MEMORANDUM

To: Members of the Permanent Subcommittee on Investigations

From: Senator Carl Levin, Subcommittee Chairman
Senator Tom Coburn, Ranking Member

Date: April 16, 2010

Re: **Wall Street and the Financial Crisis: The Role of Bank Regulators**

On Friday, April 16, 2010, beginning at 9:30 a.m., the Permanent Subcommittee on Investigations will hold the second in a series of hearings examining some of the causes and consequences of the recent financial crisis. This hearing will focus on the role played by federal bank regulators, using as a case history Washington Mutual Bank, the largest bank failure in U.S. history.

Subcommittee Investigation. In November 2008, the Permanent Subcommittee on Investigations initiated a bipartisan investigation into some of the causes and consequences of the financial crisis. Since then, the Subcommittee has engaged in a wide-ranging inquiry, issuing numerous subpoenas; conducting over 100 interviews and depositions; and consulting with dozens of government, academic, and private sector experts on banking, securities, financial, and legal issues. The Subcommittee has also accumulated and initiated review of over 50 million pages of documents, including court pleadings, filings with the Securities and Exchange Commission, trustee reports, prospectuses for securities and private offerings, corporate board and committee minutes, mortgage transactions and analyses, memoranda, marketing materials, correspondence, and email. The Subcommittee has also reviewed documents prepared by or sent to or from banking and securities regulators, including bank examination reports, reviews of securities firms, enforcement actions, analyses, memoranda, correspondence, and email.

To provide the public with the results of its investigation, the Subcommittee is holding a series of hearings addressing the role of high risk lending, regulators, credit rating agencies, investment banks, and others in the financial crisis. These hearings will examine issues related to mortgage backed securities, collateralized debt obligations, credit default swaps, and other complex financial instruments. After the hearings, a report on the investigation will be prepared.

Washington Mutual Case History. The initial hearing in the series, on April 13, used Washington Mutual Bank as a case study to examine the role of high risk loans in the U.S. financial crisis. Headquartered in Seattle, with branches and loan centers across the country, Washington Mutual Bank had over 100 years of experience in the home loan business and had grown to become the nation's largest thrift with more than $300 billion in assets, $188 billion in deposits, and 43,000 employees. Washington Mutual's thrift charter required the bank to concentrate on home loans and maintain most of its assets in mortgage related activities. Each year, it originated or acquired billions of dollars of home loans through multiple channels, including loans originated by its own loan officers, loans brought to the bank by third party mortgage brokers, and loans purchased in bulk from other lenders or firms. In addition, its

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affiliate, Long Beach Mortgage Company ("Long Beach"), originated billions of dollars in home loans brought to it by third party mortgage brokers specializing in subprime lending.

Washington Mutual kept a portion of its home loans for its own investment portfolio, and sold the rest either to Wall Street investors, usually after securitizing them, or to Fannie Mae and Freddie Mac. At first, Washington Mutual worked with Wall Street firms to securitize its home loans, but later built up its own securitization arm, Washington Mutual Capital Corporation.

Until 2006, Washington Mutual's operations were profitable. In 2007, many of its high risk loans began experiencing increased rates of delinquency and loss, and after the subprime mortgage backed securities market collapsed in September 2007, Washington Mutual was unable to sell its subprime loans. In the fourth quarter of 2007, the bank recorded a loss of $1 billion. In 2008, Washington Mutual's stock price plummeted against the backdrop of a worsening financial crisis, including the forced sales of Countrywide Financial Corporation and Bear Stearns, government takeover of IndyMac, bankruptcy of Lehman Brothers, taxpayer bailout of AIG, and conversion of Goldman Sachs and Morgan Stanley into bank holding companies. In the first half of 2008, Washington Mutual lost another $4.2 billion, and its depositors withdrew a total of over $26 billion from the bank. On September 25, 2008, Washington Mutual Bank was placed into receivership by its primary regulator and was immediately sold to JPMorgan Chase for $1.9 billion.

