Washington Mutual

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Attention Docket No. 04-22
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Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal
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Attention: Docket No. OP-1215
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Robert E. Feldman, Executive Secretary
Attention: Comments
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Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
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Washington, DC 20552

Attention: No. 2004-48
regs.comments@ots.treas.gov

Re: Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital Docket Number 04-22

Washington Mutual Inc. ("WMI") is the largest thrift institution in the United States, and one of the largest banking institutions in the country. We provide both wholesale and retail banking services. Almost one-half of our assets consist of residential mortgage related credits. We have responded to the prior ANPR documents both as an individual institution and as a member of industry organizations. As in our response to the prior components of the Basel II process, we wish to emphasize that WMI fully supports the U.S. and Basel Committee efforts to revise the capital accord in order to improve the risk sensitivity of the regulatory capital framework and to encourage the development of sound risk measurement and management practices. This comment letter speaks to the proposed "Retail Supervisory Guidance" component (Federal Register, vol. 69, no. 207, October 27, 2004) of the U.S. agencies' implementation of the so-called Advanced Internal Rating-Based ("AIRB") approach within the new Basel Capital Accord Framework.

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1. Introduction

As we have indicated in our prior comment letters to the U.S. agencies and the Basel Committee, we agree with the general construct of the Basel II framework, which relies on best-practices by banks in developing data driven measures of certain key risk parameters. This general approach represents a vast improvement over our current regulatory capital requirements. Nevertheless, significant policy and implementation concerns remain. This letter only addresses our most significant policy and implementation concerns.

Washington Mutual participates in a number of industry consortia that are collaboratively developing responses to the Retail Guidance. We are active contributors to the very recent Risk Management Association (RMA) and American Bankers Association (ABA) responses and endorse these broader and longer response letters.

As we discussed at length in our response to the first component of the Basel II ANPR, our primary concern remains the U.S. Well-Capitalized Leverage Ratio. We wish to reiterate this point given its importance to Washington Mutual and other low risk banks. The U.S. Well-Capitalized Leverage Ratio may undermine much of Basel II's goal of aligning regulatory capital requirements with risk. As we noted previously, this requirement turns into an excess capital charge that applies to low risk assets. This excess capital charge may prevent banks from engaging in low risk activities that require less than 5% economic capital. Alternatively, banks will have to engage in costly arbitrage transactions to remove low risk assets from their books while retaining the risk and return characteristics of those assets.

Again, we believe the 5% "well-capitalized" leverage standard in the U.S. should be removed or significantly lowered. One option, short of elimination, would be to apply the leverage ratio only for two of the Prompt Corrective Action levels – e.g., an "undercapitalized" standard equal to 3% or less, and a "critically undercapitalized" standard equal to 2% or less. Such an approach would preserve the benefits of the leverage ratio as a bank's condition deteriorates, but would minimize the perverse incentives described above for healthy, well-managed banks.

2. Key Concerns:

2.1. Downturn Condition LGD

Paragraph 127 of the Retail Guidance (or "Guidance") requires that LGD be measured based on 'downturn conditions where necessary'. No definition of 'downturn condition' or delineation of the criteria where this condition will be 'necessary' is provided -- although mortgages are explicitly mentioned as a portfolio where LGD may fluctuate with the cycle (so that "downturn" LGD is higher than a default-weighted through the cycle average). Unfortunately, the impact on capital

that results from any specific interpretation of the Guidance's "downturn" criterion is considerable. In addition, this requirement seems to exacerbate a problem associated with definition of default and its unintended impact on capital as discussed in section 2.4 below.

