

EMBARGOED UNTIL DELIVERY

STATEMENT OF THE

FEDERAL DEPOSIT INSURANCE CORPORATION

on

**EXAMINING THE ROLE OF REGULATORS IN THE SUPERVISION OF
WASHINGTON MUTUAL BANK 2004-2008**

before the

**PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
U.S. SENATE**

**April 16, 2010
Room 106, Dirksen Senate Office Building**

Chairman Levin, Ranking Member Coburn and members of the Subcommittee, the Federal Deposit Insurance Corporation (FDIC) appreciates the opportunity to testify regarding the causes and consequences of the recent financial crisis and specifically the role of regulators in their supervision of Washington Mutual Bank (WaMu). The FDIC shares the Subcommittee's concerns about the issues that it has identified, particularly with respect to large and complex insured depository institutions that pose significant risk to the Deposit Insurance Fund (DIF). In accordance with your invitation letters, our testimony will address the FDIC's role as back-up regulator of WaMu, our examination and enforcement policies and practices for large insured depository institutions, the level of cooperation between the FDIC and the primary federal regulator for WaMu, the Office of Thrift Supervision (OTS), and legislative and other changes to assess and respond to safety and soundness risks posed by large financial institutions.

Background

The WaMu failure must be understood in the context of events that became the catalyst for the broader financial crisis. During the years preceding the crisis, a number of mortgage lenders and originators of mortgage backed securities, including WaMu, became attracted to a variety of high-risk mortgage structures that enabled them to grow revenue and market share. Repayment or refinancing of many of these mortgages depended on a continuation of robustly increasing home prices. When home prices began to turn down, these institutions' business models could not withstand the resulting stresses. Virtually all of the large bank and nonbank mortgage lending specialists

headquartered on the West coast, and many others located around the nation, were closed or acquired. The list of these institutions in addition to WaMu includes Golden West (acquired before the crisis by Wachovia); Ownit Mortgage (closed); Fremont Investment and Loan (an industrial bank that received a March 2007 FDIC Cease and Desist order and was subsequently acquired by CapitalSource, Inc.); New Century Financial (bankrupt); American Home Mortgage (closed); Countrywide Financial (acquired during the crisis by Bank of America); IndyMac (failed); Ameriquest (closed); Pomona First Federal (failed); Downey Savings (failed); Taylor, Bean, and Whitaker (closed); and First Federal Bank of California (failed).

The mortgages originated by these institutions during the years preceding the crisis had a variety of features that, singly or in combination, greatly amplified risk and in some cases were abusive to the borrower. Practices included lending with low or no documentation of income; lending with low initial teaser payments but explosive payment increases 2 or 3 years after origination (the so-called 2-28s and 3-27s); conducting no analysis of the borrower's ability to repay these higher payments; requiring no escrows for taxes or insurance; lending at high loan-to-value ratios; and making high-cost subprime loans.

In the years leading up to the crisis, many of these loans were sold into securitizations and subdivided into tranching structures, the bulk of which received the highest investment grade ratings. When housing prices started to turn down, and investors increased their focus on the quality of the loans underlying these securities, the

securitization market shut down. Resulting liquidity pressures on these thrifts were exacerbated because counterparties were demanding higher haircuts on mortgage collateral—if they would lend against such collateral at all—and securities held in inventory could not for practical purposes be sold. Mortgage lenders had to hold in portfolio loans that had been in the securitization pipeline or loans they had committed to originate, and in some cases these lenders had to repurchase, under representation and warranty clauses, or for reputational reasons, loans they had previously sold. At all the institutions listed, with the onset of the crisis, liquidity pressures and credit losses were so severe as to rule out their survival on a stand-alone basis.

The unsustainable increase in home prices that led up to the crisis was driven, we believe, by a credit boom fueled by an unprecedented tolerance among market participants for financial leverage, in particular as it pertained to mortgage finance. The advanced approaches of Basel II provide a good indicator of the consensus regulatory thinking on acceptable leverage in mortgage lending in the years leading to the crisis. In an interagency study to estimate the impact of the Basel II rules conducted before the onset of the crisis, capital requirements for residential mortgage lending were estimated to decline by a median 73 percent across the 26 participating banks; for home equity lending, the median decline in capital requirements was 79 percent. Institutions with a focus on mortgage lending, such as WaMu, stood to benefit the most from these new rules. The reasoning that produced reductions in capital requirements of such magnitudes is similar to that which produced AAA ratings for large swaths of mortgage securities backed largely by low or no-documentation loans. In both cases, market participants

were officially encouraged to place comfort in modeling assumptions rather than traditional capital adequacy benchmarks or lending standards. The FDIC successfully delayed implementation of the Basel II rules so that large banks and thrifts maintained higher capital levels going into the crisis.

