The Second S&L Scandal

How OTS allowed reckless and unfair lending to fleece homeowners and cripple the nation's savings and loan industry.

By Michael Hudson and Jim Overton January 2009

THE SHOCKS TO AMERICA'S BANKING SYSTEM have come one after another in recent months. Among the worst blows: the meltdowns of IndyMac Bank and Washington Mutual Savings Bank. Washington Mutual represented the largest bank failure in the nation's history; IndyMac's fall was the fourth largest ever.

There was a common thread in both of these calamities: a surge of high-risk lending that put borrowers, shareholders and depositors in harm's way. The other common thread: weak regulatory oversight by the federal Office of Thrift Supervision (OTS), the agency responsible for overseeing thrifts, or savings and loans as they once were more commonly called.

IndyMac and WaMu's unsafe lending grew under the less-than-watchful eye of OTS. An analysis by the Center for Responsible Lending makes it clear that OTS failed in its responsibility to ensure the safety and soundness of thrifts and to protect consumers from abusive practices.

- During the mortgage boom, OTS allowed WaMu, IndyMac and other thrifts to engage in increasingly risky lending practices that harmed borrowers and undermined the institutions' own financial health.
- Even as thrifts' financial positions deteriorated, the OTS was slow to act—failing to take aggressive action that could have significantly reduced the economic fallout from bank failures.
- The agency obscured the seriousness of thrifts' financial problems. In some instances, the OTS allowed banks to falsify financial results to mask poor performance that would have raised alarms sooner.

The damage caused by the agency's failures is enormous. In 2008, five thrifts with assets totaling $354 billion collapsed.[1] Seven other thrifts holding assets totaling another $350 billion have been sold or are caught up in their parent companies' bankruptcies.[2]

By comparison, in the worst year of the original savings and loan crisis,1989, thrifts with assets totaling $135 billion failed.[3] Even when inflation is taken into account, the dollar total for 2008's failures still exceeds those for 1989.[4] Over the entire decade of the earlier S&L crisis (1986-1995), total failures involved $519 billion in thrift assets.[5]

OTS, which was created in 1989 to clean up that era's S&L mess, is now presiding over the nation's "Second S&L Scandal." This second historic crisis could not have happened without years of inaction and negligence by the agency responsible for policing the industry.

What Should be Done?

The Center for Responsible Lending believes OTS should be eliminated as a free-standing agency. The thrift charter is no longer an effective tool for supporting and supervising institutions involved in mortgage lending and banking. CRL supports the Treasury Department's proposal to phase out the thrift charter and merge OTS into the Office of the Comptroller of the Currency.[6]

This would be a first step toward creating a more streamlined regulatory structure for America's banks, with federally chartered banks and thrifts overseen by the OCC, bank holding companies overseen by the Federal Reserve Board and state-chartered thrifts continuing to operate under the umbrella of state regulators.[7]

None of this is to suggest that OTS was the only federal regulatory agency that failed to counter the growth of unsafe and unseemly practices in the mortgage market. The entire federal regulatory structure—including the OCC and the Federal Reserve—shares responsibility for the mortgage debacle.[8] Eliminating OTS won't cure all of the banking system's regulatory ills, and it would be incumbent upon an expanded OCC to improve its own record—by stepping up its consumer protection efforts and by giving up its efforts to shield lenders from state consumer laws and enforcement.[9]

OTS's failures stand out, however, because of its hands-off attitude toward regulating thrifts, because of the size of the institutions that have perished under its watch, and because its charter and positioning within the regulatory system make no sense in an era of rapid change and dramatic challenges within the mortgage and banking worlds.

This paper reviews OTS's record of failure and makes the case for significant changes needed to fix our nation's broken regulatory system. Finally, it lays out principles that should guide policymakers and regulators as they try to design a system that protects homeowners and families and ensures that banking institutions never again engage in the kind of reckless behavior that has helped produce America's worst financial catastrophe since the 1930s.

The OTS Record

In the face of criticism, OTS has countered that it has done all it could, considering the massive problems in the nation's mortgage markets as well as world financial markets. "Given the real estate crisis over the past 18 months, and the focus by thrifts on mortgage lending, it is not surprising that some of our institutions are facing challenges," OTS director John M. Reich said recently.[10] Reich added that OTS "would never tolerate any product that is predatory in nature. We know, however, that a reasonable product can be inappropriately 'sold' to a customer by an inexperienced, or greedy, loan originator. As part of our comprehensive examination program, we are vigilant to identify, and punish, such deplorable practices."[11]

OTS officials have even gone so far as to tout the agency's experience in supervising mortgage lending, arguing that its authority to regulate the home-loan market should be expanded.[12]

OTS's upbeat assessment of its own capabilities offers a picture of an agency that lacks awareness of its own flaws and failures. A close look at OTS's record shows the agency consistently ignored clear warning signs of the coming disaster—and that it simply doesn't have the expertise, the structure or the will to oversee the healthy functioning of mortgage and banking markets.

In 2004, as warning signs of dangerous practices in the mortgage market grew, then-OTS director James Gilleran made it clear his agency was determined to keep a pliable attitude toward policing the home lenders: "Our goal is to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion."[13] Between 2001 and 2004, OTS

slashed its staff by 25% and changed its examination structure to emphasize having lenders do "self-evaluations" of their compliance with consumer protection laws.[14] By 2005, OTS had a new director, John Reich, but the message was similar. When concerns were raised about lenders' lack of concern for borrowers' ability to repay their loans, Reich cautioned that regulators shouldn't interfere with thrifts that "have demonstrated that they have the know-how to manage these products through all kinds of economic cycles."[15]

As the housing market boomed, OTS allowed thrifts to dramatically reduce the share of revenue they set aside to cover losses. By September 2006, capital reserves held by OTS-licensed institutions had fallen to the lowest level in 20 years, to less than one-third of their historical average.[16] This left thrifts increasingly vulnerable as loans began defaulting in higher numbers and the mortgage market swooned.

Even now, the toll of OTS's regulatory missteps and inaction continues to mount, in terms of both the number of families that have lost their homes and in the number of big lending institutions that have collapsed. The problem, however, didn't begin in 2008. The seeds of the meltdown among the nation's thrifts were sown over the better part of a decade, as OTS allowed lenders under its supervision to market dangerous products and engage in increasingly unsafe practices. A look at the failures of four institutions under OTS's watch—Superior Bank, NetBank, IndyMac and Washington Mutual—provides case studies in OTS's long-standing shortcomings as a regulator.

