April 16, 2010

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

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Re: "Strengthening the Resiliency of the Banking Sector" and "International Framework for Liquidity Risk Measurement, Standards and Monitoring"

Ladies and Gentlemen:

Thank you for the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) December 2009 Consultative Documents; Strengthening the Resilience of the Banking Sector and an International Framework for Liquidity Risk Measurement, Standards and Monitoring (each a Proposal and together the "Proposals"). A number of the concepts set forth in the Proposals are sound, and we support their implementation. However, we have significant concerns about some of the concepts, many of the implementation "details", and the cumulative impact these proposals may have on the health of the financial services sector and the broader economy. We are pleased to offer our thoughts below, and believe the give-and-take process that will commence with submission of industry comment letters can be of enormous value in arriving at a high quality outcome that satisfies our mutual objectives for the industry.

SUMMARY

1. Support for Objectives: A strong and resilient banking system is in the best interest of all constituents: customers, local, regional, and national governments, bank shareholders and debt investors, and employees. As such, Wells Fargo is supportive of the BCBS's overall

goal of improving the banking sector's ability to absorb shocks arising from financial and economic stress while promoting sound credit and financial intermediation activity.

The fundamental reforms proposed in the two Consultative Documents represent the most sweeping change of the global financial system ever attempted, even without considering the numerous other regulatory reform proposals being contemplated by national governments world-wide.

2. Need for Substantial Revisions to Proposals: Many of the specific proposals are sound, and actually represent how many responsible firms currently operate, including Wells Fargo. But taken as a whole, even before consideration of other regulatory reform proposals, the cumulative financial impact represents a level of conservatism so extreme that it will harm the banking sector, banking customers, and national economies.

   Based upon numerous preliminary analyses done by both industry and outside firms, we are confident that the impact assessments currently being conducted by the public and private sectors will demonstrate that the Proposals, if implemented as initially proposed, do not achieve the balance set by the BCBS as its objective in this process. That is, to "promote a better balance between financial innovation, economic efficiency, and sustainable growth over the long run."

   Wells Fargo believes it is critical for the BCBS to conduct extensive additional consultation on the Proposals, including additional Quantitative Impact Studies, to ensure that elected officials, regulatory agencies, and banks clearly understand the impact of the Proposals.

3. Impact of Current Proposals. We believe there are four broad areas of impact:

   - Macro-Economic. Without needed modifications and appropriate calibration, the proposals as issued would hamper the ability of banks to continue serving in a prudent way the needs of their customers. Requiring financial institutions to maintain too much capital and/or too much liquidity poses risks that are equally as

threatening to national economies as too little capital and/or too little liquidity, including:

  - Reduced availability of credit,
  - higher costs paid by retail customers, small-and-medium sized businesses, and large corporations for loans and other banking services
  - The potential of firms increasing investment in high risk as-yet-not-contemplated markets and/or structures to preserve returns,
  - Reduced returns on equity for investors in financial institutions accompanied with the related challenges of attracting capital to a sector that does not produce solid returns and are increasingly difficult to predict.

  Cumulatively, these items will act as an impediment to economic growth.

- <u>Financial Markets</u>. Many of the proposals imply profound changes in markets for financial instruments, the implications of which require very careful consideration. For example, the BCBS should consider very long implementation timelines to ensure that massive supplies of debt and equity instruments are not forced into markets in a short period of time.

  Beyond the actual implications to markets the BCBS should also explicitly address the "announcement risk" of the proposals, i.e. the likely immediate impact that the announcements by the BCBS regarding its final (or near final) decisions would have on market participants. Given the magnitude of the numbers, it seems conceivable that debt and equity investors could significantly adjust prices in anticipation of bank actions to comply with the Proposals. This change in pricing could actually compromise the industry's ability to fulfill the requirements.

- <u>Interaction With Other Regulations.</u> Over the last 2 years, in addition to these Proposals, 71 additional proposed regulations have been issued by ~ 20 regulatory bodies. The interaction with and cumulative impact of these proposals and the BCBS Proposals must be weighed.

- Unintended, Follow-On Consequences.   The Proposals will have unintended consequences, and the BCBS should take time to actively consider where they may arise and to refine the Proposals as necessary to reduce them. For example, if as proposed, Banks were required to deduct unrealized losses on securities from capital, it would likely encourage portfolios to be managed to shorter durations to limit mark-to-market risk (and therefore reduce required capital). For U.S. Banks, this could come at the expense of higher interest rate risk in the banking book, since U.S. Banks are typically long retail deposits that need corresponding long assets. Moreover, since interest rate risk in the banking book doesn't have a capital "charge" under the Proposals, it provides an incentive to do so.

  Finally, a reduced appetite for longer duration securities could impact the availability of longer-term funding done by many non-financial firms in the corporate debt markets.

4. Recognition of the Need For Principles-Based Regulation and Supervision: The Proposals retreat in a very significant way from Basel II's recognition that "one size does not fit all" and related emphasis on the role of supervision (that is, Pillar 2), moving backward toward the much more blunt and simplistic approach of Basel I. In Basel I's failures, we saw that financial markets and the firms that create and work in them are complex and that regulatory proposals must acknowledge and address the idiosyncratic risks posed by the differing markets, geographies, products, customers and business models of individual firms. Our view is that these idiosyncrasies are best addressed by giving bank regulators sufficient flexibility under a broad set of governing principles rather than by prescribing detailed methods and calculations which by definition are designed to accommodate the "least common denominator".

   The Supervisory Capital Assessment Program ("SCAP") conducted by U.S. regulatory agencies provides a clear example of both why a principles-based approach considering idiosyncratic risks is necessary, and that it can be performed very successfully.

5. Recognition of Progress Made: Development of the Proposals, and in particular the timing of their implementation should include full consideration of the very substantial actions that the industry and the regulatory community have taken and continue to take in order to address many of the deficiencies evidenced by the crisis. The significant recapitalization of the industry, the improvement of governance practices, the undertaking of regular and more robust stress testing, the deleveraging of the sector, the tangible improvements of risk management capabilities (including liquidity risk management) and the profound revision to supervisory approaches in a number of jurisdictions should all be taken into account.