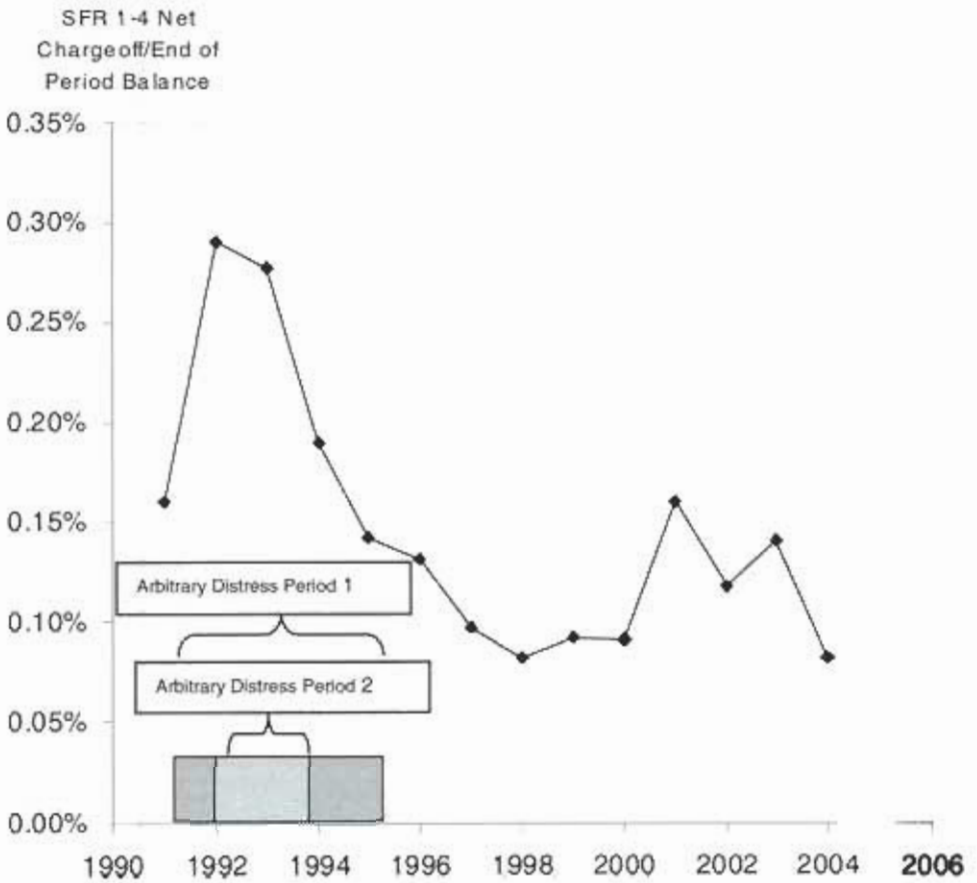

Figure 1: Net Chargeoff as a Percent of End of Period Balance for all FDIC Insured Institutions 1991-2004. **Notes: 2004 is YTD, 1991 and 1992 are the average of the largest 100 FDIC insured institutions.**

To illustrate this point, Figure 1 shows net charge-offs in mortgages for all FDIC insured institutions over time. As this chart illustrates, prior to the current downturn, the last real period of distress in retail mortgage was in the early 1990s. Unfortunately, WMI does not have significant amounts of internal data from this period. In addition, it is not possible to develop estimates of industry-wide LGDs during any particular period utilizing the Call Report and Thrift Financial Report data available from the FDIC. All that can be inferred is that aggregate loss rates experienced a peak. The contributions necessary for capital calculation: PD, LGD, asset growth (exposure), and cohort analysis cannot be accurately inferred from this data.

For this reason, WMI is developing a proprietary analysis of downturn LGDs over the early 1990's period (all the way up through the current cycle) using instrument-level

data purchased from a national servicing data vendor. However, the outcome of this analysis (not yet available) will likely be highly dependent on the definition of the 'stress period'. As an example, utilizing Figure 1 above, the resulting LGD from the assumed "Arbitrary Distress Period 1" would likely be very different from the measured LGD in the assumed "Arbitrary Distress Period 2". The matter is complicated by imprecision in any attempt to establish the absolute bottom of a housing loan loss cycle (or, put another way, the absolute top of the LGD cycle). Also, the peak of LGDs may not correspond to the peak of default frequencies. In addition, the external LGD data we are developing and analyzing may only be realistically utilized on a year by year basis, not a quarter by quarter basis. For these reasons, it may be most practical to define the downturn period as including the year on either side of the year in which the analyst believes the trough has occurred (i.e., a 3-year period encompassing the trough).

In any case, the rather arbitrary time-window of any such 'downturn condition' and the limited number of historical observations (data is available for really only one 'downturn period') leads us to conclude that incorporation of a PD/LGD correlation parameter into the capital calculation formula may be the only viable long term solution. Analysis of historical LGDs may only provide a short-term solution that ends up dependent on highly arbitrary assumptions. We will continue our research using what we believe to be the most granular data available from this early 1990's recession period and look forward to an ongoing dialogue with our supervisors on this topic.

2.2. Seasoning Effects

Paragraph 110 argues that, for segments containing 'unseasoned loans', a bank should assign a higher PD estimate than the through-the-cycle PD -- one that reflects the average annualized *cumulative* default rate over the remaining life of loans in the segment. We believe this requirement is inappropriate for several reasons.

