

Statement of
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regarding

Washington Mutual Bank

Before the
U.S. Senate Permanent Subcommittee on Investigations
United States Senate

April 16, 2010

Good morning, Mr. Chairman, and Members of the Subcommittee, my name is John Reich. I retired in February 2009 after a 49 year career that included 25 years as a community bankers in Illinois and Florida – 12 years as CEO; followed by nearly 12 years in the U.S. Senate as a staff member with former Senator Connie Mack – the last three years as his chief of staff; and eight (8) years from January 15, 2001 to February 27, 2009 as a member of the Board of Directors of the FDIC that included five (5) years as an inside director serving as Vice Chairman. In 2005, the White House asked if I would move to the Office of Thrift Supervision to serve as its Director, and on August 5, 2005, I took the Oath as OTS Director and served in that capacity for three and one-half years until I retired on February 27, 2009.

When asked by the White House to move to OTS, I agreed to do so - with some level of concern. The banking industry was at the peak of a six year boom, recording successively increasing earnings records, and a decline seemed likely. In addition, OTS staffing numbers had experienced a decline in recent years, with no new hiring at any level, and a diminishing priority had been given to the compliance function, partially evidenced by the elimination of senior level Compliance and Consumer Protection management positions in Washington, DC.

At the beginning of my tenure as OTS Director, the agency had 899 employees, 4 Regional Offices, and no centralized Compliance and Consumer Protection function in the Washington, DC headquarters office. I spent a good portion of my first year becoming familiar with staff and structure throughout the agency, initiating a number of changes. I learned very early that OTS had operated its Regions with a high degree of decentralization and autonomy. This presented challenges with achieving consistency in carrying out our responsibilities, and we sought during the duration of my tenure to change the culture to more standardized procedures with greater direction and leadership from the headquarters office.

Much of this effort was facilitated by regular meetings of senior regional staff with senior Washington, DC management, usually, but not always, including me. These Regional Management Group (RMG) meetings occurred approximately 6 times a year, rotating among Regional offices around the country and the Washington, DC office. The meetings generally lasted two to two and one-half days, and the Agenda almost always included briefings from each Region on the current status of high risk cases. Thus, Washington Mutual Bank (WaMu) was formally discussed several times a year by OTS management, and in fact, during the last year of its existence,

was discussed informally on virtually a daily basis by Washington, DC management.

The Failure of Washington Mutual Bank

There are three points I would like to make concerning the failure of WaMu on September 25, 2008:

1. Though Asset Quality was a growing and continuing concern at WaMu, this was a liquidity failure, not a capital failure, brought on because of a \$16.4 billion run on deposits, during the 10-day period preceding September 25th, with zero cost to the Deposit Insurance Fund or to taxpayers.
2. A majority of WaMu's mortgages were in California and Florida – two of the states hit with the most severe price declines.
3. WaMu suffered with a lack of diversity in its asset portfolio because of restrictions imposed by the HOLA statute under which savings institutions operate. Though they attempted asset diversity, all of the categories were in real estate related loans.

The liquidity failure at WaMu was induced by the decline in public confidence in large financial institutions, brought on by a series of prior significant events in 2008:

- a. the March failure of Bear Stearns;
- b. the July failure of IndyMac,
- c. the early September government takeover of Fannie Mae and Freddie Mac;
- d. the mid-September collapse of Lehman and bailout of AIG;
- e. the September 21st weekend approval by the Fed for Goldman Sachs and Morgan Stanley to become bank holding companies.
- f. On September 25th, WaMu was closed by OTS with zero cost to the Deposit Insurance Fund or to taxpayers.

These events were followed by:

- a. The September 29th acquisition of Wachovia announced by Citi
- b. The October 3rd acquisition of Wachovia announced by Wells Fargo
- c. The October 3rd announcement by the FDIC of an increase in deposit insurance to \$250,000 per depositor – an event which might have prevented the closure of WaMu if it had occurred a couple of weeks earlier.
- d. The November 24th announcement of a government bailout of Citigroup (not the first, by the way)

Had WaMu's liquidity crises occurred 2 weeks later, there would have been no failure, as the FDIC's October 3rd announcement of an increase in deposit insurance to \$250,000 per depositor would likely have mitigated the run on deposits which took place. Whether there would have been a later capital failure is pure conjecture. Furthermore, though I do not personally support the "Too Big to Fail" public policy which presently exists, the informal definition of which in reality was acknowledged and expanded when regulators publicly mandated a capital stress test of the 19 largest institutions in the country in 2009 with over \$100 Million in Total Assets – WaMu again would have been prevented from failure. Under an inconsistent and moving public policy, WaMu was in fact a systemically important institution and should have been treated as such. It is noteworthy that Secretary Hank Paulson in his recent book, *On The Brink*, states (on page 293) that... "I see that, in the middle of a panic, this was a mistake.

