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

Re: <u>The Proposed New Basel Capital Accord</u>

Wells Fargo & Company appreciates the opportunity to participate in the ongoing dialogue on the Basel capital reform proposal. We are a diversified financial services company, providing banking, insurance, investments, mortgage and consumer finance from more than 5,600 stores, as well as through the Internet and other distribution channels across North America. As such, we have a keen interest in the framing of the Basel Accord and hope that the comments that we offer in this paper will be of assistance in providing solutions to the issues that exist in the current proposal.

Sincerely,

Howard Atkins

cc: Basel 2003 Capital Proposal
Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Basel 2003 Capital Proposal
Office of the Comptroller of the Currency
Communications Division
Third Floor
250 E Street, SW
Washington, DC 20219

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Enclosure

Wells Fargo & Company appreciates the opportunity to participate in the ongoing dialogue on the Basel capital reform proposal. While we respect the tremendous amount of time and effort that has gone in to shaping the proposal, we find that we still have some fundamental differences of opinion with the path on which the Basel Committee is proceeding and feel that certain aspects of the proposal must be changed in order for it to be acceptable.

We will restrict our comments to the Advanced IRB approach to Credit Risk and the Advanced AMA approach to Operational Risk within the Basel proposal, since those modules are now the focus of the banking regulators in our jurisdiction. We will also allude to certain aspects of the apparent implementation plans for the Accord, as publicized by the U.S. banking supervisors, although we recognize that such plans are being undertaken solely at their discretion and are not being dictated by the Basel Committee. Nevertheless, we feel that it is important to comment on supervisory actions that are permissible within the context of the proposed Accord.

We expect that there will be a relatively uniform set of concerns that are communicated to the Basel Committee with respect to Consultative Paper 3 – excessive conservatism, undue prescriptiveness, questionable treatment of expected losses and the loan loss reserve in the capital calculations, and inadequate recognition of risk mitigation actions, to name a few. We share and support these concerns, and will offer similar comments in the course of this letter.

However, these issues relate primarily to the risk-based capital calculation itself. In the final analysis, this calculation is not critical to Wells Fargo, insofar as our pricing decisions are based not on regulatory capital, but rather on internal economic capital analyses. Moreover, we are convinced that, if any risk-weighting concessions are granted by the Basel Committee in reaction to the comments received on the Consultative Paper, they will shortly thereafter be reclaimed through a new calibration of the risk-weighting formulas present in Pillar 1, or through different Pillar 2 requirements. How else will the Basel Committee manage to keep the overall level of capital in the banking system unchanged, particularly if the only banks in the U.S. that are subject to the Accord will be those with a tendency toward diminished capital requirements under the new system?

Therefore, the primary points that we will emphasize, and where we feel that we <u>must</u> be successful in helping the Basel Committee and the U.S. regulatory authorities implement a more appropriate regulatory capital regime, are in those areas where we believe that the Accord has ventured beyond its intended scope.

1. First and foremost, we believe that **the Accord has become entirely too prescriptive and inflexible in its vision of the risk management *processes* to which banks must adhere**. This is in stark contrast to the original supposition of Basel II -- that each bank would be allowed to continue the use of its existing risk management practices, so long as they could be shown to have been effective over time. The Accord should <u>only</u> aspire to establish a more risk-sensitive framework for constructing minimum bank regulatory capital requirements. It cannot, and should not, attempt to dictate how banks actually manage risk. For those institutions, like Wells Fargo, with proven risk management processes in place, it would be imprudent, and perhaps dangerous, for them to make significant changes to their risk management systems in the absence of quantifiable and validated data that clearly demonstrates that an alternate system is more robust and accurate, and could be successfully inculcated into their risk management process.

Does the Basel Committee really intend to force the migration of well-functioning, customized risk management processes into an untested, complex framework with the potential to actually confuse, or undermine, the control and understanding that banks currently have of their credit portfolios?

2. The decision of the U.S. banking regulators to require only 10 U.S. banks to comply with the Accord increases the likelihood of creating an **uneven playing field for major competitors in the U.S. financial services industry**. Wells Fargo is large. However, our credit portfolios, customers, and risk profile more closely resembles that of smaller regional and community banks than larger, internationally-active, money center institutions. The deliberate creation of a bifurcated capital regime sets the stage for instances where direct competitors will not be subject to the same capital standards. It is likely that these inequities be particularly meaningful to those institutions, like Wells Fargo, that are widely diversified by line of business and geography and, consequently, faced with a wider variety of smaller, heterogeneous competitors.

