MEMORANDUM

(9)

TO: Public File

FROM: Karen Osterloh, Special Counsel

DATE: June 15, 2006

RE: Basel II NPR
Summary of OTS meeting with Washington Mutual

Attendees

On May 9, 2006, the following individuals met at OTS headquarters in Washington, DC to discuss the Basel II NPR:

Washington Mutual Representatives
- Vi Johnson
- Shannon Kelly
- Michelle McCarthy
- John Robinson
- John Stewart

OTS Representatives
- Grovetta Gardineer
- Eric Hirschhorn
- Teresa Luther
- Karen Osterloh
- Fred Phillips-Patrick
- Roberta Renz
- David Riley
- Michael Solomon
- David Tate

Summary of Discussion

Status. OTS reported that the Basel II NPR will not be published in the Federal Register until OMB clears the rule, even though FRB made the document public at its March 30, 2006 open meeting. OTS emphasized that the other banking agencies have not as yet approved the NPR and that the agencies may make additional changes as a result of OMB and agency final clearance.

OTS hopes to publish the NPR by the end of June. The NPR will have a 120-day public comment period, which should overlap with the comment period for the related Basel IA NPR. OTS hopes to publish the Basel IA NPR in late summer.

In addition, OTS plans to publish a market risk NPR contemporaneously with the publication of the Basel II NPR. OTS's market risk NPR is to be issued jointly with the other agencies' update of their existing rules to reflect changes in the Basel Accord. The market risk rule is expected to have the same implementation schedule as the Basel II rules.

Program-Wide Issues

Parallel Run/Floor period. OTS clarified that core banks on the effective date of the final rule would use the existing "general bank" rules during the parallel run and floor periods, rather than the general bank rules as revised in the Basel IA NPR. As a result, it is unlikely that these core banks would make any changes to comply with the Basel IA changes. In any event, OTS anticipates that the agencies will not require any bank to move to the Basel IA rule, if it does not wish to do so.

Application at the entity level. WaMu asked whether each subsidiary depository institution must have separate reference databases and separate risk parameter estimation procedures, or whether the rule would permit the use of data and estimates prepared on a consolidated-entity basis. OTS clarified that separate data bases and processes are not required. However, the parameters and data used by an institution must be representative of the risks of the institution.

Supervisory Formula Approach (SFA). OTS verified that an institution may deduct a securitization exposure rather than produce a capital measure for the securitization under the SFA. OTS noted that the SFA formula may not adequately address partially guaranteed tranches.

Control and oversight. The banking agencies are developing internal guidance for determining whether an institution's validation process is sufficiently independent of its process for developing, implementing, and operating advanced systems and models. The underlying assumption is that the primary regulator will review and evaluate the institution's validation process, but will not validate models. OTS anticipates that it will look to the robustness of formalized processes and documentation as the touchstone of the review. OTS will expect greater independence for the validation process for those models that have greater materiality to the capital calculation, and will expect that individuals who worked on the development of a model will not be involved in its validation. In addition, institutions should have an internal audit function to review the validation process to ensure that it is operating as intended. The internal guidance on the validation process should be issued by the end of the summer.

Stress tests. OTS reported that the banking agencies are internally discussing the role of stress testing. Prescriptive stress test guidelines may be seen as a de facto capital requirement; however, the intention of the stress test is to reveal weaknesses in capital analysis. Similarly, stress testing may reveal to the extent to which an institution is exposed to business cyclicality, and thus may aid in capital planning.

Pillar II. WaMu was concerned that the agencies would permit a range of practices for computing the ICAAP under Pillar II. Because its approach is relatively conservative, WaMu feared that it would be placed at a disadvantage unless the agencies approach economic capital in a consistent manner. OTS noted that there is a wide range of acceptable practices, which may lead to significantly different results.

OTS opined that issues relating to the convergence of practices at the agencies and transparency between the regulators present formidable issues, but that the agencies hope to address these matters in the ICAAP guidance.

WaMu interpreted the Pillar I capital requirement as the minimum capital level. Therefore, it would appear that the ICAAP under Pillar II would be higher because it incorporates additional risks. WaMu indicated that these risks need not be cumulative, and that the agencies should permit internal models to account for inter-risk diversification. It stated that it would file a written comment on various Pillar II issues. OTS noted that the capital requirements under Pillar I include various assumptions, such as the assumption of infinite granularity, and that Pillar II was designed to account for the fact that these assumptions will not reflect actual practice. In addition, OTS opined that an institution may use different correlations in its ICAAP.

Mergers and acquisitions. WaMu noted that the proposed rules on merger and acquisitions did not address acquisitions consummated immediately before the beginning of the parallel run. OTS suggested that it would have the ability to interpret the rules to address this issue, but suggested that WaMu could raise this issue in its comment. OTS also invited WaMu to address such other matters as the appropriateness of the time periods in the proposed mergers and acquisitions rules.

