WORLD SAVINGS

November 3, 2003

Federal Reserve Board
Attn: Vice-Chairman Roger W. Ferguson, Jr.
Copy to regs.comments@federalreserve.gov

Office of the Comptroller of the Currency
Attn: Comptroller John D. Hawke, Jr.
Copy to regs.comments@occ.treas.gov

Federal Deposit Insurance Corporation
Attn: Chairman Donald E. Powell
Copy to comments@fdic.gov

Office of Thrift Supervision
Attn: Director James E. Gilleran
Copy to regs.comments@ots.treas.gov

RE: Supplemental Comment on Basel II's Advance Notice of Proposed Rulemaking

Dear Sirs:

Our first comment letter, submitted July 18, 2003 described in detail our concerns about the proposed Basel II capital regime. Among other things, inordinately complicated risk-based rules and the resulting "black box" models will be virtually impossible to regulate and monitor effectively, and ultimately will result in the nation's largest banks sinking to the lowest levels of capital possible.

While we reaffirm our earlier comment letter (attached) and continue to believe that the proposed Basel II regime is incompatible with promoting safety and soundness in the banking system, we wish to highlight the following points.

(1) A mandatory leverage requirement needs to be maintained.

We strongly agree with the position articulated in the ANPR that the existing leverage ratio requirements, in addition to prompt corrective action legislation and implementing regulations, should be maintained even if Basel II is adopted, including a minimum 5% leverage ratio, to be classified as "well-capitalized." However, it is essential that there be legislation or binding provisions that would prohibit the leverage ratios from being reduced or waived without some high level of review and action, possibly an act of Congress or the unanimous approval of a designated group, such as the Chairman of the FDIC, the Chairman of the Federal Reserve Board and the Secretary of the Treasury. Experience suggests that banks inevitably will opt for lower capital in order to achieve higher returns on equity.

Many commentators have criticized the current capital regime, claiming it is susceptible to arbitrage. We believe that Basel II's risk-based regime will be even more easily gamed unless leverage ratios are also in place. Minimum leverage ratios should be the foundation of any capital regime, with risk-based rules existing to impose additional capital requirements for riskier assets. Among other things, the leverage ratio ensures that, regardless of the risk-based model used by a bank or the manipulation we think will be endemic under Basel II, there is at least a base level of protection in the event of a crisis, rather than relying primarily on an insurance fund or a taxpayer bailout.

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Taking the residential mortgage industry as an example, Basel II would cause risk-based capital levels for residential mortgages to fall well below most leverage ratios. Such a result could be disastrous for the mortgage industry in the absence of a leverage ratio. While we agree that mortgage lending can operate at a high level of safety when prudently managed and supervised, complexities abound and significant downturns in the mortgage industry have occurred, and will continue to occur, when potential regulatory lapses are combined with low capital requirements. Ironically, 30 years ago, it was the failure to understand these complexities that caused the United States to give unreasonably favorable treatment to mortgages, and to allow marginal players to operate with minimum levels of capital. And then, when a large part of the thrift industry failed, the industry was roundly criticized for the folly of not having had adequate capital to back up their activities. Basel II's risk-based rules use the same wishful thinking that was used 30 years ago in the United States to justify unreasonably low capital levels for mortgage activities without regard to the relevant complexities.

In addition, the existing regulatory capital ratios should be strengthened to prevent financial institutions from selling assets off-balance sheet and lowering their capital requirements even though the probability of loss remains the same. It is nonsensical that a bank should gain a capital advantage simply by shifting assets from one pocket to another (see the attached for a simple illustration). This type of manipulation would be an even greater problem after Basel II where risk-based capital levels for some asset classes will fall well below most leverage ratios, if leverage ratios are in place at all. Accordingly, Basel II delegates should ensure that the capital levels required for off-balance sheet transactions, including securitizations, are clearly specified and tested against a range of scenarios.