6. Appropriate Timelines: While acknowledging that much work remains to be done, the improvements described above have dramatically reduced risk in the system, and should give world-wide regulators comfort that the proposals can be considered in a time frame that is more appropriate for the magnitude of change being proposed.

   There are many responsible firms in the sector who have deep practical experience with these topics and we believe it is important for the BCBS and national regulators to get detailed and iterative feedback from them – far beyond the 5 month process currently being pursued. Not only should the BCBS elongate timelines because of the inherent complexity of the material, but it should also be mindful that many firms are facing multiple priorities: the business complexities of a challenging economy, evaluating the numerous proposals described above, and in many cases, implementing reforms already instituted by national regulators.

   We acknowledge the significant political pressure to conclude reform initiatives quickly. But we urge the BCBS and national regulators to take sufficient time to ensure the final proposals are carefully crafted and considered so that we end up with the best possible solutions to the issues.

   Revisions to the Proposals, their judicious calibration, consideration of the interdependencies among the proposed measures, consideration of the regulatory reform initiatives occurring outside of the BCBS Proposals, full assessment of their cumulative impact, the determination of priorities, and a realistic implementation calendar are all

essential elements that must be addressed before a final set of standards is issued for implementation by the global financial industry.

STRENGTHENING THE CAPITAL BASE

7. Summary. The Proposal to strengthen the capital base of the industry does so by significantly narrowing the definition of capital, and by applying regulatory adjustments (reductions) to the narrowed definition to account for other sources of risk. Analysts have estimated that the top 25 U.S. banks would need to raise between $250 billion and $300 billion in common or preferred equity just to maintain current ratios, before even considering the higher ratio minima being considered by the BCBS.

Raising this amount of private equity capital will be a challenge, complicated by the fact that the cumulative impact of the proposals will, absent price increases passed on to ultimate consumers, result in a dramatic drop in sector ROEs. JPMorgan Investment Research has estimated that the current proposals would cause ROEs of a representative group of 16 global banks to drop from 13.3% to 5.4% in 2011. Under these conditions, it would be difficult to attract the private capital necessary to meet higher regulatory standards and to fund growth.

There will also be significant pressure to increase ratios by reducing lending/investing activities. A simple calculation based upon the “gap” described above indicates that if banks attempted to fill the Tier 1 “gap” by reducing balance sheets, lending would diminish by $3.0 trillion.

Finally, to the extent that price increases are passed on to customers they represent a reduction in the availability of credit extended.

Given the magnitude of these estimates, and their potential for unintended and undesirable consequences to the provision of credit in still fragile economies, we recommend that the BCBS proceed with the utmost care in its revision of the Proposal.

8. Redefining Tier 1 Capital: Wells Fargo supports the objective of making the components of Tier 1 Capital as strong as possible, defined by their ability to absorb losses on a going

concern basis and to preserve management's ability to work through periods of distress without having decisions dictated by the actions of creditors or other security-holders. This has long been regulatory practice in the U.S., where common equity and retained earnings must represent the preponderance of Tier 1 Capital, and where hybrid securities in large internationally active banks are limited to 15% of a firm's Tier 1 Capital.

The 14 criteria outlined in Paragraph 91 for determining eligibility for inclusion in Tier 1 Capital have the effect for U.S. banks of restricting Tier 1 Capital to common stock and surplus, retained earnings, and non-cumulative perpetual preferred stock. This would completely eliminate U.S.-style trust preferred securities from Tier 1 Capital.

Doing so ignores the fact that U.S.-style trust preferred securities did demonstrate substantial loss absorption capacity during the recent financial crisis. Because of their equity-like characteristics (most importantly, deep subordination, long maturities, and the right to defer payments of interest), trust preferred securities of many institutions traded at deep discounts to their face amounts during the financial crisis, and their holders absorbed substantial losses. In total, 6 U.S. banks effected exchanges of common stock for trust preferred securities during 2009, generating $6.0 billion of common equity, with investors absorbing losses (through the discounted prices in the exchange offers) of $2.0 billion.

The criteria for inclusion in Tier 1 Capital should be amended to include long-dated and cumulative instruments that have meaningful deferral flexibility. U.S. regulatory limits should also remain in place, acknowledging that while these instruments do have a place in a high quality Tier 1 Capital definition, it should be prudently limited.

9. Regulatory adjustments: Adjustments – deductions or exclusions – will make a great deal of difference to the financial and economic impact of the new requirements. The reasons to increase transparency and consistency of adjustments are understood, but the industry is gravely concerned that the proposals would seriously burden both recovery from the crisis and credit capacity for the future, in ways that are ultimately unnecessary. Aspects of the Proposal (e.g deducting unrealized gains on securities and deducting 100% of deferred tax assets) would also contribute a substantial degree of pro-cyclicality, undermining the

BCBS's efforts to reduce pro-cyclicality, consistently with the mandate of the G20, in other parts of its Proposals.

10. <u>Unrealized Gains or Losses on Securities</u>: Under U.S. GAAP, unrealized gains and losses on securities in the investment portfolio that are classified as "available for sale" are excluded from earnings and recorded directly to equity in Other Comprehensive Income until realized in accordance with FASB ASC 320-10 Investments – Debt and Equity Securities (FAS 115 *Accounting for Certain Investments in Debt and Equity Securities)*. Under current U.S. regulatory capital calculations, these gains or losses are "filtered out", that is unrealized gains are not added to Tier 1 Capital, nor are unrealized losses deducted. As contemplated by Paragraph 96 of the Proposal, this convention would be eliminated, and unrealized losses would be directly deducted from Tier 1 Capital (the Proposal is silent on the treatment of unrealized gains).

    Wells Fargo strongly objects to this proposal and believes that the practice of "filtering" should be continued or, at the least, national regulators should have the flexibility to permit its continuance on a jurisdiction-by-jurisdiction basis depending upon their consideration of relevant factors, including the accounting principles applicable in the relevant jurisdiction.

