January 18, 2006


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Washington, DC 20219
*Attention: Docket No. 05-16*
*Via E-mail: regs.comments@occ.treas.gov*

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Regulation Comments
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**Re: Comments on the Joint Advanced Notice of Proposed Rulemaking (ANPR)**

Ladies and Gentlemen:

Wachovia welcomes the opportunity to comment on the Joint Advance Notice of Proposed Rulemaking ("ANPR") for the revision to U.S. risk-based capital guidelines. We have been a longstanding participant in the consultative process and appreciate the seriousness with which the Agencies view industry opinion. Extensive dialogue among stakeholders has helped refine prior guidance and will prove essential for vetting this Basel IA proposal.

Wachovia agrees that the Basel I capital framework (the current Accord) does an inadequate job of aligning capital to underlying risk. The current Accord's approach requires excess capital to compensate for unmeasured risks, and its shortcomings limit its effectiveness at ensuring adequate capital for high-risk situations. As smaller banks have adopted more advanced risk assessment techniques, its usefulness has diminished.

The Basel IA ANPR is a clear improvement. Basel IA more closely aligns internal risk management and regulatory policy, something long desired by industry. Improved risk sensitivity will undoubtedly enhance the safety and soundness of the U.S. banking system while permitting more efficient use of capital.

Although some of the detailed rules require additional refinement, as described in the attachment, our top issues are:

- that Basel I, IA, and II-AIRB be calibrated based on the need for greater caution where there is less information as well as the desire to encourage banks to adopt more advanced risk assessment approaches
- that the Basel IA rules be kept relatively simple so as to make implementation practical and not unreasonably expensive; to enable calibration without extensive and costly quantitative impact studies; to keep contention for regulatory resources at a reasonable level; and to position IA so that there are incentives for banks to undertake the additional effort to move to the AIRB approach
- and that the relationship between Basel IA and II-AIRB be maintained over time by coordinating implementation timing and by designing IA such that it is practical to use it to determine the capital floors to which AIRB banks will initially be limited.

Proper calibration should provide incentives for Basel IA banks to migrate to Basel II AIRB and for exempted banks to transition to Basel IA. As risks are more accurately measured, regulators can be confident that lower risk banks are safe and sound with somewhat less capital than they would need to hold with cruder risk measures.

Although it appears that many of the rules in the ANPR were set to provide a modest capital relief for a "typical" portfolio, some areas appear unnecessarily conservative. It is unclear, for instance, why more conservative risk weights were assigned to external credit grades than were used in Basel II's Standardized approach. Further discussion of calibration can be found in the attachment.

Wachovia believes that simple risk bucketing using easily accessible data on key risk drivers will make Basel IA significantly more risk sensitive than the current Accord. We believe that Basel IA should use uncomplicated rules and be based on readily available data if it is to be applied beyond the midsize banks. Some rules – such as the proposed trapping point approach for securitizations – are unnecessarily complex. Other comments regarding complexity are in the attachment.

More complex rules will not only make it extremely difficult and expensive to comply with Basel IA, but will also add significant uncertainty to any calibration. Questions in this area would need to be addressed through a quantitative impact study ("QIS"), an expensive undertaking that could further delay the move to new rules.

The Basel IA and AIRB implementation efforts must be coordinated. Since IA corrects several shortcomings of the current Accord, it would be a more logical basis for the AIRB floors than the current Accord. Continuing to use the current Accord would prolong the misalignment with risk that prompted an update to the capital rules in the first place. However, using Basel IA to set the floors is practical only so long as it requires no material implementation effort beyond what is required for the AIRB approach. Further

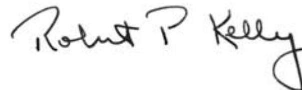
costs simply cannot reasonably be added to the compliance burden surrounding Basel II. Basel IA must use straightforward data that's already collected by AIRB banks.

