



# Offices of Inspector General

Department of the Treasury  
Federal Deposit Insurance Corporation

## Evaluation of Federal Regulatory Oversight of Washington Mutual Bank

Report No. EVAL-10-002

April 2010



## Offices of Inspector General

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**DATE:** April 9, 2010

**MEMORANDUM TO:** John E. Bowman, Acting Director  
Office of Thrift Supervision

Sheila C. Bair, Chairman  
Federal Deposit Insurance Corporation

<b>FROM:</b>	/signed/ Eric M. Thorson Inspector General Department of the Treasury	/signed/ Jon T. Rymer Inspector General Federal Deposit Insurance Corporation
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**SUBJECT:** *Evaluation of Federal Regulatory Oversight of Washington Mutual Bank (Report No. EVAL-10-002)*

Attached for your information is a copy of an evaluation report that the Offices of Inspector General (OIG) recently completed concerning the supervision of Washington Mutual Bank (WaMu). The objectives of the evaluation were to (1) determine the cause of WaMu's failure, (2) assess the Office of Thrift Supervision's (OTS) supervision of WaMu including implementation of Prompt Corrective Action, (3) evaluate the Federal Deposit Insurance Corporation's (FDIC) supervision and monitoring of WaMu as deposit insurer, and (4) assess the FDIC's resolution process for WaMu. The fourth objective will be addressed in a later report after ongoing litigation is completed.

We made three recommendations in the report — one for OTS and two for the FDIC. OTS concurred with our recommendation and has completed action to address the recommendation. FDIC also agreed with our recommendations and proposed actions to be completed by December 31, 2010. FDIC's proposed actions are responsive to our recommendations.

**This report will be publicly available on April 16, 2010 and may not be released prior to that date.** Please be advised that recipients of this report must not, under any circumstances, show or release its contents until April 16, 2010. The report must be safeguarded to prevent publication or other improper disclosure of the information contained herein. This report is not releasable outside the OTS and the FDIC without the approval of the Inspector General.

If you have questions concerning the report or would like to schedule a meeting to further discuss our evaluation results, please contact Marla Freedman, Treasury OIG, at (202) 927-5400, or Marshall Gentry, FDIC OIG, at (703) 562-6378. Thank you for your assistance with this evaluation.

Attachment

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## Abbreviations

AML	Anti-money Laundering
BSA	Bank Secrecy Act
CEO	Chief Executive Officer
DIF	Deposit Insurance Fund
DIR	Division of Insurance and Research
DSC	FDIC Division of Supervision and Consumer Protection
ERICS	Enterprise Risk Issue Control System
ERM	Enterprise Risk Management
FDIC	Federal Deposit Insurance Corporation
LBMC	Long Beach Mortgage Company
LIDI	Large Insured Depository Institution
LTV	Loan to value
MLR	Material loss review
MOU	Memorandum of Understanding
MRBA	Matters requiring board attention
MSA	Mortgage servicing asset
OIG	Office of Inspector General
Option ARMs	Payment option adjustable rate mortgages
OTS	Office of Thrift Supervision
PCA	Prompt Corrective Action
PMI	Private Mortgage Insurance
ROE	Report of examination
SFR	Single family residential
WaMu	Washington Mutual Bank

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*Department of the Treasury  
Federal Deposit Insurance Corporation*

April 9, 2010

John E. Bowman, Acting Director  
Office of Thrift Supervision

Sheila C. Bair, Chairman  
Federal Deposit Insurance Corporation

This report presents the results of our review of the failure of Washington Mutual Bank (WaMu), Seattle, Washington; the Office of Thrift Supervision's (OTS) supervision of the institution; and the Federal Deposit Insurance Corporation's (FDIC) monitoring of WaMu for insurance assessment purposes. OTS was the primary federal regulator for WaMu and was statutorily responsible for conducting full-scope examinations to assess WaMu's safety and soundness and compliance with consumer protection laws and regulations. FDIC was the deposit insurer for WaMu and was responsible for monitoring and assessing WaMu's risk to the Deposit Insurance Fund (DIF). On September 25, 2008, FDIC facilitated the sale of WaMu to JPMorgan Chase & Co in a closed bank transaction that resulted in no loss to the DIF.

Section 38(k) of the Federal Deposit Insurance Act requires the cognizant Inspector General to conduct a material loss review (MLR) of the causes of the failure and primary federal regulatory supervision when the failure causes a loss of \$25 million to the DIF 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 is 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 Inspectors General of the Department of the Treasury and FDIC believed that an evaluation of OTS and FDIC actions could provide important information and observations as the Administration and the Congress consider regulatory reform.

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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 (PCA) 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. This report covers objectives 1, 2, and 3 above. We intend to report on objective 4, the assessment of the resolution process, at a later date.

We are presenting our findings in three sections. Section I describes the causes of WaMu's failure, Section II details the supervision of WaMu by OTS, and Section III describes FDIC's monitoring of risk at WaMu and FDIC's assessments for WaMu's deposit insurance premiums.

We conducted our fieldwork from March 2009 through November 2009 at OTS headquarters in Washington, DC, and regional office in Daly City, California, and FDIC headquarters in Washington, DC, regional office in San Francisco, California, and a field office in Seattle, Washington. We reviewed supervisory files and interviewed key officials involved in regulatory, supervisory, enforcement, and deposit insurance matters. We performed our evaluation in accordance with the *Quality Standards for Inspections*. Appendix 1 contains a more detailed description of our review objectives, scope, and methodology.

We have also included several other appendices to this report. Appendix 2 contains background information on WaMu. Appendix 3 describes OTS's thrift supervision processes and FDIC's monitoring and insurance assessment processes. Appendix 4 is a glossary of terms used in this report. Appendix 5 shows OTS's examinations of WaMu and enforcement actions taken from 2003 through 2008.

## Results in Brief

**Causes of WaMu's Failure.** WaMu failed primarily because of management's pursuit of a high-risk lending strategy that included liberal underwriting standards and inadequate risk controls. WaMu's high-risk strategy, combined with the housing and mortgage market collapse in mid-2007, left WaMu with loan losses, borrowing capacity



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limitations, and a falling stock price. In September 2008, depositors withdrew significant funds after high-profile failures of other financial institutions and rumors of WaMu's problems. WaMu was unable to raise capital to keep pace with depositor withdrawals, prompting OTS to close the institution on September 25, 2008.

**OTS Supervision.** As the primary federal regulator, OTS was responsible for conducting full-scope examinations to assess WaMu's safety and soundness and compliance with consumer protection laws. OTS's examinations of WaMu identified concerns with WaMu's high-risk lending strategy, including repeat findings concerning WaMu's single family loan underwriting, management weaknesses, and inadequate internal controls. However, OTS's supervision did not adequately ensure that WaMu corrected those problems early enough to prevent a failure of the institution. Furthermore, OTS largely relied on a WaMu system to track the thrift's progress in implementing corrective actions on hundreds of OTS examination findings. We concluded that had OTS implemented its own independent system for tracking findings memoranda and WaMu's corrective actions, OTS could have better assessed WaMu management's efforts to take appropriate and timely action.

OTS repeatedly recommended corrective actions through matters requiring board attention (MRBA) and findings memoranda. In March 2008, OTS took informal enforcement action against WaMu by requiring its Board of Directors to pass a Resolution to ensure that weaknesses and concerns with earnings, asset quality, liquidity, and compliance that led to a composite downgrade to a 3 were promptly addressed. However, the Resolution that was passed addressed only near-term liquidity concerns. In September 2008, OTS took another informal enforcement action when it issued a memorandum of understanding (MOU) requiring that WaMu correct all items identified in its MRBAs and findings memoranda by specified due dates. By then, however, it was too late to prevent the thrift from failing.

We concluded that OTS should have lowered WaMu's composite CAMELS rating sooner and taken stronger enforcement action sooner to force WaMu's management to correct the problems identified by OTS. Specifically, given WaMu management's persistent lack of progress in correcting OTS-identified weaknesses, we believe OTS should have followed its own policies and taken formal enforcement action rather than informal action.

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The Treasury Office of Inspector General has made a number of recommendations to OTS as a result of completed material loss reviews of failed thrifts during the current economic crisis. These recommendations pertain to taking more timely formal enforcement action when circumstances warrant, ensuring that high CAMELS ratings are properly supported, reminding examiners of the risks associated with rapid growth and high-risk concentrations, ensuring thrifts have sound internal risk management systems, ensuring repeat conditions are reviewed and corrected, and requiring thrifts to hold adequate capital. OTS has taken or plans to take action in response to these recommendations. Additionally, OTS established a large bank unit to oversee regional supervision of institutions over \$10 billion. We are making one new recommendation. Specifically, OTS should use its own internal report of examination system to formally track the status of examiner recommendations and related thrift corrective actions. OTS concurred with our recommendation and has completed action to address it.

**FDIC Monitoring and Insurance Assessment.** FDIC was the deposit insurer for WaMu and was responsible for monitoring and assessing WaMu's risk to the DIF. As insurer, FDIC has authority to perform its own examination of WaMu and impose enforcement actions to protect the DIF, provided statutory and regulatory procedures are followed. FDIC conducted its required monitoring of WaMu from 2003 to 2008. As a result of this monitoring, FDIC identified risks with WaMu's lending strategy and internal controls. The risks noted in FDIC monitoring reports were not, however, reflected in WaMu's deposit insurance premium payments. This discrepancy occurred because the deposit insurance regulations rely on OTS examination safety and soundness ratings and regulatory capital levels to gauge risk and assess related deposit insurance premiums. Since OTS examination results were satisfactory, increases in deposit insurance premiums were not triggered. Further, because of statutory limitations and Congressionally-mandated credits, WaMu paid \$51 million of \$215.6 million in deposit insurance assessments during the period 2003 to 2008. FDIC challenged OTS's safety and soundness ratings of WaMu in 2008. However, OTS was reluctant to lower its rating of WaMu from a 3 to a 4 in line with the FDIC's view. OTS and FDIC resolved the 2008 safety and soundness ratings disagreement 7 days prior to WaMu's failure, when OTS lowered its rating to agree with FDIC's. However, by that time, the rating downgrade had no impact on WaMu's insurance premium assessments and payments.

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FDIC has enforcement powers to act when a primary regulator, such as OTS, does not take action; however, it did not use those powers for WaMu in 2008 because of the significant procedural steps necessary to invoke such action. Coordination between FDIC and OTS was problematic because of the terms of an interagency agreement governing information sharing and back-up examination authority, and the inherent tension between the roles of the primary regulator and the insurer.

According to the terms of the interagency agreement, FDIC needed to request permission from OTS to allow FDIC examiners to review information on-site at WaMu in order to better assess WaMu's risk to the DIF. Further, under the terms of the interagency agreement, FDIC had to show that a high level of risk existed for the primary regulator to grant FDIC access. The logic of the interagency agreement is circular – FDIC must show a high level of risk to receive access, but FDIC needs access to information to determine an institution's risk to the DIF. OTS resisted providing FDIC examiners greater on-site access to WaMu information because they did not believe that FDIC met the requisite need for that information according to the terms of the interagency agreement and believed FDIC could rely on the work performed by OTS. Eventually OTS did grant FDIC greater on-site access at WaMu but limited FDIC's review of WaMu's residential loan files.

We concluded that the interagency agreement did not provide FDIC with the access to information that it needed to assess WaMu's risk to the DIF. There is clearly a need to balance FDIC information needs and the regulatory burden imposed on a financial institution, but the current interagency agreement does not allow FDIC sufficient flexibility to obtain information necessary to assess risk in order to protect the DIF. Finally, we also concluded that FDIC deposit insurance regulations are restrictive in prescribing the information used to assign an institution's insurance category and premium rate.

We are recommending that the FDIC Chairman, in consultation with the FDIC Board of Directors, revisit the interagency agreement governing information access and back-up examinations for large depository institutions to ensure it provides FDIC with sufficient access to the information necessary to assess an institution's risk to the DIF. Although FDIC is taking steps to clarify access to systemically important institutions, we believe the interagency agreement should be modified for all large depository institutions. We note that risky institutions such as IndyMac Bank, F.S.B. (IndyMac),

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were not considered to be systemically important but nevertheless caused significant losses to the DIF (the IndyMac failure consumed 24 percent of the DIF balance at the time). Further, we recommend that the FDIC Chairman, in consultation with the FDIC Board of Directors, revisit 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 on the institution's capital levels. Although FDIC is taking steps to look at a number of variables that influence an institution's risk to the DIF, we believe that the bank failures of this current economic crisis show that more factors are indicative of an institution's risk to the DIF than those currently taken into consideration. FDIC agreed with our recommendations and proposed actions to be completed by December 31, 2010. FDIC's proposed actions are responsive to our recommendations. Both FDIC recommendations will remain open until FDIC OIG determine that the agreed-upon corrective actions have been implemented.

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## SECTION I

### Causes of WaMu's Failure

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## Causes of WaMu's Failure

WaMu failed because of its management's pursuit of a high-risk lending strategy coupled with liberal underwriting standards and inadequate risk controls. Ultimately, WaMu's high-risk strategy broke down when the housing and mortgage market collapsed in mid-2007, leaving WaMu with loan losses, borrowing capacity limitations, and a significantly depressed stock price. In September 2008, WaMu was unable to raise capital to counter significant depositor withdrawals sparked by rumors of WaMu's problems and other high-profile failures during that time.

### WaMu Pursued a High-Risk Lending Strategy

In 2005, WaMu management made a decision to shift its business strategy away from originating traditional fixed-rate and conforming single family residential loans, towards riskier nontraditional loan products and subprime loans.<sup>1</sup> WaMu pursued the new strategy in anticipation of increased earnings and to compete with Countrywide Financial Corporation, which, in 2005, WaMu's CEO saw as "arguably the strongest competitor at this time because of system stability, strong profitability, excellent risk management and aggressive growth plans."<sup>2</sup>

As shown in Table 1, WaMu estimated in 2006 that its internal profit margin from subprime loans could be more than 10 times the amount for a government-backed loan product and more than 7 times the amount for a fixed-rate loan product.

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<sup>1</sup> WaMu defined borrowers with a score of less than 620 on the FICO scale as subprime.

<sup>2</sup> June 1, 2004 memorandum from WaMu's CEO to the WaMu Board of Directors. Bank of America purchased Countrywide Financial Corporation in January 2008 for approximately \$4.1 billion in stock.

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**Table 1: WaMu's Estimated Gain on Sale Margin by Product Type**

<b>Loan Product Type</b>	<b>Return (in Basis Points)</b>
Subprime	150
Home Equity	113
Payment Option Adjustable Rate Mortgage (Option ARM)	109
Alt-A	40
Hybrid/ARM	25
Fixed-rate	19
Government-backed	13

Source: April 18, 2006 WaMu Board of Directors Presentation

### High-Risk Loan Concentrations

Option ARMs represented as much as half of all loan originations from 2003 to 2007 and approximately \$59 billion, or 47 percent, of the home loans on WaMu's balance sheet at the end of 2007. WaMu's Option ARMs provided borrowers with the choice to pay their monthly mortgages in amounts equal to monthly principal and interest, interest-only, or a minimum monthly payment. Borrowers selected the minimum monthly payment option for 56 percent of the Option ARM portfolio in 2005.

The minimum monthly payment was based on an introductory rate, also known as a teaser rate, which was significantly below the market interest rate and was usually in place for only 1 month. After the introductory rate expired, the minimum monthly payment feature introduced two significant risks to WaMu's portfolio: payment shock<sup>3</sup> and negative amortization.<sup>4</sup> WaMu projected that, on average, payment shock increased monthly mortgage amounts by 60 percent. At the end of 2007, 84 percent of the total value of Option ARMs on WaMu's financial statements was negatively amortizing. WaMu's December 31, 2007, financial statements included \$1.42 billion (7

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<sup>3</sup> Payment shock occurred 5 years after the loan was originated (or sooner if negative amortization increased the loan balance by more than 110 percent of the original loan amount) because the minimum monthly payment was recomputed using a market interest rate, the larger principal balance, and the remaining term of the loan.

<sup>4</sup> Negative amortization occurs when the minimum monthly payments made after the expiration of the teaser rate are insufficient to pay monthly interest cost. Any unpaid interest is added to the principal loan balance thereby increasing the original loan amount.

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percent of interest income) in interest income due to capitalized interest<sup>5</sup> on Option ARMs.<sup>6</sup>

In addition to Option ARMs, WaMu's new strategy included underwriting subprime loans, home equity loans, and home equity lines of credit to high-risk borrowers. In line with that strategy, WaMu purchased and originated subprime loans, which represented approximately \$16 billion, or 13 percent, of WaMu's 2007 home loan portfolio. Home equity products totaled \$63.5 billion, or 27 percent, of WaMu's loans secured by real estate in 2007 – a 130 percent increase from 2003.

### Systemic Underwriting Weaknesses

WaMu underwriting policies and practices made what were already inherently high-risk products even riskier. For example, WaMu originated a significant number of loans as “stated income” loans. Stated income loans, sometimes referred to as “low-doc” loans, allow borrowers to simply write in their income on the loan application without providing any supporting documentation. Approximately 90 percent of all of WaMu's home equity loans, 73 percent of Option ARMs, and 50 percent of subprime loans were “stated income” loans.