The FDIC has taken a leading role in addressing some of the unsustainable trends that precipitated the mortgage crisis. We have been an early and forceful advocate of regulatory reform to end abusive mortgage lending under the Home Ownership and Equity Protection Act (HOEPA). We have also taken a strong supervisory stance on these mortgage practices, including our Cease and Desist action against Fremont in early 2007 that predated the mortgage meltdown by several months, and our strong support for effective supervisory guidance to end these abusive practices, including the *Interagency Guidance on Nontraditional Mortgage Products Risks* (NTM Guidance). We have consistently and strongly advocated for responsible loan modifications as the most cost-effective approach to avoid needless foreclosures. We advocated strongly and successfully within the Basel process for new operational requirements for the use of credit ratings in setting capital requirements, to ensure adequate information and due diligence regarding the exposures underlying securitizations rated by the credit rating agencies. With respect to the appetite for financial leverage implicit in the advanced approach of Basel II, the FDIC was never part of the consensus. We have consistently advocated against over-reliance on models, and for robust risk-based capital floors under the advanced approaches and the retention of the simple and transparent leverage requirements that Congress mandated in 1991.

The FDIC's Role and Responsibility as Back-Up Regulator

The FDIC is charged by Congress with maintaining stability and public confidence in the nation's financial system by, among other things, examining and supervising insured depository institutions for safety and soundness and consumer protection. The FDIC is the primary federal regulator (PFR) for nearly 5000 state-chartered depository institutions that are not members of the Federal Reserve System.

In addition to its role as primary federal regulator for most state-chartered depository institutions, the FDIC also is responsible for insuring deposits at about 8000 federally insured depository institutions. This means that the DIF is exposed to losses from institutions that are not directly supervised by the FDIC. To assist the FDIC in effectively carrying out this responsibility, Congress has given the FDIC “back-up” authority to examine insured banking organizations, like WaMu, that have a different federal regulatory agency as PFR.¹ The statute authorizes the FDIC to conduct a special, or “back-up,” examination of any insured depository institution, provided the FDIC Board of Directors “determines that a special examination is necessary to determine the condition of [that] depository institution for insurance purposes.”

In 2002, the FDIC worked with the other agencies to develop an agreement to implement our statutory authority. This was a collaborative process that was meant to balance our needs for ready access to information with the primary federal regulators

¹Section 10(b)(3) of the Federal Deposit Insurance (FDI) Act [12 U.S.C. § 1820(b)(3)].

concerns with a potential duplication of efforts. In order to achieve a consensus agreement, several modifications to the statutory authority were necessary. One of the more notable concessions agreed to at the time was that the FDIC would conduct a special or back-up examination only if the institution “represent[s] a heightened risk” to the DIF. The Interagency Agreement defines institutions that present a “heightened risk” as institutions that a) have poor supervisory ratings or b) are undercapitalized for purposes of “prompt corrective action.”² Since 1979, the federal banking regulatory agencies, including the FDIC, have assessed the soundness of financial institutions according to the Uniform Financial Institutions Rating System (UFIRS).³

In addition, the agreement limited our direct access to bank employees and required the FDIC to rely, when possible, on examinations and inspections conducted by the appropriate PFR. As discussed later, the compromises that appeared reasonable in theory at the height of the banking industry profitability served to bind us when the FDIC needed to implement this agreement in practice.

The FDIC’s statutory special examination authority differs from the examination authority granted the PFR in several important respects. First, the statutory requirement

² The Prompt Corrective Action (PCA) provisions in Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) (Section 38 of the FDI Act) require that regulators set a threshold for critically undercapitalized institutions, and that regulators promptly close institutions that breach the threshold unless they quickly recapitalize or merge with a healthier institution. Bank regulators set the threshold for critically undercapitalized institutions to 2 percent tangible capital.