3. The **Pillar 3 disclosure requirements of the Accord remain overly prescriptive, inappropriate, and unnecessary**. We believe that the Pillar 3 requirements are not appropriate because public disclosure requirements ought to be set solely by those agencies that safeguard the interests of investors (i.e., the SEC, the FASB, and the rating agencies), not by banking supervisors who have neither the responsibility, the focus, nor the expertise to take on that role. Furthermore, such requirements seem unnecessary to us, because, quite outside of Basel, the market will dictate those elements of bank risk management disclosure that are most necessary to improve transparency.

We feel compelled to raise these issues, and others that we will enumerate, not only because they are important to us, but because we are concerned that the support that may exist for the Basel proposal within the banking community today stems not from a philosophical agreement with the direction of the Accord, but either from the fact that many may view the Accord as a *fait accompli* and are "jumping on the bandwagon" or, more narrowly, from the standpoint of whether or not a particular bank anticipates that it will receive a lower regulatory capital requirement under the new system. After all, if one accepts that all banks are, in principle, trying to maximize return on internal economic capital, subject to the constraint that economic capital be less than regulatory capital (in total), then regulatory capital becomes inconsequential to the risk/return proposition, *except* for the fact that banks will always argue for a less binding constraint (that is, lower regulatory capital). With Basel II, there is a further consideration in this equation, in terms of the considerable compliance costs that the Accord will impose on the banking system, an additional sunk cost without compensatory return.

THINGS THAT NEED TO BE CHANGED

Flexibility for National Banking Supervisors to Dictate Operational Details of Bank Risk Management -- The language of the Accord is, in fact, quite contradictory in and of itself on the topic of the extent to which specific operational aspects of risk management would be mandated. In describing the minimum requirements for the IRB approach, paragraph 351 of the Consultative Paper states the following: "The [Basel] Committee recognizes that differences in markets, rating methodologies, banking products, and practices require banks and supervisors to customize their operational procedures. It is not the Committee's intention to dictate the form or operational detail of banks' risk management policies and practices. Each supervisor will develop detailed review procedures to ensure that banks' systems and controls are adequate to serve as a basis for the IRB approach." And, yet, the next 50 paragraphs of the Consultative Paper itemize in detail the operational policies that the Basel Committee deems "best practice" and required for certification.

It is primarily in this area of the proposal that we have identified several specific requirements that need to be eliminated as requirements or significantly modified:

1. Paragraph 386 states that "ratings assignments and periodic rating reviews must be completed or approved by a party that does not directly stand to benefit from the extension of credit."

   Our view on the credit approval process is 180-degrees opposed to this perspective. Wells Fargo employs an Expert Judgment rating process for wholesale credits, where lending officers are responsible and held accountable for maintaining accurate and timely risk ratings. They are the principal owners of the risk ratings. The requirement of ownership is probably the most important aspect of our credit culture. We believe that lending officers need to know their customers, monitor their customers' financial condition and collateral, and surface deteriorating situations and problem loans early. The requirement and expectation that lending officers own the risk rating, and are responsible for the risk rating, forces them to meet our management's expectations with respect to the credit process; that is, properly underwriting, analyzing, and monitoring their credits. This fundamental pillar of our credit culture is augmented by a strong, independent loan review function (called Risk Asset Review) that evaluates each office's lending practices and has final authority on the risk ratings assigned.

   Now, we are being told that we must change our risk rating system to conform to some theoretical, yet unproven, new system, even though we have had one of the best credit quality trends in the industry. We are not an internationally active bank. Our credit extensions are neither exotic nor complex. 95% of our commercial loans outstanding are to middle market and small business customers. Judgments by talented and experienced lending officers and credit supervisors are particularly important for these types of customers, as compared to the analysis of loans to large corporations. To shift the responsibility for assigning wholesale lending risk ratings to an independent rating function seems totally implausible to us. This would be like asking an auditor to audit a system that has been developed and implemented by auditors. We strenuously object to regulatory efforts to disrupt successful risk management cultures, such as ours, that have been developed through years of training and practice, with proven results. The Accord should be re-worded to exclude this directive.

2. Paragraph 386 goes on to state that "independence of the rating process can be achieved through a range of practices that will be carefully reviewed by supervisors."

   Based on this language in the proposal and discussions that we have held with our national banking supervisors, we believe that our banking supervisors will require someone besides the lending officer to sign-off on <u>every</u> rating decision made by the lending officer. This idea is not only ludicrous from a cost/benefit standpoint, but it would also, over time, have a significant adverse impact on our credit culture; that is, the notion that lending officers own the risk ratings. The Accord should be re-worded so that it does not permit such an interpretation of its design.

3. Paragraph 403 states that "banks must have independent credit risk control units that are responsible for the design or selection, implementation and performance of their internal rating systems. The units must be functionally independent from the personnel and management functions responsible for originating exposures."

