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WACHOVIA

Secretariat
Basel Committee on Banking Supervision
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Wachovia appreciates the opportunity to comment on the Basel Committee's Third Consultative Paper (CP3). The interactive process used over the past few years has been key to bringing the new Basel Accord closer to the Committee's goals and making the capital framework more risk sensitive. As with earlier drafts, the Basel Committee has made changes in CP3 to respond to the needs of the financial community and to better align the regulatory capital framework with the realities of risk management best practices.

As the international process works toward its conclusion, we believe it is time to recognize a fundamental problem with the Committee's simultaneous goals: greater risk sensitivity and an overall level of regulatory capital that is the same as under today's rules. The outcome of a better risk assessment process combined with rules that require less capital for less risk may well be a move by banks to reduce risk and required capital. The Committee should state that this is an acceptable outcome rather than adhering to a view that overall capital minimums should be unchanged even if sophisticated risk assessments show that risk levels require less capital. The Accord gives regulators considerable latitude to increase capital requirements beyond that computed under Pillar I, and banks are reasonably concerned that the bar will be set higher and higher if too many of them reduce their underlying need for capital. If banks believe that their actions to reduce risk will not free up capital, they will find few benefits to offset the costs of regulatory compliance – costs that will certainly be higher than the costs of assessing these risks for internal purposes alone.

This does not necessarily mean that Wachovia or other banks would reduce their actual capital levels – we always want to be well capitalized, though not excessively so. If we do hold more capital relative to our risks, we want that fact to be recognized. We do not want our capital ratios to remain fixed simply because harsh assumptions or add-ons increase minimum capital rates and offset the benefits of a less risky portfolio.

Many of the changes in CP3 have addressed the problems of earlier proposals. The Accord has been improved and made more risk sensitive by including them. In particular, we believe that permitting banks to use internally developed PDs and LGDs for High-Volatility Commercial Real Estate will improve risk sensitivity and encourage banks to invest in better risk assessment approaches for this asset class. Operational risk sensitivity has also improved with increased flexibility under the Advanced Measurement Approach (AMA), removal of the 75% capital floor tied to the Basic Indicator Approach, and recognition of insurance as a capital adjustment.

Still, the Accord continues to have significant shortcomings in several areas. Without addressing these issues before implementation, the new Accord could prove disruptive to banks and the financial system as a whole. The most noteworthy issues to be addressed include:

- **Level Playing Field Problems**. The new Accord should maintain or improve competitive equity among banks. No bank should be disadvantaged simply because of the country where it is incorporated or the products it chooses to offer. The Accord must have sufficient clarity to ensure that key interpretations will be applied consistently from one jurisdiction to another. It appears that this is not currently the case with the rules surrounding ***the use of general reserves to offset the EL portion of risk-weighted assets***. US regulators have advised us that these rules will not be applicable in our country based on US accounting standards. We understand that banks in other nations will be able to reduce required capital through the application of reserves.

  We have similar concerns about the ***relative capital rates among retail products***. We find the current risk weight curves seriously misaligned, with high-risk loans potentially attracting less capital than low-risk loans. Allowing high-EL credit card loans to offset significant portions of their required capital with anticipated margin income only exacerbates the problem. Fairness would seem to require that if credit cards get credit for anticipated margin income, then income from other products should receive equal treatment.

  A third parity problem concerns the use of different approaches by different banks. The fact that some products require more capital under the IRB approaches than under the standardized approach (or under the non-Basel approach in the US) could lead some banks to avoid moving to more risk sensitive approaches or even to engage in regulatory capital arbitrage to take advantage of the mismatches. Under Pillar 2, supervisors should have the authority to ***require banks to hold additional capital when it is clear that they would have to do so if they calculated risk-weighted assets under a more advanced, IRB approach***. Such authority should be used for blatant under-assessments. Without such a safeguard, standardized (or non-Basel) banks could find it too easy to grow high-risk parts of their portfolios.

  Operational risk measurement methods and management practices are in the early stages of development. Ongoing dialogue and flexibility is necessary to ensure that valuable disciplines evolve at large, complex financial institutions. We recommend incorporating language in the Accord stating that supervisors should remain so engaged with banks. It is also important that supervisors apply a consistent approach for AMA approval. We support having the Accord Implementation Group develop guiding principles for implementing the new regulatory capital framework.

- **Excessive Conservatism**. The open-ended nature of ***Principle 3 under Pillar 2***, which states that supervisors should expect banks to operate above the minimum regulatory capital levels, leaves bankers uncertain about how much capital regulators will require them to hold. The true minimums could be well above the values computed under Pillar 1. Further, the buffers described in Pillar 2 potentially pile capital on top of levels already set quite conservatively. We agree that prudent risk management takes a conservative view of uncertain estimates. But the compound effect of using ***overly conservative inputs from the worst part of the credit cycle***, increased via a stress test, and then buffered with add-ons for residual risk, concentration risk, interest rate risk, business risk and more will be an excessively high capital requirement.

- **Compliance Costs**. Implementing a new regulatory framework will obviously involve significant costs. Fortunately, the Committee has tried to align the new Accord with industry best practices for risk assessment and management. To the extent that this objective is achieved, banks' compliance costs can be kept reasonable. Wachovia has invested many millions of dollars in developing its risk management systems, and we will continue to invest in improvements. We do not, however, want to be forced to divert resources to build systems or do work only for regulatory compliance. We do not want to be required to use any "one best way" when we believe we are assessing risks as well (or better) using slightly different frameworks or techniques. Likewise, frequent, full review of small loans with no indication of trouble would make such lending unprofitable for banks and close off borrowing opportunities or raise the cost of debt for these customers. Redirecting resources to redundant or unnecessary activities and systems will only detract from banks' true risk management efforts.

- **Complexity**. We are also concerned that the current rules' complexity could divert attention away from the true factors that make a difference in understanding a bank's risks. We believe that the Accord will be more successful if its complexity and prescriptiveness is replaced by simplicity and flexibility.

- **Technical Issues**. Several housekeeping and technical issues need to be addressed before implementation. Some of these problems can be easily corrected with clarifying text or additional instructions, but others are quite serious. For example, the rule requiring the ***subtraction of the entire residual*** of securitized assets from capital appears to be misspecified. The rule should apply only to the gain on the sale of securitized assets. Otherwise, banks will be required to hold far more capital for securitized loans than if they held the loans on their balance sheets.

- **Models in Pillar I**. Wachovia recognized the need to establish a distinct capital charge for Operational Risk when we revised our economic capital models in 2000. Therefore, we strongly support the use of internally developed models that align regulatory capital with economic capital models, which are used to measure earnings volatility and evaluate performance on a risk-adjusted basis.

  It is of great importance that the Accord recognizes in writing that the quantification of operational risk is complex and in the early stages of development. Over the past two years, Wachovia has noted improvements in the Accord to narrow the gaps between unrealistic quantitative expectations and the current emerging state of operational risk measurement. We believe that a practical implementation of Pillar I will serve as a catalyst for the development of operational risk management and measurement practices. Over time, this will lead to more consistency, greater transparency, comparability between institutions, improved disclosure, and more effective industry practice.

