Washington Mutual

March 20, 2007

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, D.C. 20552

Attention: No. 2006-33

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th and Constitution Avenue, NW
Washington, D.C. 20551

Re: Docket Number R-1261

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, D.C. 20219
Corporation

Re: Docket Number 06-09

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance

550 17th Street, NW
Washington, D.C. 20429

Re: RIN 1550-AB56

Dear Sir or Madam:

Washington Mutual ("WaMu") appreciates the opportunity to comment on the notice of proposed rulemaking relating to Risk-Based Capital Standards: Advanced Capital Adequacy Framework, published on September 25, 2006. WaMu supports the objectives of Basel II and the form adopted internationally – the New Basel Capital Accord ("the Accord"). We have, however, noted a number of items in the Notice of Proposed Rule-Making (the "NPR") that render the level and risk sensitivity of the capital required different than that adopted internationally, and these form the basis of the specific comments in this document.

To the extent the NPR requires higher levels of capital than that required of banks in other countries, foreign banks will have a competitive advantage both in the worldwide capital markets and in lending to consumers. To the extent that the NPR requires banks to depart from the best practice economic capital modeling that they use to manage their businesses, the NPR will impose unnecessary compliance costs, distort bank decision-making and undermine its goal of encouraging best practice risk management in U.S. banks.

The primary reason for these departures from the Accord on the part of the U.S. banking agencies appears to be the results of the QIS 4 exercise and a general risk aversion to an untested minimum capital regime. We believe there are compelling reasons not to rely on QIS 4 for such an important rule-making. Some of those reasons are articulated by the agencies in the NPR.

In addition, the transition rules for the Accord, combined with the regulators' ample authority in U.S. law and Pillar II of the Accord to deal with potentially inappropriate capital levels both generally for the industry and for specific banks, provide the regulators with the time, the necessary information and the ability to modify the rule and deal with specific bank issues if they become evident during the three year transition period. As part of the qualification process during the time leading up to the transition period and during the transition itself, the regulatory agencies will be fully immersed in the details of each bank's processes in a way they have not been to date, including during the QIS 4 exercise.

Level of Capital

Large U.S. financial institutions and those in other G10 countries should have the same minimum capital requirements for the same economic risk to prevent competitive distortions. We urge the agencies in the strongest possible terms to give the Accord an opportunity to work without prejudging the outcome based on QIS 4. The three year period that includes the parallel run year plus two years of transition with floors on individual bank capital reduction as provided in the Accord provides plenty of opportunity for the agencies to make revisions in the rule if they are necessary. Such adjustments would be based on good information on how the banks and the regulators implement the Accord rather than the flawed data from QIS 4.

If, however, during the transition period, the agencies conclude that a higher level of capital is appropriate, we strongly recommend that the agencies continue to work with the Basel Committee to make adjustments, in consultation with the industry. There is already a process in place through the Basel Committee to review the scaling factor used for capital calibration. Use of this process to adjust capital levels *in one metric only* is far superior to the NPR's approach, using multiple caps, floors, other limits not included in the international Accord, which have a distortive, cumulative effect. In addition to maintaining competitive equity among Basel II banks around the world, such an approach would ameliorate the disincentive to invest in low risk assets that exists in the NPR as written.

Assuming a leverage ratio is retained, we urge the agencies to give serious consideration to materially reducing the level of the leverage ratio required to meet the well- and adequately-capitalized tests of Prompt Corrective Action to minimize the disincentives for U.S. banks to hold low risk assets in their portfolios. We also urge the agencies to consider permitting banks to meet leverage ratio requirements with more flexible forms of capital than common shareholders' equity.

Risk Sensitivity

Certain items in the NPR, in our estimation, distort the risk sensitivity of the capital measures:

- LGD Floor
- Stressed LGD
- Small/Medium business "step function"

Other Items

There are other aspects of the NPR that cause wasteful costs as currently written, or may impose competitive distortions. We highlight these and suggest alternatives that accomplish the risk management goals of Basel II in a less burdensome way, or in a manner that causes fewer competitive inequities. These include:

- Obligor ratings for commercial real estate lending
- Definition of Default, Commercial debt priced at 95% counted as a default
- Longer transition period than the international Accord
- Treatment of Interest Rate for the Banking Book/Pillar 2
- Retail/Commercial categorization
- RTCRRI Act
- Overly Prescriptive Disclosure Requirements

Choice Among Basel Approaches

As a general principle, we support providing all U.S. banks with the same options provided foreign banks, in particular the option of the internationally adopted Standardized Approach. This alternative is especially important if U.S. measures are not risk-sensitive and contain the distortions noted above, while still being costly to implement. In this case, we seek a choice among these three approaches (AIRB/AMA, Standardized Approach, or Basel IA) to be available to U.S. banking institutions regardless of size.

- We fully support economic capital and risk sensitive tools and will continue to invest in their development regardless of the outcome of Basel II.

- We do not want to invest in a parallel, compliance-only version of AIRB/AMA, since it would accomplish no purpose of furthering the management of risk at WaMu, and, through diverting scarce resources into unproductive expense, would lessen WaMu's safety and soundness.

Nevertheless, we want to be clear. We believe it is crucial for the competitiveness of the U.S. banking industry that the final rule conform the AIRB/AMA approach in the U.S. with the Accord as closely as possible.