(2) <u>Basel II's regime would have competitive implications and a destabilizing effect.</u>

Since capital is a key driver of return-on-equity, and a major focus of investors, banks continually measure, manage and massage capital to improve their market position. Basel II's internal ratings-based (IRB) approaches will give banks a powerful tool to manipulate capital levels and try to improve their profits relative to their competitors. The result will be a race toward the lowest amount of capital reserves, thereby distorting the purpose of a capital regime. The lower capital levels that Basel II banks obtain will also threaten the viability of those banks that remain subject to Basel I's higher capital thresholds, because these Basel I banks will either become attractive takeover targets or they will find it more difficult to compete for quality assets, leaving them with riskier assets, lower credit ratings and higher costs of funding.

(3) U.S. regulators should consider whether Basel II improves the stability of the U.S. and international banking systems.

While we can appreciate that there is a significant amount of political momentum moving Basel II toward adoption, especially in light of the sunk costs already devoted to the new accord and the exhaustion and/or frustration of the participants, we would urge U.S. regulators to avoid being swept up by the push to get something done and to consider instead whether Basel II will actually improve the stability of the U.S. and international banking systems.

We continue to wonder why U.S. regulators would acquiesce to the complex rules and self-directed models being advocated by international delegations with significantly less successful banking systems. Our national banking system has, over the past 30 years, been far more stable than those abroad, in large part because our prior bank and thrift crises produced a stronger regulatory framework and because we benefited from capital rules that are simple enough to be understood by management, applied consistently across all institutions, and monitored effectively by regulators and other market participants. Again, have we forgotten that complex rules and race-to-the-bottom incentives lead to mischief and quickly spiral into full-blown crises, irrespective of the sophistication of advanced models? The reality is that no one will know how good the models are until the next crisis. Regardless of whether international banking systems adopt Basel II, we suggest that the U.S. should not subject the safety and soundness of its banking system to the proposed new rules.

We are not opposed to well-reasoned changes to the current Basel I capital accord. However, given the importance of capital rules and the consequences if mistakes are made, we recommend evolutionary changes rather than a revolutionary approach that would allow banks to determine their own capital requirements. We continue to believe that the more responsible approach would be to improve the supervisory process and re-examine and adjust, as appropriate, Basel I's risk-weights and categories.

Sincerely,

Herbert M. Sandler
Chairman and Chief Executive Officer

Exhibit A
Selling Assets Off-Balance Sheet and Reducing Capital Requirements

Scenario A: On-Balance Sheet

Scenario A shows the capital requirement for a bank that is holding $1,000,000 of qualifying 1-4 family residential mortgage loans on its balance sheet. We are assuming a minimum regulatory capital percentage of 8%.

Asset value:	$1,000,000
Risk-weighting:	50%
Regulatory %:	8%
Capital requirement:	**$40,000**

Scenario B: Selling Assets Off-Balance Sheet while Retaining Small Recourse Tranche

Scenario B assumes that the bank decides instead to sell 90% of those same assets off-balance sheet, while retaining only a 10% recourse tranche on-balance sheet.

90% Off-Balance Sheet Tranche		10% Recourse Tranche	
Asset value:	$900,000	Asset value:	$100,000
Risk-weighting:	0%	Risk-weighting:	100%
Regulatory %:	8%	Regulatory %:	8%
Capital requirement:	$0	Capital requirement:	**$8,000**

As shown above, the bank would reduce its capital requirement to $8,000 by retaining only a 10% recourse tranche. One might argue that this capital reduction is appropriate since the bank now only holds 10% of the assets. The problem, however, is that the bank's 10% tranche may in fact bear the same probable risk of credit loss as the bank would bear under Scenario A, but with significantly less capital to support the same level of risk. For example, the transaction can be structured so that the bank's 10% tranche is a credit enhancement tranche in a first-loss position, meaning the tranche bears the first 10% of credit losses. So, even though the 10% tranche might end up absorbing most, if not all, of the credit risk of the $1,000,000 in assets, and even though the probability of the bank's credit loss remains the same between Scenario A and B, the bank would be able to save $32,000 in capital. And, of course, if the bank were to recycle the $900,000 in proceeds from the off-balance sheet sale into more loans, and restructure those new loans into additional Scenario B transactions, it quickly becomes apparent that very low levels of capital will be available to support an ever-expanding loan portfolio.