Superior Bank, FSB

In July 2001, OTS declared Superior Bank insolvent in what could be called a dress rehearsal for the market-wide subprime mortgage meltdown that followed a few years later. Like many of the lenders that have imploded over the past two years, Superior did itself in with a toxic combination of risky lending and accounting that was, to put it gently, overly optimistic. Investigations by the Government Accountability Office[17]and inspector general offices at the Treasury Department[18] and Federal Deposit Insurance Corporation[19] concluded that OTS ignored growing risks in the bank's business strategy that had been evident as far back as 1993, when the bank began an aggressive program of buying subprime home-improvement loans and packaging them into mortgage-backed securities. The bank expanded this business even as the quality of the loans in its securities pools began to deteriorate due to rising delinquencies.[20]

The FDIC's audit said, "Warning signs were evident for many years, yet no formal supervisory action was taken by OTS until July 2000, which ultimately proved too late."[21] The Treasury Department's report added that the agency's examinations "lacked sufficient supervisory skepticism" and that OTS's enforcement efforts were simply "too little and too late."[22]

NetBank, FSB

OTS closed NetBank in September 2007, a failure that FDIC estimated would cost the government's Deposit Insurance Fund $108 million.[23] The bank failed to weather the general market downturn due to a combination of ineffective business controls and strategies, and high expenses and large losses on commercial leases and home mortgages.[24] Rather than dialing back its mortgage lending as the secondary mortgage market began contracting, Netbank instead tried to increase volume by reducing its underwriting and documentation standards. The result was a surge of questionable loans. In 2006, investors forced NetBank to buy back $182 million in problem loans, a threefold increase from the year before.[25]

As in the case of Superior Bank, an Inspector General's investigation found OTS to be ineffectual in its oversight of NetBank. The Inspector General said OTS "did not react in a timely and forceful manner" to "repeated indications of problems in NetBank's operations"—problems that had been evident for years in OTS examinations.[26]

The report notes that OTS failed to look at the credit quality of loans that had been sold to investors to assess the risk that NetBank might have to repurchase them later. This is a startling point, given that OTS has touted its experience in overseeing mortgage lending. Its staff's inability in this instance to fully understand a crucial risk factor faced by residential lenders casts doubt on the agency's ability to police the home loan industry.

Another concern in the NetBank case was OTS's apparent inability to learn from its failures. While a November 2007 internal OTS review acknowledged the agency should have focused more on NetBank's high-risk activities, the review "did not include any specific corrective actions OTS should take to address the areas of concern it identified," according to the Inspector General.[27] A government agency that doesn't learn from its mistakes—and fails to take aggressive steps to make sure they don't happen again—doesn't inspire confidence in its ability to do its job.

IndyMac Bank, FSB

The agency's failure to learn anything from missteps in the Superior and NetBank cases is apparent in the record of its oversight of IndyMac Bank. The failure of IndyMac is a case study in long-term regulatory inaction.

OTS didn't take effective action to correct the unsafe and unsound lending that characterized IndyMac's business model during the mortgage boom. Likewise, in the months before IndyMac failed, OTS didn't take aggressive action to respond to clear warning signs that IndyMac's loan performance and financial returns were rapidly deteriorating.

A review of the public record indicates that OTS had ample warning, going as far back as 2001, that IndyMac took a less-than-stringent approach to underwriting loans and managing the risks of doing business.

Before the boom

Court documents filed by IndyMac's former chief commercial appraiser assert that OTS raised questions in 2001 about the accuracy of appraisals done on subdivisions and other properties financed through the bank's homebuilder and commercial lending program.[28] Even after being put on notice by OTS, the former executive claimed, top IndyMac officials pressured him to approve appraisal reports that included false or misleading information, and to change appraisals that sales staffers were unhappy with. The former executive told CRL recently that he informed OTS in 2002 about his negative experiences at IndyMac.

It's unclear whether OTS took further action on the issue. It's worth noting, however, that homebuilder loans became one the worst-performing segments of IndyMac's lending businesses. Of the $1.95 billion in construction loans outstanding on IndyMac Bank's books as of June 30, 2008, 39% were delinquent, and 34% were more than 90 days past due. The $656 million in serious delinquencies—apparently related to subdivisions that may never be completed and thus may have extremely limited liquidation value—dwarfed the $487 million in mortgage loan loss reserves for loans of any description present on the bank's books at that time.[29]

During the boom

As IndyMac grew its residential mortgage business dramatically during the mortgage boom, it increasingly engaged in unsafe lending. CRL's interviews with former employees and records of lawsuits in 10 states uncovered substantial evidence that IndyMac pushed through large numbers of loans based on inflated appraisals and falsified income data that exaggerated borrowers' ability to repay their loans.[30] One former IndyMac mortgage underwriter described the drive to push through questionable loans this way: "There's a lot of pressure when you're doing a deal and you know it's wrong from the get-go—that the guy can't afford it. And then they pressure you to approve it." The refrain from management, he recalled, was blunt: "Find a way to make this work."[31]

Had OTS looked with a skeptical eye, it wouldn't have been hard for the agency to find indications that IndyMac was engaging in high-risk lending. This was made clear by the large percentage of poorly documented mortgage products that made up IndyMac's loan portfolio.

In one example, less than 10% of the dollar volume of a $354 million pool of residential mortgages that IndyMac packaged into mortgage-backed securities in 2006 involved "full-documentation" loans. The rest involved low- or no-documentation loans—mostly "stated income" loans in which borrowers' income was simply affirmed without supporting evidence such as tax documents or pay stubs.[32] IndyMac and other lenders pushed these products despite the fact that most borrowers were both able and willing to provide documentation. Lenders did so because investors were willing to pay more for risky loans and because "stated income" loans and other low or no-doc products made it easier for lenders to ignore basic underwriting standards and increase loan volume.

At IndyMac, the result was a long list of borrowers stuck in predatory loans they had little hope of paying. They are people like Simeon Ferguson, an 86-year-old retired chef living in Brooklyn, N.Y. Mr. Ferguson was suffering from dementia at the time he got a loan from IndyMac. A lawsuit filed on Mr. Ferguson's behalf claims a mortgage broker used the false promise of a 1% interest loan to steer Mr. Ferguson into an IndyMac "stated income" loan program for retirees. IndyMac made no effort to verify retirees' income, attempting to duck accountability "by deliberately remaining ignorant of the borrower's ability to pay the mortgage," the lawsuit says. IndyMac's instructions for preparing the mortgage application required that "the file must not contain any documents that reference income or assets."[33]

During the bust

After failing to check IndyMac's risky behavior during the boom years, OTS failed to take effective action to get it to pull back from risky lending as the mortgage market began to falter.

The damage to borrowers, employees, shareholders, depositors and ultimately taxpayers would have been reduced if OTS had forced IndyMac to retrench as the housing and mortgage markets slowed and then fell apart in 2006-2007. Instead, IndyMac continued to push aggressively for more loan growth, increasing its loan volume by some 50% in 2006, during a year when overall industry volume fell slightly.

IndyMac boosted volume by relying on risky, weakly underwritten mortgage products and ignoring borrowers' ability to repay their loans. In the first quarter of 2007, just 21% of IndyMac's total mortgage production involved "full-documentation" loans.[34]

As the bank's situation worsened, OTS failed to identify the danger that IndyMac faced—despite the fact that measures of the bank's financial health already showed significant signs of trouble as of June 30, 2007, and indicated an accelerating deterioration just three months later on Sept. 30, 2007.

