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Hearing on the Role of Regulators in Exercising Their Supervision of Washington Mutual Bank from 2004 - 2008

Statement of Jon T. Rymer
Inspector General
Federal Deposit Insurance Corporation

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Mr. Chairman, Ranking Member Coburn, and Members of the Subcommittee:

Thank you for providing me the opportunity to participate in this very important hearing. My name is Jon T. Rymer, and I am the Inspector General (IG) for the Federal Deposit Insurance Corporation (FDIC). As noted in your invitation letter, the purpose of today's hearing is to focus on the role of regulators in exercising their supervision of Washington Mutual Bank (WaMu). Specifically, you asked about the findings regarding the joint report entitled, *Evaluation of Federal Regulatory Oversight of Washington Mutual Bank* (Report No. EVAL-10-002), which we completed with our colleagues at the Department of the Treasury Office of Inspector General (OIG) and are releasing today. We appreciate your interest in our evaluation and hope that it contributes to the work of your Subcommittee.

The WaMu evaluation is the first report to comprehensively analyze the supervisory efforts of the Office of Thrift Supervision (OTS) and the FDIC with respect to a single failure. The two federal regulators had concurrent oversight responsibility for an institution that failed during the current financial crisis. OTS was the primary federal regulator (PFR) and was responsible for conducting safety and soundness examinations while FDIC was the back-up supervisor and was responsible for monitoring WaMu to assess risks to the Deposit Insurance Fund (DIF). WaMu was, in fact, the largest bank failure in United States history, but the sale of WaMu to JP Morgan Chase & Co. avoided a loss to the DIF.

Section 38(k) of the Federal Deposit Insurance Act requires the cognizant IG to conduct a material loss review (MLR) of the causes of the failure and PFR supervision when the losses to the DIF exceed $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver. Because the FDIC facilitated a sale of WaMu to JPMorgan Chase & Co. without incurring a material loss to the DIF, an MLR was not statutorily required. However, given WaMu's size, the circumstances leading up to WaMu's sale, and non-DIF losses, such as the loss of shareholder value, the IGs of the Department of the Treasury and FDIC believed that an evaluation of OTS and FDIC actions could provide important information and observations going forward.

Our objectives were to (1) identify the causes of WaMu's failure; (2) evaluate OTS's supervision of WaMu, including implementation of the Prompt Corrective Action provisions of Section 38(k), if required; (3) evaluate 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; and (4) assess FDIC's resolution process for WaMu to determine whether that process complied with applicable laws, regulations, policies, and procedures. The WaMu evaluation covers the first three objectives. We deferred work on objective four to a later date pending resolution of ongoing litigation.

The statement of the Treasury IG to the Subcommittee focuses on the first two objectives – causes of WaMu's failure and the OTS's supervision of the institution because of its responsibility as the IG over the PFR. As detailed in the Treasury IG's statement, we found that WaMu failed because its management pursued a high-risk lending strategy that included liberal underwriting standards and inadequate risk controls. OTS examiners spent a significant amount of time examining WaMu and identified numerous concerns with WaMu's high-risk lending strategy, including management weaknesses, single family loan underwriting, and inadequate risk controls. Although OTS supervision identified problems at WaMu, OTS did not adequately ensure that WaMu corrected those problems early enough to prevent a failure of the institution. In particular, OTS did not invoke its formal enforcement powers to compel WaMu to make changes. Further, OTS assigned satisfactory safety and soundness ratings until WaMu began encountering significant financial losses in 2008.

My written statement focuses on the FDIC's oversight and monitoring of WaMu and also addresses the questions you posed in your invitation letter.

The FDIC OIG

By way of background, the FDIC OIG is an independent and objective unit established under the Inspector General Act of 1978, as amended. Our mission is to promote the economy, efficiency, and effectiveness of FDIC programs and operations, and protect against fraud, waste and abuse. This year, the FDIC OIG is operating under a budget of $37.9 million, with an authorized staffing level of 138.

To carry out our mission, my office conducts audits, evaluations, and investigations; reviews existing and proposed legislation and regulations; and keeps the FDIC Chairman and the Congress currently and fully informed of problems and deficiencies relating to FDIC programs and operations. The FDIC OIG also has statutory responsibility to perform MLRs of failed FDIC-supervised institutions under the provisions of the Federal Deposit Insurance Act.

To date, my office has issued 58 MLRs of FDIC-supervised institutions and has an additional 34 reviews underway. In total, 163 federally regulated institutions, with assets at closing totaling $556 billion, have failed during this economic crisis. As of December 31, 2009, 702 institutions were on the "Problem List," indicating a probability of more failures to come and an increased asset disposition workload.