    - <u>Investment Securities as a Hedge</u>: In U.S. banks, the investment securities portfolio is an important tool to manage interest rate risk in the banking book. To accommodate the changes in size, composition, and rate risk characteristics of the balance sheet, U.S. banks buy, hold and may sell investment securities. To properly reflect this activity and the decision making employed, U.S. banks record the vast majority of their investment portfolios as "available for sale" because of the flexibility it accords with respect to these purchases and sales. As mentioned previously, however, it also gives rise to unrealized gains and losses that are recorded in the equity account[1].

[1] Note that if a bank elects to classify a security as "Held to Maturity" there is no requirement to mark it to market through the capital account. Different capital treatments for identical underlying economic exposures should not be allowed.

The unrealized gains and losses, however, must be recognized for what they are: one side of a hedge transaction. For example, at Wells Fargo, the investment securities portfolio is a significant hedge to our deposit gathering businesses. An asymmetric view of this transaction does not recognize the underlying economic reality. For example, if interest rates rise, the value of the investment securities portfolio could be expected to decline, giving rise to unrealized losses. Our portfolio of low-and-no cost deposits concurrently gains value in response to rising rates. Deducting the "loss" from capital while ignoring the "gain" in the banking book distorts what is actually occurring to the bank's financial condition.

- Recording Losses That May Never Be Realized: Under FASB ASC 320-10-35 (FAS 115, paragraph 16) banks are required to determine the extent to which the cash flow on any investment securities may not be fully recovered due to changes in the creditworthiness of the issuer and to take any necessary impairment as a charge to earnings. This process gives the reader of the financial statements confidence that the unrealized gains and losses arise solely from changing interest rates and credit spreads.

  Such "gains" or "losses" may in fact never be realized because it may not be the intent of the bank to sell the securities (given their role as a hedge) or because banks have significant flexibility to make a variety of decisions that affect the amount of gain or loss recognized, including which assets to sell, the timing of sale and structuring decisions with respect to particular sale transactions. Requiring banks to hold capital against such arbitrary assumptions (e.g. that the bank is assumed to sell the securities on the measurement date), does not reflect economic realities.

- Unnecessary Volatility: This proposal would introduce a significant amount of unnecessary volatility into capital measures. For example at Wells Fargo, in the last 12 months, our investment securities portfolio has swung from an unrealized loss of $4.7 billion on 3/31/09 to an unrealized gain of $6.6 billion on 9/30/09. This swing of $11.3 billion is the equivalent of 70 basis points of Tier 1 Capital.

- Pro-cyclicality: Paragraph 96 is decidedly pro-cyclical. In order to maintain minimum or targeted capital ratios, banks will feel compelled to issue Common Equity or other capital instruments because their investment portfolios experience temporary declines in value. Those temporary declines are likely to be experienced across the banking sector at the same time, and the related capital-raising will be occurring during a period of distress in the economic cycle, not a period of strength.

- Not A Significant Source of Confusion. U.S. fixed income and equity investors understand the issues described above well. In addition, both Moody's and Standard and Poors calculate key equity ratios using formulas that exclude unrealized gains and losses. We believe the "filtering" is simply not an issue that impacts the transparency or credibility of regulatory capital ratios.

11. Intangibles: Paragraph 97 would require that all intangibles be deducted from Common Equity. Although we believe there is sufficient uncertainty as to the realizable value of certain intangible assets to warrant their deduction, we do not believe that is the case for all intangible assets. Mortgage-servicing assets, nonmortgage-servicing assets and purchased credit-card relationships have shown themselves to have demonstrable realizable value over sustained periods.

    Mortgage servicing rights ("MSR"), while technically defined as intangibles under U.S. GAAP, are part of a unique class of intangibles whose value is supported by real cash flow entitlements that are based upon contractual obligations, are transferrable, and for which a market exists. Additionally, under FASB ASC 820-10, Fair Value Measurements and Disclosures (FAS 157 *Fair Value Measurements*), they are classified as a "Level III" asset and as such, are subject to significantly higher levels of scrutiny from external auditors and banking supervisors. Given all of this, to characterizing MSRs as having a "high degree of uncertainty" of being realized, and therefore ascribing to them zero realizable value, is simply incorrect.

    We fully acknowledge the fluctuations in value of MSRs due to changes in prepayment speeds. However, this risk has proven to be very manageable and is in fact not dramatically different from the prepayment risk embedded in a number of other consumer products such as whole loan mortgages and securities based upon them, auto loans, credit card loans, etc.

For U.S. banks, mortgage servicing rights are particularly important, and are an inherent part of our housing finance market. Based on information in call reports filed by the 17 largest U.S. banks, total mortgage servicing rights at 12/31/09 were $67 billion. By comparison, given differences in national housing finance policy, the amount of MSRs recorded on the books of the largest European banks are insignificant, effectively zero.

If the Proposal was enacted as proposed, the likely result in the U.S. would be severe downward pressure on MSR valuations at regulated entities and a subsequent movement of the mortgage servicing business out of regulated and into unregulated entities (where required capital levels more closely reflect the economic risk of the business). But since MSR valuation is a component not only of the servicing business but also of the price lenders offer to customers, this would also mean a dramatic shift of mortgage lending out of regulated and into unregulated entities. It is worth reminding ourselves that the lending and servicing practices of non-bank mortgage companies were a major contributor to the recent financial crisis.

Currently the U.S. regulatory regime accommodates the fluctuations in MSR value due to prepayment speeds by deducting 10% of their gross value from regulatory capital measures. Wells Fargo strongly believes that this practice should be continued or, at the least, national regulators should have the flexibility to permit its continuance on a jurisdiction-by-jurisdiction basis depending upon their consideration of relevant factors, including the accounting principles applicable in the relevant jurisdiction.

12. <u>Deferred Tax Assets</u>: Paragraph 98 would require that all deferred tax assets ("DTAs") which rely on future profitability of the bank to be realized be deducted from Common Equity. DTAs in the U.S. banking system routinely arise from the timing difference between losses recorded for accounting purposes (including the building of Allowance For Loan Losses) and losses recorded for tax purposes (realized losses only). They are routinely created and routinely resolved. The strength and realizability of DTAs depend upon the rigor of the accounting standards applied under generally accepted accounting principles in that jurisdiction. We urge the Committee to permit national regulators discretion in their treatment of DTAs which rely on the future profitability of the bank, taking into account accounting standards applied in the relevant jurisdiction. Paragraph 98

takes an even more conservative approach than is currently applied by the U.S. bank regulatory agencies under their capital guidelines and regulations. Those capital guidelines and regulations provide that DTAs dependent upon future income, net of the valuation allowance, must be deducted from core capital elements in determining Tier 1 Capital to the extent that they exceed the lesser of (i) the amount of the those DTAs that the bank is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year, and (ii) 10% of Tier 1 Capital.