Washington Mutual's Regulators. Washington Mutual's primary federal regulator was the Office of Thrift Supervision ("OTS"). OTS was created in 1989, in response to the savings and loan crisis to charter and regulate the thrift industry. It is part of the U.S. Department of the Treasury and headed by a Presidentially-appointed Director. Like other bank regulators, OTS is charged with ensuring the safety and soundness of the financial institutions it oversees. Its operations are funded through semiannual fees assessed on the institutions it regulates, with the fee amount based on the size, condition, and complexity of each institution's portfolio. Washington Mutual provided 12-15% of OTS revenue from 2003 to 2008.

OTS supervises its thrifts through four regional offices led by a Regional Director, Deputy Director, and Assistant Director. The regional offices assign an Examiner In Charge, supported by other examination personnel, to each thrift. OTS currently oversees about 765 thrift-chartered institutions. In all, approximately three-quarters of the OTS workforce reports to the four regional offices, while the remaining quarter works at the OTS Washington headquarters. Washington Mutual was supervised by the West Region whose office was, through the end of 2008, based in Daly City, California.

In addition to OTS, Washington Mutual was regulated by the Federal Deposit Insurance Corporation ("FDIC"). The mission of the FDIC is to maintain stability and public confidence in the nation's financial system by insuring deposits, examining and supervising financial institutions for safety and soundness and consumer protection, and managing failed institutions placed into receivership. To carry out these responsibilities, FDIC has backup supervisory authority over approximately 3,000 federally insured depository institutions whose primary regulators are the OTS, Office of the Comptroller of the Currency, or Federal Reserve. The

Deposit Insurance Fund is financed through fees assessed on the insured institutions, with assessments based on the amount of deposits requiring insurance and the degree of risk posed by each institution to the insurance fund.

For the eight largest institutions, the FDIC assigns at least one Dedicated Examiner to work on-site at the institution. The examiner's obligation is to evaluate the institution's risk to the Deposit Insurance Fund and work with the primary regulator to lower that risk. The FDIC has entered into a 2002 inter-agency agreement with the primary bank regulators to facilitate and coordinate their respective oversight obligations and ensure the FDIC is able to protect the Deposit Insurance Fund. Pursuant to that agreement, the FDIC may request to participate in examinations of large institutions or higher risk financial institutions, recommend enforcement actions to be taken by the primary regulator, and if the primary regulator fails to act, take its own enforcement action with respect to an insured institution. Washington Mutual had a FDIC-assigned Dedicated Examiner who worked with OTS examiners to oversee the bank.

Federal bank regulators have a wide range of informal and formal enforcement actions that may be used to ensure the safety and soundness of a financial institution. Informal enforcement actions, which are not made public, include issuing examination findings to the bank and both recommending and requiring corrective action, notifying the Board of problems, and requiring the Board to issue a resolution with commitments for corrective actions. Formal enforcement actions, which become public, include requiring the bank to enter into a Memorandum of Understanding with commitments for corrective action, imposing monetary fines, issuing cease and desist orders, and removing bank personnel.

The Examination Process. The stated mission of the OTS is "[t]o supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs." The OTS Examination Handbook, in section 10.2, requires "[p]roactive regulatory supervision" with a focus on evaluation of "future needs and potential risks to ensure the success of the thrift system in the long term."

To carry out its mission, OTS traditionally conducted an examination of its thrifts every 12-18 months and provided the results in an annual Report of Examination ("ROE"). In 2006, OTS initiated a "continuous exam" program for its largest thrifts, requiring its examiners to conduct a series of specialized examinations during the year with the results from all of those examinations included in an annual ROE. The Examiner in Charge led the examination activities which were organized around a rating system called CAMELS that is used by all federal bank regulators. The CAMELS rating system evaluates a bank's: (C) capital adequacy, (A) asset quality, (M) management, (E) earnings, (L) liquidity, and (S) sensitivity to market risk. CAMELS ratings use a scale of 1 to 5, with 1 being the best rating and 5 the worst. In the annual ROE, OTS provided its thrifts with an evaluation and rating for each CAMELS component, as well as an overall composite rating on the bank's safety and soundness.