While this is obviously an over-simplified example, it illustrates one of the many ways a bank could reduce its capital requirements even though the same underlying assets are involved and the bank has an equivalent risk exposure. And this example does not even touch upon the bank's continued exposure under representations and warranties or other informal guarantees that are often used in structured transactions.

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July 18, 2003

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Office of Thrift Supervision
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RE: Comment on Basel II's Advance Notice of Proposed Rulemaking (ANPR)

Dear Sirs:

During our 40 years in the residential mortgage lending business, we have consistently advocated for reforms to improve the profitability and viability of the banking industry, including calling for appropriate capital requirements. We are alarmed by the prospect of a new Basel II capital regime that would give banks worldwide, including the nation's largest banks, the ability and incentive to sink to the lowest denominator of capital they can get away with. Such a regime is incompatible with promoting safety and soundness in the banking system.

We strongly urge U.S. regulators and legislators not to adopt Basel II as it has been proposed. Instead, a more productive and responsible approach would be to: (1) re-examine and adjust, as appropriate, Basel I's risk-weights and categories and (2) improve the imperfections and inconsistencies in the supervisory process. We strongly support the position articulated in the ANPR that U.S. banking organizations should continue to be subject to a leverage ratio requirement as described under existing prompt corrective action legislation and implementing regulations, regardless of the risk-based capital accord that is in place. We propose that these leverage ratios should only be able to be revised or waived by legislative action. We also urge U.S. representatives on the Basel Committee to insist that the same minimum leverage ratios be required world-wide so there is a capital safety net for the international banking system.

Fundamental Requirements of any Capital Regulation

In our view, any capital regulation needs to be able to achieve the following:

(1) Maximize the safety and soundness in the international banking system by ensuring that sufficient capital is available as a cushion against mistakes or unanticipated crises.

(2) Provide a fair and level playing field for all participants, so that no banking institution is advantaged or disadvantaged because of their size or geographic location.

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(3) Try to synchronize capital levels with the relative risk of different instruments and borrowers.

(4) Enable regulators and supervisory personnel to readily understand the capital rules and ensure that adequate resources are available to provide effective supervision.

(5) Be transparent enough to enable boards of directors, senior management and business managers to direct and oversee the bank's capital program.

(6) Create appropriate incentives for banks to maintain sufficient capital levels (and disincentives to maintain inadequate levels).

(7) Provide a means for investors and other third parties to assess the adequacy of a bank's capital ratios.

As discussed below, we believe a modernized Basel I can effectively meet these standards, while Basel II will fall dangerously short by placing undue emphasis on risk sensitivity (#3 above) to the detriment of the other objectives.

A Modernized Basel I is a Better Solution

While Basel I may need some incremental improvements to continue to meet the standards described above, its rules are simple enough to be understood by all interested parties, it has substantially leveled the playing field for banks that compete under different regulatory systems, and it has a decade-long track record of not creating or exacerbating any crises.

We are not persuaded that the commonly cited criticisms of Basel I justify an overhaul of global capital rules that would disrupt settled markets and enable banks, for the first time, to pick their own capital requirements from a self-directed model. First, the one-size-fits-all approach under Basel I works *because* it is simple enough to be understood by boards of directors and management, applied consistently across all institutions, and monitored effectively by regulators and other market participants. Simplicity promotes stability. When capital rules are understood by all interested parties, it becomes more difficult for the mischievous to fool the ignorant (complexity, by contrast, invites mischief, as evidenced in other complex areas such as derivatives and special purpose entities). If additional risk categories are needed to more closely align capital requirements with risk levels, this can be done without resorting to Basel II's convoluted scheme. The risk-weighting of these categories could also be modernized to better match current knowledge about actual risk exposures. If the U.S. were to adopt Basel II, we believe it should adopt only an approach akin to Basel II's "standardized" approach that continues to assign fixed risk weights to supervisory categories.