³ Under UFIRS, which is intended to identify those institutions requiring special supervisory attention, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. The six component areas are Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. The rating system is often referred to as the "CAMELS" rating system.

for FDIC Board action to authorize special examinations builds delays into the conduct of such examinations by the FDIC. Second, the FDIC's authority applies to the insured depository institution and its affiliates, but does not specifically extend to examinations of holding companies regulated by the PFRs. Finally, when the FDIC conducts a special examination, the statute requires that the FDIC coordinate with the PFR, a provision often cited by the PFR to constrain our special examination activities.⁴

In addition, Congress also authorized the FDIC to take enforcement action in certain circumstances.⁵ Specifically, the FDIC first must recommend in writing that an institution's PFR take enforcement action. If the PFR does not act within 60 days the FDIC itself may institute an enforcement action, provided action is authorized by the FDIC's Board of Directors based on a determination that:

- (A) the insured depository institution is in an unsafe or unsound condition;
- (B) the institution or institution-affiliated party is engaging in unsafe or unsound practices, and the recommended enforcement action will prevent the institution or institution-affiliated party from continuing such practices; or
- (C) the conduct or threatened conduct (including any acts or omissions) poses a risk to the deposit insurance fund, or may prejudice the interests of the institution's depositors.

⁴ Section 10(d)(6) of the FDI Act, 12 U.S.C. § 1820(d)(6).

⁵ Section 8(t)(2) of the FDI Act [12 U.S.C. § 1818(t)(2)].

Large Insured Depository Institutions Exam and Enforcement Policies and Practices

The FDIC's Division of Supervision and Consumer Protection (DSC) monitors the activities of all insured depository institutions, conducts supervisory examinations, and develops supervisory strategies. As part of its supervisory program, DSC also identifies the impact of industry-wide risks on large insured depository institutions (LIDIs), currently defined as insured depository institutions with total assets of at least \$10 billion. At year-end 2009, the number of LIDIs was 109. The PFRs for the current LIDIs include the OTS, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the FDIC, depending upon the nature of the institution's charter (thrift, state member, national, or state non-member).

Within DSC, the Complex Financial Institution Branch (CFI Branch) supports supervisory activities in LIDIs. The CFI Branch analyzes and aggregates data on large banks as an element of its LIDI rating process. Daily responsibility for oversight of most LIDIs is assigned to a case manager. The case manager monitors examination reports prepared by the PFR, analyzes data from quarterly institution Call Reports, and analyzes other financial and economic data. The FDIC also assigns a dedicated examiner (DE) and additional on-site examination staff to the largest LIDIs. Ideally, the DE and staff work in cooperation with the PFR and bank personnel on-site at the institution on an ongoing basis. The DE performs comprehensive quarterly analyses of the risk profile of assigned LIDIs and of the PFR's proposed supervisory strategies for dealing with perceived risks.

The Division of Insurance and Research (DIR) supports DSC's supervision of insured depository institutions. Among other things, DIR identifies and analyzes emerging risks; conducts research that supports sound deposit insurance, banking policy, improved risk assessment, and consumer protection; assesses the adequacy of the DIF; and implements an effective and fair risk-based premium system.

As previously noted, in September, 2002, the FDIC began implementing a Dedicated Examiner ("DE") program at the eight largest insured banking institutions. Under this program, an FDIC senior examiner is assigned to each of these banks, regardless of who the PFR may be. Under the Interagency Agreement, PFR personnel are "expected to keep the [DE] informed of all material developments" and to "invite the [DE] to observe and participate in certain examination activities." PFR personnel are expected to ensure that "the FDIC has an understanding of the supervisory issues and risk management structure" of the LIDIs.

In addition to its DE program, the FDIC carries out its examination responsibilities with respect to LIDIs, which included WaMu, by performing offsite risk analyses under the LIDI Program. That program is designed to provide comprehensive and forward-looking assessments of the risk profiles of LIDIs. LIDI analysis helps identify the largest risks to the DIF and to identify emerging risks and trends in the banking industry.

To quantify the level and direction of risk, each LIDI is assigned a rating (A through E, with A being the best) and an outlook (positive, stable, or negative). Ratings and outlooks are assigned at least quarterly, with interim changes made when necessary. All relevant sources of information available are used in performing LIDI analysis, including both public information and confidential bank supervisory information. For non-FDIC supervised institutions, supervisory information or internal bank reports are obtained through the PFR.