At Washington Mutual, OTS examiners conducted both on-site and off-site activities to review bank operations, and maintained frequent communication with bank management through

emails, telephone conferences, and meetings. Washington Mutual formed a Regulatory Relations office charged with overseeing its interactions with OTS, the FDIC, and other regulators. During the year, OTS examiners issued "findings memos," which set forth particular examination findings, and required a written response and corrective action plan from Washington Mutual management. The findings ranged from "observations," to "recommendations," to "criticisms." The most serious findings were elevated to the Washington Mutual Board of Directors through designation as a Matter Requiring Board Attention ("MRBA"). MRBAs were set forth in the ROE and presented to the Board in an annual meeting attended by OTS and FDIC personnel. Washington Mutual tracked OTS findings and its responses through its Enterprise Issue Tracking System ("ERICS"). In a departure from its usual practice, OTS did not maintain a separate tracking system but simply relied on Washington Mutual's ERICS system to identify past examination findings and the bank's responses.

The FDIC also examined Washington Mutual, relying primarily on the examination findings and ROEs developed by OTS. The FDIC assigned its own CAMELS ratings to the bank. In addition, for institutions with assets of $10 billion or more, the FDIC has established the Large Insured Depository Institutions ("LIDI") Program to assess and report on emerging risks that may pose a threat to the Deposit Insurance Fund. Under this program, the Dedicated Examiner and other regional case managers perform ongoing analysis of emerging risks within each insured institution and assign a quarterly risk rating, using a scale of A to E, with A being the best rating and E the worst. In addition, senior FDIC analysts within the Complex Financial Institutions Branch analyze specific bank risks and develop supervisory strategies.

Washington Mutual's Examination History. From 2003 to 2008, OTS repeatedly identified significant problems with Washington Mutual's lending practices, risk management, and asset quality, and requested corrective action. Washington Mutual promised year after year to correct identified problems, but failed to do so. OTS failed to respond with meaningful enforcement action, resisted FDIC recommendations for stronger measures, and even impeded FDIC examination efforts.

OTS findings memoranda and ROEs repeatedly identified serious underwriting and risk management deficiencies at Washington Mutual. OTS elevated these issues to Washington Mutual's board by issuing MRBAs on underwriting deficiencies every year from 2003-2008. For most of those years, OTS determined that either Single Family Residential loan underwriting at Washington Mutual or subprime underwriting at Long Beach was "less than satisfactory." It also issued MRBAs on the need for stronger risk management from 2004-2008. In 2007, an OTS examiner noted that WaMu had nine different compliance officers in the past seven years, and that "[t]his amount of turnover is very unusual for an institution of this size and is a cause for concern."[1]

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[1] Draft OTS Exam Findings Memo, "Compliance Management Program," May 31, 2007, Franklin_Benjamin-00020408_001.

In January 2005, Washington Mutual made a strategic decision to shift its focus from low risk fixed rate and government-backed loans to higher risk subprime, home equity, and Option ARM loans. OTS examiners expressed concern about but did not restrict a number of high risk lending practices at the bank, including accepting stated income loans without verifying the borrower's assets or ability to repay the loan, low documentation loans, loans with low FICO scores and high loan-to-value ratios, loans that required interest only payments, and loan payments that did not cover even the interest owed, much less the principal.[2] When one OTS examiner attempted to restrict "No Income No Asset (NINA loans)" in which the lender did not have to verify information about a borrower's income or assets, the OTS West Region overruled him and ignored an OTS policy official in Washington, D.C., discouraging use of such loans, calling him a "lone ranger" within the agency.

