

Opening Statement of Senator Carl Levin (D-Mich)
Before the
U. S. Senate Permanent Subcommittee on Investigations
on
Wall Street and The Financial Crisis:
The Role of Bank Regulators

April 16, 2010

This is the second in a series of four Subcommittee hearings examining some of the causes and consequences of the 2008 financial crisis. Earlier this week, our first hearing used Washington Mutual Bank (“WaMu”) as a case history to illustrate how, from 2004 to 2008, U.S. financial institutions loaded up on risk and churned out hundreds of billions of dollars in high risk, poor quality home loans to Wall Street in exchange for big fees. Together, they initiated the economic assault.

As regulated entities, most of those financial firms couldn’t have done what they did unless their regulators let them. Today’s hearing asks why federal bank regulators saw the shoddy lending practices, saw the high risk lending, saw the substandard securitizations, understood the risk, but let the banks do it anyway.

Washington Mutual was a thrift, so its primary federal regulator was the Office of Thrift Supervision or OTS. WaMu was the largest single financial institution that OTS oversaw, with \$300 billion in assets, \$188 billion in deposits, and 43,000 employees. WaMu’s fees alone paid for 12-15 percent of the OTS budget. Because WaMu’s deposits were insured, the Federal Deposit Insurance Corporation (FDIC) served as a backup regulator whose focus was on safeguarding the Deposit Insurance Fund.

Like other bank regulators, OTS was supposed to serve as our first line of defense against unsafe and unsound banking practices. But OTS was a feeble regulator. Instead of policing the economic assault, OTS was more of a spectator on the sidelines, a watchdog with no bite, noting problems and making recommendations, but not acting to correct the flaws and failures it saw. At times, it even acted like a WaMu guard dog, trying to keep the FDIC at bay.

To document what happened, we are releasing today another big book of documents, as well as a joint report by the Treasury and FDIC Inspectors General examining shortcomings in OTS and FDIC oversight of Washington Mutual. Together, they disclose an ineffective bank regulatory culture hindered by weak standards, lax oversight, and agency infighting.

Shoddy Lending Practices

Before its fall, Washington Mutual held itself out as a well-run, prudent bank that was a pillar of its community. But Tuesday’s hearing showed that, behind closed doors, the bank’s management was surrounded by deep-seated problems including shoddy lending practices and poor quality loans.

This chart, Exhibit 1(i) from Tuesday's hearing, shows how, over a 5-year period, from 2003 to 2008, Washington Mutual and its subprime lender, Long Beach, loaded up with risk. The bank dumped low-risk 30-year fixed loans in favor of high risk subprime, option ARM, and home equity loans. Low risk loans shrunk from two-thirds of the bank's originations to one-quarter. High risk loans grew from one-third to three-quarters of the bank's home loan business.

Those high risk loans were problem-plagued. Tuesday's hearing examined voluminous evidence of WaMu internal reviews finding poor quality loans, fraud, errors, and other deficiencies. In one instance, a year-long internal WaMu probe found that two of WaMu's top loan producing offices were issuing loans with fraud rates of 58% and 83%. Another WaMu investigation two years later found that one of the office's fraud rate was 62%. At still another loan office, a sales associate admitted "manufacturing" documents to support quick loan closings.

Washington Mutual's shoddy lending practices affected more than its own operations. WaMu and Long Beach sold or securitized most of their loans. As this chart shows, from 2000 to 2007, WaMu and Long Beach securitized at least \$77 billion in subprime loans, stopping only when the subprime secondary market collapsed in September 2007. WaMu sold another \$115 billion in Option ARM loans. Together, WaMu and Long Beach dumped hundreds of billions of dollars of toxic mortgages into the financial system like polluters dumping poison in a river.

Washington Mutual's Regulatory History

So where were the bank regulators? The painful fact is that they had a front row seat to Washington Mutual's high risk lending strategy, its poor quality loans, and substandard securitization practices, but did little to stop it.

The documents reviewed by the Subcommittee show that OTS knew all about Washington Mutual's high risk lending strategy. In fact, it was OTS that required the bank to get Board approval of it in January 2005. OTS knew about WaMu's shoddy lending practices, having repeatedly identified problems with the bank's operations in examination reports year after year. Every time OTS listed a problem, it also told WaMu to take corrective action. But when the problem didn't get fixed, OTS failed to force change. Instead, OTS wrung its hands as the bank sank into deeper and deeper waters.

This chart, Exhibit 1(c), provides a quick summary of some of the findings made by OTS over the years regarding failings in the underwriting -- meaning lending -- practices at Washington Mutual.

Start with 2004: "Underwriting ... remains less than satisfactory." "[N]ot ... successful in effecting change." Next is 2005: "Underwriting exceptions evidence lack of compliance with bank policy." "Increase[s] with the risk profile of the portfolio." "[D]eterioration in these [Long Beach] older securitizations."

