January 26, 2006

Regulatory Comments
Chief Counsel's Office
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Washington, DC 20552

Attention: No. 2005-40
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Ms. Jennifer J. Johnson, Secretary
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Attention: Docket No. R-1238
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Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
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Attention: No. 05-16
regs.comments@occ.treas.gov

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications
70 FR 61068 (October 20, 2005)

Ladies and Gentlemen:

Washington Mutual, Inc. ("WaMu") greatly appreciates this opportunity to provide our comments with respect to the U.S. Banking Agencies' Advance Notice of Proposed Rulemaking ("ANPR") dealing with proposed revisions to the basic Basel Accord capital regulations (as issued in the Federal Register on October 20, 2005). As you may know, WaMu is one of the largest banking institutions in the country. We provide both retail and wholesale banking services. Almost one-half of our assets consist of residential mortgage-related credits. We are also the single largest servicer of mortgages in the U.S.

The proposed revisions would, in the main, *not* be applicable to WaMu and other so-called Basel II AIRB institutions. However, since the proposed revisions would apply to all other U.S. insured depository institutions, the effects of the proposals on economic

efficiency and competitive equity are nevertheless very important to us and to our customers.

We believe strongly that the capital rules that apply to most banks can and should be substantially improved based on what the regulatory community has learned in Basel. We continue to provide strong support for the Basel II process. We believe the Basel II changes are absolutely necessary to address several major problems with the old Accord – problems that make the regulators' jobs more difficult and problems that lead to competitive inefficiency in the U.S. markets for various financial products. In this response, we offer our views on the new proposals in the spirit of continued cooperation with U.S. banking agencies to help craft a set of capital regulations that, for all banks, would achieve the following goals: a) be more risk-sensitive, b) be more efficient in achieving the main regulatory goal of limiting bank failure to some acceptable level, c) be more closely aligned to best-practice estimates of credit risks and other risks, and d) be more effective in reducing or eliminating instances in which minimum capital standards result in inappropriate resource allocation or competitive effects. Some of these goals have been stated in prior agency statements and in the preamble to the current ANPR. Moreover, the ANPR states that

"Basel II is designed to create incentives for these organizations (referring to Basel II AIRB banks) to improve their risk measurement and management processes and to better align minimum capital requirements with the risks underlying activities conducted by these banking organizations."

We agree that Basel II should provide for incentives for banks to migrate toward Basel II; i.e., to be willing to incur the added expenses associated with Basel II. And we also believe that such incentives should exist for banks to migrate from the old Basel I to better forms of risk-sensitive capital standards that, nevertheless, are neither as complicated nor as expensive to administer as the Basel II AIRB approach. While such incentives should not be viewed narrowly as an objective, they are a necessity, if the various parts of the U.S. banking industry, and the various regulators, are to become comfortable with a significantly better set of capital standards that apply to non-AIRB U.S. banks.

In this response, we will first point out some high level conceptual issues recognizing how this ANPR would fit-in to the broader framework of U.S. bank capital requirements. Our key recommendation is that it is especially important to provide non-AIRB U.S. banks with a wider array of regulatory capital structures than presented in the ANPR. This could be done by following the international Standardized, Foundation, and Advanced structure proposed by the Basel Committee. In addition, the alternative structure based on risk-characteristics, as described within the ANPR, would also be appropriate for certain U.S. banks. In support of developing this risk-characteristic approach, we discuss some possible portfolio-specific segmentation schemes. Finally, we argue that individual institutions should be given the *option* of remaining with the old Accord (or its Standardized-like variant), or moving to a range of alternative, more complex (in concert with higher degrees of risk management sophistication) structures that, in most circumstances, would be expected to result in somewhat lower regulatory capital minimums than the less complex capital structure.

I. Broad Conceptual Issues

A. Competitive issues within the current Basel I as administered in the U.S.

In the less than two decades since Basel I was formulated, there have been very significant changes in the risk measurement, risk management, and risk pricing arenas. These changes can be very roughly summarized as a significant acceleration of the use of formal *risk metrics* within the day-to-day management practices of banks and their competitors. Economic capital has become an industry standard tool to convert these detailed underlying risk metrics into a consistent measure of the cost of risk. These risk metrics are then used within calculations of risk-adjusted-rates of return on economic capital, without regard to regulatory minimum capital standards.

