WORLD SAVINGS

January 18, 2006

Federal Reserve Board
Docket No. R-1238
regs.comments@federalreserve.gov

Office of the Comptroller of the Currency
Docket Number 05-16
regs.comments@occ.treas.gov

Federal Deposit Insurance Corporation
comments@fdic.gov

Office of Thrift Supervision
No. 2005-40
regs.comments@ots.treas.gov

RE: Comment on Joint ANPR for Proposed Revisions to the Existing Risk-Based Capital Rules

Ladies and Gentlemen:

With $125 billion in assets, World Savings is one of the nation's 15 largest banks and thrifts. We are a residential mortgage portfolio lender, and our comments on the proposed revisions to the existing risk-based capital rules (commonly referred to as "Basel IA") will mostly focus on those aspects of Basel IA with which we have direct business experience.

Overview

As we have stated in our prior correspondence on Basel II, we favor simplicity, fairness and transparency when it comes to capital regulations. Having witnessed, and survived, various financial crises in the past decades, we are acutely aware of the importance of capital to the viability of financial institutions. Accordingly, we have a strong bias in favor of regulations that ensure that institutions maintain adequate capital to provide a cushion against the primary risks associated with being a depository institution – namely credit risk, interest rate risk, and liquidity risk – and to also provide protection from mistakes and unanticipated events.

We believe Basel IA's approach of making incremental changes to Basel I is vastly superior to Basel II's complex, ill-conceived and data-deficient muddle. We are certainly not alone in believing that Basel IA should be the U.S. response to Basel II – our nation's "standardized approach" – and that Basel II's Advanced Internal Ratings Based approach (A-IRB) should only be used by institutions for internal management purposes rather than for determining what is needed to protect an insured depository institution and its various stakeholders, the FDIC insurance fund and, ultimately, the U.S. taxpayer.

We remain concerned, however, that Basel IA itself could become unnecessarily complex in its pursuit of more "risk sensitive" solutions. Although we support the general notion that capital requirements should correlate with risk levels, regulators should be cautious not to adopt changes that reduce simplicity or comparability, that shift capital regulations away from a safety and

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soundness framework to a hedge fund model focused on risk-adjusted returns, or that otherwise create incentives for institutions to find ways to inappropriately game the system.

While some incremental improvements to Basel I may be appropriate, regulators should be mindful that Basel I's rules are simple enough to be understood by all interested parties, it has substantially leveled the playing field for banks that compete under different regulatory systems, and it has a 20-year track record of not creating or exacerbating any crises. The U.S. banking system has proven that it can compete, and thrive, under a simple and conservative risk-based regime like Basel I, notwithstanding the somewhat arbitrary thresholds. The table in Exhibit A shows that the U.S. had 21 of the top 100 global banks at the beginning of 2005, and these U.S. banks had higher levels of capital and Return on Assets than the top banks in almost all other countries and still achieved among the highest Return on Equity of any major industrialized country. The table also reveals that some countries achieved high ROEs simply by holding very little Tier 1 capital – certainly not a practice we would endorse.

We recommend that Basel IA be guided by the goal of making a few incremental improvements to Basel I to make it more risk sensitive without sacrificing simplicity and without permitting inappropriate reductions in capital.

The Leverage Ratio

We strongly agree with the position articulated in the ANPR that the existing leverage ratio requirements should be maintained, including the prompt corrective action statutes and implementing regulations enacted following the banking failures in the 1970s and 1980s. These regulations, which have served our banking system well, require a minimum 5% leverage ratio for a bank to be classified as "well-capitalized." Nearly all U.S. banks have been able to maintain the 5% threshold in the past two decades, and there is no doubt that the U.S. banking system has been stronger for it.

Nonetheless, we anticipate that, either now or in the future, some special interest groups will lobby bank regulators to reduce or eliminate the leverage ratio on the grounds that: (i) the leverage ratio is incompatible with a risk-based system, (ii) the leverage ratio will motivate lenders to "top off" their balance sheets with riskier assets, or (iii) U.S. banks are allegedly disadvantaged because their foreign counterparts are not subject to a leverage ratio. None of these arguments is persuasive, and each should be rejected based on safety and soundness considerations, as discussed below.

