WORLD SAVINGS

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Commentary on the Proposed Basel II Supervisory Guidance

World Savings is one of the nation's 15 largest banks and thrifts with more than $106 billion in assets. With our large portfolio of residential mortgage assets and a long history of low credit losses and conservative operations, Basel II would almost certainly allow us to significantly reduce our risk-based capital from current levels.

"The idea that U.S. capital regulation, which is intended to protect the taxpayer from undue extension of the federal safety net, should systematically defer to the results of models – even best practice models – is unacceptable to us." [1] ***FDIC Chairman Donald E. Powell***

Nonetheless, we continue to oppose Basel II. We have been around long enough, and have survived enough industry crises, to recognize Basel II as bad public policy pretending to be sophisticated risk management.

Keep it Simple

"While prior regulatory approval is required to use the models, once obtained, an institution would effectively set its own capital requirements. This would be based largely on inputs derived from credit assessments from the institution's own [models]... It is important to keep in mind that these are human inputs and are not infallible." [2] ***OTS Director James E. Gilleran***

Capital regulations that affect the stability of our nation's banking and financial systems should be simple, not complex, and should produce results that are transparent, not obfuscated. We believe it is inherently unsafe and unsound to adopt a capital regime that will be difficult, if not impossible, for regulators, boards, senior management officials, and other market participants to effectively monitor and supervise.

Although certain control and oversight mechanisms will be required of Basel II banks, these controls cannot overcome the fundamental flaw of allowing banks to set their own regulatory capital levels from statistical models the banks themselves create and manage. Banks will only adopt Basel II if their efforts are rewarded with lower capital levels. These banks will have the tools at their disposal to achieve their desired capital levels, and industry competition and other financial rewards will provide constant incentives for the banks to play games with their models, either at the outset or over time. We have seen time and again that earnings pressures combined with complex rules and models invite mischief (e.g. Long-Term Capital Management, Enron, the housing GSEs, etc.). There is no reason to expect that Basel II would be any different.

"[T]he monumental prescriptiveness of Basel II seems at times to be motivated by a conviction that if only the rules can be made sufficiently detailed and escape-proof the Holy Grail of competitive equality can be discovered." [3] ***Former Comptroller of the Currency John D. Hawke, Jr.***

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Even without malfeasance, there is also the risk of mistakes. We have already seen that there was an error in the complex formulas provided to the banks (a misplaced square root sign) that could have caused banks to underestimate their capital needs by 60-70 percent for retail credits. It is unrealistic to expect that the bank models will not likewise contain errors. Are we to expect that bank CEOs, CFOs, or audit committee members will detect the flaws in time, or that the regulators will have the time and skills to find the needle in the haystack? Are we prepared to bet the *system that they will? With our financial markets increasingly* interdependent, even small mistakes can result in extraordinary systemic risk.

Ironically, in times of heightened focus on corporate accountability and governance, it is virtually impossible that board members or even senior management will protect against the risks that Basel II poses. Given the complex operations at most of our nation's largest banks, boards and even senior management will spend a few hours at most learning about the new accord and their banks' model, and the presentations necessarily will be very general and probably with no guidelines as to what the board is expected to do lest liability be created for the board in doing so. The heavy lifting will be left to the theoreticians and statisticians running the models, whose talents are unlikely to include an appreciation of the practical risks of running a bank. These modelers will not speak the same language as those charged with oversight of risk management, both figuratively and literally. We understand that much of the bank modeling has already been outsourced overseas, which only increases the potential for miscommunication and further *decreases the probability of effective oversight.*

This is not to say there is no role for modern risk management techniques. But they should be used by institutions primarily for internal management purposes rather than for determining what is needed to protect the FDIC insurance fund and, ultimately, the U.S. taxpayer.

