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Federal Reserve Bank of Richmond Letter from Richard F Westerkamp to G Kennedy Thompson and Joseph Neubauer Re Annual Supervisory Assessment of Wachovia

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Mr. G. Kennedy Thompson
President and Chief Executive Officer
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Mr. Joseph Neubauer
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Wachovia Corporation
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Dear Messrs. Thompson and Neubauer:

This letter conveys the Federal Reserve Bank of Richmond's annual supervisory assessment of Wachovia Corporation (Wachovia). The assessment considers the company's risk profile, the effectiveness of corporate governance, risk management practices, internal controls, and financial strength and assigns a supervisory rating for the consolidated organization. The supervisory rating is based on the results of our continuous monitoring efforts, regular discussions with management, horizontal reviews, and targeted examinations conducted during 2006. The findings of the targeted examinations were communicated to senior management through letters issued after the conclusion of each examination. In addition, we worked closely with the lead bank's primary supervisor and developed an understanding of the newly acquired thrift, GoldenWest Financial (GoldenWest), by meeting with thrift management and the Office of Thrift Supervision (OTS). With the company's significant retail brokerage activity and insurance businesses, we held regular meetings with the functional regulators and management in these businesses.

SUPERVISORY RATING

Wachovia continues to be assigned a composite supervisory rating of "2" reflecting its overall satisfactory condition. The same rating was accorded to each of the component ratings: risk management, financial condition, and the potential impact of the parent and non-bank subsidiaries on the depository institutions. Wachovia's overall rating is represented as follows:

R –Risk Management	F – Financial Condition	I – Impact on Bank Subsidiaries	C - Composite	(D) – Depository Institutions
2	2	2	2	(2)

Each of the component ratings, as well as the subcomponent ratings for Risk Management and Financial Condition, are discussed on the following pages.

OVERALL ASSESSMENT

The consolidated corporation continues to be operated in a sound manner. Board and senior management governance and oversight are satisfactory and continue to evolve with the growth and changing business profile of the company. The company has an effective enterprise risk management program that works closely with the business lines to establish both risk tolerances and strategies. The audit department remains in satisfactory condition. Internal controls are generally effective, although continued management attention is warranted towards IT/Operational risk internal controls. The assessment of operational internal controls remains fair or "3" as the efficacy of the four key remediation projects has not been validated by internal audit.

During 2006 management continued to make sound progress on a number of critical initiatives to improve the risk management and control environment of the firm. This included improving the infrastructure of the corporate investment bank (CIB) and increasing the staffing in the market risk management function. The company has devoted appropriate resources to the proximity risk issue and has developed a comprehensive plan for the Oxmoor data center. It is our expectation that funding for the build out of the Oxmoor data center will be approved by senior management in 2007. Also, we are satisfied with the performance of the compliance risk management function as the department is well positioned to monitor the risk associated with new acquisitions and business expansion.

Notwithstanding the noted improvements, the institution continues to face significant challenges going forward with the management of critical infrastructure projects. Despite the success of certain initiatives, other high profile projects have been delayed, redesigned, cancelled, and/or suffered cost overruns. Project execution challenges are further amplified by current and expected expansion plans. Wachovia altered its business mix with the acquisition of Golden West, significantly increasing the company's retail exposure and heightening merger integration risk. The company has stated it will maintain Golden West's people-dependent business model and expand the option adjustable rate mortgage (option ARM) product distribution across the legacy Wachovia franchise. To date, the merger has been executed with little disruption to normal business activities, but the significant systems and account conversions will occur in the fourth quarter of 2007. In addition to this domestic expansion, the company continues to grow internationally with the recent opening of a subsidiary bank in Ireland and further expansion into Asian markets. Wachovia is shifting from a large regional banking company with a commercial lending focus to a global financial services company with a greater retail risk concentration. The key supervisory issues noted below all revolve around supervising the heightened level of project execution risk and the need for management to be proactive in managing the infrastructure improvement projects. While the current management team appears well equipped to manage this high execution risk, the underlying issues require management's continued attention.

KEY SUPERVISORY ISSUES

Elevated Project Execution Risk and Monitoring Project Management:

Our supervisory focus is on the issue of execution risk. We are particularly concerned with inconsistent project management practices, the multitude of key projects, the recognized scarcity of experienced project management resources, and possible funding limitations given potential earnings pressures. Many of the projects have a direct impact on the strength of the company's risk management infrastructure and controls. These include the Oxmoor data center build out, the Basel II/RDS project, and CIB infrastructure improvements. We expect that the company will be proactive in managing current and future projects to limit execution risk by prioritizing investments appropriately.

Inconsistent project management performance was noted earlier in this letter, and management will need to be particularly vigilant to ensure that that the risk management infrastructure keeps pace with expansion plans and business needs. This concern is recognized by senior management and many projects receive significant attention. The company has an inventory of over 30 "must do" initiatives, which are defined as projects that cannot be deferred, are critical to a line of business or the enterprise, present significant reputational or financial risk, and/or may have an associated external commitment.

