberations. We feel that constructing a business-based approach to operational risk capital should be viewed as an acceptable alternative to the AMA track. We would encourage further discussions between the regulatory agencies and their regulated institutions along the lines of quantifying the main elements, definitions, and procedures of this type of framework.

Aside from emphasizing this important, general concept, there are several specific comments that we have on the details of the Supervisory Guidance.

Definition of Operational Risk

Paragraph 10 of the Supervisory Guidance defines operational risk to include "...exposure to litigation from all aspects of an institution's activities." This would appear to include settlements of baseless lawsuits as operational risk losses. In many cases, these settlements are made to control costs or to maintain customer relations and more appropriately represent strategic risk rather than operational risk. We believe that this language should be modified, so that banks would have some flexibility to exclude certain lawsuit settlements from the scope of operational risk capital.

We also believe that because many operational losses do not get posted to the general ledger as discrete items (e.g., trading losses), the U.S. Banking Supervisors should acknowledge that a reconcilement of operational loss data to the general ledger is not expected or required.

Corporate Governance of Operational Risk

Paragraph 15 of the Supervisory Guidance appears to mandate that an independent, firm-wide operational risk management function exist, which is separate from line of business management oversight. We believe that such a directive is premature, given that a consistent, well-meaning definition of what operational risk comprises does not yet exist. Under these conditions, how can there be a central committee to oversee something that is not defined?

For similar reasons, we are concerned that banking supervisors may interpret Paragraphs 16 and 17 to develop unrealistic expectations for the board of directors' involvement in the oversight of operational risk management. Paragraph 16 states that "the Board is responsible for overseeing the establishment of the operational risk framework, but may delegate the responsibility for implementing the framework to management." It is difficult to require board of directors oversight for something that is not well defined.

Rather than trying to devise a "one size fits all" central oversight function for operational risk management, we think that the Supervisory Guidance should be re-worded to simply require that there be a thorough governance process for overseeing what may be multiple types of operational risks, with the details left to the discretion of individual banks.

Validity of Extreme Loss Modeling

Certain operational loss events are relatively small and frequent. Such events can be successfully modeled through the use of statistical techniques applied to historical data sets. Because such losses are relatively predictable, they can effectively be priced into the product, in much the same manner as expected credit losses are priced into credit products.

We support the Basel Committee's decision to allow Future Margin Income (FMI) to offset the expected component of operational losses (EL). However, we believe that <u>the language used in Paragraph 62 of the Supervisory Guidance should be strengthened to make it clear that FMI is an acceptable offset to EL, given the existence of suitable documentation on the two metrics</u>.

On the other hand, we are doubtful that similar statistical techniques can be applied to historical data to reliably model <u>extreme</u> operational loss events. Truly catastrophic loss events cannot be predicted, and no amount of capital will protect an institution in such an instance. We believe that some form of qualitative (scenario analysis) modeling is more appropriate in assessing those types of loss events that are less predictable. Accordingly, we think that more development is necessary to finalize exactly what types of loss events ought, realistically, to be captured under AMA approaches to Operational Risk capital formulations.

Wells Fargo very much supports the use of information databases and statistical analysis, but only as a means of understanding/managing its operating expenses, not as a requirement for establishing capital levels.

Risk Mitigation

To the extent that extreme operational loss event modeling is deemed realistic, we see no reason why the recognition of insurance mitigation should be limited to 20% of the total operational risk capital charge, as suggested by Paragraph 66 of the Supervisory Guidance. To do so might lead to imprudent risk management incentives in the use of insurance programs. We recommend that the capital adjustment for insurance be based on the **full** amount of insurance protection provided by insurance policies, given that the policies meet the qualitative standards outlined in the Supervisory Guidance.

Correlation of Operational Losses

At Wells Fargo, we believe that we have consciously crafted a distinct competitive advantage by virtue of the diversity of our underlying businesses. Between mortgage banking, commercial banking, insurance, retail deposit taking, and asset management services (to name a few of our over 80 businesses), along with the significant economies of scale that we have in each of these businesses, we feel that Wells Fargo has created a portfolio of risks (both credit and non-credit) whose worst-case loss potential is substantially less than the sum of its parts. We are encouraged to see that the capture of the capital benefits created by business diversification is permissible under the AMA modeling of operational risk. We believe that this logic should extend to the modeling of capital for credit risk as well, where the impact of portfolio diversification is more substantive and more empirically justifiable.