LEVEL OF CAPITAL

WaMu fully supports the objectives of Basel II -- making capital requirements more sensitive to the risks inherent in banking portfolios 'while maintaining sufficient consistency in capital adequacy regulation to ensure that the New Accord will not be a significant source of competitive inequity among internationally active banks.' Wherever the NPR strays from this intent, it creates potential inequity and distorts incentives.

We are particularly concerned that a seriously flawed QIS 4 exercise has led the agencies to depart from the international Accord to guard against the perception that capital levels at U.S. banks subject to Basel II may fall below acceptable levels. Please see the comment letter from Citigroup, JPMorgan/Chase, Wachovia and Washington Mutual filed with each of the agencies on February 7, 2007 for a detailed discussion of this issue.

A. Leverage Ratio

The retention of a Leverage Ratio as a floor to the economic capital modeled under the Basel II advanced methods creates competitive inequities and distorts decision-making by banks, particularly if it is retained at current levels under the U.S. Prompt Corrective Action (PCA) rules. Specifically, it will either leave lower risk U.S. banks overcapitalized for the risks inherent in their portfolios, and, as such, targets of acquisition by foreign banks that do not have a Leverage Ratio floor, drive U.S. banks to increase the risks in their portfolios to equalize leverage and risk-based capital requirements, or force U.S. banks to incur wasteful costs to move low risk assets off their balance sheets.

The Leverage Ratio floor produces important disincentives in one of WaMu's key portfolio holdings: low-risk assets. Prime mortgages and other well-collateralized loans to high quality borrowers are low-risk assets. Estimates of their potential credit, market and operational loss potential under different forms of modeling may vary, but rarely arrive at a worst-case annual loss of greater than 2% of asset size. Because the minimum Leverage Ratio to be considered 'well capitalized' under U.S. rules is 5%, WaMu will face a powerful disincentive to hold low-risk assets under Basel II as drafted. While the desire among U.S. regulatory agencies to keep levels of capital stable is understandable, the likely result of this Leverage Ratio "floor" in an international, competitive environment where capital is increasingly efficiently optimized will be to ***incent U.S. institutions to disfavor holding low-risk assets such as mortgages, in favor of higher risk, lower credit quality assets.***

One way of viewing the leverage ratio is as a very simple (and overly simplistic) capital model – a single factor model that relies solely on a bank's on balance sheet assets to determine the appropriate level of capital. There may have been a time in banking history when such a model worked satisfactorily, but modern banking and finance has clearly rendered it obsolete. While it may serve as a useful proxy as a bank approaches insolvency and as a useful trigger for regulatory action as that happens, it has questionable value as a good basis for indicating appropriate capital levels for a going concern – and creates the perverse incentives identified above.

B. Basel II Risk Based Capital

Assuming that Agency policy makers agree with the premise that the minimum level of capital that a bank should hold should be a function of the risk of failure of the bank, the approach to measuring appropriate capital levels that is taken in Basel II is fully appropriate and consistent with best practice in the most sophisticated banks in the world. By setting a very high minimum statistical confidence level and applying that to each bank's product mix and historical experience in managing those products, it provides an internally consistent and sensible approach across widely varying product lines. That approach contrasts notably with the relatively crude and arbitrary approaches currently in place.

The Accord and the NPR appropriately outline the requirements for data and methodology that banks must use to qualify for the advanced approaches. As a general matter, the agencies have done a good job on this front, with a few notable exceptions that we discuss later. While the Accord and the NPR may appear complex to the layman, the fundamental underpinnings of the approach are not terribly complex. The complexity comes largely from the fact that the modern banking industry has grown very complex in its product offerings and operations.

Perhaps the most important part of the Basel II rule is contained in Pillar II – the supervisory pillar. It is in Pillar II where the agencies can and must deal with anomalies in the industry that cannot and should not be dealt with in the hard-wired rules of Pillar I. To attempt to deal with every possible variant of credit and operational risk issues in Pillar I would be an impossible task that would make the final rule either excessively complex or unrealistically conservative. It is also in Pillar II and in the approval process for certifying banks to use AIRB/AMA that the agencies should deal with outlier banks and anomalous situations. The agencies should trust their supervisory staffs, which in our experience are highly competent and conservative, to address these situations rather than trying to deal with them through the series of caps, floors and product by product rules embedded in the NPR. Those changes to the Accord introduce competitive inequities, product distortions and unnecessary costs into the process, and drive Basel II away from best practice economic capital risk management.

If, however, these approaches are insufficient for the agencies, then we urge the agencies to consider an alternative to the counter-productive combination of caps, floors and other arbitrary, non-risk sensitive limits that are contained in the NPR. We strongly recommend that the agencies continue to work with the Basel Committee to make adjustments, in consultation with the industry. There is already a process in place through the Basel Committee to review the scaling factor used for capital calibration. Use of this process to adjust capital levels *in one metric only* would address the potentially serious competitive equity issues between U.S. banks and banks elsewhere in the world as well as the risk sensitivity distortions imposed by ad hoc limits imposed at various places in the NPR. The agencies should not, however, make a decision to require increased capital until they have seen the results of the rule during the transition period and have fully considered the variations in bank capital levels that should and will occur over the economic cycle.