Incompatibility

Seasoned bankers, legislators and regulators who lived through prior bank crises wanted a fixed leverage ratio because they did not trust a risk-based system by itself. The minimum leverage ratio was to be the foundation of the U.S. capital regime, with Basel I's risk-based rules being a supplemental layer and an accommodation to achieve some degree of international uniformity. The leverage ratio was designed to ensure that a base level of capital was available even if mistakes or manipulations of the risk-based rules occurred, and it was also intended to compensate for the omission of interest rate risk from risk-based capital regulations. Former

FDIC Chairman Bill Isaac recounted some of the history that led to a 5% leverage ratio in his November 10, 2005 testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs. He noted that, after the Federal Reserve and FDIC stepped in to prop up a collapsing and undercapitalized Continental Illinois, then the eighth largest bank in the country,

> "[t]he regulators quickly agreed that no bank, no matter how seemingly strong and well run, would be allowed to maintain less than 5% tangible equity to assets."

The prosperity U.S. banks have experienced in the past decade is in no small part due to their high capital, and legislators, regulators and bankers should not be lured into eliminating or reducing what has helped create today's stronger banking system simply because of the favorable economic environment of recent years. Former FDIC Chairman Bill Seidman echoed this sentiment in his November 10 testimony before the same Senate committee:

> "My experience taught me that the minimal equity ratios prior to the banking crisis, then around 4 percent in large banks, were grossly inadequate for the problems that followed. At least two of our largest banks would have failed if there had been the slightest reduction in capital minimums...I fear that using the extraordinarily benign recent period to calculate future risk will result in banks that are systematically undercapitalized when troubles arise."

As we have stated previously, we believe there should be legislation or binding provisions that would prohibit the leverage ratio and prompt corrective action triggers from being reduced or waived, if ever, without some high level of review and action, possibly an act of Congress.

Topping Off

The argument that we sometimes hear that continuing the leverage ratio will encourage a topping off with riskier assets is a curious one, and essentially says that some banks will load up on assets that require high risk-based capital in order to make sure their aggregate risk-based capital levels are not lower than the minimum leverage requirement. In our experience, any bank that makes its business or product decisions based principally on the capital impact, rather than a sound analysis of profitability and risk, is bound to eventually lose money, should be a red flag to regulators, and only reinforces why regulators need to maintain the leverage ratio. Banks that run their business that way are likely to have much bigger problems than the leverage ratio.

In addition, if such behavior is a concern because regulators believe high risk assets could be held on bank balance sheets with inadequate capital, then perhaps some of those high risk assets deserve higher risk-weights. Otherwise, support for the "topping off" argument implies the whole risk-based capital system is substantially flawed and should be discarded.

International Competitiveness

While the argument about U.S. competitiveness vis a vis foreign banks has a certain nationalistic appeal, what it seems to really be saying is that our bank regulators need to allow U.S. banks to hold the same low levels of capital that other countries permit for their banks. That is hardly a declaration of safety and soundness. If a bank is willing to give up its FDIC insurance and direct access to the U.S. payment system, maybe it should be allowed this leeway, but not otherwise.

In addition to the benefits of FDIC insurance, there are other differences between U.S. and foreign bank regulatory systems. Most bank systems abroad lack the strong regulatory features that we have in the U.S., such as a leverage ratio requirement and active and informed regulators backed by the protections of prompt corrective action. While U.S. regulators place full-time on-site examiners at our largest banks, many comparably sized banks abroad are examined only sporadically and without anywhere near the same thoroughness. U.S. banks have been extremely sound and profitable since the adoption of strong regulatory capital regulations in the late 1980s, including the leverage ratio and prompt corrective action regulations. Of course, during that same period we witnessed the collapse of many foreign banks that were subject to lower capital standards and regulatory oversight. We think the correlation between capital levels and performance is more than a mere coincidence. In light of this, it certainly appears inappropriate and unnecessary for the U.S. to weaken its regulatory framework. U.S. bank regulators should insist on maintaining our high national standards and encouraging international banking systems to do the same.

