WaMu®

John F. Robinson
Executive Vice President
Corporate Risk Management
1301 Second Avenue
WMC3201
Seattle, WA 98101
206 500 4149 phone
206 377 3018 fax

May 29, 2007

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

Docket #2007-06

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

Re: Docket Number OP-1277

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

Re: Docket Number OCC-2007-0004

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: Basel II Supervisory Guidance

Dear Sir or Madam:

Washington Mutual ("WaMu") appreciates the opportunity to comment on the Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation ("Guidance") published in the Federal Register on February 28, 2007 relating to Risk-Based Capital Standards. WaMu supports the objectives of Basel II and the form adopted internationally – the New Basel Capital Accord ("the Accord"). We are also optimistic that Basel II, as we expect it will eventually be adopted in the U.S., will represent a very positive and significant step forward for bank regulation. We see tremendous potential benefit for regulators and banks in establishing greater alignment of capital requirements to risk levels as well as further aligning regulation to modern quantitative risk management practices irrespective of capital measurement approaches.

We recognize that the Supervisory Guidance was not intended to address the concerns that have been noted by WaMu and others associated with the Basel II Notice of Proposed Rule (NPR). However, we would like to be clear that the concerns noted in our response to the NPR have not been addressed in the Supervisory Guidance. We briefly restate the most prominent of these concerns in this response. These concerns are those primarily associated with competitive inequity associated with the additional conservatism in the U.S. version of Basel II. The most significant of these concerns include:

1. Banks of all sizes should have access to the same choices among the various approaches (e.g., Standardized, Foundation, and Advanced) available internationally. While we intend to apply advanced approaches, we believe that access for banks of all sizes to the same choices that our international competitors have access to is critical to establishing a level playing field. Furthermore, we note that for immaterial, runoff, or newly acquired portfolios, the simpler approaches available internationally could represent the best options for transitional capital arrangements.

2. The longer Basel II transitional period in the U.S. should be aligned to the mid-year text (international approach) phase-in period for greater competitive equity.

3. The transitional floors in the U.S. proposed approach should be shortened and aligned to the international approach for greater competitive equity.

4. The aggregate 10% floor in capital reduction should be removed to further align to the requirements in the mid year text for greater competitive equity.

5. The leverage ratio requirement should be addressed. Application of the leverage ratio in conjunction with the risk-based capital requirements of Basel II removes the incentive in Basel II for banks to reduce risk to lower their regulatory capital burden. This could also be stated as the leverage ratio drives banks to add risk to overcome the artificial constraint imposed by the leverage ratio. *We suggest a formal and scheduled phase-out of the leverage requirement as Basel II is phased-in.*

General Comments on the Supervisory Guidance

To the extent that the Supervisory Guidance was not meant to reflect a change in the Basel II rule as defined by the NPR, we suggest that the specific language used in the supervisory guidance be very closely aligned to that in the NPR to make this alignment unambiguous. While we appreciate the apparent attempt to simplify the description of requirements as presented in the NPR, we found ourselves wasting time parsing the specific wording trying to infer whether or not the rule was changed from the NPR to the Supervisory Guidance. We assume this same exercise will be repeated with the final rule and the final supervisory guidance. We found ourselves working to verify that no change had occurred in areas such as credit risk retail segmentation, commercial ratings, operational risk units of measure, correlation across units of measure, etc. If, on the other hand, changes to the rule did occur between the publication of the NPR and publication of the Supervisory Guidance, a clear delineation of those specific changes would be helpful given the size and complexity of the rule itself.