   With respect to retail portfolios, we have much the same philosophy as expressed in our earlier comments on rating wholesale credits. We believe in assigning responsibility for the credit modeling and risk assessment functions to those areas that are expert in the relevant product development and customer servicing. While we do distinguish the marketing and credit approval responsibilities within these business units, we feel that it is critical to hold them accountable for the full P&L impact of their credit decisions. As with our system of wholesale checks and balances, we have a strong loan review function (Risk Asset Review) that examines the accuracy with which Bank risk rating policies are followed among retail lending units. Paragraph 403 should be re-worded to eliminate the concept of functional independence of credit risk control units.

4. We are highly skeptical that the data maintenance standards for the advanced IRB outlined in Paragraphs 391 to 395 constitute "best practice." Notwithstanding the language of Paragraph 351, it appears possible that Paragraph 391 may be interpreted by our national banking supervisors in such a way that they may impose detailed data warehousing requirements on Expert Judgment risk rating systems of Advanced IRB banks. The apparent goal of such requirements would be to validate not only the accuracy of PD and LGD estimates made from a bank's rating system at the "back-end" of an account's life cycle (which is understandable), but also the accuracy of the account's initial risk ratings through an Evaluation of Developmental Evidence at the "front-end" of its life cycle.

   We are unaware of <u>any</u> form of front-end "validation" of either judgmental or modeled risk ratings that has been demonstrated to have any statistical power in use anywhere in the financial services industry, so we have a basic question about the underlying objective for the supervisory expectations regarding data maintenance. And, if such interpretive data maintenance standards are a precursor to the required development of credit scoring models for large wholesale credits, our experience over the years in credit evaluation has taught us that over-reliance on credit scoring models for the type of lending that we do could produce disastrous results. We believe that such an approach would actually *increase* risk in the banking system.

The Accord should be re-worded such that the data maintenance standards contained in Paragraphs 391 to 395 are not interpreted as a universal requirement of the Accord, but rather as a principle to be followed by banks wishing to investigate credit scoring models as "challengers" to the rating systems that they currently have in place. Our experience with such models, which is admittedly more in the area of retail credit risk management, is that such models take 3 to 5 years to build and test to the point where one would be willing to accept their results.

5. We are also apprehensive that the language of the Consultative Paper may be interpreted by banking supervisors in such a way that a certain specificity of risk rating definitions is prescribed to banks. Although Basel II allows for an Expert Judgment system, discussions with our national banking supervisors have led us to believe that they will require banks to identify and track <u>specific criteria</u> for <u>each factor</u> that is considered in a rating decision. This will be required to achieve "transparency" of a rating system. However, by dictating such a requirement, the national banking supervisors will, in effect, have eliminated Expert Judgment systems as a risk rating practice and imposed Constrained Judgment systems in their place.

   Such interpretive rulings would not represent principles of sound risk management that are unilaterally applicable. They would be prescriptions, pure and simple. We note, with interest, that the U.S. banking regulators, themselves, have not followed these prescriptions when articulating the risk rating scale on which their Shared National Credit examinations will be conducted in the future. We are adamantly opposed to this form of capital regulation. The Accord should be re-worded to exclude the possibility of such supervisory interpretations of risk rating definitions.

6. We are fearful that certain concentration limits may be imposed by our national banking supervisors on the fraction of a portfolio that can be present in any one risk rating classification (without regard to the nature of the business being conducted).

   Again, such interpretive rulings would simply be prescriptions, in the absence of any evidence that a bank's risk rating scale is obscuring the timely identification of risk in the portfolio. The scope and diversity of a bank's lending practices should be the ultimate determinant of the distribution of its portfolio across risk rating classifications; there are no arbitrary targets for this distribution. The Accord should be re-worded to exclude the possibility of isolated supervisory interpretations of credit concentrations.

There is nothing inherently wrong with any of the systems proposed by the Basel Committee and our national banking supervisors. Each may be an appropriate rating system given certain circumstances, such as the nature of a particular bank's business or the state of a company's credit culture. However, Wells Fargo has operated successfully for many years with its current Expert Judgment rating system. This is confirmed not just by our financial results, but also by the fact that independent third parties (principally, our national banking supervisors and rating agencies) have consistently concluded that Wells Fargo has a sound credit risk management process, a rating system that rank orders risk, and a rating system that is accurate.

Wells Fargo would be doing a disservice to its shareholders and debtholders if it did not defend the risk management practices that have operated so successfully for the Bank over the years. We strongly encourage the Basel Committee to reconsider some of the points that we have made above, to remove some of the regulatory prescriptiveness relative to the operational detail of bank risk management policies and practices, and to allow banks like Wells Fargo to preserve well-functioning credit cultures that they have developed.