Those 2005 findings came from a Report on Examination which stated more broadly: "[W]e remain concerned with the number of underwriting exceptions and with issues that

evidence lack of compliance with bank policy [T]he 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.”

Unfortunately, the level of deficiencies was left “unchecked.” In fact, those deficiencies continued to run rampant. Here’s 2006: “[C]ontinuing weakness in ... loan underwriting at Long Beach.” “Numerous instances of underwriter exceeding guidelines ... [and] errors.” Now 2007: “Too much emphasis on loan production ... at the expense of loan quality.” “Subprime underwriting practices remain less than satisfactory.” “[U]nderwriting exceptions and errors above acceptable levels.” And finally, 2008, the year the bank failed: “[N]ot in compliance with the Interagency Guidance on Nontraditional Mortgages.” “High ... losses due in part to ... poor underwriting.” [A]ctions should have been taken sooner.”

Those are all OTS observations about problems at WaMu year after year. In 2008, the year the bank collapsed, OTS said, “actions should have been taken sooner.” Actions sure should have been taken sooner -- by OTS itself. OTS raised the concerns listed on this chart with WaMu’s top executives and Board of Directors for 5 straight years. Each year, WaMu promised to do better, but it didn’t, and OTS never took action to change that.

At our Tuesday hearing, even WaMu officials expressed surprise at OTS’ reluctance to act. WaMu’s Chief Risk Officer from 2004-2005, Jim Vanasek, testified: “What I cannot explain is why the superiors in the agencies didn’t take a tougher tone with the banks given the degree of ... negative findings. . . . [T]here seemed to be a tolerance there or a political influence on senior management of those agencies that prevented them from taking a more active stance. By a more active stance, I mean putting the banks under letters of agreement and forcing change.” His successor at WaMu, Ron Cathcart, testified that “the approach that the OTS took was much more light-handed than I was used to. It seemed as if the regulator was prepared to allow the bank to work through its problems and had a higher degree of tolerance ... than I had seen with the other ... regulators.”

Regulations work best when regulators stay at arms length from those that they regulate. Too often in this case, WaMu regulators were not at arms length; they were arm in arm. Over time, OTS allowed Washington Mutual and Long Beach to load up on risk and engage in a host of unsafe and unsound practices. This chart, Exhibit 1(b), lists some of them.

- Targeting High Risk Borrowers
- Steering Borrowers to Higher Risk Home Loans
- Offering Teaser Rates, Interest Only, and Negative Amortizing Loans
- Not Verifying Income
- Offering Higher Pay for Making Higher Risk Home Loans

The documents show that more than one OTS examiner expressed misgivings about these lending practices, but never got the support of OTS management to end them. One WaMu examiner wrote that stated income loans – loans in which borrowers state their income without any verification -- were “a flawed product that can’t be fixed and never should have been allowed in the first place.” Another OTS examiner tried to object to so-called NINA loans – meaning loans in which “No Income and No Asset” numbers are required to be provided by the borrower. An OTS policy official agreed, writing in a 2007 email that NINA loans are “collateral dependent lending and deemed unsafe and unsound by all the agencies.” But the OTS West Region dismissed that analysis, allowed NINA loans, and called the OTS policy official a “lone ranger.”

Still another example involves Washington Mutual’s flagship product, the Option Adjustable Rate Mortgage. WaMu engaged in a host of shoddy lending practices that vastly increased the risks associated with its Option ARMs, such as permitting virtually every Option ARM borrower to make minimum payments which resulted in negatively amortizing loans in which the loan principal actually increased over time. Washington Mutual relied on rising house prices and refinancing to avoid payment shock and loan defaults. For years, OTS said that WaMu should reduce the increased risks, while watching the bank originate \$30 to \$60 billion or more in Option ARMs each year. It never took action to enforce its judgment.

In 2004, OTS found that WaMu’s incentive compensation for loan officers failed to provide any money for loan quality. Volume and speed were king, and loan officers got paid more money for more risk. OTS recommended that WaMu “enhance” its system to emphasize loan quality, and closed the finding based on WaMu’s promise to redesign its pay system. In 2005, OTS discovered that WaMu had not changed its compensation plan, and again asked the bank to fix it. In 2008, WaMu discovered rampant fraud at one of its top loan producing offices, and its own staff faulted pay incentives that put loan speed before loan quality. In four years, WaMu had never fixed the problem.

OTS had multiple enforcement tools to force change at WaMu. It could have required, for example, a private Board Resolution or a public Memorandum of Understanding, imposed a monetary fine, or issued a Cease and Desist order. But OTS didn’t take any of those steps. It acted like a spectator, chronicling the bank’s failures rather than preventing them. OTS didn’t take enforcement action on its criticisms of the bank until 2008, the year WaMu failed.

