



THE FEDERAL RESERVE BANK OF RICHMOND

RICHMOND • BALTIMORE • CHARLOTTE

Post Office Box 30248 • Charlotte, NC 28230
Office 704-358-2100 • www.richmondfed.org

July 22, 2008

Mr. Lanty Smith
Chairman of the Board
Wachovia Corporation
301 South Tryon Street
Charlotte, North Carolina 28288-0100

Dear Mr. Smith,

This letter conveys our supervisory assessment of Wachovia Corporation (Wachovia) as of June 30, 2008, using the Federal Reserves' RFI/C (D) rating for bank holding companies. The rating is based on the results of our continuous supervision program over the past year which consists of monitoring activities conducted by a team of resident examiners and a series of targeted examinations. The assessment also leverages the examination work of other primary bank and functional regulators.

SUPERVISORY RATING

The overall condition of the corporation is considered "fair" and the RFI/C (D) rating is 332/3 (2).¹ The rating is based on weaknesses in risk management, including board and senior management oversight, management information systems (MIS) and risk monitoring, coupled with the weakened financial condition of the consolidated corporation, led by poor earnings, deteriorating asset quality, and a reduced capital cushion. Since our previous assessment, Wachovia has suffered large losses due to market disruption write-downs, required over provisions, and preventable execution errors. These execution losses were partially due to weaknesses in overall risk management and "top of the house" board and senior management oversight as supervision of certain investments was inadequate or controls were not effective in certain business lines. MIS and risk monitoring has not fully captured the risk inherent in the company's balance sheet and its varied business lines. Going forward, we expect the

¹ Rating 3 (Fair). BHCs in this group exhibit a combination of weaknesses in risk management practices and financial condition that range from fair to moderately severe. These companies are less resistant to the onset of adverse business conditions and would likely deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently, these companies are vulnerable and require more than normal supervisory attention and financial surveillance. However, the risk management and financial capacity of the company, including the potential negative impact of the nondepository entities on the subsidiary depository institution(s), pose only a remote threat to its continued viability.

deterioration in consolidated asset quality and the associated provisions will continue to depress earnings, placing a continued strain on capital and liquidity.

In its current weakened condition, Wachovia is less resistant to the effects of the current adverse business environment and will require more than normal supervisory attention. To that end, this letter contains a number of Matters Requiring Immediate Attention.² Additionally, it is our intention to enter into an informal Memorandum of Understanding (MOU) with the board of directors to address corrective action needed.

SUMMARY SUPERVISORY RATINGS:

	<u>6-30-08</u>	<u>12-31-06</u>
Risk Management	3	2
Financial	3	2
Impact	2	2
Composite	3	2
Depository Institutions*	2	2

*reflects composite CAMELS rating for Wachovia Bank NA, the largest depository institution, as of June 30, 2007. Upon receipt of the June 30, 2008 report of examination, the rating will be adjusted as needed.

RISK MANAGEMENT - 3

We have downgraded our assessment of Wachovia's risk management from "satisfactory" to "fair" based on concerns with the efficacy of board and senior management oversight and the quality and flexibility of MIS and risk monitoring.

Board and Senior Management Oversight – Fair or "3"

Board of directors and senior management oversight is considered fair. This rating reflects our concerns about the oversight of senior management provided by the board of directors, the adequacy of risk management coverage, including its independence and stature, and the number of and management's response to the execution errors. Also, the board of directors and senior management have not always developed clearly defined risk tolerances for investing activities, limiting the effectiveness of risk management functions.

The board of directors has responsibility for ensuring that the culture and strategic direction established by senior management is appropriate. Many of the issues noted in this

² To improve the consistency and clarity of written communications, the Federal Reserve uses standardized terminology to differentiate among Matters Requiring Immediate Attention (MRIA), Matters Requiring Attention (MRA) and Observations. MRIs are matters arising from supervisory activities that the Federal Reserve is requiring a banking organization to address immediately; MRIs encompass the highest priority concerns and have the potential to pose significant risk to the organization's safety and soundness; MRIs may represent significant instances of noncompliance with laws and regulations and or repeat criticisms that have escalated in importance due to insufficient attention or action by the banking organization. MRAs are matters that are important and that the Federal Reserve is expecting a banking organization to address; MRAs have a lower priority than MRIs; and, must be addressed over time to preclude a significant issue. Observations are matters that are informative, advisory, or that suggest a means of improving performance or management of the operations of the organization; and, may be communicated in the report or conveyed informally.

correspondence are long-term in nature and they result from delayed investment decisions and a desire to have the business lines operate autonomously. The directorate has recently taken actions to improve governance and this process needs to continue to ensure the changes in overall culture are sustained and fulsome.

