February 3, 2012

To Office of the Comptroller of the Currency
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regs.comments@occ.treas.gov
Docket ID: OCC–2010–0003
RIN 1557–AC99

Jennifer J. Johnson
Secretary
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Docket No. R–1401
RIN 7100–AD61

Robert E. Feldman
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Attention: Comments/Legal ESS
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RIN 3064–AD70

Re: Notice of Proposed Rulemaking on Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions (the "Proposed Rule")[1]

Ladies and Gentlemen:

This letter is being submitted on behalf of Wells Fargo & Company and its depository institution affiliates, including Wells Fargo Bank, National Association, (collectively "Wells Fargo") in response to the Proposed Rule published by the Office of the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Corporation (collectively, the "Agencies") to incorporate into their proposed market risk capital rules alternative methodologies for calculating specific risk capital requirements for debt and securitization positions that do not rely on credit ratings. The Proposed Rule was issued in light of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which requires that all federal agencies remove references to credit ratings

[1] Federal Register / Vol. 76, No. 245 / Wednesday, December 21, 2011 / Proposed Rules

from their regulations and to replace such references and requirements with alternative standards of credit worthiness.

We strongly encourage the Agencies to conduct a Quantitative Impact Study on securitizations in both the trading and banking books before implementing any final rules. Wells Fargo would gladly participate in an industry-wide QIS to aid in better understanding the impact. We recognize the tight timeline for the implementation of Dodd Frank, but nonetheless feel it is important to fully understand the ramifications of the new capital factors. For the reasons outlined in more detail below, we believe the Proposed Rule is inadequate, and if adopted in its present form will have significant adverse impacts on the U.S. economy.

Introduction

We appreciate the efforts of the Agencies in seeking to implement the mandated requirements of Section 939A of Dodd-Frank. Although Wells Fargo has worked with, and endorses many the comments of the American Securitization Forum (ASF), the American Bankers Association (ABA), and The Clearing House (TCH), we also would like to take this opportunity to highlight several important concerns we have with the Proposed Rule and identify alternative proposals we believe address these concerns.

Wells Fargo believes the Simplified Supervisory Formula Approach (SSFA) put forth in the Proposed Rule is an inadequate method for assigning required regulatory capital for securitizations. Our concerns with the SSFA are as follows:

1. **The SSFA Precludes the Use of Advanced Approaches for the Underlying Exposures to More Accurately Quantify Risk.** It is critical that the risk weighting methodology used for securitizations be as consistent as possible with the K_{IRB} approach used by A-IRB banks for the underlying assets in a pool for two basic reasons. First, the approaches should produce a result that minimizes regulatory capital arbitrage for securitizations. Second, the PD, LGD, and AVC assumptions for the underlying assets in a pool are essential for properly estimating the likelihood for the attachment points of different securitization tranches to be breached. The use of Basel I

methodology in the proposed SSFA does not provide sufficient risk differentiation of the assets underlying securitizations. For instance, securitizations comprised of subprime autos would be expected to hold more credit risk than those of prime auto loans, yet the SSFA effectively treats the exposure in both asset classes as identical. Basel II established different capital computation methods for banks that qualify to use the Advanced Internal Ratings Based approach. We believe that this distinction should be retained for securitization exposures.

2. **The SSFA Fails to Incorporate Book Value Discounts as Credit Enhancement.** Securities owned at carrying values below par value, either through the prior recognition of OTTI (Other Than Temporary Impairment) or because they were purchased at a discount, effectively have established a reserve against future principal writedowns in the amount of the discount. To illustrate simplistically, suppose a security is owned by a bank at 80% of the par value. If 20% of the principal due from the security is ultimately lost as a result of the future credit performance on the underlying assets, then the bank would still receive 100% of its carrying value or, equivalently, 80% of the par value. Therefore, book value discounts are, in effect, a form of credit enhancement available to the bank that is additional to the credit enhancement provided solely by the securitization. These discounts must be incorporated into the enhancement inputs of any required capital calculations (Attachment point, A, in the SSFA or Credit Enhancement, L, in the SFA).
3. **The SSFA Lacks a Forward Looking View.** Only the historical performance of the securities and the assets underlying the securitization is considered rather than incorporating a forward looking view. This is inconsistent with the advanced approaches that are part of the Basel II Final Rule and sound risk management practices.
4. **The SSFA Creates Inappropriate Risk Management Incentives and Competitive Inequities.** A minimum risk weight floor of 20% places US banks at a significant competitive disadvantage to foreign banks which have a 7% floor. The high floor also eliminates any risk sensitivity at the higher end of the credit scale, thereby dis-incentivizing investments in higher quality assets.
5. **The SSFA Overlooks Valid Forms of Credit Enhancements.** Over-collateralization, excess spread and funded reserve accounts are all well-established and

conventional forms of credit enhancements within securitizations. These forms of credit enhancement should be incorporated into the credit quality of the securitization in addition to the subordinated tranches currently recognized as credit enhancement by the SSFA.

