BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

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Date: November 24, 2003

To: Myron Kwast

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

Subject: Report on Visit to WAMU on November 12, 2003

Attendees from WAMU: Bill Longbrake (Vice-Chair); John Robinson; John Stewart; Joe Mattey; and, Sasha Kipkalov. Mark Flood of OTS also attended and arranged the meeting.

Purpose: To seek feedback on the potential competitive affects of Basel II on bank investments in mortgages and amplification of some issues discussed in the official ANPR Comments submitted by WAMU.

Perspective of Institution: WAMU focuses on retail lending, especially in the area of residential mortgages. It originates, services, and invests in a wide variety of such loans and has a national portfolio. Investments tend to be concentrated in non-conforming products, "broadly defined"; Alt-A, limited documentation, less liquid ARMs, and some jumbo loans particularly geared to its customers and relatively difficult to securitize. Conforming loans and other standardized products are generally sold into securitization. WAMU also sells some special, portfolio designed securitization products. Their mortgage models are state-of the-art. The Vice-Chair, William Longbrake, is an experienced banker and regulator.

Key Points Regarding Competition

1) *The public statement by WAMU offers a highly articulate view of a case for significant competitive effects of Basel II; that is, WAMU (an AIRB institution)* and many non-AIRB institutions may be placed at a competitive disadvantage.
   a) WAMU argues forcefully that the affects will be both significant and, in their view, fundamentally unfair to institutions such as WAMU that invest primarily in retail assets with low or moderate credit risk.
   b) They also argue that the potential effects to which they refer will be difficult to document with historical evidence since the ingredients of Basel II that will generate the change - a bifurcated system that favors large banks with highly diversified portfolios - are new to the system. As such, arguments in support of their view must rely upon qualitative inferences, experience, and judgments.

2) *WAMU reiterated some of these arguments during the discussion—particularly the argument that a change to more risk-sensitive regulatory capital standards will affect portfolio credit risk allocation decisions.*
   a) Institutions with diversified asset portfolios that currently are weighted more heavily toward assets with relatively high credit risk will shift toward retail assets with low or moderate credit risk.
   b) This will place competitive pressure on non-AIRB banks that engage in traditional retail lending and on any institution that specializes in traditional retail lending.
3) *The leverage requirement, especially its link to the definition of a well-capitalized institution, is a major source of the unfairness of Basel II for retail specialists such as WAMU.*
   a) The leverage requirement for a well-capitalized bank - 500 bps - is well above the economic capital associated with most residential mortgages. As such, this requirement serves as a disincentive for banks to specialize in mortgages or necessitates investments in relatively risky assets in order to offset the leverage requirement and align the marginal economic capital of mortgage investments with the regulatory costs. Indeed, WAMU believes it would lead to a fundamental restructuring over the next 10-20 years.
   b) The leverage requirement leads to higher levels of capital than is justified by the economic capital associated with an A rated investor in mortgages. In principle, such overcapitalization offers potential funding benefits to a firm; for example, bank issued debt and subordinated debt costs might be lower, all else equal. WAMU argues that such benefits are nil to its shareholders owing to its reliance upon deposits and advances from the FHLB.
   c) WAMU predicts that under the proposed Basel II financial institutions such as theirs would have an incentive to diversify their investments to include riskier assets. Another less desirable alternative is to merge with financial institutions with much riskier portfolios and different lines of business. This would allow it to meet the leverage requirement and fully realize the benefits of reduced risk weights for mortgages, but also detract from its current business model and areas of expertise. They view this as inherently inefficient.
   d) For these reasons, WAMU recommends that the leverage requirement be eliminated or significantly reduced if Basel II is implemented.
4) *Accounting rules play a potentially important role in the decision to securitize mortgages.* One of the counters to the type of argument offered by WAMU is the difficulty and cost of unbundling interest rate and credit risk via the securitization process. The more costly this is to do, the lower will be the incentive and ability of financial institutions to take advantage of the lower capital rules for investment in the credit risk associated with mortgages, all else equal. Although generally confident of the ability of financial institutions to do such unbundling, WAMU raised a particularly interesting perspective on this - the interplay between accounting rules (FASB 133 and 140) and the capital rules. Essentially, both of these rules add to the uncertainty regarding the statement of earnings for a firm that holds MBS or engages in securitization with retention of the servicing role relative to one that originates and holds whole loans. This heightened uncertainty makes a bank less likely to securitize (FASB 133 impacted) and specialize in mortgage servicing (FASB 140 impacted), all

else equal. The traditional restriction of MBS issues to 14 point coupon increments may also add to the cost of securitization.