Our work on institution failures, including our work on the circumstances surrounding the failure of WaMu, is yielding important insights on regulatory supervision of the nation's financial institutions. We appreciate the Congressional support of our efforts.

Summary of FDIC OIG Findings

Overall, we determined that the FDIC monitored WaMu and, similar to OTS, identified the problems that ultimately caused WaMu's failure. The risks noted through FDIC monitoring were not, however, reflected in WaMu's deposit insurance premiums. As a result, WaMu paid deposit insurance premiums that were not commensurate with its inherent risk. This discrepancy occurred because the deposit insurance regulations relied on OTS safety and soundness ratings and regulatory capital levels to gauge risk and assess related deposit insurance premiums. Although FDIC monitoring began to show risks at WaMu earlier than OTS safety and soundness ratings, the FDIC did not challenge OTS's ratings until 2008. The FDIC did invoke back-up examination authority based on increasing FDIC internal risk monitoring in order to obtain additional information about WaMu. OTS resisted FDIC back-up examination requests because the OTS believed the FDIC did not meet the terms of an Interagency Agreement[1] governing such requests. Specifically, the interagency agreement required FDIC to prove to OTS that WaMu exhibited one of the following: (1) a heightened level of risk (meaning WaMu was a CAMELS[2] 3, 4, or 5 and was undercapitalized), (2) material deteriorating conditions at WaMu, or (3) other adverse developments that could result in WaMu becoming troubled in the near term. Finally, although the FDIC could have taken enforcement action against WaMu, the FDIC chose not to do so because of the cumbersome procedures required to independently invoke that authority. The remainder of my statement provides details on these matters.

FDIC's Oversight Role for WaMu

In its capacity as deposit insurer, the FDIC is responsible for regularly monitoring and assessing the potential risks that all insured institutions present to the DIF, including those for which it is not the PFR. FDIC was the deposit insurer for WaMu from 2003 to 2008 and was responsible for monitoring WaMu for purposes of assessing WaMu's risk to the DIF. WaMu was, in fact, one of the eight largest institutions insured by FDIC.

FDIC has a number of tools it used to monitor risk at WaMu. First, FDIC tracks macro-economic developments in the banking industry to assess broad risks and has special institution-specific programs to monitor large institutions such as WaMu. From a macro-economic perspective, the FDIC relies on two of its primary business divisions, the Division of Supervision and Consumer Protection (DSC) and Division of Insurance and Research (DIR) to synthesize information from Large Insured Depository Institution (LIDI) reports, aggregate data on large banks to identify trends and emerging risks, summarize national economic conditions and banking industry trends, and communicate this information to FDIC senior management, the FDIC Board of Directors, other regulators, and FDIC staff. The FDIC also has regional and national risk committees that

[1] *Coordination of Expanded Supervisory Information Sharing and Special Examinations* (January 29, 2002).

[2] The Uniform Financial Institution Rating System that has been developed jointly by the federal banking regulators to assign each financial institution a composite rating. The composite rating is based on the results of the on-site examination that evaluates and rates six essential components of an institution's financial condition and operations. The component factors address the adequacy of **C**apital, the quality of **A**ssets, the capability of **M**anagement, the quality and level of **E**arnings, the adequacy of **L**iquidity, and the **S**ensitivity to market risk—collectively known as the CAMELS ratings. Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile. The composite ratings range on a scale from 1 (best) to 5 (worst).

review and evaluate regional economic and banking trends and risks to determine whether any actions need to be taken in response to those trends and risks and identify and evaluate the most significant regional risks facing the FDIC and the banking industry as a whole.

Second, at the institution level, for large institutions like WaMu, whose PFR is another agency, the FDIC first relies on the examinations conducted by OTS to determine the bank's overall condition and the risks. The FDIC also conducts its own analysis and monitoring. In 2002, FDIC developed the Dedicated Examiner Program for the eight largest insured institutions to assign one FDIC examiner full-time to an institution to devote the examiner's full attention to assessing the on-going risk posed by the institution to the DIF.

One of the more significant tasks of the Dedicated Examiner was to prepare quarterly executive summaries that assigned a level of risk to WaMu using the LIDI scale from A to E. WaMu was part of the LIDI program and had a dedicated examiner assigned for the entire period covered by this evaluation from 2003-2008. The LIDI program was developed in 1984 to quantify the level and direction of a company's risk to the DIF. The LIDI program focuses on issues that are broader in nature than those covered by typical safety and soundness examinations. Specifically, the LIDI program looks at an institution's business profile and considers factors such as product mix, strategic focus across markets, overall management expertise, and franchise value. FDIC also has a number of offsite monitoring systems that generate financial ratios based on Call Report data. Dedicated examiners must perform an offsite review of situations where a bank's financial ratios fall outside of FDIC-determined tolerances.