Non-AIRB banks should follow the same implementation schedule as the larger banks: a parallel year in 2008 with full implementation in 2009 so that changes in either guidance can be factored into final rules for the other. Although we see no reason to convert the smallest banks to Basel IA, no bank should be allowed to stay under Basel I merely to avoid recognizing high-risk portfolios. With proper calibration, Basel IA will provide exempted banks incentives to upgrade their risk management processes.

Wachovia greatly appreciates the opportunity to share our views on the revised regulatory capital guidelines. The framework takes a significant step forward in the degree of risk sensitivity championed by the industry. Once the calibration, timing / transitioning, and rule-specific issues are vetted through a diligent consultative process, the final framework will promote bank safety and the efficient use of banks' capital. We look forward to working with the agencies to achieve these objectives. We invite you to contact us with any questions regarding the views expressed in this letter.

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
Russell Playford, Executive Vice President, Credit Risk Management
Gregory Norwood, Senior Vice President and Basel II Implementation Program Director
David Wilson, Examiner-in-Charge, Office of the Comptroller of the Currency

## ANPR Detailed Response

## Overall Comments:

### Calibration

Proper calibration of Basel IA to the other U.S. frameworks is paramount in order to maintain incentives for banks to adopt better risk management practices. Although moving to a more risk sensitive methodology should not guarantee a capital reduction for individual banks, measuring portfolio risk more accurately reduces the need for a conservative capital buffer. System wide, the result should be some reduction in regulatory capital requirements for credit risk.

Basel IA increases risk sensitivity through additional risk weight buckets and through more complete recognition of credit risk mitigation. As long as the rules recognize high risk lending such that particularly risky portfolios attract higher capital requirements, the rules should be calibrated to assign somewhat lower capital to more typical portfolios.

Additional analyses should be performed and made public to indicate the expected effect of implementing the Basel IA rules. The rules must be kept simple so that no dedicated QIS exercise is needed to assess the effect.

### Timing and Transitioning

Wachovia believes that Basel IA implementation should parallel the AIRB schedule: a parallel year in 2008 followed by full implementation in 2009. Such a schedule – in combination with the use of Basel IA as the basis of floors for AIRB banks – would provide three key benefits. First, this date would permit a parallel consultative process between IA and AIRB. The consultative process would ensure proper calibration of the IA framework and encourage adoption of simple rules, given the need to publish a Basel IA NPR in advance. Second, simultaneous parallel run years would permit "field testing" IA and AIRB at the same time. Finally, this timing would still allow banks to prepare data capture, calculation, and compliance processes.

**ANPR Questions:**

The following questions are adapted from the ANPR as published in the October 20, 2005 Federal Register.

Data Availability and Requirements

*Commenters are particularly requested to address whether any of the proposed changes would require data that are not currently available as part of the organization's existing credit approval and portfolio management systems.*

In general, Wachovia believes that simple data requirements are the best means to promote Basel IA's acceptance and effectiveness. Low complexity makes sense for Basel II banks that will be using Basel IA purely to comply with regulations. Furthermore, it will help promote Basel IA adoption for even the smallest banks. Rules that rely upon currently reported data would eliminate the need for a QIS exercise.

For the most part the Basel IA rules appear to align with the types of data currently used by banks. Comments on specific data that is not easily accessible can be found in individual sections.

*The Agencies specifically request comment on the extent to which any of these capital rules may adversely affect competition and whether: (1) statutory changes are necessary to eliminate specific burdensome requirements in these capital rules; (2) any of these capital rules contain requirements that are unnecessary to serve the purposes of the statute that they implement; (3) the compliance cost associated with reporting, recordkeeping, and disclosure requirements in these capital rules is justified; and (4) any of these capital rules are unclear.*

Comments on these questions can be found in individual sections.

Risk Weight Categories

*The Agencies seek comment on whether (1) increasing the number of risk-weight categories would allow supervisors to more closely align capital requirements with risk; (2) the additional risk-weight categories suggested above would be appropriate; (3) the risk-based capital framework should include more risk-weight categories than those proposed, such as a lower risk weight for the highest quality assets with very low historical default rates; and (4) an increased number of risk-weight categories would cause unnecessary burden on banking organizations.*

The increased number of risk weight categories provides a sound foundation for attaining enhanced risk sensitivity. The quantity of new categories is appropriate and reasonable. Yet some aspects of the risk weighting methodology require modification.