5) *Cost of Funds.* A key variable in the calculation of the impact of Basel II is an assumption regarding the bank's cost of debt. Since WAMU is a frequent user of FHLB advances, the question was raised as to whether this rate represented the marginal cost of additional debt. WAMU answered a strong, no. Deposit growth is the key determinant of its growth and its ability to take advantage of the lower risk weights for mortgages in Basel II. FHLB advances are important and helpful, but there are limited amounts of collateral for such advances and the advance channel imposes haircuts on the collateral. WAMU also noted that attaining a AAA rating for debt issues is seldom worth the trouble for financial institutions. They can already borrow at near AAA rates via the FHLB advance window and the additional criteria regarding tangible capital and diversification would too onerous.
6) *WAMU also offered a normative perspective on the potential competitive effects of Basel II.*
   a) The increased risk-sensitivity of the capital standard is in the direction of increased efficiency, but the lack of a level playing field will lead to undesirable concentration of mortgage credit risk at a few institutions.
   b) Fewer players imply less flexibility in mortgage markets, potential instability when a few large institutions act in the same way at the same time.

Key Points Regarding Implementation. Discussions at this meeting, a follow-up meeting with technical staff, and WAMU's formal comments raised a number of issues worth noting about the implementation of Basel II.

1) *Point in time evaluation of risk.* State-of-the-art models of mortgage credit risk and any supervisory rules should take into account the characteristics of the mortgage portfolio at the time of the evaluation. Using current loan-to-value ratios is an obvious example. Using current interest rates as well as the origination rates in prepayment functions to measure expected payments is another example of point in time evaluation of risk.
2) *Through the cycle LGD.* WAMU argues well for the use of "through-the-cycle" LGDs rather than recession or stress LGDs. One argument points out that to do otherwise leads to an implied higher standard during stressful economic times. This arises from the use of the 99.9% standard during all time periods. Also, defining a stress LGD is likely to be a significant challenge owing to the wide variety of mortgages and plausible definitions of a stress event.
3) *Usability tests.* One aspect of a supervisory review of an internal model will be its usability inside the organization. All else equal, more usability is desired; otherwise, the assumptions embedded in regulatory capital calculations are open to gaming by the financial institutions. WAMU highlighted the many different ways in which usability can be defined. They contrasted, for example, decisions regarding long-term contracts with, say, a GSE regarding the pricing of its deliveries to decisions regarding the purchase or sale of a particular seasoned portfolio. All else equal, their models are more important in the latter decision than in the first, which is often dominated by negotiating and strategic considerations.

4) *The l0 percent floor on LGD should be eliminated.* They emphasize the disincentive this poses to their use of MI, especially if the definition of LGD is moved to thru-the-cycle from recession.
5) *Time is of the essence.* WAMU urges the provision of information sooner rather than later in order to develop the data systems they need to implement Basel II. This involves such matters as the definition of default.
6) *Operational risk.* WAMU argues that institutions must have the "flexibility to classify operational risk losses closely associated with credit processes ... as operational versus credit losses." They point to pg. 85 of the AMA guidance as serving "no purpose but to complicate the development of models .. meant to predict the probability of default and loss given default..."
7) *Strengthening Pillar II.* WAMU believes that Basel II focuses excessively on Pillar 1. Pillar II offers a big advantage for U.S. institutions, since it encourages "big-picture" review over prescriptive details by supervisors.
8) *Incorporation of MI as part of the LGD computation needs to be more explicit.* The current ANPR is vague on a number of points regarding this issue.
9) *The definition of PD and its computation require clarification.* WAMU is comfortable with the 180 day delinquency component of the definition but the definition is too prescriptive with respect to other, special triggers. PD calculations should be "annualized, through-the-cycle."