Implicitly, the assumption underlying the use of risk metrics in banking is that the minimum regulatory capital standards are just that: a *minimum* standard that the well-managed bank would expect not to be binding (i.e., the degree of desired soundness of the publicly-held bank will, almost always, because of the basic interests of shareholders and debt-holders, be higher than the degree of minimum soundness required by the regulator). But for individual credit products, ranging from certain mortgage products, to other retail products, to certain commercial credits, the old Basel I is now, quite simply, a too-high-standard. Indeed, as a generality, the Basel I standard is biased against banks engaging in particularly low-risk business and it favors banks in high risk businesses. That is, any activity for which the best-practice risk metric (Economic Capital) is below 8% (or 4% in the case of single family mortgages) entails a regulatory capital standard that is *binding*[1] – the bank either has to find a way to get around the too-high capital standard or must charge higher rates on the loans involved, in order to justify the higher capital allocation, thereby giving up market share to non-regulated financial institutions.

As Washington Mutual has noted in our prior responses specific to Basel II, this bias of the old Accord is accentuated by the U.S. minimum leverage ratio rule – the rule that the bank must hold Tier 1 capital no less than 5% of assets. In effect, this rule says that regulators *do not want banks to be holding very low risk assets*, certainly no assets for which the well-managed and adequately capitalized *unregulated* lender would, with the permission of the market, hold capital of less than 5% of assets. The 5% minimum leverage ratio rule is currently becoming binding on several of the major well-managed AIRB banks. The rule is hindering us from holding low-risk assets on our balance sheets and incenting us to alter our portfolio mix in the direction of higher credit risk assets.

Finally, there are, of course, cases in which, for a particular credit product, the arbitrary 8% rule is too low – entailing an implied level of minimum soundness for a bank that, if the bank held such assets and held only 8% capital against those assets, the bank would be rated below, say, investment grade by the rating agencies. Throughout the recent history of prudential regulation, some regulators have confined their concern to such

[1] For a complete discussion of how to compare the 8% Basel standard to internal capital standards, see for example, "Analysis of QIS4 Results versus Internal Economic Capital Calculations – Level and Diversity," September, 2005, RMA, pp. 10-13.

assets that might possibly be so risky that the 8% rule involves too-low capital. These regulators have not been concerned about assets for which the regulatory capital standard was too high. What is often not considered is that when capital regulations err on the side of being too low, the public still is protected by the built-in desires of shareholders of publicly-held banks not to allow their public credit ratings to decline to too low a level – the banks are required by the market (e.g., rating agencies and investors) to hold more capital for the risky product than the regulatory minimum. But when the capital regulations err on the side of being too high, the response of the publicly-held bank, in the absence of an offsetting position where the regulatory capital is too low, must be to either exit the market, engage in wasteful structuring activities, or raise lending rates to justify the high capital allocation on the loan product, thereby reducing the share for which the regulatory capital charge is too high. *Too-high regulatory capital, therefore, clearly has an anti-competitive effect, to the detriment of regulated banks, their low-risk customers, and the economy, while a too-low regulatory capital charge has no such anti-competitive effect, nor are such too-low capital charges likely to increase the probability of failure of the publicly-monitored bank.*

B. Consistency of application.

The ANPR made no mention of two aspects of risk regulation that are key within the Basel II AIRB approach – the Pillar Two examination process, or a regulatory capital charge for operational or "other" risks.

1. Pillar Two. For many smaller community banks that, for a variety of reasons, hold capital well in excess of risk-based regulatory minimums, no change to the desired capital rules may be either necessary or desired. Some minor changes, however, along the lines of the Standardized approach within the international Basel II agreement may be useful (so long as risk-weights for various product classes are set appropriately). For others, however, there is a need for a more risk-sensitive framework that can take advantage of the emerging procedures at such banks for measuring risk parameters such as PDs and LGDs. To the extent that any reformulation of Basel I takes advantage of these risk parameterization processes, such as would be the case with either a risk-characteristic-based revision of Basel I or the use of PDs as in the Foundation approach, there should be an accompanying change in the supervision process. Specifically, such 2nd tier institutions should be subject to examinations dealing with internal procedures for identifying, measuring, and managing each of the risks to which the bank is exposed.[2] Since the newly revised Basel I process for such 2nd tier banks would be less complex than the Basel II AIRB process, the Pillar Two examination should be correspondingly less complex and less expensive to the bank than the AIRB Pillar Two process.
2. Operational risk capital. The absence of discussion of an operational risk charge in the ANPR is notable. Presumably, U.S. regulators did not want to raise op risk due to concerns over complexity. In fact, the use of the Basic

[2] This could be considered as a thorough review of an economic capital system as well as a holistic approach to ERM.