  Further, we believe the Committee should take the additional step of permitting banks to use their own capital models for credit risk with supervisory validation and approval. Such a step would be completely consistent with the Accord's approach to market and operational risk.

The enclosed material presents expanded discussions of these items, including more detailed recommendations and the rationale for our comments. Several additional issues are also discussed, which – although they may not have as large an effect on Wachovia – should be addressed before the Accord is finalized.

Our input is intended to further the development of the Accord. It is our hope that the new capital framework will be effective in assuring that banks are adequately capitalized while permitting banks that can safely operate with lower capital levels to do so.

Sincerely,

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Summary of Recommendations

1. All banks should be permitted to use general reserves as an offset to the EL portion of risk-weighted assets.
2. The Committee should permit banks to use – with supervisory validation and approval – their own capital models for credit risk.
3. The current rules requiring a deduction of residual interests are incorrectly specified and should apply only to the gain on sale realized from securitization transactions.
4. Banks should be able to use the Ratings-Based Approach for all retained interests in their own securitizations, especially when the bank's exposure is not the first-loss tranche.
5. Banks should be able to use the Supervisory Formula for retained interests in their own securitizations above k-irb, the capital required when holding the loans on balance sheet.
6. The relative risk weights among retail products remain severely misaligned with risk. The decline in asset correlations for non-mortgage products is exceptionally steep, with no apparent justification.
7. Maturity effects should be explicitly included in the retail formulas rather than being embedded in correlations. Such treatment would address the harsh treatment of home-equity loans and lines, which have shorter average lives than first mortgages.
8. Permitting only credit cards to offset required capital with anticipated margin income is inequitable. We believe that either required capital should be defined to include ***only*** unexpected loss or all banks should be permitted to offset the EL portion of risk-weighted assets with reserves for all products. We believe strongly that, at the very least, ***anticipated margin income should offset the EL portion of risk-weighted asset only to the extent that reserves are less than EL.***
9. If the Committee intends that Principle 3 under Pillar 2 be used only on an exception basis when a bank's capital level is inconsistent with the risk it is taking, then unambiguous language is needed to ensure that it is interpreted thus around the globe. If, however, supervisors will impose higher minimums that include these other risks under Pillar 2 (a new level of *de facto* minimum capital requirements), then the current Pillar 1 calibrations are incorrect and must be reopened. ***We urge that the Committee make clear that minimums will be measured in relation to Pillar 1 alone***.
10. We recommend that supervisors have the ability under Pillar 2 to require non-IRB (or non-Basel) banks to hold additional capital when it is clear that they would have to do so if they computed risk-weighted assets under a more advanced, IRB approach.
11. We would like to see clearer guidance on how examiners are to categorize institutions as "outliers" in the section on interest rate risk in the banking book.
12. LGD and EAD rates should be based on default-weighted averages, not results from only the worst part of the cycle.
13. Although a database of grading inputs may provide useful information, a rush to implementation is likely to result in high compliance costs without the anticipated benefits. Rather than making the database mandatory immediately, banks should have the time to do it right.

14. Banks must be allowed more flexibility in designing their grading frameworks than indicated in the current rules. Reality is occasionally more complex than "borrower characteristics determine PDs, and transaction characteristics determine LGD."
15. Banks should be permitted to use simply the earlier of non-accrual or charge-off to measure default.
16. The sale of a performing loan at a discount does not indicate default and should not be counted as a default.
17. Additional guidance is needed in the new Accord or in implementation guidance to ensure that supervisors in all jurisdictions apply reasonable rules to small exposures whose effect on risk in not material.
18. The effect of small commercial loans on the portfolio can be accurately assessed while regrading them only when their payment behavior indicates a change in risk. Larger loans, or those with problems, should be reviewed annually or more often.
19. Clarifications are needed around the treatment of cash, short-term "due from" amounts, and similar low-risk assets.
20. Benefits beyond the simple substitution effect should be permitted for credit derivatives, similar to the treatment proposed in the recent Federal Reserve white paper "Treatment of Double-Default and Double-Recovery Effects for Hedged Exposures under Pillar I of the Proposed New Basel Capital Accord."
21. We believe that the Accord should be written flexibly enough to permit some benefit for a remaining life of less than one year as best practices for the effect of shorter maturities develop.
22. Establishing fixed percentages for the level of pre-leasing or equity to classify a project as IPRE instead of HVCRE seems unwise. Focusing on any one factor in isolation presents an incomplete picture of the loan's risks compared to assessing a combination of elements.
23. Top down estimates for ABCP program default rates should be allowed in nearly all cases, especially for smaller programs. Further, banks should be permitted – with supervisory approval – to grade their ABCP programs and assign PDs and LGDs directly rather than using the securitization approach.
24. We suggest stating that operational risk loss classifications will evolve with industry practice and incorporating additional flexibility into the standards.
25. We believe the capital charge for operational risk should represent unexpected losses only, and that more clarity be provided on what is meant by "demonstrate adequate capture of expected loss in internal business practices."
26. We suggest incorporating language recognizing that high confidence levels for operational risk estimates may be unattainable at this early stage of development and to recognize that qualitative methods and assumptions will be necessary.
27. The requirement to map loss data to the regulatory business lines in Annex 7 requires a great deal of ongoing work that does not provide a benefit to the internal management or measurement of operational risk. We request that this requirement be eliminated.
28. We recommend eliminating the example minimum threshold for loss data and replacing it with a standard of flexibility based on business lines and model requirements.

29. We request eliminating the requirement that operational risk losses related to credit risk be separately tracked.
30. We ask for more clarity around operational risk requirements including event loss definition, record keeping, losses crossing accounting periods, general ledger reconciliation, etc.
31. We suggest incorporating language acknowledging that practices for effective use of external data in capital models are in an early stage of development. Ongoing dialog and flexibility on acceptable approaches are therefore necessary.
32. We suggest the 20% limit on the benefit of insurance be eliminated. We also believe insurance protection provided by captive insurers should not be prohibited.
33. Ongoing collaboration, coordination, and communication among banks and home and host supervisors are absolutely vital. Failure to establish an efficient implementation mechanism for the new capital framework would impose crippling global compliance costs on banks.
34. We are concerned that the increased complexity of Basel II will produce more inconsistencies in the treatment of US banks compared to each other and to international banks. We are concerned that some examiners may require additional training, experience, and technical skills to apply Basel II rules uniformly throughout the industry.
35. The Accord will be more useful, practical, and successful if its complexity and prescriptiveness is replaced by simplicity and flexibility. We ask that the Committee and the Accord Implementation Group make it clear that, wherever possible, supervisors interpret technical guidance as benchmarks or examples of processes that would produce appropriate results, not as requirements that must in every instance be followed in detail.
36. Wachovia believes that the Committee should set forth principles regarding the information to be communicated under Pillar 3 and not specify in detail the data that must be published.