WaMu also originated loans with high loan-to-value ratios. Specifically, WaMu held a significant percentage of loans where the loan amount exceeded 80 percent of the underlying property. For example, WaMu's 2007 financial statements showed that 44 percent of subprime loans, 35 percent of home equity loans,<sup>7</sup> and 6 percent of Option ARMs were originated for total loan amounts in excess of 80 percent of the value of the underlying property. Further, WaMu did not require borrowers to purchase private mortgage insurance (PMI). PMI protects lenders against the loss on default when the loan amount exceeds 80 percent of the home's value.

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<sup>5</sup> According to Financial Accounting Standards Board Statement of Financial Accounting Concepts No.5, *Recognition and Measurement in Financial Statements of Business Enterprises*, the capitalized interest on Option ARMs from negative amortization is recognized as earned interest income if there is a reasonable expectation of collection.

<sup>6</sup> WaMu included \$1.07 billion of capitalized interest in earnings in its December 31, 2006 financial statements.

<sup>7</sup> Home equity loan-to-value ratio measures the ratio of the original loan amount of the first lien product (typically a first lien mortgage) and the original loan amount of the home equity loan or line of credit to the appraised value of the underlying collateral at origination.



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WaMu's review of appraisals establishing the value of single family homes did not always follow standard residential appraisal methods because WaMu allowed a homeowner's estimate of the value of the home to be included on the form sent from WaMu to third-party appraisers, thereby biasing the appraiser's evaluation.<sup>8</sup>

Finally, WaMu did not provide adequate oversight of third-party brokers who were compensated for originating most of WaMu's mortgages but were not WaMu employees. In 2007, WaMu had only 14 WaMu employees overseeing more than 34,000 third-party brokers. Although WaMu used scorecards to evaluate its third-party brokers, the scorecards did not measure the rate of significant underwriting and documentation deficiencies attributable to individual brokers. In 2007, WaMu identified fraud losses attributable to third-party brokers of \$51 million for subprime loans and \$27 million for prime loans. These matters are under further review by law enforcement agencies.

#### Concentrations of Loans in California and Florida

Consistent with its initial business strategy, WaMu made most of its residential loans to borrowers in California and Florida, states that suffered above-average home value depreciation. Additionally, within California, WaMu's underwriting standards allowed for up to 25 percent of loans to be concentrated in one metropolitan statistical area. Table 2 presents information about WaMu's single family residential loan concentrations.

**Table 2: WaMu Loan Single Family Residential Loan Concentrations**

	<b>Option ARMs</b>	<b>Subprime</b>	<b>Home Equity</b>
California	49%	25%	53%
Florida	13%	10%	9%

Source: Washington Mutual Inc, 10-k, December 31, 2007.

#### **WaMu Did Not Have Adequate Controls in Place to Manage Its High-Risk Strategy**

As shown in Table 3, WaMu grew rapidly from a regional to a national mortgage lender through acquisitions and mergers with affiliate companies.

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<sup>8</sup> The Uniform Standards of Professional Appraisal Practice Rule 1-2(b) notes that appraisers must not allow the intended use of an assignment or a client's objectives to cause the assignment results to be biased.

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**Table 3: WaMu Acquisitions and Mergers from 1991 to 2006**

Dates	Acquisitions	Total Assets (Billions)
1991- 2002	Acquired nine institutions	\$137.16
1/1/2005	Merged with affiliate Washington Mutual Bank Seattle	\$28.77
10/1/2005	Acquired Provident National Bank	\$13.10
3/1/2006	Merged with affiliate Long Beach Mortgage Company	\$13.11
10/1/2006	Acquired Commercial Capital Bank, FSB	\$5.67

Source: FDIC Website BankFind Institution History

WaMu did not fully integrate and consolidate the information technology systems, risk controls, and policies from the companies it acquired into a single enterprise-wide risk management (ERM) system prior to embarking on its new, high-risk strategy. For example, WaMu had a number of different independent loan origination platforms and had to manually tie numbers from these systems together in order to look at WaMu-wide loan statistics. In its examinations from 2004 to 2008, OTS noted that WaMu did not have effective controls in place to ensure proper risk management. Risk management was especially important in the case of WaMu because of its high-risk lending strategy, significant and frequent management changes, corporate reorganizations, and significant growth. Further, when OTS pointed out weaknesses in WaMu's internal controls, WaMu management did not always take action to resolve those weaknesses.

### **WaMu Suffered Significant Liquidity Stress in 2008**

After the mortgage market meltdown in mid-2007, the effects of WaMu's risky products and liberal underwriting began to materialize. In the third quarter of 2007, WaMu was still profitable, but earnings were 73 percent less than the second quarter because of loan losses. In the fourth quarter of 2007 and the first quarter of 2008, WaMu suffered consecutive \$1 billion quarterly losses because of loan charge-offs and reserves for future loan losses. WaMu improved its liquidity position in April 2008 through a \$7 billion investment in WaMu's holding company made by a consortium led by the Texas Pacific Group. Of the \$7 billion investment, WaMu's holding company downstreamed \$3 billion to WaMu in April 2008 and another \$2 billion to WaMu in July 2008. WaMu's holding company used \$1.4 billion of the capital raised to pay down holding company debt in June 2008 as WaMu went on to suffer a \$3.2 billion loss in the second quarter of 2008, and WaMu's share price decreased by 55 percent. OTS officials told us that WaMu's stock price was also reduced by the volume of short selling during 2008. At the same time, the press was reporting

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that federal regulators were taking enforcement action against the institution.<sup>9</sup>

With the failure of IndyMac in July 2008, WaMu's liquidity was further stressed as WaMu encountered significant deposit withdrawals. The Federal Home Loan Bank of San Francisco also began to limit WaMu's borrowing capacity. As a result, WaMu began offering deposit rates in excess of competitors in order to bring in deposits to improve liquidity. Shortly thereafter, Lehman Brothers collapsed on September 15, 2008, and within the following 8 days, WaMu incurred net deposit outflow of \$16.7 billion, creating a second liquidity crisis. WaMu's ability to raise funds to improve its liquidity position was hindered by its borrowing capacity limits, share price decline, portfolio losses, and an anti-dilution clause tied to the \$7 billion capital investment. On September 25, 2008, OTS closed WaMu and appointed FDIC as receiver; FDIC contemporaneously sold WaMu to JPMorgan Chase & Co for \$1.89 billion.<sup>10</sup>

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<sup>9</sup> OTS was considering informal enforcement action against WaMu at that time, but that information was not released to the public.

<sup>10</sup> Certain liabilities were not assumed by JPMorgan Chase & Co.

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## SECTION II

# OTS's Supervision of WaMu

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## OTS's Supervision of WaMu

At over \$300 billion in total assets, WaMu was OTS's largest regulated institution and represented as much as 15 percent of OTS's total assessment revenue from 2003 to 2008. OTS spent significant resources monitoring and examining WaMu. OTS conducted regular risk assessments and examinations that rated WaMu's overall performance satisfactory until 2008. Those supervisory efforts also identified the core weaknesses that eventually led to WaMu's failure – high-risk products, poor underwriting, and weak risk controls.

While we saw some evidence that OTS followed up on examination findings, OTS relied largely on WaMu management to track progress in correcting examiner-identified weaknesses and accepted assurances from WaMu management and its Board of Directors that problems would be resolved. OTS, however, did not adequately ensure that WaMu management corrected those weaknesses. The first time OTS took safety and soundness enforcement action against WaMu was in 2008 after the thrift started to incur significant losses.<sup>11</sup> OTS also was not required to take PCA against WaMu at any point during its decline. In this regard, despite its significant losses, WaMu was considered well-capitalized until its closure.

### **OTS Examiners Assigned WaMu Satisfactory Composite Ratings Until 2008 Despite Noted Weaknesses**

A principal objective of the CAMELS rating process is to identify those associations that pose a risk of failure and merit more than normal supervisory attention.<sup>12</sup> The CAMELS composite rating is a qualitative assessment based on a careful review of component ratings, which evaluate, among other things, capital adequacy in relation to risk profile and operations; asset quality relative to credit risk associated with the loan and investment portfolios; whether management has established appropriate policies, procedures, and practices regarding acceptable risk exposures; and the extent of the thrift's liquid assets. Table 4 provides standard definitions of each CAMELS composite rating level.

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<sup>11</sup> OTS did impose enforcement actions in 2007 related to the Bank Secrecy Act and consumer compliance. See Table 6.

<sup>12</sup> OTS Examination Handbook, Section 070, page 070.6.

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**Table 4: CAMELS Composite Rating Definitions**

<b>1</b>	Sound in every respect
<b>2</b>	Fundamentally sound
<b>3</b>	Exhibits some degree of supervisory concern in one or more of the component areas ( <i>i.e.</i> , capital adequacy, asset quality, management, earnings, liquidity, sensitivity to market risk)
<b>4</b>	Generally exhibits unsafe and unsound practices or conditions
<b>5</b>	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

Source: OTS Examination Handbook, Section 070, pages 070A.3 & .4.

From 2001 to 2007, OTS consistently rated WaMu a CAMELS composite 2. As shown in Table 4, a composite 2 rating reflects the agency's assessment that an institution is fundamentally sound. The CAMELS composite criteria for a 2 also states that such institutions have only moderate weaknesses that are within the board's and management's capability and willingness to correct, and have satisfactory risk management practices relative to the institution's size, complexity, and risk profile. Institutions in this category are stable and capable of withstanding business fluctuations. As discussed later, the composite rating is a critical factor in supporting the need for enforcement actions and in determining the assessment rate an institution should pay for deposit insurance purposes.

Given the multiple repeat findings related to asset quality and management, and considering the definitions of the composite ratings, it is difficult to understand how OTS continued to assign WaMu a composite 2-rating year after year. It was not until WaMu began experiencing losses at the end of 2007 and into 2008 that OTS lowered WaMu's CAMELS composite rating to 3 in February 2008, and ultimately to 4 in September 2008.

### **OTS Dedicated Significant Examination Resources to WaMu**

As discussed earlier, WaMu was OTS's largest supervised institution, representing between 12 to 15 percent of OTS's total assessment revenue from 2003 through 2008.<sup>13</sup> OTS assigned significant resources to examine and monitor WaMu, including dedicated staff

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<sup>13</sup> OTS's operating budget is principally funded by periodic assessments to the thrift industry. The total periodic assessments paid by regulated thrifts for 2008 amounted to \$267.3 million.

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and numerous specialists. Table 5 shows the number of OTS staff hours spent monitoring and examining WaMu from 2003 to 2008.

**Table 5: Number of OTS WaMu Examination Hours**

<b>Examination Start Date</b>	<b>WaMu Examination Hours*</b>
3/17/2003	17,825
3/15/2004	22,838
3/14/2005	29,545
3/13/2006	30,784
1/8/2007	31,521
9/10/2007	31,273

\* Hours are totaled for safety and soundness examinations, information technology examinations, and compliance examinations.

Source: OTS Examination Activity Hours Detail Report.

In compliance with policy, OTS developed and maintained comprehensive risk assessments of WaMu during the 2003 to 2008 review periods. The risk assessments were used by OTS to determine the scope, staffing, and key areas for examinations. OTS conducted full-scope annual examinations as required from 2003 to 2006 and implemented a continuous supervision program for the 2007 and 2008 examination. Those examination efforts resulted in Reports of Examination (ROE) as well as findings memoranda.

Table 6 summarizes OTS's safety and soundness ratings, and supervisory actions for WaMu. Appendix 5 provides details of significant matters and other examination findings for 2003 to 2008.

**Table 6: OTS Ratings and Supervisory Action for WaMu 2003-2008**

Date of Report Transmittal	Examination Start Date	Examination Completion Date	CAMELS Ratings (component/ composite)	Supervisory Action
08-22-2003	03-17-2003	07-31-2003	222223/2	None
09-13-2004	03-15-2004	08-12-2004	222223/2	None
08-29-2005	03-14-2005	08-19-2005	222222/2	None
08-29-2006	03-13-2006	08-09-2006	222222/2	None
09-18-2007	01-08-2007	08-27-2007	222212/2	Cease and desist order related to deficiencies in Bank Secrecy Act and anti-money laundering compliance issued on October 17, 2007.
09-19-2008	09-10-2007	09-08-2008	Interim ratings change effective 2/27/2008 - 232432/3  Rating as of 6/30/2008 - 343432/3  Changed to 343442/4 on 9-18-2008	In February 2008, OTS required a Board Resolution (an informal enforcement action) to address the general areas of concern in asset quality, earnings, and liquidity. WaMu adopted the Board Resolution on March 17, 2008.  In July 2008, OTS requested a Memorandum of Understanding (MOU) (an informal enforcement action) to address the 2008 examination findings; the MOU was signed September 7, 2008. The ratings were changed on September 18, 2008.

Source: OTS ROEs for WaMu and Supervisory Documents.

In addition to ROEs, OTS issued safety and soundness-related findings memoranda to WaMu management during the examination cycles.<sup>14</sup> These findings memoranda consistently identified issues and weaknesses associated with WaMu operations, asset quality, and risk management. OTS categorized findings within the memoranda into three levels of severity: **criticisms** -- primary concerns requiring corrective action, inclusion in the ROE, and a written response from management; **recommendations** -- secondary concerns requiring corrective action, possible inclusion in the ROE, and discussion at examination exit meetings and WaMu Board meetings; and **observations** — weaknesses not of regulatory concern, but which could improve the bank’s operating effectiveness if addressed.

<sup>14</sup> OTS also issued findings memoranda in the areas of Compliance and Information Technology (IT). We did not include Compliance or IT in our review because neither area was directly related to the cause of WaMu’s failure.



Observations generally were not included in the ROE. As shown in Table 7, OTS examiners identified and reported a large number of findings at WaMu from 2003 to 2008.

**Table 7: OTS Findings Memoranda Issued to WaMu in 2003-2008**

Year of Examination	Findings Memoranda	Individual Findings	Criticisms	Recommendations	Observations	Not Available
2003	46	148	25	96	27	-
2004	36	116	11	90	15	-
2005	38	64	11	47	4	2
2006	17	45	3	41	1	-
2007	25	68	1	36	31	-
2008	31	104	16	70	18	-
<b>Totals</b>	<b>193</b>	<b>545</b>	<b>67</b>	<b>380</b>	<b>96</b>	<b>2</b>

Source: Analysis of OTS Findings Memoranda issued to WaMu from 2003 to 2008.

These findings memoranda received varying treatment in the ROEs. In some cases, problems requiring immediate attention from management appeared in ROEs in a separate section entitled "Matters Requiring Board Attention," while other findings memoranda were either specifically mentioned in discussion of the CAMELS components or generally mentioned in the "Corrective Actions" sections of the ROE. WaMu's resolution of these findings is discussed in more detail later in the report.

### **OTS Examiners Identified Concerns with WaMu's Asset Quality but Consistently Rated this Area Satisfactory**

Asset quality is one of the most critical areas in determining the overall condition of a bank. The primary factor affecting overall asset quality is the quality of the loan portfolio and the credit administration program. OTS examination procedures state that the asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions, and should reflect the ability of management to identify, measure, monitor, and control credit risk.<sup>15</sup>

OTS examiners repeatedly identified issues and weaknesses associated with WaMu's asset quality -- in particular, findings related to single family residential loan underwriting and oversight of third-party brokers. Nevertheless, OTS consistently assessed WaMu's asset quality as satisfactory, with a rating of 2 until February 2008

<sup>15</sup> OTS Examination Handbook, Section 070, page 070A.8.

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when asset quality was downgraded on an interim basis to a 3. The 3 rating for asset quality was maintained until September 2008 when the asset quality rating was dropped to a 4. Asset quality ratings definitions are shown in Table 8 below.

**Table 8: Asset Quality Rating Definitions**

<b>1</b>	Strong asset quality and credit administration practices
<b>2</b>	Satisfactory asset quality and credit administration practices
<b>3</b>	Less than satisfactory asset quality and credit administration practices
<b>4</b>	Deficient asset quality or credit administration practices
<b>5</b>	Critically deficient asset quality or credit administration practices

Source: OTS Examination Handbook, Section 070, page 070A.7

We asked OTS examiners why they did not lower WaMu's asset quality ratings earlier. Examiners responded that even though underwriting and risk management practices were less than satisfactory, WaMu was making money and loans were performing. Accordingly, the examiners thought it would have been difficult to lower WaMu's asset quality rating. In this regard, OTS guidance provides that: "[if] an association has a high exposure to credit risk, it is not sufficient to demonstrate that the loans are profitable or that the association has not experienced significant losses in the near term." Given this guidance, the significance of single family residential lending to WaMu's business, and the fact that the OTS repeatedly brought the same issues related to asset quality to the attention of WaMu management and the issues remained uncorrected, we find it difficult to understand how OTS could assign WaMu a satisfactory asset quality 2-rating for so long. Assigning a satisfactory rating when conditions are not satisfactory sends a mixed and inappropriate supervisory message to the institution and its board, and is contrary to the very purpose for which regulators use the CAMELS rating system.

#### OTS Reported Persistent Single Family Residential Underwriting Deficiencies

OTS identified a number of significant concerns with WaMu's single family residential underwriting practices in risk assessment documents, findings memoranda, and ROEs from 2003 to 2008. Those concerns included questions about the reasonableness of stated incomes contained in loan documents, numerous underwriting exceptions, miscalculations of loan-to-value ratios, and missing or

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inadequate documentation. Underwriting was especially important at WaMu because WaMu's single family residential loan portfolio represented more than 60 percent of total assets. Further, the fact that many of WaMu's single family residential loans were Option ARMs further underscored the risky nature of this loan portfolio.