First, the Basel II framework uses a true one-year horizon PD – not an annualized cumulative PD – to reflect best-practices used at major international institutions. These institutions, like WMI, typically segment their portfolios according to age of loan, because, in many cases, one-year PDs rise with age (that is, obligors have best intentions early in the life of their loan). In the case of mortgages, one-year PDs rise with age, then fall, as principal payments and house price increases act to build up the obligor's equity in the home.

When computing internal Economic Capital for loans in a portfolio whose loans are age-segmented, the bank typically will "move" the unseasoned loans into the higher age brackets as the loans age, thereby assigning higher PDs and correspondingly higher EC to the loans as they age. For mortgages, the internal EC on an individual loan correspondingly rises then falls as the loan ages. The Retail Guidance requirement that "unseasoned" loans be assigned capital based on a PD (the annualized cumulative PD) that is higher than the true one-year PD is really a form of

double-counting. That is, the bank must hold higher than best-practice capital when the loan is young (and has a low default probability), *and* the bank must hold appropriately high capital when the loan ages (because aged loans under the Retail Guidance, following best-practice, must employ true one-year PDs).

Second, it is our understanding that a concern behind the Retail Guidance's seasoning requirement is that the recent bulge in new mortgage originations (refinancings), due to low interest rates, results in banks having a current portfolio composition that is younger than in past years. Correspondingly, in future years, as this bulge of refinanced loans ages, the average age of the portfolio will rise and economic capital requirements will rise as well. Regulators are appropriately concerned that banks will have enough capital to meet the expected higher capital requirements as the bulge group of loans ages (assuming the new loans are retained by the bank as they age). This is a legitimate concern, which we share, but which cannot in any way be addressed by requiring more current capital for the recently refinanced loans.

The issue is essentially a Pillar 2 issue – the bank must show the supervisor that it anticipates the movement of this segment through the age brackets and has planned appropriately to have more capital when the need arises. Alternatively, the bank may plan to sell a portion of the bulge in new loans in order to maintain a desired historical age composition of its portfolio. Indeed, the Retail Guidance's requirement for increased current capital for the newly refinanced loans – through use of an annualized cumulative PD -- cannot be sufficient to meet the increased capital requirements that are likely if the bank continues to hold the new, refinanced loans. This is because the true one-year PD when the loan reaches its peak PD years is, by definition, higher than the annualized PD over the entire life of the loan.

Moreover, requiring the extra capital now, when true one-year PDs are low, creates an inappropriate incentive for the bank to hold loans that are aged (whose Basel-required PDs reflect best-practice one-year PDs) rather than loans that are new (whose Basel-required PDs are higher than best-practice). Put another way, the Retail Guidance requirement takes away from management the ability to choose its optimal age structure for its mortgage portfolio by selling new loans as they age or keeping loans that are under a particular age.

Third, the asset-value-correlations and the chosen confidence interval used for corporate and retail loans in the Basel II framework were carefully formulated to conform to best-practice economic capital models that typically employ true-one-year PDs, not annualized cumulative PDs.[1] If the U.S. were to require the use of

[1] It is our understanding that, for home mortgages, the AVCs were derived by first estimating a loss distribution for unseasoned loans, via use of a stylized simulation process, then utilizing annualized cumulative PDs and stressed LGDs to solve backwards for the AVCs (see Calem-Follain, "The Asset-Correlation Parameter in Basel II for Mortgages on Single Family Residences," FRB, November 2003). This approach to estimating AVCs is consistent with the Retail Guidance requirement for using annualized PDs. If true-one-year PDs had been used to derive the AVCs (from the estimated loss distribution) the AVCs would have been higher. However, the regulatory analysis begins with the assumption that the estimated loss distribution was "correct" to begin with -- an assertion with which

annualized PDs for one segment of loans, this would imply not only a reworking of the estimated AVCs but also application of a lower confidence interval for that segment.[2]

Finally, unlike some banks that use annualized cumulative PDs for certain internal purposes (with appropriate adjustments for confidence intervals and AVCs), WMI uses only the through-the-cycle one-year PD for internal purposes. Therefore, the Retail Guidance requirement regarding an annualized PD would require us to completely re-estimate a new cumulative PD for all of our retail products *solely* for regulatory purposes.

2.3. BEEL for Defaulted Assets

Paragraph 128 requires that once an asset defaults, a bank "must construct its best estimate of expected losses (BEEL) *based on current economic circumstances* and risk characteristics". The stressed LGD minus the BEEL is then the capital required on the defaulted asset. Because the asset is already in default, our interpretation is that BEEL is essentially the expected chargeoffs specific to the asset at the point of default.