FDIC has a number of procedural and regulatory tools at its disposal to address any identified increasing risk at a depository institution even where the FDIC is not the primary regulator.

- **Back-up Examination Authority:** Section 10(b)(3) of the Federal Deposit Insurance Act provides FDIC special examination authority (also known as back-up authority) to make any special examination of any insured depository institution whenever the FDIC Board of Directors determines a special examination is necessary to determine the condition of the institution for insurance purposes. In January 2002, the FDIC's Board of Directors approved an interagency agreement, "*Coordination of Expanded Supervisory Information Sharing and Special Examinations"* (Interagency Agreement) that established a set of principles related to use of special examination authority.
- **Challenge Ratings:** The FDIC can challenge the PFR's CAMELS composite rating if it disagrees with the PFR's conclusions.
- **Back-up Enforcement Action:** The FDIC is also authorized under Section 8(t) of the Federal Deposit Insurance Act to engage in back-up enforcement action.[3] In this capacity, FDIC generally has the same powers with respect to any insured depository institution and their affiliate as the primary federal banking agency has with respect to the institution and its affiliates.

[3] 12 U.S.C. §1818(t).

Concern Noted in FDIC Monitoring Reports Did Not Influence WaMu's Deposit Insurance Premium Payments

Our evaluation found that the FDIC followed its internal policies and completed its required monitoring. For example, the FDIC assigned a dedicated examiner to monitor WaMu and completed quarterly LIDI reports that assessed the risk that WaMu posed to the DIF. Each quarterly LIDI report included a risk rating for WaMu. The LIDI system was, in fact, developed by the FDIC in order to provide measures beyond the PFR's safety and soundness CAMELS ratings to better understand an institution's risk to the DIF. LIDI reports consider future risks at an institution, where CAMELS ratings, in practice, are more point-in-time measures of performance.[4] LIDI reports are internal FDIC ratings and are not provided to an institution. The LIDI ratings are on a scale from A to E as described in Table 1 below and the CAMELS composite rating is on a scale from 1 to 5 as defined in Table 2 below.

Table 1: FDIC LIDI Ratings Description

A	–	Low risk of concern regarding ultimate risk to the insurance funds.
B	–	Ordinary level of concern regarding ultimate risk to the insurance funds.
C	–	More than an ordinary level of concern regarding ultimate risk to the insurance funds.
D	–	High level of concern regarding the ultimate risk to the insurance funds.
E	–	Serious concerns regarding ultimate risk to the insurance funds.

Table 2: CAMELS Composite Rating Description

1	Sound in every respect
2	Fundamentally sound
3	Exhibits some degree of supervisory concern in one or more of the component areas (*i.e.*, 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

[4] The CAMELS rating criteria, as written, allow for examiners to take into account future risks. In practice, however, examiners view CAMELS as point-in-time measurements.

We compared WaMu's CAMELS composite rating, LIDI rating, deposit insurance risk category, deposit insurance premium assessment, and premium payments from 2003 to 2008 to determine their interrelationship. As shown in the Table 3, FDIC LIDI monitoring showed more concern with risk at WaMu sooner than OTS CAMELS ratings. The LIDI rating dropped in July 2004 from B, meaning WaMu was an ordinary risk to the DIF to a B/C, meaning WaMu posed a somewhat more than ordinary risk to the fund. The FDIC maintained the B/C rating for WaMu until June 2007, when the FDIC again lowered its rating from a B/C to a C, meaning WaMu posed more than an ordinary risk to the DIF. WaMu maintained the C rating through 2007. During the period from 2003 to the end of 2007 when the FDIC LIDI ratings were showing increasing concern with WaMu, the OTS CAMELS ratings maintained a consistent 2 rating, meaning OTS believed that WaMu was fundamentally sound.