- After exceeding industry averages for several years, by June 2007 IndyMac Bank's return on assets of 0.50% lagged below the industry average of 0.77%, and its equity-to-assets ratio of 6.48% lagged below the industry average of 9.87%. Other performance ratios had also fallen behind industry averages by significant margins.[35]

- IndyMac's dollar volume of non-performing assets exploded 11-fold in 15 months—going from $184 million (0.63% of assets) at the close of 2006 to $2.1 billion (6.51% of assets) at the end of the first quarter of 2008.[36]

- The company booked a loss of $203 million in the third quarter of 2007 and then a whopping $509 million loss in the fourth quarter; for the year, it posted a loss of $615 million. It continued losing money in 2008, reporting a $184 million loss in the first three months of the year.[37]

Despite these disquieting numbers, IndyMac didn't make it onto the FDIC's list of troubled institutions until June 2008, shortly before its July failure. According to the FDIC, it wasn't on the list because OTS didn't put it there.[38]

In the aftermath of the failure, an OTS spokesman said the agency was "fully aware" of IndyMac's problems and started its regular exam in January 2008, four months ahead of schedule.[39]

But as with Superior Bank and NetBank, OTS's action was too little, too late. OTS's failure to realize the seriousness of IndyMac's situation is perplexing, given that other observers, relying on publicly available data, were able to develop a clear picture of the just how bad things were at IndyMac:

- Highline Financial—a research service that rates the safety of banks and thrifts on a 99 (best) to zero (worst) scale—dropped its rating on IndyMac from 55 at the end of 2006 to one at the end of 2007—and then down to zero in March 2008.[40]

- Bankrate.com gave IndyMac its worst of five ratings in its Safe & Sound scorecard in March 2008.[41]

- An analysis by TheStreet.com found that as of December 2007, IndyMac Bank held the third highest percentage of non-performing assets among the nation's 20 largest savings and loans—and the worst ratio of non-performing loans to core capital/loan loss reserves.[42]

As IndyMac unraveled, a top OTS official worked to help the thrift delay tighter regulatory scrutiny, according to an investigation by the Treasury Department's Inspector General.[43] The probe found that, just two months before IndyMac's collapse, the OTS official gave the thrift permission to falsify its financial statements, a move that allowed it to avoid increased regulatory oversight.[44]

Investigators discovered that Darrel Dochow, OTS's western regional director, had allowed IndyMac to count money it received from its bank holding company in May 2008 in a quarterly report outlining its financial condition as of March 31, 2008.[45] The extra $18 million increased IndyMac's capital cushion, allowing it to be listed as "well capitalized" rather than "adequately capitalized," a designation that would have required the thrift to get special permission from the FDIC to collect deposits through deposit brokers.[46] Brokered deposits—sometimes known as "hot money"—are an unstable source of funding because brokers often move them quickly from institution to institution in search of the best rates.

The Inspector General also noted that OTS had allowed other institutions to engage in similar bookkeeping trickery.[47] He did not name the other thrifts.

The *Washington Post* reported that in addition to allowing IndyMac to fudge its balance sheet numbers, Dochow may have taken other actions that impeded oversight of the thrift: "At another point last spring," the *Post* said, "Dochow limited the scope of a review by OTS regulators of IndyMac's portfolio of loans and other assets, overruling the advice of others in the agency, according to a source with knowledge of the incident."[48]

OTS director John Reich downplayed Dochow's actions, describing them as a "relatively small factor in the events leading to the failure of IndyMac."[49] However, U.S. Sen. Charles E. Grassley said: "The role of the Office of Thrift Supervision, as the name says, is to supervise these banks, not conspire with them. It's good the inspector general has opened a full-blown audit as a result of this case. Everyone ought to be paying very close attention."[50]

Dochow has been temporarily relieved of his management duties. The Post noted that—in yet another indication of the parallels between the first and second S&L debacles—it is "the second time Dochow has been removed from a position as a senior thrift regulator. He was demoted in the early 1990s after federal investigators found that he had delayed and impeded proper regulation of Charles Keating's failed Lincoln Savings and Loan."[51]

The final toll

OTS closed IndyMac on July 11, 2008. It was a tragedy with severe consequences for many Americans. Thousands of bank employees lost their jobs. Large numbers of customers with uninsured deposits will get only a fraction of their savings back. FDIC announced in early 2009 that a group of private investors would buy the remnants of the thrift.[52] Even with the sale, the government expects IndyMac's failure to cost the federal Deposit Insurance Fund $8.5 billion to $9.4 billion.[53]

All this could have been avoided had OTS done its job going back to the early part of this decade, by subjecting IndyMac to firm, responsible oversight. By 2007, things had probably gone too far to prevent a severe downward slide by IndyMac. The volume of bad loans made by IndyMac was simply too immense. However, timely action during the mortgage and credit crisis would have prevented the lender from making still more abusive and unsustainable mortgages and mitigated some of the damage from IndyMac's risky practices, reducing the harm to borrowers, depositors and taxpayers.

In addition, had OTS moved faster to put IndyMac into receivership, it would have allowed the FDIC to move in earlier and tackle the bank's problems. Under its chief, Sheila Bair, the FDIC has moved to modify homeowners' loans, helping borrowers save their homes and reducing the losses incurred from IndyMac's bad lending.[54] However, the FDIC has been forced to play catch up due to OTS's lassitude.

Washington Mutual Savings Bank

OTS seized Washington Mutual Savings Bank, the largest institution under its supervision, on Sept. 25, 2008, and sold its assets to JPMorgan Chase & Co at a fire sale price of $1.9 billion.[55] A day later, the bank's holding company, Washington Mutual Inc., filed for Chapter 11 bankruptcy.

It was by far the largest bank failure in American history. The bank had roughly $307 billion in assets and $188 billion of deposits.[56] WaMu was nearly eight times larger than the biggest previous U.S. bank to fail, Continental Illinois National Bank & Trust, which had $40 billion in assets when it went under in 1984.[57] An analysis of WaMu's rise and fall shows OTS failed to stop the bank from taking the risky path that led to its collapse.

Early warning signs

In the early part of this decade, lawsuits and investigations highlighted questionable practices at WaMu, raising red flags that should have prompted OTS to be more vigilant about scrutinizing the company. For example:

- In 2001 a Mississippi jury found that Washington Mutual Finance, the bank's consumer-finance unit, had fleeced borrowers by enticing them to refinance their loans again and again and packing the deals with over-priced insurance. The jury hit the company with a $71 million verdict (later reduced to $54 million by the trial judge). Attorneys for the borrowers claimed the lender targeted borrowers who couldn't read or write.[58]

- A 2003 lawsuit by a former Washington Mutual Finance manager in Utah claimed that he'd been forced out of his job after he complained about predatory practices that hurt borrowers.[59]

- Also in 2003, class-action lawsuits in multiple states accused WaMu of gouging borrowers with illegal fees. In a Minnesota case, borrowers' attorneys claimed WaMu customers "were systematically overcharged tens of millions of dollars in excessive and unauthorized prepayment fees." The company allegedly overcharged one Minnesota borrower $8,452; another was charged $6,349 more than what his contract allowed, the suit claimed.[60]

- In October 2003, Texas' Attorney General announced that more than 200 consumer complaints had prompted it to open an investigation of lost mortgage payments and improper foreclosures at the bank. *BusinessWeek's* story about the company's legal problems was headlined: "Is This Any Way To Run A Bank? WaMu's alleged blunders have it fending off lawsuits and complaints."[61]

Texas authorities reached an agreement with Washington Mutual aimed at reforming practices that had resulted in wrongful foreclosures and unfair consumer credit reports.[62] Because federal bank regulators' enforcement actions typically aren't made public, it's unclear what action OTS took in response to WaMu's well-publicized problems in 2001 to 2003. What's clear is that whatever action OTS did take, it wasn't aggressive or far-sighted enough to rein in the bank's flawed practices.