Second, if operational risk justifies a separate capital charge, and we are not convinced it does, then Basel I could be revised to give regulators the authority to determine an appropriate capital augmentation based on a bank's operating history and internal controls. Third, if banks are retaining higher-risk assets after selling or securitizing their lower-risk assets, and if this actually increases the potential for a crisis, then arguably Basel I's capital thresholds should be increased for riskier assets.

Basel II Creates More Problems than Solutions

Basel II is another example of what happens when one puts into a room, for several years, a very bright group of people charged with developing a model to address every perceived imperfection in a highly arcane subject area. The only way for the participants to reconcile their theoretical ideas with the inevitable political concessions is to produce an expansive model that requires hundreds of mind-numbing pages to explain. Even the few experts who may believe they understand the model will be unable to appreciate all the unintended consequences that will result once market forces come into play, including how one or more parties will try to game the new model and force more conservative competitors to fall away or follow suit. We find it all oddly reminiscent of the process that resulted in the debacle of California's so-called energy deregulation, the consequences of which were mild compared to the potentially destabilizing and devastating global consequences under Basel II's privatization of bank regulation.

U.S. regulators should pause to reconsider whether the stability and competitiveness of the U.S. banking system would really be improved by joining the proposed international capital accord. As we see it, the U.S. banking system has proven stronger and more resilient during recent economic cycles than the international bank systems. This can largely be attributed to the tough lessons learned during U.S. bank and thrift crises, including the importance of core (leverage) capital, the need for laws and regulations that encourage financial institutions to act in a safe manner (and that discourage the opposite), and the critical role played by active and informed regulators backed by the strength of prompt corrective action. We believe this strong regulatory framework has contributed to the better performance of U.S. financial institutions relative to non-U.S. banks. Basel II is incompatible with these regulatory principles and is largely the product of delegates from international bank systems that are hardly worth emulating. These delegates have frequently been motivated by their own domestic agendas rather than a desire to create an accord that improves safety and soundness world-wide. Therefore, we wonder why the U.S. should acquiesce to weakening its bank regulatory standards to those used, and proposed, by other less successful international regimes. Rather than sinking to the lowest capital denominator, we should maintain our high national standards and insist that international bank systems raise their standards.

Proponents of Basel II like to rationalize the new accord's complexity by stating that banking itself has become more complex, and that more sophisticated risk-management models now exist. These justifications overlook the real-world consequences of adopting an inordinately complicated regime, including the resources needed for implementation, the problems inherent in on-going maintenance, the improbability of effective regulation and market oversight, and the competitive pressures that will encourage banks to game the system.

Implementation Concerns

A bank that needs, or elects, to adopt Basel II would have to devote substantial up-front resources to implement the accord. Estimates range from $10 million for smaller banks to upwards of $200 million for large internationally active banks. The number of personnel hours necessary to understand and implement the new accord will be substantial. The vast majority of banks in the US will be unable or unwilling to devote these resources, even if their conservative operations and asset base might warrant a lower risk-based capital charge. Basel II will result in wide variations in capital standards used by banks, with inevitable competitive implications that will be discussed below.

Those banks that can, and do, adopt Basel II, principally the largest banks, will face tremendous challenges in managing the implementation of such a complicated scheme. While the board of directors and senior management are ultimately responsible for approving the Basel II implementation plans, as well as understanding and managing the bank's risks and financial results (which responsibility has been heightened after Sarbanes-Oxley), it is unlikely that any director or executive officer will have more than a surface understanding of Basel II or the bank's own risk-based model. Rather, senior officers and directors will hear truncated reports from time to time, and may even ask questions or alter company strategy in response to the inputs and outputs generated by the bank's black box, but they will not understand the black box itself.

Nor will they want to, either because of the demands on their schedules, the absence of the required technical skills, or the insulation gained from deferring to, and keeping a safe distance from, the experts. At the same time, management would prefer that the bank's expenditures in implementing Basel II could be recouped by creating a model that reduces the bank's capital requirements. While these results-oriented pressures may not be as pronounced during the initial phase-in period, they *will* exist and will expand with time, especially in the face of competition. This is not to suggest malfeasance by directors or management; it is merely an acknowledgement of the realities that exist at most institutions. Banks will also tend to underestimate risk inputs during the implementation phase, if for no other reason than the empirical data of the last decade has been uncharacteristically favorable as compared to prior economic cycles.