All of the arguments about the problems of the U.S. leverage ratio are essentially statements that the leverage ratio might be a constraining factor for U.S. banks. Maybe we are old-fashioned, but we always thought that capital and the leverage ratio *should be* a protection against excessive growth and risk. One of the primary lessons from prior bank crises is that capital does matter – those who have it survive, and those without it struggle or disappear and in the process cause great harm to customers, employees, communities, surviving banks that bear the political and economic costs, regulators, the FDIC, the U.S. financial system, and ultimately the U.S. taxpayer. This lesson must not be forgotten or, as they say, we will be doomed to repeat it.

Residential Mortgages

We now turn to some of the specific items raised in the ANPR for Basel IA relating to one- to four-family residential mortgages.

Additional Risk-Weight Categories for Mortgages

The ANPR suggests using more, and lower, risk-weight categories for mortgages based on the loan-to-value (LTV) ratio. Since the LTV ratio has historically been a strong indicator of risk, some additional bifurcation of risk-weights based on LTVs may make sense beyond the 50%/100% split under existing Basel I rules. However, we would caution regulators that adding too many risk-weights increases complexity and additional incentives for gaming of LTV calculations. We believe the likelihood of gaming would increase with more, and significantly lower, risk-weight categories or when lenders are experiencing difficulties.

Additional tools that can facilitate gaming have increased significantly in recent years. The use of some new credit enhancements (e.g., credit default swaps, collateral guarantees) and shortcut appraisal methods (e.g., automated valuation models and drive-by appraisals) has proliferated in the past decade, and regulators should be concerned that vendors will aggressively market these and other approaches to banks as a way for banks to obtain lower risk-weights. With the variety of product options available today, we expect many banks would seek creative ways to shift nearly all their mortgages to the lowest risk-weight category the regulators permit. To address these concerns, we recommend that regulators restrict or carefully scrutinize the use of shortcut appraisal methods (as discussed further below) and also limit the benefit banks can achieve when using credit enhancements to a single risk-weight category improvement. This would mean that a loan in a particular risk-weight category could drop to the next lowest risk-weight category with credit enhancements, but could not drop any further. In fact, a strong argument could be made that credit enhancements should only allow a reduction from the 100% risk-weight to the next lowest risk-weight category, and that no other reductions should be permitted.

Although there can certainly be ample debate on the proper risk-weights to assign to mortgages, we believe more thought has to be given in particular to the lower end of the risk-weight range. We think a risk-weight of 20% is inappropriately low, particularly when considering that 20% corresponds to a capital ratio of only 1.6%, which is lower than where the savings and loan industry was in the 1970s and 1980s before the collapse. Of course, even this 1.6% capital level could be manufactured with just 0.8% of Tier 1 capital (which could include qualifying trust preferred and other items in addition to tangible common equity) and 0.8% of Tier 2 capital (which could include qualifying subordinated debt and other items). Although ivory tower theoreticians can always come up with a model justifying a 20% risk-weight, those of us who have been making real-world decisions about risk for decades find the 20% level absurdly low.

Based on what we have seen in the mortgage markets over time, we strongly disagree with the sentiment expressed by some other industry participants that a 50% risk weight (corresponding to a capital ratio of only 4%) imposes an excessive risk-based capital requirement for many mortgages. If a reduction below a 50% risk-weight were permitted, we would not support going below 35%. We also would only allow reductions in capital beyond what is permitted under current rules provided the existing leverage ratio is maintained as an absolute protection against insufficient capital.

Accordingly, we suggest some changes to the risk-weight segmentation presented in the ANPR. In doing so, we are trying to add some greater sensitivity while still keeping the system simple and legitimate.