The Board of Directors is mentioned throughout the Supervisory Guidance and the NPR as an oversight body. We recommend that the specific requirements for Board-level approval be simplified and fewer (even one), more general requirements be put in place. As written, the Board reporting requirements appear excessive, not always appropriate for a Board-level discussion, and, possibly redundant. It is critical that our scarce Board review time is used effectively and mandating Board involvement in the details of Basel II is overly prescriptive. The Board and management should be given the flexibility to prioritize their focus areas. At least nine separate Board reports/actions are proposed to be required. These include (summary level):

1. Annually approve "advanced systems" – CR S 1-3
2. Annual Basel II report from Internal Audit – CR S 7-6
3. Approve implementation plan (one time) – NPR
4. Annually evaluate the effectiveness of AMA system – OR S-4
5. Annual reports summarizing independent validation results – OR S-32
6. Ongoing review of operational risk integration into business practice – OR S-5
7. Quarterly reporting on Operational Risk exposures and trends – OR S-10
8. Board Adoption of Formal Disclosure Policy – NPR
9. "Periodically" approve ICAAP and its components – Pillar 2

For example, a simple requirement for periodic updates on Basel II methods, results, and disclosures would allow the Board and management to prioritize their own focus areas among Pillars 1, 2 and 3, Credit risk vs. Operational risk, as well as methods vs. results. In addition, the Board and management could tailor the frequency of the updates to the degree of change or the urgency of the issues at hand. Finally, we suggest that internal audit's board reporting also be changed to periodic rather than annual again because the Board, with management and internal audit, should be allowed the flexibility to prioritize their focus areas and the frequency of these updates.

Specific Comments on the Supervisory Guidance

In the rest of this comment letter, we describe specific high priority concerns we have with the supervisory guidance. This list is not, however, meant to be comprehensive. For a more comprehensive list, we note that WaMu is participating with industry working groups such as the Risk Management Association ("RMA") capital working group and the RMA AMA working group in responding to the supervisory guidance. Those letters represent an even more detailed and comprehensive description of concerns associated with the Supervisory Guidance and WaMu has endorsed those responses. Only those concerns most important to WaMu or concerns not represented in other responses are included here. We have divided our concerns into 3 areas: 1) credit risk, 2) controls and validation, 3) operational risk, and 3) Pillars 2 and 3.

1) Credit Risk

a. Standard S2-6(25) (cross default in commercial) is not consistent with S 4-16(55) (homogeneity) for some types of asset-based lending, including Multifamily and Commercial Real Estate lending as practiced by our institution. As we noted in detail in our NPR response letter, other regulation such as single action laws render the failure of one property within an obligor legal entity relationship a very poor predictor of the failure of other properties within that same obligor entity relationship. Common PD and Cross Default are not appropriately applied and are inconsistent with homogeneity in rating risk characteristics in this instance.

For application of the capital model in Basel II, we believe the homogeneity principle should have clear precedence and common PD and cross default should be subordinate to this requirement. Forced application of S2-6, cross default, will result in many cases of zero loss defaults and, with this, artificially low LGDs and very low (artificially low) capital.

S 2–6(25) Banks must assign an obligor to only one rating grade. 25. At the bottom of any IRB rating scale is at least one default rating grade. Once an obligor is in default on any exposure to the subject bank, the obligor rating grade associated with all of its exposures to that bank will be the default rating grade—even for those exposures of the obligor that have not triggered any element of the definition of default.

S 4-16(55). Because different methods of aggregation are possible, a bank should have a clear and well-supported policy regarding how aggregation should be accomplished. Banks are required to have a quantification system in which the rating grades or segments are homogeneous with regard to risk; in this case, each obligor or exposure within homogeneous grades or segments would receive equal emphasis in quantification.

b. S 3-3.13. The 10% floor imposed on Mortgage LGD at a segment level will have a very different impact on each institution depending on how each institution's respective LGD segmentation system is defined. This will result in widely different capital levels for comparable risk levels across institutions. Less granular LGD segmentation schemes will benefit (even if no 'artificial' segmentation structure is developed). We propose either removing the LGD floor or applying the floor at a portfolio level rather than a segment level.

   For example, consider two institutions that have comparable portfolios and both use LTV, balance, product type, and geography as LGD segmentation attributes. One institution has 4 geographic segments used to differentiate long term housing volatility; another has 50 geographic segments to address variations in local foreclosure regulation as well as differing historical volatility. Neither segmentation is considered 'artificial' by the institution and each segmentation model and result can be independently validated. Application of the 10% floor to the more granular segmentation could easily result in dramatically higher capital levels vs. the less granular segmentation because diversification is allowed within segments, but not across segments in both cases. Again, we propose either removing the floor or applying the floor at a portfolio level instead of segment level.

