PRESS RELEASE
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HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS COMMITTEE
Carl Levin, Chairman
Tom Coburn, Ranking Minority Member

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Senate Subcommittee Holds Second Hearing on Wall Street and the Financial Crisis: The Role of Bank Regulators

WASHINGTON –Feeble oversight by regulators, combined with weak regulatory standards and agency infighting, allowed Washington Mutual Bank, a $300 billion thrift and the sixth largest U.S. depository institution, to engage in high-risk and shoddy lending practices and the sale of toxic and sometimes fraudulent mortgages that contributed to both the bank's demise and the 2008 financial crisis, a Senate investigation has determined.

The U.S. Senate Permanent Subcommittee on Investigations, chaired by Sen. Carl Levin, D-Mich., and whose Ranking Member is Sen. Tom Coburn, R-Okla., is holding a series of four hearings on some of the causes and consequences of the recent U.S. financial crisis. On Friday morning, the second in the series will focus on the role of federal regulators, using the case history of Washington Mutual, the largest bank failure in U.S. history.

"Washington Mutual's collapse is a tale of greed and mismanagement, but it is also a case history of ineffective bank regulators who saw years of unsafe and unsound banking practices, but failed to stop them," said Levin. "Instead of stopping the abuses they saw, OTS regulators stood idly by while WaMu executives loaded up on risk and churned out billions of dollars in toxic mortgages that poisoned not only the bank, but also our financial system."

In addition to releasing the results of its investigation, the Subcommittee will publicly release nearly 500 pages of OTS, FDIC, and WaMu internal documents, and take testimony from the Treasury and FDIC Inspectors General who have examined shortcomings in OTS and FDIC oversight of the bank and will release their highly critical report.

In an earlier hearing, the Subcommittee examined Washington Mutual's role in stoking the financial crisis. The Subcommittee introduced documents which showed how the Seattle-based thrift's decision in 2005 to replace its low-risk 30-year fixed loans with high-risk mortgages that could be readily sold in bulk on Wall Street, combined with shoddy lending practices laced with fraud, and pay policies that rewarded volume over loan quality, led to the origination and sale of billions of dollars in poor quality loans and toxic mortgages.

Friday's hearing will examine how federal regulators saw, but failed to act to stop these practices. Washington Mutual's primary regulator was the Office of Thrift Supervision (OTS).

WaMu was the largest financial institution overseen by OTS, and from 2005 to 2008, supplied fees to OTS equaling 12 to 15 percent of its budget. Because WaMu's deposits were insured by the Federal Deposit Insurance Corporation (FDIC), that agency served as a backup regulator.

OTS regulators authorized Washington Mutual to embark upon a high risk lending strategy. OTS examiners also repeatedly criticized the bank for inadequate controls. OTS examination documents cite "less than satisfactory" underwriting standards, "higher than acceptable" underwriting errors, weak risk management controls, and a disturbing numbers of loans with false borrower information or that failed to comply with the bank's credit requirements. Despite citing these problems repeatedly over a period of five years, OTS took no enforcement action to end them.

From 2003 to 2007, OTS gave the bank a 2 CAMELS rating, signifying it was fundamentally sound, despite the repeated criticisms during those years. It downgraded the bank for the first time in 2008, the year the bank failed.

In 2006, in the face of deteriorating lending standards and increasing mortgage risk at lenders across the United States, federal banking regulators decided to develop inter-agency guidance on so-called "nontraditional mortgages." During the drafting process, OTS resisted efforts by other agencies to strengthen restrictions on high risk loan products, and argued its case using data provided by WaMu showing that it would lose business. After the Guidance was issued, while other regulators required prompt compliance from the financial institutions they oversaw, OTS delayed making the guidance effective for over a year. When WaMu determined that the new standards would reduce its loan volume by a third because fewer borrowers would qualify for loans, it decided to "hold off on implementation until required to act for public relations … or regulatory reasons," according to documents obtained by the Subcommittee.

OTS regional officials obstructed efforts by the agency's own staff to rein in WaMu. One of Washington Mutual's examiners said that stated income loans were "just a flawed product that can't be fixed and never should have been allowed in the first place," but OTS management told him that simply wasn't OTS policy. Another OTS official objected to NINA loans – loans in which "No Income and No Asset" information was even collected -- saying that they were "unsafe and unsound." But the OTS West Region official, who was in charge of examiners for Washington Mutual, dismissed him as a "lone ranger." OTS also allowed WaMu to issue tens of billions of high risk Option ARM loans each year.

OTS also impeded efforts by the FDIC, which was responsible for insuring WaMu depositors in case of a WaMu collapse, from exercising oversight of the bank. In 2006, OTS limited the number of FDIC staff allowed on site, denied FDIC examiners access to bank data, and refused an FDIC request to participate in a bank examination. OTS also rejected an FDIC request to review WaMu loan files to evaluate the bank's compliance with the new interagency guidelines on nontraditional mortgages, disclosing to the FDIC for the first time that OTS was allowing thrifts more time to comply with the new guidelines.

In late 2007, after the subprime market had frozen and WaMu was stuck with billions of dollars in suddenly unmarketable high risk loans, the bank recorded a loss of $1 billion. In February 2008, OTS downgraded the bank for the first time in years to a 3 rating, but failed to take the enforcement action that its policies required to be taken as a result of a downgrade. WaMu lost another $4.2 billion in the first and second quarters of 2008, while its stock price tumbled.

After Indymac, another lender known for high risk loans, was taken over by the FDIC in July 2008, WaMu depositors withdrew about $9 billion from the bank. The FDIC urged OTS to require capital increases and downgrade the bank further, but did not take an independent enforcement action against Washington Mutual. A senior FDIC official told the Subcommittee staff that taking an independent enforcement action against WaMu would have been seen as an "act of war" that would damage its working relationship with other regulatory agencies.

In September 2008, after Lehman declared bankruptcy, WaMu depositors withdrew another $17 billion from the bank, causing a liquidity crisis. The bank then had about $188 billion in deposits, enough to exhaust the federal Deposit Insurance Fund containing about $45 billion. After deciding the bank had insufficient funds to last to the end of the week when banks are usually closed, the OTS closed Washington Mutual's doors on Thursday, September 25, 2008, and appointed the FDIC receiver for the bank. The FDIC immediately sold the bank to JPMorgan Chase for $1.9 billion, without tapping into the Deposit Insurance Fund or requesting a taxpayer bailout.

The Subcommittee investigation reached the following findings of fact:

(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

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.

The April 16 hearing will take testimony from the Treasury Inspector General Eric Thorson, FDIC Inspector General Jon Rymer; former and current OTS officials who oversaw Washington Mutual: former OTS Director John Reich, former West Regional Director Darrel Dochow, and former Examiner-In-Charge Lawrence Carter, now an OTS National Examiner; and FDIC Chairman Sheila Bair and OTS Acting Director John Bowman.

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