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Washington Mutual

July 30, 2003

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

Dear Members of the Basel Committee:

Washington Mutual Inc. ("WMI") is the largest thrift institution in the United States, and the 7th largest banking institution in the country based on assets. Although we provide both wholesale and retail banking services, almost one-half of our more than $280 billion in assets consists of residential mortgage related credits. We are also the single largest servicer of mortgages in the U.S. Due to our importance in the home loan markets, as well as our importance more broadly within U.S. financial markets, WMI is expected to be among the small group of U.S. banks whose regulatory capital requirements will be determined by the Advanced Internal Ratings Based ("AIRB") approach to the New Accord. We are therefore pleased to respond to the Basel Committee's Consultative Paper no. 3 ("CP3") with views that are unique to this institution, although much of what we address in this letter will be germane to other lenders that concentrate in the retail credit arena as well.

WMI is also a member of the Risk Management Association ("RMA") Capital Working Group – a group consisting of the heads of economic capital at the largest North American banking institutions. The Basel Committee will be receiving a separate analysis of CP3 from RMA. We endorse the views of the RMA Group. As indicated in the introduction to the RMA response, WMI remains convinced that the analytical underpinnings of CP3 are reasonable and that movement toward a New Capital Accord is consistent with having regulatory minimum capital requirements that are responsive to best-practice measurements of actual risk. In that regard, CP3 incorporates significant improvements in the Pillar 1 structure of capital regulations when compared with the Old Accord and with earlier versions of the New Accord.

While CP3 represents a major advance, there still remain significant areas that need immediate attention by the Committee. These areas are of such importance that, if left unchanged from the current prescriptions within CP3, the resulting regulatory capital requirements may be quite a bit higher than under the QIS3 exercise, possibly even greater than reasonably conservative market requirements for capital at banks such as Washington Mutual. Because of the importance of these few areas, we have chosen not to address every issue in CP3. Our concerns below, therefore, are limited to the areas that would have the greatest impact on financial institutions similar to WMI.

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1. The treatment of Expected Losses ("EL"). As stated many times in the literature on capital, best-practice banks are careful to include expected loss rates in their pricing of credit products. In particular, expected margins (net of non-interest-expenses) *must cover* not only EL but also a reasonable rate of return to capital, in order for the bank to satisfy its shareholders. For this reason, capital is *not* needed to cover EL and, therefore, best-practice financial institutions measure required capital to be equal to the so-called "loss at the confidence interval" minus EL – otherwise known as *unexpected losses*. For reasons having to do more with traditional supervisory views rather than market views, Basel so far has chosen to measure required capital as inclusive of EL (with an apparent partial exception for revolving retail credits).

However, CP3 contains language in paragraphs 347 and 348 that would permit the elimination of the Basel EL charge via the "back-door" of using some portion of the Allowance for Loan and Lease Losses ("ALLL") to offset the EL charge. The ability of financial institutions in the U.S. to use the ALLL to offset the EL charge is highly problematic, primarily because of differences in the way in which the ALLL is established (for accounting purposes) in the U.S. versus the other Basel countries. Common fairness would therefore dictate that Basel conform to market practices and eliminate the EL charge from required capital *for all credit products in all countries*. Because expected operational losses are also covered by expected margins, required capital for operational risk should also be defined as unexpected losses at the confidence interval. This is the right thing to do from an analytical perspective.[1]

2. Operational risk capital charges under the Advanced Measurement Approach ("AMA"). In the U.S., banks using the AIRB approach are likely to be required to use the AMA for operational risk capital as well. This tying of credit-risk approaches and operational risk approaches may also occur in other Basel countries. The essential problem with the AMA is that, from an analytical perspective, the measurement of operational risk has not yet evolved into a "mature" practice, as is the case for credit risk or market risk. There simply is no consensus on what constitutes best practice. For example, there are several defensible methods for utilizing external op risk loss data, including several methods for "scaling" these external loss events to the operations of the financial institution in question. Pillar 1 should be lauded for not specifying the exact manner in which such research is conducted or the way in which the "scaling" process takes. Nevertheless, it would be preferable for even these modest AMA prescriptions in CP3 (for Pillar 1) to be replaced with some generalized principles within Pillar 2. In particular, institutions such as WMI currently are spending significant research effort on operational risk measurement and management. We are concerned that, in future iterations of the Pillar 1 prescriptions for op risk, industry research might be constrained to less-than-best-practice, as has been the case with credit risk measurement practices in some instances. Additionally, there is a very significant trade-off between, on the one hand, managing operational risk so as to reduce such risk, versus, on the other hand, requiring regulatory capital for measured operational risk that has not been managed or insured away. Only the supervisory process can determine how well the individual bank

[1] For a complete treatment of this issue, see "Response to Basel's Third Consultative Paper on the New Capital Accord," The Risk Management Association, July 2003.

is managing (reducing) operational risk; therefore, only the supervisory process can effectively reach conclusions regarding how much capital should be held against residual operational risk.