Commercial credits with external bond ratings below BBB- carry more punitive risk weights than those from Basel II Standardized. BB represents typical credit quality for unrated loans, and such loans carry only a 100% risk weight. We recommend that the Basel IA commercial risk weights be aligned with those of Basel II Standardized, as the latter has already been calibrated.

## External Credit Ratings

*The Agencies solicit comment on (1) whether the risk-weight categories for NRSRO ratings are appropriately risk sensitive, (2) the amount of any additional burden that this approach might generate, especially for community banking organizations, in comparison with the benefit that such organizations would derive, (3) the use of other methodologies that might be reasonably employed to assign risk weights for rated exposures, and (4) methodologies that might be used to assign risk weights to unrated exposures.*

We agree with the proposal to broaden the use of NRSRO ratings. As far as other methodologies are concerned, there appear to be no practical alternatives other than an outright transition to the AIRB framework.

## Expansion of Recognized Collateral and Guarantors

*The Agencies are seeking comments on whether this approach for expanding the scope of eligible collateral improves risk sensitivity without being overly burdensome. The Agencies seek comment on expanding the scope of recognized guarantors to include any entity whose long-term senior debt has been assigned an external credit rating of at least investment grade by an NRSRO. The Agencies are also seeking comments on using a ratings-based approach for determining the risk weight applicable to a recognized guarantor and, more specifically, limiting the external rating for a recognized guarantor to investment grade or above.*

Broader collateral and guarantor eligibility is a favorable step towards enhanced sensitivity; it also dovetails with industry best practice of using high quality credit risk mitigants. Consequently, banks should be prepared to take advantage of the revised rules.

We support the decision to expand eligible guarantors to include any entity with investment grade long-term senior debt.

One-to-Four Family Mortgages: First and Second Liens

*The Agencies seek comment on (1) the use of LTV to determine risk weights for first lien one-to-four family residential mortgages, (2) whether LTVs should be updated periodically, (3) whether loan-level or portfolio PMI should be used to reduce LTV ratios for the purposes of determining capital requirements, (4) alternative approaches that are sensitive to the counterparty credit risk associated with PMI, and (5) risk-weight floors for certain mortgages subject to PMI, especially higher-risk loans and novel products.*

We agree with the Agencies' choice of loan-to-value ("LTV") as the primary risk driver for retail mortgages; LTVs should be computed based on collateral values at origination. Refreshed valuations in rapidly appreciating markets would lower capital requirements in the "frothiest" markets, which is not consistent with prudent risk management. Loans subject to negative amortization should use their maximum projected balance in the calculation.

A reduction in LTV seems prudent when PMI is present. We recommend that this provision apply only in circumstances where the senior unsecured debt rating of the PMI provider is AA or above. Additional complexity is unwarranted.

*The Agencies seek comment on (1) the use of an assessment mechanism based on LTV ratios in combination with credit assessments, debt-to-income ratios, or other relevant measures of credit quality, (2) the impact of the use of credit scores on the availability of credit or prices for lower income borrowers, and (3) whether LTVs and other measures of creditworthiness should be updated annually or quarterly and how these parameters might be updated to accurately reflect the changing risk of a mortgage loan as it matures and as property values and borrower's credit assessments fluctuate.*

We recognize that greater collateral risk can be acceptable when lending to lower risk borrowers, so it would be beneficial to add a second dimension related to borrower credit quality to the retail mortgage risk weight framework. Credit scores could serve this purpose in the U.S., but their use might create problems for banks active in international markets where credit scores are not established or comparable. Past due status would be a more widely available indicator of credit quality. (Materially past due accounts could attract more capital, and accounts that have remained current for a significant period could attract less capital.)

