Embargoed until presented on
April 16, 2010

Statement of

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Acting Director, Office of Thrift Supervision

regarding

Wall Street and the Financial Crisis: The Role of Bank Regulators

before the

Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
United States Senate

April 16, 2010

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Testimony on

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I. Introduction

Good afternoon, Chairman Levin, Ranking Member Coburn and Members of the Subcommittee. Thank you for the opportunity to testify today on the supervision of Washington Mutual Bank (WaMu). We appreciate the Subcommittee's efforts to examine this and other matters associated with the recent financial crisis. We share the Subcommittee's commitment to examine the causes and consequences of the crisis and to prevent any recurrence.

In my testimony, I will discuss the supervision of WaMu by the Office of Thrift Supervision (OTS) and the circumstances surrounding its failure. I will also discuss the draft findings of a joint investigation of the inspectors general of the Department of the Treasury and the Federal Deposit Insurance Corporation (FDIC) concerning the Federal Regulatory Oversight of WaMu. Finally, I will describe changes in policies and procedures that the OTS has adopted since the failure of WaMu to assess the safety and soundness of thrifts and respond to risks.

II. Background

WaMu was a federally chartered stock savings bank with its home office in Henderson, Nevada, and its primary executive and business office in Seattle, Washington. It operated primarily in major metropolitan areas on both the east and west coasts and in selected other states with four primary business units: (1) the home loans group, which engaged in nationwide single-family residential (SFR) lending, servicing and capital market activities, (2) the card services group, which operated a nationwide credit card lending business, (3) the commercial group, which conducted a multi-family and commercial real estate lending business, and (4) the retail banking group, which operated a retail bank network of 2,239 offices in California, Florida, Texas, New York, Washington, Illinois, Oregon, New Jersey, Georgia, Arizona, Colorado, Nevada, Utah, Idaho and Connecticut. Before WaMu's failure, it had $307 billion in assets. WaMu's OTS-chartered operating subsidiary, Washington Mutual Bank fsb, of Park City, Utah, held WaMu's investment portfolio. Washington Mutual, Inc., of Seattle, Washington (Holding Company), its top-tier holding company, was mainly a shell holding company. Based on its consolidated assets on December 31, 2007, the Holding Company was the seventh largest among all U.S.-based bank and thrift holding companies.

WaMu was incorporated in 1889 as the Washington National Building Loan and Investment Association. In 1983, WaMu purchased a brokerage firm (Murphey Favre) and demutualized, converting to a capital stock savings bank. After demutualization, WaMu grew largely by acquisition. By 2005, it was the third largest mortgage lender in the U.S. and, with the acquisition of Providian Financial Corporation, the ninth largest credit card company.

In 2005, WaMu management made a decision to shift the firm's business strategy away from originating traditional, fixed-rate, conforming single-family residential loans, toward nontraditional loan products and subprime loans. At the same time, management diversified liabilities and equity via preferred stock and hybrid issuances. WaMu pursued the new strategy in anticipation of increased earnings and to compete with other mortgage lenders and banks. This business model catered to a strong demand by capital markets for new, higher-yielding loan products that easily could be placed into securitized structures.

From 2005 through the first part of 2007, WaMu was able to sell most of its nontraditional and subprime loans to the secondary market at sizeable gains. However, the mortgage securities market severely deteriorated in the summer of 2007 as rising delinquencies on subprime loans suggested greater than anticipated losses for holders of bonds collateralized with these assets. Investors shunned the mortgage securities market and thus removed a key source of funding for mortgage originators, such as WaMu. By August 2007, there was simply no market for WaMu and other originators to sell or securitize loans.

Even before the secondary mortgage market had essentially frozen, WaMu management began tightening credit standards for credit cards and subprime lending, and shifted focus to a more retail-based strategy through its retail branches. After the third quarter of 2007, WaMu instituted significant operational changes, including exiting all subprime SFR lending, discontinuing certain loan purchase and sale operations, tightening underwriting of all portfolios, closing all freestanding home loan offices, exiting the wholesale lending channel, increasing reliance on Federal Home Loan Bank (FHLB) advances, releasing approximately $30 billion in available collateral, issuing $3 billion and $7 billion in preferred and common stock, respectively, with $4 billion of the proceeds infused into WaMu, curtailing dividends from WaMu to the Holding Company and from the Holding Company to shareholders, and ceasing option ARM and stated income lending.