Reserves as an Offset to the EL Portion of Risk Weighted Assets

CP3 (p 342-348) states, "a bank may recognize provisions (e.g., … general provisions) in offsetting the expected loss (EL) of risk weighted assets. … The amount equal to 12.5 time the amount of portfolio-specific general provisions … can be used to charge against the EL portion of the risk-weighted assets of the pool of exposures against which these provisions have been taken." US regulators have advised us that these phrases do not refer to any of the reserves established by banks under US Generally Accepted Account Principles. We understand that banks in other countries do have significant reserves that would fall under these rules. Clearly, such a disparity in interpretation and implementation will lead to noticeable differences in capital ratios from one jurisdiction to another. The rules for crediting reserves against the EL portion of risk-weighted assets must be written to preserve a level playing field across borders.

The banking industry and the consultants who have spent years developing economic capital concepts are in essentially complete agreement that capital is needed for ***unexpected*** loss. Within the regulatory framework, reserves are a bank's first protection against losses. We believe that general reserves should offset the EL portion of risk-weighted assets. Permitting all banks to make this offset would also address an inequity in the current proposal: that credit cards and no other product can use anticipated income as an offset to risk-weighted assets. Unlike anticipated income, which is subject to estimation errors and other variables that may be difficult to validate, reserves are unambiguously part of a bank's financial statements.

Recognition of Banks' Credit Risk Models

Given the level of inputs to the regulatory capital formulas already in CP3, we believe the Committee should take the additional step of permitting banks to use – with supervisory validation and approval – their own capital models for credit risk. Such a step would be completely consistent with the existing market risk regime and the emerging operational risk framework. Such models would better consider the benefits of diversification as well as reflecting the lack of diversification in portfolios concentrated in a single product or narrow geography.

This step would further advance the development of credit risk modeling and highlight its importance in banks' risk management systems. Efforts that may be divided between internal and regulatory systems for the next several years could be combined, resulting in improved efficiency and effectiveness. Further, communications under Pillar 3 would be consistent with banks' economic capital disclosures based on internal models, resulting in less confusion for investors and analysts.

Asset Securitizations (as Originator)

Asset securitizations have more complex structures than most credit exposures. It is no easy task to fit these exposures into a simple, risk-sensitive framework. Wachovia appreciates that the Basel Committee has devoted considerable effort to this part of the Accord and that considerable progress has been made toward a solution that can deal with a range of structures. Still, several critical problems remain. In particular, we believe that the current rules requiring a deduction of residual interests are mis-specified and should apply only to gains recorded on the sales of securitization interests. We also ask the Committee to permit banks to use the Ratings-Based Approach for all retained interests in their own securitizations, especially when the bank's exposure is not the first-loss tranche.

Deduction of the Residual from Capital
We understand that the rules requiring a deduction of capitalized future margin income (except for certain situations involving credit cards) exists to prevent the "creation" of capital through the securitization process. Without this rule, a bank could book gains from future margin income that would be added to retained earnings, improving capital ratios compared to holding the loans on the balance sheet. However, as the illustration below shows, there are plenty of instances where deductions are required that far exceed the capital added to the balance sheet in these transactions.

Securitization Example, Gain versus Residual. Loans on Books for Par.

1)	**Unpaid balance of loans on balance sheet**	1,000,000
2)	**Book Value of loans on balance sheet (assumes Par)**	1,000,000

3) **Securitization Created**

Bond Rating	Balance	Value (Both Examples)	% Of Value (Both Examples)
AAA	600,000	600,000	58.25%
AA	200,000	200,000	19.42%
A	100,000	100,000	9.71%
BB	100,000	100,000	9.71%
Residual	N/A	30,000	2.91%
Total	1,000,000	1,030,000	100.00%

4) **Basis Allocation**

Bond Rating	Allocated Book Value (Both Examples)	% Of Value (Both Examples)
AAA	582,524	58.25%
AA	194,175	19.42%
A	97,087	9.71%
BB	97,087	9.71%
Residual	29,126	2.91%
Total	1,000,000	100.00%

5) **Bonds are sold at Par**

		Example 1			Example 2		
Bond Rating	Balance	Allocated Book Value	Sales Price	Gain On Sale	Allocated Book Value	Sales Price	Gain On Sale
AAA	600,000	582,524	600,000	17,476	582,524	Not Sold	Not Sold
AA	200,000	194,175	200,000	5,825	194,175	5,825	5,825
A	100,000	97,087	100,000	2,913	97,087	Not Sold	Not Sold
BB	100,000	97,087	100,000	2,913	97,087	Not Sold	Not Sold
Residual	N/A	29,126	Not Sold	Not Sold	29,126	Not Sold	Not Sold
Total	1,000,000	1,000,000	1,000,000	29,126	1,000,000	5,825	5,825

6) **Residual versus Gain**

	Example 1	Example 2
G/L Book Value of residual	29,126	29,126
Gain on sale of bonds	29,126	5,825
Difference	0	23,301

Example 1 shows the prototypical transaction. Here $1 million of consumer loans are placed in a trust, which issues bonds. The bank owns the residual interest, which is valued at $30,000. When the securities are created, the bank adjusts its basis in taking them onto its balance sheet per FAS 140. The value of all interests combined is equal to that of the loans transferred into the trust. Since the residual is 3.0% of the total, the value of all the trust interests is adjusted to 100/103. As bonds are sold at par, the bank realizes gains. In this case, where everything except the residual is sold, the residual has a similar value to the gain on sale, which was added to capital. The value of the residual would be deducted from capital. No other capital charges or deductions are required, since all bonds are sold. If the bank retained the riskiest tranches of the securitization, it would also hold capital up to the level required if the loans were held on the balance sheet, k-irb. While we may not agree completely with these capital rules, the treatment of the retained interest in this situation seems reasonable.

Example 2 begins like Example 1. Again, the values of the trust interests are adjusted to 100/103. Now, however, the bank sells only a portion of the most senior tranche. Since the bank chooses to retain many of the bonds, little of the future margin income in the retained interest is realized and turned into capital. Still, the rules require that banks deduct the *entire* value of the retained interest from capital. This transaction is not intended to transfer credit risk (only to enhance liquidity), so it is reasonable that little or no capital relief is generated. But it should not *increase* required capital, either. Many securitizations look like this, at least at some point in their lives. These transactions make the bank's portfolio more liquid and are economically valuable even though their primary purpose is not to transfer risk. The current Basel capital rules incorrectly increase required capital compared to simply retaining the loans on the banks' books.

Some regulators are concerned that banks can use overly optimistic assessments of future margin income when valuing their residuals. Subtracting the gain-on-sale rather than the entire residual would protect against this behavior. Consider Example 2 again. Now suppose that the bank valued the residual at $60,000 rather than $30,000. Now the trust interests are all adjusted to 100/106. As long as few bonds are sold, the bank continues to hold k-irb in capital for the interests it owns and to deduct only the small gain it realized on the sold position. The overly optimistic valuation need not be deducted, since it has not increased the bank's capital. If, however, most of the bonds were sold, the bank would still hold k-irb for the credit risk in its retained loans and deduct the larger gain-on-sale it realized when it sold the bonds.