Reputation and strategic risk. WaMu asked how they should account for reputation and strategic risk, which are not addressed by credit risk or operational risk capital measures under the NPR. OTS indicated that these risks would be taken into account in the ICAAP in Pillar II. Unlike certain other risks addressed under Pillar II (interest rate risk, concentration risk, and liquidity risk), OTS noted that it may be difficult to quantify a capital measure for strategic and reputation risk. Accordingly, like the guidance on complex structured transactions, OTS expects that the ICAAP guidance will require certain controls and management processes, and will state that the agencies will review each institution's analyses of risks and related controls and processes on a case-by-case basis. WaMu asked whether controls and processes alone would be sufficient for non-quantifiable risks. OTS responded that the matter is unsettled and invited WaMu to comment on the ICAAP guidance when it is proposed.

Disclosure (Pillar III). OTS confirmed that depository institution subsidiaries of a savings and loan holding company must make the full set of Pillar III disclosures (unless the institution is a subsidiary of another depository institution that must make the full set of disclosures). WaMu asked whether the proposed rule would permit disclosure at the consolidated savings and loan holding company level, as is permitted for bank holding companies. WaMu noted that consolidated disclosures would be more useful to its investors, who hold holding company rather than thrift stock.

Disclosure Table 11.5 requires a comparison of actual risk parameter estimates to predicted risk parameters. WaMu noted that there are many circumstances (point-in-time versus through-the-cycle) where actual and predicted result would diverge, and that the required disclosure could mislead some investors to conclude that the differences are indicative of shortcomings in the models. OTS and WaMu discussed whether the disclosure of long-term measures could mitigate this problem.

OTS urged WaMu to work with others to comment on these issues and other disclosure issues including the comparability of disclosures, the disclosure of proprietary information, and alternatives to disclosure of stress PD. WaMu indicated that it would file a written comment on this issue.

2008 Readiness. WaMu asked whether the agencies will tolerate imperfection or error after the parallel run begins in 2008. OTS expects that institutions will develop implementation milestones so that they will have operational models in place at the beginning of the parallel run, but that this would not preclude model adjustments during the parallel run and floor periods.

Use test. Under the NPR, systems and processes used for risk-based capital purposes must be consistent with the institution's internal risk management information reporting system. WaMu asked how to reconcile this "use test" with its more sophisticated economic capital models. OTS indicated that the use test was not intended to apply prescriptive requirements, although the regulators may require the use of the same data and risk drivers. Although processes can differ, the guiding principal is that models should be directionally consistent.

WaMu noted that its economic model provides a PD rating for each wholesale exposure. By contrast, the NPR requires one rating for each obligor. OTS noted that the institution's ratings system may not contradict the Pillar I rating, and must be consistent with risk management practices. OTS suggested that WaMu could include a detailed discussion of their concerns in their comment.

Retail Exposures

Overdrafts. OTS clarified that undrawn overdraft protection is generally a service, but that overdraft lines of credit generally are qualifying retail exposures.

Default (Retail). The proposed definition of default (wholesale) includes a credit-related loss on 5 percent or more in connection with the sale or transfer of the exposure. This provision is not included in the proposed definition of default (retail). WaMu was concerned that institutions may sell retail loans immediately prior to triggering another aspect of the retail default definition (i.e., immediately before the loans are 120/180 days past due), and evade treatment of the sale as a default. OTS indicated that the guidance would provide that if an institution regularly sells retail loans prior to default, they must take these loans into account in the estimation of risk parameters.

Seasoning. Where seasoning is material, PDs for non-defaulted retail segments must be the annualized cumulative default rate over the expected remaining life of the loan (on an over the cycle basis). However, an exemption is made for the mortgage banking business where loans are routinely sold soon after origination.

Segmenting. OTS verified that an institution could segment by parameters used in loan-by-loan scoring (i.e., custom scores, refreshed FICO scores) where the underlying scores use continuous explanatory variables. WaMu also asked how OTS could prevent an institution from artificially grouping low LGD loans with high LGD loans to avoid the 10% LGD floor for residential mortgage exposures. OTS observed that the rule may remove the incentive to create a granular LGD segmentation process, and urged WaMU to comment on this issue.

Wholesale exposures

Default (wholesale). The definition of default (wholesale) states that an obligor is in default where the bank has taken a full or partial charge off or write-down on an exposure due to the obligor's distressed condition. WaMu asked whether there was a materiality threshold for charge-off or write down. OTS indicated that the guidance would address this issue and that the agencies were considering a 5% threshold based on the outstanding exposure. WaMu indicated that this guidance might require changes to their models.

Default also includes a "credit-related" loss of 5 percent or more in connection with a sale of the loan or a transfer of the loan to another reporting category. WaMu opined that it would be difficult to back out credit-related losses, particularly on a historical basis, and that they would address this issue in their comments.