Indicator approach to operational risk, as in the Standardized Basel II approach, would be extremely simple, utilizing General Ledger information. On the other hand, if regulators do *not* have an op risk charge, then there will be a temptation to assign correspondingly higher risk-weights for various assets to address the deficiency. This will compound the problem with the current Accord in which risk-weights for certain credit products are too high. In summary, assessing a separate op risk charge is the right thing to do, and it would permit regulators to assign risk-weights to credit assets that better reflect the diversity across products and banks with respect to credit risk and market risk. Conversely, implicitly including an op risk charge in the risk weight for individual credit products assumes that op risk economic capital is related to or is proportional to credit risk economic capital – an assumption that is not warranted.

C. Proper alignment of incentives.

As stated in the ANPR, banks should have an incentive to migrate to a more complex version of Basel I, since the more complex version results in a more risk-sensitive capital standard that is better-aligned with best-practice estimates of differences in risk. As a practical matter, better risk measurement requires significant resources. Even in the absence of any capital regulation we would expect forward-thinking managers to be willing to undertake this increased expense, so long as the result is more accurate risk measurement that can be translated into higher returns on economic capital. More accurate risk measurement, properly utilized, is tantamount to a reduction in risk insofar as uncertainty in key risk positions is reduced (e.g., measurement and model risk) and risk therefore can be better managed. Creating a modest incentive structure in the regulatory capital framework is critical in order to provide clear incentives for continued enhancements in risk management. We would expect this ANPR to be consistent with this perspective and that over the long run, a significant proportion of the banking industry will want to migrate toward a capital standard that reflects the kind of analysis underlying the Basel II AIRB/AMA approaches.

All of this means that, other things equal, as regulators progress up through tiers of complexity – from the old Basel I, to the Standardized approach, to the Foundation approach (or similar), to the AIRB approach – regulatory minimum capital, expressed in simple ratio terms, *should* decline given a correlation between sophistication in risk measurement and desire to apply for a more sensitive regulatory capital approach. The examination process should take care of instances when the specific bank should be an exception to the norm, such as may be the case for the bank with a particularly risky portfolio or inadequate risk management process. Absent these exceptions, there should be built-in regulatory-capital-declines as incentives, albeit modest incentives, to move to ever more complex and expensive forms of capital regulation and corresponding risk measurement.

II. Specific areas of concern in the ANPR.

A. The EL charge.

Basel II (AIRB approach) requires that regulatory capital be held against Expected Losses ("EL"). This capital charge is taken in the form of an EL reduction in the amount of the loss reserves (ALLL) that can count as Tier 2 capital. Washington Mutual, the RMA, and other market participants have indicated in many direct responses that such an EL charge is inappropriate and can distort resource allocation. In Economic Capital and RAROC measurements, expected losses are covered by asset yields net of expenses. These margins must cover not only EL but a desired return to Economic Capital. As a practical matter, margins on performing assets are high enough to cover EL simply out of the necessity of producing a positive return to shareholders (and, capital is available for protection against tail events). For this reason, there should be no need for capital to cover EL whatsoever, and all of the ALLL should be treated as regulatory capital.[3]

If regulators are going to continue to assess an EL charge for AIRB banks, simple fairness requires that such a charge should be assessed all banks. Since the proposed changes to Basel I would not involve calculations of EL, this means that the risk-weights for the (revised) Basel I framework should be based on some reasonable measures of unexpected losses ("UL") *plus* EL. See the discussion immediately below on appropriate risk-weights for various product categories.