OTS's Examination Handbook discusses the importance of underwriting, noting that "[a] savings association's first defense against excessive credit risk is the initial credit-granting process."<sup>16</sup> OTS reviewed WaMu's underwriting and included MRBAs related to single family residential loan underwriting in the 2004 to 2008 ROEs and included MRBAs related to subprime lending and subprime underwriting in the 2004, 2006, and 2007 ROEs. For example:

- **2003 and 2004** - OTS reported that underwriting of single family residential loans, WaMu's core loan activity, was less than satisfactory. In 2004, OTS identified causes for underwriting deficiencies, including: (1) a less than optimal organizational structure with multiple origination platforms (in part due to merger activity) and inconsistent origination procedures, (2) a sales culture focused on building market share, and (3) extremely high origination volumes fueled by the low interest rate environment. OTS recommended that management define and monitor specific loan quality goals tied to incentive compensation programs for the appropriate managers.
- **2005** - OTS reported that although overall single family residential loan quality and performance trends were stable, the thrift's underwriting remained less than satisfactory. OTS noted that this concern had been expressed at several prior exams as well as internal reviews and that the examiners remained concerned with the number of underwriting exceptions and with issues that evidenced a lack of compliance with bank policy. The ROE stated "We believe the level of deficiencies, if left unchecked, could erode the credit quality of the portfolio. Our concerns are increased when the risk profile of the portfolio is considered, including concentrations in Option ARM loans to higher-risk borrowers, in low and limited documentation loans, and loans with subprime or higher-risk characteristics. We are concerned further that the current market environment is masking potentially higher credit risk."

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<sup>16</sup> OTS Examination Handbook, Section 201, page 201.8.

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- **2006 to 2007** - OTS reported that single family residential loan and prime underwriting had improved to marginally satisfactory and generally satisfactory, respectively. However, OTS reported concerns with subprime underwriting practices by Long Beach Mortgage Company (LBMC), a WaMu affiliate that merged with WaMu on March 1, 2006. OTS reported that subprime underwriting practices remained less than satisfactory and cited exceptions related to the miscalculation of debt-to-income ratios, reasonableness of stated incomes on loan documents, and borrower acknowledgement of payment shock. Examiners found that underwriting exceptions were more prevalent on higher-risk loans. (It should be noted that WaMu discontinued subprime lending in the fourth quarter of 2007.)
  - **2008** - OTS reported that WaMu management had not effectively managed underwriting risk despite it having been identified as an issue for some time by WaMu's Corporate Credit Review Group and WaMu's Internal Audit staff. In this regard, OTS had cautioned management, over several examinations, about the level of layered risks (multiple risk factors such as high loan-to-values, stated income lending, option ARMs, and geographic concentration) in the single family loan portfolio. The examination criticized WaMu's stated income lending practices; reliance on an automated underwriting system without the involvement of experienced underwriters; and the prudence of Option ARM lending to foreign nationals without any credit, income, or asset verification.

In addition to the ROEs, OTS examiners repeatedly issued findings memoranda from 2003 through 2008 related to various aspects of single family residential loan underwriting deficiencies. OTS also consistently included concerns about the underwriting practices in OTS risk assessments, field visitations, and regulatory profile reviews. During the period 2005 through 2007, while OTS was issuing multiple repeat findings pertaining to single family residential loan underwriting, WaMu originated almost \$618 billion in single family residential loans.

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## WaMu's Oversight of Third-Party Originators Needed Improvement

In addition to retail loans originated by WaMu employees, WaMu also originated and purchased wholesale loans through a network of brokers and correspondent banks.<sup>17</sup> Wholesale loan channels represented 48 to 70 percent of WaMu's total single family residential loan production during the years 2003 to 2007.<sup>18</sup> The financial incentive to use wholesale loan channels for production was significant. According to an April 2006 internal presentation to the WaMu Board, it cost WaMu about 66 percent less to close a wholesale loan (\$1,809 per loan) than it did to close a retail loan (\$5,273). Thus, WaMu was able to reduce its cost of operations through the use of third-party originators but had far less oversight over the quality of originations.

OTS's Examination Handbook states that, in reviewing the wholesale production activities of savings associations, examiners should confirm how savings associations define, use, and monitor brokers, correspondents, and other third-party arrangements.<sup>19</sup> We saw evidence that OTS examiners reviewed WaMu's oversight of third-party originators and reported weaknesses during several examinations. Examination findings included underwriting weaknesses and deficient processes and tools for approving and monitoring third-party originators. For example:

- **2003** - OTS reported underwriting problems and related weaknesses in correspondent and wholesale broker channel management, recourse administration, and quality assurance. OTS's review disclosed the need for more comprehensive supervision of outside loan originators. OTS concluded that the annual review and monitoring process for wholesale mortgage brokers was inadequate, as management did not consider key performance indicators such as delinquency rates and fraud incidents. OTS also found that the approval and monitoring process for correspondent lenders needed improvement. OTS noted that WaMu's internal auditors had reported similar weaknesses and that OTS had reported wholesale broker concerns in a prior examination. OTS also reported that

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<sup>17</sup> Brokers concentrate on finding customers in need of financing and process the loan application and mortgage documents. Correspondents deal with the customer, then close and fund the loan before selling the loan to an investor.

<sup>18</sup> WaMu exited wholesale lending channels in 2008 as losses mounted.

<sup>19</sup> OTS Examination Handbook Section 750, page 750.12.

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WaMu's Residential Quality Assurance (RQA) office<sup>20</sup> had reviewed mortgage loan production and reported a high rate of unacceptable loans for all channels of production. In this regard, the RQA office reported an error rate of 29 percent for wholesale mortgage loans, more than triple the acceptable error rate of 8 percent established by WaMu.

- **2004** - OTS concluded that management's oversight of third-party originators had improved from the prior examination. OTS noted that approximately 20,000 brokers and correspondents generated most of WaMu's single family residential loan originations, and such volume was understandably challenging to manage. OTS noted that WaMu had implemented a tracking and risk system for approving and monitoring third-party originators. The conclusions in the ROE, however, were at odds with a 2004 findings memorandum prepared by OTS to communicate the results of a single family residential loan file review. In that findings memorandum, OTS reported underwriting and documentation inconsistencies, particularly in the brokered channel, including inconsistent borrower credit classifications and missing employment, asset, and income verification for "full-doc" loans.
  
- **2006** - The 2006 examination reported that 68 percent of WaMu's \$207.7 billion in loan originations during 2005 were via wholesale broker and correspondent channels and noted that WaMu was restructuring the units responsible for overseeing brokers and correspondents and redefining processes. OTS findings memoranda in 2006 and 2007 reported that WaMu needed to improve
  - review processes for third-parties exceeding key performance indicators,
  - reporting of early payment defaults and other fraud indicators at the individual third-party level,<sup>21</sup>
  - procedures for assessing underwriting for third-party originators who had been placed on a watch list, and
  - procedures for approving and annually re-certifying continued association with brokers.

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<sup>20</sup> The Residential Quality Assurance office was an asset review group in WaMu's Home Loans and Insurance Services Group that was responsible for conducting origination, purchase, and servicing quality assurance activities for WaMu's single family residential loan portfolio.

<sup>21</sup> A loan that becomes delinquent or goes into default within its first year is a strong indicator of possible mortgage fraud.

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- **2007** - The 2007 examination stated that WaMu's policies and procedures, performance monitoring scorecards, and watchlist process for overseeing brokers needed improvement. An OTS findings memorandum associated with the examination period noted that WaMu had 14 full-time equivalent employees responsible for third-party oversight of more than 34,000 brokers. The findings memorandum noted shortcomings with WaMu's broker credit administration policies and third-party oversight scorecard. Further, OTS reported that WaMu had discontinued all remaining lending through its subprime mortgage channel and the purchase and sale/securitization of loans in the fourth quarter of 2007.

In April 2008, WaMu management announced that it would discontinue all wholesale channel lending. In the ROE for 2008, OTS referenced prime loan fraud losses totaling \$27 million and subprime fraud losses totaling \$51 million for 2007 reported by WaMu, and OTS noted that the majority of the fraud losses for both portfolios was attributed to the wholesale channel. These matters are under further review by law enforcement agencies.

### **OTS Consistently Rated Management Satisfactory Despite Examiner-Identified Problems**

OTS's guidance states that one of the most important objectives of an examination is to evaluate the quality and effectiveness of a savings association's management, and that the success or failure of almost every facet of operations relates directly to management.<sup>22</sup> Management ratings definitions are shown in Table 10 below. OTS reported concerns regarding WaMu management in ROEs, findings memoranda, and risk assessment reports from 2003 through 2008. The primary areas of concern were the lack of effective internal controls and an insufficient commitment on the part of WaMu's Board and management to take action to address OTS-identified weaknesses.

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<sup>22</sup> OTS Examination Handbook, Section 330, page 330.1.

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**Table 10: Management Rating Definitions**

<b>1</b>	Strong performance by management and the Board of Directors and strong risk management practices
<b>2</b>	Satisfactory performance by management and the Board of Directors and satisfactory risk management practices
<b>3</b>	Improvement needed in management and Board of Directors performance or less than satisfactory risk management practices
<b>4</b>	Deficient management and Board of Directors performance or inadequate risk management practices
<b>5</b>	Critically deficient management and Board of Directors performance or risk management practices

Source: OTS Examination Handbook, Sections 070A.8 and 070A.9.

Despite noted concerns, OTS generally reported that WaMu's Board oversight and management's performance was satisfactory through 2007 and rated the CAMELS management component a 2 in those examinations. It was not until 2008 that OTS reported that WaMu's Board oversight and management's performance was less than satisfactory and downgraded the CAMELS management component to a 3. OTS faulted the WaMu Board and management for not adequately addressing MRBAs from prior examinations, including single family mortgage loan underwriting weaknesses and an ineffective ERM function. OTS concluded that failure to address those weaknesses in a timely manner was exacerbating credit losses and exposing WaMu to heightened reputation risk. Based on the management component ratings definitions and WaMu's lack of progress in addressing OTS-identified weaknesses, we believe that a less than satisfactory management component rating should have been assigned to WaMu sooner.

#### WaMu Management Did Not Have Controls in Place to Manage Its High-Risk Strategy

The primary concern noted by OTS within the management component of the examinations from 2004 to 2008 was that WaMu did not have an effective ERM strategy in place to manage the risks in its portfolio. OTS guidance notes the interrelationship between ERM and corporate governance and recognizes that one of the fundamental concepts of ERM is to provide management and the board of directors with reasonable assurance that the savings association is managing its risk.<sup>23</sup> Risk management was especially important in the case of WaMu because of its size, high-risk lending strategy, continuous restructuring, and changes in management.

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<sup>23</sup> OTS Examination Handbook, Sections 310, pages 310.2 and 310.3.



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OTS repeatedly identified WaMu's ERM function as a significant issue in the MRBAs, requiring the attention of the WaMu Board to

- monitor and obtain reports from management on the status of the ERM function in terms of effectiveness and resource adequacy (2004 and 2005 ROEs);
- establish an ERM strategy in order to integrate the acquisition of Providian (2005);<sup>24</sup>
- maintain open dialog between the WaMu Board, Chief Enterprise Risk Officer, and the thrift's independent auditor (2005 and 2006 ROEs); and
- continue to monitor and obtain reports from management on the status of ERM to ensure its effectiveness and adequacy of resources and ensure that ERM provided an important check and balance on profit-oriented units, which warranted strong Board commitment and support, particularly given WaMu's strategy involving increased credit risk (2006, 2007, and 2008 ROEs).

In addition to the ERM issues, OTS also reported management-related MRBAs regarding the quality of information presented by WaMu management to its Board, the adequacy of the information to allow its Board to assess WaMu's risk, and the Board's committee structure.

Findings memoranda also reported concerns with ERM, corporate risk oversight, internal audit, and suspected fraud reporting. For example, in a 2004 findings memorandum, OTS reported that WaMu management was not providing timely responses to reports issued by the thrift's Corporate Risk Oversight Group.<sup>25</sup> In a 2008 findings memorandum, examiners disclosed concerns about the limited scope of some internal audits and the sufficiency of actions taken to resolve certain internal audit findings.

OTS's field visit reports, regulatory profiles,<sup>26</sup> and risk assessments also showed that WaMu displayed weaknesses in ERM and general management oversight. For example,

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<sup>24</sup> WaMu acquired Providian National Bank on October 1, 2005. Providian had a large subprime credit card operation.

<sup>25</sup> WaMu's Corporate Risk Oversight Group was located in ERM and had responsibility for WaMu's Internal Asset Review function, Credit Oversight function, and Quality Assurance and Compliance testing.

<sup>26</sup> Regulatory profiles were quarterly reports developed by OTS and provided quarterly financial ratios and narrative describing events at WaMu and the status of many of the CAMELS components.

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- **2003 Field Visit** - Examiners determined that increased risks related to organizational changes, less favorable market conditions, and volatility of earnings also impacted capital adequacy and required management intervention. Examiners expressed concerns about the spans of control and depth of direct experience among key individuals leading important WaMu functions. Examiners noted that, although the ratings given at the prior examination remained appropriate, some of the ratings were predicated on OTS's expectations of continued forward progress by WaMu.
  - **2005 Regulatory Profile** - OTS noted that organizational adjustments and management changes had failed to stabilize WaMu and stressed the need to have appropriate performance measures across all business lines.
  - **2006 Regulatory Profile** - Examiners continued to note WaMu's organizational and management instability.
  - **2007 Risk Assessment** - Examiners stated that management and Board oversight had been satisfactory for the past three examinations but expressed reservations about management's ability to correct persistent weaknesses in WaMu's home lending operation.
  - **2008 Risk Assessment** - Examiners stated that ERM was continuing to evolve but was experiencing turnover in key positions.

#### WaMu Did Not Correct Many Examiner-Identified Weaknesses

OTS examination reports directed that WaMu take corrective actions in response to examination findings. Nevertheless, WaMu management did not make lasting or complete improvements to its risk management programs and asset quality despite repeated mention of these areas by OTS. OTS guidance notes that governance is strong when the Board addresses and corrects problems early. That guidance also states that where governance is weak or nonexistent, problems remain uncorrected, possibly resulting in the association's failure.<sup>27</sup>

In an effort to determine the extent to which WaMu addressed OTS findings, we reviewed 545 OTS findings reported in 193 findings memoranda and WaMu's responses to ROEs for 2003 through 2007. WaMu tracked the status of corrective actions for findings memoranda in a tracking system called Enterprise Risk Issue Control System

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<sup>27</sup> OTS Examination Handbook, Section 310, page 310.1.

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(ERICs). Based on our review of eight ERICS reports and other documents, we were unable to readily determine whether a number of findings had been closed and resolved. As discussed later, after some effort, OTS was able to provide evidence that some of those findings had been closed.

Additionally, a number of findings memoranda were included as repeat findings, indicating the issue was identified during more than one examination cycle. For example, 18 percent of the criticisms between 2003 and 2006 were categorized as repeat findings. WaMu discontinued indicating in ERICS whether a finding was a repeat finding in 2006. Thus, the number of repeat findings could have been greater.

### **OTS Should Have Done More to Formally Track WaMu's Progress in Correcting Findings and Compel WaMu to Correct Deficiencies**

OTS largely relied on WaMu's ERICS system to track corrective actions. Given the size of WaMu and the number of findings, we concluded that OTS needed a more formal, independent system to track its findings. Further, although OTS had formal enforcement action authority to compel WaMu to correct deficiencies, OTS never took such action. OTS did impose two informal enforcement actions in 2008 -- a Board Resolution and an MOU -- but those measures lacked sufficient substance to require action on the part of WaMu and were too late to make a significant difference. Finally, OTS was not required to invoke PCA because WaMu remained well-capitalized until its closure.

### **OTS Largely Relied on WaMu to Track the Status of Findings Memoranda**

OTS largely relied on WaMu's ERICS system to track WaMu's progress in implementing corrective actions for the 545 OTS findings identified from 2003 to 2008.<sup>28</sup> OTS examiners told us that they had a process for reviewing WaMu's corrective actions that was independent of the finding status noted in ERICS. In this regard, OTS officials stated that during an examination, OTS divided the ERICS report among the OTS examiners based upon each examiner's area of responsibility. Each OTS examiner was responsible for determining whether ERICS properly reflected the status of findings for their area. The examiner then signed off on the respective ERICS report.

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<sup>28</sup>OTS also relied on WaMu to track the status of information technology and compliance issues.

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We reviewed eight ERICS status reports for the years 2003 through 2008 and found evidence of examiner sign-off for certain findings on only three of those reports. We provided OTS with information about 39 criticisms that appeared to be open in ERICS reports that we reviewed and asked OTS to provide evidence of each finding's status. OTS's response showed that about 41 percent (16) of the criticisms were issued during 2008 and remained unresolved as of WaMu's failure in September 2008. OTS also provided references to ROEs or other documents as evidence of closure for 21 percent (8) of the criticisms. OTS provided us with ERICS reports with handwritten OTS notes as evidence of closure for an additional 21 percent (8) of the criticisms. For the remaining findings (7), OTS either did not provide evidence as to the findings' status or stated that the findings had been replaced by new findings memoranda pertaining to a repeat finding area. While OTS was ultimately able to provide some additional information about the status of certain criticisms, doing so required considerable time and effort on OTS's part. We concluded that had OTS implemented its own independent system for tracking the status of findings memoranda and WaMu's corrective actions, OTS would have had better information to make decisions. It could also have better assessed WaMu management's efforts to take appropriate and timely corrective action in response to the repeat deficiencies identified by OTS's examiners.