Current Basel I Standard

LTV Ratio	Risk Weight
90.01-100	100%
≤90	50%

ANPR Illustration

LTV Ratio	Risk Weight
91-100	100%
81-90	50%
61-80	35%
<60	20%

What We Recommend

LTV Ratio	Risk Weight
90.01-100	100%
80.01-90	75%
65.01-80	50%
<65	35%

Updating LTVs with Reappraisals

In our view, the LTV ratio should be based on the original appraisal obtained at origination, unless a full appraisal involving an in-person inspection of the property is subsequently obtained and is in connection with a new, independent transaction such as the addition of a second mortgage or a refinancing.

In our experience, the quality of the appraisal is critical, and we would support a rule requiring that a traditional full appraisal be obtained in order to adjust the LTV ratio for capital purposes. We are less confident about the quality of other shortcut appraisal methods, such as black box automated valuation models (AVMs), estimates of regional price changes published by regulators or others, or drive-by appraisals. We think it is more difficult for regulators to monitor the use and accuracy of these shortcut methods, and there is a greater potential for gaming than with a traditional full appraisal. We would encourage rigorous examinations to evaluate the quality of these other appraisal methods, and particularly so when lenders may be using shortcut appraisal methods as a way to justify holding less capital.

We do not believe that lenders should be required or encouraged to reappraise properties regularly, since a good up-front appraisal is probably the best method for determining capital levels, and regularly conducting full appraisals for an entire portfolio would be difficult and prohibitively expensive. If the regulators should decide to require or allow reappraisals, however, three key issues need to be addressed: (i) will lenders be required or allowed to selectively reappraise loans or will they need to reappraise the entire portfolio, (ii) will lenders be required to also reappraise when home prices decline, and (iii) what type of appraisals will be permitted.

Use of Credit Scores or Debt-to-Income Ratios

We think using credit scores or debt-to-income ratios to determine capital levels would create unnecessary complexity without adding a meaningful benefit over using LTVs alone. In our experience, neither measure is as reliable an indicator of credit risk as the LTV. Credit scores have been used broadly for mortgages only during the last decade or so, which has been a period with low credit losses and strong price appreciation. The scores have therefore not been tested in a stressed mortgage environment. More important, credit scores can change quickly and differ widely from one credit agency to the next, in many cases by as much as 100 points or more. Debt-to-income ratios suffer from serious problems as well, since they are only snapshots at a point in time, the accuracy of which is uncertain. The debt ratios will be of limited utility over time, and they would be impractical to update and questionable in their accuracy.

Due to these concerns, we would not recommend using credit scores or debt-to-income ratios for capital purposes. However, if the regulators permit their use, lenders should first demonstrate that they have sufficient experience using credit scores and debt-to-income ratios to evaluate the credit risk in their portfolios and that there is a statistically significant historical correlation between these alternative measures and their losses.

Mortgage and Pool Insurance

We agree that the traditional use of mortgage and pool insurance provides an additional layer of protection for mortgage lending with LTVs above 80%. However, if economic conditions were to result in banks experiencing significant losses on mortgages, it is quite likely that mortgage insurance companies would simultaneously be under stress. Problems at an insurance company would only exacerbate the capital-constraints of banks and the FDIC insurance fund, both of which were counting on the insurance company being a "supplier" of capital. In light of this concern, we reiterate our prior recommendation that mortgage lenders only be allowed to improve the risk-weight by a single category when using mortgage insurance.

The ANPR also discussed the use of portfolio or pool-level insurance. Although pool insurance can be structured in a number of ways and the terms of the insurance can impact the effective coverage of the loans in the pool, it is clear that pool insurance provides more protection than having no insurance at all. Since regulators might be cautious about assigning a value to pool insurance that is equivalent to loan-level insurance, perhaps a proportionate value could be assigned based on the percentage of the loan pool with effective coverage, or regulators could place a ceiling on the value assigned to pool insurance (e.g. half the value of loan-level insurance) that would be subject to examination and would be reviewed from time to time as more experience with pool insurance is obtained.