B. Appropriate risk-weights for a revised Basel I.

The ANPR generally does not propose specific risk-weights for various credit products so much as give examples of possible risk-weights. The examples given, however, appear to err on the side of being too high. For example, for most community banks, externally rated loans are of almost no significance, while single-family residential mortgages with LTVs over 90% may indeed be significant. Therefore, the reductions in capital for rated loans may be more than offset by the increase in capital for high-LTV loans. Moreover, the ANPR's proposed increase in capital for high LTV loans appears to be based on the arbitrary 4% standard for mortgages in the current Accord – the ANPR suggests that since high LTV mortgages are riskier than low-LTV mortgages, the resulting capital requirement for high-LTV mortgages should be twice as high as the 4% standard, even though the 4% standard is itself arbitrary. Indeed, neither the Basel II AIRB approach nor best-practice internal measurements of EC (even if such measurements included the erroneous EL charge and some allocation of capital for op risk and market risk) would result in capital for a *current* 95% LTV mortgage that is anywhere near 8%.

The ANPR asks whether risk-weights in the new Basel should be based on risk-characteristics such as LTV, FICO, current status, etc. While such risk-characteristic-based standards may indeed provide more risk-sensitivity than the old Accord, such standards would be inappropriate for some banks, because the necessary data (such as

[3] To compound matters, regulators view the ALLL as Tier 2 capital, while practitioners view the accounting ALLL as another form of real capital which can as easily be accounted for as equity on the right hand side of the balance sheet. In particular, the market value of a performing asset is not its carrying value net of the ALLL but rather the value is close to its gross accounting value.

currently updated FICO or Current LTV) are not available on existing systems and would involve considerable expense for such institutions. For these institutions, we suggest the new Basel I should continue to be based on simple credit product definitions, such as those within the Standardized approach to Basel II. *Indeed, we suggest the U.S. adopt the widely-agreed-upon Standardized approach (including adoption of the risk weights) for these institutions.* But, as discussed subsequently, we also suggest that an additional 'tier' of risk management sophistication/regulatory capital requirements be added.

In the following section, we discuss the benefits and costs of a risk-characteristic-based approach to capital for the 2nd tier risk-management-sophistication institutions. For these banks, neither the old Basel I nor the Standardized approach equivalent is sufficient. Moreover, if a risk-characteristic-based bucket system is used, as suggested in the ANPR, this may be less risk-sensitive, and possibly more expensive, than some banks' own internal risk measurement methodology. *In other words, we suggest the U.S. employ more than a 2-tiered system of capital requirements for non-AIRB institutions.* Therefore, as discussed below, we believe a third option consistent with the goals of the Foundation IRB approach that is available in the other Basel II nations should be made available. This approach would recognize and provide incentives for more sophisticated risk measures, but without the limitations of a simple segmentation approach as proposed in this ANPR.

C. A capital framework for the middle-tier of banks.

Along with others in the industry, we support the creation of an alternative to Basel II and a 'bucketing" approach as described in the ANPR – although we believe that both of these should be options available. We believe that the approach described in the ANPR will severely restrict the risk-sensitivity of the capital rules for the some banks and many of the more sophisticated institutions will prefer an option that recognizes a progression to Basel II.

While a risk-characteristic-bucketing approach (as in the ANPR) can be considerably more risk-sensitive than the Standardized approach, it suffers from several potential significant deficiencies that the agencies should take great care to avoid to the extent possible.

1. Any bucketing approach of the regulators will differ from the internal bucketing (segmentation) approach of each individual bank. As a result, each bank subject to these capital requirements may have to construct expensive data systems to track both sets of bucketing definitions. *This expense would also be troubling if regulators were to set the capital requirements for such a bucketing approach as the floor for the Basel II AIRB banks.* Then, the Basel II AIRB banks would have to compute capital under several alternative approaches, including the old Basel I approach, which many observers still wish to compare to Basel II or a revised Basel I.
2. The choice of reasonable bucket characteristics and ranges of characteristics will be difficult, given the wide range of current research results on appropriate bucket

definitions. In the 2003 survey of retail credit risk measurement practices, RMA found a wide variety of practices.

a. Some banks define bucket ranges based on likely important risk characteristics, such as LTV, FICO, etc., then measure PDs as the historical mean default frequency within each of the buckets.
b. Some banks define bucket ranges then estimate a separate PD function for each bucket using explanatory variables that are in addition to the bucket variables (e.g., internal behavioral scores, or number of times the account has been delinquent in the past 12 months, etc.).
c. Some banks may estimate a single PD function at the loan level without regard to bucketing.