Why was OTS so reluctant to act? A 2007 email by OTS Director John Reich, Exhibit 78, supplies part of the answer. He wrote to his staff: “Kerry Killinger, the CEO of Washington Mutual (WaMu) will be in town Friday and wants to have a lunch meeting. He’s my largest constituent.” OTS viewed WaMu as its constituent, losing sight of the fact that OTS’ real constituents were not the banks it oversaw, but the American people it was supposed to protect from unsafe and unsound banking practices.

A 2005 email by the OTS Examiner in Charge at Washington Mutual is also telling. The Examiner in Charge wrote to his bosses: “[T]his is just one of several symptoms of the ongoing broader problem of getting their house in order from an underwriting standpoint. It has been hard for us to justify doing much more than constantly nagging (okay, “chastising”) through ROE [Reports on Examination] and meetings, since they have not been really adversely impacted in terms of losses.” Think about that. The WaMu bank examiner felt he couldn’t do

more than “nag” the bank, unless WaMu was losing money. The OTS handbook, by the way, states explicitly that losses are not necessary for an examiner to take action. But the OTS examiner saw himself, not as a civil servant enforcing the law and protecting the banking system, but as just a nag.

Still another part of the answer may be that WaMu was OTS’ largest bank and supplied the largest amount of fees of any bank.

Washington Mutual’s Demise

WaMu’s downfall began in 2006, when the value of its subprime loans began falling. In July 2007, after two credit rating agencies suddenly downgraded hundreds of subprime mortgage backed securities, the subprime market froze, and banks like WaMu were left holding billions of dollars of suddenly unmarketable home loans. The value of those assets began plummeting. Washington Mutual recorded a \$1 billion loss in the fourth quarter of 2007, and another \$1 billion loss in the first quarter of 2008.

Finally, in late February 2008, OTS downgraded the bank from a 2 to a 3 CAMELS rating. The CAMELS rating system is used by all the federal bank regulators to rate the safety and soundness of financial institutions, and measures capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. It uses a scale of 1 to 5, with 1 being the best rating and 5 the worst. The ratings are normally not made public. Washington Mutual had a 2 rating for many years, which signifies a fundamentally sound bank.

Once OTS assigned the 3 rating, which signifies a troubled bank, OTS policy required it to issue a public Memorandum of Understanding at the same time, to correct the bank’s deficiencies. But OTS inexplicably didn’t. Instead OTS waited until the next month and accepted a nonpublic Board Resolution in which the Board promised to fix problems but provided no specific plans or deadlines for doing so. It was a kid gloves approach that made absolutely no sense given the bank’s problems and the intensifying financial crisis.

In the meantime, the FDIC expressed increasing concerns about the bank, which its internal Large Insured Deposit Institution (LIDI) reports showed to be deteriorating. FDIC told the OTS that the bank should consider an outside purchaser. In March 2008, WaMu invited potential buyers of the bank to review its internal data. In April, WaMu announced it had lost another \$3.2 billion in the second quarter. JPMorgan Chase made an offer to buy the bank, but WaMu turned it down, after raising \$7 billion in capital to reassure the market.

In July 2008, IndyMac, another high-risk thrift on the west coast, closed its doors. WaMu’s large depositors, fearing a similar fate at Washington Mutual, withdrew about \$9 billion in a quiet run on the bank. Two months later, on September 15, 2008, Lehman Brothers declared bankruptcy, and over the next eight days, WaMu depositors withdrew another \$17 billion from the bank, triggering a liquidity crisis.

On September 7, 2008, OTS took its first formal enforcement action against the bank, but it was way too little too late. After more than a month of trying to persuade OTS that WaMu

should be downgraded to a 4 rating, the FDIC independently downgraded the bank on September 18. OTS reluctantly followed suit that same day. By then, the FDIC was contemplating whether the \$300 billion thrift, if it failed, might exhaust the entire federal Deposit Insurance Fund which then contained a total of about \$45 billion.

On September 25, 2008, due to the bank's intensifying liquidity problems, the regulators finally pulled the plug. They felt the bank couldn't even make it to the end of the week, as their usual practice, and instead moved on a Thursday. OTS closed Washington Mutual and appointed the FDIC as its receiver. That same day, the FDIC sold the bank's assets and deposits to JPMorgan Chase for about \$1.9 billion.

Critics complain that WaMu should not have been shut down, that it should have received a taxpayer bailout under the TARP program, emergency lending from the Federal Reserve, and SEC protection from short-selling. But our focus here is not on the regulators' decision to close the bank, but on how regulators let the bank deteriorate to the point where its failure threatened to bust the Deposit Insurance Fund.