Level of Cooperation between the FDIC and OTS

The 2002 Agreement that was negotiated with the other agencies included various provisions that limited our ability to conduct the special examinations that were authorized under the Statute. It is noteworthy that the Interagency Agreement requires FDIC to show “heightened risk” to the deposit insurance fund, with specific reference to the bank being 3, 4, or 5 rated or undercapitalized. Further, the CAMELS trigger is tied solely to the primary federal supervisor’s evaluation of the institution, not the FDIC’s. Therefore, the argument for FDIC participation proved to be circular. When an institution is deteriorating but has not triggered any of these provisions it becomes difficult to gain entry as often the reason we have requested an on-site presence is to determine if these conditions exist. Further, we had difficulty gaining access at WaMu because of a requirement in the Interagency Agreement that: “To the fullest extent possible, FDIC should continue to rely on the results of the work performed by the primary bank supervisors in assessing the condition of individual institutions.”

Following is a chronological review of the level of cooperation between OTS and FDIC in the supervision of WaMu.

Years 2004- 2006

In 2004, WaMu's holding company, Washington Mutual Inc. ("WMI"), owned and controlled a state chartered bank, Washington Mutual Bank ("WMB"), for which the FDIC was the PFR. FDIC last conducted an examination of WMB in March 2004 and a visitation in October 2004.

On January 1, 2005, WMI merged its thrift and state chartered bank. The resulting institution was a federally chartered savings association, for which the OTS was the PFR. As the PFR, OTS became responsible for scheduling, staffing and setting the scope of supervisory activities for the institution, including pursuit of necessary formal and informal administrative enforcement actions. Following the merger, FDIC assessed WaMu's safety and soundness, and the risk posed by WaMu to the DIF, primarily by participating in OTS examinations of WaMu in a back-up capacity.

In 2005, WaMu management made the decision to change its business strategy from traditional fixed rate conventional single family loans toward nontraditional and subprime loan products. In August 2005, OTS management for the first time expressed to FDIC its determination that FDIC should not actively participate in OTS examinations

at WaMu, citing the 2002 Interagency Agreement. Subsequently, following the protocol as set forth in the Interagency Agreement, the FDIC San Francisco Regional Office requested permission to participate in the 2006 OTS examination. OTS responded by letter indicating: "...we (OTS) do not plan to have FDIC examiners actively participate in the examination review and rating assessment." The letter also informed the FDIC that it would not be allowed to participate in a review of subprime lender Long Beach Mortgage, then a subsidiary of WaMu's holding company and thus an affiliate of the bank. Ultimately, the FDIC participated in the March 2006 examination, but was not allowed to review loan files at Long Beach Mortgage.

The FDIC again experienced resistance from OTS to our participating in examinations September 2006. That month, OTS moved to a "continuous examination approach," whereby OTS performed periodic "target" examinations during an examination cycle and issued an annual "rollup" examination report. In early September, the OTS informed the FDIC that it must demonstrate a regulatory need to join an examination of a 2-rated bank, and that since OTS was not aware of any disagreements between the agencies as to WAMU, FDIC had failed to demonstrate such need. FDIC pointed out that regulatory disagreement was not a prerequisite for participation under the Agreement. Following elevation of the dispute to our respective Washington Offices, denial of participation was reversed in November, with the proviso that the FDIC's DE must funnel all requests through the OTS examiner in charge (EIC). FDIC then participated in the OTS's 4th quarter 2006 target exam of WaMu.

For four months after WaMu moved to new headquarters in 2006, OTS failed to provide the FDIC's DE with either access to WaMu's electronic "Examiner Library" (WaMu's electronic repository of the supervisor and regulatory information it prepared for the regulators), or a physical workspace on-site at WaMu. The FDIC ultimately was able to obtain this access in late October, again after the issue was elevated to the Washington Offices of both agencies.

Years 2007

Beginning in 2007, OTS restricted FDIC examinations staff from reviewing all loan files, indicating that an FDIC loan file review would be duplicative and a regulatory burden for the bank. FDIC argued unsuccessfully that we needed to review the loans for compliance with the NTM Guidance, and suggested that we split the review with OTS examiners for this purpose. OTS refused, indicating that the OTS was not reviewing loan files until WaMu had time to make some changes in its practices in order to comply with the NTM Guidance.