However, we are concerned by the language of Paragraph 64 of the Supervisory Guidance, which 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 that these assumptions are appropriate and reflect the institution's current environment". The requirement for institutions to demonstrate that explicit and embedded dependence (correlation) assumptions are appropriate needs to be clarified. It is important that reasonability be incorporated into this standard. Insufficient data will be available to statistically prove correlations across business lines and event types. Therefore, correlations most likely will be determined from qualitative reasoning based on the underlying nature of the risks. We suggest that the language in this section recognize the fact that qualitative judgment will be necessary and that flexible approaches need to be allowed, provided that institutions have a well - reasoned basis for their assumptions. It is important that overly conservative criteria not be applied regarding correlation assumptions so that banks using more risk-sensitive "bottoms-up" approaches to the quantification of operational risk capital are not penalized.

Use Of External Data

We do not believe that the direct incorporation of external loss data should be a required component of a bank's operational loss modeling. While it is instructive for banks to be aware of external loss events, applying that information across all institutions in a formulaic manner seems problematic to us. The quality and consistency of external data would prove difficult to verify, especially given the lack of common data collection standards within the industry. Furthermore, each bank will have its own inherent and specific causes of risk depending on the diversification of its lines of business and appetite for risk. Without a relatively detailed awareness of the internal control conditions that led to those losses at other institutions, it is difficult, at best, to do much more than guess the impact of a seemingly similar event on a given bank. Accordingly, external data should only be one of several, <u>optional</u> considerations when performing scenario analysis, and not necessarily the most important.

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To: Addressees

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Re: Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit

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.

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Communications Division
Third Floor
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Mr. Robert E. Feldman, Executive Secretary
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We will direct our comments here to the Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit dated July 1, 2003. We have drafted separate comment letters for the related Advanced Notice of Proposed Rulemaking ("ANPR") and the Draft Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital, although we may allude to some of that commentary in the course of this dialogue.

There has been a relatively uniform set of concerns communicated to the Basel Committee in response to Consultative Paper 3 (CP3) on the topic of prescriptiveness. However, we fear that these criticisms have been too general in nature to be of much value as an agent of change. In fact, the Committee may be receiving mixed signals from the industry in terms of its requests to have more rigidity built into the Accord on some issues and less rigidity on others.

The areas where we feel that clarity is required relate primarily to definitional issues within the Accord – a common definition of default or future margin income, long-run average versus point in time PD or LGD estimates, and similar metrics or terms that are necessary to create an unambiguous foundation upon which the new, more risk-sensitive, regulatory capital calculations can be computed.

Where clarity is **not** required, and where the Supervisory Guidance steps over the line and into the realm of unwarranted prescriptiveness, comes from its attempts to dictate how banks actually **manage** risk. The Supervisory Guidance is too prescriptive and inflexible in its vision of the risk management **processes** to which banks must adhere.

This is in stark contrast to the original supposition of Basel II -- that each bank would be allowed to continue the use of its existing risk management practices, so long as they could be shown to have been effective over time. The Accord and Supervisory Guidance should only aspire to establish a more risk-sensitive framework for constructing minimum bank regulatory capital requirements. They cannot, and should not, attempt to dictate how banks actually manage risk. For those institutions, such as Wells Fargo, with proven risk management processes in place, it would be imprudent, and perhaps dangerous, for them to make significant changes to their risk management systems in the absence of quantifiable and validated data that clearly demonstrates that an alternate system is more robust and accurate, and could be successfully inculcated into their risk management process. And, even if an alternate system were deemed to be superior, to attempt such changes on an accelerated timetable would be risky where credit portfolios of significant size and scope were at stake.

Do the Basel Committee and the U.S. Banking Supervisors really intend to force the migration of well-functioning, customized risk management processes into an untested, complex framework with the potential to actually confuse, or undermine, the control and understanding that banks currently have of their credit portfolios?

The primary points that Wells Fargo will emphasize, and where we feel that we must be successful in helping the Basel Committee and the U.S. regulatory authorities implement a more appropriate regulatory capital regime, are in those areas where we believe that the Accord has ventured beyond its intended scope. We have organized our comments into the same chapters presented in the Supervisory Guidance.

Ratings for IRB Systems

1) **Definition of Default --** We believe that the definition of default outlined in Paragraphs 29-32 of the Supervisory Guidance should be simplified to correspond more closely to what is more commonly used by risk practitioners. That is, loans that fall under the corporate and specialized lending models should define default to coincide solely with the incidence of non-accrual or charge-off status (to exclude the 90 days past due and other isolated conditions present in the Accord's current definition), and loans that fall under the retail model should define default to coincide with the Uniform Retail Credit Classification standards published by the FFIEC.