*The Agencies are interested in any specific comments and available data on non-traditional mortgage products (e.g., interest-only mortgages). In particular, the Agencies are reviewing the recent rapid growth in mortgages that permit negative amortization, do not amortize at all, or have an LTV greater than 100 percent. The Agencies seek comment on whether these products should be treated in the same matrix as traditional mortgages or whether such products pose unique and perhaps greater risks that warrant a higher risk-based capital requirement.*

As noted, the greater risk of negatively amortizing loans could be addressed by applying the amortization schedule's peak loan value to the LTV measure. Additional risk weight buckets may be appropriate for LTVs of more than 100 percent.

*For stand-alone second lien mortgages and HELOCs, where the institution holds a second lien mortgage but does not hold the first lien mortgage and the LTV at origination (original LTV) for the combined loans does not exceed 90 percent, the Agencies are considering retaining the current 100 percent risk weight. For second liens, where the original LTV of the combined liens exceeds 90 percent, the Agencies believe that a risk weight higher than 100 percent would be appropriate in recognition of the credit risk associated with these exposures. The Agencies seek comment regarding this approach.*

We agree that the proposed risk weights adequately reflect the underlying risk.

## Multifamily Residential Mortgages

*The Agencies seek comment and request any available data that might demonstrate that all multifamily loans or specific types of multifamily loans that meet certain criteria, for example, small size, history of performance, or low loan-to-value ratio, should be eligible for a lower risk weight than is currently permitted in the Agencies' rules.*

In addition to the criteria used to differentiate risk in the Agencies' current rules, additional consideration should be given to very low LTV multifamily mortgages in the Basel IA rules.

## Other Retail Exposures

*The Agencies request comment on any methods that would accomplish their goal of increasing risk sensitivity without creating undue burden, and, more specifically, on what risk drivers (for example, LTV, credit assessments, and/or collateral) and risk weights*

*would be appropriate for these types of loans. The Agencies further request comment on the impact of the use of any recommended risk drivers on the availability of credit or prices for lower-income borrowers.*

We agree that it would be beneficial to differentiate risk for other retail loans, and we urge the use of one simple metric. Because other retail covers a range of products, we suggest a measure of borrower credit quality rather than loan-to-value. As with mortgages, we note that credit scores could be used but may present problems for internationally active banks. An alternative would use days past due and time since last delinquency.

## Short-Term Commitments

*The Agencies solicit comment on the approach for short-term commitments as discussed above. Further, the Agencies seek comment on an alternative approach that would apply a single CCF (for example, 20 percent) to all commitments, both short-term and long-term.*

We prefer a single credit conversion factor ("CCF") of 20% since artificial breakpoints distort data in a manner that compromises transparency. Though use of a single factor belies the objective of greater risk sensitivity, its straightforward application counterbalances new complexities within the ANPR and provides incentives to transition to AIRB.

## Loans 90 Days or More Past Due or in Nonaccrual

*The Agencies are considering assigning exposures that are 90 days or more past due and those in nonaccrual status to a higher risk-weight category. However, the amount of the exposure to be assigned to the higher risk-weight category may be reduced by any reserves directly allocated to cover potential losses on that exposure. The Agencies seek comments on all aspects of this potential change in treatment.*

Current methodologies for reserves and loan write-downs should be adequate to address the risks stemming from non-accruing loans.

## Commercial Real Estate ("CRE") Exposures

*The Agencies seek recommendations on improvements to these standards that would result in prudent capital requirements for ADC loans while not creating undue burden*

*for banking organizations making such loans. The Agencies also seek comments on alternative ways to make risk weights for commercial real estate loans more risk sensitive. To that end, they request comments on what types of risk drivers, like LTV ratios or credit assessments, could be used to differentiate among the credit qualities of commercial real estate loans, and how the risk drivers could be used to determine risk weights.*

We agree that risk levels for Acquisition, Development, and Construction ("ADC") CRE lending can vary, so it makes sense to make risk weights sensitive to risk drivers. LTV at origination has been the traditional industry risk measure and should be available as it is part of current FDICIA reporting requirements. Although it is true that risk is further mitigated when borrowers contribute equity to a project, the ANPR requirement that a project be "supported by … equity …. in cash and liquid assets" presents several problems. We observe some dispersion in the way banks define these terms for CRE projects, so care would be needed to ensure consistency of application. More importantly, it is not clear that many banks can reasonably report this data. It seems that additional requirements beyond LTV are simply not readily available and so should not be used.