Such an approach would remove some of the disincentive to invest in low risk assets, and is similar in form to the treatment used for capital for the trading books under the Market Risk Accord; it produces the fewest distortions that might favor or disfavor a given asset class, while providing a tool to control the overall level of capital in the financial system. It is important to find one place in the measure to affect the overall level of capital to avoid unintended distortions that result from piecemeal changes. In the section on Risk Sensitivity, we address other points in the measure where Agency choices add layers of conservatism that add to the overall level of capital, but in uneven, distortive ways. Achieving comfort with the overall level is best done at the top of the measure; extra elements of conservatism deeper in the measure, particularly those not practiced in the international version of Basel II, will cause unwanted disincentives for U.S. banks to participate in given products or activities and distort decision-making in those banks.

RISK SENSITIVITY

As noted above, certain items in the NPR result in distortions in relative levels of capital required. These distortions have the potential to adversely affect the competitive environment in which banks operate and create unwanted incentives for the banks operating under these requirements. Our recommendation is that relative risk sensitivity be maintained within the rule by removing these barriers to accurate measurement. Additional conservatism to ensure safety and soundness, if found necessary after the parallel run and early transition years could be established in the form of a single measure outside of these detailed measures as noted in the preceding section. Some of the places where risk sensitivity is not established or is inequitable include:

A. LGD Floor

The 10% floor on loss given default that applies to residential mortgages should be removed. This arbitrary floor penalizes very low risk residential mortgage lending and disincents banks from holding high quality collateral (i.e., the capital requirement will be relatively high for lower loan to value (LTV) loans that could result in LGDs lower than 10% except for this floor).

B. Stressed LGD

A number of concerns are associated with the stressed LGD (called LGD in the wording of the NPR):

1. The U.S. definition of LGD is significantly more conservative than that defined in the international accord. Consistency in definition should be

established in this critical parameter that has a significant impact on capital requirements.

2. Within the U.S. framework this measure should be unambiguously defined given the sensitivity of the capital calculation to the result. A minimum is set at a through-the-cycle default weighted average. Then, a stress must be applied to reflect potential LGD variation during downturn conditions. The agencies should provide guidance outlining the principles they expect banks to follow to establish the confidence level that the required stress reflect and the level of portfolio segmentation that is appropriate.

3. The Stressed LGD mapping function provided for situations where internal data does not allow for direct measurement of stressed LGDs is problematic. First, this approach will likely be applied in situations where limited stress condition internal loss data is available. This will likely be due to high credit quality with few defaults and low LGDs in the portfolio. This mapping function penalizes the low PD, LGD situation by placing an arbitrary floor on LGD at 8% for all loans. Low expected LGDs are scaled up dramatically so the stress condition measure is always at least 8%. So, a fully guaranteed or fully cash-collateralized loan will always have a floor LGD of 8%. This creates an incentive for banks to structure loans with a minimum expected LGD much greater than zero where this scaling up factor from expected to stressed LGD is reduced.

   Second, mixing and matching of direct measurement along with the mapping function should be allowed within a Basel II portfolio category. Currently, use of the mapping function for a small portfolio at the same time as measured LGDs in another portfolio but within the same Basel II category is prohibited. For example, if a commercial portfolio with very few losses has insufficient data for internal measures of stressed LGD, the NPR requires that the mapping function be applied to all commercial portfolios in that category in order to prevent 'cherry-picking' of approaches. We suggest that the supervisory process be used to prevent cherry picking rather than adding conservatism that prevents use of internal measures where they make sense.

C. Small/Medium Business Step Function

The NPR notes that the small and medium enterprise (SME) category has been dropped due to a lack of empirical evidence to support it. The absence of this category appears to create: 1) a step function between the retail and commercial categorizations with a potentially large increase as a specific obligor is designated as commercial instead of retail and 2) a significant difference in the U.S. application of Basel II vs. the rest of the world. We suggest that the U.S. add this category back since such step function in capital requirements is not observed by industry practitioners and to reduce competitive inequities with non-U.S. banks.

OTHER ITEMS

We also note a number of other concerns with the NPR related to: inaccurate risk measurement, excessive and burdensome implementation requirements, and risks to competitive equity. These concerns include:

A. Inaccurate Obligor Ratings for Some Types of Commercial Real Estate (CRE) Lending – Conflicting Principles within Basel II

Basel II defines credit obligors by legal entity. All commercial loans to a common legal entity must have a common probability of default. For portfolios where little or no correlation of defaults is observed across loans to a single shared legal entity, this requirement is not consistent with good risk management practices and it results in inaccurate capital measures.

Moreover, the Basel II notice of proposed rulemaking ("NPR") has conflicting principles in the wholesale AIRB requirements when applied to income-producing real estate.

Principle 1 – Homogeneity: Basel II requires that credit exposures be rated for probability of default (PD) and loss given default (LGD) in categories with homogenous credit risk characteristics. This requirement of homogeneity is repeated throughout the supervisory guidance text as a requirement for wholesale credit ratings and retail credit scores. We also believe this homogeneity requirement is fundamental to correct application of the capital model embedded in the Basel II framework.