   With respect to retail lending, the ANPR presents an updated point of view from the U.S. banking supervisors that the FFIEC definitions of loss recognition for retail credit will prevail. However, the ANPR goes on to state that retail default will also include the occurrence of any of the following events: 1) full or partial charge-off, 2) a distressed restructuring or workout involving forbearance and loan modification; or 3) notification that the obligor has sought or been placed in bankruptcy. We believe that the retail charge-off and bankruptcy conditions are addressed in the FFIEC guidelines, and, as such, would be appropriately triggered as defaults by those procedures. However, the distressed restructuring criterion is outside of the scope of FFIEC and should be excluded from the Basel definition of default.

   Our comments here will address primarily the application of the default definition to corporate and specialized lending portfolios. We are concerned that, in the absence of moving the Basel default definition for wholesale loans to be based solely on the occurrence of non-accrual or charge-off status, **banks will be forced to track** two **separate measures of default – one for internal risk assessment and a second for regulatory capital purposes.** This would seem to be a meaningless, yet costly, exercise, since the ultimate driver of risk is loss, and **these fine lines of default definition will only serve to shift the mix of PD and LGD in an offsetting fashion, without significantly affecting ultimate loss.**

   Non-Accrual status already subsumes the more detailed definitions of default. Generally, an asset is placed on non-accrual when it is 90 days past due or when reasonable doubt exists about a loan's collectibility. And, a declaration of bankruptcy would almost certainly trigger the condition of reasonable doubt regarding collectibility.

   An exception to these general rules occurs when a loan is well secured and in the process of collection, in which case it will not necessarily be placed on non-accrual status. However, this exception only applies in limited situations. To be well secured, the asset must be secured by lien or pledge of collateral with realizable value sufficient to fully meet the obligation or guaranteed by a financially responsible party. An asset is in the process of collection if the collection through legal or other means is in due course. Generally, an asset can only remain that status for 30 days unless it can be demonstrated that the amount and timing of the payment is sufficient and reasonably certain.

There are already internal controls, internal audits, external audits and supervisory processes to ensure that non-accrual and charge-off policies are applied correctly. These policies, which govern whether banks continue to recognize income on their financial statements, should be sufficient to satisfy the Basel definition of default. The broader IRB definition of default, which includes bankruptcy, selling at a loss, distressed restructuring (either wholesale or retail), and 90 days past due, is likely to arrive at virtually the same overall conclusion regarding the frequency of defaults, once consideration is given to materiality and purely technical defaults are excluded.

The U.S. banking supervisors seem overly concerned regarding the potential for "silent defaults;" that is, instances where the well secured and in the process of collection exceptions to non-accrual policies are triggered. Capturing this data is a meaningless exercise for two reasons. First, these are exceptions precisely because there is a strong expectation of zero loss. And, second, as we previously stated, the net result of tagging such events as defaults would be negligible, since increased PD estimates would be offset by lower LGD estimates.

The same thought process around silent defaults also seems to have driven the additional criterion to include loan sales at material credit related discounts as defaulted assets. We oppose this criterion on both practical and conceptual grounds. Loan sales are a part of the portfolio management function. Portfolio management strategies differ significantly across banks, with some institutions being much more active than others. Even within a single institution, loan sale strategies will vary across time depending on overall balance sheet management and liquidity issues. Clearly, including performing loan sales in the definition of default would introduce comparability problems. Further, discounts on loan sales can be due to a variety of factors unrelated to credit such as interest rates, liquidity or technical supply and demand issues. It would be quite difficult, and ultimately arbitrary, to disentangle these effects.

Finally, on a more fundamental level, the loss in a loan's value due to credit deterioration is migration risk and not default risk. Migration risk is already included in the framework through the maturity adjustment portion of the IRB formula. To be consistent with the derivation of the formula, the default probability that is estimated should not be artificially inflated for downgrades, and then only for those that are "realized" through discretionary loan sales. Such regulation could create perverse incentives for bank credit portfolio management and actually add to risk in the portfolio.