Competitive Equality – Our second primary issue with the Accord deals with the scope of its application. Recently, the U.S. banking regulators decided that only 10 U.S. banks must comply with the Accord. We believe that this decision increases the likelihood of creating an uneven playing field for major competitors in the U.S. financial services industry. Activities that, we feel, receive particularly onerous treatment in the Accord, such as retail lending and operational risk (e.g., transaction processing and asset management), would gain an undue advantage when offered outside of the Accord, either by non-bank competitors or other large banks.

Although we have not seen a list of the 10 mandatory "Basel Banks" in the U.S., we estimate that many of the institutions that we compete with most directly in our various regional markets may not be subjected to Basel's strict compliance standards and costs. Wells Fargo competes directly against smaller regional and community banks within the geographic footprint in which our respective banking franchises operate, yet they would not be subject to the same capital standards simply because they do not have the same scale of business as we do <u>outside</u> of this geographic footprint, but within the U.S. A number of banks that are as large or larger than Wells Fargo in terms of particular product lines, but smaller than our Bank in terms of total assets, would not be subject to the same capital standards merely because they are not as diversified as we. Other examples of potential competitive inequality include monoline non-bank competitors in the credit card and retail lending business, as well as some of the largest institutions offering personal and institutional asset management. Across the sphere of diversified financial services that Wells Fargo offers, there will be meaningful instances where our direct competitors will not be taxed to the extent that we will be, simply because they do not enjoy the business diversity and economies of scale that we do.

With respect to competition, our contention would be that <u>size</u> is not the same as <u>risk</u>, and that an arbitrary measure like total assets is not the only, or best, way to measure either size or risk. The only fair way to enforce the Basel standards is to apply them to <u>all</u> banks, using the full range of options (Standard, Foundation, Advanced) that Basel envisions. If the U.S. regulators deem it necessary to impose the Advanced IRB (A-IRB) approach to Credit Risk on the largest U.S. banking institutions, in light of credit risk being the predominant risk that banks undertake as a matter of course, we believe that in order to lessen the competitive equality issues, the managed asset size threshold for mandatory A-IRB compliance should be reduced so as to include the top 50 U.S. banks, and that smaller banks should be required to adopt either the Standard or Foundation approach. While such a bifurcated system might result in higher credit capital requirements for smaller banks, it is the smaller banks that historically have had the greatest frequency of failure and the less-developed risk management processes. This approach is the only way, we feel, to adequately address both competitive equality and safety and soundness considerations.

In contrast, because there is no accepted methodology for quantifying Operational Risk, we also believe that the AMA approach to Operational Risk should not be the sole option that is made available to U.S. banks. We will expand on this thought in our commentary below that is specific to Operational Risk.

Pillar 3 – The final area in which we believe that the Accord has ventured beyond its intended scope is Pillar 3. The proposed Accord requires that a bank make extensive disclosures about its risk profile and risk management processes. We view the proposed requirements for Pillar 3 disclosure as excessive and costly to implement, with the resulting information being potentially confusing to the investment community, particularly with respect to efforts to compare the risk profile of one institution to another. Rather, we feel that market forces can act as a better policing authority for required disclosures, compelling companies to achieve a requisite level of transparency on topical issues. We believe that the proposed approach is flawed on several counts:

- First, we see no basic need for such disclosures. The market is sufficiently well informed already, as evidenced by the breadth of banks' securities issuance activities. Securities transactions require the market to constantly assess a financial institution's creditworthiness, risk profile, and capital structure. If the market needs more information in order to perform this assessment, it will demand it; and, it will penalize the reputation of those that cannot provide the necessary information. We do not believe that the Basel Committee can effectively, nor should it, determine the informational requirements of bank credit markets.

- Second, efforts to employ disclosures such as those proposed in order to make comparisons in the risk profiles of two financial institutions will invariably lead to mis-interpretations among readers of the information. We know well from our considerable experience in acquiring other banks how different two banks' approaches to risk rating loans can be. Without exception, we have come away from the due diligence efforts on potential acquisition candidates planning for the changes that we will have to make to the target company's reporting of its risk profile in order to make it comparible to our more conservative approach. This same issue will extend to a comparison of Probability Of Default, Loss Given Default, and other metrics across institutions, as each company will take a different approach to its parameter estimation process.