In February 2008, as WaMu incurred significant losses, the OTS lowered WaMu's composite CAMELS rating from a "2" to a "3." In that month, the OTS took informal enforcement action against WaMu by requiring it to adopt a Board Resolution to address areas of concern over asset quality, earnings and liquidity. WaMu adopted the Board Resolution on March 19, 2008.

In response to continuing losses and at the OTS's urging, the Holding Company infused WaMu with an additional $3 billion, $2 billion and $500 million in capital in April, July and September 2008, respectively. Despite its other problems, WaMu remained well capitalized.

In June 2008, the OTS notified WaMu that OTS would be taking another enforcement action. The OTS would require WaMu to enter into a Memorandum of Understanding (MOU) as a result of WaMu's composite "3" rating that was to be reported for the examination ending June 30, 2008. The MOU, which the OTS issued on September 7, 2008, required WaMu to: (1) correct all findings noted in the June 30, 2008, examination by the dates specified; (2) submit a contingency capital plan within 90 days and maintain certain capital ratios; (3) submit a three-year business plan to OTS within 30 days; and (4) certify compliance with the MOU requirements on a quarterly basis.

On September 18, 2008, the Regional Office provided notice to the Institution that its CAMELS Composite and Liquidity ratings were downgraded to a "4." On September 25, 2008, the OTS closed WaMu and appointed the FDIC as receiver. WaMu was immediately merged with JPMorgan Chase & Co and subsequently operated as part of JPMorgan Chase Bank, N.A., Columbus, Ohio. The failure of WaMu resulted in no cost to the Deposit Insurance Fund (DIF).

III. Cause of WaMu's Failure

A liquidity crisis was the immediate cause of WaMu's failure. After the closing of IndyMac Bank in July 2008, WaMu's liquidity became stressed. Cash outflows in July and August 2008, primarily related to deposit withdrawals, totaled about $9.1 billion. WaMu then began offering deposit rates exceeding competitors' rates to bring in deposits to improve liquidity, resulting in a net inflow of approximately $4.3 billion. However, in September 2008, the media speculated about the future of WaMu and a possible sale. Another deposit outflow gained momentum, combining with payments on other obligations for a net cash outflow of more than $17.3 billion in 14 business days. The largest single day had a net cash outflow of $3.6 billion.

During this period of time, Lehman Brothers filed for bankruptcy, Merrill Lynch agreed to be acquired by Bank of America, the Federal Reserve Board was bailing out American International Group, or AIG, and Fannie Mae and Freddie Mac were placed under government conservatorship. The market was extremely anxious; large-dollar, uninsured depositors were especially skittish.

The deposit outflow nearly eliminated WaMu's ability to meet its needs for operating liquidity. As of September 23, 2008, WaMu had only $4.6 billion in cash to meet its obligations. Its core earnings were insufficient to supplement its cash base and it depended on borrowings from the FHLB of San Francisco, the FHLB of Seattle and the Federal Reserve Bank of San Francisco to meet its funding needs. The FHLB of San Francisco had recently decreased the amount of daily funding it had been providing to WaMu. In addition, market-based funding sources, such as sales of new unsecured debt and securitizations, were unavailable. Moreover, most WaMu assets that were not already pledged as collateral for borrowings at the FHLBs or the Federal Reserve Bank were of either insufficient quality to secure other borrowings or were not readily saleable.

Poor earnings and asset quality problems created additional liquidity concerns because continued deterioration in these areas could have significantly reduced the level of available funding sources. Nonetheless, WaMu was well capitalized when it was placed into receivership, with reported capital ratios as of June 30, 2008 of 7.07 percent core capital and 12.44 percent risk-based capital. These capital ratios were higher than they had been in the three prior year-end periods.