2) **Obligor Ratings** -- Paragraph 35 of the Supervisory Guidance states that separate exposures to the same obligor must have the same obligor rating grade. This contradicts paragraph 359 of CP3, which states that there are two exceptions to this rule. Firstly, in the case of country transfer risk, where a bank may assign different borrower grades depending on whether the facility is denominated in foreign or local currency. And, secondly, when the treatment of associated guarantees to a facility may be reflected in an adjusted borrower grade. There is a third instance not explicitly mentioned in CP3 (but which we feel is equally applicable), where certain types of specialized lending may be symptomatic of instances where fluctuations in collateral value influence not only the LGD of a facility, but its PD as well.

We think that there should be no such restriction that all exposures to the same obligor must have the same obligor rating grade. At the same time, banks should be held accountable for defending instances where this rule of thumb does not hold true. For similar reasons, we do not agree with Paragraph 36, which states that, "once an obligor is in default on any material credit obligation.. . all of the facilities at that institution are to be considered in default," and believe that it should be re-worded to exclude that stipulation.

3) Default Grades – Paragraph 36 also references the regulatory expectation that obligors in default will be assigned to one obligor default grade. We see no reason why it should be necessary to create a risk rating bucket that, by design, has a 100% PD, so long as a bank would always be able to identify what the actual default rate is for each of its rating buckets. While it is highly likely that defaulting borrowers would congregate at the lower end of a rating scale, we do not think that a unilateral default rating construct should be prescribed to banks.

Given the overly broad regulatory definition of default that has been proposed, placing all defaulted borrowers into one risk rating category would cause Wells Fargo to actually lose risk rating granularity. In the design of our risk rating scale, defaulted borrowers are assigned a variety of obligor ratings, depending on the probability that they will ultimately repay their obligations. We believe that it is important to preserve this granularity of "distressed" asset risk rating, both for loan loss reserving purposes, and due to the fact that it drives our problem loan and collection processes. Paragraph 36 should be changed to acknowledge that defaulted borrowers can represent a wide variety of risks of repayment and, therefore, may be assigned different obligor ratings.

The proposed mandate for a single default bucket becomes a potentially bigger issue when added to the fact that we disagree with the proposed definition of default in the first place. Without some change in the default definition, banks would be faced with the unnecessary cost of actually creating parallel risk rating methodologies – one for internal risk assessment and a **second for regulatory capital purposes, with no value added to the risk management process, and, indeed, the potential to create confusion among those responsible for identifying and managing risk in the portfolio.**

4) **Obligor Rating Granularity --** We are also apprehensive that the language of the Supervisory Guidance may be interpreted by banking supervisors in such a way that certain concentration limits may be imposed on the fraction of a portfolio that can be present in any one risk rating classification (without regard to the nature of the business being conducted). Paragraphs 44-46 describe some of the tests that banks must conduct in order to justify the number of obligor grades used in its rating system, but it clearly leaves banks open to regulatory criticism on that issue. This should not be the subject of capital regulation. Rating systems should be tasked solely with rank-ordering risk in the portfolio and producing valid estimates of PD and LGD that can be used in the construction of a risk-based capital requirement. The Accord and the Supervisory Guidance should be silent on the issue of granularity.

5) **Stress Condition LGD's –** Paragraph 51 of the Supervisory Guidance suggests that conservatism be built into the estimates provided for LGD by limiting the underlying observation set to particular years that can be called stress conditions. We believe that LGD should simply be estimated using a "default-weighted'' process that is naturally weighted toward periods with high defaults. Stressed parameters, such as recessionary LGD's, should be used separately in stress analyses.

6) **Recognition of Risk Mitigation** – Paragraph **59** states that "while guarantees may provide grounds for adjusting PD or LGD, they cannot result in a lower risk weight than that assigned to a similar direct obligation of the guarantor. While this application of the "substitution approach" may be roughly appropriate to certain forms of guarantees in which the financial condition of the borrower and guarantor are closely linked (say, a proprietor who provides a personal guarantee against the performance of his business), there are other forms of guarantees (such as credit derivatives), where this approach does not adequately recognize the lower risk of joint default or the benefit of double recovery associated with guarantees.

   Failure to recognize the risk mitigation effect of double default in credit derivatives would send inappropriate signals to banks about the use of guarantees and credit derivatives -- financial instruments that have provided enormous value in the active management of portfolio credit risk.

   As one illustration of the proposal's inadequacy, consider the case where a AA-rated counterparty is used to enact a hedge on an unrelated AA-rated exposure in the banking book. Using the substitution approach, there would be no capital benefit. Moreover, the bank would have to add a capital charge for the counterparty exposure associated with the hedge provider. In effect, the bank would be required to hold more capital than if it had not hedged at all.