The inconsistency issue is further complicated and amplified by the limited number of qualified senior project managers and the company's desire to control costs. As with many organizations, there is a recognized scarcity of IT/Project management resources and this limitation will challenge the company's ability to execute effectively. Similar to many of its peers, Wachovia's margins will be pressured in 2007 with the flat yield curve environment. This challenge, coupled with the expectation for a return to more normal credit provisioning expenses, present earnings challenges for the company and the potential inclination to limit funding for certain projects. Accordingly, management needs to remain attentive to these infrastructure projects and provide appropriate funding.

With limited resources and numerous initiatives, the company will need to be proactive in identifying and addressing project management issues. In 2006, the Investment Review Board (IRB) began monitoring key projects and serves as a positive control process to insure oversight of end-to-end investment management decisions. While this process has led to greater accountability, management also recognizes the need to have an investment review process that insures future expenditures align with strategic needs. In particular, the company will need to carefully distribute project management resources given the continued growth of the franchise and potential funding constraints.

The Golden West Integration:

The integration of GoldenWest will present new challenges to the organization. The GoldenWest business model is highly dependent on judgmental processes that have allowed the company to offer its products to the full spectrum of borrowers yet limit credit losses. Wachovia management recognizes the importance of knowledge transfer to the continued success of the Golden West model, and this process will be emphasized during the integration given the potential that key managers of legacy GoldenWest could leave the company. Based on that "flight risk", talent retention efforts are also important.

RISK MATRIX

Wachovia's overall inherent risk profile remains moderate. Comments regarding our assessment of risk management have been integrated into the following discussion of the supervisory rating.

	Inherent	**Risk Management**
Overall	Moderate	Satisfactory
Credit	Moderate	Satisfactory
Market	Moderate	Satisfactory
Liquidity	Limited	Satisfactory
Operational	Considerable	Satisfactory
Legal/Compliance	Considerable	Satisfactory

RISK MANAGEMENT

Wachovia's risk management program remains satisfactory based on the firm's effective corporate-wide processes for identifying, measuring, monitoring and controlling risk.

Risk Management	**Satisfactory (2)**
Board and Senior Management Oversight	Satisfactory (2)
Policies, Procedures and Limits	Satisfactory (2)
Risk Monitoring and Management Information Systems	Satisfactory (2)
Internal Controls	Satisfactory (2)

Board and Senior Management Oversight

Board and senior management oversight is satisfactory. The rating continues to reflect active Board oversight with strong interaction evidenced in the company's business activities, risk management, and compliance practices. In 2006, there were some changes to the senior management team with CFO Wurtz and CIO Enos replacing seasoned leaders in the company. The management team effectively transitioned these key players into new roles with minimal impact to the corporation. CEO Thompson and his executive management team continue to provide capable, experienced leadership while also demonstrating a solid understanding of the risks facing the company. The Board committee structure effectively completed its oversight duties as evidenced by the work of the Risk Committee and Audit Committee. Senior level discussions were noted around emerging risks and industry issues in key senior management committees including the Senior Risk Committee, the Operating Committee, the Credit Risk Policy Committee, and ALCO. The business line leadership governance structure ensures ownership and accountability for risks and appropriately rewards risk mitigation practices. Enterprise-wide risk management is sufficiently aligned with key business lines. Appropriate attention continues to be centered on key risks including long standing IT/Operational risk weaknesses, strategic investment decisions, strengthening BSA compliance across all parts of the company, and reviewing new/complex product offerings.

Policies, Procedures and Limits

Policies and procedures across the financial institution are considered satisfactory. The company has established a conservative limit structure for credit, trading exposures, interest rate risk, and liquidity. In some areas, however, the updating of corporate policies has not kept pace with the business activity of the company. Throughout 2006, there were a significant number of relationships and some industry exceptions to the current credit capital guideline structure. Management is aware of the issues surrounding the credit capital limit exceptions and is reviewing the guidelines, which are dated given the growth in the company's capital base. While this process has been somewhat protracted, the reassessment is appropriate as the large number of exceptions makes it difficult to determine if the company is exceeding its risk tolerance.

Risk Monitoring and Management Information Systems

The institution's risk monitoring and management information systems (MIS) are satisfactory. Wachovia continues to demonstrate effective risk management oversight given the risk profile of the company. During 2006, our compliance monitoring and testing examination noted a satisfactory monitoring program while recommending consistent usage of the issues tracking database and the formalization of the issues escalation procedures. Firm-wide stress scenario analysis is still evolving. Risk reporting for interest rate, market, and liquidity risk include stress scenarios but specific credit event stress tests are only completed on an ad-hoc basis. While the current practice may be appropriate, additional consideration should be given to a more rigorous and frequent credit stress test regimen given the expectation of a return to a more normal credit loss environment. Operational risk metrics continue to evolve as management develops methodologies for quantifying top-of-the-house metrics.