Principle 2 – Common PD: Basel II requires that wholesale exposures to a common legal entity have a common PD and a linked default status so when one exposure defaults, all exposures to the same obligor are assigned default status. The common PD principle is ostensibly based on industry risk management practices for large corporate and middle market lending; however, when applied to income-producing real estate ("IPRE") such as WaMu's Multi-Family ("MFL") and Commercial Real Estate ("CRE") lending portfolios, it is in direct conflict with the homogeneity principle.

Default risk in IPRE is heavily influenced by property characteristics and local market dynamics such as rents, vacancies, construction, employment, etc. Additionally, state-specific foreclosure regulations such as single-action laws apply to much of our portfolio. These laws limit lenders to collecting either on the properties or the obligor entity, but not both. In many cases, the combination of these factors makes one loan defaulting a poor predictor of default for other loans to the same legal entity. Said differently, the core issue here is the difference between borrowing entities with a combined source of financial resources for repaying debt obligations (traditional operating companies) and those with multiple discrete sources of cash flow and related debt repayment (analogous to MFL lending) that are separated by factors such as single action laws.

An analysis of WaMu obligors with multiple MFL loans and one loan in default supports this hypothesis. For obligors with one loan in default tracked from August 2001 to January 2007, we found that 76% of the time the borrower did not default on any other loans; 6% of the time the borrower defaulted on some, but not all other loans; and 19% of the time the borrower defaulted on all other loans. An 'ever-default' definition was applied for the entire period of over 5 years.

Due to the poor correlation of default among multiple IPRE loans to one obligor, the Basel II requirement for a common PD within a legal entity is not a useful measure for risk management or for capital purposes. If an obligor has multiple loans, each financing a different property, assigning the same rating to each loan distorts the risk profile of each exposure. This distortion makes segmenting exposures into homogeneous risk pools (Principle 1) impossible and renders the obligor ratings useless for risk management and business application (e.g., servicing, pricing, portfolio management, etc.). Complying with the common PD principle prevents WaMu from complying with the homogeneity principle and the Basel II use test.

A related concern is that the cross-default provisions as applied to some CRE portfolios may artificially lower capital requirements. Because defaults from a common obligor entity have a low correlation of occurrence, application of the cross default requirement results in many *zero loss* default events and correspondingly very low LGDs. Although higher PDs are also observed, the greater sensitivity of the capital result to low LGD will result in lower capital than would otherwise be observed.

Foregoing the common PD principle not only generates more useful ratings, it also results in more appropriate capital requirements. As described above, when one loan defaults, other loans to the same obligor often do not default. If cross-default were applied and related performing loans were assigned default status, PD's would be higher, but LGD's would be lower due to the high occurrence of no loss default events created by the artificial default status. Because on average LGD has a greater proportional impact on capital than PD, the net effect of cross-default status (higher PD's and lower LGD's) is lower capital. This impact is demonstrated in the example below where expected loss (EL) is held constant at 20 basis points. Asset value correlation (AVC) varies due to the Basel II AVC formula for wholesale exposures which has an inverse relationship to PD.

Table 1: Illustration of Capital Required for Common EL with Application of Cross-Default and No Cross-Default for MFL

	EL	PD	LGD	AVC	Required Capital (M = 5)
Case 1: Cross Default Not Applied	0.20%	0.80%	25.00%	20.04%	5.03%
Case 2: Cross Default Applied	0.20%	4.00%*	5.00%**	13.62%	1.49%

*Application of cross default inflates PD

**Numerous zero loss defaults are observed in this case and reduce LGD

We recommend that for portfolios where a low correlation of default occurrence within a common obligor entity relationship is observed or the portfolio can demonstrate separation of the obligor entity from loan facilities such as where 'single action' laws or similar regulation is present, that Basel II allow for a modified definition of the obligor entity. One option would be to individually rate properties (loans) for relevant capital parameters and allow for potential additional credit protection due to the obligor entity (or a guarantor or sponsor) through adjusted PD or LGD ratings. This approach could be similar to existing approaches for application of third party guarantees.

B. Definition of Default

The U.S. definition of default should be made consistent with the definition of default in the international Accord. Numerous models, systems and measures are calibrated off of this critical definition and multiple versions of the definition create an enormous and unnecessary implementation burden for banks adopting Basel II. Similarly, the requirement that commercial debt priced at a credit-related 5% haircut be counted as a default should be removed. This arbitrary 5% measure appears to fall within a realm of normal market volatility and our expectation is that numerous false default indications will result. Numerous 'false' default occurrences render the measures and systems designed for Basel II even less useful for internal risk management purposes.

C. Longer Transition Period/Transitional Floors

The transition period for the U.S. should be made consistent with international application of Basel II. Transitional floors should also be synchronized with international application so as to not create disparate competitive impacts.

D. Treatment of Interest Rate for the Banking Book/Pillar 2

WaMu continues to be concerned regarding accurate and equitable treatment of interest rate risk in the banking book. Specifically, we are seeking affirmation in the final rule that the agencies will collaborate to: 1) provide similar 'Pillar Two' treatment of this risk across institutions that 2) is based on an accurate and consistent quantification framework. A wide range of industry practice is in place for measurement of interest rate risk in accrual accounted portfolios. Simply adding on these different types of measures to "Pillar 1" capital will lead to inequitable and inaccurate measures of required capital.

