

**STATEMENT OF THE HONORABLE ERIC M. THORSON**  
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**BEFORE THE SENATE HOMELAND SECURITY AND**  
**GOVERNMENTAL AFFAIRS COMMITTEE**  
**PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**  
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Chairman Levin, Senator Coburn, and Members of the Committee, thank you for the opportunity, along with Mr. Jon Rymer, the Inspector General of the Federal Deposit Insurance Corporation (FDIC), to discuss our joint evaluation of the failure of Washington Mutual Savings Bank (WaMu) of Seattle, Washington.

Over the past 2 plus years, our country has found itself immersed in a financial crisis that started when housing prices stopped rising and borrowers could no longer refinance their way out of financial difficulty. Since then, we have seen record levels of delinquency, defaults, foreclosures, and declining real estate values. As a result, securities tied to real estate prices have plummeted, and financial institutions have collapsed. In many cases, these financial institutions were large and, before the crisis, seemed to be financially sound. But the warning signs were there. Since mid-2007, my Office has completed 18 reviews of failed financial institutions, including the one that we are testifying about this morning. Based on those reviews, we have found that time and time again, the regulators for which we have oversight, the Office of Thrift Supervision (OTS) and the Office of Comptroller the Currency (OCC), frequently identified the early warning signs (or "red flags") that could have at least minimized, if not prevented, the losses associated with the financial institutions' failure but did not take sufficient corrective action soon enough to do so.

My testimony today, and that of my colleague, will focus on the failure of WaMu. WaMu was a federally-chartered savings association established in 1889 and FDIC-insured since January 1, 1934. WaMu was wholly owned by Washington Mutual, Inc., a non-diversified, multiple savings and loan holding company. WaMu grew rapidly through acquisitions and mergers during the period 1991 to 2006, acquiring 11 institutions and merging with 2 affiliates with assets totaling nearly \$198 billion. At the time of its failure, WaMu was one of the eight largest federally-

insured financial institutions, operating 2,300 branches in 15 states, with total assets of \$307 billion.

## **TREASURY OFFICE OF INSPECTOR GENERAL OVERVIEW**

My office provides independent audit and investigative oversight of the Department of the Treasury's programs and operations and that of its bureaus, excluding the Internal Revenue Service and the Troubled Asset Relief Program also known as TARP. In addition to overseeing Treasury's financial institution regulators, OTS and OCC, we oversee Treasury's programs and operations to combat money laundering and terrorist financing, manage federal collections and payments systems, manage and account for the public debt, maintain government-wide financial accounting records, manufacture the Nation's currency and coins, collect revenue on alcohol and tobacco products and regulate those industries, provide domestic assistance through the Office of the Fiscal Assistant Secretary and the Community Development Financial Institutions Fund, and international assistance through multilateral financial institutions. Our current on-board staffing level is 144 which breaks down as follows: 100 personnel in the Office of Audit and 20 personnel in the Office of Investigations. The remaining personnel include my deputy, my legal counsel, our administrative support staff, and me. Our fiscal year 2010 budget appropriation is \$29.7 million.

## **INSPECTOR GENERAL REVIEWS OF FEDERALLY-INSURED FAILED FINANCIAL INSTITUTIONS**

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires that the Inspector General of the cognizant federal banking agency review and report to that agency when an institution under its supervision fails and that failure results in a material loss to the Deposit Insurance Fund. Among other things, these reviews determine the causes of the institution's failure and assess the supervision exercised over the failed institution. Furthermore, a loss to the Deposit Insurance Fund is considered material if it exceeds the greater of \$25 million or 2 percent of an institution's total assets at the time of its failure.

With that in mind, beginning with the failure of NetBank, FSB, in September 2007, 65 Treasury-regulated (OTS and OCC) financial institutions have failed as of April 1, 2010. Of those, 49 have met the material loss review threshold. Of those, my office has completed and issued 17 such reviews (8 to OTS and 9 to OCC); we currently have another 32 failed thrift/bank reviews in progress. The total estimated loss to the Deposit Insurance Fund attributable to those 49 Treasury-regulated failed financial institutions is approximately \$34.5 billion. Unfortunately, looking forward, I believe my office will be busy conducting such reviews for some time to come.

## **JOINT TREASURY OIG/FDIC OIG REVIEW OF WAMU**

On September 25, 2008, OTS closed WaMu and FDIC facilitated the sale of WaMu to JPMorgan Chase in a closed bank transaction for \$1.89 billion that resulted in no loss to the Deposit Insurance Fund. It should be noted that since the failure of WaMu did not result in a loss to the Deposit Insurance Fund, it did not trigger a material loss review by my office. Nonetheless, given the size of WaMu and the loss that it would have caused to the Deposit Insurance Fund had a sale not been facilitated, Inspector General Rymer and I decided that an evaluation of OTS and FDIC supervision was warranted. Among other things, we thought such a review would provide important information and observations as the Administration and Congress consider regulatory reform.