Table 3: WaMu Ratings and Insurance Assessments

Insurance Assessment Period	CAMELS Composite Rating	FDIC LIDI Rating	Insurance Risk Category	FDIC Premium	WaMu Payment
January 2003	2	B	1A	$0	$0
July 2003	2	B	1A	$0	$0
January 2004	2	B	1A	$0	$0
July 2004	2	B/C	1A	$0	$0
January 2005	2	B/C	1A	$0	$0
July 2005	2	B/C	1A	$0	$0
January 2006	2	B/C	1A	$0	$0
July 2006	2	B/C	1A	$0	$0
March 2007	2	B/C	R-I	$33,416,173	$0
June 2007	2	C	R-I	$31,461,565	$0
September 2007	2	C	R-I	$30,966,418	$0
December 2007	2	C	R-I	$28,905,951	$0
March 2008	3	D	R-II	$39,178,352	$9,113,681
June 2008	3	E	R-II	$51,742,730	$42,205,190
TOTAL				**$251,671,191**	**$51,318,871**

Both the FDIC LIDI rating and the OTS CAMELS rating dropped during the first quarter of 2008. The LIDI rating indicated a D, meaning the FDIC had a high level of concern about WaMu's risk to the DIF. The OTS 3 rating indicated that there was some degree of supervisory concern. This period coincides with WaMu posting back-to-back $1 billion losses in the 4Q 2007 and 1Q 2008. In June 2008, the FDIC LIDI rating fell to its lowest level of E, meaning there were serious concerns about the risk WaMu posed to the DIF. The OTS completed its examination at this point and decided to maintain a CAMELS rating of 3 despite a $3.2 billion 2Q 2008 loss suffered by WaMu.

Despite the increasing risks shown in the FDIC's LIDI reports, WaMu remained in the highest-rated (lowest-risk) deposit insurance risk category (1A/R-I) from January 2003 until December 2007 and in the second highest-rated deposit insurance category (R-II) from March to June

2008.[5] This disconnect occurred because WaMu's deposit insurance risk category assignment, by regulation,[6] was based on WaMu's consistent CAMELS composite 2 rating and WaMu's regulatory capital level. Table 3 illustrates the insurance assessments by period.

Further, as a result of WaMu's placement in the 1A insurance risk category from January 2003 to July 2006, the FDIC did not charge WaMu any deposit insurance premiums for that period. In fact, FDIC did not charge deposit insurance premiums for any institution in the 1A insurance risk category during this period because the amount of money in the deposit insurance funds (there were two funds at the time) exceeded a statutory ratio requirement to hold $1.25 for every $100 in insured deposits at financial institutions.[7] When that requirement was met, FDIC could not, by statute, set premiums that would increase the statutory ratio except when an institution "exhibited financial, operational, or compliance weakness or is not well-capitalized."[8] The FDIC Board, by regulation, interpreted the statute to mean that FDIC could not charge premiums for any institutions in the 1A risk category. Therefore, despite WaMu's size and pursuit of a high-risk lending strategy during this period, FDIC could not charge WaMu any deposit insurance premiums because WaMu's CAMELS composite 2 rating and capital level placed it in the 1A risk category.

From March 2007 to June 2008, FDIC assessed WaMu $215 million in insurance premiums based upon WaMu's insurance risk category. WaMu paid $51 million, or 24 percent, of those premiums. WaMu payments were less than FDIC premium charges because of a one-time credit that Congress included in the Federal Deposit Insurance Reform Act of 2005 (Reform Act). According to the Congressional Record, the credit was meant to reward the institutions that capitalized the deposit insurance funds in the mid-1990s. The Reform Act did include a limit on, but not an elimination of, the credit when an institution exhibited certain financial, operational, or compliance weakness. On May 25, 2007, WaMu received a $164.4 million credit to be used to offset premiums beginning in 2007 according to the terms of the Reform Act. WaMu used the credit to offset the full balance of the insurance assessment between March 2007 and December 2007. FDIC limited WaMu's use of its credit in March 2007 because of WaMu's composite 3 CAMELS rating, but WaMu was able to use the $9.1 million of its remaining credit in June 2008. In effect, WaMu was able to use the entire $164.4 million credit to offset premiums.

FDIC LIDI Monitoring Reports Prompted FDIC Back-up Examination Requests from 2005 to 2008 But Those Requests Met Resistance from OTS

Prior to 2005, FDIC was the primary regulator for a smaller financial institution held by WaMu's parent company. Examiners told us FDIC and OTS had a very good working relationship during this period and the OTS routinely used FDIC examiners to assist OTS examiners with their examination. In 2005, the FDIC-supervised institution was merged into WaMu, and FDIC no

[5] FDIC Deposit Insurance Regulations changed the deposit insurance risk assessment categories in 2007. Prior to 2007, 1A was the high-rated/lowest risk category and after 2007 the category was changed to R-I. R-II was the second high-rated/lowest risk category in 2007.
[6] 12 C.F.R. 327.
[7] The ratio is known as the Designated Reserve Ratio.
[8] 12 U.S.C. 1817(b)(2)(A)(v).

longer held a primary regulator role. Because FDIC was no longer a primary regulator, FDIC was required to invoke back-up examination authority to bring any examiners, other than the FDIC dedicated examiner, to WaMu, if additional monitoring was warranted.