When Washington Mutual announced its shift to higher risk loans, OTS examiners observed that robust risk management practices would be necessary to function as a check and balance on the high-risk lending strategy. Yet from 2005 through 2008, OTS examiners consistently found Washington Mutual's risk management practices lacking. In addition, as noted above, throughout this period, OTS examiners continuously criticized Washington Mutual's underwriting standards and practices as "less than satisfactory" and the amount of underwriting errors as "higher than acceptable." OTS also observed over the years loans with erroneous or fraudulent information, loans that did not comply with the bank's credit requirements, or loans that contained other problems. Notwithstanding the many control weaknesses the bank's underwriting and risk management practices, OTS examiners took no action to bring about change in these areas.

OTS examiners were also aware that many Washington Mutual and Long Beach loans were brought to the bank by third party mortgage brokers or lenders over which the bank exercised weak oversight, but again took little action. For example, when OTS examiners noted in a 2007 findings memo that Washington Mutual had only 14 full-time employees overseeing over 34,000 third-party brokers, the examiners made only the following observation: "Given the . . . increase in fraud, early payment defaults, first payment defaults, subprime delinquencies, etc., management should re-assess the adequacy of staffing."[3] Washington Mutual management agreed with the finding, but provided no corrective action plan, stating only that "[s]taffing needs are evaluated continually and adjusted as necessary."

In 2006, due to increasing concerns about lax lending practices and exotic high-risk mortgages, federal bank regulators worked together to draft inter-agency guidance on

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[2] *See, e.g.*, OTS Report of Examination for Washington Mutual Bank, March 14, 2006, at 19, OTSWMEF-0000047030 ("We believe the level of delinquencies, if left unchecked, could erode the credit quality of the portfolio. Our concerns are increased when the risk profile of the portfolio is considered, including concentrations in Option ARMS to higher-risk borrowers, in low and limited documentation loans, and loans with subprime or higher-risk characteristics. We are concerned further that the current market environment is masking potentially higher credit risk.").

[3] OTS Examination Findings Memo, "Broker Credit Administration," June 7, 2007, Hedger_Ann-00027930_001.

nontraditional mortgage products ("NTM guidance"). During the drafting process, OTS argued for less stringent lending standards than other regulators were advocating, using data supplied by Washington Mutual in order to protect the bank's loan volume. Once the guidance was issued in October 2006, while other bank regulators told their institutions that they were expected to come into immediate compliance, OTS took the position that compliance was something institutions "should" do, not something they "must" do, and allowed its thrifts over a year to comply.

For example, the NTM guidance required banks to evaluate a borrower's ability to repay a mortgage using a fully-indexed interest rate and fully-amortized payment amount. Washington Mutual, after learning that compliance with that requirement would lead to a 33% drop in loan volume due to borrowers who would no longer qualify for the loans, determined to "hold[] off on implementation until required to act for public relations … or regulatory reasons."[4] OTS allowed Washington Mutual to continue qualifying borrowers using lower loan payment amounts for another year, resulting in the bank's originating many Option ARM loans that would later suffer significant losses.

OTS justified its regulatory stance in part by pointing to Washington Mutual's profits and low level of mortgage delinquencies during the height of the mortgage boom, reasoning that the lack of losses made it difficult to require the bank to reduce the risks threatening the bank's safety and soundness. The OTS Examiner in Charge put it this way in a 2005 email: "It has been hard for us to justify doing much more than constantly nagging (okay, 'chastising') through ROE and meetings, since they have not been really adversely impacted in terms of losses."[5] Another examiner concerned about the bank expressed her frustration this way: "I'm not up for the fight or the blood pressure problems. . . . It doesn't matter that we are right . . . They [Washington Mutual] aren't interested in our 'opinions' of the program. They want black and white, violations or not."[6]

FDIC evaluations of Washington Mutual were consistently more negative than those of the OTS, with LIDI ratings that showed a higher degree of bank risk than OTS CAMELS ratings indicated, creating friction between the two agencies. In 2006, OTS began to exclude FDIC staff from active bank oversight by limiting the number of staff allowed on site, temporarily disrupting FDIC access to office space and bank information, and refusing to allow FDIC to review loan files, even for higher risk loans that could affect the FDIC's assessment of insurance fees on Washington Mutual or pose a threat to the deposit insurance fund. In February 2007, OTS refused to allow the FDIC to review loan files to evaluate Washington Mutual's compliance with the NTM guidance. In April 2007, when FDIC officials raised the issue with the OTS West Region Director, he disclosed for the first time to the FDIC that OTS was allowing the bank additional time to comply with the guidance before conducting file reviews.