E. Retail/Commercial Categorization

Retail vs. commercial treatment should align to how the loans are managed instead of defined with fixed thresholds. Loans managed in homogeneous pools based on similar risk characteristics should be treated as retail. Loans managed individually should be treated as commercial.

However, even in cases where loans are managed in homogeneous pools (retail), we believe that direct application of, for example, validated logistic regression models based on relevant credit attributes should be permitted in Basel II. This would allow for greater granularity and precision in calculation of capital requirements. For example, a model to predict probability of default based on relevant credit attributes could be applied directly at a loan level (the factors in the model here would imply a segmentation, but with infinitely fine-grained variability as the credit attributes varied) rather than using the model to define a segmentation and then estimating default only at the discrete levels of that segmentation. The segmentation for Basel II appears to serve dual purposes of: 1) capital calculation and 2) portfolio monitoring and reporting. Limiting PD variability for capital calculation to discrete segments also aligned to feasible tracking and reporting seems like an unnecessary constraint. The goals of portfolio monitoring and reporting are easily addressed through other means. Both approaches would be based on the same historical data sets and results would be similar with the exception that the segmentation requirement will be less granular.

F. RTCRRI Act

The RTCRRI Act capital requirements do not align with risk and should be removed. Clearly these flat and prescribed capital requirements will not align with the underlying risk of the portfolio. If these prescribed capital levels are not removed, the unused, underlying risk measures for the Basel II capital calculations should not be required.

G. Overly Prescriptive Disclosure Requirements

The Pillar 3 disclosure requirements still appear to be overly prescriptive in ways that could lead to harmful competitive effects and be potentially misleading. We are also concerned that the amount of detail required may reveal competitively proprietary information such as very specific target market credit quality for a given product type. For banks that have a significant number of products within a given Basel II portfolio category, this is less of a concern because the Basel II category average results are reported. But, for banks with fewer products within a category (for example, if credit card portfolio results are reported directly rather than being combined with other products), proprietary information may be revealed.

In addition, the requirement in Table 11.5 to report risk parameter estimates in comparison to 'a longer period' of actual outcomes may result in misleading disclosures. Even with a reporting start in 2010 for this data element as footnoted in the proposed rule, there is a significant danger of mixing point-in-time results with long-term averages or through-the-cycle risk measures (or, conversely, point in time risk measures with long-term average results).

Finally, while we fully support public disclosures that improve the market's ability to evaluate a bank's risk profile, we are concerned that some of the disclosures proposed risk significant misunderstanding by the marketplace and could result in confusion or disruption, in addition to the potential for revealing competitively proprietary information noted above. As a result, we suggest the reporting templates be defined on a more general basis, where both the level of portfolio granularity as well as the time horizon for comparison of model results vs. actual outcomes is at the discretion of the reporting institution. By scaling back the public disclosure templates to focus on clarity and usefulness, Pillar 3 will better serve investor needs. In addition, we urge the agencies to consider all reporting confidential until the Basel II process has at least completed one or two years of the transition period. Such a delay in public reporting will help the regulators and the industry ensure comparability of the information and reduce to potential for investor confusion and misunderstanding.

CHOICE AMONG BASEL APPROACHES

As discussed above and as we replied in our comment letter on the Basel 1A ANPR, we believe that, consistent with application of Basel II for all nations outside of the U.S., *choices in approaches for regulatory capital measurement should be available to all institutions*. Basel 1A, as well as the 'Standardized', 'Foundation' and 'Advanced' versions of Basel II should be available to all institutions. No single choice is ideal for effective management and supervision of all banks, even when considering categories of only large, regional or community institutions. Choices should be available to all.

In some cases, smaller institutions with sophisticated risk measurement would benefit from adoption of the more advanced approaches. In other cases, large and complex organizations that would be creating a compliance-only version of the risk measures for Advanced approaches in Basel II could choose to adopt a simpler approach to avoid the considerable expense and risk associated with the implementation. The very significant expense, burden, *and risk (e.g., numerous process system changes that would otherwise be unnecessary)* associated with the more advanced approaches should allow management of these more complex institutions to choose simpler approaches as their specific situation requires.

The distortions of the proposed U.S. Advanced approach due to the multiple layers of arbitrary conservatism will force the development of risk measures solely for the purposes of Basel II. While our overwhelming preference is to fix the Advanced approach in the U.S., if changes are not made, WaMu requests the option of access to the simpler and less costly Standardized Approach as well as other alternatives such as Basel IA.

We have invested heavily in best practice economic capital modeling and decision tools and will continue to do so for business purposes regardless of the outcome of the Basel II rulemaking. However, we do not want to invest in a parallel, compliance-only version of AIRB/AMA, since it would accomplish no purpose of furthering the management of risk at WaMu. Through diverting scarce resources into unproductive expense and numerous process and systems changes, a compliance-only version of Basel II would lessen WaMu's safety and soundness. At a minimum, the compounded conservatism and lack of risk sensitivity in the U.S. Basel Advanced should be accompanied by an option to allow U.S institutions to adopt the most simple and most conservative approach established internationally, that of Basel II Standardized Approach.

We have attached a separate Appendix that organizes our comments in response to the specific questions that the agencies raised in the NPR.