Probability of default. Under the NPR, an institution would assign a single PD rating to each wholesale obligor. WaMu argued that this approach does not accurately reflect credit risk for wholesale exposures, particularly exposures secured by income producing real estate. It observed that the likelihood of default for these exposures depends significantly upon the cash flows from the properties. Moreover since many transactions are made without recourse to the obligor, WaMu argued that we should not assume that there will be cross-collateralization across properties, or that cash flows will be diverted from other properties to support a failing property. WaMu indicated that common influences on default risk such as local real estate markets or property management should be considered as direct factors in the rating of individual properties. WaMu indicated that it would file a written comment on this issue.

Multifamily residential properties. Under the NPR, residential mortgage exposures include multifamily properties of less than $1 million that are managed as a part of a segment of exposures, not on an individual basis. WaMu asked OTS to clarify when a loan is managed on an individual basis. OTS stated that management on an individual basis envisioned a transaction-by-transaction customization of the loan.

Maturity. The NPR defines effective maturity for many wholesale exposures as the weighted average maturity of expected contractual cash flows from the exposure, using undiscounted amounts of the cash flows. WaMu argued institutions should be permitted to consider the likelihood of prepayment and discounted cash flows in their estimates of the effective maturity.

Defaulted assets. WaMu opined that the description of the capital charge computation for defaulted exposures did not consider charge offs of defaulted exposures. It was suggested that the agencies revise this provision to refer to the pre-default capital charge as a rate, rather than as an amount.

Under the NPR, the expected credit loss (ECL) for defaulted exposures is equal to the institution's ALLL impairment estimate. WaMu noted that the use of the ALLL impairment estimate was likely to increase, rather than decrease, implementation burdens. OTS suggested that WaMu may wish to comment on this issue.

RTCCRI Act. OTS clarified that the statutorily prescribed risk weights for multifamily loans would apply only where a loan meets the definition of qualifying multifamily loan. For example, if the loan has a term to maturity of less than 7-years it would not be subject to the statutory 50% risk-weight, but rather would be risk weighted using the institution's models.

Operational Risk

Expected operation loss (EOL). Under the NPR, EOL may be deducted from required capital for business lines and event types that have highly predictable and routine losses. OTS clarified that eligible operational risk offsets include but are not limited to reserves. Other eligible operational risk offsets include amounts that are generated by internal business practices that provide predictable and stable cash flows to absorb predictable and stable operational losses. OTS indicated that this is a high standard and that non-reserve offsets would probably be permitted only for high frequency, low severity events such as credit card fraud or processing errors. WaMu stated that external fraud losses in their deposit accounts have exhibited the required characteristics of predictability and stability and asked if they might qualify for EOL offset. OTS opined that they could if WaMu could demonstrate that the losses and the business practices to provide the offset meet the standard.

WaMu asked whether the source of the amounts generated by internal business operations must be tied to the loss. For example, would an institution have to track credit card margins to losses. OTS opined that if you budget or price for the amount, you should be able to point to where it is generated.

Alternative Approach: WaMu requested clarification on when the alternative approach to measure operational risk exposure would be available. OTS clarified that the alternative approach is for institutions with multiple insured depository institutions. The general principal has been that each significant depository institution must have a standalone AMA because corporate separateness bars a receiver of a failed depository institution from access to capital at affiliated corporations. However, the cross-guarantee provisions of the FDIA give the FDIC access to capital at affiliated insured depository institutions, so the U.S. is offering the alternative approach to individual affiliated insured depositories. An AMA would be required to estimate operational loss exposure at the aggregate depository institution level, but alternative approaches could be used at the individual institutions to allocate the AMA capital among the depository institution affiliates.

Unit of measure. Under the NPR, the unit of the measure is the level (for example, organizational unit or operational loss event type) at which the bank's operational risk quantification system generates a separate distribution of potential operational losses. An institution must demonstrate that its "unit of measure" is appropriate for the bank's range of activities and the variety of operational loss events to which it is exposed. OTS clarified that the unit of measure concept was designed to prevent an institution from mixing high risk and low risk activities, and should generally reflect major business segments. OTS anticipates that data limitations will lead most institutions to start out with a fairly low number of units of measure and increase the granularity of their quantification systems over time.

Annual evaluation. The agencies expect boards of directors to evaluate the effectiveness of the bank's advanced systems at least annually. OTS indicated that it does not expect the board to perform an annual in depth review of the model. Rather, it expects the board to review the overall risk management structure and clarified that this an oversight function where the board makes sure that the overall structure is in place and an audit function is in place, etc.

Expected comments

WaMu indicated that it would comment on the following additional areas:

- The proposed 1.06 multiplier. OTS noted that the 1.06 multiplier was designed as a placeholder, that the multiplier may be revised as data becomes available during the parallel run, and that the agencies will conduct ongoing review until we have a robust estimate for the multiplier.
- How retention of the leverage ratio will create perverse incentives under Basel II.
- Whether the asset value correlations used in the various formulae are appropriate, and whether there should be a range of AVCs for different assets.