Ramping up abusive loans

In fact, the bank increased its level of risky lending to new heights as the housing and mortgage markets boomed. WaMu grew its volume of subprime lending from just under $20 billion in 2003 to $36 billion in 2005, according to *Inside Mortgage Finance*.[63] In 2005 and 2006 WaMu funded a total of $107 billion in payment option adjustable rate mortgages (POARMs), and, by the end of 2007, it held $48 billion in POARMs that resulted in negative amortization, meaning that monthly payments weren't enough to cover monthly interest charges.[64]

Poorly underwritten "negative amortization" loans can be hazardous for borrowers, because the mortgage payments are kept artificially low, and the total homeowner's overall debt climbs as each month passes. The loans also can distort reported profitability of the financial institution. Because the institution books accrued interest as income, the kind of downturn we have seen over the past two years can wipe out paper profits, and further jeopardize the financial future for the institution.

According to former employees cited in court documents, WaMu lowered its loan underwriting standards to such an extent that borrowers with weak credit histories qualified for prime loans, and loans that were designated "fully documented" in fact were approved with little or no documentation of borrowers' incomes and assets.[65] Former employees also confirm in the court documents that, well into 2007, WaMu underwrote pay option ARM loans based on the borrowers' ability to afford the low "teaser" payment—and not the full payment that inevitably would cause borrowers' monthly obligations to skyrocket.[66]

The result of WaMu's high-wire strategy: a glut of loans that borrowers couldn't afford. Foreclosure rates for Washington Mutual Savings Bank quadrupled, going from 0.11% in the second quarter of 2007 to 0.46% in the second quarter of 2008.[67]

One example of WaMu's less-than-sterling lending record has been highlighted by Mike Shedlock, an economic analyst who's been tracking a bundle of more than $500 million in loans that WaMu packaged into a mortgage-backed securities pool around May 2007. The borrowers didn't appear to be bad risks; their average FICO score topped 700, indicating they had solid credit histories. But little more than 10% of the loans in the pool required full documentation from the borrower. One year into its life, 23 percent of the pool was already in foreclosure or in repossession.[68]

Behind the numbers, WaMu's bad lending produced real suffering among the real people who were on the receiving end:

- A disabled homeowner in Kansas City, Mo. claims in a lawsuit that an independent mortgage broker stuck her in an adjustable-rate loan from WaMu that was packed with predatory fees and left her paying nearly 70% of her income in monthly mortgage payments. The suit charges that WaMu's subprime home-loan unit, Long Beach Mortgage, relied on a grossly inflated appraisal and failed to verify whether she could afford the loan, dramatically increasing the chances she'd lose the home that she'd owned for more than three decades.[69]

- In a case reported by the *Los Angeles Times*, a 54-year-old Mexican immigrant with a sixth grade education ended up with a WaMu loan his family couldn't afford after signing loan documents written only in English, "a language he neither speaks nor reads." The Santa Ana, Calif., resident claimed an independent mortgage broker working on Washington Mutual's behalf misled him about how much the loan would cost. In addition, the loan application that WaMu approved inflated his income, as well as the income of his daughter, claiming he made $7,400 a month as owner of a landscaping company and that she made $5,700 as month as owner of a housecleaning company. In truth, he worked as a glass cutter and she worked in a noodle factory, and both made $9 hour. Rather than earning $157,000 a year between them, they actually made closer to $60,000.[70]

- In a similar case reported by the *Mercury News*, a Latino couple in East San Jose, Calif. claimed it received two mortgages through Long Beach Mortgage after the lender approved a loan application that falsely claimed the family had income of more than $100,000, as well as $19,700 in the bank. The loan contracts called for the family to initially pay over $3,500 a month, more than the family's actual monthly income. And things would only get worse: the monthly payments were poised to adjust every six months and climb above $4,300 and beyond.[71]

These borrowers weren't alone. Evidence turned up in investigations by government officials, private attorneys and news outlets indicate WaMu's bad practices went well beyond individual cases and instead involved systematic efforts to mislead borrowers and investors.

State authorities in New York are pressing a case that accuses WaMu of widespread fraud in its appraisal process. Appraisal fraud is often a crucial element of predatory lending; inflating home values allows lenders to make shaky loans that are unlikely to be approved otherwise, and then offload the risks to investors who are led to believe that the loans are safer bets than they really are.

In November 2007, New York state Attorney General Andrew Cuomo sued one of the nation's largest appraisal companies, claiming that the firm had caved into the pressure from WaMu to use only appraisers who would "bring

in the values" that WaMu's loan production staff demanded.[72] Cuomo said WaMu had "strong-armed" the appraisal firm into allowing the bank to hand-pick appraisers willing to inflate home values and help questionable loans go through, as part of "a system designed to rip off homeowners and investors alike."[73] In all, the appraisal firm did more than 260,000 appraisals for WaMu between the spring of 2006 and the fall of 2007, earning $50 million in fees.

A securities fraud class action in federal court in Seattle claims WaMu took irresponsible risks and manipulated the appraisal and underwriting processes in order to exaggerate home values and borrowers' ability to pay.[74] The lawsuit claims WaMu management used intense pressure and rich financial incentives to push employees to ignore common-sense underwriting principles and pump up loan volume.

The risks the company took were "very scary," according to a former assistant vice president at WaMu who is quoted in the lawsuit. A former WaMu underwriter in Oregon reports in the lawsuit that employees regularly inflated borrowers' incomes on their loan applications, noting that on "stated income" loans that $5,000-a-month was the "magic number" that employees would put down for borrowers' incomes. "It got to be a joke after a while," the former underwriter said.

An ABC News investigation that draws on the lawsuit found evidence that WaMu's management brushed aside and in some cases fired risk management gatekeepers who warned that the bank was steering down a dangerous path. "Everything was refocused on loan volume, loan volume, loan volume," a former senior risk manager told ABC, adding that on several occasions higher ups pressured him to upgrade his risk assessment in order to make a loan deal go through.[75] Dorothea Larkin, a former credit risk manager for Washington Mutual, told the *Washington Post* that the bank aggressively pushed exceptions to its lending standards that allowed it to approve more and more option ARM loans. "As we kept making the same exception over and over again, what was an exception in 2003 and in 2004 became the norm in 2005," Larkin said.[76]

In 2005, a group of senior risk managers crafted a plan requiring that loan officers document that borrowers could afford the full monthly payment on option ARMs. A former bank official told the *Washington Post* that OTS signed off on the plan, but "never said anything" after bank executives rejected the plan.[77]

OTS also allowed WaMu to reduce the share of revenues it set aside to cover losses on new loans. By mid-2005, WaMu held $45 to cover losses on every $10,000 in outstanding loans, or about 25% less than the already declining average for OTS-regulated institutions.[78]

This lethal combination—a growing flood of risky loans combined with a dwindling cushion against defaults—doomed WaMu.