Ronald J. Cathcart
Executive Vice President and Chief Enterprise Risk Officer
WaMu

Attachment: RESPONSES TO SPECIFIC QUESTIONS IN THE NPR

APPENDIX
RESPONSES TO SPECIFIC QUESTIONS IN THE NPR

Question 4*: The agencies seek comment on the use of a segment-based approach rather than an exposure-by-exposure approach for retail exposures.*

Answer to Question 4:

Even in cases where loans are managed in homogeneous pools (retail), we believe that direct application of, for example, validated logistic regression models based on relevant credit attributes should be permitted in Basel II. This would allow for greater granularity and precision in calculation of capital requirements. For example, a model to predict probability of default based on relevant credit attributes could be applied directly at a loan level (the factors in the model here would imply a segmentation, but with infinitely fine-grained variability as the credit attributes varied) rather than using the model to define a segmentation and then estimating default only at the discrete levels of that segmentation. The segmentation for Basel II appears to serve dual purposes of: 1) capital calculation and 2) portfolio monitoring and reporting. Limiting PD variability for capital calculation to discrete segments also aligned to feasible tracking and reporting seems like an unnecessary constraint. The goals of portfolio monitoring and reporting are easily addressed through other means. Both approaches would be based on the same historical data sets and results would be similar with the exception that the segmentation requirement will be less granular.

Question 7*: The agencies request comment on whether U.S. banks subject to the advanced approaches in the proposed rule (that is, core banks and opt-in banks) should be permitted to use other credit and operational risk approaches similar to those provided under the New Accord. With respect to the credit risk capital requirement, the agencies request comment on whether banks should be provided the option of using a U.S. version of the so-called ``standardized approach'' of the New Accord and on the appropriate length of time for such an option.*

Answer to Question 7:

As a general principle, we support providing all U.S. banks with the same options provided foreign banks, in particular the option of the internationally adopted Standardized Approach. This alternative is especially important if U.S. measures are not risk-sensitive and contain the distortions noted above, while still being costly to implement. In this case, we seek a choice among these three approaches (AIRB/AMA, Standardized Approach, or Basel IA) to be available to U.S. banking institutions regardless of size.

Question 10: *The agencies seek comment on this approach, including the transitional floor thresholds and transition period, and on how and to what extent future modifications to the general risk-based capital rules should be incorporated into the transitional floor calculations for advanced approaches banks.*

Question 12: *The agencies seek comment on this proposed timetable for implementing the advanced approaches in the United States.*

Answer to Questions 10 and 12:

The transition period for the U.S. should be made consistent with international application of Basel II. Transitional floors should also be synchronized with international application so as to not create disparate competitive impacts.

Question 13: *The agencies seek comment on this aspect of the proposed rule and on any circumstances under which it would be appropriate to assign different obligor ratings to different exposures to the same obligor (for example, income-producing property lending or exposures involving transfer risk).*

Answer to Question 13:

Basel II defines credit obligors by legal entity. All commercial loans to a common legal entity must have a common probability of default. For portfolios where little or no correlation of defaults is observed across loans to a single shared legal entity, this requirement is not consistent with good risk management practices and it results in inaccurate capital measures.

Moreover, the Basel II notice of proposed rulemaking ("NPR") has conflicting principles in the wholesale AIRB requirements when applied to income-producing real estate.

<u>Principle 1 – Homogeneity</u>: Basel II requires that credit exposures be rated for probability of default (PD) and loss given default (LGD) in categories with homogenous credit risk characteristics. This requirement of homogeneity is repeated throughout the supervisory guidance text as a requirement for wholesale credit ratings and retail credit scores. We also believe this homogeneity requirement is fundamental to correct application of the capital model embedded in the Basel II framework.

<u>Principle 2 – Common PD</u>: Basel II requires that wholesale exposures to a common legal entity have a common PD and a linked default status so when one exposure defaults, all exposures to the same obligor are assigned default status. The common PD principle is ostensibly based on industry risk management practices for large corporate and middle market lending; however, when applied to income-producing real estate ("IPRE") such as WaMu's Multi-Family ("MFL") and Commercial Real Estate ("CRE") lending portfolios, it is in direct conflict with the homogeneity principle.

Default risk in IPRE is heavily influenced by property characteristics and local market dynamics such as rents, vacancies, construction, employment, etc. Additionally, state-specific foreclosure regulations such as single-action laws apply to much of our portfolio. These laws limit lenders to collecting either on the properties or the obligor entity, but not both. In many cases, the combination of these factors makes one loan defaulting a poor predictor of default for other loans to the same legal entity. Said differently, the core issue here is the difference between borrowing entities with a combined source of financial resources for repaying debt obligations (traditional operating companies) and those with multiple discrete sources of cash flow and related debt repayment (analogous to MFL lending) that are separated by factors such as single action laws.

An analysis of WaMu obligors with multiple MFL loans and one loan in default supports this hypothesis. For obligors with one loan in default tracked from August 2001 to January 2007, we found that 76% of the time the borrower did not default on any other loans; 6% of the time the borrower defaulted on some, but not all other loans; and 19% of the time the borrower defaulted on all other loans. An 'ever-default' definition was applied for the entire period of over 5 years.