Not only should the op risk capital charge for AIRB banks be moved to Pillar 2 (as is the case, for example, with market risk in the banking book), but also the supervisory process should be very cognizant of the following:

- Individual institution's op risk profile will depend on internal factors such as current operations and operations management, the quality of the bank's products, the audit and compliance processes, the use of performance scorecards and other quality metrics, etc. Any over-prescribed supervisory approach not tailored to the specifics of the individual business lines would be costly, ineffectual, and most likely penalize the banks that spend the most on reducing op risk.
- It is not clear that all of the data requested for the internal loss event database will have a meaningful relationship with the tail event losses that should define operational risk capital. We propose that internal data collection be structured around specific data items that relate to managing operational risk according to our risk profile and processes.
- External op risk loss data requirements in CP3 are especially problematic. In particular, it is not clear how an actual operational loss event at another institution should be "scaled" to fit the circumstances of the bank in question. Size of operation (assets, revenues, etc.) may not necessarily be an appropriate indicator of the size of the operational loss if it were to occur at the bank in question. Many more years will need to pass, with many more observations of major op risk loss events, before the industry can measure the relationship, if any, between size of bank and size of extreme loss event.
- Losses that some may view as "op risk losses" may be generated by credit activities and may just as easily be characterized as "credit risk losses." Examples include collateral management failures that result in the decline of collateral value. CP3 indicates that some such loss events might continue to be treated as credit risk losses, but must nevertheless be tracked over time as part of the internal operational risk loss database (but flagged as credit risk events; see paragraph 633). Such specificity under Pillar 1 is an example of the constraints that Basel may inadvertently place on the evolution in best practices. In the example given, it may be far more efficient for the bank to track the credit-related loss within the credit loss database, without having to duplicate the effort within the operational risk loss database.

As these examples show, Basel should carefully consider prescribing specific requirements regarding operational risk databases and operational risk measurement under the AMA. Pillar 2 is the proper place for Basel's oversight of operational risk capital – and we fully expect that several more years of supervisory and industry experience are needed before Pillar 1 prescriptions can reasonably be formulated with regard to operational risk measurement.

3. Cross-portfolio and cross-risk-type diversification benefit. As is made clear in the RMA response, CP3 does not take into account the "diversification benefit" associated with a bank offering a full menu of credit products, including both wholesale and retail products. That is, losses in one credit portfolio are not perfectly correlated with losses in another portfolio. Thus, a particularly high, unexpected loss in one portfolio can be *cushioned* not only by the capital allocated to that portfolio, but also by the capital allocated to other portfolios. This cross-portfolio diversification benefit has been measured to be on the order of 20% or more (that is, required economic capital for the whole bank is at least 20% lower than implied by the simple sum of the capital levels measured for each business line). Similarly, an extreme unexpected loss of a given type (e.g., a credit risk loss) may be uncorrelated with an extreme unexpected loss of another type (e.g., an operational risk loss). Simply adding up the allocated capital requirements for each type of risk – credit, operational, and market – significantly overstates bank-wide required capital. Basel can handle either of these two difficulties in a simple, straightforward manner by providing for a haircut to the total bank-wide capital charge based on some conservative assumptions regarding cross-portfolio and/or cross-risk-type loss correlation.

4. Cumulatively conservative assumptions used by Basel in measuring capital for credit risk. As noted by many observers, CP3 seems to have adopted a strategy of assuming the worst at each step in the process of developing the AIRB approach. On the whole, Basel's Asset-Value-Correlations ("AVCs") are higher than industry AVCs for retail credit products. But Basel does not stop there.

- Losses-given-default (LGDs) and Exposures-at-default (EADs) are to be measured at their observed levels during recessions, not through-the-cycle. Furthermore, it is not clear how recessions should be defined in order to define stressed LGD scenarios; in some portfolios a recession may not have occurred for over 10 years and historical data from such a long time ago may not be available. Moreover, very old data may not be representative of current underwriting standards, so that LGDs in future recessions may be quite a bit lower than in past recessions. As it is, WMI uses through-the-cycle, default-weighted LGD estimates, which are quite conservative in that the estimates are tilted toward periods with higher numbers of defaults on which LGDs are higher than in other years.
- An arbitrary lower limit to LGD is imposed for residential mortgages (10%) – clearly inappropriate for loans with a very low loan-to-value (LTV) ratio. Moreover, setting a floor to LGD acts as a disincentive for the bank to use private mortgage insurance.

These prescriptions, some of which did not appear in the QIS3 exercise, are so far removed from industry best-practice, that the results may be fatally burdensome to AIRB banks. In particular, given Basel's choice of a 99.9% confidence interval, the Committee seems to be saying that there should be only a 1 in 1000 chance that the bank will fail, even during a recession, and even assuming very conservative correlation parameters. This is the equivalent of requiring all AIRB banks to be even more sound than implied by a Triple-A rating. Some risk practitioners believe that the recessionary LGD requirement

(paragraph 430) may itself result in a very significant increase in regulatory capital over that estimated within the QIS3 exercise. Clearly, these conservative prescriptions need to be moderated.