Reckless disregard

As in the case of IndyMac, the OTS waited until the eleventh hour before allowing WaMu to be placed on the federal government's list of troubled banks. That designation didn't come until a week before WaMu's failure. According to *American Banker,* FDIC officials had begun pushing OTS in August 2008 to downgrade WaMu's supervisory rating and clear the way to put the company on the government's list of problem banks. But that sparked an argument between the agencies, with OTS "arguing that WaMu's situation was stable, and that it was working to correct the problem."[79]

OTS was wrong. WaMu wasn't stable and the agency's efforts didn't save the troubled bank. WaMu failed because its leaders put short-term gains and market share ahead of the interests of its customers and shareholders—and in

large measure because OTS didn't take to heart the lessons it should have learned from the falls of NetBank and IndyMac, as well as the general implosion of other lenders and financial firms.

Too Much to Handle: OTS and Financial Conglomerates

Among the accomplishments that OTS touted in its 2007 annual report was the agency's designation as an "equivalent consolidated supervisor"—a seal of approval from European financial regulators that essentially authorized the U.S. agency to serve as the worldwide regulator for a number of financial conglomerates with international breadth. These included three of the biggest names in American finance: GE Capital Services, Ameriprise Financial Group and American International Group (AIG). OTS, which had federal authority over the three because they operated thrifts, boasted that the designation was "a striking sign of how well other nations regard the quality of OTS supervision."[80]

The Europeans' regard for OTS was misplaced. It's now clear that OTS's inability to oversee the risks associated with complex financial derivatives contributed to the near-failure of AIG, which in turn has forced the federal government to dole out more than $150 billion in bailout monies to keep the company alive.

AIG, the world's largest insurance company, was nearly destroyed by "a freewheeling little 377-person unit in London" that infected the company with a virus of monstrously bad bets on insurance-like derivatives products known as "credit-default swaps."[81] According to the *New York Times,* the small AIG unit that handled these transactions pushed its huge corporate parent to the brink because it operated "in a climate of opulent pay, lax oversight and blind faith in financial risk models."[82]

OTS failed—until it was too late—to understand the dangers that massive derivative bets had created for AIG. A top OTS official has admitted that the agency misjudged the risks of more than $500 billion in credit-default swaps that AIG held on its balance sheet as of 2007. AIG's balance sheet risks included some $60 billion in swaps tied to subprime mortgages.[83]

"We were looking at the underlying instruments and seeing them as low-risk," said C.K. Lee, head of the OTS's Complex and International Organizations unit, which oversaw AIG. "The judgment the company was making was that there was no big credit risk."[84]

Credit default swaps are designed to help companies cushion risks, acting as insurance policies if, for example, a corporate borrower defaults on a debt. But swings in market conditions can sting buyers or sellers of swaps, forcing them to take big losses or raise big sums as collateral.[85] Lee said the swaps were viewed as "fairly benign products" and that "we missed the impact" of so-called collateral triggers, which required AIG to set aside billions of dollars to increase the safety cushion in the event of a market downturn or a downgrade in the company's credit rating.

In a recent article, the investigative news organization ProPublica found that OTS had failed to take strong steps to force AIG to curb its exposure despite years of accounting errors and other problems in its derivatives business. Among the red flags:

- 2004: AIG paid an $80 million fine to settle a criminal investigation by the U.S. Justice Department, which had accused AIG of aiding and abetting securities fraud involving swaps and other transactions.
- 2005: AIG reported accounting errors and weaknesses relating to derivatives totaling roughly $2.5 billion.
- 2006: AIG reported $300 million in "out-of-period adjustments" relating to derivative-related assets.

- 2007: A dispute with trading partner Goldman Sachs raised new questions about the value of AIG's swaps.
- Early 2008: AIG disclosed that a "third-party analysis" had predicted $9 billion to $11 billion in losses on its credit-default swaps portfolio. Nevertheless, AIG's own forecast predicted losses of just $1.2 billion to $2.4 billion.[86]

OTS raised concerns with AIG about its derivatives bets but never took formal enforcement action. In March 2008 Lee sent AIG a letter asking the firm to come up with a "corrective action plan" regarding its derivatives bets within 30 days.[87]

But Lee left his job of as head of OTS's Complex and International Organizations unit a month later, and the unit was "quietly disbanded," according to ProPublica. "AIG missed its deadline for a corrective plan, and the one it later submitted couldn't stop the company's decline."[88]

AIG came under increasing strain as market conditions worsened and collateral requirements for its swaps increased, growing from $850 million in mid-2007 to $16.5 billion in mid-2008. After AIG's credit rating was downgraded in September 2008, AIG couldn't come up with an additional $18 billion in additional collateral required under derivatives contracts it had issued.[89] The situation was perilous.

AIG probably would have gone under if the Federal Reserve hadn't stepped in September 2008 with an emergency $85 billion loan. Since then, the Federal Reserve and the U.S. Department of Treasury have aggregately escalated their total package of loans and equity investments in AIG to more than $150 billion.[90]

OTS Should be Eliminated for Structural Reasons

Beyond the agency's performance record in recent years, there are other sound reasons for ending the thrift charter and doing away with OTS. Structural flaws in the federal bank regulatory system make it unlikely that even the most conscientious efforts could transform OTS into an effective regulator.

Ending regulatory duplication

In making the case for eliminating the thrift charter, the Treasury Department's modernization plan correctly explains that changing rules and changing market conditions have meant there's less and less distinction between banks and thrifts, and thus little reason to continue regulating them under separate structures.[91] Thrifts once did the bulk of single-family home lending in the United States, but the nature of mortgage lending has changed markedly in recent decades.

Thrifts no longer control the lion's share of the mortgage market; in fact, by 2005, commercial banks' share of the residential mortgage market was roughly twice that of thrifts.[92] At the same time, the thrift industry remains subject to regulatory constraints that limit members' ability to diversify their loan portfolios. As a result of their heavy concentration in residential lending, they are vulnerable to the housing market's historical boom-and-bust cycle, as has been shown with the mortgage market meltdown of the past two years.[93] To the extent that they do diversify, thrifts become more like commercial banks, which further weakens any argument that they need a separate regulator.

Treasury Secretary Paulson has noted that markets can develop so quickly that portions of the government's regulatory structure can be rendered "relatively obsolete." He went on to say that the federal thrift charter "has run its course and should be phased out."[94] Other banking experts agree. "It makes no sense to me to have a separately regulated thrift industry any longer," said Jim Barth, a Lowder Eminent Scholar in Finance at Auburn University and a former OTS economist. "It would be far better to consolidate the OTS and the Comptroller of the Currency."[95]

Reducing "regulator shopping"

Allowing banks to choose their federal regulator—by choosing between a thrift charter and a commercial banking charter—makes the system vulnerable to regulator shopping, or what some policy analysts call "regulatory arbitrage." This encourages institutions to "shop" for the easiest regulator—that is, the regulator that promises the least oversight. In turn, such an arrangement encourages regulators to "compete" with each other to offer the most lenient oversight. There is strong incentive to do so, because the size of regulators' budgets depends on the fees that they get from the institutions they regulate. Because larger institutions pay a large chunk of regulators' fees, there's a powerful incentive for regulators to go easy on big institutions. The result is a race to the bottom that undermines the regulatory system's ability to protect borrowers, depositors and shareholders, as well as the financial system at large.