Due to the poor correlation of default among multiple IPRE loans to one obligor, the Basel II requirement for a common PD within a legal entity is not a useful measure for risk management or for capital purposes. If an obligor has multiple loans, each financing a different property, assigning the same rating to each loan distorts the risk profile of each exposure. This distortion makes segmenting exposures into homogeneous risk pools (Principle 1) impossible and renders the obligor ratings useless for risk management and business application (e.g., servicing, pricing, portfolio management, etc.). Complying with the common PD principle prevents WaMu from complying with the homogeneity principle and the Basel II use test.

A related concern is that the cross-default provisions as applied to some CRE portfolios may artificially lower capital requirements. Because defaults from a common obligor entity have a low correlation of occurrence, application of the cross default requirement results in many *zero loss* default events and correspondingly very low LGDs. Although higher PDs are also observed, the greater sensitivity of the capital result to low LGD will result in lower capital than would otherwise be observed.

Foregoing the common PD principle not only generates more useful ratings, it also results in more appropriate capital requirements. As described above, when one loan defaults, other loans to the same obligor often do not default. If cross-default were applied and related performing loans were assigned default status, PD's would be higher, but LGD's would be lower due to the high occurrence of no loss default events created by the artificial default status. Because on average LGD has a greater proportional impact on capital than PD, the net effect of cross-default status (higher PD's and lower LGD's) is lower capital. This impact is demonstrated in the example below where expected loss (EL) is held constant at 20 basis points. Asset value correlation (AVC) varies due to the Basel II AVC formula for wholesale exposures which has an inverse relationship to PD.

Table 1: Illustration of Capital Required for Common EL with Application of Cross- Default and No Cross-Default for MFL

	EL	PD	LGD	AVC	Required Capital (M = 5)
Case 1: Cross Default Not Applied	0.20%	0.80%	25.00%	20.04%	5.03%
Case 2: Cross Default Applied	0.20%	4.00%*	5.00%**	13.62%	1.49%

*Application of cross default inflates PD

**Numerous zero loss defaults are observed in this case and reduce LGD

We recommend that for portfolios where a low correlation of default occurrence within a common obligor entity relationship is observed or the portfolio can demonstrate separation of the obligor entity from loan facilities such as where 'single action' laws or similar regulation is present, that Basel II allow for a modified definition of the obligor entity. One option would be to individually rate properties (loans) for relevant capital parameters and allow for potential additional credit protection due to the obligor entity (or a guarantor or sponsor) through adjusted PD or LGD ratings. This approach could be similar to existing approaches for application of third party guarantees.

Question 14*: The agencies seek comment on this proposed definition of default and on how well it captures substantially all of the circumstances under which a bank could experience a material credit-related economic loss on a wholesale exposure. In particular, the agencies seek comment on the appropriateness of the 5 percent credit loss threshold for exposures sold or transferred between reporting categories. The agencies also seek commenters' views on specific issues raised by applying different definitions of default in multiple national jurisdictions and on ways to minimize potential regulatory burden, including use of the definition of default in the New Accord, keeping in mind that national bank supervisory authorities must adopt default definitions that are appropriate in light of national banking practices and conditions.*

Answer to Question 14:

The U.S. definition of default should be made consistent with the definition of default in the international Accord. Numerous models, systems and measures are calibrated off of this critical definition and multiple versions of the definition create an enormous and unnecessary implementation burden for banks adopting Basel II. Similarly, the requirement that commercial debt priced at a credit-related 5% haircut be counted as a default should be removed. This arbitrary 5% measure appears to fall within a realm of normal market volatility and our expectation is that numerous false default indications will result. Numerous 'false' default occurrences render the measures and systems designed for Basel II even less useful for internal risk management purposes.

***Question 16**: The agencies seek comment on and supporting empirical analysis of (i) the proposed rule's definitions of LGD and ELGD; (ii) the proposed rule's overall approach to LGD estimation; (iii) the appropriateness of requiring a bank to produce credible and reliable internal estimates of LGD for all its wholesale and retail exposures as a precondition for using the advanced approaches; (iv) the appropriateness of requiring all banks to use a supervisory mapping function, rather than internal estimates, for estimating LGDs, due to limited data availability and lack of industry experience with incorporating economic downturn conditions in LGD estimates; (v) the appropriateness of the proposed supervisory mapping function for translating ELGD into LGD for all portfolios of exposures and possible alternative supervisory mapping functions; (vi) exposures for which no mapping function would be appropriate; and (vii) exposures for which a more lenient (that is, producing a lower LGD for a given ELGD) or more strict (that is, producing a higher LGD for a given ELGD) mapping function may be appropriate (for example, residential mortgage exposures and HVCRE exposures).*

Answer to Question 16:

LGD Floor

The 10% floor on loss given default that applies to residential mortgages should be removed. This arbitrary floor penalizes very low risk residential mortgage lending and disincents banks from holding high quality collateral (i.e., the capital requirement will be relatively high for lower loan to value (LTV) loans that could result in LGDs lower than 10% except for this floor).

Stressed LGD

A number of concerns are associated with the stressed LGD (called LGD in the wording of the NPR):

1. The U.S. definition of LGD is significantly more conservative than that defined in the international accord. Consistency in definition should be established in this critical parameter that has a significant impact on capital requirements.