Back-up examination authority is a key tool that FDIC can use when risk is increasing in an institution like WaMu. As previously discussed, the FDIC's Board of Directors approved an Interagency Agreement that established a set of principles related to the use of back-up examination authority for those institutions that present "heightened risk" to the DIF and delegated its authority to DSC.[9] The term "heightened risk" is defined as an institution having a composite rating of 3, 4, or 5 and that is undercapitalized, as defined under Prompt Corrective Action rules. Further, FDIC may request permission from the PFR to participate in an examination for an institution that does not meet the heightened risk definition but exhibits material deteriorating conditions or other adverse developments that may result in the institution being troubled in the near-term.

Procedurally, a dedicated examiner prepares a memorandum documenting the basis for a back-up examination request and submits the request to the FDIC Regional Director or Deputy Regional Director who may accept or reject the request. If the request is based on heightened risk, the Regional Director formally notifies the PFR counterpart by sending a letter stating FDIC would like to participate in the examination. If the request is not based on heightened risk, the process is more in the manner of a request where the FDIC Regional Director asks the PFR counterpart whether the PFR would object to FDIC's participation. Implicit in both of these requests is the principle of effective and efficient supervision. In the event that FDIC and the PFR disagree as to the appropriateness of FDIC's participation, the respective agency supervision representatives determine whether FDIC participation is appropriate. In the event the agency representatives cannot agree, the FDIC Chairman and the principal of the PFR will make the determination.

FDIC invoked back-up examination authority in each year from 2005 to 2008 in order to obtain additional information about the risks in WaMu's portfolio. Generally, FDIC used back-up examination authority to bring examiners to WaMu to review specific areas of concern, such as single family lending and mortgage servicing rights. 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, because it was a subsidiary of WaMu's parent corporation and not part of WaMu.

In 2006, FDIC's request for back-up examination authority, was initially denied by OTS. It appears that 2006 was a turning point in the relationship between FDIC and OTS in terms of information sharing that carried through to 2008. The September 1, 2006, letter from the OTS Regional Director denying back-up authority indicates that OTS believed that FDIC had not shown the requisite regulatory need for back-up examination authority according to the terms of the Interagency Agreement.

Internal OTS emails indicate that OTS interpreted the Interagency Agreement test for a material deteriorating condition or adverse development as requiring a composite 3 rating for WaMu.

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[9] January 29, 2002 Interagency Agreement, "*Coordination of Expanded Supervisory Information Sharing and Special Examinations.*"

Such a requirement is not contained in the Interagency Agreement. In response to the denial of back-up examination authority, the FDIC Regional Director sent a letter to the OTS Regional Director expressing concern about the denial,

> [r]egarding your reasoning for rejecting our participation in these target reviews, you are correct that our request is not predicated on any current disagreement related to examination findings or concern regarding supervisory activities at Washington Mutual. Such criteria are not prerequisite for requesting – or for the OTS granting – FDIC staff participation in targeted examination activities… The 2002 [Information Sharing] Agreement clearly allows for FDIC staff participation in examination activities to evaluate risk of a particular banking activity to the DIF. Washington Mutual is a very large insured financial institution, and in our view participation on the upcoming targeted reviews is necessary to fulfill our responsibilities to protect the deposit insurance fund.

The request was elevated to FDIC and OTS Washington officials, and about 2 months after the denial letter, OTS decided to grant FDIC back-up examination authority. The November 10, 2006 letter from the OTS Regional Director rescinding the denial states,

> OTS does not seek to have FDIC staff actively participate in our examination activities and conclusions at Washington Mutual. We do understand your need for access to examination information and your need to meet with OTS staff to discuss our supervisory activities at Washington Mutual. To facilitate this information sharing and discussions, we have agreed to allow your Dedicated Examiner…to conduct his FDIC risk assessment activities on site at Washington Mutual when our examination team is on site. All FDIC requests for information should continue to be funneled through our examiner-in-charge…We will consider these limited requests to send additional FDIC staff to Washington Mutual on a case-by-case basis.

The OTS granted the FDIC's 2007 back-up examination request but did not allow FDIC examiners access to WaMu residential loan files. Emails indicate the 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 examiners had not adequately reviewed the loan files during the examination to fully understand the embedded risk. Underwriting was a significant issue because WaMu's liberal underwriting standards were a significant contributing factor to WaMu's failure. As discussed later, FDIC also wanted to review loan files to assess WaMu's compliance with new nontraditional mortgage guidance.