Mortgage Lending

Since the focus of this latest supervisory guidance is on retail credit risk, allow us to say a few words about residential mortgages, the retail product we know best. Basel II would have us believe that mortgages are so safe as to require only minimal amounts of risk-based capital, perhaps only 1% of mortgage

"National bank regulators could be overwhelmed by the implementation of Basel II, with its intensive need for verification of the internal systems and databases of individual banks ... By passing to an internal model-based framework regulators run the risk of being co-opted by the diversified, complex international banks, which have more resources and have an interest in promoting their own risk management systems and in proving the appropriateness of their own capital allocation." [4] ***Standard & Poor's***

"The proposal is highly complex ... We believe it would be more advisable to adopt a simpler rule that supervisors can enforce equitably and effectively." [5] ***House Financial Services Committee***

"Regulators are already fearful that they will lack both the knowledge and person-power to review the complicated models ... Real-world supervisory limits add still more force to arguments for a less ambitious rule that first does what regulators know they can do in areas of clear concern and only then moves on to more difficult tasks." [6] ***Karen Shaw Petrou, Managing Partner of Federal Financial Analytics***

assets or a fraction thereof. These levels would be lower than what thrifts were required to hold in the years preceding the savings and loan crisis when some mistakenly believed that mortgage portfolios were so safe that only minimum capital was needed. Although mortgage credit risk has been relatively benign in the past decade for reputable lenders, the industry has experienced high credit losses in the past and will surely do so again.

"The reductions in capital for single-family residential mortgages appear to constitute a significant expansion of the safety-net support provided to this activity when conducted within national banking systems. A backward look at the credit risk performance of this sector may suggest such safety-net support will never need to be exercised, but this appears to be a heavy bet for bank regulators to place." [7] ***FDIC Paper***

And of course we must not forget the recent troubles at Fannie Mae and Freddie Mac, the nation's largest holders of mortgages and mortgage securities. Fannie Mae's and Freddie Mac's regulator has recently concluded that these housing GSEs need to raise their capital levels, an opinion that is shared by Federal Reserve Chairman Alan Greenspan. The irony, of course, is that the GSE capital levels will be required to be increased at the same time that Basel II banks' capital for the same mortgage assets will be allowed to decline to levels ***below*** what is currently held by Fannie Mae and Freddie Mac. Someone is not connecting the dots.

"The extensive set of rules and formulas to calculate the capital adequacy ratio suggests a degree of quantitative certitude that does not exist... Recessions are difficult to predict and capital is harder to raise once one has started." [8] ***Standard & Poor's***

We also disagree with allowing the nation's largest banks to hold less capital for retail assets than Basel I banks would be required to hold for the same assets. Some are suggesting that Basel I capital levels for retail assets therefore need to drop to match those of Basel II banks. We are concerned that this would simply result in a chase to the lowest common denominator and would result in the entire U.S. banking system operating with deficient capital levels for retail assets. The safer course of action would be to require all U.S. banks to hold capital for retail assets at levels comparable to what is required today. This approach should not hurt internationally active U.S. banks since retail assets sold to U.S. consumers is not where the main competition lies between U.S. and foreign banks. Any foreign bank that wanted to sell retail products on U.S. soil would be subject to the same regulatory capital standards as American banks, and U.S. regulators could also ensure that foreign banks are restricted from gaming the system through securitizations or otherwise.

"Because of the broader implications of a failure for the financial system and for the economy as a whole, the supervisory framework for the largest systematically significant banking organizations ... needs to produce a higher level of financial soundness than might be indicated by measures of economic capital or expected by shareholders and creditors of the institution." [9] ***Timothy F. Geithner, President and CEO of the Federal Reserve Bank of New York***

On the One Hand, On the Other Hand

Strong bank capital levels protect the system in the event of a crisis. According to Federal Reserve Vice Chairman Ferguson, the Fed's point person on Basel II, high capital may help mitigate the severity of recessions. In a recent speech, he stated that the health of the U.S. financial sector, including the capital levels that

had been built up after the adoption of Basel I, helped keep the 2001 U.S. recession relatively short and shallow. He added: "Despite the recession, banks remained well-capitalized, and their strength eliminated the threat of a vicious credit crunch or the risk of fragility in the system." We assume that Vice Chairman Ferguson also realizes that low capital levels will likely lead to, and exacerbate, financial crises.

