Washington Mutual

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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Statement of "Proposed Treatment of Expected and Unexpected Losses" (Oct. 11, 2003)

Dear Members of the Basel Committee:

Washington Mutual Inc. ("WMI") is the 7th largest bank in the United States. We provide both wholesale and retail banking services and hold a large portion of our portfolio in retail mortgages. WMI fully supports the U.S. Regulatory and Basel Committee efforts to revise the capital Accord to encourage the development of sound risk measurement and management practices. This comment letter responds to the October 11, 2003 press release from the Basel Committee on Banking Supervision (BCBS) on the proposed treatment of expected and unexpected losses as part of the new Basel Capital Accord.

We acknowledge this latest proposal on the treatment of expected losses as a step in the right direction and appreciate the efforts of the Committee. However, this latest proposal is still importantly flawed and must be modified prior to adoption of the new capital accord. The proposal, combined with Basel II's measurement of *actual* (as differentiated from *required*) capital, results in inconsistent and inappropriate capital requirements. Specifically, treatment of the allowance for loan and lease loss (ALLL) is inappropriate in the context of Basel II's proposed treatment of actual capital including Tier 1, Tier 2, and the U.S. 'well-capitalized' requirements. Because a change in Tier 2 capital accompanies the Oct. 11 proposal, now is the time to address some remaining fundamental issues regarding treatment of actual capital.

Primary Concerns

Two key issues inherent in the proposed capital rules structure remain that will disadvantage low risk institutions relative to higher risk institutions:

1) Cross-bank Inconsistencies in the Tier 1 Capital Requirements
2) "Well-Capitalized" Standards Should be the Same Across All Basel Countries.

1) Cross-bank Inconsistencies in the Tier 1 Capital Requirements

The Basel Committee got it right in developing a consistent and effective approach for measurement of *total* risk-based capital requirements[1]. *However, the Committee got it wrong for Tier 1 and well-capitalized requirements in a way that will likely penalize low credit risk institutions with a higher capital standard.* Like the leverage ratio, the effect of this Tier 1 requirement will generally be to promote higher credit risk activities, contrary to the goals of Basel II and prudent bank supervision. The correct and effective *total* risk-based capital requirement in Basel II is based on a consistent loss-at-confidence-level measure of unexpected loss. This approach is not extended to calculation of the extremely important Tier 1 and well-capitalized requirements.

Instead, an inappropriate, simple multiplication of the total capital that was calculated from the loss-at-confidence-level result is proposed to calculate the Tier 1 and well-capitalized requirements. The proposal is a <u>linear</u> scaling (multiplication) of a <u>highly non-linear</u> relationship between capital and frequency of insolvency (confidence level) with arbitrary multiples (e.g., multipliers of 0.5 for Tier 1, 1.25 for well-capitalized).

As WMI and other observers have noted [4], these arbitrary multiples of total capital result in different implied "confidence levels" for the Tier 1 and well-capitalized requirements. Confidence levels imply probabilities of failure (risk). Loss at a given confidence level is a consistent measure of capital aligned with risk. *This simple multiplication is a serious problem; it distorts the distribution-based measures and results in a systematically inconsistent capital vs. risk relationship at the important Tier 1 and well-capitalized levels.* *<u>The resulting capital thresholds will likely systematically penalize low credit risk institutions with a comparatively higher capital requirement at the Tier 1 and well-capitalized levels; conversely, this arbitrary scaling may excessively reduce Tier 1 limits for riskier institutions</u>*[2].

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[1] Ignoring the "well-capitalized" requirements, Basel II offers a consistent level of protection to depositors. Here total capital is measured consistently with a loss at confidence level. But, Basel II offers an inconsistent level of protection against insolvency and bank failure due to varying loss at confidence levels for the equity position – closest to Tier 1. As we note, this is due to Tier 1 requirements being derived from a simple multiplication rather than a loss-at-confidence level measure.

[2] The implied Tier 1 requirements (derived from one-half of total capital and then compared against the Basel II loss distribution to get the implied confidence level – ignoring 'well-capitalized') may vary dramatically and perversely with each institution's risk. For example, consider two institutions, A and B, each with a 99.9% total capital, loss-at-confidence level measure as required by Basel II (this is derived from one of RMA's published examples in reference 4). Then assume an aggregate LGD of 50% for each institution and a PD of 0.1% for institution A and 2.0% for institution B (B is much riskier). Assume Basel II 'corporate' asset value correlations. The implied Tier 1 confidence levels will be 99.50% for institution A (high standard) and 98.75% for B (**a lower standard for the riskier institution!**). This is because 50% of total capital for a low-risk (thin-tailed) institution is a much higher level of protection than the same requirement at a higher-risk (thick-tailed) institution due to variation in the distribution shapes with risk profile.

Our recommendation is that the Tier 1 required capital level be set at a single Basel II (international) confidence level (e.g., RMA's recommended 99.5%) that is in-addition-to, but lower-than the Total Capital confidence level. Using a 99.5% confidence level is tantamount to establishing a maximum insolvency probability of 0.5% -- roughly equivalent to low investment grade rating. Under this proposal, Tier 1 requirements may actually increase over the one-half of total capital as currently proposed in Consultative Proposal Three.