There is much disagreement over what is truly best-practice. Some banks have found statistical evidence, for example, that age of account and FICO score become statistically insignificant when other explanatory variables have been used. Still other banks believe that FICO and age are statistically important, so long as the FICO score is continually updated. It does appear, however, that more and more AIRB banks are evolving toward loan level PD, LGD, and EAD estimating functions, whether or not the estimating equations differ across buckets. In effect, these practitioners believe that, for any realistically small number of buckets (e.g., a few hundred buckets) there are statistically significant differences across individual loans in a particular bucket with respect to, say, the loan's underlying PD.

3. We are concerned that there may be a tendency for the regulatory bucket definitions to become the de facto Basel II AIRB standard, thereby running counter to the risk parameter estimation philosophy on which the AIRB approach is based. International regulators, including U.S. agencies, have gone to great lengths to allow AIRB banks wide discretion, subject to the Pillar Two review, in establishing PD estimation procedures for Basel II purposes (e.g., AIRB banks are being encouraged to use the same bucketing procedures for both internal EC purposes and Basel II purposes). The long-term use of regulatory defined buckets, instead, might lead to even greater differences between internal EC estimation and regulatory standards than in the current Accord or the current Basel II AIRB formulation.
4. The Basel II AIRB approach calls for AIRB banks to validate annually their choice of bucket ranges. That is, banks must show that their choice of bucket variables (e.g., FICO, LTV) are appropriate (are statistically more significant than other explanatory variables). The choice of variables ranges (e.g., FICOs from 700 to 720 rather than FICOs from 710 to 730) must also be validated. It is unlikely that regulators would apply these same validation requirements to their own bucket choices. Rather, it is highly likely that, once chosen, the regulatory bucket-variable ranges would remain unchanged for many years, potentially creating even greater differences in the future between internal best-practice segmentation techniques and the regulatory segmentation scheme.

These concerns lead us to conclude that an internally-estimated PD approach for the 2nd tier banks is much more flexible and, ultimately, preferable to a regulator-defined bucket approach. In other words, we see no reason why the U.S. needs to depart from the

Foundation Basel II approach for those banks that are willing the make the investment in risk measurement systems and the processes to make them functional. Again, the "Pillar Two" process would ensure that these large banks were, or were not, estimating their PDs in valid fashion.[4]

III. Risk Characteristic Bucket Approach

Notwithstanding the concerns noted above, if U.S. regulators were to give banks the option of choosing between a PD-based (Foundation-type) approach and a risk-characteristic based bucket approach, we have the following suggestions with regard to the proper risk-characteristics for use in such a bucket approach.

A. Mortgage and HELOC/HEL

The ANPR outlines a few key risk characteristics such as loan-to-value, measures of borrower credit risk quality (such as credit score and delinquency status), and lien position. While these are not the only risk drivers that impact mortgage credit performance, our own research and experience generally concurs with broader industry research and experience that identifies these characteristics as explaining a great majority of differential risk in mortgage loans. We have additionally found seasoning (or age of the loan) as an important attribute for risk segmentation, although its impact is somewhat muted when considering risk over a longer horizon, so it may be appropriate for simplicity to omit this attribute. Indeed, limiting the segmentation of loans into a few broad credit quality categories is reasonable given the size of most Basel 1a portfolios -- and, for this purpose, a) FICO score at origination, b) delinquency status (current, 30DPD, 60DPD and 90DPD or greater), and c) LTV are attributes that most Basel 1a institutions will have. To assign risk-weights based upon these risk dimensions, the agencies should benchmark the chosen risk-weights against industry aggregate loss data for mid-sized banks.