We completed our joint review and issued our results to Acting OTS Director Bowman and FDIC Chairman Bair on April 9, 2010. That report discussed three things: (1) the causes of WaMu's failure; (2) OTS's supervision of WaMu, and (3) FDIC's monitoring of WaMu in its role as deposit insurer, including the manner and extent to which FDIC and OTS coordinated oversight of the institution. The balance of my testimony will cover the causes of WaMu's failure and OTS's supervision of it. Inspector General Rymer's testimony will focus on FDIC's role as deposit insurer and its coordination with OTS with regard to exercising its back-up examination authority. I will also briefly share the results of other work conducted by my office involving a certain senior OTS official that interacted with FDIC in the federal supervision of WaMu.

### **CAUSES OF WAMU'S FAILURE**

WaMu failed because its management pursued a high-risk business strategy without adequately underwriting<sup>1</sup> its loans or controlling its risks. WaMu's high-risk strategy, combined with the housing and mortgage market collapse in mid-2007, left WaMu with loan losses, borrowing capacity limitations, and a falling stock price. In September 2008, WaMu was unable to raise capital to counter significant depositor withdrawals sparked by rumors of WaMu's problems and other high-profile failures at the time. OTS closed WaMu on September 25, 2008.

#### **High Risk Lending Strategy**

In 2005, WaMu shifted away from originating traditional fixed-rate and conforming single family residential loans, towards riskier subprime loans<sup>2</sup> and option adjustable

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<sup>1</sup> Underwriting is the process by which a lender decides whether a potential borrower is creditworthy and should receive a loan.

<sup>2</sup> WaMu defined borrowers with a score of less than 620 on the FICO scale as subprime. FICO is a credit score representing the creditworthiness of a person or the likelihood that person will pay his or her debts. A person's FICO score falls somewhere between 300 and 850.

rate mortgages also known as Option ARMs.<sup>3</sup> WaMu pursued this new strategy in anticipation of higher earnings and to compete with Countrywide Financial Corporation, which, at the time, it viewed as its strongest competitor.

In 2006, WaMu estimated in internal documents that its internal profit margin on subprime loans was more than 10 times the amount for a government-backed loan product and more than 7 times the amount for a fixed-rate loan product. WaMu also estimated its internal profit margin on Option ARMs at more than 8 times the amount for a government-backed loan product and nearly 6 times the amount for a fixed-rate loan product. In short, WaMu saw these riskier loan vehicles as a way to substantially increase its profitability.

Option ARMs represented nearly half of all WaMu loan originations from 2003 to 2007 and totaled approximately \$59 billion, or 47 percent, of the home loans on WaMu's balance sheet at the end of 2007.

WaMu's underwriting policies and procedures made inherently high-risk products even riskier. For example, WaMu originated a significant number of loans as "stated income" loans, sometimes referred to as "low-doc" loans. These loans allowed borrowers to simply write-in their income on the loan application without providing supporting documentation. Approximately 90 percent of all of WaMu's home equity loans, 73 percent of its Option ARMs, and 50 percent of its subprime loans were "stated income" loans.

WaMu also originated loans with high loan-to-value ratios.<sup>4</sup> To that end, WaMu held a significant percentage of loans where the loan exceeded 80 percent of the underlying property value. For example, at the end of 2007, 44 percent of WaMu's subprime loans, 35 percent of WaMu's home equity loans, and 6 percent of WaMu's Option ARMs were originated for total loan amounts in excess of 80 percent of the property's value. Moreover, WaMu did not require borrowers to

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<sup>3</sup> An option ARM is an adjustable rate mortgage that typically offers a very low teaser rate which translates into very low minimum payments for a very short period of time. WaMu's Option ARMs provided borrowers with the choice to pay their monthly mortgages in amounts equal to monthly principal and interest, interest-only, or a minimum monthly payment. The minimum monthly payment was based on teaser rate. After the introductory rate expired, the minimum monthly payment feature introduced two significant risks to WaMu's portfolio: negative amortization and payment shock. Negative amortization occurred when the minimum monthly payments made after the expiration of the teaser rate was insufficient to pay monthly interest cost. The unpaid interest was added to the principal loan balance thereby increasing the original loan amount. Payment shock occurred 5 years after the loan was originated, or sooner in some circumstances, because the minimum monthly payment was recomputed using a market interest rate, the larger principal balance, and the remaining term of the loan.