IV. No Cost to Deposit Insurance Fund

WaMu is the largest bank failure in U.S. history and OTS has been criticized for regulating the largest bank that failed. However, it is important to remember the failure of WaMu resulted in no cost to the DIF. Also, institutions much larger than Washington Mutual — for example, Citigroup and Bank of America — collapsed, but the federal government prevented their failures by authorizing open bank assistance. By law, this assistance can be granted only to prevent failure. These "too big to fail" institutions are not regulated by the OTS. The OTS did not regulate the largest bank that failed; the OTS regulated the largest bank that was *allowed to fail.*

V. Inspectors General Draft Report

The inspectors general of the Department of the Treasury and the FDIC have investigated the federal regulatory oversight of WaMu and issued a draft audit report of their findings. Since the closure of WaMu resulted in no loss to the DIF, a material loss review was not mandated under Section 38(k) of the Federal Deposit Insurance Act.[1] We understand, however, that the inspectors general undertook the joint review as an exercise in good government.

After undertaking this review, the inspectors general made one recommendation to the OTS, that the agency should use its own internal system to formally track the status of examiner recommendations and related thrift corrective actions.

The OTS concurs with that recommendation and already has systems in place to implement it. In October 2007, the OTS added a new follow up function to its internal Examination Data System/Reports of Examination (EDS/ROE) to allow examiners and other regional staff members to associate dates and comments with matters requiring

[1] 12 U.S.C. 1831o(k).

board attention and other important issues identified by examinations as requiring follow-up. Five new reports were added to EDS/ROE to provide staff with the tools necessary to monitor follow-up items. This follow-up system is now well populated and actively used by staff and monitored by senior management for all OTS-regulated institutions.

VI. Additional Changes in Policies and Procedures

OTS is committed to strengthening its supervisory process. As discussed above, we fully concur with the single recommendation in the inspectors general draft report. Similarly, we have been responsive to recommendations and lessons learned from OTS's own internal failed bank reviews in the past and material loss reviews by Treasury's Inspector General. The OTS has made important changes in policies and procedures since the failure of WaMu to better assess the safety and soundness of thrifts and respond to risks.

The agency has developed internal and external guidance to identify and improve risk management. The agency released several CEO Letters to the industry, expanding guidance in crucial risk areas. Key examples include guidance on best practices for estimating allowances for loan and lease losses;[2] guidance on asset and liability concentrations and related risk management practices;[3] guidance regarding accounting considerations related to other-than-temporary impairment of securities;[4] guidance on prudent commercial real estate loan workouts;[5] guidance on the supervisory expectations for sound interest rate risk management;[6] and guidance on sound practices for managing funding and liquidity risk.[7]

Internally, the agency has also made structural changes to better manage and monitor large banks and problem banks. OTS established the Assistant Deputy Director position to improve oversight of the OTS regions. OTS also created a Large Bank Unit, headed by the Assistant Deputy Director, to oversee all savings associations with more than $10 billion in total assets. The Large Bank Unit hosts quarterly briefings on the large bank caseload and is responsible for providing an independent review and rating concurrence for all large bank examinations. The group also acts as a liaison between the regional offices and senior managers at OTS headquarters in Washington, D.C., for significant large bank issues that arise.

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[2] OTS CEO Letter 304 – May 27, 2009 – ALLL – Observed Thrift Practices Including Sound Lending Practices.

[3] OTS CEO Letter 311 – July 9, 2009 - Risk Management: Asset and Liability Concentrations.

[4] OTS CEO Letter 320 – September 3, 2009 – Accounting Considerations Related to OTTI of Securities.

[5] OTS CEO Letter 325 – October 30, 2009 - Guidance on Prudent Commercial Real Estate Loan Workouts.

[6] OTS CEO Letter 334 – January 7, 2010 – Interagency Advisory on Interest Rate Risk Management.

[7] OTS CEO Letter 342 - March 17, 2010 – Interagency Policy Statement on Funding and Liquidity Risk Management.