Supervisory Formula versus Ratings Based Approach

We believe that originating IRB banks should be permitted to ***apply the Ratings Based Approach to all rated exposures they retain, not only those above k-irb***. Where an external or inferred rating is not available, the capital would be determined using the Supervisory Formula, as in the current rules. Such treatment would better align the Basel requirements with both market practices and the capital that investing banks would be required to hold for the same exposure.

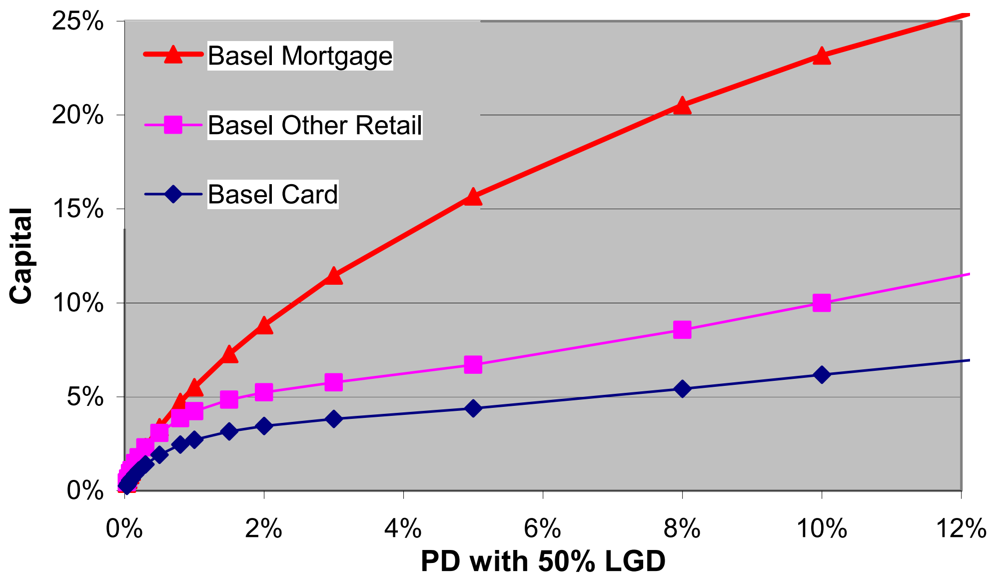
Applying RBA capital to positions below k-irb would be consistent with the market's view of the risks of these exposures. Banks that claim the Basel rules are treating them harshly – perhaps because their diversification and risk management have produced less volatile losses than assumed in the Basel formulas – could then take their claims to investors and rating agencies and potentially see a benefit in their capital requirements by demonstrating that the risks of the underlying loans are adequately covered by subordinated tranches.

Further, permitting use of the RBA would simplify the MIS implementation cost for banks that create securities that are typically sold in their entirety. The Committee has written that it wants to give favorable capital treatment to banks that use securitization to sell risk, and the utmost example is banks that package loans and sell all tranches of a securitization. Banks may enhance the marketability of these securities by occasionally buying some of the securities in the secondary market, thus increasing liquidity. Such banks are not required to maintain complete risk information for these securitizations when they have sold everything. But all the Basel grading and MIS requirements would suddenly apply if a bank bought a security backed by these loans. Such a requirement would make such transactions prohibitively expensive and be a disincentive to engage in these risk-reducing activities. Holding capital for these exposures based on the RBA would keep compliance costs reasonable while still requiring originating banks to hold as much capital as an investing bank.

Further, we believe ***originating banks should be given the option of using the Supervisory Formula*** for tranches above k-irb, even if ratings exist. In many cases, the information banks have on expected losses, which determine k-irb, is more informative and more closely aligned with best practices for determining economic capital than the rating itself.

Relative Capital Among Retail Curves

CP3 continues to suffer from a lack of differentiation between high-quality consumer loans and sub-prime non-mortgage loans. The latest proposal took a small step to remedy the problem by providing some relief to the highest quality credit card exposures, but the relative risk weights among retail products remain severely misaligned with risk. For instance, a credit card with an 8% PD requires *less* capital than a home equity loan with a 1% PD (all other things equal[1]), as shown in the graph.



One problem is with the asset correlations. We understand that asset correlations in the Basel formulas are not conceptually equal to asset correlations in industry models. Rather, the asset correlations (for mortgages, at least) also incorporate a maturity effect, which is not otherwise captured for retail credits. If this is true, we view the mortgage function as reasonably consistent with available data and our usage for economic capital modeling. However, we believe a better approach would be to deal with maturity explicitly. Such treatment would overcome a short-coming of the proposed treatment: many home-equity loans and lines of credit have shorter average lives than first mortgages and are treated too harshly under the current mortgage function.

However, we are not aware of any solid evidence that consumer asset correlations decline as default probabilities increase. The commercial model uses declining asset correlations because

[1] Although only some second mortgages have LGDs approaching those of credit cards, the formulas should produce reasonable results.

smaller firms with lower asset correlations tend to have higher PDs. In addition, declining correlations reduce the pro-cyclical effect of migration. Unfortunately, very different asset correlation structures were used for the retail portfolios. The decline in asset correlations for non-mortgage products is far, far steeper than that used in commercial, with no apparent justification. At the same time, no reduction at all is attributed to asset correlations for the mortgage and home equity portfolios. It is no surprise, then, that we get the odd relationships described above.

We are surprised at the extremely low asset correlations and risk weights for the highest risk sub-prime non-mortgage borrowers. The Risk Management Association's paper on retail lending ("Retail Credit Economic Capital Estimation – Best Practices", dated February, 2003) shows that the industry's median asset correlation for nearly all the non-mortgage retail products is higher than the Basel value when PDs are above about 5% (pp 24-32).

Some have surely argued that they can manage high-loss consumer portfolios with little volatility. Unfortunately, not all banks have had that experience. US industry data shows considerable volatility in credit card loss rates.[2] It seems imprudent to assume that all banks can manage sub-prime portfolios well, or even to assume that low correlations will hold in the event of a recession that hits consumers especially hard.

Others have likely claimed that the lives of non-mortgage retail loans are quite short, so less capital is required in the same way that less capital is required for short-maturity commercial loans. When measured at the portfolio level, it may be true that the duration of revolving consumer loans is low. It is the many *low-risk* borrowers, however, who pay off their accounts quickly and shorten the portfolio's average life. The riskiest consumers do not amortize their loans nearly as fast. US regulators have in fact expressed considerable concern about extreme amortization periods being applied to high-risk borrowers – even finding cases of negative amortization. This maturity effect would point to ***increasing*** the asset correlation values as PDs rise, not decreasing them.