Year 2008

In 2008, OTS objected to the number of examiners that FDIC proposed to have involved in the examination. OTS management communicated to the FDIC that the number of examiners it proposed be involved in the examination was excessive. Again, OTS did not permit FDIC examiners to conduct an exam or review loan files. Further,

OTS indicated that should FDIC want to review asset quality, FDIC could review OTS workpapers only.

As WaMu's PFR, OTS assigned a Composite 2 CAMELS rating until February 27, 2008, when OTS made an interim rating change to a Composite 3. WaMu had suffered operating losses of \$1.8 billion in the 4th quarter of 2007. WaMu suffered another \$1.1 billion loss in the 1st quarter of 2008, but another downgrade was averted when WMI, its holding company, raised \$7 billion in capital in April 2008 and downstreamed \$3 billion of this amount to the bank. Subsequently, another \$2 billion was downstreamed by WaMu's holding company, for a total capital infusion to WaMu from WMI of \$5 billion in 2008. The remaining \$2 billion raised remained at WMI for debt service.

During this period, WaMu received a strategic offer by JP Morgan Chase to acquire the company for approximately \$7 billion or as much as \$8 per share. Instead, WaMu management accepted a capital infusion (described above) from TPG that preserved WaMu's independence but also limited future options for raising capital.

Following the \$7 billion capital raise, the FDIC prepared a capital analysis that revealed that in a stress scenario WaMu would need \$5 billion in addition to the \$5 billion of capital already downstreamed, to survive. The stress capital analysis took into account the estimated embedded losses in WaMu's portfolio, which were likely to require additional capital, and gave WaMu credit for pre-provision and pre-tax income that it

could reasonably expect to generate. The analysis was based on the premise that while WaMu's reserves might cover its expected losses in the near term, more capital was necessary to protect WaMu from unexpected losses in the long term. The FDIC shared and discussed its WaMu stress capital analysis with the OTS in May of 2008. OTS rejected the analysis, arguing that the analysis was not in accord with Generally Accepted Accounting Principles (GAAP). The FDIC responded that a stress capital analysis is different from a GAAP analysis. OTS did not provide a capital analysis of its own to the FDIC.

At this point, the FDIC's view was that WaMu needed more capital. The FDIC was also concerned that the institution did not recognize the problems facing it and was not taking the necessary corrective measures. The FDIC believed that if WaMu management would not take these essential steps on their own, the regulators would need to take additional supervisory action to bring about corrective measures.

At a July 15, 2008 WaMu Board of Directors meeting, OTS presented its exam findings and stated that WaMu's CAMELS rating would continue to be a Composite 3. FDIC examiners put WaMu's Board on notice that the FDIC considered WaMu's CAMELS rating to be a Composite 4, thus putting the Board on notice of a possible downgrade. OTS proposed that corrective action be memorialized in a Memorandum of Understanding (MOU) with the WaMu Board of Directors. The MOU was executed on September 17, 2008, 8 days before WaMu was closed. The OTS accepted FDIC input for the MOU provisions that required:

- Downstreaming of an additional \$2 billion capital from the parent (as referenced above)
- Maintenance of PCA capital ratios at least 1 percent in excess of “Well Capitalized”
- A contingency capital plan
- Maintenance of adequate Allowance for Loan and Lease Losses (“ALLL”).

In the weeks following the July 11 failure of IndyMac Bank, WaMu suffered a \$10 billion retail deposit run-off. The deposit run-off, combined with WaMu’s significant loss operations and the need for capital, further supported FDIC’s view that WaMu should be downgraded to a Composite 4. On August 11, FDIC forwarded draft comments in support of a Composite 4 rating to OTS and met with OTS to discuss the agencies’ ratings disagreement on August 28. FDIC presented its in-house analysis and projections. OTS presented WaMu’s projections, which relied on WaMu’s credit card division (formerly Provident) to restore WaMu to profitability in 2009. The FDIC determined that a restoration of profitability for WaMu in 2009 was implausible. The agencies’ rating disagreement was escalated to their respective Washington Offices for resolution.