#### OTS Did Not Use Its Formal Enforcement Power

OTS has a number of informal and formal enforcement tools to carry out its supervisory responsibilities. Generally, OTS policy provides that formal enforcement action should be taken when any institution is in material noncompliance with prior commitments to take corrective actions and for composite 3-rated institutions with weak management, where there is uncertainty as to whether management and the board have the ability or willingness to take appropriate corrective measures.<sup>29</sup>

We were told that OTS had a general sense of the status of WaMu's progress in addressing weaknesses, but OTS examiners said that tracking progress was difficult given the size and complexity of WaMu. Further, OTS examiners noted that WaMu would often replace business line managers when significant findings were noted within

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<sup>29</sup> OTS Regulatory Bulletin 37-23, July 18, 2008, pages 1 and 2. This bulletin rescinded OTS Regulatory Bulletin 32-28 dated June 11, 2003.

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the manager's group. WaMu would then ask OTS for time to allow the newly hired manager to implement plans to address weaknesses. Given the size of WaMu, the magnitude of the weaknesses identified, and the limited progress made by WaMu management in correcting those weaknesses, we believe that OTS should have elevated its supervisory response sooner, to include formal enforcement action, to compel WaMu to correct its weaknesses.

OTS Issued Two Informal Enforcement Actions in 2008, but They Lacked Sufficient Substance to Compel WaMu to Act

OTS asked WaMu to enter into two informal enforcement actions in 2008, a Board Resolution and an MOU. OTS sought the Board Resolution as a result of the interim downgrade of WaMu from a composite 2 to a composite 3 on February 27, 2008. The MOU was put into place as a consequence of OTS's composite 3 rating at the end of the OTS examination on June 30, 2008. Neither action was sufficient to compel WaMu to correct weaknesses.

WaMu's Regulatory Relations Officer drafted the Board Resolution and sent it to the OTS West Region Director on March 13, 2008. The Board Resolution endorsed undertaking strategic initiatives to improve asset quality, earnings, and liquidity and directed WaMu management to implement and report on those initiatives. The strategic initiatives were outlined by WaMu management in a four-page PowerPoint presentation to the Board that tied improvements to asset quality, liquidity, and earnings to either (1) the sale of WaMu or (2) raising \$3 billion to \$4 billion in capital. The initiatives addressed short-term liquidity issues but did not mention taking action to correct systemic problems with WaMu that were noted in prior MRBAs or findings memoranda.

The OTS West Region Director sent the Board Resolution to two members of OTS's regional management for their comments. Both OTS West regional management officials expressed concern with the Board Resolution because it did not require specific corrective actions. Further, those officials recognized WaMu's lack of follow-through on past promises to engage in corrective action and believed that OTS needed to take time to review management's strategic plans to ensure they addressed the critical weaknesses linked to WaMu's composite downgrade. Despite the concerns of these regional management officials, OTS's West Region Director approved WaMu's version of the Board Resolution, which the Board passed on March 17, 2008.

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In June 2008, the Director of OTS notified WaMu's chief executive officer (CEO) that OTS intended to issue an MOU as a result of WaMu's composite 3 rating that was to be reported for the examination ending June 30, 2008. Emails between the OTS West Region Director and WaMu's CEO revealed that WaMu management exerted pressure on the OTS to delay the issuance of the MOU. In those emails, the CEO continually emphasized WaMu's commitment to correct problems, as well as corrective actions already taken in response to the requirements in the Board Resolution. The OTS West Region Director noted in a June 2008 email to OTS headquarters senior management that he had told the WaMu CEO that, as a matter of policy, OTS believed that 3-rated institutions warranted informal supervisory action as well as consideration of formal action, in particular because of repeat examination findings that WaMu had not corrected.

OTS drafted the MOU and provided a copy to FDIC for comment. FDIC proposed a number of changes to the MOU, including a provision that WaMu raise an additional \$5 billion in capital. OTS did not want to include the \$5 billion capital increase requirement because OTS believed that WaMu's capital was sufficient following a \$2 billion contribution from WaMu's holding company in July 2008. Further, OTS was concerned that FDIC model used to determine the \$5 billion amount was premised on faulty assumptions. FDIC and OTS compromised and included a capital contingency plan requirement in the MOU rather than a specific amount. OTS sent WaMu management a copy of the MOU on August 1, 2008, that required

- correcting all findings noted in the June 30, 2008, examination by the dates specified;
- submitting a contingency capital plan within 90 days and maintaining certain capital ratios;
- submitting a 3-year Business Plan to OTS's within 30 days;
- engaging a consultant to review WaMu's risk management structure, underwriting, management, and board oversight; and
- certifying compliance with the MOU requirements on a quarterly basis.

On August 4, 2008, WaMu reviewed a draft of the MOU and proposed that the requirement for the consultant review of Board oversight be removed. OTS accepted WaMu's change notwithstanding the OTS examiners' findings over many years that the Board's performance

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was weak. By August 25, 2008, WaMu attorneys and OTS had informally reached agreement on the terms of the MOU and were waiting for final execution of the MOU. However, it was not until September 7, 2008 that OTS signed the MOU. A week later, WaMu was placed into receivership. In the end, the MOU was ineffective action given its timing.

We believe that OTS should have taken formal enforcement action against WaMu sooner based on WaMu management's persistent delays in correcting weaknesses. We recognize that it is speculative to conclude that earlier and more forceful enforcement action would have prevented WaMu's failure. Nevertheless, by using more forceful action with WaMu in 2006 or 2007, OTS may have compelled WaMu's Board and management to take more aggressive steps to correct weaknesses and stem the losses that eventually occurred because of its risky loan products.

#### Prompt Corrective Action

PCA provides OTS with supervisory remedies aimed to minimize losses to the DIF. PCA requires that certain operating restrictions take effect when a savings association's capital levels fall below well-capitalized. In the case of WaMu, OTS did not take, and was not required to take, PCA action because WaMu remained well-capitalized through September 25, 2008, when it was placed in receivership. As discussed above, in September 2008, WaMu depositors withdrew significant funds after the news of other high-profile financial institution failures and rumors of WaMu's problems. At the same time, WaMu was unable to raise capital to keep pace with depositor withdrawals, prompting OTS to close the institution. That said, it was only a matter of time before losses associated with WaMu's high-risk lending practices would have depleted its capital below regulatory requirements.

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## SECTION III

# FDIC Monitoring of WaMu and Insurance Assessments



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## FDIC Monitoring of WaMu and Insurance Assessments

WaMu was one of the eight largest institutions insured by FDIC. FDIC determined that its estimated cost to liquidate WaMu in 2008 would have been approximately \$41.5 billion<sup>30</sup> – a sum that would have depleted the entire balance of the DIF at the time. Ultimately, FDIC was able to resolve WaMu with no loss to the DIF.

As insurer, FDIC is responsible for monitoring an institution's risk to the DIF. FDIC had authority to perform its own examination of WaMu and impose enforcement action to protect the DIF, provided statutory and regulatory procedures were followed. Our evaluation found that FDIC followed its internal policies and completed its required monitoring. FDIC monitoring noted an increase in risk at WaMu in late 2004 that increased significantly in 2007 and into 2008. Despite those noted risks, WaMu remained in the highest-rated (lowest-risk) deposit insurance risk category from January 2003 until December 2007 and in the second highest-rated deposit insurance category from March to June 2008. FDIC monitoring did not influence WaMu's deposit insurance risk category because the risk category was based on WaMu's consistent CAMELS composite 2 rating and WaMu's regulatory capital level.

WaMu was not assessed any deposit insurance premiums from January 2003 to December 2006 because FDIC was prohibited from charging premiums to any institution in the highest-rated insurance risk category during that period. FDIC did not charge premiums during this time period because the DIF had reached a statutory limit that prohibited FDIC from charging institutions in the highest-rated insurance category. From January 2007 to June 2008, WaMu paid \$51 million or 24 percent of the \$216 million in insurance premiums assessed by FDIC. WaMu was not required to pay 76 percent of the premium assessments because of a one-time credit included in the Federal Deposit Insurance Reform Act of 2005.

FDIC has a number of procedural and regulatory tools at its disposal to address a depository institution's increasing risk. FDIC used its back-up examination authority to bring additional FDIC examiners to WaMu to assess risk but met resistance from OTS. FDIC made use of the tools available to challenge WaMu's CAMELS composite rating in 2008 but again met resistance from OTS. FDIC did not invoke its

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<sup>30</sup> FDIC expressed the risk of loss to the DIF as a range from \$25.3 billion to \$57.8 billion, with a midpoint of \$41.5 billion.

back-up enforcement powers against WaMu because of procedural hurdles required to invoke such action and chose not to make a small adjustment to WaMu's insurance premium in 3Q 2007.

### **Risks Noted in FDIC Monitoring Reports Were Not Reflected in WaMu's Deposit Insurance Premium Payments**

In its capacity as insurer, FDIC monitors and assesses risks at all insured financial institutions and determines each institution's insurance risk category<sup>31</sup> and premium rate. As shown in Table 11, until January 2007, an institution's risk category (1A through 3C) was derived from the institution's CAMELS composite rating and regulatory capital level. FDIC regulations assign each risk category a specific insurance assessment rate (in basis points) that is used to compute an institution's insurance premium.<sup>32</sup>

**Table 11: Risk-Based Assessment Matrix Effective Until January 2007**

Regulatory Capital	CAMELS Rating		
	A (CAMELS 1 & 2)	B (CAMELS 3)	C (CAMELS 4 & 5)
<b>1. Well-Capitalized</b>	<b>1A</b> (0 bps)	<b>1B</b> (3 bps)	<b>1C</b> (17 bps)
<b>2. Adequately Capitalized</b>	<b>2A</b> (3 bps)	<b>2B</b> (10 bps)	<b>2C</b> (24 bps)
<b>3. Undercapitalized</b>	<b>3A</b> (10 bps)	<b>3B</b> (24 bps)	<b>3C</b> (27 bps)

Source: 12 CFR Part 327, Final Rule Supplemental Information

FDIC has a number of tools it uses to monitor risk.<sup>33</sup> 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. The FDIC Large Insured Depository Institution (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

<sup>31</sup> Prior to January 2007, the term "insurance risk classification" was used instead of "insurance risk category." Since both terms refer to the risk rating derived from CAMELS and regulatory capital, we are using the term "insurance risk category" to avoid confusion between the pre- and post-2007 insurance periods.

<sup>32</sup> FDIC premiums are calculated by multiplying the assessment rate basis points (bps) by the institution's deposit base.

<sup>33</sup> See Appendix 3 for a more detailed explanation of FDIC monitoring tools.

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such as product mix, strategic focus across markets, overall management expertise, and franchise value. 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. WaMu was part of the LIDI program and had a dedicated examiner assigned for the entire period covered by this evaluation from 2003-2008.

### FDIC Monitoring Noted an Increase in Risk at WaMu

FDIC completed its required monitoring of WaMu during the entire period from 2003 to 2008. 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 as shown below.

**Table 12: FDIC LIDI Ratings Descriptions**

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

Source: FDIC Case Managers Manual

From 2003 to 1Q 2004, FDIC rated WaMu a B on the LIDI scale meaning FDIC believed WaMu presented an ordinary risk to the DIF. In 2Q 2004, the LIDI rating for WaMu dropped from B to B/C meaning that the risk WaMu posed to the fund increased from an ordinary level to a somewhat more than ordinary level of risk. The quarterly report indicated concern with WaMu's projected flat earnings and pressure to remove \$1 billion from its cost structure over the next four quarters. Further, 2004 was seen as a critical year for WaMu management to demonstrate it could execute its plans.

FDIC maintained the B/C rating for WaMu through 2Q 2007. Although the intervening quarterly reports do not adjust the LIDI rating, they note increased risk associated with WaMu's pursuit of a high-risk lending strategy. Specifically, in 2Q 2005, the report states, "[a]sset

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quality is satisfactory ... , however, the overall risk profile is higher than suggested by the balance sheet or traditional performance indicators. Management's program to increase subprime, home equity, and income property loan portfolios combined with a geographic concentration risk, new product risk, and other factors embedded in the single-family residential (SFR) loan portfolio aggregate to elevate the overall risk profile of the loan portfolio ... These factors combined with ongoing underwriting deficiencies suggest that the portfolio may experience stress during adverse economic periods." FDIC examiners told us that the risk was noted, but concern was not elevated because the loans were performing well during that period. Also, a portion of the loans were sold in the secondary market and therefore not held on WaMu's books. There was concern about what could happen in a few years, but FDIC examiners said there was no way to predict a precipitous collapse in the secondary market at that time. Further, FDIC examiners noted that by that point, WaMu's management of the Mortgage Servicing Asset (MSA) had improved, with high-risk lending taking its place as a concern.

In 2Q 2007, FDIC again dropped WaMu's LIDI rating from a B/C to a C, meaning that WaMu posed more than an ordinary risk to the DIF. The quarterly report notes, "SFR credit risk remains the primary risk. The bank has geographic concentrations, moderate exposure to subprime assets and significant exposure to mortgage products with potential for payment shock. The risk trend is increasing because of the late stage housing market and the meltdown in the subprime and private mortgage markets."

FDIC dropped the WaMu LIDI rating from a C to D in 1Q 2008 indicating FDIC had a high level of concern regarding the ultimate risk of loss to the DIF. The quarterly report notes significant deterioration at WaMu, "[a] D rating is now warranted and the outlook is negative as management has been unable to stem asset quality trends or get a firm handle on remaining loan losses and the timing of such loan losses. Management expects losses in residential portfolio to be \$12 to \$19B. The bank's culture emphasized home price appreciation and the ability to perpetually refinance, including the ability to sell nonperforming assets. The bank's underwriting standards were therefore lax as management originated loans under a securitization model to transfer risk to the market. However, when the market collapsed in July 2007 for private label and subprime loans, the bank's business model failed. The bank is now stuck holding large amounts of poorly underwritten mortgage loans in a prolonged downturn in the real estate market."

In 2Q 2008, FDIC ultimately dropped WaMu's LIDI rating from a D to the lowest possible rating of E meaning that FDIC had serious concerns regarding WaMu's ultimate risk to the DIF.

**FDIC Monitoring Did Not Impact FDIC's Rating of WaMu's Risk to the DIF**

In determining an institution's deposit insurance premium, FDIC first assigns an institution a risk category. FDIC's LIDI analysis described above did not factor into FDIC's insurance risk category rating of WaMu. Instead, the deposit insurance regulations require use of an institution's composite CAMELS rating and regulatory capital level to assign a deposit insurance risk category.

Table 13 below shows a comparison of FDIC LIDI rating, CAMELS composite rating, regulatory capital level, and deposit insurance risk category for WaMu from January 2003 through June 2008.

**Table 13: WaMu Regulatory Ratings 2003 through 2008**

<b>Insurance Assessment Period</b>	<b>LIDI Risk</b>	<b>CAMELS Composite Rating</b>	<b>Regulatory Capital Level</b>	<b>Insurance Risk Category</b>
January 2003	B	2	Well-capitalized	1A
July 2003	B	2	Well-capitalized	1A
January 2004	B	2	Well-capitalized	1A
July 2004	B/C	2	Well-capitalized	1A
January 2005	B/C	2	Well-capitalized	1A
July 2005	B/C	2	Well-capitalized	1A
January 2006	B/C	2	Well-capitalized	1A
July 2006	B/C	2	Well-capitalized	1A
March 2007	B/C	2	Well-capitalized	R-I
June 2007	C	2	Well-capitalized	R-I
September 2007	C	2	Well-capitalized	R-I
December 2007	C	2	Well-capitalized	R-I
March 2008	D	3	Well-capitalized	R-II
June 2008	E	3	Well-capitalized	R-II

Source: OTS and FDIC examination and insurance pricing information.

From January 2003 through July 2006, WaMu's insurance risk category was 1A, meaning WaMu was ranked in the highest-rated of nine possible deposit insurance risk categories and therefore paid the lowest premium rate. WaMu maintained that 1A insurance risk rating despite the increase in LIDI risk shown in January 2005 because WaMu's CAMELS composite rating and regulatory capital level were unchanged.

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In January 2007, FDIC changed the deposit insurance risk categories from nine levels to four levels: R-I to R-IV. From March 2007 to December 2007, WaMu's insurance risk category was R-I, meaning WaMu was again rated in the highest-rated deposit insurance risk category and therefore paid among the lowest premium rates. WaMu maintained that insurance risk category despite increasing concern noted in the deteriorating LIDI rating because WaMu's CAMELS composite rating remained a 2 and its regulatory capital level was unchanged.

On February 27, 2008, WaMu's insurance risk category dropped one level to R-II – the second best of four possible insurance risk rankings because WaMu's CAMELS composite ranking decreased from a 2 to a 3. WaMu maintained the R-II risk rating into June 2008. WaMu's insurance risk ranking dropped only one level notwithstanding FDIC's LIDI ranking decreasing to the lowest possible level and indicating serious concern on the part of FDIC as to WaMu's risk to the fund.