S 3–3 A retail segmentation system must produce segments that accurately and reliably differentiate risk and produce accurate and reliable estimates of the risk parameters. 13. A bank should not artificially group exposures into segments specifically to avoid the 10 percent LGD floor for mortgage products. A bank should use consistent risk drivers to determine its retail exposure segmentations and not artificially segment low LGD loans with higher LGD loans to avoid the floor.

c. S 4-18 (70). While we appreciate the fact that the language regarding retail seasoning effects is becoming clearer, we are concerned that the guidance as written forces banks into a choice of either: 1) maintaining a duplicate capital reporting infrastructure (seasoning adjusted vs. non-seasoning adjusted) or 2) adding permanent conservatism to younger loans to avoid the cost of the duplicate infrastructure. The wording in the guidance acknowledges that when the age of the portfolio is relatively stable, no seasoning adjustment is needed. However, we can clearly envision some rare scenarios where the aggregate age of the portfolio can change rapidly and an adjustment would be needed on short notice. It appears that we would need to switch Pillar 1 approaches on potentially short notice. We suggest that this seasoning adjustment be completely removed from Pillar 1 and that it be part of an addition to Pillar 2, or, that wording that acknowledges application of a seasoning adjustment as quickly as feasible be added.

S 4–18 Effects of seasoning, when material, must be considered in the PD estimates for retail portfolios. seasoned exposures. 70. Even when age is a significant risk factor and default rates follow a characteristic age profile, seasoning effects may not be material if a retail exposure subcategory's age distribution is stable and the age distribution of the portfolio is not concentrated in unseasoned exposures.

2) Controls and Validation

a. S 7-6 (17). With regard to the prescribed internal audit review frequency defined in this standard, Washington Mutual believes that the use of the word "annual" as it relates to the IRB controls review is overly prescriptive and is not consistent with the accepted risk based audit approach executed by most Financial Services internal audit departments, especially if it implies that every control process and model validation linked to Basel II would be required to be reviewed on an annual basis by Internal audit. We suggest the word "periodic" would provide for more appropriate flexibility in accommodating control environment and validation reviews during business audits which are generally cycled based upon risk.

S 7-6 (17) Internal audit must, at least annually, assess the effectiveness of the controls supporting the IRB system and report its findings to the board of directors (or a committee thereof). 17. A bank must have an internal audit function that is independent of business line management and that assesses at least annually the effectiveness of the controls supporting the IRB system and reports its findings to the board of directors (or its designated committee). At least annually, internal audit should review the validation process including procedures, responsibilities, appropriateness of results, timeliness, and responsiveness to findings. Further, internal audit should evaluate the depth, scope, and quality of the independent review processes and conduct appropriate testing to ensure that the conclusions of these reviews are well founded.

3) Operational Risk

a. S 28. Given the potential for large variation in the capital requirement, we suggest making clear the analytical requirements for justifying correlation assumptions, specifically tests around "uncertainty and robustness" that could trigger large potential capital increases. Operational risk tail event data is far more limited than credit and market risk and such tests can be difficult to perform. The wording in the guidance seems to suggest that if this somewhat subjective demonstration fails, a 100% dependence assumption for correlations across all business lines and event types is required. This would be an extremely punitive assumption (and an assumption that would penalize granular units of measure vs. less granular). If such a pass/fail test is going to result in such a potentially large impact on capital requirements, we suggest a clearer description of the burden of proof for the uncertainty and robustness test aligned to industry practice of operational risk measurement and, in many cases, the more limited data sets of the operational risk measurement field.