Under this approach, unlike the arbitrary 50% multiplier, the capital requirement would be consistent across all institutions. This required capital level would be compared against actual Tier 1 capital equal to tangible equity plus the ALLL (not ALLL minus EL). This will result in a more effective, consistent, and appropriate capital requirement based on consistent Tier 1 requirements. The Total Capital requirements could continue to be determined by the proposed confidence level of 99.9% (see discussion below regarding "well-capitalized" standards).

2) "Well-Capitalized" Standards Should be the Same Across All Basel Countries.

Finally, while the Committee endorses a "well-capitalized" standard over and above the Basel minimum capital standard, the choice of the "well-capitalized" standard is left up to the individual countries. As we noted in our U.S. "ANPR" response, this position will result in the difficult situation of inconsistent capital regulations across the Basel countries. In the U.S., for example, the "well-capitalized" standards are the *de facto* minimums – no U.S. bank could afford to be viewed as anything less than well-capitalized. Moreover, the U.S. well-capitalized rules are arbitrary multiples of the Basel Tier 1 and Total Capital standards.

Again, a confidence-level based requirement would be the consistent way to apply such a standard. These multiples result in effectively distorting the confidence levels being applied to the loss distributions of each U.S. bank. As in the case of Basel's Tier 1 standards, generally the banks with the riskiest portfolios are subject to the lowest confidence levels and are therefore allowed to operate with higher insolvency/failure probabilities than banks with low-risk portfolios (the reference in footnote 4 provides a detailed case study of this effect for the 'well-capitalized' requirements).

As a final point, the U.S. applies an even more arbitrary "Tier 1 leverage" ratio of 5% (defined as the ratio of Tier 1 capital to total assets) in order for a bank to be deemed "well-capitalized". As we have noted in our prior responses, the leverage requirement forces banks with the least risky portfolios (those for which best-practice Economic Capital requirements and Basel minimum Tier 1 requirements are less than 5% of un-risk-weighted assets) either to engage in costly securitization to reduce reported asset levels or give up their lowest risk business lines. These perverse effects were not envisioned by the authors of the U.S. "well-capitalized" rules, but some other Basel countries have adopted these rules and still others might be contemplating doing the same.

We ask the Basel committee to address this issue by: a) moving expeditiously towards a common set of confidence level based "well-capitalized" standards that are above the Basel minimums, and b) in so doing, reject the sort of arbitrary multiples of the Basel minimums capital standards now in use in the U.S. We recommend instead that separate confidence levels be applied to the Tier 1 and Total Capital requirements, both for the minimum and "well-capitalized" rules. In particular, the minimum Total Capital rule already is quite high (at a 99.9% confidence level). We support RMA's proposal that the minimum Tier 1 requirement be applied at a 99.5% confidence level. Other thresholds for well-capitalized and total capital could be similarly developed based on the loss at confidence level framework. This is relatively easy to implement – recalculate the Basel II capital calculation multiple times with varying confidence level assumptions.

Expected Loss and the ALLL

The October 11th proposal is an improvement on CP3 in that it appropriately removes expected losses from the measure of required capital based on an institution's risk profile. As the Committee knows, it is fundamental to the Economic Capital theory on which Basel II is based that actual capital is not held against expected losses, only unexpected loss. However, the proposal then inappropriately subtracts expected losses from actual capital (capital an institution 'has') by limiting Tier 2 ALLL only to the excess of ALLL over expected loss (EL). This purported compromise is hardly a step forward in the sense of removing the EL charge as the industry has been requesting. *The EL charge has simply been moved from the required capital measurement to a deduction from actual capital.*

EL Should Not be Deducted From ALLL

ALLL should continue to be included in a bank's actual capital irrespective of EL. As we and other sources[3,4,5] *have noted, it is our profit margins net the cost of holding (economic) capital that must more than cover EL.* As a member of the Risk Management Association's (RMA) Capital Working Group, we refer the reader to a previously published detailed discussion of this issue that we have participated with other RMA members in developing[4]. This issue is also addressed at length in RMA's pending response to this same Oct. 11, 2003 proposal.

Move ALLL to Tier 1

WMI has also recently collaborated with RMA members in developing a detailed position paper on classification of ALLL. Our view is that reserves in the form of the ALLL are, in an economic sense, most appropriately treated as part of tangible equity and should be considered part of Tier 1. On this issue, WMI endorses the position presented at considerable length in a separate RMA response to the recent U.S. ANPR[4]. Note that

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[3] Washington Mutual U.S. Risk-Based Capital ANPR Response, Nov. 1, 2003.

[4] Risk Management Association U.S. ANPR Response, Nov. 5, 2003 (Attachment B of this response addresses this issue). See www.rmahq.org.

[5] Pending Financial Services Roundtable response to Basel Committee October 11, 2003 proposal.

operational risk has a similar set of issues to the credit risk/ALLL discussion: expected operational risk losses are part of profit margins and unexpected losses are covered by capital.

Finally, we appreciate this opportunity to engage in this constructive dialogue.

Sincerely yours,

John F. Robinson
Executive Vice President
Corporate Risk Management

cc: Office of Thrift Supervision
Federal Deposit Insurance Corporation
Board of Governors of the Federal Reserve System
Office of the Comptroller of the Currency