2. Within the U.S. framework this measure should be unambiguously defined given the sensitivity of the capital calculation to the result. A minimum is set at a through-the-cycle default weighted average. Then, a stress must be applied to reflect potential LGD variation during downturn conditions. The agencies should provide guidance outlining the principles they expect banks to follow to establish the confidence level that the required stress reflect and the level of portfolio segmentation that is appropriate.

3. The Stressed LGD mapping function provided for situations where internal data does not allow for direct measurement of stressed LGDs is problematic. First, this approach will likely be applied in situations where limited stress condition internal loss data is available. This will likely be due to high credit quality with few defaults and low LGDs in the portfolio. This mapping function penalizes the low PD, LGD situation by placing an arbitrary floor on LGD at 8% for all loans. Low expected

LGDs are scaled up dramatically so the stress condition measure is always at least 8%. So, a fully guaranteed or fully cash-collateralized loan will always have a floor LGD of 8%. This creates an incentive for banks to structure loans with a minimum expected LGD much greater than zero where this scaling up factor from expected to stressed LGD is reduced.

Second, mixing and matching of direct measurement along with the mapping function should be allowed within a Basel II portfolio category. Currently, use of the mapping function for a small portfolio at the same time as measured LGDs in another portfolio but within the same Basel II category is prohibited. For example, if a commercial portfolio with very few losses has insufficient data for internal measures of stressed LGD, the NPR requires that the mapping function be applied to all commercial portfolios in that category in order to prevent 'cherry-picking' of approaches. We suggest that the supervisory process be used to prevent cherry picking rather than adding conservatism that prevents use of internal measures where they make sense.

***Question 25**: The agencies request comment and supporting evidence on the consistency of the proposed treatment with the underlying riskiness of SME portfolios. Further, the agencies request comment on any competitive issues that this aspect of the proposed rule may cause for U.S. banks.*

Answer to Question 25:

The NPR notes that the small and medium enterprise (SME) category has been dropped due to a lack of empirical evidence to support it. The absence of this category appears to create: 1) a step function between the retail and commercial categorizations with a potentially large increase as a specific obligor is designated as commercial instead of retail and 2) a significant difference in the U.S. application of Basel II vs. the rest of the world. We suggest that the U.S. add this category back since such step function in capital requirements is not observed by industry practitioners and to reduce competitive inequities with non-U.S. banks.

***Question 32**: The agencies understand that there is a tension between the statutory risk weights provided by the RTCRRI Act and the more risk-sensitive IRB approaches to risk-based capital that are contained in this proposed rule. The agencies seek comment on whether the agencies should impose the following underwriting criteria as additional requirements for a Basel II bank to qualify for the statutory 50 percent risk weight for a particular mortgage loan: (i) That the bank has an IRB risk measurement and management system in place that assesses the PD and LGD of prospective residential mortgage exposures; and (ii) that the bank's IRB system generates a 50 percent risk weight for the loan under the IRB risk-based capital formulas.*

Answer to Question 32:

The RTCRRI Act capital requirements do not align with risk and should be removed. Clearly these flat and prescribed capital requirements will not align with the underlying risk of the portfolio. If these prescribed capital levels are not removed, the unused, underlying risk measures for the Basel II capital calculations should not be required.

***Question 61**: The agencies seek commenters' views on all of the elements proposed to be captured through the public disclosure requirements. In particular, the agencies seek comment on the extent to which the proposed disclosures balance providing market participants with sufficient information to appropriately assess the capital strength of individual institutions, fostering comparability from bank to bank, and reducing burden on the banks that are reporting the information.*

Answer to Question 61:

The Pillar 3 disclosure requirements still appear to be overly prescriptive in ways that could lead to harmful competitive effects and be potentially misleading. We are also concerned that the amount of detail required may reveal competitively proprietary information such as very specific target market credit quality for a given product type. For banks that have a significant number of products within a given Basel II portfolio category, this is less of a concern because the Basel II category average results are reported. But, for banks with fewer products within a category (for example, if credit card portfolio results are reported directly rather than being combined with other products), proprietary information may be revealed.

In addition, the requirement in Table 11.5 to report risk parameter estimates in comparison to 'a longer period' of actual outcomes may result in misleading disclosures. Even with a reporting start in 2010 for this data element as footnoted in the proposed rule, there is a significant danger of mixing point-in-time results with long-term averages or through-the-cycle risk measures (or, conversely, point in time risk measures with long-term average results).

Finally, while we fully support public disclosures that improve the market's ability to evaluate a bank's risk profile, we are concerned that some of the disclosures proposed risk significant misunderstanding by the marketplace and could result in confusion or disruption, in addition to the potential for revealing competitively proprietary information noted above. As a result, we suggest the reporting templates be defined on a more general basis, where both the level of portfolio granularity as well as the time horizon for comparison of model results vs. actual outcomes is at the discretion of the reporting institution. By scaling back the public disclosure templates to focus on clarity and usefulness, Pillar 3 will better serve investor needs. In addition, we urge the agencies to consider all reporting confidential until the Basel II process has at least completed one or two years of the transition period. Such a delay in public reporting will help the regulators and the industry ensure comparability of the information and reduce to potential for investor confusion and misunderstanding.