Prior to the U.S. FASB's adoption of its Statement No. 109 ("FAS 109"), *Accounting for Income Taxes* (FASB ASC 740-10 Income Taxes) in 1992, U.S. GAAP did not permit the recording of deferred tax assets that are dependent upon future taxable income. FAS 109 changed U.S. GAAP to permit the recording of DTAs that are dependent upon future taxable income, but importantly, requires the establishment of a valuation allowance, if warranted, to reduce the DTA net of the valuation allowance to an amount that is more likely than not (i.e., a greater than 50% likelihood) to be realized.

Effective April 1, 1995, the U.S. bank regulatory agencies, in response to the changes in the U.S. GAAP treatment of DTAs brought about by FAS 109, amended their capital guidelines and regulations to include the limitations on DTAs as described above. Prior to those amendments, the U.S. bank regulatory agencies' capital guidelines and regulations did not include a limitation on DTAs.

This approach to DTAs has been successfully managed by both industry and regulators for many years and through several credit cycles. Accordingly, we urge the Committee to permit national regulators discretion in their treatment of DTAs which rely on future profitability of the bank.

13. <u>Provisioning Shortfalls</u>: Under U.S. GAAP, the Allowance For Loan Losses reflects losses "inherent" in the loan portfolio. Generally, for retail credit portfolios, this amounts to losses expected to be incurred in the next 12 months. For commercial/wholesale credit portfolios, this represents expected losses for the next 12-36 months. Under Basel II, "expected losses" (EL) are calculated as 12 months of losses based upon long-run average probabilities of default and loss-given-defaults. Attempting to equilibrate two distinctly different concepts through the capital account adds volatility and diminishes transparency to capital measures.

Wells Fargo strongly disagrees with the current treatment under Basel II (where shortfalls are deducted 50% from Tier 1 Capital and 50% from Total Capital), and our disagreement is exacerbated with the proposed movement to a 100% deduction of shortfalls from Tier 1 Capital.

14. Pension Fund Assets and Liabilities: Treatment of pension assets and liabilities is likely to matter only in insolvency (gone concern); as such, the proposed deduction exclusively from Tier 1 capital may contribute excessively to volatility and pro-cyclicality and fail to recognize the allocation of pension burdens between the going concern and possible gone-concern claims. The valuation of pensions also requires further guidance from the regulators and accounting setters to work out appropriate treatment and measurement of pension issues without exacerbating pro-cyclicality. In particular, there are choices to be made between the measures of pension liabilities; the solvency approach, the going concern approach and the funding or accounting approach.

INTRODUCTION OF A NEW UNIVERSAL LEVERAGE RATIO

15. An Internationally Consistent Leverage Ratio. Wells Fargo supports the adoption of an internationally consistent leverage ratio having the objectives outlined by the Committee in Paragraph 204; a leverage ratio has long been present in the U.S. system of regulation. We agree with the Committee that the measure of exposure generally should be the accounting measure of exposure. However, we are concerned that the proposed addition of several items to GAAP assets to determine the "exposure measure" (i.e. the denominator), has two flaws. First, it does not reflect underlying economic realities, and second, it would increase the denominator for many banks by substantial multiples of their GAAP assets. This "inflation" of the denominator would require the Committee to, in the calibration process, choose a percentage for the leverage ratio that is so small as to make the ratio meaningless.

    Legally Enforceable Netting Arrangements. We strongly disagree with the proposed treatment of netting in the Proposals and urge the Committee to recognize legally enforceable netting arrangements, whether in the context of credit or other derivatives or repurchase agreements.

Banks have a great deal of experience with evaluating when and whether bilateral netting is enforceable, taking into account for multi-jurisdictional transactions the impact of bankruptcy and insolvency laws in the relevant jurisdictions. Over the years, individual banks and trade associations, including ISDA, have expended substantial effort on analyzing the enforceability of netting in various jurisdictions and obtaining relevant opinions. If there is a concern with netting, we expect that it would arise not so much out of incorrect determinations as to whether multiple contracts may be netted in a legally enforceable manner, but, instead, out of the operational challenges of identifying which contracts are subject to netting and determining the current exposure after giving effect to netting. If that is a concern, then we urge national regulators to address it, as a supervisory matter, by reviewing the documentation, recordkeeping and operational requirements that banks should satisfy and follow in order to demonstrate their ability on a timely basis to identify which contracts are netted and the net current exposure.

During the crisis, the validity of netting was proven at Wells Fargo by its exposure to Lehman Brothers. On a gross basis, Wells Fargo had a long exposure to Lehman of $1.4 billion. This is the amount that would be included as our exposure under the Proposals. Netting agreements reduced our exposure to $400 million, and collateral reduced that exposure to $100mm, ultimately the amount of loss our firm incurred as a result of their bankruptcy.

- <u>Credit Derivatives</u>. Paragraphs 230-231 would require banks to include in the denominator of the leverage ratio 100% of the notional value of credit derivatives where the bank is the seller of credit protection without any reduction for credit derivatives where the bank has hedged its exposure by buying credit protection on the same reference entities or reference obligations. Wells Fargo believes this is completely inappropriate. Credit derivatives – typically credit default swaps, or "CDS", and total return swaps, or "TRS" – are a valuable tool used by many companies (banks and non-banks alike) to manage exposure to third parties. Used properly, they perform a valuable function in distributing risk within the financial system. Banks that conduct this business for customers, as end users, almost always

maintain off-setting positions to limit their exposure (unlike our understanding of AIG's activities in this area). The bank is acting as a financial intermediary, and the service it is providing is one that is appropriate for financial intermediaries. The inclusion in the leverage ratio denominator of the notional amount of credit protection sold would inflate the denominator of the ratio in a manner that bears no relationship to actual exposure.