Among the incentives offered by the federal regulators to lure institutions to their charter is the promise of "federal preemption"—the right of the institution to ignore state laws like anti-predatory lending laws, and to ignore law enforcement officials such as state attorneys general. Unfortunately, federal laws don't do enough to protect customers as an alternative to the displaced state laws.[96] Although federal preemption applies to OCC-supervised institutions as well, OTS has aggressively asserted a scheme of preemption that goes the farthest in attempting to displace state law. That is another path on the race to the bottom. Banks that want to get the most insulation from consumer protection laws tend to be attracted to the charter that provides the greatest shield from state laws.

Case in point: Playing musical chairs with the federal charter

An example of the dangers of regulatory arbitrage can be seen in the record of Countrywide Bank's shift to a thrift charter.

OTS approved Countrywide Financial Corporation's application to convert Countrywide Bank into a thrift in March 2007. This action consolidated federal regulation of both the bank and the holding company within the OTS. Previously, the OCC had regulated the bank and the Federal Reserve had regulated the holding company.

Senior bank executives who participated in meetings between Countrywide and OTS told the *Washington Post* that the agency pitched itself as a "less antagonistic" regulator. "The general attitude was they were going to be more lenient," one Countrywide executive told the *Post*.[97] The *Post* has also reported that Darrel Dochow, the OTS official who was later investigated for of his role in the IndyMac case, played a "leading role" in persuading Countrywide to switch to OTS supervision.[98]

One sign of OTS's greater flexibility was its willingness to limit the amount of charges that Countrywide might have to take as it suffered losses due to problems with home-equity and "Alt-A" loans. At the time, Federal Reserve and OCC regulations required commercial banks to take an immediate charge in such instances, while OTS rules were more accommodating.[99] *Financial Week's* headline said it all: "Bank-to-Thrift Shift Helps Countrywide Sneak By."

American Banker, the industry's premier trade paper, noted that the switch to OTS also benefited Countrywide because the agency was more tolerant of alternative mortgage products than other federal agencies.[100] In the application process, the OTS had heard lots of criticism about Countrywide's "exotic loan portfolio," and fielded questions about its ability to regulate affairs of the company.[101] In the two years before the regulatory changeover, under the watch of the OCC, the company boosted its loan volume by making large numbers of poorly unwritten pay option ARM mortgages and home equity lines of credit—loans that were approved with little scrutiny of borrowers' long-term ability to stay afloat as monthly payments began to rise.[102]

In late September 2006, federal regulators adopted joint guidelines, "Interagency Guidance on Nontraditional Mortgage Product Risks," to address concerns that some lenders were originating nontraditional loan products to borrowers who could not afford to pay them off, like the payment option ARMs that comprised an increasingly large share of Countrywide's portfolio.[103]

Guidances, however, are only as effective as the regulator applying them. Both the OCC and Federal Reserve, which supported the interagency guidance, began tightening their scrutiny of Countrywide's lending practices.[104] Only weeks later, in November 2006, Countrywide acted to switch its charter to the OTS—the agency with the reputation in the industry for being most forgiving in its views on these products.

Under OTS supervision, Countrywide Bank and its sister companies continued to originate loans that did not meet interagency guidance on ability to repay. The company continued, at least until August 2007, to book a significant level of pay option ARM mortgages and home equity lines of credit that gave little consideration to whether borrowers had the capacity to repay them.[105]

By the end of the third quarter of 2007, the results of Countrywide's poor loan underwriting were plain to see, with delinquencies climbing far above industry averages and holding company Countrywide Financial Corporation booking a $1.2 billion loss.[106] By early January 2008, Countrywide's financial situation was so shaky that Bank of America was able to acquire the company for a fraction of what had been Countrywide's market value less than a year before.[107]

There is no publicly available evidence that OTS took strong action to curb the risky practices that had landed Countrywide into severe financial straits. A top OTS official told the Reuters Regulation Summit that, at the time of the sale to Bank of America, OTS had no formal enforcement action pending against Countrywide Bank or against its holding company.[108] The episode underscores why it's not sound public policy for depository institutions to be able to switch charters at their own whim, especially in the midst of a burgeoning financial and mortgage market crisis. In the crucial period between March and December 2007 when Countrywide's survival was decided, OTS failed to act, either because it was still getting acquainted with the company's problems, or because the agency did not have the will to act effectively in the face of a burgeoning crisis.

The Amazing Shrinking Agency: Emerging Budget Woes

As the supplement beginning on page 16 indicates ("The OTS: Overseeing a Disappearing Industry?"), the mortgage meltdown is already leaving the OTS a shadow of its former self:

- Institutions accounting for $354 billion of its $1.5 trillion managed asset portfolio (as of 12/31/07) have already been shut down this year.

- Institutions with assets totaling an additional $350 billion are likely to disappear from OTS's supervision soon, based on announced mergers and acquisitions of thrifts by other institutions.
- At least 20 other thrifts with assets totaling $293 billion could also leave the OTS regulatory framework soon. They are all subsidiaries of larger institutions, and are increasingly likely to fall totally under the regulatory control of the Federal Reserve as bank holding companies.

In sum, the OTS is facing the potential loss of well over half of its current asset portfolio in the immediate future.

Currently, OTS receives its entire budget from fees assessed on its regulated institutions. The loss of these assets will severely impact the agency's budget and effectiveness. It's unlikely that the remaining institutions will be willing or able to cover the shortfall through a large increase in their examination fees.

Main report continues on page 21

The OTS: Overseeing A Disappearing Industry?

THIS REPORT CONTAINS many examples of lax regulatory oversight from the Office of Thrift Supervision. But trends in the industry raise another question about the future of OTS: Even if OTS survives, what will its regulatory scope look like?

Trends in the industry are foreshadowing a bleak outlook for OTS. Because of the thrift crisis that it helped create, OTS has become an agency overseeing a significantly shrinking field.

The number of thrifts in this country has steadily eroded over the past 20 years. There were more than 3,000 chartered thrifts when Congress founded OTS in 1989. Since that time, the industry has continued to lose institutions, dropping to only 1,068 by the end of 2000 and to 826 by the end of 2007. This decline was offset to some extent by the growth in assets: The total OTS thrift portfolio got bigger—increasing from $839 billion in 2000 to more than $1.5 trillion at the end of 2007.

Now, however, the agency has seen two of its largest thrifts—IndyMac Bank and Washington Mutual—disappear as casualties of their own risky lending practices. Recently, the OTS has also closed Downey Savings & Loan Association and PFF Bank & Trust, further eroding its supervised asset base.

Here is a list of the institutions that failed in 2008*:

Table 1: Institutions Under OTS Supervision that Failed in 2008

	$ Assets at failure (in billions)	Notes
Washington Mutual Bank	$307.02	closed & sold to JP Morgan Chase 9/25/08
IndyMac Federal Bank, FSB	$30.70	closed 7/11/08; FDIC is selling to a new firm
Downey S & L A	$12.78	closed 11/21/08
PFF Bank & Trust	$3.72	closed 11/21/08
Ameribank	$0.10	closed 9/19/08
Total	**$354.32**	

On The Way Out?