On-Going Maintenance Problems

Only a handful of employees at any bank will understand the most complicated elements of the black box, and virtually no one will understand it in totality. Those individuals with the skill set to understand the complexity will probably have an academic bent and will not fully understand the dynamics of each of the bank's business units. They could easily miss important, subtle distinctions or developments that could have a dramatic impact on real-world risk at the bank. Consultants hired to advise the bank about the black box likewise will almost certainly lack experience managing or operating a bank. Even assuming a small group of employees and consultants initially understands a bank's model, personnel turnover will inevitably occur, and their successors will not understand all the tradeoffs, assumptions and other idiosyncracies that have been built into the model. Directors and management will increasingly rely on the expertise and judgment calls of the black box technicians, even though there will be a continual loss of memory about the original details of the model. Later generations of technicians will be less equipped to recognize the problems in the model, or to acknowledge its obsolescence, and will be incented to make incremental "improvements" to the black box to deliver acceptable results.

The bank's model will also require regular data inputs from individuals and departments throughout the bank, even though few if any of them will understand the nuances of Basel II or the bank's model. There will be immense pressures, both explicit and not-so-explicit, for people in the field to report information that will yield a positive result in the model. The flow of information into the black box will inevitably be delayed, as people in the field will want to ensure the accuracy of the data and may be prone to scrub any departmental data that could conceivably have a negative impact on their particular capital requirements. It could take years for subtle changes in a bank's risk management systems to be accurately reflected in the bank's model, and longer still for management to understand the implications. Additionally, in major transactions, such as mergers or acquisitions, a bank may not realistically understand all the integration and other risks for many years, even though management will likely underestimate the negative impact of those uncertainties in their risk-based model until it becomes apparent at a much later time. Many recent crises, including those on Wall Street, have resulted from individuals glossing over, or obfuscating, near-term unfavorable results in the hope that nobody would notice and results would ultimately improve. Basel II gives banks a major incentive to do the same.

Improbability of Effective Regulation and Market Oversight

If the drafters of Basel II had devoted as much time addressing imperfections and inconsistencies in the supervision of capital rules as they did in creating formulas to correct every perceived imperfection and inconsistency in capital calculations, the risks in the global banking system would have been much more effectively mitigated. Unfortunately, Basel II does nothing to improve supervisory standards and is too optimistic about the ability of regulators to supervise the new and highly complicated risk-based capital rules. The U.S. regulatory agencies also are not "proposing to introduce specific requirements or guidelines to implement" the supervisory pillar of Basel II. (ANPR, p. 19) We are concerned with the seeming lack of attention being given to the very practical realities of trying to implement and then regulate the new complex risk-based capital rules. Regardless of the intelligence and good intentions of regulatory agencies charged with supervising a bank's activities, we believe they will not be able to effectively validate a bank's internal methods of risk management and guard against systemic risks.

First, it will be difficult for all the global regulatory agencies to find sufficient talent to fill their ranks, especially when they will be competing for PhD-level expertise against banks with far deeper pockets. Without sufficient staff to understand and keep current on each bank's unique black box, and to conduct the increasingly complex bank examinations, regulators will be forced to make resource allocation decisions that diminish across-the-board oversight.

Second, even if adequate resources are available, unless a supervisor actually participates in building and then managing a bank's black box, it will be virtually impossible to understand all the model's assumptions and anticipate its limitations. At the same time, a supervisor who does participate in the model's development and maintenance is more likely to be co-opted into believing the model works or to be so buried in the details as to overlook emerging risks. Basel II places inordinate faith in singularly skilled and self-assured supervisors who can understand both a bank's intricate model and its unique real-world risks, and can then identify and advocate technical fixes in the face of rebuttals and protests from the dozens of skilled bank employees who spent years developing the models. Without hundreds, if not thousands, of these skilled supervisors throughout the world, the measurement and management of risks in the global banking system will be determined by bank technocrats managing the black boxes.