However, for most of our mortgage asssets in a default state, the state is after non-accrual at 90+ days past due (DPD) and prior to chargeoff at 180+. This means that for most of these assets, no property-specific expected chargeoff is calculated (or applied) and therefore is not available for the BEEL calculation. To meet the spirit of this requirement, average or aggregate chargeoff factors by pool at 180+ DPD could be applied with a 'cure' factor to lower the expected chargeoff by a cure/prepay rate. This however would essentially reduce the BEEL to a through-the-cycle LGD.

2.4. Definition of Default

Paragraph 98 provides specific criteria for a retail definition of default. As it is written, the Retail Guidance says that default occurs (for IRB purposes) *if any one* of the following conditions hold: a) The days-past-due ("DPD") reaches the upper bounds specified in the FFIEC Uniform Retail Credit Classification guidance; b) a partial or full write-off is taken; or c) the exposure is placed on non-accrual. This language seems to specifically disallow usage of an internal DPD criterion that is less than the FFIEC maximum and less than or equal to the point at which write-downs or non-accrual status occurs. This language in the Guidance is in conflict with our understanding of the FFIEC guidance, which simply places an upper bound on the

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many industry participants disagree. The primary concerns have been that the processes for generating random interest rate changes and random housing price changes when deriving the loss distribution used by regulators were too conservative. Thus, the Basel AVCs, even though generated by a process involving annualized cumulative PDs, are roughly 50% higher than used by the majority of risk practitioners. Note also that other, non-mortgage products involve the use of regulatory AVCs which, to our knowledge, were *not* derived using annualized PDs.

[2] For full detail, see the appendix to the [planned] RMA full response to the Retail Guidance.

DPD criterion. That is, the FFIEC guidance permits the bank to use a 90 DPD default definition, but the Guidance does not, if non-accrual occurs *past* 90 days. Rather, the Retail Guidance seems to say that, for mortgages, if non-accrual or write-down occur before 180 days, then either of those occurrences must be used as the default definition, not, say, a 90 DPD criterion.

This interpretation of the Guidance language would needlessly require WMI to change its risk management practices. Our existing default estimation models have been developed based on a 90+ days past due definition all across our institution. For the most part, this practice is consistent with our non-accrual policies and it allows for consistent comparison of estimated default risk across products and segments. The Guidance requirement, interpreted literally, however, would require recalibration or rebuild of our default estimation models to accommodate products that use an alternate non-accrual policy such as 120 days past due, with little or no added benefit in terms of making our capital requirement more precise. Indeed, our downturn LGDs are estimated by applying multipliers to our TTC LGDs. If we are forced to use a longer number of DPD for our default definition this would increase our TTC LGD (since the more liberal default definition would decrease cures+prepays), but the longer DPD definition would also likely decrease the cyclicality of LGDs, acting to offset the rise in TTC LGDs. Further, the more liberal definition of default would, of course, reduce our estimated TTC PDs. The end result would be very little change in our Basel capital requirement, at the cost of a complete overhaul of our risk parameter estimation process.

We had not thought that U.S. Regulatory Agencies intended for charge-off and non-accrual policies to significantly impact a bank's Basel II capital requirements. But that might happen unless the wording in the Retail Guidance is changed to read something like the following: "....when, at the option of the bank, any one of the following occurs": a) a DPD criterion that is equal to or less than the FFIEC maximum permissible number of DPD; b) full or partial write-off; or c) non-accrual.

2.5. Downturn Condition LEQ

Finally, Paragraph 146 in the Retail Guidance requires an arbitrarily defined stress be applied to the loan equivalency ratio for retail products involving unused lines of credit (such as HELOCs). The key issue is similar to what has been defined in section 2.1 -- this requirement seems to place an arbitrary stress parameter in the capital calculation. WMI does not have internal data on HELOC usage going back prior to the current cycle. Moreover, we do not believe many or any other institutions have such data either. Further, there exist no industry-wide data of which we are aware that measure line usage at default. Thus, for all practical purposes, the only LEQ estimates we can construct would be based on recent years' data. Since aggregate industry data appear to show that HELOC loss rates have been higher in the current cycle than in the early 1990's downturn, we believe public policy would be best served by permitting use of these current data to establish the Basel LEQ.

3. Conclusions

Washington Mutual Inc. fully supports the development of the new risk-based capital standards. This response is submitted in the spirit of a constructive dialogue in order to develop the most accurate capital accord feasible. We also acknowledge the excellent and very hard work of the regulatory community in the final stages of developing this complex and difficult accord.

Sincerely,

John F. Robinson
Executive Vice President
Corporate Risk Management