- Third, the Pillar 3 disclosure requirements may be duplicative to, and potentially inconsistent with, existing or future GAAP and non-GAAP accounting disclosures, and unnecessarily costly to compile and report within adequate standards of audit controls. We view the potential for lawsuits as being very high, and regard the provisions of Paragraph 765 (which allows that Pillar 3 disclosures need not be audited externally, unless otherwise required) as an empty gesture, since no large issuer is going to be disclosing material public information without appropriate (but costly and time consuming) internal review.

- And fourth, the proposed disclosures will create an uneven playing field between banks and their non-bank competitors, who will be free to pursue their business activities unencumbered by supervisory capital rules and the excessive compliance costs that they will engender.

We recommend that Pillar 3 be eliminated or, at least, made voluntary, so that the market and those agencies that are appropriately tasked with safeguarding the interests of investors (i.e., the SEC, the FASB, and the rating agencies) could determine the need for any additional disclosure about a public company's risk profile and risk management practices.

MACRO-LEVEL TECHNICAL CONCERNS

Let us now address some macro-level technical concerns that we have with the proposed Accord. These issues deal with the topics of Pillar 1 Conservatism, Operational Risk, and the Accord's treatment of Goodwill, the Loan Loss Reserve, and Expected Losses.

Excessive Conservatism -- We believe that Pillar 1 contains excessive conservatism that would, in aggregate, significantly overstate banks' need for capital and would propose that either Pillar 1 be modified to be more consistent with bank risk estimation practices or that Pillar 2 be expanded to create a forum for banks to present evidence in support of their contradiction of the Pillar 1 formulae. Examples of the proposed Accord's conservatism include the following:

1) **No capital relief is given for credit portfolio diversification** - At Wells Fargo, we believe that we have consciously crafted a distinct competitive advantage by virtue of the diversity of our underlying businesses. Between mortgage banking, commercial banking, insurance, retail deposit taking, and asset management services (to name a few of our over 80 businesses), along with the significant economies of scale that we have in each of these businesses, we feel that Wells Fargo has created a portfolio of risks (both credit and non-credit) whose worst-case loss potential is substantially less than the sum of its parts. In fact, when we have simply modeled portfolio losses across all of our various credit portfolios in the past, we typically have concluded that the worst-case overall credit portfolio result is roughly 65-75% of the raw summation of the individual sub-portfolio worst-case events – a significant impact. We also understand that the capture of such capital benefits may be allowed under the AMA modeling of operational risk. If this is, in fact, the case, then why would this logic not extend to the modeling of capital for credit risk, where the impact is more substantive and more empirically justifiable?

2) **Limited capital relief is given for future margin income** - Internal capital generation acts as a primary buffer against losses in the portfolio, even before loan loss reserves and equity capital are drawn upon. While this concept has long been valued by bank debt rating agencies in their evaluation of bank capital structures and securitizations of pools of assets, it has been virtually ignored in the Accord. Even recent amendments to the Accord with respect to Future Margin Income are fundamentally understated, by virtue of restricting their focus to higher-margin retail lending portfolios and operational risk. Margin income is found throughout a diversified bank holding company and, regardless of its source, serves as a component of internal capital generation. Stated simply, it is not the risk alone of extending credit that creates a requirement for capital outlay at a financial institution. It is this risk absent a compensatory reward that raises capital requirements. We would argue that some fraction of Future Margin Income should be deducted from <u>all</u> Pillar 1 capital formulations.

3) **99.9% confidence level as a minimum standard –** The Accord employs a 99.9% confidence level (roughly a single-A debt rating for a one-year horizon) as the minimum capital requirement before potential Pillar 2 and "well-capitalized" increments are taken into account. We would recommend either setting the minimum standard closer to a level associated with a low investment grade rating, or employing the 99.9% level as the well-capitalized standard (after stress tests and FDICIA prompt corrective action provisions have been take into account).

4) **Unrealistic asset correlation assumptions** - The Accord employs unrealistically high asset correlation assumptions in the risk-weighted asset calculations, which make the estimated 99.9th percentile loss level arbitrarily high in the first place. These assumptions result in an exaggerated view of worst-case loss levels across all of the retail lending product categories, and are particularly misrepresentative in the case of high-EL/high-FMI (non-prime) retail lending.

5) **Stress testing requirements** - The Accord requires stress tests to the 99.9th percentile calculations, which may translate into required capital in excess of the 99.9th percentile. We do not understand the need for such a required incremental capital buffer, if so high a minimum confidence level has already been assessed.

6) **Omission of the tax consequences of losses** - The Accord fails to recognize the fact that worst-case losses should be supported by capital on an after-tax, rather than pre-tax, basis, thereby reducing the amount of capital required. After all, the actual drain on retained earnings occasioned by most losses is inclusive of the tax benefit associated with those losses. The omission of this benefit effectively overstates the required capital support for a business by 30-40%!

