Basel Committee Secretariat

Basel Committee on Bank Supervision

Bank for International Settlements

CH-4002

Basel, Switzerland

Re: New Basel Capital Accord: January 2001 Consultative Paper

Washington Mutual respectfully submits the following comments on a proposal for a New Basel Capital Accord, as issued by the Basel Committee on Banking Supervision on 16 January 2001. Washington Mutual is one of the largest financial institutions in the United States, and has a significant portfolio of retail financial products. It is the largest savings institution in the United States and, is the nation's largest single family home lender on a pro forma basis, giving effect to its acquisition of Fleet Mortgage Company. As of March 31, 2001, Washington Mutual’s total assets were approximately US$ 220 billion. Although Washington Mutual does not have significant international activities, the proposed risk-based capital methodology is likely to affect the cost of business of retail financial institutions generally in the United States, due to the probable adoption of conforming national regulations. Therefore, we think it is important to comment on some aspects of the proposed New Capital Accord and probable resultant changes in risk-based regulatory capital requirements for retail financial institutions in the United States.

Washington Mutual recognizes the significant progress which the Basel Committee on Bank Supervision has achieved by segmenting banks and separating different types of risks in the New Basel Capital Accord. Most importantly, with the internal ratings based (IRB) approaches, the Basel Committee has begun the process of linking the measure of regulatory capital to true underlying economic risk. The proposed New Accord represents a good beginning but, as with any new methodology, still has many flaws and inconsistencies. We look forward to co-operating with the Basel Committee on Bank Supervision as the risk measurement methodologies are refined and enhanced to tie more effectively to the measure of economic risk - expected losses.

This letter summarizes the issues that would have an immediate effect on the regulatory capital of retail financial institutions, and particularly mortgage lenders, in the United States. These issues include incentives for better risk measurement, the absolute level of total capital, the appropriate time horizon for measuring expected losses for certain retail products, treatment of operational risk capital, and asset securitization. We are conducting a thorough study of these issues and plan to provide more specific analysis and recommendations by the November deadline.

Disincentives for Use of Advanced IRB Approaches

Washington Mutual supports the Committee’s efforts to provide incentives for better risk management and capital measurement. We believe, however, that the incentives in the current proposal are inadequate to achieve the objective of encouraging financial institutions to use the Foundation or Advanced IRB approaches. It is currently impossible to determine whether these IRB approaches would correctly measure credit risk for retail financial products,

because the description of capital requirements for retail products in the current version is a mere outline of methodology that is too vague and tentative for concrete analysis. The current version could have the unintended consequence of increasing capital requirements for retail products to levels significantly in excess of underlying economic risk.

The qualification requirements for the IRB approaches in the current proposal are too formulaic. There is a significant likelihood that individual banks may measure risks in a manner that is truly consistent with best practices, yet fail to qualify under the currently proposed requirements. More liberal qualification rules for the IRB approaches would encourage the development of better risk measurement methodologies.

The proposed requirement that capital under the Advanced approach be no less than 90% of the capital under the Foundation approach would be counterproductive. This requirement would eliminate most of the incentive for a bank to progress from the Foundation approach to the Advanced approach. This limitation on the ultimate benefits also may deter some banks from even beginning the process of moving up from the Standardized approach. For example, nothing in the current proposal would provide an incentive for a bank with a concentration of low probability of default (PD) products, such as Washington Mutual's residential mortgage loans, to move up from the Standardized approach.

Total Capital Level

Washington Mutual recognizes the importance of developing more risk-sensitive measures with regard to determining the appropriate risk-based level of overall capital. Banks with sophisticated systems and procedures for risk measurement should be encouraged to qualify for the Advanced approach. The only meaningful incentive to go through this qualification process would be a resultant lower capital requirement. It is not clear at this point, however, that the Advanced approach would result in less credit and operational risk capital than the current approach for any institution. The previously noted vague and tentative description of capital requirements for retail products precludes retail financial institutions, in particular, from discerning any incentive for use of an IRB approach.

One Year Horizon

The Committee recommends using a one-year horizon for the PD assessment for all entities and all categories of assets. We understand that a unified approach has its benefits, but risk for certain retail products would be better assessed over a longer time horizon. With regard to single-family residential mortgages, a more appropriate horizon would be at least three years, and a five-year horizon would provide still more reliable data. This longer timeframe more accurately reflects the lagging update of credit scores (FICO) and longer workout periods generally required for such credits. Washington Mutual is in the process of conducting a thorough study on the significance of different time horizons for PD and economic capital for such mortgages.