<sup>4</sup> Loan to value (LTV) is one of the key risk factors that lenders assess when qualifying borrowers for a mortgage. Typically, low LTV ratios (below 80 percent) carry with them lower rates for lower-risk borrowers. Conversely, as the LTV ratio of a loan increases, the qualification guidelines for certain mortgage programs become much more strict. Lenders can require borrowers of high LTV loans to buy private mortgage insurance to protect the lender from borrower default.

purchase private mortgage insurance to protect itself against loss in case of default by the borrowers.

### **Inadequate Controls to Manage the High-Risk Strategy**

In addition to originating retail loans with its own employees, WaMu began originating and purchasing wholesale loans through a network of brokers and correspondents.<sup>5</sup> From 2003 to 2007, wholesale loan channels represented 48 to 70 percent of WaMu's total single family residential loan production.<sup>6</sup> WaMu saw the financial incentive to use wholesale loan channels for production as significant. According to an April 2006 internal presentation to the WaMu Board, it cost WaMu about 66 percent less to close a wholesale loan (\$1,809 per loan) than it did to close a retail loan (\$5,273). So while WaMu profitability increased through the use of third-party originators, it had far less oversight and control over the quality of the originations.

In fact, WaMu did not adequately oversee the third-party brokers who were originating most of WaMu's mortgages. Specifically, in 2007, WaMu only had **14 WaMu employees** overseeing more than **34,000 third-party brokers** – an **oversight ratio of over 2,400 third party brokers to 1 WaMu employee**. WaMu used scorecards to evaluate its third-party brokers, but those scorecards did not measure the rate of significant underwriting and documentation deficiencies attributable to individual brokers. Furthermore, in 2007, WaMu itself identified fraud losses attributable to third-party brokers of \$51 million for subprime loans and \$27 million for prime loans. These matters are under further review by law enforcement agencies.

Risk management was especially important for WaMu because of its high-risk lending strategy, significant and frequent management changes, corporate reorganizations, and significant growth as well as its sheer size. WaMu grew rapidly from a regional to a national mortgage lender through acquisitions and mergers with affiliate companies. From 1991 to 2006, WaMu acquired 11 institutions and merged with 2 affiliates. WaMu, however, did not fully integrate and consolidate the information technology systems, risk controls, and policies and procedures from the companies it acquired into a single enterprise-wide risk management system. To that end, from 2004 through 2008, OTS repeatedly noted that WaMu did not have effective controls in place to ensure proper risk management.

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<sup>5</sup> Brokers concentrate on finding customers in need of financing and process the loan application and mortgage documents. Correspondents deal with the customer, then close and fund the loan before selling the loan to an investor.

<sup>6</sup> WaMu exited wholesale lending channels in 2008 as losses mounted.

## **Significant Liquidity Stress in 2008**

WaMu experienced liquidity problems beginning in late 2007. In the fourth quarter of 2007 and first quarter of 2008, WaMu suffered consecutive \$1 billion quarterly losses because of loan charge-offs and reserves for future loan losses. WaMu did briefly improve its liquidity position in April 2008 through a \$7 billion investment in WaMu's holding company made by a consortium led by the Texas Pacific Group, \$5 billion of which was downstreamed to WaMu. Nevertheless, WaMu went on to suffer a \$3.2 billion loss in the second quarter of 2008 and saw its share price decrease by 55 percent.

The high-profile failure of IndyMac Bank in July 2008 coupled with rumors of WaMu's problems further stressed WaMu's liquidity. At the same time, the Federal Home Loan Bank of San Francisco began to limit WaMu's borrowing capacity. As a result, WaMu began offering deposit rates in excess of its competitors in order to bring in deposits to improve liquidity. Shortly thereafter, Lehman Brothers collapsed on September 15, 2008, and over the following 8 days, WaMu incurred net deposit outflows of \$16.7 billion, creating a second liquidity crisis. WaMu's ability to raise capital was hindered by its borrowing capacity limits, share price declines, portfolio losses, and an anti-dilution clause tied to the \$7 billion capital investment. On September 25, 2008, OTS closed WaMu and appointed FDIC as receiver.

## **OTS'S SUPERVISION OF WAMU**

WaMu was OTS's largest regulated institution and represented as much as 15 percent of OTS's revenue from 2003 through 2008. OTS spent significant resources examining WaMu. For example, in 2003, OTS devoted 17,285 examination hours to WaMu (the equivalent of more than 8 full time employees for the entire year). Annually increasing the hours, by 2007 OTS devoted over 31,000 examination hours to WaMu (the equivalent of more than 15 full time employees for the entire year).