7) **Required conservatism in EAD/LGD estimation** - The Accord forces the use of conservative, rather than expected, estimates for EAD and LGD. This directive has a multiplicative impact on worst-case loss estimates. In addition, in the case of retail exposures secured by residential properties, a minimum LGD of 10% has been mandated, with no theoretical support. This LGD floor could also have public policy implications, with respect to its impact on banks who use PMI insurance as a tool to facilitate the granting of loans at attractive rates to borrowers who have not accumulated a 20% down payment. In such cases, the PMI insurance may well limit a bank's expectation of LGD to below 10%.

8) **Additional capital for "well-capitalized" standard** - As we understand it, in the U.S. the well-capitalized standard under the FDICIA prompt corrective action provisions may impose an additional 2.00% total capital requirement on banks, on top of the conservatism already built into the assumptions above.

Operational Risk -- With respect to the Advanced Measurement Approach to Operational Risk, there are several issues that, we believe, need to be resolved:

- Certain operational loss events are relatively small and frequent. Such events can be successfully modeled through the use of statistical techniques applied to historical data sets. Because such losses are relatively predictable, they can effectively be priced into the product, in much the same manner as expected credit losses are priced into credit products, and we support the Committee's decision to allow Future Margin Income to offset the expected component of such losses.

  However, we are doubtful that similar statistical techniques can be applied to historical data to reliably model extreme operational loss events. Truly catastrophic loss events cannot be predicted, and no amount of capital will protect an institution in such an instance. We believe that some form of qualitative (scenario analysis) modeling is more appropriate in assessing those types of loss events that are less predictable. Accordingly, we think that more development is necessary to finalize exactly what types of loss events ought, realistically, to be captured under AMA approaches to Operational Risk capital formulations.

  Wells Fargo very much supports the use of information databases and statistical analysis, but only as a means of understanding/managing its operating expenses, not as a requirement for establishing capital levels.

- To the extent that extreme operational loss event modeling is deemed realistic, we see no reason why the recognition of insurance mitigation should be limited to 20% of the total operational risk capital charge, as suggested by Paragraph 637 of the Consultative Paper. To do so might lead to imprudent risk management incentives in the use of insurance programs.

- We do not believe that the direct incorporation of external loss data should be a required component of a bank's operational loss modeling. While it is instructive for banks to be aware of external loss events, applying that information across all institutions in a formulaic manner seems problematic to us. Without a relatively detailed awareness of the internal control conditions that led to those losses at other institutions, it is difficult, at best, to do much more than guess the impact of a seemingly similar event on a given bank. Accordingly, external data should only be one of several, optional considerations when performing scenario analysis, and not necessarily the most important.

The proposed AMA framework for Operational Risk leaves banks with the task of developing a complex and costly methodology for operational loss estimation. This choice begs the question of whether there may be an alternative approach to determining operational risk capital that is consistent with the way sound businesses actually operate without being overly complex or costly to administer.

For example, we note that the well-known concept of operating leverage, or business risk, seems to be totally overlooked in the Basel Committee's operational risk capital deliberations. We feel that constructing a business-based approach to operational risk capital should be viewed as an acceptable alternative to the AMA track. We would encourage further discussions between the regulatory agencies and their regulated institutions along the lines of quantifying the main elements, definitions, and procedures of this type of framework.

Because there is no accepted methodology for quantifying Operational Risk, we believe that the AMA approach should not be the only option made available to U.S. banks. All institutions subject to the Accord should be allowed to develop any risk measurement methodology (Basic Indicator, Standard, AMA, or an alternative such as a business-based approach) that is acceptable to their national banking supervisors, and to disclose their methodology and their key controls for managing operational risk in their public filings.

Treatment of Goodwill as Capital – Subsequent to the inception of the existing Risk-Based Capital Accord in 1988, the accounting principles (GAAP) that affect the treatment of the Goodwill asset on the balance sheet have changed. Under GAAP today, Goodwill must be revalued to its fair market value on a quarterly basis. As such, we believe that Goodwill now represents an asset with an accepted value equal to its recorded balance sheet amount, and should no longer be a required deduction from Tier 1 Capital in the regulatory capital calculations. In contrast to other banking assets that, by GAAP standards, are subjected to similar impairment analyses on an ongoing basis, the capital treatment of Goodwill is disproportionately harsh.