A second problem is that high-EL credit card loans can offset significant portions of their required capital with anticipated margin income. Fairness would seem to require that if credit cards get credit for anticipated margin income, income from other products should receive equal treatment.

Within the regulatory capital framework, expected losses should be covered first and foremost with reserves. Elsewhere, we make the case that general reserves should always be permitted as an offset to the EL portion of risk weighted assets. Even without this offset, however, reserves are part of total capital and available to cover required capital. At the very least, therefore, we believe that anticipated margin income should offset the EL portion of risk-weighted asset ***only to the extent that reserves are less than EL***. Otherwise, credit card lenders could reduce required capital with anticipated margin income and ***also*** use their general reserves – the purpose of which is to cover EL – to cover not only the remaining EL but also a portion of ***un***expected losses. Such a treatment would unfairly favor credit card income and reserves over all other forms of income and reserves.

[2] Per the US FRB quarterly statistical release of charge-off rates for the top 100 banks, the average charge-off rate for credit cards for 1986QI through 2003QI was 4.25%. Assuming a constant LGD of near 100%, the capital charge for this thoroughly diversified "portfolio" would be about 8.0%, using the correlations in the Basel formula. This is far too close to the highest observation of 7.8% for 2002QI. The industry is more volatile than implied by the low asset correlations in the current formula.

Supervisory Expectations that Banks Operate Above Pillar I Minimums

The current language under Pillar 2 raises some serious implementation questions. Like earlier versions of the new Accord, CP3 states that supervisors can require banks to hold capital beyond the amount computed under Pillar 1. But CP3 dramatically expands the list of factors potentially requiring more capital to include business cycle risk; concentrations; residual risks of credit risk mitigation; interest rate risk in the banking book; liquidity risk; strategic risk; measurement, systems, and modeling risk; reputation risk; and other risks.

Conversations with US regulators lead us to believe that this language is intended simply to provide regulators with the ability to act when individual banks are taking on risk out of proportion with their capital levels. US regulators have long had the authority to mandate "prompt corrective action" to restore sound capital levels in US banks, and their actions have not produced disruptions. As we have stated in earlier comments, we believe that supervisory review, including an assessment of a bank's individual capital needs, is altogether appropriate. Wachovia has always supported an open, active dialogue with our national supervisors.

If this is indeed the intent of Pillar 2, then unambiguous language is needed to ensure that it is interpreted thus around the globe. Absent additional clarity, Pillar 2 could be used to create a *de facto* standard higher than that published under Pillar 1. Such a situation could lead to confusion in financial markets, as banks and investors will not know how much capital is truly required. Banks could be forced to operate at uneconomic capital levels, as most would want to keep a buffer beyond the "true" minimums. We urge that the Committee make clear that minimums will be measured in relation to Pillar 1 alone.

Capital ratios in the 1988 Accord were set at levels higher than that needed for credit risk alone. The recent QIS showed that new Accord's reduction in credit risk capital rates was generally offset by the addition of capital requirements for operational risk. Credit risk capital requirements are still higher than the levels generated by most banks' internal models. The credit risk capital Wachovia requires under the Accord (based on the recent QIS) substantially exceeds the amount of economic credit risk capital calculated internally, even though Wachovia's internal economic capital calculations are set to a higher confidence level. We have accepted this misalignment, believing that regulatory credit risk capital ***still*** covers risks not explicitly handled by the new Accord. ***If***, however, supervisors impose higher minimums under Pillar 2 that ***include*** these other risks, then the current ***Pillar 1 calibrations are incorrect and must be reopened.***

Differences in Pillar One Capital due to Approach should be Addressed in Pillar Two

The fact that some products require more capital under the IRB approaches than under the standardized approach (or under the non-Basel approach in the US) could lead some banks to avoid moving to the more risk sensitive approaches to keep their Pillar One risk weighted assets low. The differences among the approaches could create new capital arbitrage opportunities, where standardized or non-Basel banks hold higher capital loans like sub-prime credit cards while selling low-risk mortgages. Indeed, a reluctance to create even greater divergence between the standardized and IRB approaches may be a motive behind flattening the risk weight curves for retail products, reducing risk sensitivity for these products. (See our comments on relative capital among retail curves.)

These concerns can be addressed if supervisors have the ability under Pillar 2 to require banks to hold additional capital when it is clear that they would have to do so if they computed risk-weighted assets under a more advanced, IRB approach. Given that Wachovia has emphasized our concern about excessive add-ons under Pillar 2 (see on comments on conservatism), we do not make this proposal lightly. It should be used only for blatant under assessments. Indeed, the QIS showed that most banks can reduce their regulatory capital by moving to more advanced approaches. However, some banks specialize in higher-risk lending, and the without the means to deal with significant mismatches, they could "hide" behind less risk-sensitive capital rules.

Conservatism Surrounding Inputs

Some of the language in CP3 pushes prudent conservatism to the point of bias. We appreciate that prudent risk management uses conservative estimates for uncertain inputs. Using default-weighted averages – which overweight periods of economic stress – is more appropriate than using time-weighted averages in estimating loss given default, for instance.

It seems ***in***appropriate, however, to use rates from the ***worst*** part of the cycle for each input. The compound effect of using inputs that are knowingly higher than actually expected will be biased EL and capital rates.

Grading Database

The requirement that banks maintain a database containing all the drivers of each grading decision (Paragraph 391) could well result in excessive costs and confusion for banks without achieving the Committee's desired goals. We understand that there are two reasons for this requirement: that bank supervisors can validate that banks' grading systems are functioning properly and that banks can retrospectively assess the effect of changes in their grading systems. We believe that in many cases the databases will not achieve these objectives and that the cost of implementation will be excessive and unreasonable if required for the entire portfolio.

Wachovia's grading system includes a significant subjective component. Although our grading framework is based on hard data such as financial ratios, the combining and weighting of the factors going into the grading decision is not predetermined. It varies from one borrower to another based on the risks in the situation and the borrower's approach to mitigating those risks. We believe that experienced underwriters bring a level of expertise to these situations that models have not yet achieved. We continue to evaluate models, and we expect that they will get better and better, but we have not yet concluded that we can remove the subjective portion of our grading process. Our results lead us to believe that the process is producing consistent grading with good differentiation of risk among our borrowers.

Consequently, a database alone will not lead a supervisor to the assigned grade. One must also understand how the factors were combined, a process that would be difficult if not impossible to capture in the database. It follows, then, that retrospective grading will also not directly lead to the grade that would be assigned using a new system.

Further, given that Wachovia has a well-diversified portfolio with many types of borrowers, a single database will not capture the drivers for many of the borrowers in the portfolio. The key risk factors for a large corporation are quite different from those for a small business, a municipality, a non-profit health-care provider, a church, or a special purpose entity. A bank will either need to design a multitude of databases or include so many questions in the database that each underwriter will have to wade through many questions that are irrelevant for his decision.