The FDIC Board of Directors discussed reconciliation of the rating differences at its September 16 meeting. The FDIC Board received a staff briefing, and the OTS strongly disagreed with the FDIC proposed composite rating of 4. After the Board

meeting, on September 18, the OTS nevertheless determined to lower WaMu's rating to Composite 4.

In the wake of the failure of Lehman Brothers in mid-September 2008, WaMu experienced a second run on deposits. The institution lost nearly \$17 billion in deposits over an 8-day period, resulting in a liquidity crisis. Average daily deposit withdrawals (both retail and commercial) exceeded \$2 billion on multiple days over the week preceding the September 25 receivership. The run on deposits extended to both insured and uninsured accountholders.

Bank customers began to request cash payouts rather than accepting official checks. While the Bank had access to Federal Home Loan Bank and Federal Reserve Discount Window borrowing lines, these totaled less than \$10 billion; and, both were evaluating the overall financial condition of WaMu and had initiated actions to diminish borrowing capacity, due to deteriorating asset quality. The Federal Reserve Bank of San Francisco had dropped the bank to secondary credit status on September 24, thus reducing the bank's borrowing capacity, and was prepared to impose a 10 percent haircut on collateral requirements of the bank. On that day, cash on hand declined to \$4.4 billion, a dangerously low number for a \$300 billion institution that had experienced deposit runoff as high as \$3 billion in a single day during the latest deposit run.

.

On September 25, the OTS projected that the institution would likely be unable to pay obligations or meet depositor demands in the normal course of business over the near term. OTS closed WaMu on Thursday, September 25.

Lessons Learned

It has been an extraordinarily challenging time for the nation's banking industry, and we have all learned lessons at many levels.

We welcome findings and recommendations from the FDIC's Inspector General (IG) and the Inspector General of the Department of the Treasury in connection with their evaluation of the federal regulatory oversight of WaMu. The evaluation identified the Interagency Agreement's "heightened risk" requirement as limiting the FDIC's ability to assess the potential risk of an institutional failure and the resulting impact on the DIF, corroborating the FDIC's experience. The IG report also expresses concerns about the FDIC's historic reliance on CAMELS ratings for the purpose of establishing risk-based premiums for deposit insurance coverage. The IG report includes recommendations to address both issues. The FDIC agrees with the recommendations, and had already begun a number of initiatives which will implement these recommendations, as described below.

Strengthening the Interagency Agreement

At the outset of the testimony we mentioned that the FDIC has authority to conduct special or “back-up” examinations of insured depository institutions. The usefulness of this authority has been limited by its procedural bottlenecks and requirement, established in less stressful times than we have now, that these examinations can be made only when necessary to deal with “heightened risk” to the insurance fund, a determination that logically can be most prudentially made only after a special examination has taken place. The MOU requires the FDIC to rely on the PFR. The FDIC has proposed modifications to the other PFRs to strengthen the Interagency Agreement. The FDIC must, as Congress clearly intended, be able to make an independent assessment of the risk of insured banks to the DIF, perform contingency resolution planning, obtain the information necessary to protect the DIF, or for such other purposes that the FDIC determines is necessary for effective administration of the provisions of the Federal Deposit Insurance Act.

The FDIC also needs the ability to determine the time and manner in which such special examinations shall be conducted and to maintain an examination staff with an on-site and continual presence at the largest depository institutions in order to facilitate the conduct of special examinations. We are hopeful that a consensus on a new Interagency Agreement can be reached in the near future.

Similarly, the FDIC recommends that the procedural limitations on our ability to take enforcement action to correct any violation of law or regulation, or any unsafe and unsound banking practice be removed. The FDIC recommends that we be given the ability to move decisively to deal with such situations without having to wait for 60 days for a decision by another agency on whether such action may be implemented.

Deposit Insurance Pricing Revisions

Also, the FDIC has proposed new deposit insurance assessment regulations for large insured institutions that are consistent with the FDIC's Inspector General (IG) recommendations that the FDIC not rely too heavily on the primary federal regulator's assignment of CAMELS ratings and capital levels. The current system constricts FDIC's ability to differentiate risk because institutions are placed in one of four risk categories determined by their CAMELS ratings and capital category. Therefore, if CAMELS are slow to reflect elevated risk, the current system limits the amount that can be charged to reflect that risk.