Specific Mortgage Products

We believe all residential mortgages should be governed by the same capital standards. A risk-weight matrix based on LTV ratios should generally be the main factor regardless of the loan product, *as long as loans are properly underwritten, appraised, and managed.* The italicized language in the preceding sentence is critical, and regulators always have the discretion and responsibility to impose higher capital charges if a lender's underwriting, appraisal or other practices are inadequate.

We intend in the coming weeks to provide additional views on ARM lending in response to the recently issued proposed guidance on what the agencies refer to as "non-traditional mortgage products." However, some background in this response letter is appropriate since there is relevance to the capital regulations.

We are in a unique position to discuss ARMs with borrower payment options (so-called "Option ARMs") because we have been originating the loan since 1981, when our regulator first authorized ARM lending after fixed rate lenders were on the brink of collapse due to the interest rate risk associated with borrowing short and lending long. For some time before 1981, we and other major financial institutions in California and throughout the country, trade groups and others began to study the various forms of adjustable rate mortgages. At the end of the day, there were essentially two main structures, the Option ARM that gives borrowers payment options and permits negative amortization, and the "No Neg" ARM that does not allow for negative amortization and can cause payments to adjust as interest rates change.

After we and others ran thousands of simulations of both types of ARMs, all the major residential portfolio lenders on the West Coast, and various others throughout the country, chose the Option ARM because it was structured with annual payment caps and allowed borrowers to defer interest and incur negative amortization to protect against payment shock. Our simulations demonstrated that the No Neg ARM posed significant concerns about early, and continuing, payment shock to the borrower. Experienced lenders were concerned that by using the No Neg ARM, we might have greater interest rate risk and the potential for more serious credit risk problems. Since we were all portfolio lenders – that is, we originated loans and held them in our portfolios – it was imperative that borrowers have a loan that worked for them. In essence, what all of us were trying to do was find a loan product that at the same time worked for the borrower and could be held in portfolio without a recurrence of the interest rate risk disaster of the 1970s and early 1980s.

The Option ARM has been our core product since 1981 and now comprises 99% of our portfolio. We have been originating these loans, and with extremely low losses, throughout interest rate cycles, recessions and home price changes. Our average annual chargeoffs in the quarter century we have been originating the loan is less than 5 basis points. Year-by-year details are attached in Exhibit B. Our record of chargeoffs during the past 25 years is lower than virtually every other depository institution of size, including institutions that have only made fixed-rate loans. We are also unable to identify a single delinquent loan, much less a foreclosure or loss, due to the structure of the Option ARM product. As this history suggests, Option ARM loans that are properly underwritten, appraised and managed are not inherently riskier than other loan products and therefore should not require any additional capital.

For virtually all of the past 25 years, we and other residential mortgage portfolio lenders with years of experience with the Option ARM limited the difference between the starting payment rate and the fully indexed rate (sometimes referred to as the "payment discount"). We did this because simulations showed that the key risk to the borrower and the lender was an excessive payment discount, and that a loan with a starting payment rate 500 basis points lower than the fully indexed rate is significantly more risky than a loan with a 250 basis point payment discount, especially in a rising rate environment. This is because a deeper payment discount results in greater levels of negative amortization and a greater potential for payment shock when the loan is reamortized.

The capital regulations should not assume that lenders who sell Option ARMs with deep payment discounts into the securitization market are immune from the associated credit risks. If an originator's disclosures or representations in connection with the secondary market sale prove to be inadequate or inaccurate, the loans are likely to be put back to the originating lender. Equally if not more important, to handle loan workouts, for a variety of legal and practical reasons, the originating lender may first have to buy back the troubled loans and hold capital for the nonperforming loans. In addition, litigation by borrowers may force originators to repurchase the loans, as will the reputational risk of losing access to the secondary market if troubled loans are not repurchased. All of this suggests there could be a greater need for capital for deeply discounted Option ARMs and there is a high risk of implicit recourse when Option ARMs with deep payment discounts are sold.