This brings us to the most harmful aspect of the database requirement. Done improperly or with questions that don't match the borrower, populating the database will require excessive amounts of unproductive time. It is easy to envision a process in which graders – having already made their decision – go through a trial-and-error process until they get the database aligned with their risk assessment. The cost of an expensive grading process will be less accurate grading as resources are diverted to completing the forms rather than assessing the risks.

Banks are, of course, extremely interested in improving their risk assessment processes. But supervisors must go slow in this area and not make the database mandatory – especially for atypical parts of the portfolio. Banks should have the time to do this right rather than being forced into rushed implementation that serves no purpose but regulatory compliance.

Grading System

The requirements surrounding banks' grading systems must be implemented with enough flexibility to allow banks to capture complex borrower behavior. Otherwise, the cost of compliance will become unreasonable and the accuracy of banks' measurements will suffer.

CP3 lays out a good basic framework for describing credit losses: PD * LGD * EAD = Expected Loss. Unfortunately, the realities of lending are more complex and confusing. Guarantors sometimes inject capital and keep firms from defaulting. Other times, guarantors wait until the borrower defaults and make banks go through the courts to collect on their guarantee. In some cases, the guarantee reduces the default rate; in others, the loss given default. Likewise, monitored collateral, combined with control over a borrower's receipts through a lock box (typical terms for asset-based lending in the US) can likewise result in reduced default rates compared to borrowers with similar characteristics, as the lender is paid out before default occurs. In some cases, the borrower may be defaulting on other obligations while payments to the bank payments are not even late. Wachovia's data show that loan balances are typically reduced for certain borrowers during the troubled debt management process ***before*** borrowers default. The presence of loan covenants often allows banks to take action to reduce exposures while there is still an ability to pay.

The data analyses surrounding these situations can be complicated. Characteristics that "should" influence one aspect of the grading system show up in another. Supervisors will have to work with banks to understand these results and be open to grading systems that describe a reality that is more complex than "borrower characteristics determine PDs, and transaction characteristics determine LGD." If banks are forced to use an inflexible grading system that is not aligned with their actual results, Basel will inhibit the development of better practices and a deeper understanding of risk.

Default Definition

The definition of default used in the Basel Accord (Paragraph 414-419) remains problematic. In the United States – and presumably in other nations as well – regulators have clear rules to establish when loans must be placed on non-accrual or charged off. Non-accrual is a measure that is very familiar to banks, analysts, investors and regulators. All banks have existing systems in place to track when loans go to non-accrual. In practice, most banks use non-accrual to drive their default estimates for internal capital calculations. Wachovia would argue strongly that borrowers whom we have not placed on non-accrual – with the concurrence of our regulators – have not defaulted. ***We believe that banks should be permitted to simply use non-accrual (or charge-off, for consumer loans) to measure default.***

Requiring banks to use slightly different default definitions will unreasonably raise compliance costs with no real benefit. Two similar definitions will require system changes to capture both indicators and extensive training for those who maintain the systems so that they properly code each loan. Since the definitions are so similar, it is likely that the distinctions will be confusing, with considerable opportunity for errors. Two definitions will increase the debates between banks and regulators as to whether a borrower should be classified as non-accruing and/or defaulted, requiring additional resources from both banks and regulators. Using non-accrual as the default definition will produce essentially the same result while keeping the cost of compliance reasonable. This is especially true for AIRB banks, where EAD and LGD are measured from the point of default, so moving a small number of zero-loss defaults from one side of the line to the other will have offsetting effects on LGDs compared to PDs.

One aspect of the proposed default definition should be revised because it will introduce errors into the PD calculation. ***The sale of a performing loan at a discount does not indicate default and should not be counted as a default.*** This activity is an important portfolio management tool, reducing the risk of extreme losses. Penalizing all loan sales by including them in banks' default rates (published under Pillar 3) will result in a *riskier* banking system.

Consider a reasonable portfolio management rule: sell all loans that lose their investment-grade rating. A bank that follows such a rule would appear to have high default rates from investment grade categories. In addition to producing misleading information to investors that review the bank's statistics published under Pillar 3, counting these loans as defaults would distort the inputs to the Basel capital formulas. The fact that these loans had very small losses would be diffused over all loans with similar collateral: the low LGDs for the sold loans would not be credited to the investment grade loans alone. (Indeed, regulators would likely find fault with an LGD grading system that gave a benefit for borrower characteristics, which properly belong in the borrower grade.) The effect is that the PDs for investment grade loans will be too high, and the LGDs for loans that truly defaulted will be too low.

Example: Default Definition Problem

All loans unsecured (Single LGD rate)

Grade	Loans	Sold	Discount	Loss	Actual Defaulted	LGD	Loss
Inv. Grade	10,000	200	5%	0.10%	-	-	-
Speculative	1,000	-	-	-	200	50%	10%

Grade	Computed Def. Rate
Inv. Grade	2%
Speculative	20%

	Computed LGD
All defaults	27.5%

Grade	PD	LGD	EL	Actual Loss
Inv. Grade	2%	27.5%	0.55%	0.10%
Speculative	20%	27.5%	5.50%	10.00%

We recognize that loans sold at a discount do represent a credit cost and should be included somewhere in the PD/LGD framework. Banks should determine – with their supervisor's approval – how best to do this given their practices.

Maturity Adjustment

We understand that risk does not disappear as remaining maturity approaches; maturity itself can trigger default for stressed borrowers. However, it is clear that a loan with six months remaining has less risk than an identical loan with a full year until maturity. Otherwise, one would have to conclude that the first six months of that final year were risk free. Consequently, a fixed, twelve-month floor for the maturity adjustment is too harsh. We believe that the Accord should be written flexibly enough to permit some benefit for a remaining life of less than one year as best practices for the effect of shorter maturities develop.

Materiality

It would be unwise to apply the full range of requirements to each and every exposure that a bank faces. Every day, banks undertake a range of transactions that contain some element of credit risk, but which are not material. Additional guidance is needed in the new Accord or in implementation guidance to ensure that supervisors in all jurisdictions apply similar, reasonable rules to small exposures outside of the loan portfolio. Examples could include such items as cash due from other banks, loans held temporarily (and ungraded) awaiting sale, transactions awaiting settlement, etc. Grading systems typically do not address such transactions, as the exposure time and level of risk are so small as to make it uneconomic to do so. Banks should be permitted to use rules of thumb rather than individually grading each of these counterparties or transactions, or the exposure should be excluded from portfolio computations and handled as "other assets."

Similarly, flexibility is needed to deal with immaterial differences between the precise language in CP3 and industry practices. For instance, maturity rules in paragraph 291 speak of "an original maturity below three months." Exposures with an original maturity of exactly three months or 90 days (when that happens to be longer than three calendar months) should be treated as complying. Otherwise, banks will face the costs of revising their practices to change 90-day and 3-month notes to be "less than three months," with no real change in risk.

Our experience also clearly indicates that we can assess the effect of small commercial loans on the portfolio while regrading them only when their payment behavior indicates a change in risk. Larger loans, or those with problems, are reviewed annually or more often. The cost of frequent, full review for small loans with no indication of trouble would make such lending unprofitable and close off borrowing opportunities for these firms.