#### FDIC Was Precluded from Charging Premiums for Institutions with 1A Risk Ratings

As shown in Table 14, FDIC did not charge WaMu any deposit insurance premiums from 2003 to 2006. In fact, FDIC did not charge deposit insurance premiums for any institution in the 1A insurance category. During this period, 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.<sup>34</sup> 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.”<sup>35</sup> 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 strategy, FDIC could not charge WaMu any deposit insurance premiums because WaMu's composite 2 rating and capital level placed it in the 1A risk category.

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<sup>34</sup> The ratio is known as the Designated Reserve Ratio.

<sup>35</sup> 12 U.S.C. 1817(b)(2)(A)(v).

**Table 14: WaMu Deposit Insurance Assessments 2003 - 2006**

Assessment Period	LIDI Risk	Insurance Risk	FDIC Assessments	WaMu Payments
January 2003	B	1A	\$0	\$0
July 2003	B	1A	\$0	\$0
January 2004	B	1A	\$0	\$0
July 2004	B/C	1A	\$0	\$0
January 2005	B/C	1A	\$0	\$0
July 2005	B/C	1A	\$0	\$0
January 2006	B/C	1A	\$0	\$0
July 2006	B/C	1A	\$0	\$0

Source: FDIC Assessment Reports

WaMu Did Not Pay Its Full Premium for 2007 and 2008 Because of a Congressionally-Mandated One-Time Credit

FDIC regulations in effect beginning in 2007 continued to set assessment rates based on an institution's risk category. One difference from the prior assessment regulations was that institutions in the R-I risk category could be assessed within a range of rates versus a specific assigned rate. Until changes were made in the second quarter of 2009, assignment within the R-I rate range for large institutions such as WaMu took into account CAMELS ratings and the institution's long-term debt issuer ratings from Moody's, Fitch, and Standard & Poor's.

**Table 15: New Risk Categories Effective January 2007**

Capital Group	CAMELS Rating		
	A CAMELS 1 & 2	B CAMELS 3	C CAMELS 4 & 5
<b>1. Well-Capitalized</b>	R-I 5 to 7 bps	R-II 10 bps	R-III 28 bps
<b>2. Adequately Capitalized</b>			
<b>3. Undercapitalized</b>		R-III 28 bps	R-IV 43 bps

Source: 2007 deposit insurance regulations.

As shown in Table 16, FDIC assessed WaMu \$215 million in insurance premiums from March 2007 through June 2008 based on 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).

**Table 16: WaMu Deposit Insurance Assessments 2007-2008**

Assessment Period	LIDI	Insurance Risk	FDIC Assessments	WaMu Payments
March 2007	B/C	R-I	\$33,416,173	\$0
June 2007	C	R-I	\$31,461,565	\$0
September 2007	C	R-I	\$30,966,418	\$0
December 2007	C	R-I	\$28,905,951	\$0
March 2008	D	R-II	\$39,178,352	\$9,113,681
June 2008	E	R-II	\$51,742,730	\$42,205,190
<b>TOTAL</b>			\$215,671,191	\$51,318,871

Source: FDIC Assessment Reports

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 2008 because of WaMu's composite 3 CAMELS rating. WaMu used the \$9.1 million of its remaining credit in June 2008. Despite the limitations, WaMu was able to use the entire \$164.4 million credit to offset premiums.

### **FDIC Can Take Action When an Institution's Risk Increases and FDIC Made Use of Some of Its Available Tools**

FDIC has a number of procedural and regulatory tools available to take action when an institution's risk increases. In the case of WaMu, FDIC had the ability to request back-up examination authority to obtain additional information from WaMu to further understand risk; challenge OTS's composite rating of WaMu; encourage OTS to take enforcement action against WaMu or take independent enforcement action against WaMu; and, beginning in 2007, make certain small adjustments to WaMu's insurance rate.

### **FDIC Invoked Back-up Examination Authority in Each Year 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



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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 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.

According to the terms of the Coordination of Expanded Supervisory Information Sharing and Special Examinations (January 29, 2002)<sup>36</sup> (the interagency agreement) governing information sharing and back-up examinations, FDIC was required to submit a written request to the OTS and show that WaMu posed “heightened risk” to the deposit insurance fund (meaning the institution had a CAMELS composite rating of 3, 4, or 5 or was undercapitalized), or that WaMu exhibited material deteriorating conditions or other adverse developments that may have resulted in the institution being troubled in the near-term. The heightened risk test has clear objective measures, but the test for material deteriorating conditions or adverse developments is subjective. Additionally, even when back-up examination authority is granted, FDIC does not receive direct access to an institution’s data. The principles governing the interagency agreement require that FDIC rely to the fullest extent possible on the primary regulator’s work in order to reduce the burden on the institution. The primary regulator determines whether FDIC’s request meets the requisite level of risk to grant back-up examination authority.

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. The OTS granted FDIC’s 2005 back-up examination request but denied FDIC the ability to review the subprime operations of WaMu’s affiliate, LBMC, because LBMC was a subsidiary of WaMu’s parent corporation and not part of WaMu.

In 2006, FDIC again requested back-up examination authority, and OTS initially denied the FDIC request. 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

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<sup>36</sup> The interagency agreement is based upon 12 U.S.C. § 1820(b)(3) which provides for special examination authority for any insured depository institution.

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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. Emails between OTS Washington and OTS West Region state, “The arrangement we had discussed is that FDIC would work through staff of the primary supervisor to obtain key information, and that it would be in rare situations that they would join our examinations as long as these systemically important institutions remained 1 or 2 rated. This request sounds like a departure from that arrangement.” The denial letter states, “[w]e are not aware of any disagreement the FDIC has with our examination findings or any expressed concerns regarding our examination activities. Regarding the specific areas of FDIC interest, the scope of our upcoming examination work includes reviews of economic capital and higher risk lending and we plan to share our examination findings with the FDIC as we have in the past. Based on our agreed upon examination conclusions, the lack of any known FDIC concerns regarding our past or planned examination activities, and our continued commitment to share all appropriate information, the FDIC has not shown the regulatory need to participate in the upcoming Washington Mutual Examination.”

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

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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.”

OTS granted FDIC’s 2007 back-up examination request but did not allow FDIC examiners access to WaMu residential loan files. Emails indicate 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.

Finally, in granting 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.

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 Did Not Challenge WaMu’s Composite Rating Until 2008 and Encountered Resistance from OTS to Downgrade the Rating

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

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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.<sup>37</sup> 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 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

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<sup>37</sup> FDIC Case Managers Manual, Section 3.4 (VI).

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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 FHLB; 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 and OTS 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 10 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, 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.<sup>38</sup> 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

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<sup>38</sup> Statements from former FDIC Chairman William Isaac, The Wall Street Journal, August 19, 2008 describing the roles of primary regulator and insurer.

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change had no impact on WaMu's deposit insurance premium prior to failure.

#### FDIC Elected Not to Take Enforcement Action Against WaMu in 2008 Because of Procedural Hurdles

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.<sup>39</sup> 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 Primary Federal regulator."<sup>40</sup>

In July 2008, FDIC believed WaMu could be rated a composite 4 and that WaMu needed \$5 billion in capital to withstand potential future losses. At that time, OTS had an 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.

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<sup>39</sup> 12 U.S.C. §1818(t).

<sup>40</sup> FDIC Case Manager Manual, Enforcement Actions, page 8-2.

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FDIC Had an Opportunity to Make a Minor Adjustment to WaMu's Insurance Premium in 3Q 2007 But Chose Not to Do So

The 2007 deposit insurance regulations provide FDIC an opportunity to make small adjustments to insurance premiums for institutions in the R-I category.<sup>41</sup> In simple terms, an adjustment may be warranted when FDIC identifies inconsistencies between an institution's risk ranking and the ranking of similar institutions. When such inconsistencies are noted, the institution is placed on a priority list and FDIC personnel, in consultation with the primary federal regulator, review the facts and circumstances and determine whether to make an adjustment.

WaMu was placed on the priority list in 3Q 2007, but a decision was made by FDIC that WaMu's insurance premium should not be adjusted. The report noting the decision states, "there is inadequate support for a pricing adjustment at this time. While asset quality and market factors are indicating higher risk levels ... most capital and [year-to-date] earnings measures remain in line. Further, recent agency downgrades will raise the assessment rate during the fourth quarter to a level more consistent with the institutions' [sic] apparent risk profile." An FDIC official explained that the decision was somewhat procedural in nature. Effectively, because FDIC reviewed the third quarter 2007 assessment in the fourth quarter, FDIC knew the rating agencies had downgraded WaMu and also knew that those downgrades would automatically increase WaMu's premium. Given that FDIC must provide a one quarter advanced notice of any FDIC ratings adjustment, the FDIC official said there was no point in FDIC making an adjustment when an adjustment would take place automatically because of the rating agency downgrades.

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<sup>41</sup> 12 C.F.R. 327.

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**SECTION IV**  
**Conclusions and Recommendations**



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## Conclusions and Recommendations

### **OTS – Conclusions**

The Treasury Office of Inspector General has made a number of recommendations to OTS as a result of completed material loss reviews of failed thrifts during the current economic crisis. These recommendations pertain to taking more timely formal enforcement action when circumstances warrant, ensuring that high CAMELS ratings are properly supported, reminding examiners of the risks associated with rapid growth and high-risk concentrations, ensuring thrifts have sound internal risk management systems, ensuring repeat conditions are reviewed and corrected, and requiring thrifts to hold adequate capital. OTS has taken or plans to take action in response to each of these recommendations. Additionally, OTS has established a large bank unit to oversee regional supervision of institutions over \$10 billion. Based on our review of the WaMu failure, we reiterate the importance of the prior recommendations.

With respect to coordination with FDIC, current OTS policy states that FDIC will perform all savings association examination activities on a joint basis unless compelling reasons dictate otherwise. For joint examinations, FDIC and OTS are to jointly scope the examination at the EIC level or at the respective regional office level. In this regard, disagreements over scope are to default to the broader alternative.<sup>42</sup> While that did not always happen in the case of WaMu, we believe OTS's underlying policy is not at issue.

### **OTS – Recommendation**

As a result of this review, we are making one new recommendation to OTS. Specifically, the Director of OTS should:

1. Ensure that the OTS internal report of examination system is used to formally track the status of examiner recommendations and related thrift corrective actions.

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<sup>42</sup> OTS Examination Handbook, Section 060.

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## **OTS Management Response**

OTS concurred with our recommendation. In 2007, OTS implemented an internal system to track matters requiring board attention and other matters identified during the examination that require follow-up. OTS stated that, for a variety of reasons, the system was not used for WaMu but is used for all other thrifts and is actively used by OTS staff and monitored by senior management. The OTS response is included in Appendix 6.

## **FDIC – Conclusions**

WaMu is our second review of FDIC's monitoring and insurance assessment for large non-FDIC supervised institutions. We issued an evaluation report on FDIC's monitoring of IndyMac on August 27, 2009.<sup>43</sup> 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 this report and our report on IndyMac, OTS's consistent assignment of a CAMELS composite 2 ratings for those institutions until their near failure shows the unreliability of CAMELS ratings as predictors of risk to the DIF.

The interagency agreement was intended to balance the needs of 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

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<sup>43</sup> FDIC OIG Report, The FDIC's Role in the Monitoring of IndyMac Bank, EVAL-09-006, August 2009.

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possible, on the work of the primary regulator. In practical terms, the interagency agreement appeared to drive a wedge between 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.

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.

We note that the FDIC Board took steps, effective April 1, 2009, to include factors other than CAMELS and regulatory capital in the computation of an institution's deposit insurance premium but maintained the use of CAMELS and regulatory capital to determine an institution's deposit insurance risk category. Further, FDIC is proposing to include risk factors such as incentive compensation packages to adjust deposit insurance premiums.

On February 26, 2010, the FDIC Chairman announced FDIC's 2010 Performance Goals (Goals) and a number of the new FDIC initiatives address the issues found in our evaluation. The Goals include enhancing FDIC's oversight of large/complex insured institutions in order to assess the risk posed by each institution to the DIF by: (1)

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developing memoranda of understanding by April 30, 2010, with each primary federal regulator for systemically important institutions that clearly define the roles of FDIC personnel on-site and ensure access by FDIC employees to all information requests and (2) developing and implementing by December 31, 2010 a new deposit insurance pricing system for large banks that better differentiates risks and no longer relies on external ratings.

### **FDIC – Recommendations**

With this in mind, we make the following recommendation to the FDIC Chairman in consultation with the FDIC Board of Directors:

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.

While certain procedures are needed to govern access to an institution's information, FDIC must be able to make its own independent assessment of risk to the DIF without a requirement to prove a requisite level of risk and without unreasonable reliance on the work of the primary regulator. Large depository institutions pose significant risk to the DIF, and FDIC should not be hindered in obtaining information in order to gauge risk. Although FDIC is taking steps to clarify information access for the eight (soon to be ten) systemically important institutions, the interagency agreement needs to be revised to address all large depository institutions because risky institutions such as IndyMac were not considered to be one of the eight systemically important institutions, yet losses to the DIF were substantial.

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.

The FDIC's Division of Insurance and Research is uniquely positioned to evaluate an institution's risk to the DIF by looking not only at supervisory information, but also considering other institution-specific and macro-economic factors in order to determine an institution's likely risk to the DIF. Current regulations base an institution's

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insurance risk category solely on the institution's CAMELS rating and capital level, but allow for the consideration of other factors – unsecured debt, secured liabilities and brokered deposits – in computing the assessment rate. There are also potential changes to the regulations that would include incentive compensation as a factor influencing an institution's risk to the DIF. Those changes are all positive steps in considering an institution's risk. We believe, however, that the bank failures of 2008 and 2009 show that more factors were indicative of an institution's risk to the fund than those currently taken into consideration. Factors such as an institution's lending concentrations, business models, loan types, underwriting, and enterprise risk management systems were strong indicators of risk. Those factors are considered in CAMELS ratings, but as shown in WaMu, IndyMac, and a number of other institutions, CAMELS ratings did not look at future risk (as would be the case with insurance) but only measured risk based on the financial performance of the institution at a point in time. CAMELS ratings in those instances were favorable until loan losses occurred. Therefore, the risk was factored into deposit insurance assessments too late to adjust and collect insurance premiums.

### **FDIC Management Response**

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 risks at large depository institutions. 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. FDIC response is included in Appendix 6.

### **OIG Comment**

OTS and FDIC planned actions meet the intent of our recommendations. Both FDIC recommendations will remain open until the FDIC OIG determines that the agreed-upon corrective actions have been implemented.

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We would like to extend our appreciation to OTS and FDIC for the cooperation and courtesies extended to our staff during the evaluation. Major contributors to this report are listed in Appendix 7.

Eric M. Thorson  
Inspector General  
Department of the Treasury

Jon T. Rymer  
Inspector General  
Federal Deposit Insurance Corporation

## Objectives

This report presents the results of our review of the failure of Washington Mutual Bank (WaMu), Seattle, Washington, the Office of Thrift Supervision's (OTS) supervision of the institution, and the Federal Deposit Insurance Corporation's (FDIC) monitoring and insurance assessments for WaMu. Our objectives were to: (1) determine 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 supervision of the institution; and (4) assess FDIC's resolution process for WaMu to determine whether those processes complied with applicable laws, regulations, policies, and procedures. This report covers objectives 1, 2, and 3 above. We intend to report on objective 4, the assessment of the resolution process, at a later date.

Section 38(k) of the Federal Deposit Insurance Act, requires the cognizant Inspector General to conduct a material loss review (MLR) of the causes of the failure and primary federal regulatory supervision when the failure causes a loss of \$25 million to the DIF or 2 percent of an institution's total assets at the time the FDIC was appointed receiver. Because FDIC resolved WaMu without incurring a material loss to the DIF, an MLR is not statutorily required. However, given WaMu's size, the circumstances leading up to the FDIC-facilitated transaction, and non-DIF losses, such as the loss of shareholder value, the Inspectors General of FDIC and the Department of the Treasury believed that an evaluation of OTS and FDIC actions was warranted in that it could provide some important information and observations as the Administration and the Congress consider regulatory reform.

## Scope and Methodology

To accomplish our objectives, we conducted our fieldwork from March 2009 through November 2009 at OTS headquarters in Washington, DC, and one of its regional offices in Daly City, California, and at FDIC headquarters in Washington, DC, FDIC regional office in San Francisco, California, and a field office in Seattle, Washington. We reviewed supervisory files and interviewed key officials involved in the regulatory, supervisory, enforcement, and deposit insurance matters.

To assess the adequacy of OTS's supervision of WaMu, we determined (1) when OTS first identified safety and soundness

problems at the thrift, (2) the gravity of the problems, and (3) OTS's supervisory response to get the thrift to correct the problems. We also determined whether OTS (1) might have discovered problems earlier; (2) identified and reported all the problems; and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we did the following:

- We reviewed OTS supervisory files and records for WaMu from 2003 through 2008. We analyzed examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OTS used to assess the thrift's condition, and the regulatory action used by OTS to compel thrift management to address any deficient conditions.
- We interviewed and discussed various aspects of the supervision of WaMu with OTS management officials and examiners to obtain their perspective on the thrift's condition and the scope of the examinations. Interviews included discussions with former OTS officials.