In light of concerns with deeply discounted Option ARMs, we would recommend that the regulators address the risk that originators may have to repurchase the loans out of securitizations in their implicit recourse regulations, much as they have proposed doing in the ANPR to address the early amortization feature of securitizations of revolving credits like credit cards.

50% Risk-Weight for All Mortgages

If Basel IA uses risk-weights below 50% for mortgages with lower LTVs, we would support a rule allowing lenders to forego the lower risk-weights and assign a 50% risk-weight for their entire portfolio of mortgages. If this were permitted, however, regulators may want to allow lenders to use the 50% risk-weight for their entire mortgage portfolio only if the lender is well-capitalized and the lender's mortgage portfolio has a weighted average LTV below a threshold, such as 80%.

Other Issues

Continued Use of Basel I

We question the usefulness of banks being allowed to continue using the existing Basel I standard after Basel IA is adopted. We believe that Basel IA should become the standard for all U.S. banks. If multiple standardized capital regimes were permitted, this would foster confusion and permit less comparability across institutions.

Use of External Credit Ratings

We think the regulators should be cautious about being too dependent on rating agencies to determine appropriate capital levels for certain recourse obligations and mortgage-backed securities (MBS). While it may be appropriate to continue to use credit ratings for debt or other instruments that are sufficiently well-understood, we question whether it is appropriate to delegate to the credit rating agencies the determination of regulatory capital levels for MBS and other complex instruments. Rating agencies have been criticized for reacting too slowly during crises, and the complexity of some instruments may delay a rating agency response. In addition, we think there is a high potential for gaming when virtually any asset can be churned through a securitization and transformed into a AAA-rated asset, and when a multi-billion dollar industry is all too eager to facilitate this alchemy.

In addition, we continue to believe a 20% risk-weight is too low, particularly since virtually any asset, irrespective of its quality, can be turned into a AAA or AA security. Consistent with our view on individual mortgages, we think a 35% risk-weight should be the lowest level permitted. We also question whether single-A rated exposures should be granted a risk-weight even as low as 35%.

Multifamily Residential Mortgages

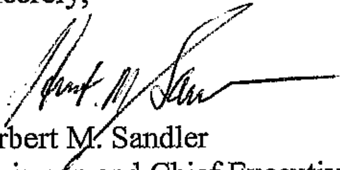
The ANPR also discusses multifamily residential mortgages, and asks if some multifamily loans should be eligible for a lower risk weight than is currently permitted. We do not see an

imperative to permit lower risk weights and are satisfied with the current OTS regulations in this area.

Conclusion

Overall, we commend the regulators for proposing an approach to capital regulation that is more simple, fair and transparent than Basel II, and for committing to maintain the existing leverage ratio. We hope that Basel IA can achieve a greater level of risk sensitivity without adding complexity or permitting substantial reductions in capital. In the end, we believe that a well-structured Basel IA can, and should, become the standardized approach that would apply to all U.S. banks.