Finally, in granting the FDIC's 2008 back-up examination request, OTS was concerned about FDIC's request for nine examiners, indicating 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. Once again, OTS did not allow FDIC examiners to review WaMu loan files.

The terms of the Interagency Agreement and the OTS interpretation of requisite risk necessary to invoke back-up examination authority served as roadblocks in FDIC's ability to assess WaMu's risk. In the end, the information obtained from invoking back-up examination authority did not prompt FDIC to challenge OTS's composite rating of WaMu until mid-2008.

FDIC LIDI Monitoring Reports Did Not Prompt the FDIC to Challenge OTS CAMELS Ratings of WaMu until 2008, and That Challenge Met with OTS Resistance

FDIC did not challenge the OTS CAMELS composite rating for WaMu in any year except for the composite 3 rating assigned by OTS in July 2008. FDIC did not challenge those prior ratings despite LIDI ratings decreases because FDIC believed the CAMELS composite ratings were appropriate. FDIC's rationale was that the risks in WaMu's portfolio had not manifested themselves as losses and nonperforming loans, and therefore did not impact WaMu's financial statements. Further, FDIC examiners explained that no one could have predicted the precipitous fall in home prices and the complete shut-down of the secondary market. In essence, FDIC considered WaMu's potential risk in the LIDI rating but did not consider that future risk to be significant enough to be reflected in the CAMELS composite rating.

FDIC has a protocol in place for interagency CAMELS rating disagreements. The protocol provides a hierarchy where differences are to be resolved beginning at the examiner level and then referred to the next more senior level of each respective agency.[10] If the disagreement reaches the level of the FDIC Associate Director of the Division of Supervision and Consumer Protection (DSC) without a satisfactory resolution, the DSC Director, in consultation with the FDIC Chairman, will make the final decision concerning FDIC's rating.

A May 8, 2008 email provided the first indication that FDIC disagreed with the OTS's plan to assign WaMu a composite 3 rating at the completion of the OTS examination in July 2008. The primary area of concern was that FDIC believed that WaMu needed an additional $5 billion in capital to weather potential portfolio losses. The FDIC capital projection was based upon a capital needs model that FDIC developed at the request of the FDIC Chairman in 2007 after the near collapse of Countrywide. The model was different from traditional FDIC analysis as it focused on forward-looking, long-term capital requirements similar to a private sector purchase analysis.

FDIC regional officials followed the disagreement protocol and provided a written memorandum outlining FDIC's support for a composite 4 rating for WaMu to the OTS Regional Director on August 11, 2008. Discussions were held at the regional level on August 28, 2008, but regional management for FDIC and OTS continued to disagree on the ratings.

On September 8, 2008, the FDIC DSC Director sent an email to the OTS Chief Operating Officer communicating FDIC's intention to rate WaMu a composite 4, including a copy of

[10] FDIC Case Managers Manual, Section 3.4 (VI).

FDIC's rationale for the rating, and requesting a meeting to discuss the issue before September 12, 2008. The OTS Chief Operating Officer responded,

> I believe the OTS and FDIC staff has met a number of times to discuss differing views and, until this email and the very recent communication from the FDIC Chairman, was under the impression that this item was still under active discussion between our regional staff. Our Regional Director has not received any written communication from his FDIC counterpart that a final rating difference exists between the regional offices. As a consequence, our regional staff has not been afforded the opportunity to counter any FDIC views in a written response. If my understanding is accurate, it seems that we should insist that regional protocol be followed before you and I attempt to reconcile differences.

That same day, the FDIC Regional Director again sent the same information to OTS that was provided on August 11, 2008 justifying the ratings downgrade.

On September 10, 2008, FDIC decided to speak directly to the newly installed WaMu CEO and notify him that FDIC intended to rate WaMu a composite 4. OTS and FDIC officials subsequently made presentations to the FDIC Board on September 16, 2008 to support their ratings conclusions although the presentations were not a requirement according to the protocol. As the dialogue between OTS and FDIC was ongoing, WaMu continued to have its borrowing capacity limited by the Federal Home Loan Bank; raised its certificate of deposit rates higher than competitors to gain depositors; and continued to experience significant deposit withdrawals. FDIC and OTS were monitoring liquidity, but to put things in perspective, the financial market was in turmoil at that time. FDIC had just closed one of the largest institutions in its history, IndyMac, and OTS examiners told us FDIC expressed concern about the FDIC's ability to handle a WaMu failure as WaMu's assets were ten times larger than IndyMac's. During this same period, the Federal Reserve released a statement that the downside risks to growth had increased appreciably; Fannie Mae and Freddie Mac were placed under government conservatorship; and there were rumors of problems with Merrill Lynch and Lehman Brothers.