Point-in-Time Versus Through-the-Cycle PDs

A major problem with the one-year-PD-based approach is its short-term sensitivity to economic cycles. The average probability of default within the portfolio follows the economic cycle. If the economy is stable and the expected PDs are low, the bank would compute less economic capital than it would during an economic downturn. During an economic downturn, the credit quality of the

portfolio would deteriorate, thus driving average PD and economic capital levels up. Therefore, just at the time when a bank would need capital resources to maintain sustainability, market conditions would be such that it would be too expensive to raise additional capital. A more appropriate process, for purposes of economic capital estimation (but not necessarily for purposes of pricing), would be to use PD estimates that are more cycle-neutral, thus preserving a certain stability in economic capital estimates over the cycle.

Operational Risk Capital

Washington Mutual understands that the approach to operational risk assessment requires additional studies and calibration. But none of the three proposed stages deliver consistent and convincing methods of risk assessment. The Basic Indicator approach takes into account gross income. Although this approach reflects an intuitive relationship between risk and return, it does not address the fundamental risk feature–uncertainty (i.e., the approach does not involve estimating the shape of the tail of a loss distribution). Neither the Basic Indicator approach nor the Standardized approach would provide incentives for a bank to manage and mitigate operational risk. Regardless of the degree of risk mitigation a bank might engage in, the bank’s regulatory capital level would be determined by the betas assigned by the regulators.

The Internal Measurement approach relies on the construction of an internal operational loss-events database. Most operational losses related to the retail products involve small loss given defaults (LGDs) and high probabilities of occurrence. These events should be categorized as expected losses – (EL) - and covered by profit cushions built into pricing rather than by a capital charge. The true low-frequency, high-severity catastrophic events, which represent a mortal threat to a bank, and therefore should be covered by capital, generally are not applicable to these databases. That is, since such high-severity events would have caused the near-collapse of the bank, there would be few or no observations of such events within the database. Furthermore, there is no evidence of correlation between the two classes of events. Therefore, we conclude that maintaining a database of high-frequency, low-severity loss events, while important for risk management and pricing purposes, does not provide a material basis for an operational risk capital charge. Finally, like the Basic Indicator and Standardized approaches, the Internal Measurement approach should properly take into account insurance and other risk mitigation techniques.

Another problem is that the current definition of operational risk includes indirect losses. Under the current proposal, a large portion of operational risk capital actually would be covered by credit risk capital. Risk managers generally cannot narrowly identify the reason for a retail borrower’s default according to the classification system used in statistical models. For example, is a loan default caused by the borrower’s true credit quality, by fraud, inefficient underwriting policy, or a deficient information technology system? Many possibilities that might be characterized as “operational events” should affect a bank’s PD estimates (and, thus, its credit risk capital). Therefore, credit capital would properly cover at least a portion of operational risks. Assigning additional capital for operational risk would double count these risks of “indirect losses”.

Asset Securitization

Washington Mutual endorses the Committee’s approach for risk-weighting assets-backed securities (ABS) based on the external credit rating of the

securitization tranche. WAMU has been using this approach and has found it to reasonably reflect the underlying risk of ABS. However, the proposed IRB treatment of securitizations within the New Accord requires the ABS originator and loan servicer to deduct the full amount of the credit enhancement from capital. The proposed IRB approach results in higher capital charges for the ABS than the charges that would be applied to the asset pool before the securitization. In effect, the proposal creates a disincentive to securitize even when there are sound business reasons for doing so. The following table shows capital calculated for ABS positions held by Washington mutual according to a) the internal Washington Mutual approach to economic capital measurement, b) the current RBC approach, and c) the proposed IRB approach:

Approach	RBC/ABS Balance
Internal WAMU	2.58%
Current RBC	3.14%
Advanced IRB	15.21%

The ratios in the table are expressed as percentages of the underlying asset pool. Under the new proposals there is also an inconsistency in applying the external rating approach to different classes of assets. Under the Standardized approach, the risk weight for a BB-rated corporate security is 100%, but an asset-backed security with the same rating receives a 150% risk weight.

We look forward to providing ongoing comments to the Basel Committee directly or through US regulators. Thank you for considering the view of Washington Mutual on these important issues. If you have any questions or comments, please do not hesitate to contact Sasha Kipkalov <alexander.kipkalov@wamu.net> at (206) 490-3724 or Brad Anderson <brad.anderson@wamu.net> at (206) 461-3802.

Sincerely,

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