5. Pillar 2 is too prescriptive in nature and immutable. In many Basel countries, bank-by-bank supervision (Pillar 2) has been the main device by which both "sides" of the regulated industry learn about best-practices. Supervisors of large, complex banking institutions – in making the rounds of the examination process – learn which banks have truly expanded the frontiers of knowledge with regard to risk measurement. This knowledge, subject to appropriate confidential treatment of proprietary procedures, is often disseminated bank to bank via supervision. Similarly, the views of supervisors have been affected by what they have learned during the examination process -- witness the growing awareness of supervisors during the 1990's that the old Accord was not up to the task of setting minimum capital requirements in the era of modern risk measurement. Thus, to a large extent, the supervision of banks has always been a two-way street. This two-way benefit is in danger of being constrained by the prescriptions of CP3 with regard to Pillar 2. Indeed, the Pillar 1 text in CP3 contains very specific requirements for, for example, PD, LGD, and EAD estimation – requirements that would best be replaced with a set of general principles within Pillar 2. And a true two-way street should mean that, when a best-practice bank can show supervisors the empirical and analytical proof of its best-practice, the improved practice should replace the regulatory requirement that had gone before. For these reasons, the final version of the New Accord should recognize the goal of eventually moving to a true internal models version of the Accord – a version in which empirically sound estimates of all risk parameters (including AVCs) should be the basis for minimum regulatory capital requirements.

6. We agree generally with the approach in CP3 for the treatment of securitization positions of AIRB banks. A major concern, however, is the treatment of senior positions held by originating banks. Paragraph 575 states that originating AIRB banks must first estimate KIRB on the underlying pool of assets. If the bank's retained positions are in excess of KIRB, such positions will be subject to the Ratings-Based-Approach ("RBA"). If KIRB cannot be estimated, 100% of the position must be deducted from regulatory capital. Normally, the AIRB bank should have little difficulty in estimating KIRB on the underlying pool. However, some securitization transactions may have been conducted prior to the time when the bank instituted internal Economic Capital procedures, making it very difficult to go back and estimate the PDs and LGDs for the individual assets within the pool. In such circumstances, if the bank retains no first- or second-dollar positions, and holds only highly-rated senior securities, it would serve little purpose to require a calculation of KIRB in order for the bank to use the RBA. That is, A-rated (or better) senior securities are almost certainly going to involve prior credit protection that greatly exceeds KIRB. Rather than placing the burden of proof on the bank, capital for such positions should be subject to the RBA without the need for a "KIRB test." In effect, the originating bank has sold the assets with no recourse and is in a similar risk position as the investing bank that would be subject to the RBA. An

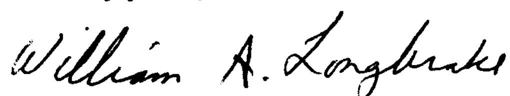
exception to Paragraph 575 therefore should be crafted for originating banks that have no interests other than highly-rated senior securities.

7. On the important, basic issues, all of the Basel countries should be operating on a level playing field. This is currently not the case and will not be the case under the New Accord, as currently proposed. Two very important differences across Basel countries have not been addressed in CP3.

- Some Basel countries, such as the U.S., have "well-capitalized" standards in place that, when coupled with the New Accord, may result in very onerous true capital requirements. In the U.S., for example, in order to meet a "well-capitalized" standard, banks must hold an arbitrary 1.5 times the Basel minimum Tier 1 capital requirement. By remaining silent on such issues, Basel is assuring anything but the desired level playing field. Under the old Accord, banks had the ability to engage in significant regulatory capital arbitrage to avoid onerous and arbitrary country-imposed capital standards. This is no longer the case with the New Accord. Therefore, it is imperative that Basel weigh in with specific guidance on how countries might impose such "well-capitalized" standards.
- Minimum "leverage" standards are imposed by some Basel countries. In the U.S., for example, the "well-capitalized" standard for a minimum Tier 1 equity to un-weighted regulatory assets ratio is 5%. For any large, well-managed bank specializing in retail lending, this country-imposed requirement may be very much higher than the Basel minimum Tier 1 ratio. Such banks, in order to survive, may have to securitize large portions of their retail credit portfolio, while retaining the significant portion of the underlying credit risk, in order to avoid the arbitrary leverage requirement. Absolute bank capital remains the same, overall bank risk remains the same, but expenses dramatically rise. No good purpose is served by such a requirement, and it would be helpful if Basel would address arbitrary simple leverage capital requirements that are unrelated to any meaningful measures of risk.

We appreciate this opportunity to respond to the work of the Committee, and we hope to continue this dialogue in the future as Basel goes about the difficult task of implementing the New Accord.

Sincerely yours,



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