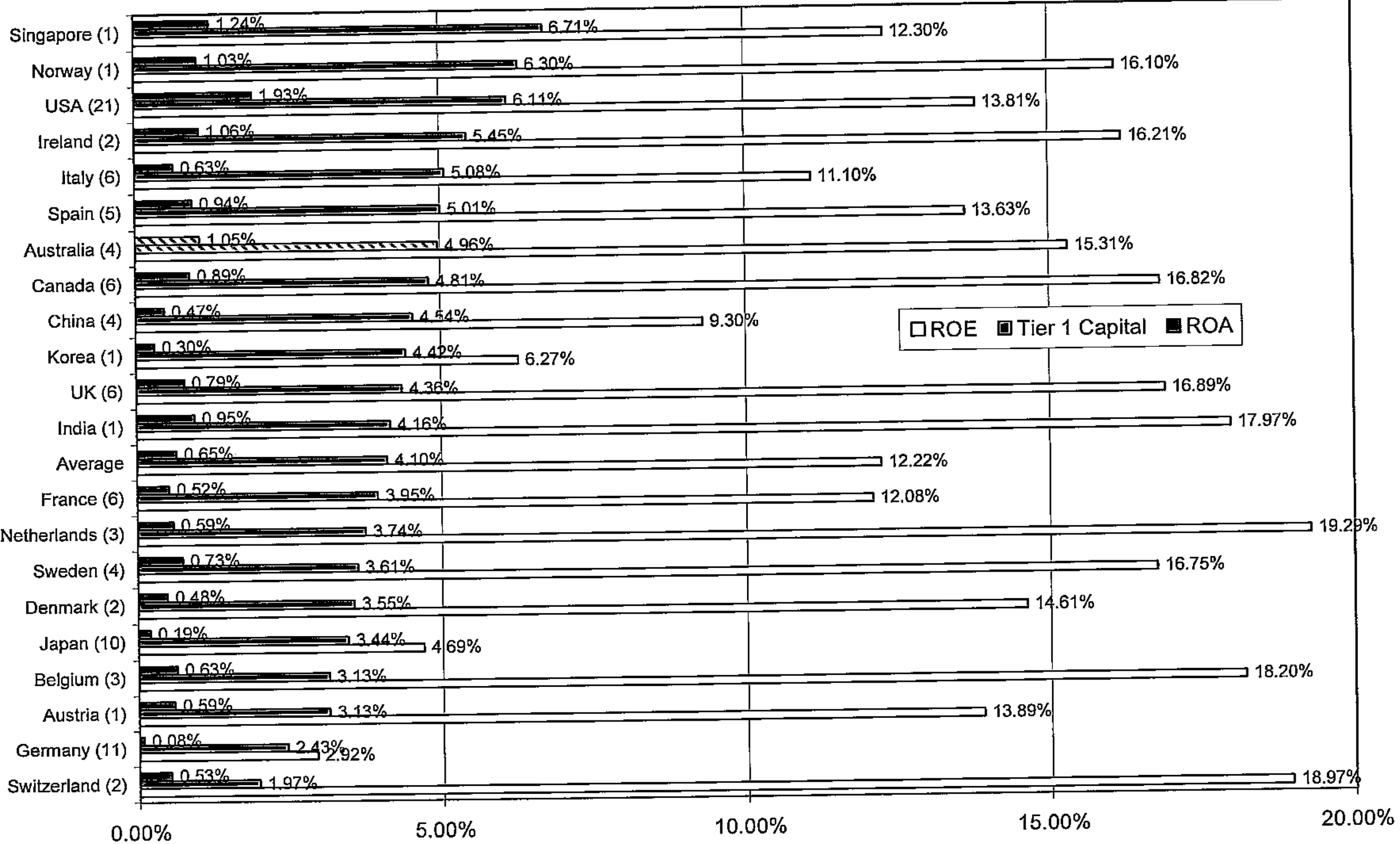
Sincerely,



Herbert M. Sandler
Chairman and Chief Executive Officer

EXHIBIT A

Tier 1 Capital Ratio, ROA, and ROE Performance Measures for the Top 100 Global Banks



Tier 1 capital ratio as reported in the July 2005 edition of "The Banker", an international finance magazine. The top 100 banks are determined by "The Banker" based on amount of tier 1 capital. ROE and ROA from BankScope, a database of data on private and public international banks. All numbers as of December 31, 2004.

EXHIBIT B

Average Annual Chargeoffs Since 1981 for
Golden West Financial Corporation (parent of World Savings Bank)
on a consolidated basis

	Chargeoffs as a % of Average Loans Outstanding (in basis points)
1981	-1
1982	-1
1983	-1
1984	0
1985	3
1986	10
1987	8
1988	6
1989	4
1990	7
1991	7
1992	9
1993	16
1994	18
1995	15
1996	10
1997	6
1998	0
1999	-1
2000	0
2001	0
2002	0
2003	0
2004	0