6. **The SSFA Produces Drastic Cliff-Effects and Discourages Risk Transference.** The minimum floor table can result in significant pro-cyclical cliff-effects. Furthermore, it can lead to higher regulatory capital requirements for senior positions in the securitization than if the underlying assets were held on-balance sheet unsecuritized and thereby penalize the presence of risk protection. Bondholders of senior securities, defined as securities with a detachment point = 100%, effectively own the underlying assets of a securitization with the additional benefit of credit enhancement. Requiring banks to hold 100% capital for senior securities would remove a significant source of funding for loans where securitization plays an important role and would result in much higher borrowing costs for American consumers, businesses and entrepreneurs.
7. **The SSFA Fails to Differentiate Higher-Risk from Lower-Risk Resecuritizations.** We recognize and can appreciate the desire of the Agencies to associate higher capital charges with resecuritization transactions. Many of these transactions, the worst of which were made up of junior classes from highly correlated ABS transactions (i.e. ABS CDOs), performed poorly and are in danger of suffering losses to their most senior classes. However, there are some transactions that fall under the resecuritization definition that are fundamentally sound. For example, over the past several years, many banks with senior RMBS securities had these positions split into a new senior security and a subordinate security, and then held on to the new higher rated senior security for the purpose of reducing regulatory capital under Basel II. The resulting position is actually safer than the original bond and effectively de-risked the original position. The transactions themselves usually restore better liquidity to the senior safer portions of those securities and thus benefit the fixed income market as a whole. The Proposed Rule treats this senior/de-levered position on a similar basis as the riskier repackaged transaction (CDO Squared for example).The second type of lower-risk resecuritization is a transaction where the amount of underlying ABS is so small as to be inconsequential to the transaction. For example, many collateralized loan

obligation (CLO) structures permit the manager to buy a small amount of other CLO tranches into their asset mix (the maximum amount is typically 5% of assets but the average CLO only owns about 2%), which is otherwise mostly comprised of senior secured corporate loans. For the senior CLO classes in these transactions, that typically have credit enhancement in the range of 20% to 40%, the 2% of underlying CLO collateral is inconsequential. In the SSFA framework, we would recommend that only securitization positions where more than 10% of the underlying positions are securitizations be considered as resecuritizations. For these exposures, it would be more rational to apply a look-though approach to the underlying exposures and apply 100% capital to those exposures where the capital calculation is too difficult. This conservative approach would thereby apply a higher capital charge for non-senior resecuritizations of poor quality assets.

Our concerns are heightened to the extent the proposed SSFA will serve as the framework to assign capital requirements for securitizations in the banking book.

To address these concerns, we propose the concurrent implementation of two approaches: 1) a Simplified Approach and 2) an Advanced Approach. The use of a dual-approach is consistent with other Basel II rules and promotes greater accuracy for those banks able to use the advanced approaches. However, we would note that it is likely that most holders of securitization tranches among US banks are A-IRB banks, and, therefore, we are more focused on ensuring that the advanced approach addresses the primary concerns that we raised above. As further described below, the Simplified Approach would incorporate changes to the proposed SSFA and the Advanced Approach would adjust the existing Supervisory Formula Approach (SFA) contained in Basel II.

Simplified Approach

The Simplified Approach would make the following modifications to the proposed SSFA:

1. **Modify K_G.** The intent of the Basel committee when crafting the rules for Basel II and II.5 was to create a metric (K_{IRB}) which more accurately reflected the characteristics of

the underlying assets. Wells Fargo recognizes the need for the Agencies to develop an approach that can be used to calculate the capital of the underlying assets by banks that do not qualify for the Basel II A-IRB approach. For this Simplified Approach, we recommend a more granular K_G that would account for performing and non-performing assets instead of the flat K_G of 4% for qualifying mortgages and 8% for all other assets in the proposed rule as represented by the following formula, .

$$K_G = \%perf \times K_{perf} + \%delq \times LGD$$

where

i. *%perf* is the percentage of performing assets in the pool,

ii. K_{perf} is a more granular measure of capital per $ of underlying exposure as shown in following table,

iii. *%delq* is the percentage of delinquent assets in the pool, and

iv. *LGD* is the greater of the most recent one-month, three-month and six-month loss severities on the underlying exposures.

As illustrated in the table below, K_{perf} would be assigned by a wider representation of assets classes than currently reflected in the proposed SSFA. Given the limited time frame to respond to the Proposed Rules, we request for additional time to conduct the due diligence industry-wide to propose appropriate K_{perf} levels by asset class.