Internal Controls

Corporate-wide internal controls are satisfactory. We note the improvement in the control environment, which is reflected in the results of internal audits, external reviews, and regulatory examinations. However, long-standing weaknesses with IT/Operational controls remain. It is expected that completion and validation of the four key IT remediation projects will address many of the weaknesses with operational internal controls. Data center risk has also been a longstanding concern, but we are satisfied with the company's progress on the issue and management's plans to utilize the third data center in Birmingham as a meaningful backup resource. Other control functions, including business line risk management and compliance, demonstrate a solid understanding of the risks facing the company. Internal audit remains satisfactory and it appears the selection of former controller Julian to replace retiring General Audit Schild is reasonable. Credit review continues to demonstrate its stature as an independent control function which helped reinforce the risk tolerance of the company. Credit risk portfolio hedging continues to be proactive by implementing measured credit risk mitigation activities. While not currently an issue, management should ensure that any future cost reduction and efficiency improvement targets do not affect the control functions in compliance, risk management, or audit.

FINANCIAL PERFORMANCE

Wachovia's Financial Condition rating is Satisfactory, or "2", unchanged from our assessment one year ago. Within the sub-components of this rating, we have lowered the Liquidity rating from "1" to "2" reflecting a shift in the funding structure to an increased reliance on wholesale funding subsequent to the GoldenWest acquisition.

Financial Performance	**Satisfactory (2)**
Asset Quality	Strong (1)
Earnings	Satisfactory (2)
Capital	Satisfactory (2)
Liquidity	Satisfactory (2)

Asset Quality

Asset quality remains strong, reflecting lower than peer levels of nonperforming and criticized assets. While charge-offs have increased moderately with the acquisition of WestCorp Financial, this increase was expected due to the subprime nature of the portfolio. Overall the firm's credit risk exposure is well diversified by industry and concentrations are not a supervisory concern. The acquisition of GoldenWest has lowered the average FICO score of the consumer portfolio with 20% of the acquired portfolio having a FICO score below 620 (the secondary market standard for subprime mortgages). This credit risk is offset by the emphasis on collateral coverage.

Earnings

Consolidated earnings are satisfactory. The acquisitions completed in 2006 supported strong annual earnings growth. However, the flattening yield curve environment led to a further contraction in net interest margin, which was compounded by an expansion of long term debt in anticipation of the GoldenWest acquisition. Provisioning for loan losses increased as a result of Westcorp charge-offs. The benefits of diversified noninterest income streams were seen during 2006, with improved capital market related revenues towards the close of the year compensating for some reduction in banking fee growth. Stronger revenues, including through acquisition, improved overhead efficiency ratios. Earnings relative to average assets and average equity improved on a year-on-year basis, but trended lower over the second half of the year and continue to lag peers.

Capital

Wachovia continues to maintain adequate capital, although its core capital ratios trended lower over the course of the year and continue to track below peer norms. In 2006, the corporation shifted the mix of regulatory capital by significantly increasing the level of tier 2 capital through subordinated debt issuance. The WITS issuance in the first quarter of 2006 lifted tier 1 capital, but the effect was more than offset by an active share re-purchase program. The company plans to adjust repurchase activity as necessary in 2007 to compensate for tier 1 capital requirements, including the reduction associated with prior leveraged leasing arrangements. The company has an economic capital model and granular analysis further supports the adequacy of the firm's capital base. The dividend payout is reasonable and consistent with the company's stable earnings stream.

Liquidity

The company's liquidity position has shifted with a greater emphasis on wholesale funding. The GoldenWest purchase resulted in an increase in borrowing from the Federal Home Loan Bank and the cash requirements of the purchase terms necessitated the issuance of long-term debt. As a result, traditional liquidity measures are lower that that in 2005 and the "2" rating reflects this change. Notwithstanding, the company's debt ratings have improved with the industry as a whole and current funding mix does not raise supervisory concerns.

IMPACT OF PARENT AND NON-BANK SUBSIDIARIES

The parent company and the non-bank subsidiaries present limited likelihood of a significant negative impact to the depository institutions and the Impact rating is "2". Although the parent company is less liquid due to the cash used to purchase GoldenWest, cash flow to meet funding needs is in excess of 12 months. Of the non-bank subsidiaries, the retail and wholesale broker dealers poses the highest degree of potential stress through losses or litigation costs. In our discussion with functional regulators and through knowledge gained from our continuous supervision program, it was noted that the control environment has improved in these businesses. Other parent investments including the private equity holdings pose little risk relative to the corporation as a whole.

In closing, thank you for your attention to the information in this letter. Should you have any questions or comments, please contact me at (704) 358-2558. In addition, please note that this letter contains confidential supervisory information and should be treated accordingly. 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 information.

Sincerely,

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