OTS conducted regular risk assessments and examinations that rated WaMu's overall performance satisfactory until 2008. Furthermore, it should be noted that those supervisory efforts did identify the core weaknesses that eventually led to WaMu's demise – high-risk products, poor underwriting, and weak risk controls. In fact, issues with poor underwriting and weak risk controls were noted at least as far back as 2003, the earliest examination documentation we looked at during our review, and issues with high-risk loan products were reported soon after WaMu started to offer them in 2005. OTS, however, relied largely on WaMu management to track progress in correcting examiner-identified weaknesses and accepted assurances from WaMu management and its Board of Directors that problems would be resolved. The problem was, however, that OTS did not ensure that WaMu corrected those weaknesses. In fact, OTS did not take any safety and

soundness enforcement action against WaMu until 2008 after the thrift started to incur significant losses, and the two actions taken were very weak.

Bank regulators, including OTS, use a uniform rating system called CAMELS<sup>7</sup> to assess financial institution performance. The CAMELS rating is a critical factor in supporting the need for enforcement actions and in determining the assessment rate an institution should pay for deposit insurance. Briefly put, CAMELS ratings are based on a scale from 1 to 5, with 1 being the best rating and 5 being the worst. Generally, if a financial institution has a composite CAMELS rating of 1 it is considered to be a high-quality institution, while financial institutions with composite CAMELS ratings of greater than 3 are considered to be less than satisfactory.

The following table provides standard definitions of each CAMELS composite rating level.

**CAMELS Composite Rating Definitions**

1	Sound in every respect
2	Fundamentally sound
3	Exhibits some degree of supervisory concern in one or more of the component areas ( <i>i.e.</i> , capital adequacy, asset quality, management, earnings, liquidity, sensitivity to market risk)
4	Generally exhibits unsafe and unsound practices or conditions
5	Exhibits extremely unsafe and unsound practices or conditions; exhibits a critically deficient performance; often contains inadequate risk management practices relative to the institution's size, complexity, and risk profile; and is of the greatest supervisory concern

From 2001 to 2007, OTS consistently rated WaMu a CAMELS composite 2, meaning, by definition, that OTS considered WaMu as fundamentally sound during these years. Specifically, the CAMELS composite criteria for a 2 rating state that such institutions have only moderate weaknesses that are within the board's and management's capability and willingness to correct, and have satisfactory risk management practices relative to the institution's size, complexity, and risk profile. Furthermore, institutions in this category are considered to be stable and capable of withstanding business fluctuations.

<sup>7</sup> The CAMELS rating is a supervisory rating of a financial institution's overall condition. Bank regulators assign each financial institution under their supervision a score on a scale of 1 (best) to 5 (worst) for each CAMELS component. The CAMELS components are: C - Capital adequacy, A --- Asset quality, M - Management quality, E - Earnings, L - Liquidity, and S - Sensitivity to Market Risk.

Given the multiple repeat findings related to asset quality and management, and considering the definitions of the composite ratings, it is difficult to understand how OTS continued to assign WaMu a composite 2-rating year after year. It was not until WaMu began experiencing losses at the end of 2007 and into 2008 that OTS lowered WaMu’s CAMELS composite rating to 3 in February 2008, and ultimately to 4 in September 2008.

The following chart shows the CAMELS composite ratings and asset management and management component ratings assigned to WaMu by OTS from 2003 through 2008.

<b>WaMu’s OTS–Assigned CAMELS Ratings</b>			
Year	Composite	Asset Quality	Management
2003	2	2	2
2004	2	2	2
2005	2	2	2
2006	2	2	2
2007	2	2	2
2008			
As of February 27	3	3	2
As of June 30	3	4	3
As of September 18	4	4	3

### **OTS Examiners Identified Concerns with WaMu’s Asset Quality**

Asset quality is one of the most critical areas in determining the overall condition of a financial institution. The primary factor to consider in assessing an institution’s overall asset quality is the quality of the loan portfolio and the credit administration program.

OTS examiners repeatedly identified issues and weaknesses associated with WaMu’s asset quality – especially with regard to issues identified in single family residential loan underwriting and oversight of third-party brokers. Nevertheless, OTS rated WaMu’s asset quality as satisfactory (CAMELS component rating of 2) until February 2008, when it downgraded it to a 3 on an interim basis. The asset quality rating was further dropped to a 4 in June 2008.

CAMELS asset quality ratings definitions are shown in the table below.

**CAMELS Rating Definitions for Asset Quality**

1	Strong asset quality and credit administration practices
2	Satisfactory asset quality and credit administration practices
3	Less than satisfactory asset quality and credit administration practices
4	Deficient asset quality or credit administration practices
5	Critically deficient asset quality or credit administration practices

OTS identified a number of significant concerns with WaMu's single family residential underwriting practices from 2003 to 2008. Those concerns included questions about the reasonableness of stated incomes contained in loan documents, numerous underwriting exceptions, miscalculations of loan-to-value ratios, and missing or inadequate documentation. Furthermore, the fact that so many of WaMu's single family residential loans were Option ARMs further underscored the risky nature of its loan portfolio. In the 2005 Report of Examination to WaMu, OTS wrote, "We believe the level of deficiencies, 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 ARM loans 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."