Beyond the thrifts that have already gone under, there's another set of institutions that appear likely to exit the OTS portfolio in the near future.† All of them have either merged into other institutions, are part of announced mergers, or (in the case of Lehman) are affiliates of companies in bankruptcy. While the new parent institutions haven't announced final plans for these thrifts, it's likely most, if not all, of these assets will leave the thrift world and become part of their new corporate entities.

* Data on closings taken from OTS website reports.
† Data on asset size and merger announcements from SNL Financial.

Table 2: Institutions "On the Way Out"

	$ Assets (in billions) 9/30/08	Notes
Countrywide Bank, FSB	$112.95	merged with Bank of America
Sovereign Bank	$77.15	to be acquired by Banco Santander
Wachovia Mortgage, FSB	$67.06	merging with Wells Fargo
Merrill Lynch Bank & Trust FSB	$35.85	merging with Bank of America
Wachovia Bank, FSB	$33.22	merging with Wells Fargo
Chevy Chase Bank, F.S.B.	$15.50	to be acquired by Capital One
Lehman Brothers Bank, FSB	$7.21	corporate parent bankrupt; future unclear
Total	**$348.93**	

In sum, the 12 thrifts that either failed in 2008 or are likely to leave the OTS portfolio represent more than $700 billion of the OTS' base of portfolio assets. From the historically high levels of more than $1.5 trillion in managed assets, the elimination of these assets will drop the total portfolio under OTS supervisory authority to roughly $800 billion.

Thrifts In Name Only?

Along with thrifts that have failed or appear likely to leave OTS's jurisdiction, there are other thrifts that also might not remain under OTS supervision for long. These are thrifts that are small parts of much larger institutions.

OTS has long touted the flexibility of its holding company oversight. Even with the failure of thrifts like IndyMac and Washington Mutual, the OTS still oversees more than 450 thrift holding companies that among them have more than $8.1 trillion in assets.

The nature and size of these holding companies are extremely diverse. For instance, more than 35 insurance companies have thrift subsidiaries, and more have announced plans to buy thrifts to qualify for the federal government's TARP bailout funds.

Though there is no immediate reason why these institutions will be removed from the OTS portfolio, the experience with AIG oversight (see pages 11 and 12) has led the GAO to question the quality of OTS oversight of large holding companies*—and regulatory reform has been talked about widely as an early agenda item for the incoming Congress.

The following list of the 20 largest known thrifts† are subsidiaries of larger entities that, based on the AIG situation, raise questions of how well OTS can oversee their operations:

* U.S. Government Accountability Office, "A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System," GAO-09-216 (January 8, 2009).

† Information on asset size and corporate parents taken from SNL Financial.

Table 3: Thrifts in Name Only?

Subsidiary Thrift List	$ Assets (in billions) 9/30/08	Industry of Parent	Business Notes
ING Bank, FSB	$81.60	insurance	Thrift does have active mortgage loan and MBS program
E*TRADE Bank	$45.62	broker/dealer	Thrift runs major online home-equity-loan operation
USAA Federal Savings Bank	$31.68	insurance	Thrift has active consumer and home loan programs
American Express Bank, FSB	$23.60	specialty lender	Thrift focuses on commercial and consumer loans
Charles Schwab Bank	$23.70	broker/dealer	Thrift converted from bank in 2007; does market home loans
Citicorp Trust Bank, FSB	$19.60	bank	Thrift has active book of home loans
State Farm Bank, FSB	$16.46	insurance	Thrift concentrates heavily on consumer loans
GE Money Bank	$15.72	conglomerate	Thrift focuses on consumer loans, with markets in China & Europe
Raymond James Bank, FSB	$11.38	broker/dealer	Thrift invests heavily in commercial loan participations
Morgan Stanley Trust	$5.25	investment bank	Thrift has no loan portfolio; mostly buys MBS
Mutual of Omaha Bank	$3.95	insurance	Thrift has small loan portfolio; concentrated in commercial & nonresidential loans
IronStone Bank (First Citizens)	$2.64	commercial bank	Corporate parent has announced plans to merge thrift into commercial banking
Nationwide Bank	$1.90	insurance	Thrift books relatively few loans; does invest in MBS
FPC Financial, FSB. (John Deere)	$1.84	farm equipment	Thrift has active farm credit programs—especially for John Deere products
BB&T Financial	$1.74	commercial bank	Corporate parent has marketed credit-card programs through thrift
Acacia FSB (UNIFI Ins.)	$1.57	insurance	Acacia operates like a traditional thrift: 87% of loans are home loans
Prudential Bank & Trust	$1.56	insurance	Thrift has no loans on books; assets are mostly cash, with some MBS
Ameriprise Bank, FSB	$1.46	insurance	Thrift has only 30% of assets in direct loans; strong concentration of MBS
AIG Federal Savings Bank	$1.32	insurance	Thrift traditionally served as origination platform for AIG subprime subsidiaries
H&R Block Bank	$1.06	financial services	Thrift has large mortgage portfolio—but 23% are nonperforming
Total Assets	**$293.67**		

It is notable that most of these institutions bear very little resemblance to a standard thrift—one with a large mortgage portfolio that is held directly on the balance sheet:

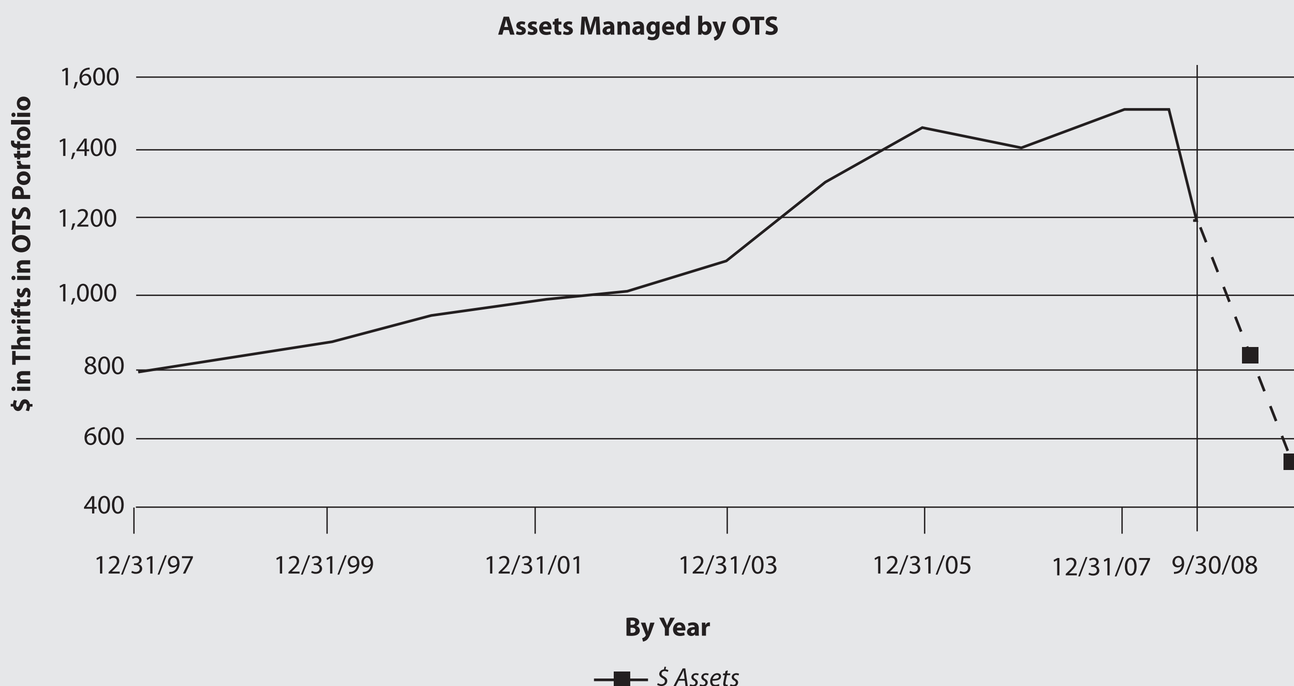
- Almost all of them are tiny subsidiaries of much larger holding companies. In contrast, most thrifts are the primary asset in their holding company. For instance, ING Bank represents less than 5% of the 1.37 trillion pounds in assets controlled by insurance company ING Groep, N.V., and American Express Bank represents less than 20% of the assets of the American Express Company. E*TRADE Bank does account for 90% of the parent company's $49.7 billion in assets—but is a far smaller portion of the broker/dealer's revenues and expenses.