MRIA - Board of Directors Governance

To insure that its governance is appropriate, the board of directors must conduct an analysis to assess the effectiveness of Wachovia's corporate governance at the board, management, and committee levels. This analysis will assist in the development of management structures that are commensurate with the size, complexity, and business activities of Wachovia and assist in the development of effective risk management practices.

The current risk culture is a result of management's desire to use a decentralized approach to managing business line risk. This structure led to an environment with inconsistent and inadequate identification, escalation, and coverage of all the risk taking activities of the company. The market disruption revealed that leaders did not have a complete understanding of the risk inherent in certain investments and business lines. Examples include but are not limited to the level of subprime risk in the trading books and retained positions, the risk in certain nonbank investments including BluepointRE, and the concentration of subprime borrowers in the GoldenWest portfolio. These concerns are partially offset by some examples where the risk management processes functioned adequately both in the business lines and with the centralized corporate function. With trading book VaR limits, market risk management and the business lines effectively reduced exposures or obtained overlimit exceptions from the chief risk officer. Also, the corporate investment bank (CIB) took actions to limit risk and sold much of the super senior CDO positions in its active originate to distribute business model.

The lack of strong independent risk management functions also contributes to our concern with oversight, especially with investing outside the normal course of business. A particular concern shared by this Reserve Bank and noted in recent examinations completed by the OCC is the lack of strong independent risk management over the Treasury and Balance Sheet Management group. We understand management's desire to use treasury functions to take additional risk for yield or tax benefit where appropriate. This risk is usually taken in the form of structured transactions and/or other investments and many of these transactions have not performed as planned. Going forward, it is incumbent on risk management to insure that investments are made within the corporation's risk appetite and that potential downside risk is evaluated.

MRIA - Risk Management Adequacy Assessment

To strengthen risk management practices, management must conduct an independent assessment of the adequacy of risk management both as a centralized function and within the business lines. The assessment needs to review the level of independence, overall stature, and the ability to measure/monitor current risk exposures within all risk taking areas of the corporation. Particular emphasis should be placed on determining if all risk management functions are both sufficiently independent and enabled to discontinue business activities that are outside corporate risk tolerances. The review needs to include an assessment of the risk management systems to insure appropriate stress testing is completed to better understand risks that cross business lines. Specific areas of concern include but are not limited to investment decisions and commitments of capital outside the traditional trading books, including those made within the Treasury function; the monitoring of these non-traded investments during its life; and the setting of risk tolerances.

Until recently, senior management has not promoted a culture of accountability as clear responsibility for execution errors was not transparent. With the issues of the Payments Processing Corporation (PPC) agreement, the municipal bid rigging case, the Casa de Cambio investigation and associated foreign exchange trade failure, the Sagittarius documentation error, and the BOLI counterparty issue, increased prompt accountability could have limited the problems. The ability of management to increase accountability was further hampered by the lack of clear lines of authority.

MRIA - Execution Problems and Improved Accountability

To limit execution errors occurring across the various business lines, management must take actions to improve accountability. This process needs to include a review of execution errors to understand control weaknesses; the development of clear accountability standards for large investment decisions to insure that leaders in the business line and risk management are held accountable; and a review of compensation programs. The compensation review must insure that incentives established within compensation programs are aligned with the risk appetite of the company.

Finally, the rating of board and senior management oversight is also influenced by changes in leadership at the CEO level. Newly hired CEO Steel has a limited background in traditional banking and will have to gain this knowledge while changing the culture of the company.

Policies Procedures and Limits – Satisfactory or “2”

Policies, procedures, and limits generally worked effectively during the market disruption and as the market began to turn. Established limits helped management to note quickly the depth and serious nature of the market disruption. VaR limits and other trading controls worked adequately and appropriate attention/approval was given to overages. The company monitored counterparty limits, despite weaknesses in systems. To maintain credit exposures within limits, the company hedged certain exposures on specific counterparties. Accounting policies were conservative and the company was quick to recognize losses in their remaining exposures, especially in the CDO book. It is expected that policy limits will need to be adjusted to reflect the weakened financial condition of the company. Key areas include capital and liquidity policies and credit approval limits.