During this time, however, the OTS and FDIC had competing interests. As noted by former FDIC Chairman William Isaac, OTS as primary regulator wanted to rehabilitate WaMu and keep it in business while FDIC, on the other hand, as an insurer wanted to resolve the institution's problems as soon as possible to maintain the value of WaMu in order to reduce the cost of any failure.[11] In the end, both FDIC and OTS agreed to change WaMu's composite rating to a 4 on September 18, 2008, only 7 days prior to WaMu's failure. The ratings change had no impact on WaMu's deposit insurance premium prior to failure.

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[11] Statements from former FDIC Chairman William Isaac, *The Wall Street Journal*, August 19, 2008 describing the roles of primary regulator and insurer.

The FDIC Elected Not to Invoke Its Enforcement Authority against WaMu in 2008 Because of Procedural Hurdles

Section 8(t) of the Federal Deposit Insurance Act allows FDIC to take enforcement action against an institution in the same manner as if FDIC were the primary regulator, provided certain procedural requirements are fulfilled.[12] In the case of an OTS-supervised institution, FDIC must request that OTS take action by providing a formal written recommendation to OTS and allowing OTS 60 days to take action. If such action is not taken, FDIC must petition the FDIC Board to take action. The FDIC Board membership includes the Director of the OTS. FDIC can take action without first requesting OTS action in certain exigent circumstances; however, the FDIC Board must agree to such action. Enforcement actions under this authority generally include formal actions that carry civil money penalties and are enforceable in federal court. FDIC guidance notes that FDIC should take action under that authority when there is an "immediate near-term risk to the fund or unsafe or unsound conditions or practices are noted without appropriate action by the PFR."[13] From a procedural perspective, DSC officials indicated that a number of cumbersome steps would be required to commence a Section 8(t) enforcement action.

In July 2008, FDIC believed WaMu should be rated a composite 4 and that WaMu needed $5 billion in capital to withstand potential future losses. At that time, OTS had a Memorandum of Understanding (MOU) underway to address issues at WaMu but did not issue the MOU to WaMu until September 7, 2008. An MOU is an informal agreement that does not fall within FDIC's formal enforcement action authority noted above. Given OTS's reluctance to issue the MOU along with the significant risks at WaMu, FDIC could have taken enforcement action to remedy or prevent unsafe or unsound practices. FDIC Washington officials told us they briefly contemplated enforcement action, but given the procedural hurdles involved in invoking such action and the time required to implement an action, it was easier to use moral suasion to attempt to convince OTS to change its rating. According to OTS guidance, there is a strong presumption that institutions with 4 ratings warrant formal enforcement actions; therefore, convincing OTS to rate WaMu a 4 would have the same effect.

Evaluation Recommendations and Observations

We recommended that the FDIC Chairman, in consultation with the FDIC Board of Directors, take the following actions:

1. **Information Access** – Revisit the Interagency Agreement governing information access and back-up examination authority for large insured depository institutions to ensure it provides FDIC with sufficient access to information necessary to assess risk to the DIF.

2. **Deposit Insurance** – Revisit the FDIC Deposit Insurance Regulations to ensure those regulations provide FDIC with the flexibility needed to make its own independent determination of an institution's risk to the DIF rather than relying too heavily on the primary regulator's assignment of CAMELS ratings and capital levels.

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[12] 12 U.S.C. §1818(t).

[13] FDIC Case Manager Manual, Enforcement Actions, page 8-2.

FDIC concurred with both of our recommendations. FDIC is actively working with other primary regulators to enhance information sharing including revising the Interagency Agreement to provide FDIC with greater access to information about risk at other large depository institutions (institutions with assets greater than $10 billion). FDIC anticipates that agreements can be reached by December 31, 2010 and in the interim, FDIC is using all available authority to acquire timely access to information related to risks posed by financial institutions to the DIF. FDIC is also developing a new proposed deposit insurance pricing system for large banks that does not rely on external CAMELS and capital ratings. FDIC anticipates that this change will be implemented by December 31, 2010.

We note that WaMu is our second review of FDIC's monitoring and insurance assessment for large non-FDIC supervised institutions. As previously mentioned, we issued an evaluation report on FDIC's monitoring of IndyMac on August 27, 2009.[14] We found that a number of the issues we noted with FDIC's monitoring and insurance assessments for IndyMac were also present at WaMu.