Regulatory Failures

The fact is that our bank regulators failed us. OTS failed to stop Washington Mutual from engaging in high risk lending practices that created a mortgage time bomb. It failed to force the bank to correct years-long deficiencies. It failed to cooperate with efforts by the FDIC to evaluate the bank's operations. And it failed to stop the bank from sending toxic mortgages into the financial system and poisoning the secondary market. These failures were not limited to Washington Mutual, but were symptomatic of sector-wide failures that played a major role in the 2008 financial crisis.

The Washington Mutual case history makes it clear that OTS had bought into the view that as long as Washington Mutual was profitable, the bank could continue its high risk lending strategy. OTS management saw no reason to tighten lending standards, even after its fellow regulators decided to issue joint guidance to strengthen lending standards for so-called "nontraditional mortgages." OTS argued against strong restrictions, noting internally that they needed to go "on the offensive" to stop them, and even presenting data supplied by WaMu showing how stronger lending standards would reduce the bank's business.

The Guidance On Nontraditional Mortgages was promulgated by all the banking regulators in October 2006. Other agencies told their financial institutions to comply promptly, but OTS did not. In 2007, when the FDIC asked OTS to review WaMu loan files to evaluate its compliance with the Guidance, OTS refused and disclosed it was giving its thrifts more time to comply. Meanwhile, WaMu had calculated that complying with the Guidance would reduce its loan volume by 33 percent, because fewer borrowers would qualify for loans. In an email to colleagues, WaMu's Chief Risk Officer argued "in favor of holding off on implementation until required to act for public relations ... or regulatory reasons." By the time, OTS made the Guidance effective for its thrifts, the subprime secondary market had frozen and WaMu's loan originations had already dropped.

Turf War. At the same time the documents show OTS' reluctance to say no to WaMu, they show that OTS did have a backbone when it came to saying no to a fellow regulator.

For many years, OTS and FDIC had shared a cooperative relationship in regulating Washington Mutual. In 2006, OTS practices abruptly changed. The West Region Director told his staff: "[T]he message was crystal clear today. Absolutely no FDIC participation on any OTS 1 and 2 rated exams." Since WaMu had a 2 rating, OTS rejected the FDIC's request to participate in a WaMu exam.

OTS went further. It actually impeded FDIC's examination efforts. It denied the FDIC examiner access to WaMu data, refused for several months to assign him space on-site at the bank, and rejected his requests to review bank loan files. When the FDIC urged OTS to lower WaMu's rating, OTS resisted. OTS fought this turf war at the same time the largest financial institution it was supposed to regulate was losing value, capital, and deposits.

Systemic Risk. OTS also took a narrow view of its responsibility to the U.S. banking system as a whole. The documents show that OTS allowed Washington Mutual to engage in high risk lending, in part, because the bank did not plan to keep the high risk loans on its books, but sell them into the marketplace. OTS never considered how dumping billions of dollars in toxic mortgages into the stream of commerce would weaken the financial system and even come back to harm its own institutions.

One OTS examiner commented on the agency's approach in a 2008 email as follows: "We were satisfied that the loans were originated for sale. SEC and FED [were] asleep at the switch with the securitization and repackaging of the cash flows, irrespective of who they were selling to."

OTS examiners knew that Washington Mutual and Long Beach were notorious for selling bad loans. As early as 2005, an OTS examiner sent an email to colleagues with this description of Long Beach mortgage backed securities: "[Securitizations] prior to 2003 have horrible performance. . . . [Long Beach] finished in the top 12 worst annualized [Net Credit Losses] in 1997 and 1999 thru 2003. . . . At 2/05, [Long Beach] was #1 with a 12% delinquency rate. Industry was around 8.25%." Yet OTS took no steps to require Long Beach or Washington Mutual to clean up their securitizations or the bad loans underlying them. OTS just didn't see it as part of its job, even while the flood of toxic mortgages was slowly poisoning the secondary markets, leading to their collapse and the financial crisis of 2008.

Conclusion

Our bank regulators were not blind to the problems building up in the mortgage banking system. They knew. Instead of getting in the game, they sat on the bench. OTS, in particular, didn't act on what it knew. It appeared to have been too close to the banks it oversaw. The bottom line is that OTS never said "no" to any of the high risk lending or shoddy lending practices that came to undermine WaMu's portfolio, its stock price, its depositor base, and its reputation. The result was a bank failure, a financial system it helped poison with toxic mortgages, and an economic meltdown.

Today, we are examining what happened in this case history. The question for Congress is how do we strengthen our regulatory culture.

On that somber note, I turn to my Ranking Member, Senator Coburn, for his insights. I thank him again for his and his staff's support in this investigation.