Examples of WaMu underwriting deficiencies identified by OTS from 2003 to 2007 when asset quality was rated as a 2 are described below.

- **2003 and 2004** - OTS reported that underwriting of single family residential loans, WaMu's core loan activity, was less than satisfactory.
- **2005** - OTS reported that although overall single family residential loan quality and performance trends were stable, the thrift's underwriting remained less than satisfactory. OTS noted that this concern had been expressed at several prior exams as well as internal reviews and that the examiners remained concerned with the number of underwriting exceptions and with issues that evidenced a lack of compliance with bank policy.
- **2006 to 2007** - OTS reported that single family residential loan and prime underwriting had improved to marginally satisfactory and generally satisfactory, respectively. However, OTS reported concerns with subprime underwriting

practices by Long Beach Mortgage Company, a WaMu affiliate that merged with WaMu in March 2006. OTS also reported that subprime underwriting practices remained less than satisfactory and cited exceptions related to the miscalculation of debt-to-income ratios, reasonableness of stated incomes on loan documents, and borrower acknowledgement of payment shock. (It should be noted that WaMu discontinued subprime lending in the fourth quarter of 2007.)

From 2005 through 2007, while OTS was issuing multiple repeat findings pertaining to single family residential loan underwriting, WaMu originated almost \$618 billion in single family residential loans.

As discussed earlier, in addition to originating retail loans with its own employees, WaMu began originating and purchasing wholesale loans through a network of brokers and correspondent banks. So much so that wholesale loan channels represented 48 to 70 percent of WaMu's single family residential loan production from 2003 to 2007. The financial incentive to use the wholesale channels was significant—internal WaMu documents dated April 2006 showed that it cost WaMu more than \$5,000 to close a retail loan but only \$1,800 to close a wholesale loan. It was simply far cheaper, and more profitable, for WaMu to purchase loans then to originate them with its own employees.

From 2003 to 2007, OTS repeatedly identified weaknesses in WaMu's oversight of third-party originators. As discussed earlier, in 2007, there were only 14 WaMu employees overseeing more than 34,000 third-party brokers. It wasn't until April 2008 that WaMu management announced that it would discontinue the wholesale channel.

During our review, we asked OTS examiners why they did not lower WaMu's asset quality ratings earlier. Examiners responded that even though underwriting and risk management practices were less than satisfactory, WaMu was making money and loans were performing. Accordingly, the examiners thought it would have been difficult to lower WaMu's asset quality rating.

This position was a surprise to us since OTS's own guidance states: "[if] an association has a high exposure to credit risk, it is not sufficient to demonstrate that the loans are profitable or that the association has not experienced significant losses in the near term."

Given this guidance, the significance of single family residential lending to WaMu's business, and the fact that the OTS repeatedly brought the same issues related to asset quality to the attention of WaMu management and the issues remained uncorrected, we find it difficult to understand how OTS could assign WaMu a satisfactory asset quality 2-rating for so long. Assigning a satisfactory rating when conditions are not satisfactory sends a mixed and inappropriate supervisory message to the institution and its board. It is also contrary to the very purpose for which regulators use the CAMELS rating system.

## OTS Examiners Identified Problems but Consistently Rated WaMu Management Satisfactory

OTS's guidance states that one of the most important objectives of an examination is to evaluate the quality and effectiveness of a savings association's management, and that the success or failure of almost every facet of operations relates directly to management.

The CAMELS management rating definitions are below.

### **CAMELS Rating Definitions for Management**

1	Strong performance by management and the Board of Directors and strong risk management practices
2	Satisfactory performance by management and the Board of Directors and satisfactory risk management practices
3	Improvement needed in management and Board of Directors performance or less than satisfactory risk management practices
4	Deficient management and Board of Directors performance or inadequate risk management practices
5	Critically deficient management and Board of Directors performance or risk management practices

OTS identified problems regarding WaMu management in its examination documents from 2003 through 2008. The primary areas of concern were the lack of effective internal controls and an insufficient commitment on the part of WaMu's Board and management to take action to address OTS-identified weaknesses.

Despite its concerns, OTS reported that WaMu's Board oversight and management's performance was satisfactory through 2007 and rated the CAMELS management component a 2 in those examinations. It was not until June 2008 that OTS reported that WaMu's Board oversight and management's performance was less than satisfactory and downgraded the CAMELS management component to a 3. OTS faulted the WaMu Board and management for not adequately addressing prior examination findings, including single family mortgage loan underwriting weaknesses and an ineffective enterprise-wide risk management system. OTS now (in 2008 and after WaMu started incurring big losses) concluded that failure to address those weaknesses in a timely manner was exacerbating credit losses and exposing WaMu to heightened reputation risk.