Third, many of these skilled supervisors will have other job opportunities, leaving later generations without the institutional knowledge necessary to understand the complexities of each bank's black box. It is difficult to imagine that later generations of supervisors will ever be closer than three or four steps behind the bank personnel that manage the model. As a consequence, it will be much more difficult for supervisors to respond quickly when things start to go wrong. Prompt corrective action, one of the most important safety nets for U.S. banks, will almost always arrive too late.

The third pillar in Basel II, that of market discipline, is based on the notion that the market, and/or the banks' own internal-based modeling, will ensure that banks maintain adequate capital levels. We certainly support efforts to encourage the market to provide additional oversight of the adequacy of bank capital, but Basel II does not provide any meaningful protection in this regard. As proposed, we do not believe the markets will be in any better position than the regulators to understand all the implications of a bank's risk-based model. If anything, they will be worse off in having to rely on the disparate black boxes. Also, since markets do not always operate efficiently or with perfect information, market disclosure and discipline is unlikely to identify, and may tend to minimize, problems in the banks or the banks' models. Rating agencies have been criticized for reacting too slowly during crises and for being under pressure to deliver good ratings in order to continue to win business. Accordingly, this form of market discipline will function least when needed most. Additionally, market oversight has not proven particularly effective at preventing other crises, as market participants selectively overlook potential problems during the build-up of speculative bubbles. Finally, any bank that develops an internal risk management model will want to design it to be market sensitive. If every bank does so, then all the models will be sensitive to the same market information, causing institutions to all react the same way during a crisis.

Competitive Pressures

Regulatory capital is a key driver of return-on-equity and, therefore, profitability. At the same time, it is axiomatic that banks cannot grow their asset base without correspondingly increasing their capital levels (since capital thresholds are expressed as a percentage of assets). While many conservative banks maintain capital levels in excess of regulatory thresholds, other banks are more aggressive at managing their capital levels in order to grow their asset base and/or free up capital for other purposes.

Contrary to what some Basel II proponents have said (that levels of required capital do not have a competitive impact), capital is a fundamental financial metric that all companies actively measure, manage and massage in order to improve their earnings and competitive position. The pricing and structure of commercial loan transactions is very much influenced by the impact on the counter-party's capital. Our bank has entered into transactions with other financial institutions that charged higher prices if the transaction required higher capital. Additionally, any commercial bank borrower is familiar with 364-day credit facilities that roll over each year, a structure that was essentially invented solely to allow commercial banks to avoid a higher capital charge on loans. There are few, if any, transactions in which a bank does not consider the impact on the bank's capital.

In the face of both international and domestic competition, a large U.S. bank under Basel II would have every incentive to create and maintain a risk-based model that allows it to reduce capital levels below both its Basel I level and the capital levels of its competitors. Failure to do so could not only jeopardize the bank's profitability relative to its peers, but could also enable competitors to boost their asset base and invest freed-up capital elsewhere. Even if only a few large banks start out trying to game the system, others will find it difficult to stay on the sidelines. The result could be a race by the nation's largest banks toward the lowest amount of capital reserves. Basel II banks will have an incentive to find or create the capital model that requires the least amount of its capital, and will even be encouraged to find ways to exchange their high-capital assets with other banks whose own risk-based models (or supervisors) would accommodate a lower risk-based capital charge for those same assets. As a consequence, instead of ensuring that sufficient capital is available to address risks, Basel II's do-it-yourself capital measurements will have distorted economic incentives and will lead to greater risk-taking and greater concentrations of risk.

The lower capital levels that large banks obtain under Basel II also will inevitably threaten the viability of small to medium-sized banks. These smaller banks perform a critical role in local economies, especially as lenders of residential, small-business and other retail products. Since most of these smaller banks will remain under Basel I, they will have difficulty competing against bigger Basel II banks that benefit from reduced risk-weighting for these same assets. Furthermore, small Basel I banks would be likely takeover targets for Basel II banks that believe they could deploy Basel I bank capital more "efficiently." Basel I banks that survive will find it more difficult to compete for quality assets and could be left with riskier assets, lower credit ratings and higher costs of liabilities.