Credit Derivatives

The use of credit derivatives to mitigate credit risk is an increasingly important risk management tool. The credit derivative market continues to evolve, and we expect that it will continue to mature as more participants in the credit markets seek to manage their large exposures.

Given the developing nature of this market, it is natural that there are questions about how best to model the risks of credit derivatives and how these products will behave in a period of high stress. Such questions should lead risk managers to take a conservative approach to the uncertainties. The issue is how conservative one should be.

The recent Federal Reserve white paper "Treatment of Double-Default and Double-Recovery Effects for Hedged Exposures under Pillar I of the Proposed New Basel Capital Accord" lays out a general framework for analyzing the benefits of credit derivatives. A range of correlation assumptions is investigated, along with alternatives for considering "wrong way" risk and the effect of "double recovery" assumptions. The key point we take from the paper is this: ***even with extremely conservative correlation and recovery assumptions, the appropriate level of capital for exposures with protection through credit derivatives is significantly lower than that computed using the substitution approach currently proposed***. We believe that an approach similar to that presented in the Fed's paper should be developed and implemented. Given the uncertainties around correlations, we believe that the less complex form of the Fed's framework (equation 4 on page 38) would be sufficient. Further, to offset the uncertainties surrounding market behavior in the event of a major counterparty default, conservative correlation and LGD assumptions may be appropriate. Even with these concessions, the resulting capital rates would be substantially reduced from the CP3 levels.

If banks had the option to use either the substitution approach or the more complex, but less conservative approach, those banks willing to take the time and effort to make the necessary calculations under the more complex approach could realize greater capital relief under Pillar I. Meanwhile, the substitution approach would still provide some capital relief to those banks who do not believe the relief justifies the additional effort. Additional criteria could be introduced to address concerns about excessively correlated guarantors and obligors (as with a developing country bank guaranteeing debt from the same country) or concentrated exposures to a single guarantor.

High Volatility Commercial Real Estate

The Committee has corrected a significant problem in earlier rules by permitting banks to use internal PDs and LGDs – with supervisory validation – for commercial real estate. Banks such as Wachovia, with significant commercial real estate portfolios, have *more* HVCRE data than for any other single industry. Our approach recognizes that recent periods have not seen a severe real estate downturn, and our PDs and LGDs are estimated conservatively, taking into account that the long-term average will include recessions. We believe using these internal numbers will produce more accurate risk measures than the supervisory slots. Further, the Committee's actions provide ongoing incentives for banks to invest in better tools to assess the risks in their real estate portfolios and to estimate defaults and losses.

The dividing line between HVCRE and Income Producing Real Estate will need to be worked out between banks and supervisors during implementation. Establishing fixed percentages for the level of pre-leasing or the amount of equity for a project to be classified as IPRE instead of HVCRE seems unwise. Our risk assessments consider the *combination* of pre-leasing, equity, *guarantor support, and market conditions* for AD&C loans. Focusing on any of these factors in isolation presents an incomplete picture of the loan's risks.

Asset-Backed Commercial Paper Programs

We find several changes in the rules for Asset-Backed Commercial Paper Programs to be significant improvements. In particular, both the amended rules for recognizing eligible liquidity facilities and the relaxation of the rules on using the "top-down" approach for computing k-irb are better aligned with sound practices in the industry. These changes will also keep implementation costs reasonable. Even further moves in the same direction would be welcome and would have no material effect on the accuracy of risk assessments for ABCP programs. Top down estimates for program losses should be allowed in nearly all cases, especially for smaller programs. Further, banks should be permitted – with supervisory approval – to grade their ABCP programs and assign PDs and LGDs directly. Many program-specific ABCP exposures are smaller than many individual corporate exposures, and the added systems requirements will provide few benefits. A grading process that meets supervisory expectations can provide a risk assessment that is just as accurate, or more so, as the complex formulas for asset securitizations.

Operational Risk – Quantitative Standards

Loss Classifications – Wachovia supports the loss classifications under Paragraph 629(a), which provide a useful framework for understanding and collecting operational loss information. As the industry gains experience with this framework, however, knowledge will be gained that will lead to more meaningful and effective ways to classify loss information. Therefore, we suggest incorporating flexibility into the standards and explicitly recognizing that the classifications will evolve with industry practice.

Expected Losses – Paragraph 629 (b) requires banks to calculate regulatory capital as the sum of expected loss and unexpected loss, unless the bank can demonstrate that it is adequately capturing expected loss in its internal business practices. We believe the capital charge for operational risk should represent unexpected losses only, and that more clarity be provided on what is meant by "demonstrate adequate capture of expected loss in internal business practices."

Correlations – Paragraph 629 (d) indicates a bank "may be permitted to use internally determined correlations in operational risk losses across individual operational risk estimates, provided it can demonstrate to a high degree of confidence and to the satisfaction of the national supervisor that its systems for determining correlations are sound, implemented with integrity, and take into account the uncertainty surrounding any such correlation estimates (particularly in periods of stress)." Data will not be initially available to statistically prove risk correlations across business lines and risk types but most likely will be determined from qualitative reasoning and logic based on the underlying nature of the risks. We suggest incorporating language in this section recognizing that high confidence levels may be unattainable at this early stage of development and to recognize that qualitative methods and assumptions will be necessary.

Internal Data

Wachovia has made progress in collecting operational risk loss data since completing the 2001 Loss Collection Exercise. As we progress, however, certain issues are surfacing which must be addressed now to satisfy the requirement to collect comprehensive data beginning January 2004. These decisions are being made and systems established without the benefit of knowing whether they will fully meet standards for AMA approval. Therefore, this is an area where clarity is needed. Specific comments relating to loss data are outlined below:

Loss Mapping – Paragraph 633 indicates a bank must be able to map its historical internal loss data into supervisory categories defined in Annexes 6 and 7 and to provide these data to supervisors upon request. The requirement to map loss data to the regulatory business lines in Annex 7 requires a great deal of ongoing work that does not provide a benefit to the internal management or measurement of operational risk. We therefore request that this requirement be eliminated.

Threshold for Losses - Paragraph 633 requires banks to establish a minimum threshold for loss collection and provides an example of 10,000 Euro. Wachovia recommends eliminating the example and replacing it with language that provides flexibility for thresholds to be established based on business lines and capital model requirements.

Overlaps with Credit Risk – Paragraph 633 states that operational risk losses related to credit risk included in the bank's credit risk databases (e.g. collateral management failures) would continue to be treated as credit risk for purposes of calculating regulatory capital. However, it also requires such losses (defined in Annex 7) to be recorded and segregated in the operational risk databases. We understand that operational processes associated with lending products can be the cause of loss and this is important to understand from an operational risk management perspective. However, we have insufficient information to know whether the benefit of this duplicative process of loss recording would exceed its cost. Therefore, we request eliminating this requirement. If not eliminated, we suggest the Committee grant financial institutions the flexibility to determine where these types of losses are significant enough to warrant the additional cost.