- Off Balance Sheet Exposures. If the Committee determines to include off-balance sheet items in total exposure for leverage ratio purposes, we urge the Committee to consider reasonable conversion factors (and not apply a blanket 100% conversion factor) in order to make the leverage ratio reflective of the underlying economic reality and therefore more meaningful. Wells Fargo has extensive experience in the performance of its committed and uncommitted facilities, direct credit substitutes, acceptances, trade letters of credit, failed transactions, and unsettled securities during the crisis (and actually data extending many years prior to the crisis). Generally, throughout the crisis we experienced no discernable increase in utilization in these areas. In fact, the secular trend over the past couple of "crisis" years has been a decline in utilization as both consumers and businesses choose to "de-lever" in response to uncertain economic conditions.

  We urge the Committee to permit banks that have substantial history, subject to consultation with and approval by their national regulators, to use conversion factors based on their historical experience, not arbitrary factors.

ADDRESSING PROCYCLICALITY THROUGH BUFFERS

16. Capital Buffers: Wells Fargo shares the Committee's concern with the pro-cyclicality of the existing capital framework. However, we do not favor adopting as an international standard the buffer framework outlined in Paragraphs 247 through 259. Instead, we strongly believe that capital conservation should be addressed as a supervisory matter by national regulators, not through a series of prescriptions.

- In our view, a buffer scheme would create unnecessary confusion and ambiguity regarding precisely what capital ratios are required and would cause the sum of the minimum capital ratios "plus buffers" to become the de facto minimum ratios. The Proposals attempt to distinguish a bank that does not meet minimum capital requirements from a bank that does so but fails to maintain recommended "buffers" by suggesting that the latter will be able to conduct "business as usual," subject to certain constraints on distributions. It seems unlikely to us that a bank subject to broad restrictions on its corporate activities would be viewed as is conducting "business as usual." Instead, as expressed above, we are concerned that "buffered" capital levels will become de facto minimums, with both banks and their investors and creditors wanting to stay above "buffered" levels at all costs. As a result, banks would have to maintain "buffers" even higher than the nominal required "buffers" – another layer of conservatism on an already conservative approach.

- We believe any necessary capital conservation measures such as limitations on dividends, share buybacks, and discretionary bonus payments, etc. are best addressed by regulators within each jurisdiction taking into account the circumstances of that jurisdiction. The U.S. supervisors clearly have this ability under the "prompt corrective action regulations", adopted pursuant to Section 38 of the Federal Deposit Insurance Act. We do not believe that a single international standard would be useful and, if anything, may well work at odds with regulatory regimes in many jurisdictions that are satisfactory in their current form.

17. Excessive Credit Growth. The Proposals discuss the possibility of increasing local capital requirements in times of "excessive credit growth" (Paragraphs 41-43, 260-262). We believe that imposing higher capital requirements in jurisdictions with "excessive" credit growth would be a highly subjective exercise and difficult to implement in a non-arbitrary way. It seems very unlikely to us that, even with the benchmarking approach discussed in Paragraph 262, the Committee will be able to develop a compelling "one size fits all" macroeconomic model to discern "excessive" credit growth around the world – especially when this is an area where supervision by national regulators, who will have a deeper understanding of their economies, would appear to be a better alternative.

We believe that in this case, the Proposals tend to emphasize complex quantitative modeling beyond the point of diminishing returns. The difficulty of developing and administering an accurate set of rules becomes prohibitive in comparison to the costs and benefits of an approach that is more standards-based and supervisory oriented. We agree that excessive credit growth could not be monitored and controlled by "a strict rules-based regime", as the Proposals acknowledge (Paragraph 262). We also believe, however, that accurately determining the predictors of future credit "bubbles" in every economy is likely to prove insuperably difficult, even with supervisory adjustments at the margins. Especially for growing economies, we are dubious that a fixed set of variables could effectively distinguish between "good" and "excessive" credit growth based on factors such as GDP. Moreover, there is no guarantee that future credit "bubbles" will take the same form as they have in the past. We believe that leaving the question of credit growth to national regulators as part of Pillar 2 regulation is a more sensible approach to this difficult issue, not only because it will help to avoid the problems discussed above, but also because it will make it easier for credit growth monitoring to evolve over time with local economies.

LIQUIDITY

18. Summary. Wells Fargo agrees that the recent crises have demonstrated the importance of ensuring that large banks are resilient to liquidity stress. And, as mentioned above, while we agree conceptually with many of the principles contained in the Proposals, we are very concerned that, taken as a whole, the Proposals are overly conservative to the point of being extreme, and are not at all reflective of our experience in the recent crisis. Moreover, our experience is highly relevant because of our acquisition of Wachovia Corporation in late 2008, which experienced significant liquidity issues prior to the announcement of the acquisition. Studying that experience allowed us to critically evaluate the Proposals in light of real data, and led to our conclusion that the BCBS should consider extensive revisions, taking into account the following points.

19. Prescribed Approaches: As noted in the introductory paragraphs of this letter we are concerned with the level of prescription in the Proposals, especially with the funding parameters in the International Framework for Liquidity Risk Measurement, Standards and Monitoring. We believe the Proposals are unsound because they fail to recognize important

differences among banks and that approach leads to shortcomings similar to those of Basel I for capital.

Liquidity risk management inherently depends on many firm-specific variables, including business model, mix of business, customer profiles, depth of customer relationships, and market status and access. As a consequence, there has been – and we believe, both as a matter of supervisory policy and sound management for individual banks, should be – less convergence around standardized approaches to measuring liquidity risk than approaches to other aspects of bank regulation. National regulators historically have recognized, even in recent pronouncements, the reality that liquidity risk processes and systems cannot be reduced to prescriptive formulas.[2]

An analog to this is interest rate risk management, which is similarly idiosyncratic. Regulators in the U.S. have long been insistent that certain principles be followed (e.g. ensuring data integrity, requiring proper model validation and requiring appropriately stressful scenarios, etc). But this has not resulted in highly standardized processes. Indeed, even attempts to compare results across firms on a standardized basis have been unsuccessful. However, the absence of prescriptive standards has not at all diminished the efficacy of interest rate risk management programs across the major banks in the U.S.