Risk Monitoring and Management Information Systems – Fair or “3”

Overall consolidated risk monitoring and MIS is fair. The corporation's MIS did not fully capture the risk profile of the company which contributed to less than effective risk identification. Also, management reporting contains minimal analytical narrative content relative to other peer institutions and key reports are often more line of business/product-focused which makes enterprise risk assessment cumbersome.

Exposure tracking systems were slow to produce complete and accurate information, especially with the monoline insurers and retained risk in certain CDO holdings. For the GoldenWest mortgage portfolio, MIS did not highlight the increased risk in the large portion of near or subprime borrowers as indicated by the FICO distribution. In CIB, both the level and types of subprime exposures were not tracked or considered adequately in risk/position reports. Counterparty credit systems were unable to measure exposures across multiple business lines without significant manual intervention. With liquidity MIS, reports did not capture several funding needs that arose during the stressed environment and these needs were not addressed in the contingency funding plan (CFP). Further, the production of consolidated liquidity MIS is not

sufficiently automated, limiting management's ability to develop consolidated funding analysis promptly or to readily create nonstandard reporting during stressed periods. Many of these reporting deficiencies were issues known by management and investments in and projects to improve systems capabilities were delayed to the detriment of overall risk management.

The lack of comprehensive stress testing also contributed to weaknesses in overall MIS as analyses were not regularly presented or requested by the directorate or senior management. In addition, the board of directors did not sufficiently question business investment decisions and the lack of stress testing limited management's ability to identify potential risks across business lines. Stress testing across business lines is restricted given difficulties in aggregating exposures. Often, credit IT systems have not kept pace with the growth of the franchise or product offerings. The RDS central data repository is supposed to provide a substantial improvement in enterprise data aggregation and analytical flexibility, but the RDS project has been delayed. Ultimately, many of the issues listed above are due to management's decision to defer investments in systems.

MRIA Risk Monitoring and MIS

Management must take actions to improve overall MIS. Key areas to address include the inability to aggregate exposures in a prompt fashion and the limited analytical content of overall MIS. An assessment of the adequacy of systems feeding MIS is necessary to insure stress testing can be conducted effectively. An emphasis should be placed on limiting the number of manual processes required to complete consolidated MIS over key risks. Instances where manual processes are involved include, but are not limited, the production of consolidated liquidity reports, counterparty credit MIS, and aggregating CDO exposures.

Internal Controls – Satisfactory or “2”

Internal controls are satisfactory and we are pleased with the company's efforts to address long standing IT infrastructure issues. Since our 2006 letter which required a satisfactory plan to remediate the unacceptable level of proximity risk with the two Winston Salem data centers, progress on the Oxmoor data center conversion has been satisfactory. It is our expectation that this project will continue to receive adequate funding despite announced expense reduction efforts. The IT remediation projects are substantially complete, but distributed server access controls remain unresolved. Additionally, the control environment has benefited from a satisfactory audit program. In 2008, the company successfully transitioned to a new general auditor and it appears the stature of the department is improving. We have discussed further enhancements the audit department should make to help the organization improve risk identification. These include continuing to define and communicate audit's role as a reassurance function, not risk management or a first line of defense. It is expected that audit will become more proactive versus reactive in identifying weaknesses.

Elsewhere in this letter we note several execution errors and other apparent one-off situations that in aggregate may point to internal control weaknesses. If further evaluation indicates that these issues are systemic in nature, we will revise this rating.

FINANCIAL CONDITION - 3

The overall financial condition of the consolidated corporation is fair³ and the weakened condition of the company is a direct result of the decline in earnings performance, the deterioration in consolidated asset quality, and the reduced capital cushion. While we are pleased that management has taken appropriate actions to increase capital, current projections for 2008 indicate the consolidated company will suffer losses that will erode the buffer provided by recently raised capital. Given this scenario, management must evaluate its capital plan. In addition, the deteriorating financial condition and the expectation that the company's credit rating will be downgraded will place additional stress on liquidity and, appropriately, management has reviewed its contingency funding planning (CFP). We have been briefed on management's extensive plans for potential liquidity needs in a stressed market and we are encouraged with these efforts. Nonetheless, we are highlighting the potential for downgrades of the liquidity component should current trends continue and/or should plans not prove effective.