OTS examination reports repeatedly directed that WaMu take corrective actions in response to examination findings. Nevertheless, WaMu management did not make lasting or complete improvements to its asset quality or risk management programs. Here again OTS's own guidance notes that governance is strong when

the Board addresses and corrects problems early. That guidance further states that where governance is weak or nonexistent, problems remain uncorrected, possibly resulting in the association's failure.

In an effort to determine the extent to which WaMu addressed OTS findings, we attempted to review the 545 findings made by OTS and WaMu's responses to them from 2003 through 2007. The status of these findings were tracked in a WaMu system called Enterprise Risk Issue Control System (ERICS) and not independently by OTS on an OTS system. Based on our review of ERICS reports and other documents, we were unable to determine whether a number of findings had been closed and resolved. As discussed later, after considerable effort, OTS was able to provide evidence that some of those findings had been closed.

We also noted that a number of the findings reported by OTS were repeat findings, indicating the issue was identified during more than one examination cycle. For example, 18 percent of OTS's more significant findings (those specifically directed to WaMu's Board for corrective action) between 2003 and 2006 were categorized as repeat findings. However, WaMu discontinued indicating in ERICS whether a finding was a repeat finding in 2006. Thus, the number of repeat findings could have been much greater.

Given WaMu's lack of progress in addressing OTS-identified weaknesses, we believe that a less than satisfactory management component rating should have been assigned to WaMu sooner.

### **OTS Should Have Done More to Track WaMu's Progress**

We found, to our surprise, that OTS largely relied on WaMu's ERICS system instead of its own to track corrective actions. As I mentioned earlier, we tried to track findings closed and resolved through the WaMu tracking system, but could not.

OTS examiners told us that they had a process for reviewing WaMu's corrective actions. Specifically, we were told that during an examination, ERICS reports were divided up among the OTS examiners based upon each examiner's area of responsibility. Each examiner was responsible for determining whether ERICS properly reflected the status of findings for their assigned area. If satisfied, the examiner would then sign-off on the respective ERICS report.

With that in mind, we reviewed 8 ERICS status reports for the years 2003 through 2008, and found evidence of examiner sign-off on only 3 of the 8 reports. During our review, we asked OTS to provide evidence of the status of 39 significant findings that appeared to be open in the ERICS reports.

OTS showed us that 16 findings were issued/newly identified during 2008 and remained unresolved as of WaMu's failure. For another 16 findings, OTS provided

evidence, although limited in some cases (such as handwritten notes on an ERICS report), that those findings were resolved. For the other 7 findings, however, OTS either did not provide evidence as to the findings' status or stated that the findings had been replaced by new findings pertaining to a repeat finding area. While OTS was ultimately able to provide some additional information about the status of certain findings, doing so required considerable time and effort on OTS's part. This further underscores the flawed decision by OTS to rely on the WaMu system for tracking the examiner findings.

### **OTS Enforcement Actions Against WaMu Were Limited and Late**

OTS can take a variety of enforcement actions, both informal (which are non-public) and formal (which are public), to address, among other things, unsafe and unsound practices by a thrift.

In general, OTS policy provides that formal enforcement action should be taken when any institution is in material noncompliance with prior commitments to take corrective actions and for CAMELS composite 3-rated institutions with weak management, where there is uncertainty to whether management and the board have the ability or willingness to take appropriate corrective measures.

OTS never took formal enforcement action against WaMu to force it to correct its safety and soundness deficiencies. OTS did impose two informal enforcement actions against the thrift, but not until 2008. The informal enforcement actions — a Board Resolution and an MOU—lacked sufficient substance and were too late to make a difference. Moreover, though, there were other troubling aspects as to how OTS handled both actions. In the instance of the Board Resolution, the OTS West Region Director approved the Board Resolution despite concerns raised by other regional management officials. Furthermore, with regard to the MOU, an important provision that FDIC had proposed that would have required WaMu to raise \$5 billion in additional capital was replaced with a capital contingency plan, and another requiring that a consultant review of Board oversight was dropped at the request of WaMu.

During our review, we were told that OTS had a general sense of the status of WaMu's progress in addressing weaknesses, but OTS examiners said that tracking WaMu's progress was difficult given its size and complexity. Further, OTS examiners told us that WaMu oftentimes replaced managers as its response to significant findings in their areas of responsibility. WaMu would then ask OTS for time to allow the newly hired manager to implement plans to address weaknesses. Given the size of WaMu, the magnitude of the weaknesses identified by OTS examiners year after year, coupled with the limited progress made by WaMu management in correcting those weaknesses, we believe that OTS should have elevated its supervisory response much sooner and much more forcefully.