S 28. The bank may use internal estimates of dependence among operational losses within and across business lines and operational loss events if the bank can demonstrate to the satisfaction of its primary Federal supervisor that the bank's process for estimating dependence is sound, robust to a variety of scenarios, and implemented with integrity, and allows for uncertainty surrounding the estimates. If the bank has not made such a demonstration, it must sum operational risk exposure estimates across units of measures to calculate its total operational risk exposure. . . A bank using internal estimates of dependence, whether explicit or embedded, must demonstrate that its process for estimating dependency is sound, robust to a variety of scenarios, and implemented with integrity, and allows for the uncertainty surrounding the estimates. To the extent a bank cannot support its process for estimating dependence, the bank must sum operational risk exposure estimates across its chosen units of measure to calculate the bank's total operational risk exposure.

b. S-27. While we agree with the spirit of the requirement that heterogeneous risk profiles should not be combined in a single distribution, we are concerned with the ambiguous burden of proof in the guidance. While all attempts are made to not combine heterogeneous risk groups, in business lines and loss event types with highly limited data, it is hard to both model individually and also have credible statistical proof of homogeneity. We suggest the guidance to reflect that individual circumstances will be evaluated not only to test for meeting the conditions but also for what the conditions for homogeneity need to be. These conditions should be based on reasonable data availability and supervisor judgment.

S 27. The bank must employ a unit of measure that is appropriate for the bank's range of business activities and the variety of operational loss events to which it is exposed, and that does not combine business activities or operational loss events with different risk profiles within the same loss distribution.

c. S 5. One of the newly added qualifying texts to Standard S 5 indicates a requirement of management to oversee a *flexible compensation policy to attract and retain competent operational risk expertise*. While we agree with the statement we believe it is overly prescriptive and unnecessary. Clearly, management should be given the discretion to use whatever attraction and retention mechanisms it sees fit. Much of the supervisory guidance text for this particular standard seems simply unnecessary and potentially overly prescriptive (e.g., ensuring accountability, reporting results regularly, etc.)

S 5. The board of directors and management should ensure that the bank's operational risk management, data and assessment, and quantification processes are appropriately integrated into the bank's existing risk management and decision-making processes and that there are adequate resources to support these processes throughout the bank. . . Other management responsibilities include ensuring that . . . Compensation policies are sufficiently flexible to attract and retain qualified and competent operational risk expertise;

4) Pillar 2

a. Paragraph 13 on ICAAP. As we and others have commented in our responses to the NPR, regulatory capital requirements should not be considered to be a '*greater of*' Pillar 1 or ICAAP/Pillar 2. Rather, ICAAP and stress testing should be used to inform a separate analysis regarding whether potential additions to Pillar 1 should be required under the course of the supervisory review. Both ICAAP and stress testing have no requirement for comparability either to Pillar 1, Tier 1 and Tier 2 physical capital definitions, or competitor's ICAAP practices. There is danger tremendous disparate competitive impact if this comparability to Pillar 1 is not specified as informal rather than an explicit.

ICAAP practices will diverge widely across institutions for reasons that should not necessarily lead to higher regulatory capital requirements. For example:

- At management's discretion, one institution measures interest rate risk (not part of Pillar 1) in a way that results in a very conservative ICAAP measure in comparison to peers. This is done while recognizing the wide range of industry practice in measuring interest rate risk.
- Another institution may target a much higher target debt rating in its own ICAAP process vs. peer institutions (e.g. it may use 99.97% solvency instead of 99.90% solvency).
- Another may use a definition of physical capital available (e.g., including a wide or narrow range of hybrid instruments) that is widely different from both competitor's practices and from Tier 1 and Tier 2 definitions.

Because ICAAP has been defined at a principles based level, we are interpreting it as an analysis used to inform the assessment of Pillar 1 requirements. However, we note that regulatory examination teams appear to be interpreting this as a 'greater of' requirement. This, of course, would lead to widely differing and inequitable regulatory capital treatment across institutions. The wording in the Supervisory Guidance should be clear on the intended use of ICAAP. It is not appropriately applied as a direct over-ride on Pillar 1.

Conclusion

WaMu remains very supportive of the goals of Basel II of aligning capital requirements with risk. We appreciate the opportunity to comment on the supervisory guidance standards and we understand that this guidance was not intended to advance policy-level concerns associated with the NPR, and it does not (e.g., alignment to mid-year text, other competitive inequities, the leverage ratio). We hope that the agencies will find our comments on the specific aspects of the guidance helpful as the rule is brought to completion in the very near future.

Sincerely,

John F. Robinson
Executive Vice President
Corporate Risk Management