As with today's rules, 1-4 family residential construction should not be included in the CRE ADC category.

Small Business Loans

*The Agencies believe that under these circumstances the risk weight of a small business loan could be lowered to, for example, 75 percent. The Agencies seek comment on whether this relatively simple change would improve the risk sensitivity without unduly increasing complexity and burden. The Agencies seek comment on any alternative approaches for improving risk sensitivity of the risk-based capital treatment for small business loans, including the use of credit assessments, LTVs, collateral, guarantees, or other methods for stratifying credit risk.*

The reduced risk weight appears reasonable for these limited situations (fully amortizing in 7 years, fully secured by real estate). It should be noted, however, that some of the data requirements might impose significant implementation costs on banks trying to identify loans that qualify for the favorable treatment.

We assume the phrase "full amortization over a period of seven years or less" excludes loans with longer amortization schedules that have a balloon maturity within seven years.

Early Amortization

*The Agencies seek comment on whether to adopt either alternative treatment of securitizations of revolving credit facilities containing early amortization mechanisms and whether either treatment satisfactorily addresses the potential risks such transactions pose to originators. The Agencies also seek comment on whether other early amortization triggers exist that might have to be factored into such an approach, e.g., level of delinquencies, and whether there are other approaches, treatments, or factors that the Agencies should consider.*

We support the use of a flat, 10% conversion factor because of its straightforward approach in assigning a capital charge. It also provides an incentive for banks to transition to the Basel II AIRB approach.

Beyond its greater complexity, the excess spread treatment may not be effective for Basel IA banks. The ongoing process to monitor such data is operationally burdensome and overly complex.

Application of the Proposed Revisions

*The Agencies seek comment on whether there is an asset size threshold below which banking organizations should be allowed to apply the existing risk-based capital framework without revision.*

It seems reasonable that the industry's smallest community banks be provided an option to remain under the current framework. The threshold for treatment should be determined through consultation with these small banks.

*The Agencies are also considering allowing banking organizations to choose among alternative approaches for some of the modifications to the existing capital rules that may be proposed. For example, a banking organization might be permitted to risk-weight all prudently underwritten mortgages at 50 percent if that organization chose to forgo the option of using potentially lower risk weights for its residential mortgages based on LTV or some other approach that may be proposed. The Agencies seek comment on the merits of this type of approach.*

The option to choose among alternative approaches is acceptable for smaller portfolios or when a bank holds capital well in excess of minimums. The option should not be available as a way to avoid holding capital for real risks. Banks should not be able to cherry pick a preferential treatment whenever they have materially higher risks.

Understandably, a framework embedded with too many optional approaches creates its own administrative complexity through regulatory enforcement and internal cost / benefit analyses. In addition, Call Report disclosures will be that much more difficult to compare across institutions.

*To the extent that revisions result from this ANPR process, the Agencies seek commenters' views on whether the revisions should be incorporated into the definition of the Basel II capital floor.*

As previously discussed in this letter, we believe that it is conceptually better to base the Basel II capital floors on Basel IA capital levels. There is little sense in prolonging the use of a framework that mischaracterizes the true degree of portfolio risk. It is vital, however, that the Basel IA rules be as straightforward as possible to minimize the implementation burden to applicable banks.

Reporting Requirements

*The Agencies seek comment on the various alternatives available to balance the need for enhanced reporting and greater transparency of the risk-based capital calculation, with the possible burdens associated with such an effort.*

Reporting should be structured along asset class categories and align, where possible, with existing Call Report formats.