Underlying Assets	K_{perf}
Qualifying Mortgages	4%
Prime Autos	
Prime Credit Cards	
Sub-prime Autos	8%
Non-qualifying Mortgages	
Second Lien Mortgages	
Sub-prime Credit Cards	
Other Assets	

Table 1: Illustration of K for performing assets

As an example of how capital would be calculated, assume a qualified mortgage securitization with the following asset characteristics:

i. K_{perf} of 4% from Table 1,

ii. *%delq* (over 90 days delinquent) of 5%,

iii. One-month loss severity of 20%, three-month loss severity of 22%, and six-month loss severity of 25%,

would result in a K_G of 5.05% as follows:

$$K_G = 95\% \times 4\% + 5\% \times 25\% = 5.05\%$$

2. **Capital Ceiling.** We recommend that senior securities, defined as securities with a detachment point = 100%, hold a maximum capital percentage of the underlying assets, represented by the adjusted K_G. This would ensure the SSFA capital is not greater than the capital charge of the underlying assets if they were held on the balance sheet. This is also consistent with the approach in the Basel II Final Rule.
3. **Carrying Value Adjustment.** We propose an adjustment to the attachment point to treat book value discounts as available credit enhancement. We suggest that such an adjustment be made as follows:

   $$A_{\text{mod}} = A + (D - A) \times (1 - C)$$

   where C is the *carrying value of security/par value of security*.
4. **Additional Credit Enhancements.** Over-collateralization and Reserve accounts funded through the retention of excess spread should be incorporated into determining the attachment point of a securitization exposure.
5. **Eliminate the Supervisory Minimum Risk Table.** Table 15 as proposed in the NPR relies on historical performance and does not consider the future credit quality of the pool. Yet, historical performance is already reflected in the formula itself in that the attachment point of a bond will decrease as the performance of the underlying assets worsens. Also, adjusting K_G for delinquent loans, as noted above, is a better representation of future credit quality.
6. **Set the Minimum Floor to 7%.** The minimum risk weight floor of 20% in the proposal is inconsistent with the international standards of 7% and would put US banks at a competitive disadvantage.
7. **Resecuritization.** The resecuritization capital penalty should be eliminated as currently written (adjustment to "p"). Banks should be allowed to look through to the underlying exposures of a resecuritization exposure in order to calculate K_G. In cases where the bank cannot calculate capital of the underlying exposure in a resecuritization,

due to lack of resources or calculation difficulty, the bank should assume 100% capital on the resecuritization exposure. For example, if a bank cannot calculate capital on the underlying assets of a resecuritization that makes up 2% of the transaction and the remainder of the securitization assets have K_G = 5%, the K_G of all the underlying assets would equal 7%. However, if the resecuritization capital penalty must be retained, an exclusion should be made where the amount of underlying securitization positions are so small as to be inconsequential to the transaction (<10% of the transaction assets).

Advanced Approach

The Advanced Approach would modify the existing SFA found in Basel II. The modifications, as proposed previously by the ASF, would be:

1. **Pool based risk characteristics.** Allow for the asset performance of wholesale and retail portfolios to be calculated and updated quarterly using pool-wide determinants of the Probability of Default (PD) and Loss Given Default (LGD) consistent with current market practice. This includes eliminating the less than one year maturity requirement for the use of the pool-wide approach for wholesale exposures. This approach will result in a more risk-sensitive framework than the alternative of dealing with an overly simplified formula.
2. **Carrying value adjustment.** Incorporate the effect of carrying value on the credit enhancement (L) and tranche thickness (T) of a bank's securitization exposure. Applying the same capital percentage to a bond held at par and when marked at a discount overstates the credit risk of the bond held at a discount. Adding the discount as a form of credit enhancement in the SFA formula is an appropriate remedy.

   $$L_{\mathrm{mod}} = L + T \times (1 - C)$$

   $$T_{\mathrm{mod}} = T \times C$$

   where L is the current credit enhancement, T is the tranche thickness, and C is the *carrying value of security/par value of security*.
3. **Less punitive risk characteristics.** Subject to regulatory approval, allow banks to use a conservative estimate for LGD of less than 100% where LGD cannot be otherwise determined for a securitized asset pool. The Agencies should also allow for the use of

conservative proxies for PD and LGD for asset pools with little historical performance or that have experienced low default and/or low losses.

4. **Additional Credit Enhancements.** Banks should be allowed to use additional credit enhancement not represented by subordinate securitization positions. This includes Over-collateralization and Reserve accounts funded through the retention of excess spread. These are well-established and conventional forms of credit enhancements within securitizations.

In short, while we appreciate the thought and effort by the Agencies to develop the Proposed Rule, we do not believe the proposal achieves the fundamental goal of a rule to reasonably assign capital to securitization exposures commensurate with the inherent risk of the exposure. We urge that the Agencies conduct further studies as suggested above with a view to adoption of the suggested modifications to the final rule.

We appreciate your consideration of our comments. We will gladly make ourselves available for any further consultations and/or questions you have. Please contact me at 415-396-5196 if we can assist you in any way.

Sincerely,

Paul R. Ackerman
Executive Vice President and Treasurer