To assess FDIC's monitoring and insurance assessments for WaMu, we determined (1) when FDIC monitoring indicated risk at WaMu, (2) the nature of the identified risk and whether FDIC-identified risk corresponded with OTS risk assessments, (3) how FDIC's risk monitoring affected WaMu's deposit insurance premiums, and (4) whether FDIC used its regulatory tools. We also assessed the relationship between FDIC and OTS.

- We reviewed and analyzed FDIC monitoring reports and insurance ratings information for 2003 through 2008, including information contained in the FDIC's ViSION system as well as files maintained by examiners in the FDIC San Francisco Regional Office and Seattle Field Office.
- We interviewed FDIC regional and Washington officials who monitored WaMu for federal deposit insurance purposes.
- We reviewed and analyzed deposit insurance rules and regulations and interviewed DIR personnel responsible for insurance assessments.

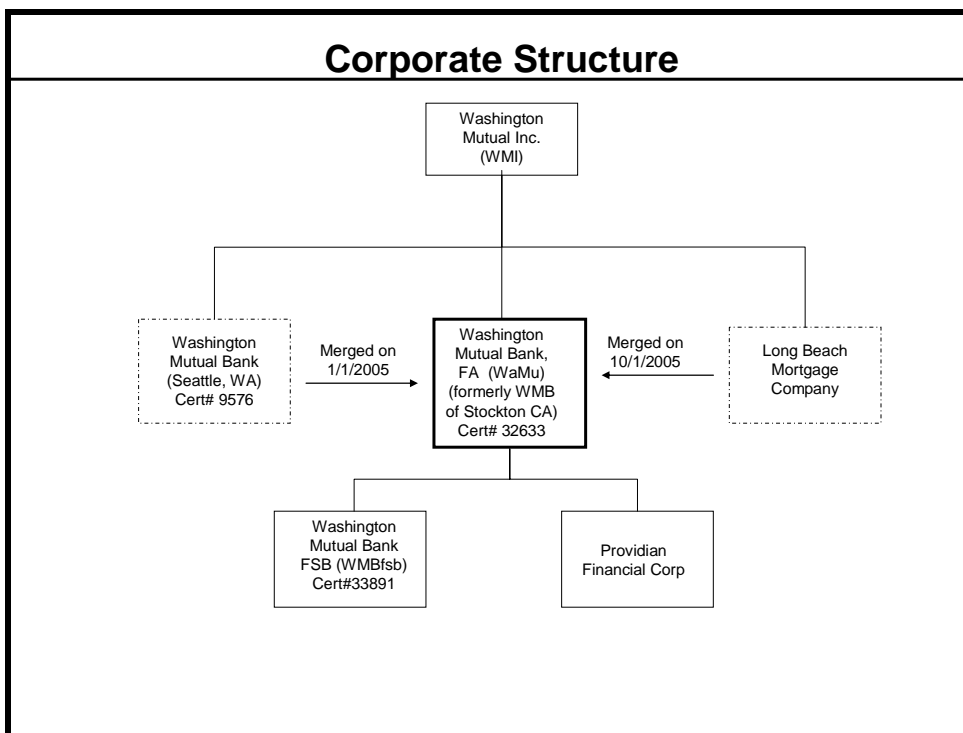


- We reviewed and analyzed OTS and FDIC correspondence in order to understand the working relationship between the two regulators.

We conducted our evaluation in accordance with the *Quality Standards for Inspections*.

## Washington Mutual Bank, History

Washington Mutual Bank (WaMu) was a federally-chartered savings association established in 1889 and FDIC-insured since January 1, 1934. WaMu was wholly owned by Washington Mutual Inc., (WMI) a non-diversified, multiple savings and loan holding company that was regulated as a unitary holding company. The chart below shows the primary WMI subsidiaries.



WaMu grew rapidly through acquisitions during the period 1991-2006, acquiring 12 institutions with assets totaling \$197.8 billion. At the time of its failure, WaMu operated 2,300 branches in 15 states, with total assets of \$307 billion.

Operational problems arose from management's failure to adequately integrate previous acquisitions, which became an ongoing concern to regulators and increased WaMu's risk profile. In 2003, WaMu announced a major restructuring to reorganize itself around its retail and commercial customers. This essentially entailed reducing its three business groups to two, the Consumer Group and the Commercial Group.

During the second half of 2004, WMI merged its subsidiary, Washington Mutual Bank, Seattle, into WaMu effective January 1, 2005, consolidating all of WMI's insured depository institutions under WaMu. Washington Mutual Bank, Seattle's primary regulators were the State of Washington and FDIC, but the merger transferred regulatory oversight to OTS, thereby eliminating examinations by the State of Washington and reducing FDIC participation on safety and soundness exams. During this period, WaMu rapidly expanded its retail franchise through an aggressive branching strategy, with 200 new branches added per year between 2003 and 2005.

On June 6, 2005, WaMu altered its organic approach with the announcement of its planned acquisition of Provident Financial Corp. The acquisition was consummated during the third quarter of 2005, and valued at \$6.2 billion. The acquisition of Provident on October 1, 2005, created a fourth business line, subprime credit cards. In 2006, the specialty mortgage finance company, Long Beach Mortgage, was moved out of WMI and merged within WaMu's Home Loans Group.

During late 2006 and early 2007, as the credit environment started to deteriorate, management began tightening credit standards with respect to credit card and subprime lending. Total assets at year-end 2006 of \$345.6 billion were nearly unchanged from \$330.7 billion at year-end 2005. In the first half of 2007, management shrank the balance sheet by selling certain lower-yielding loans. Total assets shrank to \$311.1 billion by June 30, 2007. In July 2007, given the disruption of the secondary mortgage market, management cut back on loans originated for sale and began transferring held-for-sale loans to the held-for-investment portfolio. Most of these loans were transferred at a mark-to-market loss. The lack of loan sale activity along with the transfer of loans into the held-for-investment portfolio resulted in total assets increasing to \$328.8 billion at September 30, 2007. At December 31, 2007, total assets had decreased slightly to \$325.8 billion.

During the examination which began on September 10, 2007, OTS downgraded WaMu's composite rating to "3" based on net losses and negative asset quality trends. In response to the supervisory ratings downgrade letter from the OTS Regional Director on February 27, 2008, the Board resolved on March 27, 2008, to undertake strategic initiatives to improve weaknesses noted in the letter, including weaknesses related to asset quality, earnings, and liquidity by either selling WaMu or obtaining additional capital. WMI was able to obtain a \$7 billion capital injection from a private equity group, \$5 billion of

which was down-streamed to WaMu. However, WaMu's "3" composite rating was confirmed at the completion of the OTS examination on June 30, 2008. OTS entered into MOUs with both WaMu and WMI, which became effective concurrently with a change in Chief Executive Officer (CEO) on September 7, 2008.

After September 15, 2008, WaMu experienced deposit withdrawals exceeding \$16 billion, and WaMu's capacity with the Federal Home Loan Bank and Federal Reserve Discount Window borrowing lines was curtailed significantly. WaMu hired Goldman Sachs to conduct marketing activities on its behalf, but following due diligence, no bids were received. On September 18, 2008, FDIC and OTS separately issued WaMu letters downgrading its rating to a composite "4."

On September 25, 2008, OTS closed WaMu and appointed FDIC as receiver. WaMu was immediately merged with JPMorgan Chase & Co and subsequently operated as part of JPMorgan Chase Bank, National Association in Columbus, Ohio. At the time of closing, WaMu had total assets of \$307 billion, with retail deposits of \$134.7 billion.

## OTS Supervisory Process for WaMu

OTS followed a supervisory process at WaMu that included an annual risk assessment, supervisory plans, targeted examination work programs, detailed findings memoranda issued to WaMu management that categorized the severity of issues, and annual ROEs. Table 17 presents an illustration of OTS's supervisory process for WaMu.

**Table 17: OTS Supervisory Process for WaMu – Key Segments**

Supervisory Segment	Description
Risk Assessment and Supervisory Strategy (RASS)	The RASS was used to guide OTS supervision of WaMu for planning, organizing, and directing OTS resources based on a documented, structured risk assessment of the WaMu organization, including the holding company. Major risks assessed were: strategic, reputation, credit, market/interest rate risk, liquidity, operational, and compliance. The RASS was intended to be used by OTS senior staff and managers to quickly understand major risks and issues of significance and supervisory strategies being employed to address the risks and issues. Lead examiners used the RASS for scoping examinations and field visits; examiners used the RASS for updated detail on significant findings and issues.
Risk Assessment and Supervisory Plan (RASP)	OTS used the RASP in conjunction with the continuous supervision process implemented for WaMu beginning with the 2007 examination. Similar to the RASS, the RASP included a risk assessment and supervisory plans addressing key examination areas by CAMELS components. The RASP was updated annually, by August 31, and was supplemented by quarterly updates, each of which served as an attachment to the Regulatory Profiles.
Regulatory Profiles	OTS prepared quarterly Regulatory Profiles that served as concise, written summaries of WaMu's characteristics and conditions. Regulatory Profiles reflected data gathered through examinations and off-site monitoring, including: WaMu's operating profile, identified risks, holding company profile and impact, examination status and ratings support, supervisory strategy, enforcement actions, and significant recent events.
Work Programs	OTS developed over 60 safety and soundness work programs for the CAMELS areas, each containing procedures to be used in examinations, based upon the savings association's risk assessments. Examiners used asset quality work programs in the areas of: One- to Four-Family Real Estate Lending, Construction Lending; Other Commercial Lending; Sampling, Consumer Lending; Credit Card Lending, and Adequacy of Valuation Allowances. Examiners used management work programs in the areas of: Oversight by the Board of Directors; Management Assessment, Internal Control; External Audit, Internal Audit; Fraud/Insider Abuse, and Transactions with Affiliates.
Findings Memoranda	Examiners prepared formal findings memoranda to document the issues identified during the examination. A detailed explanation of the findings memoranda process is provided in the text that follows this table.

Source: OTS Examination Handbook and New Directions Bulletin 06-12, dated September 27, 2006.

OTS examiners documented the issues they identified in findings memoranda, which were presented to WaMu management for

response. The findings memoranda were addressed to WaMu management responsible for the subject area being reviewed and included:

- background information related to the reviewed area;
- examination findings categorized, depending on their level of severity, into Criticisms, Recommendations, or Observations;
- management's response -- agreement, partial agreement, or disagreement; and
- the corrective action proposed by management, including specific action steps planned, the assigned responsible manager, and target dates for completing the action.

OTS categorized findings memoranda by severity as follows:

**Criticism**: A primary concern requiring corrective action. Criticisms were often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the ROE, warranted increased attention by senior management and the Board, and required a written response. Criticisms were subject to formal follow-up by examiners and, if left uncorrected, could result in stronger action.

**Recommendation**: A secondary concern requiring corrective action. A recommendation could become a criticism in future examinations should risk exposure increase significantly or other circumstances warrant. Recommendations could be included in the ROE and mentioned in exit and Board meetings. Examiners could request a written response from management during the examination. OTS examiners reviewed management's actions to address recommendations at subsequent or follow-up examinations.

**Observation**: A weakness identified that is not of regulatory concern but which could improve the bank's operating effectiveness if addressed. Observations were made in a consultative role. OTS presented observations to management either orally or in writing, but observations were generally not included in the ROE. Examiners rarely requested a written response during the examination.

### Types of Examinations Conducted by OTS

As required by law, OTS conducts full-scope, on-site examinations of insured depository institutions with assets over \$500 million, as in the case of WaMu, once a year. OTS also conducts limited examinations

under certain conditions which focus on high-risk areas. In addition, OTS conducts information technology examinations to evaluate the institution's compliance with applicable rules and policies of OTS.

OTS uses the CAMELS rating system to evaluate a thrift's overall condition and performance by assessing six rating components. The six components are Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. OTS then assigns each institution a composite rating based on the examiner's assessment of its overall condition and level of supervisory concern. Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and the highest degree of supervisory concern. A full-scope examination also looks at the thrift's compliance with fair lending, consumer protection, and other public interest laws and regulations, such as the Bank Secrecy Act.

The examination team prepares a report of examination (ROE) incorporating program findings and conclusions. OTS regional staff send the ROE to 1- and 2-rated thrifts within 30 days of the completion of on-site examination activities, and to 3-, 4-, and 5- rated associations within 45 days of completion of on-site examination activities.

OTS provides FDIC information on, and access to, thrifts that represent a heightened risk to the Deposit Insurance Fund. OTS presumes heightened risk to a thrift with a composite rating of 3, 4, or 5 or a thrift that is undercapitalized as defined under Prompt Corrective Action (PCA). FDIC may request participation in examinations when a thrift exhibits material deteriorating conditions that could result in the institution becoming troubled in the near future. In this regard, FDIC may need to develop contingency plans for a thrift's possible failure or begin the resolution process.

### Enforcement Actions Available to OTS

OTS performs various examinations of thrifts that result in the issuance of ROEs identifying areas of concern. OTS uses informal and formal enforcement actions to address violations of laws and regulations and to address unsafe and unsound practices.

### ***Informal Enforcement Actions***

When a thrift's overall condition is sound, but it is necessary to obtain written commitments from a thrift's board or management to ensure that it will correct identified problems and weaknesses, OTS may use informal enforcement actions. OTS commonly uses informal actions for problems in

- well or adequately capitalized thrifts,
- thrifts with a 3 rating with strong management, and
- thrifts with a CAMELS composite rating of 1 or 2.

Informal actions notify a thrift's board and management that OTS has identified problems that warrant attention. A record of informal action is beneficial if formal action is necessary later.

If a thrift violates or refuses to comply with an informal action, OTS cannot enforce compliance in federal court or assess civil money penalties for noncompliance. However, OTS may initiate more severe enforcement action against a noncompliant thrift. The effectiveness of informal action depends in part on the willingness and ability of a thrift to correct deficiencies that OTS identifies.

Informal enforcement actions include supervisory directives, board resolutions, and memoranda of understanding.

### ***Formal Enforcement Actions***

Formal enforcement actions are enforceable under the Federal Deposit Insurance Act, as amended. They are appropriate when a thrift has significant problems, especially when there is a threat of harm to the thrift, depositors, or the public. OTS is to use formal enforcement actions when informal actions are considered inadequate, ineffective, or otherwise unlikely to secure correction of safety and soundness or compliance problems.

OTS can assess civil money penalties against thrifts and individuals for noncompliance with a formal agreement or final orders. OTS can also request a federal court to require the thrift to comply with an order. Unlike informal actions, formal enforcement actions are public.

Formal enforcement actions include cease and desist orders, civil money penalties, and Prompt Corrective Action directives.



### OTS Enforcement Guidelines

Considerations for determining whether to use informal action or formal action include the following:

- the extent of actual or potential damage, harm, or loss to the thrift because of the action or inaction;
- whether the thrift has repeated the illegal action or unsafe or unsound practice;
- the likelihood that the conduct may occur again;
- the thrift's record for taking corrective action in the past;
- the capability, cooperation, integrity, and commitment of the thrift's management, board, and ownership to correct identified problems;
- the effect of the illegal, unsafe, or unsound conduct on other financial institutions, depositors, or the public;
- the examination rating of the thrift;
- whether the thrift's condition is improving or deteriorating;
- the presence of unique circumstances;
- the extent to which the thrift's actions were preventable; and
- the supervisory goal OTS wants to achieve.

### **Types of Monitoring Conducted by FDIC**

FDIC is responsible for insuring depository institutions in the United States. In its capacity as insurer, FDIC is responsible for regularly monitoring and assessing the potential risks at all insured institutions, including those for which it is not the primary federal regulator (PFR). To assess and monitor risk, FDIC takes a two-fold approach: (1) research and analysis of trends and developments affecting the health of banks and thrifts broadly and (2) reliance on the PFR supervisory activities of individual institutions. To assess risk at a broader level, FDIC conducts a wide range of activities to monitor and assess risk from a regional and national perspective. At the institutional level, FDIC monitors large non-FDIC supervised institutions primarily through its Dedicated Examiner and Case Manager Programs. FDIC relies on the PFR's examinations to determine a bank's overall condition and the risks posed to the Deposit Insurance Fund. Additionally, FDIC, by statute, has special examination authority and certain enforcement authority for all insured depository institutions for which it is not the PFR.

## **Broad Risk Monitoring Activities**

FDIC's Division of Supervision and Consumer Protection (DSC) and Division of Insurance and Research (DIR), along with FDIC regional and national risk committees, are responsible for conducting broad monitoring activities designed to identify industry-wide risks and develop corresponding supervisory strategies.

DSC's Complex Financial Institution Program supports supervisory activities in large banks (defined to be institutions with total assets of at least \$10 billion). The focus of the program is to ensure a consistent approach to large-bank supervision and risk analysis on a national basis. The Large Bank Section synthesizes information from Large Insured Depository Institution (LIDI) reports, aggregates data on large banks to identify trends and emerging risks, and communicates these trends and emerging risks to FDIC senior management, the FDIC Board of Directors, other regulators, and DSC staff.