Use of Loan Loss Reserve as Capital -- We believe that banks should be allowed to effectively count their entire loan loss reserve (ALLL) as capital, rather than having its usage capped (at 1.25% of risk-weighted assets (RWA), or aggregate expected losses (EL)). If usage of the ALLL is capped, a major portion of three primary buffers against loss volatility – portfolio diversification, margin income, and part of the loan loss reserve – will effectively have been ignored. It would also be the case in this instance that banks with low expected losses would receive an arbitrary capital advantage, since it is more likely that their ALLL would "fit" under the 1.25% of RWA cap.

Wells Fargo thinks of the loan loss reserve as another form of capital. We see no reason why banks should not be able to effectively count their entire ALLL as capital, regardless of the proposed treatment of EL in the risk-weighted asset formulae. It is particularly objectionable to us that the current proposal gives an arbitrary advantage to some banks in terms of their ability to make full use of their ALLL.

Treatment of Expected Losses (EL) as Capital – As a separate issue from the use of the ALLL in the capital calculation, Wells Fargo supports the widely-held industry belief that capital is not needed to cover EL because bank pricing practices are generally constructed such that pricing covers expected losses, other expenses, and a targeted minimum return on economic capital. Stated differently, risk does not emanate from losses that are expected and priced for; it is created by uncertainty, in terms of unexpected credit events or mis-managed operating leverage.

Consequently, we would suggest that EL be excluded from the computation of required capital. If this treatment is not adopted, it seems to us that the only fair approach is to permit consideration of those elements that act as offsets to EL in practice – the full amount of the loan loss reserve and an appropriate portion of Future Margin Income (discussed earlier). We believe that excluding EL from the capital calculation would be the simpler and, actually, more conservative, in terms of resulting in a higher capital requirement when compared to the alternative of subtracting Future Margin Income.

We would also repeat that, in its current form, the Accord is internally inconsistent in its treatment of EL. It permits Future Margin Income to offset EL in the case of qualifying revolving retail exposures and operational risk, but does not allow it for any other banking risks. We find this illogical.

MICRO-LEVEL TECHNICAL CONCERNS

Finally, we have some detailed technical concerns with the current wording of the proposed Accord. These issues are clearly subordinate to some of our overriding concerns, but if the Basel Committee is determined to continue on its current path, then we feel that our remaining issues should be addressed, so as to make the compliance burden somewhat more reasonable for the affected banks.

Definition of Default -- We believe that the definition of default outlined in paragraph 414 should be simplified to correspond more closely to what is more commonly used by risk practitioners. That is, loans that fall under the corporate and specialized lending models should define default to coincide solely with the incidence of non-accrual status (to exclude the 90 days past due and other isolated conditions present in the Accord's current definition), and loans that fall under the retail model should define default to coincide with the Uniform Retail Credit Classification standards published by the FFIEC. In the absence of this change, banks will be forced to track two separate measures of default – one for internal risk assessment and a second for regulatory capital purposes. This would seem to be a meaningless exercise, since the ultimate driver of risk is loss, and these fine lines of default definition will only serve to shift the mix of PD and LGD, without significantly affecting ultimate loss.

A related issue evolves from the interplay of paragraphs 414 and 366. Paragraph 366 prescribes that banks must have one point on their borrower rating scales that is reserved solely for defaulted loans. We see no reason why it should be necessary to create a risk rating bucket that, by design, has a 100% PD, so long as a bank would always be able to identify what the actual default rate is for each of its rating buckets. While it is highly likely that defaulting borrowers would congregate at the lower end of a rating scale, we do not think that a unilateral default rating construct should be prescribed to banks. This becomes a potentially bigger issue when added to the fact that we disagree with the proposed definition of default in the first place. As a result, banks are faced with another unnecessary cost of creating parallel risk rating methodologies, with no value added to the risk management process.

Electronic Storage of Guarantor Rating Histories – Another unnecessary cost that we perceive in the proposed Accord is the requirement in paragraph 392 that banks maintain rating histories on recognized guarantors. While we agree with the standards that are laid out in the Accord for the recognition of guarantees, we feel that a lender's supporting documentation for 1) the recognition of a guarantee, 2) analysis of the strength of a guarantor, and 3) the PD estimate attached to the guarantor should only need to appear in the physical credit files. It would be unnecessarily costly, confusing, and without any value, to reproduce this data electronically when Expert Judgment risk rating systems are employed. In particular, instances of partial guarantees or multiple guarantees make the systematic storage of such data problematic. This is another aspect of the data maintenance requirements of the Consultative Paper that we feel is overly prescriptive and adds unnecessary costs to the implementation process.