WaMu, the sixth-biggest bank in the country, was systemically important.”

I agree with Secretary Paulson’s revised view.

WaMu and OTS and Staffing

During my tenure at OTS, I believe WaMu at its peak size represented approximately 23% of the Total Assets in institutions supervised by OTS, and its assessment revenue represented approximately 12 to 13% of OTS’s Total Assessment Revenue.

As Director of the agency, I never ever felt beholden to ‘preserve’ WaMu or any other chartered entity under our supervision for the purpose of preserving OTS’s revenue stream or its standing as a separate regulatory agency.

I’m fully aware there is a belief - long held by some - that a supervising agency dependent on those it supervises for significant components of its revenue stream, may tend to supervise or administer with a lighter touch in order to preserve the future of the supervising agency. I understand why that belief is held – for in Material Loss Reviews and case studies throughout all of the Federal Banking Agencies over the years, including OTS, OCC, FDIC, and the Fed, there are examples cited indicating that examination information was known and recommendations made by examiners calling attention to serious weaknesses which if not corrected

could jeopardize an institution's safety and soundness. In a number of instances in recent years, including WaMu, these prophecies came true, though in WaMu's case, I strongly maintain the immediate cause of OTS's decision to close the institution and appoint the FDIC as receiver was not a depletion of capital, but a depletion of liquidity.

Some opinions to the contrary, I firmly believe that size of an institution and its proportion of an agency's revenue stream are irrelevant factors. It is also an insult to the integrity of nearly 5,000 bank examiners and professional regulators around the country to suggest their priorities and motivations would be anything other than to provide for the safety and soundness of our nation's financial institutions. Anyone aware of the psyche of the typical career bank examiner or career regulator would understand this view. These are dedicated public servants committed to their mission, and are often described by bankers as overly-zealous.

OTS, though a small agency, had sufficient resources dedicated to the examination of WaMu, including resident examiners and assigned specialists. In 2005, at the time I became Director of OTS, the agency was performing full-scope annual 'point-in-time' examinations. In 2007, OTS moved to a 'continuous' examination process, issuing 'findings memoranda'

to bank management during the year, and including these as necessary in a final Report of Examination.

With regard to Agency staffing, we restored a hiring and internal professional development program, and over the period 2005 to 2009, with approximately 45 to 50 retirements per year, OTS recruited well over 200 new employees, and total staffing stood at approximately 1,030 employees at the time of my retirement, with an approved staffing level of 1,060. In addition, we almost immediately restored and staffed a centralized Compliance and Consumer Protection management function in Washington, DC, coordinating compliance and consumer protection through Regional Compliance and Consumer Protection managers and gave increased emphasis on compliance and consumer protection examinations. Many new hires were directed into the compliance examiner training program.

OTS Supervision of WaMu

I believe the record (Reports of Examination) and any external Inspector General reviews of OTS's work will show that OTS examiners were diligent and rigorous in the conduct of their work and in identifying matters requiring attention. Many issues and weaknesses were brought to bank management's attention during the examination process, not waiting for the production of a Report, but communicated through periodic

memorandums which contained findings classified as Criticisms, Recommendations, or Observations.

Asset Quality was an underlying concern at WaMu monitored continuously by OTS examiners and highlighted in Reports of Examination. As worldwide liquidity markets crashed in August, 2007, considerable losses developed in WaMu's loan portfolio because of stated income, low doc and no doc loans. For some time I had been concerned about these types of loans. As a former banker, these concepts were anathema to me, having grown up in an era when loans were made, regardless of type, based upon the 5 C's of Credit: Character, Collateral, Capacity, Capital, and Conditions. My greatest regret as a regulator is that I did not act to eliminate these types of loans. I was influenced by the argument that these types of loans had been successfully underwritten and administered by institutions on the West Coast of the United States for more than 20 years with minimal loss experience. As simplistic as it may seem, regardless of size of institution, if the 5 C's of credit administration had been followed in the past, and if they are utilized as fundamental components of lending policies in the future, any meltdown such as we have recently experienced will be far less traumatic.