Definitions and Standards – Operational loss data is required as a quantitative standard for capital measurement and as a qualitative standard for management and Board reporting. However, limited guidance has been provided from an accounting definition and standards perspective. There are outstanding questions of a detail nature including event loss definition, record keeping losses crossing accounting periods, general ledger reconciliation, etc., that need to be addressed if loss data is to be quantified and reported consistently.

External Data

Paragraph 634 indicates external data should include data on actual loss amounts, information on the scale of business operations where the event occurred, information on the causes and circumstances of loss events, etc. Some of this information is not currently available (pooled data) and there are outstanding questions related to scalability and relevance (public data). We agree external data should be considered in the development of a capital model, yet uncertainty exists on how to use this data effectively. We suggest incorporating language in this section acknowledging that effective use of relevant external data in capital models is in the early stages of development and that ongoing dialog and flexibility regarding acceptable approaches are necessary during the implementation phase of the Accord.

Operational Risk – Risk Mitigation

While specific compliance criteria is outlined in Paragraph 637 for insurance to qualify as a reduction to operational risk capital, recognition of insurance is limited to 20% of the total operational risk capital charge. We believe the capital adjustment for insurance should not be restricted to 20% but should be based on the amount of insurance protection provided. The 20% arbitrary ceiling could diminish the accuracy of capital measurement and serve as a disincentive for organizations to pursue insurance to reduce their operational risk profile. Also, we believe insurance protection provided by captive insurers should not be prohibited. We suggest ongoing dialogue during the implementation phase with industry groups such as the IIF Working Group on Operational Risk to help ensure the appropriate level of recognition for risk mitigation products is attained.

Home / Host Supervision

Wachovia believes the home country supervisor should have responsibility for reviewing and approving the soundness of the bank's AMA regulatory capital methodology, including the allocation of capital to individual legal entities. Host supervisors should rely on the home supervisor to review the conceptual soundness of the AMA model, with the primary responsibility of ensuring that the allocation of capital in their jurisdiction is based on sound principles.

Likewise, cooperation among home and host supervisors is needed for credit risk, too. We believe that no single approach should be forced on all banks, as banks divide the responsibility for risk management activities differently. Responsibility for the structure of the grading system and calibration of PDs, for example, could reside entirely in the home office, with international subsidiaries responsible for execution and appropriate assignment of grades. In other cases, a subsidiary could have responsibility for its own grading practices. Host supervisors would appropriately have a broader review of the latter bank's processes. In the first case, home supervisors' approval of the grading system and PDs should be sufficient when communicated to host regulators.

Ongoing collaboration, coordination, and communication among regulators and the banks are absolutely vital. Failure to establish an efficient implementation mechanism for the new capital framework would be fatal to its effectiveness and could impose crippling global compliance costs on banks.

Supervisory Judgment and Guidance

US regulators exercise judgment today in assessing the adequacy of a bank's capital. Banks and regulators generally maintain an open dialogue around the judgmental aspect of assessing capital adequacy. While this functions reasonably well today, we wonder how well it will work under the new Accord. ***We are concerned that the increased complexity of Basel II will produce more inconsistencies in the treatment of US banks compared to each other and to international banks.*** We are concerned that some examiners may require additional experience and technical skills to apply Basel rules uniformly throughout the industry. The need for additional training has been clear during the comment periods for past consultative papers and the QIS. The potential for inconsistency could very well extend to Pillar II, as examiners assess the need for requiring a bank to hold additional capital under a complex framework.

Some specific concerns with paragraphs 719 – 755 include:

- We would like to see clearer guidance on how examiners are to categorize institutions as "outliers" in the section on interest rate risk in the banking book (paragraphs 720 – 722). The Economic Value of Equity measure mentioned in paragraph 722 can be dramatically influenced by modeling techniques and assumptions regarding indeterminate maturity products and thus can produce very different EVE changes under a +/- 200 bp shock.

- We are likewise concerned about the lack of clarity regarding the credit stress testing currently proposed (paragraph 724).

- Several of the additional credit risks mentioned under Pillar II (residual risk, definition of default and credit concentration risk) have only vague suggestions regarding their treatment and implementation under the New Accord. Once again, much is left to the supervisor's discretion and at this point, little guidance has been provided to Wachovia regarding these risks.

A related issue is the ability of supervisory personnel to provide guidance on the meaning of the Basel rules. During the QIS, we occasionally received inconsistent or unclear interpretations of the Pillar 1 rules. Securitizations are a case in point. This process has been frustrating for us as well as our on-site supervisors. Similarly, we remain unclear on the details of the Pillar III disclosure requirements. In the US, at least, supervisory guidance will be published and should provide much of the clarity we are looking for. We urge the Basel Committee and the Accord Implementation Group to provide greater clarity in the Accord itself and to promote additional guidance on a national basis – to both banks and supervisors – where needed.

Complexity

Wachovia recognizes that any new capital framework will be somewhat complex, since the management of risk is no simple task. We understand that the Committee's goal was a balance between simplicity and flexibility, on the one hand, and complexity, precision, and uniformity on the other. By and large, the Committee did address all of these aims. We believe, however, that the Accord will be more useful, practical, and successful if even more of the complexity and prescriptiveness is replaced by simplicity and flexibility. Since the inputs to the capital equations are taken from the way a bank's loans perform, their meaning comes from the way each bank manages credit risk. Adding layers of technical requirements regarding how banks capture data, how they track collateral, and which ratios they monitor adds to banks' compliance costs but not to effective assessments of their risks. It is our fear that supervisors will be distracted by the volume of technical issues that are easy to inspect while missing the true factors that make a difference in understanding the risks in banks' portfolios. Even worse, redirecting resources to the former at the expense of the latter creates new risks. We ask that the Committee and the Accord Implementation Group make it clear that, wherever possible, supervisors interpret technical guidance as benchmarks or examples of processes that would produce appropriate results, not as requirements that must in every instance be followed in detail.

Disclosure

Wachovia agrees that disclosure of pertinent risk information can benefit banks and the banking system. We support the Committee's efforts to develop disclosure standards that give market participants the information they need to understand a bank's risk profile without revealing confidential information.

We also support the steps the Committee has made in CP3 to make its earlier disclosure rules more practical. However, we believe the Committee stopped short of the changes needed to best accomplish the transparency the Committee seeks. Wachovia believes that the Committee should set forth principles regarding the information to be communicated and not specify in detail the data that must be published. The measurement and understanding of risk is an evolving field, and an approach based on broad disclosure principles will be more adaptable than an overly prescriptive one. The latter invites legalistic compliance without meaning and is contrary to trends in accounting standards.

We believe that an overly rigid disclosure framework would put participating banks at a disadvantage compared to financial institutions against whom we compete. The disadvantage lies not only in the extra costs required to comply, but even more importantly in the potential for investors and analysts to wrongly assess the value of participating banks if they misunderstand a flood of data.

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