Capital - 3

Management has taken the appropriate steps to ensure capital adequacy, but recent losses and revised capital projections highlight the vulnerability of the capital base to current business conditions and support a capital rating of fair. Since September 30, 2007, the company has raised significant capital funds to insure adequate capital. In December 2007 and January 2008 Wachovia raised a combined \$5.8 billion in preferred capital and in April 2008 Wachovia raised an additional \$8.0 billion of common and convertible equity. To preserve capital, the corporation has cut the dividend and is adopting strategies to limit asset growth. However, even after these actions, the tier 1 capital ratio is projected to be 7.8% at year-end 2008 versus the 9.0% projection for year-end in April. With rapidly changing earnings projections, the tier 1 capital ratio will continue to move closer to the "dated" pre-disruption policy limit of 7.5%. Required economic capital has grown also as the risk profile of the company has been increasing largely due increased credit risk. In addition, the required provision in 2009 will continue to strain capital ratios. As a result, we expect management to consider additional actions including further reducing its dividend and/or raising additional capital to ensure that the corporation maintains sufficient capital.

MRIA - Capital Planning

Management must update and maintain current capital policies and plans. We expect management to formally re-evaluate its current target level for the tier one capital ratio in light of the corporation's current condition and prospects for near term earnings and asset quality deterioration. In addition, the board of directors needs to update its capital adequacy plan to include capital triggers that if breached would require corrective action as well as providing the potential actions to be taken.

³ Rating 3 (Fair). A rating of 3 indicates that the consolidated BHC exhibits a combination of weaknesses ranging from fair to moderately severe. The company has less than adequate financial strength stemming from one or more of the following: modest capital deficiencies, substandard asset quality, weak earnings, or liquidity problems. As a result, the BHC and its subsidiaries are less resistant to adverse business conditions. The financial condition of the BHC will likely deteriorate if concerted action is not taken to correct areas of weakness. The company's cash flow is sufficient to meet immediate obligations, but may not remain adequate if action is not taken to correct weaknesses. Consequently, the BHC is vulnerable and requires more than normal supervision. Overall financial strength and capacity are still such as to pose only a remote threat to the viability of the company.

Basel II compliance remains a concern as this project has remained in status "Red" for the past 12 months. The company has moved its implementation date back, leaving little cushion for an adequate parallel run of four quarters. We expect the corporation to enter the first transitional floor in April 2011 as required of banks designated as core when the final rule was adopted. Qualifying on time is critical as it indicates that the company has rigorous risk management practices and that its capital levels reflect a more granular estimate of its risk and thus will be an important signal to the market participants. Going forward, management will need to provide appropriate resources to insure key deadlines are met for Basel II qualification.

Asset Quality – 3

Consolidated asset quality is rated fair. Currently, concerns are centered in the GoldenWest mortgage portfolio and the commercial and residential real estate construction book, especially in the Florida market. Classified assets as a percentage of Tier 1 capital plus ALLL have increased led by rising classifications in loans to homebuilders and property developers. Given the current business environment, contagion to other portfolios is probable and as a result management needs to conduct stress/scenario analyses to dimension the extent of the potential losses embedded in the loan portfolio. The GoldenWest mortgage portfolio is quickly deteriorating and the cumulative loss rate is estimated in excess of 9%. Nonperforming assets (NPAs) for this portfolio are projected to increase to \$11.4 billion by year-end 2008. In total NPAs for the consolidated company are expected to grow to \$18.2 billion and will represent 3.71% of total outstanding loans and other real estate owned by year-end. Portfolio net loss rates are very dependent on the underlying value of residential real estate which is causing projected losses to increase as housing markets decline. The projected increase in nonperforming assets and loan losses will continue to negatively affect consolidated asset quality. To date, management has taken steps to increase collections and explored mitigation strategies. The extensive analysis recently developed to isolate risk exposures by FICO score, loan-to-value, and geography of the mortgage is a positive development. These efforts and further loss mitigation strategies will be necessary to lower credit risk. Management's actions to provide additional funds for loan loss reserves and the company's recognition of projected housing market declines in the reserve model are also appropriate.

MRIA – Asset Quality, Increased Stress Testing on High Risk Loan Portfolios, and Credit Risk Mitigation

To dimension the extent of potential write downs and to understand vulnerabilities, the company must periodically stress at risk portfolios and sub portfolios. The stress tests should encompass both regional concentrations and product concentrations. Once the stress tests are completed, mitigation strategies should be developed to reduce credit risk.