OTS sought a Board Resolution as a result of the interim downgrade of WaMu to a CAMELS composite 3 rating in February 2008. WaMu drafted the Board Resolution and sent it to the OTS West Region Director on March 13, 2008. The Board Resolution endorsed undertaking “strategic initiatives” to improve asset quality, earnings, and liquidity and directed WaMu management to implement and report on those initiatives. The strategic initiatives tied the improvements to either (1) the sale of WaMu or (2) raising \$3 billion to \$4 billion in capital. Interestingly, the resolution only addressed short-term liquidity issues, not the systemic problems repeatedly noted by OTS.

The OTS West Region Director sent the Board Resolution to two members of OTS’s regional management for their comments. Both OTS regional management officials expressed concern about the fact that the Board Resolution did not require specific corrective actions. Further, those officials recognized WaMu’s lack of follow-through on past promises and believed that OTS needed to review management’s strategic plans to ensure they addressed the critical weaknesses linked to WaMu’s composite downgrade. Despite the concerns of these officials, the OTS West Region Director approved WaMu’s version of the Board Resolution anyway, which the Board passed on March 17, 2008.

The second informal enforcement action taken by OTS against WaMu was an MOU as a consequence of its downgraded CAMELS composite 3 rating at the end of its examination on June 30, 2008. OTS drafted the MOU and provided a copy to FDIC for comment. FDIC proposed a number of changes to the MOU, including a provision that WaMu raise an additional \$5 billion in capital. OTS did not want to include the \$5 billion capital increase requirement because OTS believed that WaMu’s capital was sufficient following a \$2 billion contribution from WaMu’s holding company in July 2008. Further, OTS thought that FDIC’s model used to determine the \$5 billion amount was flawed. FDIC and OTS eventually compromised and included a capital contingency plan requirement in the MOU rather than a specific amount. OTS sent WaMu management the proposed MOU on August 1, 2008, that would require WaMu to

- correct all findings noted in OTS’s June 30, 2008, examination;
- submit a contingency capital plan and maintain certain capital ratios;
- submit a 3-year Business Plan to OTS;
- engage a consultant to review WaMu’s risk management structure, underwriting, management, and board oversight; and
- certify compliance with the MOU quarterly.

On August 4, 2008, WaMu asked that the requirement for the consultant review of Board oversight be removed from the proposed MOU. OTS accepted WaMu’s

change notwithstanding the OTS examiners' findings over many years that the Board's performance was weak. By August 25, 2008, WaMu's attorney and OTS had informally reached agreement on the terms of the MOU and were waiting for final execution of the MOU. However, it was not until September 7, 2008, that OTS signed the MOU. A week later, WaMu was placed into receivership. The MOU was therefore obviously ineffective.

While we recognize it is speculative to conclude that earlier and more forceful enforcement action would have prevented WaMu's failure, we believe that more forceful action in 2006 and 2007 may have compelled WaMu's Board and management to take more aggressive steps to correct deficiencies and stem the losses that eventually occurred because of its risky loan products and weak controls.

### **Prompt Corrective Action Was Not a Factor With WaMu**

The Prompt Corrective Action (PCA) provisions of the Federal Deposit Insurance Act provides OTS with supervisory remedies aimed to minimize losses to the Deposit Insurance Fund. PCA requires that certain operating restrictions take effect when a thrift's capital levels fall below well-capitalized. In the case of WaMu, OTS did not take, and was not required to take, PCA action because WaMu remained well-capitalized through September 25, 2008, when it was placed in receivership. That said, it was only a matter of time before losses associated with WaMu's high-risk lending practices would have depleted its capital below regulatory requirements.

### **TREASURY OIG RECOMMENDATIONS**

We have made a number of recommendations to OTS as a result of completed material loss reviews of failed thrifts during the current economic crisis. These recommendations have pertained to the need for OTS to take more timely formal enforcement action when circumstances warrant, ensure that high CAMELS ratings are properly supported, remind examiners of the risks associated with rapid growth and high-risk concentrations, ensure thrifts have sound internal risk management systems, ensure repeat conditions are reviewed and corrected, and require thrifts to hold adequate capital. OTS has taken or plans to take action in response to each of these recommendations. As a result of this review, we made one new recommendation to OTS. Specifically, OTS should ensure that an internal OTS system is used to formally track the status of examiner recommendations and related thrift corrective actions. The Acting Director of OTS concurred.

### **FINAL REMARKS AND OBSERVATIONS**

Among other things, in my invitation to testify before you this morning, the Subcommittee requested that I address our Office's findings regarding OTS's implementation of the *Interagency Guidance on Nontraditional Mortgage Product*

*Risks* (NTM Guidance) at WaMu as well as its level of cooperation with other federal financial regulators towards WaMu, including but not limited to FDIC.