The FDIC Board has approved publication of a notice of proposed rulemaking that would eliminate those risk categories and, therefore, the amount of risk differentiation would not be constrained to the same degree by CAMELS ratings. This risk differentiation would be based on well-defined financial measures that are more forward looking and better suited to measure the unique and concentrated risks posed by the largest institutions, which is also consistent with the IG's recommendations.

Recognizing that the FDIC's role as insurer is, in some ways, very different from the role of a supervisor, the proposed rule would increase or decrease the assessment rate for banks depending on how expensive it would be for the FDIC to resolve. The proposed rule would also retain the FDIC's ability to make discretionary adjustments, based on the risk factors that the FDIC deems relevant. If the proposed rule had been in effect prior to WaMu's failure, WaMu would have paid significantly higher assessments in the periods leading up to its failure. Following the completion of public rulemaking processes, it is expected that these new standards will be implemented by the beginning of next year.

Other Proposed Rulemakings

Consistent with some of the reform proposals pending before Congress, the FDIC is considering proposing a rule to require LIDI subsidiaries of large and complex financial parent companies to provide the FDIC with analyses, information, and contingent resolution plans that address and demonstrate each LIDI's ability to be separated from its parent structure, and to be wound down or resolved in an orderly fashion. Once finalized, this rule will enhance the FDIC's ability to engage in a direct dialogue with complex LIDIs about mitigating or eliminating identified impediments to the FDIC's ability to conduct an orderly resolution of the insured institution.

The FDIC also is considering a rulemaking to tie federal deposit insurance assessments to bank employee compensation structure in order to keep compensation in

line with the long-term interests of the institution. The financial crisis has shown that most financial-institution compensation systems were not properly linked to risk management. Formula-driven compensation allows high short-term profits to be translated into generous bonus payments, without regard to any longer-term risks. Mortgage brokers and bankers went into the subprime and other risky markets because these markets generated high returns not just for investors but also for the originators themselves, and this of course was the case at WaMu as well. The lack of a downside in these compensation schemes ultimately hurt both the borrowers who could not pay their risky mortgages and the economy. Your comments would be most welcome on this rulemaking.

A further proposal the FDIC Board is considering would require banks to retain a portion of the credit risk of any securitizations they sponsor. This latter proposal will be presented to our Board at the May Board meeting.

Regulatory Reform

The FDIC strongly supports pending legislative reform efforts to address the orderly resolution of large financial organizations, and other financial reform measures already discussed above. In particular, legislation currently under consideration by the Senate Banking Committee and legislation approved by the House of Representatives would establish enhanced oversight of large bank holding companies and non-bank financial companies that are systemically significant and should be subject to heightened

prudential standards and oversight -- and we support their hard work in this regard. The ability to resolve these large and complex institutions in a manner similar to how smaller banks are treated is essential to ending the too-big-to-fail doctrine.

The FDIC also strongly supports the need for an independent consumer financial protection regulator. As we have testified previously, many of the current problems affecting the safety and soundness of the financial system were caused by a lack of strong, comprehensive rules against abusive lending practices applying to both banks and non-banks, and lack of a meaningful examination and enforcement presence in the non-bank sector. Products and practices that strip individual and family wealth undermine the foundation of the economy.

Conclusion

While the FDIC would much rather see a troubled institution return to health and safe and sound practices, at the point at which WaMu failed, the embedded losses and liquidity problems had made the institution unviable. Critics may say it was overly harsh to close WaMu, but the reality is that mortgage losses were mounting, downgrades were occurring, and efforts to raise capital had been exhausted. The institution had already gone through one major deposit run and was in the midst of another. The franchise value of WaMu was dissipating rapidly. Action had to be taken. Further delay by the government would have significantly raised the costs to the FDIC of fulfilling its obligation to protect the \$160 billion of insured deposits at WaMu.

This resolution went remarkably smoothly. The FDIC was able to preserve all of WaMu's deposits, both insured and uninsured. The resolution left branches open, preserved many jobs, and allowed for a seamless transition for WaMu's customers the day after the bank was closed. The resolution came at zero cost to the DIF, and the institution was not bailed out. In contrast, had the FDIC been forced to liquidate WaMu, the FDIC estimates that it would have suffered approximately \$41 billion in losses.

Again, thank you for the opportunity to testify. We are pleased to answer any questions.