First, the terms of the Interagency Agreement governing information sharing and back-up examinations require that FDIC prove a requisite level of risk at an institution – heightened risk, material deteriorating conditions, or adverse developments – in order for the primary regulator to grant FDIC access to the institution's information. The level of risk is largely based on an institution's CAMELS composite ratings and regulatory capital level.

For large institutions such as WaMu, that by their sheer size pose a high risk to the DIF, we believe FDIC should not have to prove a particular level of risk to the primary regulator to obtain access to the institution's information, as the institution's risk of failure and the resulting potential impact on the DIF should be enough to allow FDIC access to information it needs to assess risk of loss. As shown in our WaMu report and our report on IndyMac, OTS's consistent assignment of a CAMELS composite 2 ratings for those institutions until their near failure raises questions about the reliability of CAMELS ratings as predictors of risk to the DIF.

The Interagency Agreement was intended to balance the needs of the FDIC against the regulatory burden on an institution of having two regulators duplicating examinations. One key principle of the Interagency Agreement is that FDIC must rely, to the fullest extent possible, on the work of the primary regulator. In practical terms, the Interagency Agreement appeared to drive a wedge between the OTS and FDIC, as attempts by FDIC to review information at WaMu were seen as an affront to the capabilities of OTS examiners. We believe FDIC must have sufficient and timely access to information at all large insured depository institutions (defined by FDIC as having assets of $10 billion or more) in order to properly assess risk and appropriately price deposit insurance. We also believe that it may not be in the best interest of FDIC to place too much reliance on the ability of the primary regulator to assess risk to the DIF. Ultimately, the DIF, which is backed by the full faith and credit of the United States, and thus the American taxpayer, is responsible for absorbing an institution's failure, not the primary regulator.

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[14] FDIC OIG Report, *The FDIC's Role in the Monitoring of IndyMac Bank,* EVAL-09-006, August 2009.

Second, at both IndyMac and WaMu, the CAMELS ratings and capital levels drove FDIC's assessment of the institutions' risk to the DIF and the institutions' deposit insurance premium computation despite indications in the LIDI reports that the risk posed by those institutions was higher than that indicated by the CAMELS ratings. We believe there is currently too much reliance on the CAMELS rating for the purpose of assessing the risk that an institution poses to the DIF. At both WaMu and IndyMac, FDIC examiners generally agreed with their OTS counterparts that composite CAMELS 2 ratings were appropriate despite high levels of risky loan products and inadequate underwriting practices because those loans were performing and the institutions were profitable. Such an analysis may be insufficient for assessing risk for purposes of insuring deposits, as those loans may potentially cause future losses. FDIC must have significant flexibility to take into account more than CAMELS ratings and regulatory capital levels to adequately price an institution's risk to the DIF.

Response to Other Issues

We note in your invitation letter that you inquired about the FDIC's interpretation of the *Interagency Guidance on Nontraditional Mortgage Product Risks* (Guidance) issued by the federal financial institution regulatory agencies in October 2006. The Guidance specifies safety and soundness standards and practices to assist financial institutions with managing the risks associated with the growing use of nontraditional mortgages (NTM), or affordability products. Among such standards and practices are:

- Qualifying borrowers' repayment capacity at the fully indexed rate of interest;
- Evaluating borrowers' financial capacity to repay the debt until final maturity, including any balance increase that may accrue as a result of negative amortization;
- Avoidance of sole dependency on collateral value or ability to refinance;
- Strong quality control and risk mitigation in the area of risk layering, including high loan to value, low doc features, or stated income loans.

Our evaluation report does not directly address WaMu's compliance with the Guidance. However, the report discusses in detail certain aspects of the NTM guidance (*e.g.*, WaMu's high-risk loan products such as Option ARM loans with negative amortization and payment shock potential and oversight of third party originators). Further, the source of confrontation between FDIC and OTS over FDIC's request to review WaMu loan files in 2007 and 2008 noted above centered on the FDIC's concern that WaMu was not following the NTM guidance. FDIC was attempting to gain access to WaMu loan files for the purpose of assessing WaMu's compliance with the NTM guidance.

Regarding whether the Guidance was mandatory or enforceable, FDIC viewed the Guidance as a best practice, or expectation of controls that banks should have in place, rather than a rule or regulation. However, substantial non-compliance with the guidance would influence the FDIC's view of management and could impact the CAMELS ratings. Further, safety and soundness issues related to NTM lending could lead to enforcement actions.

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Thank you again for allowing me to testify today. I appreciate the Subcommittee's interest in our work and look forward to continuing to effectively and efficiently conduct work on behalf of the Congress, the FDIC, and the American public. This concludes my testimony. I welcome the opportunity to answer any questions that you might have.