One goal of the Large Bank Unit is to ensure consistency between the OTS regions in all aspects of examination and supervision for the large bank caseload. The Large Bank Unit coordinates extensively with subject matter experts in critical disciplines, such as accounting, capital risk, credit risk, information technology, compliance with consumer protection laws and regulations, interest rate risk, liquidity risk and holding company policy. Coordination with these experts connects policy development with examination activities and ensures that new guidance is uniformly applied in all key examination activities, including scoping and supervisory planning.

The OTS has also expanded its program for monitoring problem banks. In addition, the agency has established national guidance for regions to hold Enforcement Review Committee (ERC) meetings to discuss and approve all informal and formal enforcement actions. The ERC guidance also outlines appropriate timeframes for enforcement actions to take effect following ratings downgrades. The agency continues to hold quarterly high risk briefings about thrifts with elevated or unique risk profiles that are at risk of failure. Most recently, the agency improved its examination follow-up system to provide staff with automated notifications for all examination and enforcement actions that are coming due or are overdue.

Since the failure of WaMu, the OTS has more than tripled the number of formal enforcement actions it has taken each year. As indicated in the table below, the OTS took 225 formal actions in 2009. By way of comparison there were 47 such actions in 2007 and 68 in 2008. So far this year the agency has taken 51 formal enforcement actions.

OTS Formal Enforcement Actions

	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010 (*as of 4/05*)**
Cease and Desist Orders:	**30**	**15**	**13**	**20**	**34**	**106**	**17**
Supervisory Agreements:	**14**	**16**	**15**	**7**	**8**	**30**	**5**
Civil Money Penalties:	**26**	**19**	**10**	**5**	**11**	**26**	**10**
Prompt Corrective Action (PCA) Directives:	**1**	**1**	**0**	**2**	**3**	**18**	**11**
Prohibition Orders:	**20**	**19**	**15**	**13**	**12**	**45**	**8**
TOTALS:	**91**	**70**	**53**	**47**	**68**	**225**	**51**

OTS also has developed an internal failed bank review program requiring completion of a review within 90 days of each thrift failure. The failed bank review program is required to identify the causes of failure, develop a chronology of events leading to the failure, assess the appropriateness and timeliness of OTS's supervisory actions, and make recommendations for addressing findings and correcting supervisory weaknesses. The review is required to be independent of the supervisory and examination staff that worked directly on the failed institution.

OTS has also educated staff internally. The agency hosts monthly policy conference calls for examiners to highlight key elements of new guidance. The agency has released a series of internal memos called New Directions Bulletins to raise staff awareness of changes in procedures and to highlight key lessons learned from the financial crisis. The agency released 16 bulletins in 2008 and 37 bulletins in 2009. Key examples include "Lessons Learned – Failed Thrift Institution Review;"[8] "Failed Thrift Institution Review Time Frames;"[9] "Examination and Supervision of Mortgage Banking Activity;"[10] "Allowance for Loan and Lease Losses – Observed Thrift Practices Including 'Better Practices;' "[11] "Regional Enforcement Review Committees;"[12] "Reminder – Required Follow-up on Examination Findings;"[13] "Brokered Deposit Restrictions;"[14] "Classification of Real Estate Owned;"[15] and "Authority to Impose Higher Capital Requirements."[16]

VII. Conclusion

In conclusion, the OTS supports the work of this Subcommittee to examine the causes and consequences of the financial crises in general and the supervision of WaMu in particular. The OTS is committed to continually improving its supervision of thrifts.

Thank you again, Mr. Chairman, Ranking Member Coburn and Members of the Subcommittee for the opportunity to testify on behalf of the OTS.

We look forward to working with the Members of this Subcommittee and to reviewing the Subcommittee's report on this important matter.

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[8] OTS New Directions Bulletin 08-05.
[9] OTS New Directions Bulletin 08-05a.
[10] OTS New Directions Bulletin 08-08.
[11] OTS New Directions Bulletin 08-11.
[12] OTS New Directions Bulletin 09-11a.
[13] OTS New Directions Bulletin 09-06.
[14] OTS New Directions Bulletin 9-12.
[15] OTS New Directions Bulletin 09-35.
[16] OTS New Directions Bulletin 09-37.