As an indication of how inappropriate prescriptive, one-size fits all parameters are to this problem, we compared the factors for deposit run-off, line draws, etc. to our experience with Wachovia Corporation. At Wells Fargo we have had the unique opportunity to collect and analyze data from Wachovia, an acquisition we announced in October 2008. Prior to the acquisition announcement, Wachovia experienced significant liquidity events that ultimately made its survival as a stand-alone entity impossible. These experiences, which we studied at a

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2 The U.S. Department of the Treasury and the U.S. Federal bank regulatory agencies, in their revised *Interagency Policy Statement on Funding and Liquidity Risk Managemen*t issued last month, 75 Fed. Reg. 13656, 13661 (March 22, 2010), commented on this several times, including in Paragraph 5 of the Policy Statement as follows:

> "An institution's obligations, and the funding sources used to meet them, depend significantly on its business, mix, balance-sheet structure, and the cashflow profiles of its on- and off-balance sheet obligations."

very granular level, are significantly different from the parameters suggested in the Proposal. Generally, our experience vis-à-vis the Proposal is as follows:

- Retail and small business deposit attrition/diminution factors in the Proposal are <u>several times higher</u> than the amount experienced by Wachovia.
- Actual wholesale deposit attrition/diminution experienced by Wachovia was 30-50% <u>lower</u> than the factors outlined in the Proposal.
- Draws on non-cancellable lines of credit were <u>negligible</u> at Wachovia, compared to the flat 10% factor contained in the Proposal.
- The ability to acquire funding under secured borrowing lines, such as lines with the Federal Home Loan Banks, was employed by Wachovia throughout the crisis, whereas the use of secured funding facilities, even where collateral has already been pledged and accepted, is not included in the Proposal.
- Repurchase agreements using mortgage backed securities (including securities guaranteed by government sponsored enterprises ("GSEs") such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation) as collateral remained a highly liquid source of funding which was available to Wachovia through the height of the crisis. Much of this repo was transacted through the General Collateral Finance ("GCF") Repo service of Fixed Income Clearing Corporation. GCF Repo offers a highly liquid market for securities financing by allowing members to execute repo on securities issued or guaranteed by the U.S. Treasury, its agencies or GSEs on an anonymous basis.

A prescriptive approach is inherently more likely to include inappropriate funding parameters and produce undesired and problematic results over a longer time horizon. This is exacerbated when the factors are not based upon broadly developed empirical evidence (and the Quantitative Impact Study is not gathering any data that will help fill this gap).

Under a less prescriptive and more principles-based approach, the Proposal would include a Liquidity Coverage Ratio ("LCR") and Net Stable Funding Ratio ("NSFR") much as proposed, including with respect to the objective addressed by each ratio, but would not specify the funding parameters. Banking regulations would leave the determination of the funding parameters to be

used to each bank's discretion, in discussion with its national regulator as a matter of supervisory oversight. This approach would also give banks some flexibility, in discussion with their national regulators, to determine the components of the numerators and denominators in the ratios.

Were the Committee to ultimately consider such an approach, it could be implemented as, effectively, an "*enhanced Pillar 2*" approach, similar to the foundation and advanced internal ratings-based, or "*IRB*", approach to capital in Basel II. Under this approach, the Committee would adopt an LCR and NSFR as the foundation approach to liquidity measurement, taking into account comments received on the Proposal and learning obtained through the QIS, but then also permit banks to propose and, if approved, instead use as an alternative internal liquidity models ("ILMs") tailored by each bank to its own business and experience, as the advanced approach to liquidity measurement. The liquidity rules of national regulators would specify minimum requirements for entry and on-going use of ILMs proposed by individual banks taking into account their own circumstances and the unique aspects of their businesses, similar to the advanced IRB approach to capital in Basel II.

20. <u>Role of Central Banks in a Severe System-Wide Stress Scenario</u>. Wells Fargo agrees with the premise that firms must have sufficient liquidity to weather idiosyncratic problems and to do so in a period of market stress. Responsible firms, including Wells Fargo, have long-standing practices designed to ensure this. However, the design of the scenario to have all firms "self insure" against <u>all</u> potential systemic shocks should be reconsidered. As the Bank of Canada recently observed:

> "Clearly it would be prohibitively inefficient, if not impossible for [a financial institution] to fully protect itself against systemic shocks. Thus, to balance the costs and benefits of liquid assets … consistent with the BCBS principles for liquidity management, the objective of a macroprudential tool, such as a liquidity standard should be for [financial institutions] to protect themselves against their own institution-specific liquidity and funding shocks, as well as most adverse market shocks … Institution-specified shocks occur much more frequently than systemic ones. In the case of the former, there must be consequences for not adhering to the standards if supervisors are to encourage the prudent management of liquidity risk and mitigate moral hazard … the challenge comes when the event is a systemic shock, as occurred in the autumn of 2008. In this period of heightened aversion to credit risk, [financial institutions] saw their access to funding markets evaporate … Uncertainty regarding future access to funding boosted [financial institutions'] demand for liquid assets, which, at a systemic level, could only be met either by increased issuance of government

> debt or by liquidity supplied by central banks. In such circumstances, the liquidity positions of [financial institutions] relative to a regulatory liquidity standard … may deteriorate, but that deterioration is an indication of systemic stress…. Attempts by [financial institutions] to collectively reduce credit supply could result in customers withdrawing funds from the system to service their own obligations. This, in turn would aggravate the funding pressures on the financial system as a whole … Therefore, while there must be consequences for [financial institutions] that fall below the standards in most periods, from a macroprudential perspective, it is extremely unhelpful if, in an exceptional period of systemic stress, the liquidity standards give [financial institutions] an incentive to disengage (more than they otherwise would) from funding markets and decrease their market-making activities.[3]

All banks within a system cannot simultaneously lose liquidity; indeed there is a tacit acknowledgement of this in the construct of the ratio because it assumes that a bank can realize its cash by liquidating assets. Making this assumption requires that some counterparties have liquidity to offer. In fact many sound institutions, including Wells Fargo, experienced significant growth in deposits during the recent crisis.

