BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

Date: December 29,2003

To: Myron Kwast

From: Paul Calem, Mark Flood (OTS), and Jim Follain

Subject: Report on Visit to World Savings Visit on November 11, 2003

Attendees: Golden West/World Savings Representatives: Herb Sandler (Chairman of the Board of Golden West), Russ Kettell, Bruce Fuller, Mike Roster, Steve Daetz, and Georganne Proctor. Mark Flood of OTS was in attendance and arranged the meeting.

Purpose: To seek feedback on the potential competitive effects of Basel II on bank investments in mortgages and amplification of some issues raised in the official ANPR Comments submitted by World Savings.

Perspective represented: World is a relatively specialized institution in that it originates, services, and invests in ARMs. Interest rate risk is managed by maintaining a close relationship between its primary sources of funds – deposits and FHLB advances – and the indexes to which the ARMs are tied.

Key Points Discussed in the Meeting

1) *Leverage must be maintained to guarantee safety and soundness.*
   a) The leverage ratio in the range of 5 to 6 percent is the key to maintaining a safe and sound banking system and limiting the risk of inadequate capital under a bank's risk-based capital model caused by errors, aggressive estimates or "gaming". They sense a significant reduction in the focus on safety and soundness and far too much emphasis upon using modern credit risk modeling to minimize a bank's capital requirements.
   b) World stated that bond ratings drive banks to hold excess regulatory capital, although World predicts that the rating agencies will drop their required capital for a particular rating if the regulatory requirement is reduced under Basel 11.
2) *Competitive effects are likely and potentially harmful to the stability of the banking system*
   a) A "race to the bottom" will be a likely result of Basel II due to competitive pricing advantages enjoyed by banks that can model the lowest capital requirements. Higher capital banks will be incented to modify their risk-based models to compete. It will be easy for a bank to adopt a model that supports lower capital

requirements. Basel II banks would also have the means to "game" the system by, for instance, assigning inappropriately low values to PD or LGD to a set of loans.

b) Moral hazard is sufficiently prevalent in banking for such gaming to occur. There will be ample incentives for banks to reduce capital, and few consequences if they reduce capital too low. This arises in part because ROE is the main driver of investment and executive compensation decisions. Since capital is the denominator in the calculation of ROE, a bank that can reduce its capital will require less profitability to achieve a target ROE. The fact that many Basel II banks will be "too big to fail" aggravates the moral hazard problem.

c) Higher concentrations of investment brought about by Basel II will lead to more similarity in bank portfolios, which can contribute to destabilization.

d) Banking supervisors will be hard pressed to understand bank risk models, let alone identify and monitor the gaming that is likely to occur. Indeed, the inevitable turnover in bank staff will lead to difficulties in the maintenance of internal oversight processes, especially those built upon hard to quantify judgments by senior management and those who develop the models. Supervisors and senior management will not know there is a problem until it is too late. PCA will always be too slow to function as an effective restraint.

e) The analogy to the S&L debacle was stressed. For example, 19 of the 20 big thrifts have disappeared since 1990 (World is the only one that remains), with most of the now-gone thrifts having exhibited asset quality problems. Also, troubled thrifts of the 1980s were often paying the highest rate on deposits and this behavior prompted responses by the relatively secure thrifts.

3) *Regulatory capital drives many bank investment decisions.* World specifically cited the 364 day facility as a tactic driven by regulatory capital considerations.

4) *Little profit from securitization of ARMs.* Although World securitizes a significant percentage of its ARMs which it holds in portfolio, it does so to provide collateral for securitized borrowings, not to reduce capital (World retains full recourse so there is no capital reduction).

5) *Profitability of Mortgage Banking Questioned.* World does not view the mortgage banking model – originate, perhaps service, and sell the interest and credit risk to the secondary market via securitization – as a highly profitable business. The profits come from holding the mortgages that are originated by its network. Thus, the mortgage banking model is not the antidote to potential competitive effects of Basel 11.

6) Go *slow.* World endorses a longer transition period in which Basel I is adjusted to include more specific corrections to address the shortcomings of Basel I, rather than adopting a new bifurcated system so reliant upon internal models.