We believe it is best practice for accurately categorizing risk to periodically update LTV by incorporating changes in balances and estimates of property value changes. However, the update method should not be too burdensome; for example, estimates of property valuation should allow for the use of automated valuation models (AVMs) or housing indices. We agree with the proposal to reduce LTVs by loan-level PMI in order to assign lower risk-weights for an institution's reduced exposure. Institutions should not be required to deduct for counterparty risk in these adjustments if the PMI providers are

[4] Rather than using regulator-defined buckets within the formal capital standards, supervisors may wish to define a set of buckets for each retail credit product, then collect industry-wide default frequency, LGD, and EAD data for each bucket over time. These data could then constitute a useful benchmark for the Pillar Two supervision process and help satisfy the benchmarking requirement previously stated in the Retail Supervisory Guidance. Careful attention would need to be paid to minimizing the cost to Foundation and Advanced IRB banks of having to maintain these regulator-bucket databases (by, for example, requiring data submissions to be only on an annual basis for 2nd tier and AIRB banks). Washington Mutual would be pleased to work with the banking agencies to help develop appropriate bucket definitions for various retail products for benchmarking purposes.

rated AA or better. Stand-alone second liens do pose higher risk to the institution and should appropriately receive a higher risk-weight than other mortgage loans. However, we disagree with the proposal to assign a risk-weight greater than 100% to **all** stand-alone second lien mortgages and HELOCs with combined LTV > 90%. For better credit quality borrowers this may place the risk-weight for second lien mortgages and HELOCS above that for an unsecured credit card to the same borrower, with prime credit cards risk-weighted at 100% -- clearly an inconsistent and inappropriate outcome. The assignment of Basel 1a risk-weights should accurately rank risk by borrower credit quality and loan types and be consistent with the general Basel II standards.

B. Credit Cards

For credit card portfolios, segmentation by updated characteristics is necessary to accurately capture portfolio credit risk. For unsecured lines of credit the main drivers of credit loss can be decomposed into risk from default (PD) and draw-downs on the open line up to the point of default (EAD), as loss severity tends to be close to 100% once a loss is recognized. Borrowers' current credit quality and performance histories to date drive credit risk; for example, refreshed generic credit score and delinquency status sufficiently separate default risk. Additional segmentation by credit utilization or open credit line provides increased predictive power for PD and EAD. At a minimum, risk-weights should be assigned by key drivers of PD for smaller, less complex, institutions, and for larger institutions risk-weights should be assigned by key drivers of both PD and EAD.

For inactive accounts risk-weights can be assigned by open credit lines and by risk factors that reflect the likelihood of account activation and default. Generally, inactive accounts are concentrated in the highest credit scores, so little predictive power is provided when segmenting these loans by score. Default likelihood for inactive accounts is low, except among accounts that actually activate. What the risk-weights should try to capture are the high EADs on what are generally large open credit lines.

C. Multifamily and Commercial Real Estate (MFL and CRE)

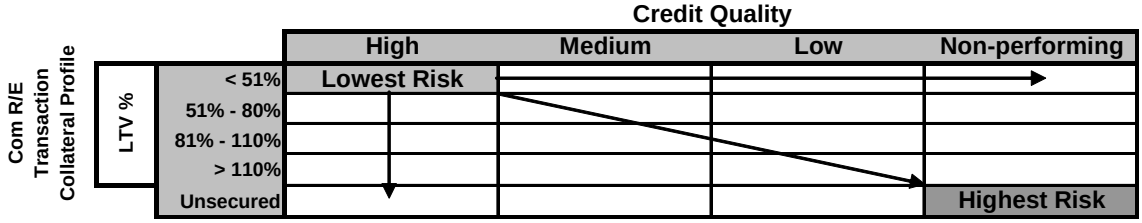
Commercial Real Estate financing (including multifamily lending) covers a broad range of common credit risks. These credit risks are typically profiled by:

- The type of property being financed
- The nature of the financing needed (e.g. new construction vs. permanent financing of a stabilized property)
- Market characteristics – micro/macro
- Property and owner credit characteristics such as cash flow, leverage and liquidity.
- Recourse vs. Non Recourse

Within the categories of MFL/CRE, broad ranges of markets with widely varying risk characteristics and appropriate risk profiling practices exist. Different institutions may

focus and target their lending production, and retained credit risk, on any combination of the factors (or others) and deploy various and in some cases unique underwriting practices. Our own research indicates that, particularly for multifamily lending, a simple segmentation scheme based on LTV along with an indicator of default propensity (typically based on an internal credit rating or score) could serve the purposes of a simple risk-characteristic/bucketing approach as discussed in the ANPR.