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[4] Email from Ron Cathcart to David Schneider, dated March 19, 2007, JPM_WM02571598.

[5] EIC Lawrence Carter email to West Region Deputy Director Darrel Dochow, Sept. 15, 2005, OTSWMS05-002 0000535.

[6] Email from Mary Suzanne Clark to EIC Ben Franklin, dated June 3, 2007, OTSWMS07-013 0002576.

When asked why the FDIC did not use its independent enforcement authority at Washington Mutual, one senior FDIC official told the Subcommittee that the agency had never used that authority because its fellow banking agencies would view an independent enforcement action as "an act of war" – an invasion of their regulatory turf that would irreparably harm the FDIC's working relationships with those agencies. Rather than take independent enforcement action, the FDIC had restricted itself to urging action by the primary bank regulator.

In July 2007, U.S. financial markets took a turn for the worse. Credit rating agencies suddenly downgraded hundreds of subprime mortgage backed securities, including over 40 Long Beach securities, and the subprime market collapsed. Washington Mutual was suddenly stuck with billions of dollars in unmarketable subprime loans and securities, and reported a $1 billion loss in the fourth quarter of 2007. In late February 2008, OTS downgraded Washington Mutual for the first time, changing its CAMELS rating from a 2 to a 3, signifying a troubled bank. At that point, consistent with its own practice, OTS should have concomitantly issued an enforcement action, but did not do so. Washington Mutual lost another $1 billion in the first quarter of 2008, and $3.2 billion in the second quarter. Its stock price plummeted, and depositors began withdrawing substantial sums.

In March 2008, at the urging of the FDIC, Washington Mutual invited potential buyers of the bank to review its information. Several institutions responded, and JPMorgan Chase made an offer which Washington Mutual turned down. The bank raised additional capital of $7 billion instead to reassure the market. In July 2008, IndyMac, another thrift with high risk loans, failed and was taken over by the FDIC. In response, Washington Mutual depositors began to withdraw more funds from the bank, eventually removing over $9 billion.

During this liquidity run on the bank, the FDIC formally challenged the OTS CAMELS rating, advocating a downgrade to a 4, indicating significant concern about the bank's long-term viability. The two agencies argued amongst themselves over the rating for weeks during the summer of 2008, as the bank's condition continued to deteriorate. Finally, in September 2008, as the FDIC's judgment of Washington Mutual's risk profile became more severe, the FDIC independently downgraded the bank to a 4. In response, mere days before the bank's failure, OTS agreed to the 4 rating. In addition, on September 7, 2008, OTS took its first formal enforcement action, requiring the bank to enter into a Memorandum of Understanding. Even then, the MOU did not require the bank to strengthen its lending or risk management practices, instead directing it to hire a consultant to revise its business plan. FDIC contributed the strongest measure, requiring development of a plan to increase the bank's capital. Apart from the capitalization plan, OTS' Chief Operating Officer described the MOU as a "benign supervisory document."

After Washington Mutual failed, the OTS Examiner in Charge at the bank expressed his frustration with the role played by the bank regulators, writing to an OTS colleague: "You know, I think that once we (pretty much all the regulators) acquiesced that stated income lending was a reasonable thing, and then compounded that with the sheer insanity of stated income, subprime, 100% CLTV [Combined Loan-to-Value], lending, we were on the figurative bridge to nowhere. Even those of us that were early opponents let ourselves be swayed somewhat by

those that accused us of being 'chicken little' because the losses were slow in coming, and let[']s not forget the mantra that 'our shops have to make these loans in order to be competitive'. I will never be talked out of something I know to be fundamentally wrong ever again!!"[7]

OTS' failure to act allowed Washington Mutual to engage in unsafe and unsound practices that cost borrowers their homes, led to a loss of confidence in the bank, and sent hundreds of billions of dollars of toxic mortgages into the financial system with its resulting impact on financial markets at large.