DIR assesses risks to the insurance fund, manages the FDIC's Risk-Related Premium System (RRPS), conducts banking research, publishes banking data and statistics, and analyzes policy alternatives. DIR has a leading role in preparing the semiannual "Risk Case", which summarizes national economic conditions, banking industry trends, and emerging risks, and "Rate Case" that recommends the deposit insurance premium schedule based on analysis, including likely losses to the fund from failures of individual institutions and other factors.

FDIC regional and national risk committees review and evaluate regional economic and banking trends and risks and determine whether any actions need to be taken in response to those trends and risks. The regional risk committees prepare semiannual reports highlighting emerging and increasing risk areas. For example, during our period of review, the San Francisco Regional Risk Committee and the National Risk Committee reported concerns with respect to subprime and non-traditional lending.

### FDIC Risk Monitoring Activities from an Individual Institution Perspective

FDIC assigns responsibility for a caseload of institutions to a case manager. The case manager monitors potential risks by reviewing examination reports prepared by the PFR, analyzing data from

quarterly institution Call Reports,<sup>44</sup> and analyzing other financial and economic data from government and private sources to monitor the financial condition of an institution. The emphasis of the program is to ensure that the level of regulatory oversight accorded to an institution is commensurate with the level of risk it poses to the Deposit Insurance Fund.

FDIC assigns a dedicated examiner to the largest insured financial institutions. The dedicated examiner serves as the case manager for these institutions and works in cooperation with primary supervisors and bank personnel to obtain real-time access to information about an institution's risk and trends.

The dedicated examiner/case manager conducts comprehensive quarterly analyses of the risk profile and supervisory strategies as part of the LIDI program. The purpose of the LIDI program is to provide timely, comprehensive, and forward-looking analyses of companies with total assets of \$10 billion or more, on a consolidated entity basis.<sup>45</sup> Timely and complete analysis of the risk profiles of these companies provides a proactive approach aimed at identifying and monitoring the largest risks to the insurance fund. Dedicated examiners/case managers prepare written reports that document the analysis and risk profile and supervisory strategies of large depository institutions. The analysis is comprised of four major areas:

- organizational structure and strategic focus of the company;
- overall risk profile and financial condition of the company;
- an identification and review of significant issues, current events, and challenges facing the company; and
- the review and development of a sufficient supervisory program to address the risk issues facing the company.

FDIC developed the LIDI reports and associated rankings as an additional means to measure an institution's financial health beyond the CAMELS ratings. LIDI reports are used to inform FDIC senior management, the FDIC's Board of Directors, and other regulators about risks to the insurance fund as well as provide updates about the supervisory programs in place to respond to those risks.

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<sup>44</sup> All regulated financial institutions are required to file quarterly financial information. For banks, this report is formally known as the *Report of Condition and Income* but is generally referred to as the Call Report. Thrifts file a similar report known as the Thrift Financial Report or TFR.

<sup>45</sup> Companies with consolidated total assets of at least \$3 billion but less than \$10 billion can be added to the LIDI Program at the discretion of the Regional Director.

FDIC also has a number of offsite monitoring systems that generate financial ratios based on Call Report data. Dedicated examiners/case managers must perform an offsite review of situations where a bank's financial ratios fall outside of FDIC-determined tolerances. Dedicated examiners/case managers must also review the Risk Related Premium System (RRPS). The RRPS is used to determine an institution's FDIC deposit insurance assessment rate. FDIC has an RRPS Reconciliation List that identifies institutions where the CAMELS ratings are inconsistent with offsite ratios and institutions with atypical high-risk profiles among the group of institutions in the best-rated insurance premium category. If the Reconciliation List is triggered, a case manager must review the appropriateness of the risk category assigned by the RRPS.<sup>46</sup> During the period covered by our review, WaMu's financial ratios did not trigger any offsite reviews or RRPS reconciliation reviews.

### **FDIC Special (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 whenever the FDIC Board of Directors determines a special examination of any such depository institution 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 that established a set of principles related to use of special examination authority for those institutions that present "heightened risk" to the Deposit Insurance Fund and delegated its authority to DSC.<sup>47</sup> The term "heightened risk" is defined under statute as an institution having a composite rating of 3, 4, or 5 or that is undercapitalized as defined under Prompt Corrective Action rules.<sup>48</sup> 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 case manager prepares a memorandum documenting the basis for a back-up examination request and submits the request to

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<sup>46</sup> The Reconciliation List was a semiannual review until June 6, 2007, at which time it became a quarterly review.

<sup>47</sup> January 29, 2002 Interagency Agreement, "Coordination of Expanded Supervisory Information Sharing and Special Examinations".

<sup>48</sup> 12 U.S.C. §1820(b)(3).

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 Back-up Enforcement Authority**

FDIC is authorized under Section 8(t) of the Federal Deposit Insurance Act to engage in back-up enforcement action.<sup>49</sup> In this capacity, FDIC generally has the same powers with respect to any insured depository institution and its affiliates as the primary federal banking agency has with respect to the institution and its affiliates. FDIC may recommend in writing that an institution's PFR take a range of enforcement actions authorized under the Federal Deposit Insurance Act with respect to any insured depository institution or any institution-affiliated party, based on an examination by FDIC or the PFR. The recommendation must be accompanied by a written explanation of the concerns giving rise to the recommendation. If, within 60 days of such recommendation, the institution's PFR does not take the enforcement action recommended by FDIC or provide an acceptable plan for responding to the concerns, FDIC may petition the FDIC Board of Directors for such enforcement action to be taken. Only after Board approval may FDIC take action in its capacity as insurer. However, the composition of the FDIC Board, which includes the Director of OTS and the Comptroller of the Currency, essentially puts the enforcement decision back into the hands of the PFR that was reluctant to take action in the first place. The statute provides for a similar exercise of FDIC's authority in exigent circumstances without regard to the 60-day time period; however, such circumstances also require approval of the FDIC Board of Directors prior to any action being taken.

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<sup>49</sup> 12 U.S.C. §1818(t).

## FDIC Deposit Insurance Assessments

Prior to the passage of the Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Reform Act Conforming Amendments of 2005 (collectively referred to as the Reform Act), FDIC was statutorily required to set assessments semiannually. Specifically, the FDIC Improvement Act of 1991 (FDICIA) required that FDIC establish a risk-based assessment system. To implement that requirement, FDIC adopted by regulation a system that placed institutions into risk categories based on two criteria: (1) capital levels and (2) supervisory ratings, as illustrated in Table 18. In practice, the subgroup evaluations were generally based on an institution's composite CAMELS rating. Generally, institutions with a CAMELS rating of 1 or 2 were put into supervisory subgroup A. Supervisory subgroup B generally included institutions with a CAMELS composite rating of 3; and supervisory subgroup C generally included institutions with CAMELS composite ratings of 4 or 5.

**Table 18: Risk-Based Assessment Matrix Effective Until January 2007**

Capital Group	Supervisory Group		
	A	B	C
1. Well-Capitalized	1A	1B	1C
2. Adequately Capitalized	2A	2B	2C
3. Undercapitalized	3A	3B	3C

Source: 12 CFR Part 327, Final Rule Supplemental Information.

A risk-based system is defined as one based on an institution's probability of causing a loss to the Deposit Insurance Fund due to the composition and concentration of the institution's assets and liabilities, the amount of loss given failure, and the revenue needs of the fund. Provisions in the Reform Act continued to require that the assessment system be risk-based but allowed FDIC to define risk broadly. Under the rule adopted by FDIC to implement the Reform Act, deposit insurance assessments are collected after each quarter ends—which was intended to allow for consideration of more current information than under the prior rule. Effective January 1, 2007, the nine risk classifications in the risk-based assessment matrix were consolidated into four risk categories. However, the implementing regulation continued to use capital ratios and supervisory ratings to determine an institution's risk category. Table 19 shows the relationship between the old nine-cell matrix and the new risk categories.

**Table 19: New Risk Categories Effective January 2007**

Capital Group	Supervisory Group		
	A	B	C
<b>1. Well-Capitalized</b>	I		
<b>2. Adequately Capitalized</b>		II	III
<b>3. Undercapitalized</b>		III	IV

Source: FDIC's Website – *Deposit Insurance Assessments – Key Provisions Pertaining to Risk-based Assessments.*

The amount each institution is assessed is based upon factors that include the amount of the institution's domestic deposits as well as the degree of risk the institution poses to the insurance fund. For large institutions (generally those institutions with \$10 billion or more in assets) that have long-term debt issuer ratings, base assessment rates are determined from weighted average CAMELS component ratings and long-term debt issuer ratings. For larger Risk Category I institutions, additional risk factors will be considered to determine if the assessment rates should be adjusted up to a ½ basis point higher or lower. This additional information includes market data, financial performance measures, considerations of the ability to withstand financial stress, and loss severity indicators.

CAMELS

An acronym for the performance rating components: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Numerical values range from 1 to 5, with 1 being the highest rating and 5 representing the worst-rated banks.

Concentration

As defined by OTS, a group of similar types of assets or liabilities that, when aggregated, exceed 25 percent of a thrift's core capital plus allowance for loan and lease losses. Concentrations may include direct, indirect, and contingent obligations or large purchases of loans from a single counterparty. Some higher-risk asset or liability types (e.g., residual assets) may warrant monitoring as concentrations even if they do not exceed 25 percent of core capital plus allowance for loan lease losses.

FICO scores

Credit scores provided to lenders by credit reporting agencies to reflect information that each credit bureau keeps on file about the borrower and that are produced from software developed by Fair Isaac and Company. The credit scores take into consideration borrower information such as (1) timeliness of payments; (2) the length of time credit has been established; (3) the amount of credit used versus the amount of credit available; (4) the length of time at present residence; and (5) negative credit information such as bankruptcies, charge-offs, and collections. The higher the credit score is, the lower the risk to the lender.

Generally accepted accounting principles

A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board.

Loan-to-value ratio

A ratio for a single loan and property calculated by dividing the total loan amount at origination by the market value of the property securing the credit, plus any readily marketable collateral or other acceptable collateral. In accordance with Interagency Guidelines for Real Estate Lending Policies (appendix to 12 C.F.R. § 560.101), institutions' internal loan-to-value limits should not exceed (1) 65 percent for raw land; (2) 75 percent for



land development; and (3) 80 percent for commercial, multifamily, and other nonresidential loans. The guidelines do not specify a limit for owner-occupied one-to four-family properties and home equity loans. However, when the loan-to-value ratio on such a loan equals or exceeds 90 percent at the time of origination, the guidelines state that the thrift should require mortgage insurance or readily marketable collateral.

Matter requiring board attention

A thrift practice noted during an OTS examination that deviates from sound governance, internal control, and risk management principles, and which may adversely impact the bank's earnings or capital, risk profile, or reputation, if not addressed; or result in substantive noncompliance with laws and regulations, internal policies or processes, OTS supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by the institution. A matter requiring board attention (MRBA) is not a formal enforcement action. Nevertheless, OTS requires that thrifts address the matter, and failure to do so may result in a formal enforcement action.

Mortgage banking

The term refers to the origination, sale, and servicing of mortgages. A mortgage banker takes an application from the borrower and issues a loan to the borrower. The mortgage banker then sells the loan to an investor and may retain or sell the servicing of the loan that includes collecting monthly payments, forwarding the proceeds to the investor who purchased the loan, and acting as the investor's representative for other issues and problems with the loan.

Nontraditional mortgages

Mortgages that include "interest-only" and "payment option" adjustable-rates. These products allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period.

Pipeline

Loans inventoried in an institution's held-for-sale portfolio to be sold to investors.

Prompt corrective action

A framework of supervisory actions, set forth in 12 U.S.C. § 1831o, for insured depository institutions that are not adequately capitalized. It was intended to ensure that

action is taken when an institution becomes financially troubled in order to prevent a failure or minimize resulting losses. These actions become increasingly severe as a thrift falls into lower capital categories. The capital categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The prompt corrective action minimum requirements are as follows:

<b>Capital Category</b>	<b>Total Risk-Based</b>		<b>Tier 1/ Risk-Based</b>		<b>Tier 1/ Leverage</b>
Well-capitalized <sup>a</sup>	10% or greater	and	6% or greater	and	5% or greater
Adequately Capitalized	8% or greater	and	4% or greater	and	4% or greater (3% for 1-rated)
Undercapitalized	Less than 8%	or	Less than 4%	or	Less than 4% (except for 1-rated)
Significantly Undercapitalized	Less than 6%	or	Less than 3%	or	Less than 3%
Critically Undercapitalized	Has a ratio of tangible equity to total assets that is equal to or less than 2 percent. Tangible equity is defined in 12 C.F.R. § 565.2(f).				

<sup>a</sup>To be well-capitalized, a thrift also cannot be subject to a higher capital requirement imposed by OTS.

Risk-based capital

A thrift's risk-based capital is the sum of its Tier 1 capital plus Tier 2 capital (to the extent that Tier 2 capital does not exceed 100 percent of Tier 1 capital). This amount is then reduced by (1) reciprocal holdings of the capital instruments of another depository institution, (2) equity investments, and (3) low-level recourse exposures and residual interests that the thrift chooses to deduct using the simplified/direct deduction method, excluding the credit-enhancing interest-only strips already deducted from Tier 1 capital.

Risk-weighted asset

An asset rated by risk to establish the minimum amount of capital that is required within institutions. To weight assets by risk, an institution must assess the risk associated with the loans in its portfolio. Institutions whose portfolios hold more risk require more capital.

Secondary market

Financial market where previously issued securities (such as bonds, notes, shares) and financial instruments

(such as bills of exchange and certificates of deposit) are bought and sold. All commodity and stock exchanges, and over-the-counter markets, serve as secondary markets which (by providing an avenue for resale) help in reducing the risk of investment and in maintaining liquidity in the financial system.

Stated income

A stated income mortgage loan is a specialized mortgage loan where the mortgage lender verifies employment and assets, but not income. Instead, an income is simply stated on the loan application (the stated income on the application has to be realistic for the employment type).

Thrift Financial Report

A financial report that thrifts are required to file quarterly with OTS. The report includes detailed information about the institution's operations and financial condition, and must be prepared in accordance with generally accepted accounting principles. The thrift financial report for thrifts is similar to the call report required of commercial banks.

This appendix lists OTS safety and soundness examinations of WaMu from 2003 until the thrift's failure in September 2008 and provides information on the significant results of those examinations. Generally, MRBAs represent the most significant items requiring corrective action found by the examiners.

Date Exam Started	CAMELS Rating	Total Assets (\$billions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examination	Enforcement Action
3-17-03	2/222223	\$243	<p><b><u>Matters requiring board attention</u></b>  <b>Sensitivity to Market Risk:</b> Ensure that management fulfills the commitments made in the bank's responses to the various findings memos issued during the examination. Particular attention is directed to upgrading risk management practices associated with mortgage banking activities. Also important is the Board's commitment to building the enterprise-wide risk management function, with an emphasis on corporate market risk management.</p> <p><b><u>Corrective actions</u></b>  <b>Capital Adequacy:</b> Implement appropriate corrective action, as agreed to by management, in the responses to the various findings memos issued during the examination.  <b>Asset Quality:</b> Implement appropriate corrective action, as agreed to by management, in the responses to the various findings memos issued during the examination.  <b>Management:</b> Monitor implementation of corrective actions initiated in response to the various findings memos issued during the examination.  <b>Earnings:</b> Implement appropriate corrective action, as agreed to by management, in the responses to the various findings memos issued during the examination.  <b>Liquidity:</b> Implement recommendations in Joint Memo 16, as agreed.  <b>Sensitivity to Market Risk:</b> Implement appropriate corrective action, as agreed to by management, in the responses to the various findings memos issued during the examination.</p>	<u>None</u>

Appendix 5  
OTS WaMu Examinations and Enforcement Actions

Date Exam Started	CAMELS Rating	Total Assets (\$billions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examination	Enforcement Action
3-15-04	2/222223	\$248	<p><b>Matters requiring board attention</b></p> <p><b>Asset Quality – Single Family Residential Underwriting:</b> Ensure that management follows through with plans to improve single family underwriting practices and gauge the effectiveness of these plans through close monitoring by Finance Committee of independent reviews performed by ERM units.</p> <p><b>Asset Quality – Subprime Borrowers:</b> Review and diligently question management's definitions of high-risk/subprime borrowers and recommended portfolio concentration limits for loans to such borrowers; identify plans to track the performance of such loans; and approve a prudent subprime lending strategy.</p> <p><b>Asset Quality – Single Family Loan Channel Profitability:</b> Require management to provide information on single family loan channel profitability, particularly the correspondent channel, and require thorough explanation for any strategy that does not provide an acceptable risk-adjusted return.</p> <p><b>Asset Quality – ERM:</b> Obtain updates from management on the progress in consolidating Residential Quality Assurance (RQA), Optimum Support, Servicing Quality Assurance, Compliance Review, and other review functions within ERM. Finance Committee should ensure that management maintains integrity of RQA and Compliance Review activities during and after consolidation and provide support to RQA in terms of making sure it obtains timely and appropriate responses to findings from line management.</p> <p><b>Asset Quality/Sensitivity – Data Management:</b> Monitor management's progress in improving the management and accuracy of pipeline and warehouse data, including plans to reduce the manual control process.</p> <p><b>Sensitivity – Mortgage Servicing</b></p>	None