   As a solution to this situation, we would support the use of some form of the modified ASRF approach suggested in the recent Federal Reserve paper on guarantees and credit derivatives. Under this approach, regulators could (at least initially) assign the necessary 3 "types" of asset value correlation (AVC) in conservative fashion (e.g., obligor and guarantor AVCs according to the Basel AVC-PD equation for commercial credits, and a "wrong-way" asset-value-correlation of, say, 50%). This would produce significant reductions in the regulatory capital charges for a hedged transaction.

Quantification of IRB Systems

1) **Short-Dated Maturities** -- Paragraph 173 of the Supervisory Guidance states that most credit exposures must be assigned a maturity value of no less than one year. We believe that the resultant capital treatment for legitimate short-term maturities under one year would be excessive. This unintuitive outcome could easily be adjusted by essentially de-compounding the annualized PD for the subject facility to the appropriate fraction of a year that corresponded to the remainder of the exposure. An obligor's probability of default over, say, the next quarter, must be lower than his cumulative probability of default over the next 4 quarters, even assuming no credit quality deterioration. Consequently, unexpected losses (and, therefore, capital) must be less for the short-dated facility. Implicit in this conclusion is the requirement that the bank must have the unquestioned right to cancel the facility at the end of its current term.

Data Maintenance

1) **Data Warehousing Requirements --** We are highly skeptical that the data maintenance standards outlined in Paragraphs 189 to 196 constitute "best practice." Based on this language, it appears possible that Paragraphs 189 to 191 may be interpreted by our national banking supervisors in such a way that they may impose detailed data warehousing requirements on Expert Judgment risk rating systems of Advanced IRB banks. The apparent goal of such requirements would be to validate not only the accuracy of PD and LGD estimates made from a bank's rating system at the "back-end" of an account's life cycle (which is understandable), but also the accuracy of the account's initial risk ratings through an Evaluation of Developmental Evidence at the "front-end" of its life cycle.

   We are unaware of *any* form of front-end "validation" of either judgmental or modeled risk ratings that has been demonstrated to have any statistical power in use anywhere in the financial services industry, so we have a basic question about the underlying objective for the supervisory expectations regarding data maintenance. And, if such interpretive data maintenance standards are a precursor to the required development of credit scoring models for large wholesale credits, we believe that over-reliance on credit scoring models for many types of wholesale lending could produce disastrous results. We believe that such an approach would actually *increase* risk in the banking system.

   The Supervisory Guidance should be re-worded such that the data maintenance standards contained in Paragraphs 189 to 196 are not interpreted as a universal requirement of the Accord, but rather as a principle to be followed by banks wishing to investigate credit scoring models as "challengers" to the rating systems that they currently have in place. <u>There should be no implicit, or explicit, mandate in the Accord for the development of credit scoring models for large wholesale credits.</u> Furthermore, the Accord should focus solely on back-testing the accuracy of PD and LGD estimates made from a bank's rating system, while eliminating any requirements to validate the accuracy of initial risk ratings through an Evaluation of Developmental Evidence.

2) **Electronic Storage of Guarantor Rating Histories –** A specific, unnecessary data maintenance cost that we perceive in the proposed Accord is the requirement in paragraph 392 of CP3 that banks maintain rating histories on recognized guarantors. While we agree with the standards that are laid out in the Accord for the recognition of guarantees, we feel that a lender's supporting documentation for 1) the recognition of a guarantee, 2) analysis of the strength of a guarantor, and 3) the PD estimate attached to the guarantor should only need to appear in the physical credit files. It would be unnecessarily costly, confusing, and without any value, to reproduce this data electronically when Expert Judgment risk rating systems are employed. In particular, instances of partial guarantees or multiple guarantees make the systematic storage of such data problematic.

There may be instances, such as the use of credit derivatives in hedging the risk in large commercial loan facilities, where it becomes necessary to explicitly track both the PD of the borrower and the PD of the guarantor in order to properly model their joint probability of default. However, such forms of risk mitigation are much less prevalent in Wells Fargo's commercial loan portfolio of predominantly middle market and small business customers, and, therefore, present fewer systematic issues.

The Accord should be re-worded such that the systematic maintenance of rating histories on recognized guarantors is an option, not a requirement.

Control and Oversight Mechanisms

1) **Independence of Rating Assignments -** Paragraph 217 of the Supervisory Guidance states that "ratings assignments and periodic rating reviews must be completed or approved by a party that does not directly stand to benefit from the extension of credit."