Findings. Federal bank regulators are supposed to ensure the safety and soundness of individual U.S. financial institutions and, by extension, the U.S. banking system. Washington Mutual was just one of many financial institutions that federal banking regulators allowed to engage in such high risk home loan lending practices that they resulted in bank failure and damage to financial markets. The ineffective role of bank regulators was a major contributor to the 2008 financial crisis that continues to afflict the U.S. and world economy today.

Based upon the Subcommittee's ongoing investigation, we make the following findings of fact regarding the role of federal regulators in the Washington Mutual case history.

(1) **Largest U.S. Bank Failure.** From 2003 to 2008, OTS repeatedly identified significant problems with Washington Mutual's lending practices, risk management, and asset quality, but failed to force adequate corrective action, resulting in the largest bank failure in U.S. history.

(2) **Shoddy Lending and Securitization Practices.** OTS allowed Washington Mutual and its affiliate Long Beach Mortgage Company to engage year after year in shoddy lending and securitization practices, failing to take enforcement action to stop its origination and sale of loans with fraudulent borrower information, appraisal problems, errors, and notoriously high rates of delinquency and loss.

(3) **Unsafe Option ARM Loans.** OTS allowed Washington Mutual to originate hundreds of billions of dollars in high risk Option Adjustable Rate Mortgages, knowing that the bank used unsafe and unsound teaser rates, qualified borrowers using unrealistically low loan payments, permitted borrowers to make minimum payments resulting in negatively amortizing loans (*i.e.*, loans with increasing principal), relied on rising house prices and refinancing to avoid payment shock and loan defaults, and had no realistic data to calculate loan losses in markets with flat or declining house prices.

(4) **Short Term Profits Over Long Term Fundamentals.** OTS abdicated its responsibility to ensure the long-term safety and soundness of Washington Mutual by concluding that

[7] OTS EIC Benjamin Franklin email to OTS Examiner Thomas Constantine, Oct. 7, 2008, Franklin_Benjamin-00034415.

short-term profits obtained by the bank precluded enforcement action to stop the bank's use of shoddy lending and securitization practices and unsafe and unsound loans.

(5) **Impeding FDIC Oversight.** OTS impeded FDIC oversight of Washington Mutual by blocking its access to bank data, refusing to allow it to participate in bank examinations, rejecting requests to review bank loan files, and resisting FDIC recommendations for stronger enforcement action.

(6) **FDIC Shortfalls.** FDIC, the backup regulator of Washington Mutual, was unable to conduct the analysis it wanted to evaluate the risk posed by the bank to the Deposit Insurance Fund, did not prevail against unreasonable actions taken by OTS to limit its examination authority, and did not initiate its own enforcement action against the bank in light of ongoing opposition by the primary federal bank regulators to FDIC enforcement authority.

(7) **Recommendations Over Enforceable Requirements.** Federal bank regulators undermined efforts to end unsafe and unsound mortgage practices at U.S. banks by issuing guidance instead of enforceable regulations limiting those practices, failing to prohibit many high risk mortgage practices, and failing to set clear deadlines for bank compliance.

(8) **Failure to Recognize Systemic Risk.** OTS and FDIC allowed Washington Mutual and Long Beach to reduce their own risk by selling hundreds of billions of dollars of high risk mortgage backed securities that polluted the financial system with poorly performing loans, undermined investor confidence in the secondary mortgage market, and contributed to massive credit rating downgrades, investor losses, disrupted markets, and the U.S. financial crisis.

(9) **Ineffective and Demoralized Regulatory Culture.** The Washington Mutual case history exposes the regulatory culture at OTS in which bank examiners are frustrated and demoralized by their inability to stop unsafe and unsound practices, in which their supervisors are reluctant to use formal enforcement actions even after years of serious bank deficiencies, and in which regulators treat the banks they oversee as constituents rather than arms-length regulated entities.