Appendix 5  
OTS WaMu Examinations and Enforcement Actions

Date Exam Started	CAMELS Rating	Total Assets (\$billions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examination	Enforcement Action
			<p><b>Rights (MSR):</b> Continue to focus attention on understanding the behavior of the bank’s MSR, particularly in terms of hedge performance. Require management to either reduce concentration risk or enhance MSR risk management capabilities to reduce volatility, including risk limit setting process.</p> <p><b>Sensitivity – Net Income Scenario Analysis:</b> Discuss expectations with management for net income scenario analysis that should be presented to the Board on a regular basis. Ensure management expands the range of interest rate environments for presentation of net income, net interest income, and net portfolio value sensitivity information to the Board. Monitor management’s progress in completing the development of prepayment models.</p> <p><b>Management – ERM:</b> Monitor and obtain reports from management on status of ERM function in terms of effectiveness and resource adequacy.</p> <p><b>Management – Cost-Cutting Measures:</b> Ensure cost-cutting measures are not impacting critical risk management areas.</p> <p><b>Management – Organizational Changes:</b> Closely monitor impact of organizational changes, particularly in terms of making sure adequate, committed resources support an experienced management team.</p> <p><b>Corrective actions</b>  <b>Capital Adequacy:</b> None.  <b>Asset Quality:</b> Implement appropriate corrective actions as agreed to in management’s responses to the various findings memos issued during the examination.  <b>Management:</b> Implement the required actions set forth in the MRBAs section of the report and monitor implementation of corrective actions initiated in response to</p>	

Appendix 5  
OTS WaMu Examinations and Enforcement Actions

Date Exam Started	CAMELS Rating	Total Assets (\$billions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examination	Enforcement Action
			<p>the various findings memos issued during the examination.  <b>Earnings:</b> None.  <b>Liquidity:</b> Implement recommendations in Joint Memo #1, as agreed.  <b>Sensitivity to Market Risk:</b> Implement appropriate corrective actions as agreed to by management in the responses to the various findings memos issued during the examination.</p>	
3-14-05	2/222222	\$306	<p><b><u>Matters requiring board attention</u></b>  <b>Asset Quality – SFR Underwriting:</b> Ensure that management follows through with plans to improve SFR underwriting and appraisal practices and gauge the effectiveness of these plans through close monitoring of independent reviews performed by ERM units.  <b>Asset Quality – Credit Risk Oversight (CRO):</b> Ensure that the Board is receiving and reviewing appropriate reports from CRO summarizing loan review activities and trends. Ensure that CRO is appropriately developing and executing an adequate Performance Plan. Support CRO in obtaining timely and appropriate responses to findings from line management.  <b>Management – ERM:</b> Monitor and obtain reports from management on status of ERM in terms of effectiveness and resource adequacy. Maintain open dialog between the Board, Chief Enterprise Risk Officer (CERO), and general auditor. Be prepared to review criticality plans for integrating Providian's risk management organization into WaMu's, ensuring that staffing levels and expertise are commensurate with the risks and complexities of the combined organizations, and that strong risk controls remain in place through the integration process.</p> <p><b><u>Corrective actions</u></b>  <b>Capital Adequacy:</b> Implement the required Basel II/economic capital allocation model development monitoring</p>	None

Appendix 5  
OTS WaMu Examinations and Enforcement Actions

Date Exam Started	CAMELS Rating	Total Assets (\$billions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examination	Enforcement Action
			<p>actions set forth in the MRBA section of the report.</p> <p><b>Asset Quality:</b> Implement the required actions set forth in the MRBAs. Monitor implementation of corrective actions initiated in response to the various findings memos issued during the examination.</p> <p><b>Management:</b> Implement the required actions set forth in the MRBAs. Monitor implementation of corrective actions initiated in response to the various findings memos issued during the examination.</p> <p><b>Earnings:</b> None.</p> <p><b>Liquidity:</b> No findings memos were issued in this area; however, management is expected to follow through with its corrective actions initiated in response to the Internal Audit report on branch profitability.</p> <p><b>Sensitivity to Market Risk:</b> Senior management and the Board should closely monitor progress on the pipeline and pricing control automation project and provide sufficient support to ensure timely implementation.</p>	
3-13-06	2/222222	\$347	<p><b>Matters requiring board attention</b></p> <p><b>Asset Quality – Subprime SFR Underwriting:</b> Ensure that management follows through with its commitment to reduce underwriting deficiencies within established limits by December 31, 2006, through close monitoring of reviews performed within the business unit and overseen by ERM.</p> <p><b>Management – ERM:</b> Continue to monitor and obtain reports from management on the status of ERM to ensure its effectiveness and adequacy of resources. Maintain open dialog between the Board, the CERO, and general auditor. ERM should provide an important check and balance on profit-oriented units and warrants strong Board commitment and support, particularly given the bank’s current strategy involving increased credit risk.</p>	None



Appendix 5  
OTS WaMu Examinations and Enforcement Actions

Date Exam Started	CAMELS Rating	Total Assets (\$billions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examination	Enforcement Action
			<p><b>Corrective actions</b>  <b>Capital Adequacy:</b> None.  <b>Asset Quality:</b> Implement the required actions in the MRBA section of this report. In addition, monitor implementation of corrective actions initiated in response to the various findings memos issued during the examination.  <b>Management:</b> Implement appropriate corrective action as agreed by management in their various written responses to findings memos issued during the examination.  <b>Earnings:</b> None.  <b>Liquidity:</b> None.  <b>Sensitivity to Market Risk:</b> Management should implement the corrective actions set forth in the bank's response to S&amp;S Finding Memo #17.</p>	
1-08-07	2/222212	\$318	<p><b><u>Matters requiring board attention</u></b>  <b>Asset Quality – Subprime SFR Underwriting:</b> Ensure that management reduces underwriting deficiencies to the tolerance levels agreed upon in response to Asset Quality Findings Memo 3.  <b>Management – Enterprise Risk Management:</b> Continue to monitor and receive reports on the status of ERM to ensure its effectiveness and that appropriate resources and support are provided for this function. Maintain open dialog between the Board, CERO, and general auditor. ERM should provide an important check and balance on profit-oriented units and warrants strong Board commitment and support.</p> <p><b>Corrective actions</b>  <b>Capital Adequacy:</b> None  <b>Asset Quality:</b> (1) Ensure corrective actions as indicated in responses to various asset-quality findings memos are implemented in a timely manner and (2) implement required corrective actions identified in the MRBAs.  <b>Management:</b> (1) Implement required</p>	Cease & desist order related to deficiencies in BSA/AML on 10/17/07.

Appendix 5  
OTS WaMu Examinations and Enforcement Actions

Date Exam Started	CAMELS Rating	Total Assets (\$billions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examination	Enforcement Action
			<p>actions set forth in the MRBA section of the ROE and the enforcement actions resulting from the Bank Secrecy Act (BSA) Anti-Money laundering (AML) deficiencies and civil money penalty resulting from the Commercial Flood Insurance violations and (2) implement the corrective actions agreed to by management in its written responses.</p> <p><b>Earnings:</b> None.  <b>Liquidity:</b> None.  <b>Sensitivity to Market Risk:</b> None.</p>	
9-10-07	3/343432  Changed to 4/343442 on 9-18-08	\$318	<p><b><u>Matters requiring board attention</u></b></p> <p><b>Asset Quality – SFR Lending:</b> Conduct an independent review of the SFR lending process to determine whether weaknesses identified in the Corporate Fraud Investigation (April 4, 2008) are systemic and to identify any other internal control or underwriting weaknesses. Develop a plan for correcting any weaknesses identified.</p> <p><b>Asset Quality – ALLL:</b> Continue to refine and develop an effective ALLL methodology and maintain an adequate ALLL at all times.</p> <p><b>Management – Board Information:</b> Assess information provided to the Board to ensure that the Board receives sufficient, consistent, and understandable information from management to appropriately assess the bank’s risk.</p> <p><b>Management – Board Committee Structure:</b> Assess the current Board committee structure to determine whether the risk factors are appropriately delineated among current committees.</p> <p><b>Management – ERM:</b> Ensure that management develops an effective ERM function and that appropriate resources and support are provided for this function. ERM should provide an important check and balance on profit-oriented units and therefore warrants strong Board commitment and support.</p> <p><b>Management – Strategic Plan:</b> Continue to develop and finalize the new</p>	<p>February 27, 2008, OTS required a Board Resolution (informal enforcement action) addressing the general areas of concern in asset quality, earnings, and liquidity. WaMu adopted the resolution on March 17, 2008.</p> <p>July 2008, OTS requested a Memorandum of Understanding (MOU) (an informal enforcement action) to address the 2008 examination findings; the MOU was signed on September 7, 2008.</p>

Appendix 5  
 OTS WaMu Examinations and Enforcement Actions

Date Exam Started	CAMELS Rating	Total Assets (\$billions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examination	Enforcement Action
			<p>strategic plan that is currently a work in progress.</p> <p><b>Corrective actions</b>  <b>Capital Adequacy:</b> Management must (1) update capital projections expeditiously to reflect any material change in the bank’s operating condition, but no less than quarterly and (2) maintain capital at internal capital levels agreed upon with OTS.</p> <p><b>Asset Quality:</b></p> <ul style="list-style-type: none"> <li>• Ensure that corrective actions indicated in the responses to the various Asset Quality related findings memoranda are implemented in a timely manner.</li> <li>• Perform an assessment of the control weaknesses related to SFR underwriting that were identified in the internal Corporate Fraud investigations Report (April 2008) and correct all deficiencies noted.</li> <li>• Continue to refine and develop an effective ALLL methodology.</li> <li>• Ensure that ALLL is maintained at an adequate level at all times.</li> <li>• Cease “stated income” lending for all mortgage loans and all other loans over \$50,000.</li> <li>• Ensure that the bank adequately documents the borrower’s ability to pay on all non-mortgage loans over \$50,000.</li> </ul> <p><b>Management:</b></p> <ul style="list-style-type: none"> <li>• Implement the actions set forth in the MRBA section of this report.</li> <li>• Ensure full compliance with the requirements of all outstanding enforcement actions.</li> <li>• Implement the corrective actions agreed to by management in the written responses to findings memos issued during the examination.</li> <li>• Submit the Strategic Business Plan as requested.</li> <li>• Strengthen the Compliance Manager position.</li> </ul>	

Appendix 5  
 OTS WaMu Examinations and Enforcement Actions

Date Exam Started	CAMELS Rating	Total Assets (\$billions)	Significant safety and soundness matters requiring board attention and corrective actions cited in reports of examination	Enforcement Action
			<p><b>Earnings:</b> Monitor actual versus projected operating results and keep OTS informed of material differences.</p> <p><b>Liquidity:</b></p> <ul style="list-style-type: none"> <li>• Cure violations of the WaMu Liquidity Management Standard as soon as possible, but no later than October 30, 2008. Maintain sufficient liquidity thereafter.</li> <li>• Improve reporting of uninsured deposits and brokered deposits in liquidity risk reports to management and the Board, as detailed in SS Memo #6 – Liquidity Risk Reporting.</li> </ul> <p><b>Sensitivity to Market Risk:</b></p> <ul style="list-style-type: none"> <li>• Enhance the net portfolio value (NPV) modeling process particularly relating to Option adjustable rate mortgages (ARM) loan and subprime loan valuations.</li> <li>• Introduce non-parallel stress scenarios to complement the existing parallel shift stress scenarios within the Downside Net Interest Margin measure.</li> </ul>	

**Appendix 6  
Management Response**



**Office of Thrift Supervision  
Department of the Treasury**

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6372

**John E. Bowman**  
*Acting Director*

March 30, 2010

**MEMORANDUM FOR:** Eric M. Thorson  
Inspector General  
Department of the Treasury

Jon T. Rymer  
Inspector General  
Federal Deposit Insurance Corporation

**FROM:** John E. Bowman /s/  
Acting Director

**SUBJECT:** Draft Audit Report on the “Evaluation of Federal Regulatory Oversight of Washington Mutual Bank”

Thank you for the opportunity to comment on your draft audit report entitled “Evaluation of Federal Regulatory Oversight of Washington Mutual Bank.” We received the draft report on March 16<sup>th</sup>, and previously had an opportunity to review a discussion draft of the report. The report focuses on causes of the failure of Washington Mutual (Wamu), the Office of Thrift Supervision’s (OTS) supervision of Wamu, and the Federal Deposit Insurance Corporation’s (FDIC) monitoring of Wamu and assessment of insurance premiums.

The closure of Wamu approximately a year and a half ago during the middle of the recent economic downturn resulted in no loss to the Deposit Insurance Fund (DIF). Since there was no loss to the DIF, a material loss review (MLR) was not mandated under Section 38(k) of the Federal Deposit Insurance Act. 12 U.S.C. 1831o(k). We understand that your offices undertook this joint review as an exercise in good government.

The draft audit report makes one recommendation to OTS:

Specifically, OTS should use its own internal report of examination system to formally track the status of examiner recommendations and related thrift corrective actions.

Draft report at pp. 4 and 55.

## Appendix 6 Management Response

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OTS is committed to strengthening its supervisory process and has been responsive to recommendations and lessons learned from both prior internal failed bank reviews and MLRs by Treasury's Inspector General.

OTS fully concurs with the report's one recommendation stated above and already has systems in place to implement that recommendation. In October 2007 a new follow up function was added to OTS's internal Examination Data System/Reports of Examination (EDS/ROE) to require examiners and other Regional staff to associate dates and comments with matters requiring board attention and other material matters identified during an examination that require follow-up. Five new reports were added to EDS/ROE (Summary, List View, History, Reason Summary and an Excel spreadsheet report) to provide staff with the tools necessary to monitor follow up items. This follow-up system is well populated and actively used by staff and monitored by senior management.

In the case of Wamu, the centralized internal follow up system was not fully utilized when it became available in late 2007 for a variety of reasons. OTS management is unaware of any other OTS-regulated institution that is not tracked in the OTS internal follow-up system.

Thank you again for the opportunity to review and respond to your draft report. We appreciated the professionalism and courtesies provided by the staff of both Offices of Inspector General. We look forward to reading your report on objective 4 of this review, noted at p.2, regarding the assessment of the resolution process regarding Wamu.

cc: Sheila C. Bair  
Chairman, FDIC

**Appendix 6  
Management Response**



**Federal Deposit Insurance Corporation**

550 17th Street NW, Washington, D.C. 20429-9990

Office of the Chairman

March 30, 2010

**TO:** John T. Rymer, Inspector General  
Federal Deposit Insurance Corporation

Eric M. Thorson, Inspector General  
Department of the Treasury

**FROM:** Sheila C. Bair, Chairman /Signed/  
Federal Deposit Insurance Corporation

**SUBJECT: FDIC Response to the Evaluation of Federal Regulatory Oversight of  
Washington Mutual Bank**

Thank you for the opportunity to review and comment on the joint Offices of Inspector General (OIG) report entitled, *Evaluation of Federal Regulatory Oversight of Washington Mutual Bank* (Report No. EVAL-10-002). The report identifies impediments to the FDIC's back-up supervisory authority inherent in the interagency agreement governing information sharing that limit the FDIC's ability to assess the potential risk of an institutional failure and the resulting impact on the Deposit Insurance Fund (DIF). The report also notes concerns about the FDIC's reliance on CAMELS ratings for the purpose of establishing risk-based premiums for deposit insurance coverage. It includes recommendations to address both issues.

The FDIC has also been concerned about these issues, particularly with respect to large depository institutions that pose significant risk to the DIF, and FDIC staff has been working for some time on proposals to address both of these concerns. The report specifically recommends that the FDIC "revisit the interagency agreement governing information access and back-up examination authority for large insured depository institutions to ensure it provides the FDIC with sufficient access to information necessary to assess risk to the DIF." The FDIC agrees with this recommendation and has been actively working with the other primary federal regulators (PFRs) to develop modifications to the agreement that will provide the FDIC with greater access to information about the risks posed by these institutions.

Proposed new memoranda of understanding with each of the other PFRs will be presented to the Board of Directors for its approval in the near future. The revised memoranda of understanding will clearly define for large depository institutions with \$10 billion or more in assets (a) the extent of the FDIC on-site presence at these institutions; (b) the type of information that will be shared; and (c) the extent of FDIC access to information, the PFR and bank personnel. We are hopeful that agreements can be reached in the near future. In any event, please be assured that the FDIC is committed to using all available legal authority to acquire timely access to information related to the risks that institutions pose to the Deposit Insurance Fund.

## Appendix 6 Management Response

The report also recommends that the FDIC “revisit the FDIC Deposit Insurance Regulations to ensure those regulations provide the 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.” The FDIC also agrees with this recommendation and has been developing for consideration by the Board of Directors a proposed new deposit insurance pricing system for large banks that better differentiates risks and does not rely on external ratings. I fully expect that a new pricing system will be adopted soon by the Board, following the completion of appropriate rulemaking processes, and will be implemented by the end of the year.

In closing, I would like to reaffirm the FDIC’s determination to move quickly to address the lessons learned from the current financial crisis and to strengthen its overall financial regulatory framework. The recommendations in the joint OIG report are an important component of that effort.

cc: John E. Bowman, Acting Director  
Office of Thrift Supervision



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Director, Division of Insurance and Research  
Director, Office of Enterprise Risk Management

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### **Office of Management and Budget**

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Committee on Banking, Housing, and Urban Affairs  
Committee on Finance  
Permanent Subcommittee on Investigations, Committee on  
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