Implementation of NTM Guidance. In short, this guidance, issued in October 2006 by the federal financial institution regulatory agencies, sets forth supervisory expectations for institutions that originate or service nontraditional mortgage loans, including:

- **Portfolio and Risk Management practices.** Financial institutions should have strong risk management practices, capital levels commensurate with risk, adequate allowances for loan losses, and strong systems and controls for establishing and maintaining relationships with third parties.
- **Loan Team and Underwriting Standards.** Institutions should establish prudent lending policies and underwriting standards for nontraditional mortgage products that include consideration of a borrower's repayment capacity.
- **Risk Layering.** Financial institutions that layer multiple product types may increase the potential risks of alternative mortgage products. Institutions should perform adequate underwriting analysis when layering products, including alternative mortgage loans, reduced or no documentation loans, loans without customer verification, or a combination of any of these mortgages with simultaneous second mortgages.
- **Consumer Protection.** Institutions should implement programs and practices designed to ensure that consumers receive clear and balanced information to help them make informed decisions while shopping for and selecting alternative mortgage loans.

Our work did not specifically evaluate OTS's assessment of WaMu's implementation of, or compliance with the NTM Guidance. Nonetheless, based on your request, I had my staff review the documents we had collected in the conduct of our work. To that end, we did find that in the 2007 report of examination on WaMu, OTS noted that while WaMu was not in complete adherence with the NTM Guidance, satisfactory progress had been made to address identified risks. OTS also drafted a finding during the 2007 examination cycle that identified the steps WaMu planned to take to comply with the guidance and also included that WaMu should review third-party originators because they were a key source of WaMu's nontraditional loans. OTS classified this finding as an "observation" which meant that it was a weakness that was not a regulatory concern, but could improve the bank's operating effectiveness if addressed.

OTS Cooperation with Other Federal Financial Regulators. Our work did not expressly evaluate OTS's cooperation with other federal financial regulators. However, we are able to comment on OTS's relationship with FDIC as the deposit insurer. In this regard, FDIC, as the deposit insurer, has a number of

procedural and regulatory tools available to take action when an institution's risk increases, to include requesting that the primary regulator (OTS in the case of WaMu) grant FDIC back-up examination authority. FDIC invoked its back-up examination authority each year from 2005 to 2008. Those requests, however, often met with resistance from OTS.

A discussion of OTS's interaction with FDIC on these requests follows. OTS granted FDIC's 2005 back-up examination request but denied FDIC the ability to review the subprime operations of WaMu's affiliate, Long Beach Mortgage Company (LBMC), because LBMC was a subsidiary of WaMu's parent corporation and not part of WaMu. In 2006, FDIC again requested back-up examination authority, and OTS initially denied the FDIC request. After the matter was elevated to OTS and FDIC headquarters, OTS eventually granted FDIC back-up examination authority.

OTS granted FDIC's 2007 back-up examination request but did not allow FDIC examiners access to WaMu residential loan files. OTS considered loan file review to be an examination activity rather than an insurance risk assessment activity. FDIC wanted to review the files because of underwriting concerns and because FDIC had concerns that OTS had not adequately reviewed the loan files during its examination to fully understand the embedded risk.

In granting FDIC's 2008 back-up examination request, OTS was concerned about the number of examiners (nine) that FDIC was planning to use. OTS indicated that it was a heavy staffing request given OTS's on-site presence and reiterating that FDIC was not to actively participate in the examination.

As one final matter, as I noted above, we were troubled by the handling of the informal enforcement actions that OTS finally did impose in 2008 including the decision by the then OTS West Region Director to approve the use of a Board Resolution that did not require WaMu to correct its deficiencies. This is not the only decision by that OTS official that we have found of serious concern. As our office previously reported,<sup>8</sup> the same OTS official approved IndyMac Bank, FSB, to backdate a capital contribution made in May 2008 to the quarter ending March 31, 2008. The impact of recording the capital contribution in this manner was that IndyMac was able to maintain its well-capitalized status for the quarter, and avoid the requirement in law to obtain a waiver from FDIC to accept brokered deposits.<sup>9</sup> Having said that, I do want to note that shortly after our Office first reported this matter to the Treasury Secretary, OTS placed the official on administrative leave pending an internal review. The official has since retired from federal service.

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<sup>8</sup> Treasury OIG, *Safety and Soundness: OTS Involvement With Backdated Capital Contributions by Thrifts* (OIG-09-037; issued May 21, 2009).

<sup>9</sup> On July 11, 2008, OTS closed IndyMac and appointed FDIC as conservator. As of December 31, 2008, the estimated loss to the Deposit Insurance Fund for IndyMac was \$10.7 billion.

That concludes my prepared statement. I will be happy to answer any questions you may have. Thank you.