As challenging as it is, the BCBS must explicitly articulate the role of Central Banks in providing liquidity during severe systemic events. These could include either short-term events, e.g. originating from operational issues such as the inability of a clearing bank to process payments, or longer term systemic problems. The desirability of this was evidenced during the recent crisis, where the U.S. Federal Reserve Bank provided many secured lending facilities to ensure ample system-wide liquidity. Wells Fargo believes many of these actions were highly effective in reducing the depth and duration of the crisis. Moreover, the vast bulk of these programs have now been successfully terminated without any cost to the U.S. government.

Without an explicit consideration and articulation of the role of the Central Bank, the Proposals will by definition, cause firms to maintain too high a stock of liquidity reserves, crowding out lending activities by displacing loans in favor of government bonds.

21. Broader Implications of the Net Stable Funding Ratio. An essential social function of the banking system historically has been maturity transformation – that is, intermediating the

[3] Bank of Canada, *Financial System Review*, December 2009, pp. 38-9, citations omitted. See also David Longworth, "Bank of Canada Liquidity Facilities: Past, Present and Future", February 17, 2010, at p. 8 and notes 17-21.

imbalances between short-term and long-term needs of borrowers and availability of credit. Banks establish their own risk appetites and measures for managing risks in performing this role. The Proposal will have the effect of substantially limiting banks as intermediaries performing that social function. In fact one expert has concluded that to maintain the proposed NSFR, banks will become net consumers of liquidity from the broader economy, not providers.

We are concerned that the macroeconomic consequences of narrowing the role of banks in maturity transformation are not at all understood. Maturity transformation still needs to occur, whether facilitated by banks or by unregulated financial entities. The Proposal as written will encourage the flow of capital and resources from regulated to unregulated financial entities who will replace banks in performing this function.

Acknowledging that the level of desired maturity transformation may differ from jurisdiction to jurisdiction, we urge the BCBS to build in sufficient flexibility in the construct of the NSFR to allow national regulators to tailor it to support, not eliminate, the desired level of maturity transformation in their jurisdictions.

22. <u>Sources of Liquidity Too Narrowly Defined</u>. Wells Fargo believes the population of liquid securities/sources of liquidity provided in the Proposal is too narrowly defined and should be modified as follows:

- The Proposal has a strong bias in favor of sovereign debt, and we believe the "fundamental" and "market-related" characteristics of such assets described in Paragraph 29 are found in a wider range of assets than just sovereign debt.
- *US GSE and US Agency MBS securities.* Paragraph 34 limits the definition of liquid assets to cash and securities that are assigned a 0% risk-weight under the Basel II standardized approach. We recommend including the obligations of GSEs and obligations explicitly guaranteed by the relevant sovereign, including securities issued by banks or other financial services entities. In the U.S., this would permit inclusion of debt of GSEs such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). These obligations have

demonstrated appropriate characteristics such as low risk and high liquidity, justifying their inclusion in a definition of high quality liquid assets.

- *Corporate Bonds.* We support the inclusion of highly rated, liquid corporate bonds in the stock of high quality liquid assets. Such bonds, especially when meeting the extensive criteria set forth in the Proposals (Paragraph 36), have the quality and liquidity to justify their inclusion in the numerator of the LCR.

  We note that the criteria for qualifying corporate bonds, while obviously intended to correlate with safety and liquidity in times of financial crisis, include very specific quantitative tests for characteristics such as credit risk and historical bid-ask-yield spread. Furthermore, the proposed 20% and 40% figures for corporate bond haircuts are presented in the Proposals without elaboration or derivation. We believe that the Committee should disclose the models it has employed and the reasoning it has used to design these criteria and the associated haircuts, which are difficult to evaluate. The collective knowledge and experience of the constituencies commenting on the Proposal could be used to refine the treatment of corporate bonds and potentially suggest other ways of tailoring their weighting more closely to the risk profiles of individual institutions.

- *Other Liquid Assets*. We believe that obligations of municipalities (including state and local governments and other public sector entities), certain Asset-Backed Securities, listed equities and other types of securities should be given some liquidity value in a 30-day time horizon after consideration of appropriate haircuts. In the United States, many types of securities had a high degree of liquidity throughout the crisis especially in the repurchase agreement markets.

- *Secured Funding from the Federal Home Loan Bank (“FHLB”) System.* The FHLBs are government sponsored entities whose own borrowings are conducted on a consolidated basis through a combined funding office. Borrowings from the FHLBs are secured, and each FHLB specifies its own collateral requirements. Eligible collateral customarily includes a variety of assets, including mortgages and mortgage-related securities, that is much broader in scope than the high-quality liquid assets as defined for purposes of the LCR and NSFR. The LCR and NSFR as described in the Proposals do not give effect to

the availability of FHLB borrowings. Secured borrowing facilities, where existing collateral is already pledged such as the FHLB, provide an ability to monetize assets very quickly and should be included. We believe they must; not doing so would arbitrarily eliminate a major and reliable liquidity source for U.S. banks.

- *Additional Sources of Liquidity under the NSFR scenario.* We believe the NSFR should consider other sources of liquidity and management actions available to an institution within a one-year time horizon. In particular, other securities and assets not currently contemplated in the NSFR should be assumed as pledgeable or saleable with appropriate haircuts applied. The ability to curtail loan origination and other similar management actions may also serve as a source of liquidity.

23. Implementation Plans Should Proceed With Extraordinary Care. By now, many investment banks and analysis firms have attempted to estimate the impact of the liquidity proposals. The estimates of the amount of additional intermediate-to-long term debt issuance required by the top 25 U.S. banks to achieve compliance with the Proposal range from a low of $1.3 trillion to a high of $1.9 trillion for U.S. banks alone. In comparison, during 2006 and 2007, boom years for debt issuance, senior debt issued by banks in the U.S. averaged ~$650 billion per year much of which was needed to refund existing maturities. In 2009, non-guaranteed debt issued by U.S. financial institutions was $150 billion. Accordingly, new supply to facilitate compliance with the Proposal would be 2x to 3x of the greatest market capacity exhibited, and 8x to 13x of current levels. This supply would be in addition to routine refunding banks must accomplish.