Capitalized Future Margin Income – We feel that paragraph 523 in the securitization section of the Consultative Paper is too vague in its statement that "Banks will be required to deduct from Tier 1 capital any expected future margin income (FMI) (e.g. interest-only strips receivable) that has been capitalized and carried as an asset on the balance sheet and recognized as regulatory capital." We believe that this paragraph was intended to only refer to *credit enhancing* interest-only strips receivable. Mortgage Servicing Rights (MSR's) and other non-credit sensitive interest-only strips are sometimes retained and capitalized on the balance sheet. To avoid confusion, we would suggest that paragraph 523 be augmented to clarify that MSR's and non-credit enhancing interest-only strips (whether in securitized or non-securitized form) are explicitly excluded from its scope.

Implicit Support -- In a similar fashion, we would suggest that the concept of "implicit support" of securitizations mentioned in paragraphs 513 and 524 be clarified so that it is understood that this concept does not extend to situations where banks buy loans out of pools for breaches of contractual representations and warranties which they have made as sellers and servicers in securitizations. In addition, it should be made clear that the term "implicit support" does not cover instances in which mortgage servicers periodically buy back loans from GNMA securitization pools under GNMA's Early Pool Buy-out Program. Purchase of these loans does not create any incremental credit support, as these securities are covered by the full faith and credit guarantee of the U.S. government.

Risk Weights for Securitization Tranches -- We believe that the proposed risk weights in the Ratings-Based Approach to be used by Investing Banks in the mezzanine and senior tranches of securitizations are too high, and could lead to irrational incentives to trade securities. These weights could be made to coincide more closely with the weights generated by the corporate risk weight formula for assets with comparable PD's. In reference to Paragraph 575 of the Consultative Paper, we also believe that originators should not be treated differently than investing institutions with respect to the capital treatment of retained or repurchased tranches of securitizations. Rather than being required to deduct from regulatory capital all positions below K_{IRB} regardless of rating, originators should be allowed to apply the same RBA risk weights used by investors for the subject tranches when performing the calculation, since the risk is the same.

Specialized Lending Rating System Design -- Paragraph 362 of the Consultative Paper describes an exemption from the two-dimensional rating system design requirement that is available to banks using the supervisory slotting criteria. It states that "given the interdependence between borrower/transaction characteristics in Specialized Lending, banks may satisfy the requirements under this heading through a single rating dimension that reflects EL by incorporating both borrower strength (PD) and loss severity (LGD) considerations." We agree about the presence of significant correlation between PD and LGD in commercial real estate lending, and feel that Advanced IRB banks should be allowed the same flexibility to use a single rating scale to assess risk in investor/developer real estate lending. We believe that this would be a much more reliable manner in which to capture the collateral-intensive nature of that business and its correlation with borrower PD.

SME Risk Weight Function -- The capital formulation for SME's (small and medium-sized enterprises) should be simplified so that it is not so complex and, potentially, costly for banks to comply with, in terms of assembling the required data. There is little theoretical support for modeling borrower asset correlation as so granular a function of sales size as is suggested by the Accord. We do not understand why a lower asset correlation specification could not be devised, using the same functional form, but lower parameter settings, as the Corporate risk weight function, while simply stipulating a maximum sales size for a borrower to be considered an SME. Ideally, this function could also be made to eliminate the arbitrage possibilities that currently exist between corporate and retail SME risk weightings.

Overdrafts -- We believe that the treatment of overdrafts outlined in paragraph 421 is potentially destructive and should be clarified so as to ensure sound risk management of overdrafts. Paragraph 421 states that "Authorized overdrafts must be subject to a credit limit set by the bank and brought to the knowledge of the client". We interpret this passage to mean that, assuming a bank does calculate and deploy an overdraft limit for each checking account (whether business or consumer), the bank needs to notify the client of the available overdraft limit. If this is the proper interpretation, a bank is put in a difficult position in terms of notifying the client about the limit. This would increase the risk of the deposit account, exposing the bank to adverse selection. Clients might focus not on what funds they have in their checking accounts (avoiding overdrafts), but, rather, on the amount that they can legitimately overdraw their account, potentially increasing the amount of losses resulting from overdrafts.

Interest Receivables -- We believe that the balance sheet item called "Accrued Interest & Fees Receivable" should receive a 0% risk weight, since the credit risk associated with this account is captured in the economic loss measured for the associated asset portfolios as part of the LGD parameter estimation methodology. This logic may also be applicable to "Other Real Estate & Other Collateral Owned," depending on the time horizons used by banks in estimating LGD's for the underlying asset portfolios. The conditions under which a 0% risk weight could be justified for these asset classes should be made clear in the final rules.

In conclusion, we would like to acknowledge the work done by the Basel Committee and its support staff in raising the awareness of the complexity of today's risk management process in a dynamic banking environment. We are hopeful that our thoughts expressed here are helpful not only in terms of pointing out issues with the proposed Accord, but also in suggesting solutions.