   Wells Fargo's view on the credit approval process is 180-degrees opposed to this perspective. We employ an Expert Judgment rating process for wholesale credits, where lending officers are responsible and held accountable for assigning and maintaining accurate and timely risk ratings. They are the principal owners of the risk ratings. The requirement of ownership is probably the <u>most</u> important aspect of our credit culture.

   We believe that lending officers need to know their customers, monitor their customers' financial condition and collateral, and surface deteriorating situations and problem loans early. The requirement and expectation that lending officers own the risk rating, and are responsible for the risk rating, forces them to meet management's expectations with respect to the credit process; that is, properly underwriting, analyzing, grading, and monitoring their credits. We further believe that, because of their frequent contact with their customers, lending officers are the best prepared to surface deteriorating situations in a timely manner. This fundamental pillar of our credit culture is augmented by a strong, independent loan review function (called Risk Asset Review) that evaluates each office's lending practices and has final authority on the risk ratings assigned.

   Now, we are being told that we must change our risk rating system to conform to some theoretical, yet unproven, new system, even though we have had one of the best credit quality trends in the industry. We are not an internationally active bank. Our credit extensions are neither exotic nor complex. 95% of our commercial loans outstanding are to middle market and small business customers. Judgments by talented and experienced lending officers and credit supervisors are particularly important for these types of customers, as compared to the analysis of loans to large corporations. A fundamental tenet of our credit culture is to "know our borrowers."

   To shift the responsibility for assigning wholesale lending risk ratings to an independent rating function seems totally implausible to us. This would be like asking an auditor to audit a system that has been developed and implemented by auditors. We strenuously object to regulatory efforts to disrupt successful risk management cultures that have been developed through years of training and practice, with proven results. The Accord should be re-worded to exclude this directive.

Paragraph 220 states that "independence of the rating process can be achieved through a range of practices that will be carefully reviewed by supervisors."

Based on this language in the proposal and discussions that we have held with our national banking supervisors, we believe that our banking supervisors will require someone besides the lending officer to sign-off on <u>every</u> rating decision made by the lending officer. This idea is not only impractical from a cost/benefit standpoint, but it would also, over time, have a significant adverse impact on our credit culture; that is, the notion that lending officers own the risk ratings. The Supervisory Guidance should be re-worded so that it does not permit such an interpretation of its design.

2) **Transparency of Risk Ratings --** We are also apprehensive that the language of the Supervisory Guidance may be interpreted by banking supervisors in such a way that a certain specificity of risk rating definitions is prescribed to banks. Although Basel II allows for an Expert Judgment system, Paragraphs 221-222 of the Supervisory Guidance require banks to identify and track <u>specific criteria</u> for <u>each factor</u> that is considered in a rating decision. This will be required to achieve "transparency" of a rating system. However, by dictating such a requirement, the national banking supervisors will, in effect, have eliminated Expert Judgment systems as a risk rating practice and imposed Constrained Judgment systems in their place.

Such interpretive rulings would not represent principles of sound risk management that are unilaterally applicable. They would be prescriptions, pure and simple. We note, with interest, that the U.S. banking regulators, themselves, have not followed these prescriptions when articulating the risk rating scale on which their Shared National Credit examinations will be conducted in the future. We are adamantly opposed to this form of capital regulation. The Supervisory Guidance should be re-worded to exclude the possibility of such supervisory interpretations of risk rating definitions.

There is nothing inherently wrong with any of the systems proposed by the Basel Committee and our national banking supervisors. Each may be an appropriate rating system given certain circumstances, such as the nature of a particular bank's business or the state of a company's credit culture. However, Wells Fargo has operated successfully for many years with its current Expert Judgment rating system. This is confirmed not just by our financial results, but also by the fact that independent third parties (principally, our national banking supervisors and rating agencies) have consistently concluded that Wells Fargo has a sound credit risk management process, a rating system that rank orders risk, and a rating system that is accurate.

Wells Fargo would be doing a disservice to its shareholders and debtholders if it did not defend the risk management practices that have operated so successfully for the Bank over the years. We strongly encourage the Basel Committee and the U.S. banking supervisors to reconsider some of the points that we have made above, to remove some of the regulatory prescriptiveness relative to the operational detail of bank risk management policies and practices, and to allow banks like Wells Fargo to preserve well-functioning credit cultures that they have developed.