    At present, we believe the market has not priced in such a supply, believing that regulators would not consider enacting such proposals. If the markets were to become concerned about a significant overhang of supply, price discovery would become exceedingly difficult and credit spreads could widen out dramatically, not due to intrinsic changes in creditworthiness, but simply because investors would demand to be compensated for taking risk that subsequent debt issuances would require a higher spread to clear the market. A dramatic widening of credit spreads not only would make funding more difficult and expensive, but asset prices would decline. Declining asset prices could lead to forced sales,

which in turn would put further pressure on asset prices, leading to an undesirable feedback loop that would reduce, not promote market stability.

The notion that the BCBS can put Proposals of this magnitude out in the public domain and then "correct any issues through calibration" (a comment we have heard repeatedly) strikes us as imprudent. We strongly encourage the BCBS to carefully consider its implementation plan for the final (or even near-final) Proposals, including explicitly addressing announcement risk.

24. Disclosure. Liquidity is an area where perception affects reality. As a result, we have considerable concern about the consequences of the proposed public disclosure by banks of their percentages under the LCR and NSFR.

Inevitably, the more standardized the funding parameters and other substance of the ratios, the less reliable the ratios are as tools to measure liquidity risk in a truly meaningful manner across different mixes of businesses, geography and market participation. Public disclosure may therefore expose banks to market penalties for marginal differences in their ratios as compared to peers, even where the differences do not reflect meaningful differences in the banks' respective liquidity strength. This could, in turn, set up an undesirable feedback loop in which disclosure of the LCR or NSFR ratios for a bank with ratios below those of its peer banks makes obtaining funding more costly, if not impossible, which in turn could create actual liquidity issues. As we saw during the crisis, once such a feedback loop starts (and some would contend that issues like this could be willfully exploited), it is exceedingly difficult, if not impossible to stop.

Additionally, while the LCR and NSFR seek to establish liquidity buffers sufficient to withstand a severe stress, disclosure of the ratios limits the ability of institutions to draw down their buffers in a time of crisis. Once a liquidity event begins and outflows start to occur, the thresholds will be violated if the outflows are not replenished. If the buffers cannot be rebuilt immediately due to the lack of market liquidity, disclosure of violations in the LCR or NSFR would very likely initiate negative feedback loops for the institutions involved.

In our view, the better approach would be to use the LCR and NSFR only as supervisory tools – a component in the assessment by banks, national regulators and supervisory colleges to determine the adequacy of a bank's liquidity position and processes.

COUNTERPARTY RISK

25. Summary. Wells Fargo recognizes that it is appropriate to review the capital treatment and related risk management methods for counterparty credit exposures given recent market events. This review should result in:

    - Measurements which accurately recognize risks and mitigants, such as netting, collateral agreements, diversification, active portfolio management and prudent hedging
    - Consistent application of calculation methodologies across institutions and regulatory regimes to achieve a level playing field
    - Recognition of the cumulative effects of individual Proposal, so that capital requirements are aligned with true economic risks
    - Adequate time to respond to the final proposal and to implement the infrastructure to comply with the new requirements

    Our specific comments and concerns are detailed below.

26. CVA Capital Charge. Like many other large financial institutions, Wells Fargo applies a Credit Value Adjustment ("CVA") to our OTC derivative exposures. Paragraphs 123 through 125 describe the inclusion of an additional capital charge to measure the CVA volatility, which would be based on creating a zero-coupon bond equivalent for each counterparty exposure. We are concerned that the methodology being proposed does not accurately represent economic risk and is not consistent with the market risk framework being applied for similar trading assets.

    Specifically, the proposed bond equivalent exposure is equal to the total EAD of a counterparty with a maturity based on the longest dated netting set of the counterparty. We

believe that this is overly conservative as it does not adequately correlate to the factors which drive risk and are used to value and hedge these assets.

Most firms actively hedge CVA using a variety of trading instruments, including single-name, basket and index CDS. The Proposal only permits consideration of single-name hedges, thus excluding important tools which are currently used to efficiently hedge these risks. This may create a disincentive to apply the most prudent hedging strategies since there would be costs associated with this without the corresponding capital relief.

We recommend that regulatory capital for counterparty risks which are marked-to-market be treated consistently with other trading book assets under the market risk framework.

27. Asset Value Correlation. Paragraphs 135 through 140 describe increasing the asset value correlation used to calculate exposure for many categories of financial institutions. While we understand the rationale behind exploring correlation factors, we are concerned with several aspects of this proposal.

- This proposal does not appear to consider that most transactions between financial institutions incorporate risk mitigation techniques, such as netting and collateralization, to reduce exposure.
- While it is not possible to comment on the calibration level without understanding the data on which the proposal is based, we question the application of a standard 25% increase in asset value correlation to all financial institutions regardless of credit quality or specific business activities that these firms engage in.
- We are concerned with how this might be extended beyond OTC derivatives, repos and securities financing transactions to also include other forms of exposure.

28. Stressed Effective EPE. Paragraphs 118 through 122 describe applying stressed inputs when calculating Effective EPE using the internal Models Method ("IMM"). While Wells Fargo will apply the Current Exposure Method ("CEM") for Basel II capital processes, we are concerned about still to be defined potential changes to the CEM formulae which will be based on the QIS calibration process. We welcome clarification of how these stressed

inputs will be calibrated against similar methodologies being applied within the Pillar 2 framework and the proposed capital buffers, as there is a risk of double or triple counting the overall capital impact.

29. Central Counterparties. We understand the potential benefits related to standardized processes and transparency which central counterparties may provide, and support industry efforts to move toward transacting with these entities where practical. However, there are risks associated with concentrating exposure with a small number of counterparties which must be considered. Regulators will need to define criteria for central counterparties, including operational standards, capital requirements and oversight accountabilities, to instill confidence in trading partners. There will also be some products, due to their non-standardized nature, that will not qualify to transact through central counterparties.

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Wells Fargo appreciates your consideration of the views expressed in this letter. We will gladly make ourselves available for any further consultations and/or questions you have. Please contact Paul Ackerman at 415-396-5196 if we can assist you in any way.

Sincerely,

Howard Atkins

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