The competition described in the preceding paragraph also could destabilize the nation's housing market, one of the few bright spots currently in the U.S. economy. Because of the lower capital requirements under Basel II for residential mortgages, large banks may increase their asset base allocated to mortgages, price mortgage products below what Basel I banks can offer, and enhance their ability and desire to acquire small lenders. They also may increasingly try to categorize consumer and other credit as mortgage-related assets, and competition in pricing could make the system vulnerable to a speculative bubble. With industry consolidation, products also may become further standardized, in which case consumers and businesses would have fewer choices. The concentration of mortgage assets in just a few institutions would further heighten potential system risk.

Recommendations and Conclusion

The drafters of Basel II purportedly set out to devise a more efficient and effective risk-based capital model; instead, they have crafted a risky model that inevitably will lead to capital deficiencies. The objectives of any capital accord should be to promote stability by requiring that sufficient capital be available, level the playing field, and enable interested parties (boards of directors, management, regulators and other market participants) to effectively monitor capital levels and intervene if necessary. Basel II will not achieve this result, because of its complexity, its high potential for manipulation, and the impracticalities of effective regulation and market oversight.

A much better way to proceed would be to make specific incremental changes to Basel I in areas where the existing accord currently falls short and to improve the imperfections and inconsistencies in the supervisory process. For the reasons discussed above, we believe that capital requirements could be more closely aligned with actual risk, without resorting to Basel II's bank-driven models, simply by increasing somewhat the number of risk categories and re-calculating specific risk-weightings using modern risk management techniques. This modernized Basel I approach would avoid the unnecessary complexity and competitive implications of the Basel I/Basel II bifurcated regulatory framework being proposed.

At the very least, any capital accord should co-exist along with a minimum leverage requirement that applies to both domestic and international banks. We agree with the position articulated in the ANPR that the existing leverage ratio requirements under prompt corrective action legislation and implementing regulations should be maintained, including a minimum 5% leverage ratio to be classified as "well-capitalized." Moreover, there should be legislation or binding provisions that would prohibit the leverage ratios from being reduced or waived without legislative action. Among other things, a minimum leverage ratio ensures that, regardless of the risk-based capital model used by a bank, there is a base level of capital available in the event of a crisis. It would serve as a counter-balance to unexpected risks that might arise or the manipulation created by either Basel I or Basel II. The U.S. regulatory agencies properly have decided not to "place sole reliance on the results of economic capital calculations for purposes of computing minimum regulatory capital requirements." (ANPR, p. 10) Because of the added safety and soundness protection that a leverage ratio provides, we would urge American representatives in Basel II to insist that a leverage ratio be applied to all banks world-wide under the accord.

As a matter of sound public policy, we believe it is infinitely wiser for a capital accord to err on the side of overcapitalized banks, rather than giving banks worldwide the ability and incentive to reduce capital levels as low as possible. Unless the U.S. dispenses with Basel II's fanciful scheme, the seeds of the next bank crisis will have been sown, watered, and be well along in destructive growth.

Sincerely,

Herbert M. Sandler
Chairman and Chief Executive Officer

Appendix I

About World Savings

- World Savings is the principal subsidiary of Golden West Financial Corporation, a NYSE-listed company (ticker: GDW)

- As of March 31, 2003, World Savings held assets of over $70 billion, most of which consist of adjustable rate loans secured by residential mortgages. World Savings currently operates 476 savings and lending offices in 38 states.

- The company's compound average annual earnings per share growth for the past 35 years has been 20%

- World Savings' "double A" credit rating is the highest ever earned by an independent savings institution and a full two notches above any other independent thrift.

- World Savings' high capital level falls in the "well-capitalized" category with the Office of Thrift Supervision, the top tier available. A well-capitalized bank must have a Tier 1 core or leverage ratio of 5% or greater (ours is above 7%), a Tier 1 risk-based capital ratio of 6% or greater (ours is above 13%), and a total risk-based capital ratio of 10% or greater (ours is above 14%).

As of July 18, 2003