"Contrary to descriptions of Basel II not significantly changing overall capital requirements, we expect large percentage reductions in risk-based capital requirements ... We believe that during most of a typical economic cycle, risk-based capital requirements for Basel II banks would be far below the levels needed for current Prompt Corrective Action (PCA) purposes..." [10] ***FDIC Paper***

Mr. Ferguson's argument underscores another point, which is that 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. There can be little doubt that the growth in capital levels at U.S. banks and thrifts has produced a banking system that today is sounder and more competitive than those abroad. Why risk an unproven and unprecedented approach to capital regulation when what we already have has proven to be working?

"Reducing the leverage ratio would undermine our whole system of prompt corrective action which is the foundation stone of our system of supervision ... I think we need to reach an appropriate accommodation where we try to make our basic system of regulatory capital rules more risk-sensitive, but we shouldn't do that at the price of dismantling or significantly impairing the basis for our supervision of U.S. banks." [11] ***Former Comptroller Hawke***

We are not arguing that Basel I is perfect. However, there are much sounder ways to modernize the current risk-based capital regulations than what is being proposed. Focused changes to Basel I – such as by further stratifying classes of assets, modernizing risk-weights, and addressing specific issues like securitizations – would probably take care of all legitimate capital issues.

And Whatever Happened to Safety and Soundness?

We are particularly disheartened that in virtually all the Basel II discussions, the phrase "safety and soundness" is seldom if ever mentioned. To protect the safety and soundness of our federally insured banks is a key reason for strong capital regulations and the related burdens on bank regulators, directors and management. Indeed, if Basel II is implemented and inevitably leads to one or more serious crises, we wonder who will come forward and admit that maybe they gave short shrift to safety and soundness. The more cynical among us might even say the reason the Basel II proponents do not discuss safety and soundness is they do not want their words to come back to haunt them.

"We also believe it is appropriate for staff at the agencies to consider, on a parallel track, whether there are more incremental alternatives to Basel II that can achieve the same goals without creating such substantial regulatory discontinuities and without such large potential changes in capital, both in aggregate and for specific activities." [12] ***FDIC Chairman Powell***

The quotes included in this commentary reveal that we are not

alone in expressing serious concerns about Basel II. We hope that the authors of these quotes and others will continue to express their opinions about how best to preserve the safety and soundness of the world's strongest banking system.

"We simply can't afford to bet the system on a theoretical model." [13] ***William Isaac (former Chairman of FDIC)***

We also hope, and sooner rather than later, that people will acknowledge that Basel II is not the answer, and that the only Basel II formula that really matters is a formula that is truly easy for everyone to understand:

$$\frac{\textit{(Complex Models) x (Bank Incentives to Reduce Capital + Human Error)}}{\textit{(Inadequate Supervision + Improbable Management and Board Oversight)}} = \textbf{\textit{Unsafe and Unsound}}$$

Herbert M. Sandler
Chairman and Chief Executive Officer

References

1. Letter addressed to Federal Reserve Vice Chairman Roger W. Ferguson, Jr. and then Comptroller of the Currency John D. Hawke, Jr. (June 9, 2003).

2. Testimony before the Subcommittee on Financial Institutions and Consumer Credit of the House Financial Services Committee (June 19, 2003).

3. Remarks at the American Academy of Berlin: "Basel II: A Brave New World for Financial Institutions?" (December 15, 2003).

4. "Basel II: No Turning Back for the Banking Industry" (Scott Bugie, Tanya Azarchs, Yves Burger, Scott Quinn) (August 22, 2003).

5. Letter to the four U.S. bank regulators signed by Representatives Oxley, Frank, Baker, Kanjorski, Kelly, Gutierrez, King, Maloney, Ney, Waters, and Bachus (November 3, 2003).

6. Testimony before the Domestic and International Monetary Policy, Trade and Technology Subcommittee on Financial Services (February 27, 2003).

7. "Estimating the Capital Impact of Basel II in the United States" (George French, Deputy Director for Policy and Examination Oversight in the Division of Supervision and Consumer Protection (December 8, 2003).

8. See endnote 4.

9. Remarks at the Conference on Systemic Financial Crises at the Federal Reserve Bank of Chicago (October 1, 2004).

10. See endnote 7.

11. Testimony before the Senate Banking Committee (April 20, 2004).

12. See endnote 1.

13. American Banker (March 16, 2004).