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WACHOVIA

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Office of Comptroller of the Currency
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Dear Roger,

This letter is Wachovia's response to the issues raised at the meeting on July 25th, 2007. We appreciate the opportunity to discuss the treatment of bank investments in equities and first-loss positions under Basel II.

The capital treatment for these exposures should follow the principle that US rules be aligned with the international framework. Accordingly, only those exposures with the economic substance of securitizations should be subject to securitization rules, and all other equity investments should be subject to the equity rules or to look-through rules. The question, then, is how one identifies situations appropriate to each set of rules.

The first step is to identify cases where the underlying exposures are not financial assets, which are to be treated under the equity rules. We believe it is important to affirm that this be applied to the economic substance of the situation rather than a legal structure.

- Securitization rules should not be applied where the entity in which the bank invests is an operating company, even if the entity itself technically owns stock rather than the operating assets. The legal structure of the borrower should not override the economic substance. This is true for exposures to holding companies that own operating subsidiaries and to funds that own operating companies, including private equity groups as discussed in the meeting. The conclusion that private equity groups should be treated as securitizations is inconsistent with their ownership of operating businesses.

- Likewise, securitization rules should not be applied to situations where participants have different priorities for receiving payments from a single loan to an operating company. In such a case, there is one loan that will default or not default, and participants may have different LGDs. The securitization framework is inappropriate in this case. The situation is no different than if the operating company took out multiple loans, and the fact that one agreement with the borrower (a financial asset) has been divided among participants does not change the economic reality that the exposure is to an operating business.

We next consider cases where the entity is an operating business, even if the assets of the business are financial.

- We believe it is not controversial that non-consolidated equity investments in banks, equity REITs, business development firms, etc. are to be treated under the equity rules. The overly broad interpretation discussed in our meeting would lead to such equity investments being classified as requiring securitization treatment.

  Although the balance sheets of such firms comprise largely financial assets, it is the operation of the business that drives the returns to the equity investors, not merely the performance of the assets.

- This approach should also apply to other entities having the characteristics of businesses, including some that may be called hedge funds.

What remains are entities for which results are essentially determined by the performance of the entity's assets and similar off-balance sheet risks alone. In these cases, management takes a far more limited role. The Structured Investment Vehicles discussed at the meeting fall in this category. First-loss investments in these entities would be assessed capital under the investment fund and securitization rules. Interpretations as to which investments are in businesses and which are in funds should be aligned with international practices.

Several changes to the rules proposed in the US NPR are needed to produce appropriate capital requirements with the investment fund and securitization rules:

- The look-through approach should use the weights from the standardized approach adopted internationally, not higher weights unique to the US.

- Banks should be permitted to assign risk weights based on a fund's actual asset mix even when the fund's assets are not known precisely enough to compute a capital requirement under the rules used for the bank's own assets. That is, there needs to be an approach between the full look-through and the two modified look-through approach described in the NPR.

  - This new look-through approach should permit use of risk-weights based on recent disclosures from the fund.

  - The requirement in the two modified look-through approaches that the fund's actual asset mix be ignored in favor of the riskiest possible mix of investments permitted by the fund's controlling documents is unreasonably harsh. Such an approach would be appropriate only if the fund disclosed no information about its actual asset mix.

  - Likewise, any computations for the securitization approach should use the actual leverage disclosed in the fund's reports; it would be inappropriate that banks be required to use the greatest leverage possible under the fund's controlling agreements.

- The capital requirement computed with this approach would also be the underlying capital requirement when securitization rules must be used.

- As in the modified look through approach, the use of derivatives, short sales, and similar tactics should not automatically add to the capital requirement in this new approach.

A bank's approach to these exposures would be subject to Pillar II review. Further, Pillar II provides a second safeguard to ensure that adequate capital is held for these exposures. Each AIRB bank will have internal processes to assess the risk and required capital for its equity investments, including investments in entities whose assets may be primarily financial assets.

We are aware that one objective of these rules was to protect against arbitrage. However, accounting rules require the consolidation of entities established to purchase assets from a firm's balance sheet that do not either: a) meet the definition of a Qualified Special Purpose Entity with sufficient outside beneficial holders or b) distribute the majority of risk contained in the entity to outside beneficial holders. The combination of these consolidation requirements and the securitization rules should eliminate significant opportunities for this sort of arbitrage. Inappropriate application of the rules should be identified and corrected under Pillar II.

Please contact us if you would like to discuss this issue further.

Sincerely,

RG Playford

Russell Playford
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