Inherent in a well developed risk rating system is a robust segmentation scheme. Natural segmentation occurs that typically includes characteristics such as: property type, cash flow, FICO, micro/macro market characteristics, recourse/non-recourse, etc. A suggested segmentation approach would be to utilize a bank's risk rating methodology in conjunction with LTV segmentation to arrive at an adequately granular risk distribution.



This is illustrative; LTV segmentation would be unique by property type and transaction type.

The Credit Quality (default propensity as reflected in the columns above) component could be based on an institution's internal risk rating methodology validated through the examination process. In the example illustrated above, a bank's risk rating grades would be partitioned into four bands of credit quality (high, medium, low & non-performing). An alternative would be to segment the credit quality component by each discrete grade, plus a non-performing segment. This final partition for non-performing assets may be necessary to account for the significant increase in capital needed to support this specific class of asset, accounting for the near collateral dependent state that exists at this end of the risk spectrum.

On the collateral profile leg (the rows in the table above), an "unsecured" or equivalent segment needs to be included to account for real estate transactions that have been adversely impacted by items such as: environmental contamination; clouded or failed property title; or other situations that can cause an lender to avoid or otherwise be unable to take possession of the underwritten realty asset.

Finally, we caution that segmentation and related weighting schemes need to be sufficiently robust so that non traditional risk segments are considered in the risk measurement framework. Maintaining a more traditional approach to segmentation may result in understated risk for non traditional underwriting and objectives to achieve a common framework to allocate risk capital on a relatively even basis across the industry may not be realized.

D. Small Business

Small Business Lending is a broad category encompassing multiple loan products (real estate secured, term loans, lines of credit, credit cards, etc.) and defining the target market

as businesses with revenues anywhere from $100,000 to over $10.0 million. Different institutions may focus on particular segments of Small Business and employ various underwriting practices, from score-based automated decisioning to fully manual and judgmental underwriting. As such, any segmentation and risk weighting scheme needs to have enough flexibility to allow individual institutions the ability to use an approach that is appropriate for the Small Business space a particular institution occupies. For Washington Mutual, a simple segmentation scheme would be as follows:

Initial Risk Weight Grid – Before Product Differentiation

Collateral / Credit Quality [1]	Real Estate	Specific Assets	Blanket Business Lien	Unsecured
High	Lowest Risk			
Medium				
Low				Highest Risk

[1] Possible credit quality indicators include: 1) guarantor FICO scores; 2) delinquency status; 3) time in business.

Revolving Product Adjustment to Initial Risk Weight

Utilization [2]	High	Medium	Low
Initial Risk Weight	No Change		Higher Risk

[2] In order to capture the impact of contingent liability on revolving loans in the assessment of risk, utilization can be used as a segmentation variable. Loans with low utilization have higher contingent liability requiring an increase in the risk weightings. This is consistent with the LEQ concept in the Basel II framework.

Institutions need to have some latitude in deriving the risk weights for each segment, again, subject to the validation process. As discussed above, portfolio performance can vary based on the target market and the underwriting strategy.

Conclusion

We believe it is especially important to provide non-AIRB U.S. banks with a wider array of regulatory capital structures than presented in the ANPR. This can be done by following the international Standardized, Foundation, and Advanced structure. The alternative structure based on risk-characteristics, as described within the ANPR, may also be appropriate for certain U.S. banks. Most importantly, however, individual institutions should be given the *option* of remaining with the old Accord (or its Standardized-like variant), or moving to alternative, more complex structures that, in most circumstances, would be expected to result in somewhat lower regulatory capital minimums than the less complex capital structure.

This natural and appropriate incentive, even if modest, would help move all U.S. banks in future years to better risk measurement systems. Finally, no matter the number of options U.S. banks are given, it is vital that U.S. regulators get the associated risk-weight for each defined bucket "right." These risk-weights should not be arbitrary, as in the old Accord,

but should be based on the only widely-accepted framework for measuring risk – the evolving economic capital process. Therefore, U.S. regulators should work closely with best-practice banks to achieve the right risk-weights, all the while moving quickly, so as not to delay any more than necessary the inception of the AIRB approach – the adoption of which is sorely needed to eliminate problems associated with the old Accord.

Sincerely,

John F. Robinson
Executive Vice President
Corporate Risk Management