Earnings – 3

While the corporation was profitable in 2007, performance was below street expectations and historical norms due to significant write-downs associated with the market disruption booked in the fourth quarter. The company suffered losses of \$707 million in the first quarter of 2008 and \$2.7 billion in the second quarter. The second quarter loss does not include a goodwill impairment of \$5.4 billion. Losses are primarily due to large provisions and there is little expectation for improvement in the near term. Budget projections show minimal net income for the remainder of 2008 and margins will be negatively affected by high funding costs related to deposit promotions. The loss for 2008 could exceed \$3.0 billion which if realized will put this rating at risk of a further downgrade. Positive earnings are key to sustained capital adequacy and to instilling market confidence in the condition and management of the company.

Liquidity - 2

Consolidated liquidity is currently adequate to meet the funding needs of the corporation with available liquidity of approximately \$150 billion in the form of Federal funds sold, un-pledged securities, and discount window pledged securities. Throughout the market disruption, management has opportunistically raised funds, maintained excess funds at the parent, and appropriately worked to minimize exposure to overnight funding markets. The liquidity position also continues to benefit from the corporation's large core deposit base. However, management is appropriately concerned with prolonged volatile markets and the potentially higher cost of issuing term debt. We recognize and are pleased by management's efforts to identify funding vulnerabilities and to assess available sources for meeting potential shortfalls. Nonetheless, we expect management to continue its efforts to maintain significant liquidity cushions, formalize the corporation's contingency funding plans, and to make additional improvements to its liquidity risk management processes, including ensuring sufficient management resources.

MRIA – Liquidity Management and Contingency Funding Plans (CFP)

Management must update and continually re-evaluate liquidity policies and plans. As required in our Liquidity Management target inspection letter dated June 23, 2008, management must update the corporation's CFP with an assessment of all potential funding needs and various scenarios that could negatively affect the corporation's access to both overnight and term funding. In addition, management must undertake a review of staffing in the treasury funds management group and address identified key man risk to ensure continual and appropriate management of liquidity across all key legal entities as well as on a consolidated basis.

IMPACT - 2

The likelihood that the parent or nonbank subsidiary will have a negative impact on the depository institution remains limited⁴ but is increasing. The parent has acted as a source of strength to the depository institutions by raising capital funds and accessing the market for additional liquidity. Nonbank assets remain low relative to the size of the consolidated organization and nonbank activity has not required additional equity funds. The broker-dealers, the corporation's most significant nonbanks, have not required additional liquidity and are self-funded with repurchase agreements. However, the parent has experienced write-downs on its investment in an insurance subsidiary, purchased assets at a loss from a money market fund and another fund advised by a subsidiary, and provided liquidity support to another nonbank. These activities draw on parent company resources that would be otherwise available to support depository subsidiaries.

⁴ Rating 2 (Limited Likelihood of Significant Negative Impact). A rating of 2 indicates a limited likelihood that the nondepository entities of the BHC will have a significant negative impact on the subsidiary depository institution(s) due to the adequate financial condition of the nondepository entities, the satisfactory risk management practices within the parent nondepository entities, or the corporate structure of the BHC. The BHC maintains adequate capital allocation across the organization commensurate with associated risks. Intra-group exposures, including servicing agreements, are unlikely to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow is satisfactory and generally does not require excessive dividend payments from subsidiaries. The potential risks posed to the subsidiary depository institution(s) by strategic plans, the control environment, risk concentrations, or legal or reputational issues within the nondepository entities are modest and can be addressed in the normal course of business.

REQUIRED RESPONSE

At the August 2008 board of directors meeting we plan to discuss our assessment of the corporation. As discussed above, we will be presenting a Memorandum of Understanding, which the board of directors is expected to adopt with the Federal Reserve Bank of Richmond to address the MRIs above. We will monitor progress with the items in the MOU on a quarterly basis by requiring regular submissions to ensure compliance with provisions in the agreement.

Thank you for your prompt attention to the contents of this letter. We would like to express our sincere appreciation for management's concerted efforts to fulfill the multiple information requests during these difficult times for the industry. Please note that this letter contains confidential material and should be treated accordingly by your organization. As such, the contents of this letter are subject to the rules of the Board of Governors of the Federal Reserve System regarding disclosure of confidential supervisory information⁵. If you have any questions, please feel free to contact me at (704) 358-2558.

Sincerely,



Richard F. Westerkamp, Jr.
Assistant Vice President
Central Point of Contact

cc. Joseph Neubauer, Chairman of the Audit Committee
Robert K. Steel, Chief Executive Officer
Dave Wilson OCC
Robert Burns FDIC
Nicholas Dyer, OTS

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