Long Beach Mortgage Company (LBMC) was a source of concern from the bottom to the top of OTS management because of its subprime

mortgage practices. My recollection is that OTS insisted that certain underwriting improvements take place before WaMu was permitted to integrate LBMC into the bank. In the second half of 2007, WaMu ceased making subprime loans, though – in my recollection - not before this component of their portfolio represented a little over 10% of their entire portfolio.

Relationship with FDIC

As previously mentioned, I spent five of my eight years as a regulator as an inside Director within the FDIC, serving as Vice Chairman for several years, and as Acting Chairman for several weeks during 2001 prior to Donald Powell taking the Oath as Chairman. During this period, the failure of Superior Bank FSB, Hinsdale, Illinois occurred. The institution was supervised by OTS, and it became necessary for me to make the then-OTS Director aware that OTS's Regional Office in Chicago had declined FDIC's request to participate in a joint examination. My call resulted in the reversal of OTS's decision, but it was too late to preserve the institution. I cite this experience to indicate that I am well aware of the FDIC's need for timely examination visits and information, and am generally predisposed to agree to such requests.

Part of the tension is attributable to the composition of the FDIC Board – currently five members, with three inside Director positions and two outside Director positions – the Comptroller of the Currency and the Director of the OTS. I believe a diverse board is an asset. There are occasional differences of opinion on policy issues which come before the FDIC Board resulting in a 3-2 split. The inside directors may think the outside directors are viewing issues from their own independent agency's parochial point of view and not from the standpoint of what is in the best interests of the FDIC and its Deposit Insurance Fund. Conversely, the outside directors may believe the inside directors view issues from an overly narrow perspective and do not always appreciate the potential for unintended consequences and negative impacts on institutions the FDIC does not supervise and about which they may not have an informed perspective.

Some Members of Congress seem to believe that disagreement among regulators is unseemly and an indication the process is broken and needs to be changed. I could not disagree more with that view. Like the U.S. Congress, differences of opinion are desirable, productive, and usually result in the best policy being adopted.

In the exercise of its backup supervisory authority, the FDIC has the unfettered right to examine any 3, 4, or 5 rated institution. For institutions

rated 2 or higher, the FDIC must have the consent of the primary federal regulator in order to perform or participate in an examination of an institution that it does not directly supervise. These backup policies and practices exist for basically four reasons in my opinion:

1. The statutory authority of the primary supervisory gives that supervisor the responsibility for the oversight of the institution.
2. The presence of another supervisory authority creates room for confusion among the staff of the financial institution over what agency really is in charge.
3. Past experience has highlighted situations that occur among financial institutions over the additional regulatory burden presented when an additional agency's staff is on site making requests, sometimes duplicative.
4. Finally, the presence of FDIC staff in an institution for which it is not the primary federal regulator heightens concern and alarm within an institution and a community if it becomes known that the FDIC is on site.

Conclusion

WaMu failed because of an acute run on deposits totaling \$16.4 Billion during the 10 days preceding September 25, 2008, resulting in backup liquidity lines at the Federal Home Loan Bank of Seattle, the Federal Home Loan Bank of San Francisco, and the Federal Reserve Bank of San Francisco being reduced or pulled. Its financial condition was exacerbated over the years by the fact it operated under an obsolete HOLA statute which essentially mandates two-thirds of a savings institution's assets be invested

in real estate related loans. Hence by definition, a savings institution's portfolio is a concentration of assets in what has now proven to be a vulnerable component of our economy – the housing market.

In my opinion, the current thrift charter is obsolete. Savings institutions need the flexibility for greater asset diversity, and Congress needs to provide for that capability in any reform legislation. In addition, the competitive landscape needs to be leveled from a regulatory point of view. We cannot continue to have an environment where highly regulated institutions compete against lesser or unregulated entities for the same or similar financial products.