- Many of them veer off the standard bread-and-butter model of residential lending. For instance, GE Money Bank mostly markets consumer loans, including international operations in markets like China and Denmark. American Express Bank focuses mostly on commercial and consumer loans. Even thrifts subsidiaries that focus heavily on home loans—like Nationwide Bank—keep very few of those loans on their books as directly held loans.

- Many of them have tie-ins to other parts of the holding company enterprise. Raymond James Bank, for example, has a heavy concentration of deposits from its corporate parent's investment customers. FPC Financial largely finances consumer purchases of farm equipment—especially equipment marketed and sold by dealers of corporate parent John Deere.

In sum, most of these business models are extremely complex—and need more oversight than the OTS can muster.

If these institutions end up being removed from the OTS portfolio, that would leave the regulator with a portfolio of slightly more than $500 billion. This chart shows the historical—and prospective trends:



Where Did Those Loans Go?

Recent data from *Inside Mortgage Finance** has also shown that trends in the thrift industry have also eroded the thrifts' primary role as a supplier of residential mortgages:

1. Through 9/30/08, year-to-date thrift mortgage production is down by 40.8% compared to 2007.

2. In the third quarter, production declined by 39%, compared to a mortgage-industry-wide drop of 21%.

3. Portfolios have declined by 26.9%, and the value of mortgage servicing rights for these institutions has declined from $13.76 billion to $7.76 billion in the third quarter alone.

4. More than 45% of the thrift production in 2008 has come from the institutions listed above that have either failed or announced that they will be acquired by other institutions that are not regulated by OTS—including Countrywide, WaMu, Wachovia, Merrill Lynch and Downey.

In large part because of this declining business, as well as problems with the existing mortgage portfolios, thrifts lost $3.99 billion in the third quarter of 2008, and through September had lost $15.1 billion.

All of these trends taken together—the declining number of thrifts to manage and the steadily worsening financial performance of remaining thrifts—indicate that OTS's sphere of oversight could diminish significantly within the next year.

* *Inside Mortgage Finance* (December 5, 2008).

Continued from page 15

The new Congress has placed regulatory reform high on its list of priorities for the new session. It will likely face the need to either overhaul the funding scheme for the OTS—or, as we recommend, fold it into the rest of the federal financial regulatory apparatus.

Conclusion: Reforming the Banking System

OTS's record indicates it is an agency that has failed in its primary mission. The depth and the extent of the current banking crisis, however, clearly indicate that it is not alone. The OCC and the Federal Reserve have also failed in their duty to serve as guardians of consumers and the financial system, and they should be subject to major reforms that make them more responsive and more credible as consumer watchdogs.

Merging the OTS into the OCC would be a first step in the regulatory reform necessary to return our nation's banking system to sound fundamentals. Americans need a regulatory system that focuses on the long term, rather than one that allows itself to become captive to market incentives that emphasize short-term gains, fueling "boom and bust" cycles driven by unsustainable growth in loan volume.

In particular, CRL believes that the revised "post-OTS" regulatory framework must embody a set of standards that will truly protect the interests of bank customers, with a strong emphasis on mortgage borrowers.

The need for this emphasis is compelling. Despite occasional nods in the direction of consumer protection by federal regulators in the years after 2000, they did little to provide real protection to consumers. Indeed, as it announced that it was preempting Georgia's anti-predatory lending law, the OCC proposed a breathtakingly broad rule preempting state laws, which it eventually adopted in January 2004. Asked why the agency went ahead with the final rule despite requests from Congress to pull back, a spokeswoman admitted, in essence, that it was to protect lenders from state anti-predatory lending legislation.[109]

Until the problem was well on its way to becoming unmanageable, federal regulatory agencies resisted the need for clear and legally enforceable rules to combat the unfair practices and reckless loan underwriting that put millions of consumers into mortgages they could not afford. Federal agencies preferred to define the boundaries for bad practices behind closed-doors in an after-the-fact, case-by-case basis.[110]

OTS, the OCC and the Federal Reserve failed to stop predatory and unsafe practices because they operated under the flawed assumption that consumer protection was a drag on the lending industry, an unnecessary burden that got in the way of institutional growth and profits and, thus, safety and soundness. As this crisis and others before it have shown, consumer protection is a safeguard that protects the banking industry from its own excesses, as well as protecting consumers, their neighbors and the world economy.

As FDIC Chairman Sheila Bair said recently, "Protecting the consumer from . . . perils is not simply a do-good public service. In fact, consumer protection and safe and sound lending practices are two sides of the same coin. Lenders who put their retail customers at risk also put themselves, their investors, and our entire financial system in danger."[111] In particular, if borrowers can't afford their loans, the resulting foreclosures will cause losses for banks, threatening their safety.

As reform moves forward, consumer protection must take its rightful place front and center in regulation of depository institutions. CRL believes these principles should guide the reform process:

1. The dual banking system should be preserved.

Improving the federal regulatory scheme shouldn't require sacrificing the dual state-federal banking system. The modest numbers of state-licensed thrifts—just over 80 as of the end of 2006—generally operate efficiently and are small enough that state regulators have adequate resources to oversee them. State licensing also serves as a counter to the massive consolidation that's now occurring in the banking industry; it will preserve financial institutions that are sensitive to concerns of local communities, are cost-effective choices for consumers and serve as a bulwark against anti-competitive practices.

As part of this plan, the FDIC should replace OTS as the federal regulator for state-chartered thrifts, providing assistance to state regulators who oversee these institutions. The FDIC already provides supervisory support for roughly 400 state-chartered savings banks.

2. Federal standards should act as a floor, not a ceiling.

The federal government should stop getting in the way of states that are trying to do something about predatory practices in the mortgage market. The "first responders" to the serious problems in the industry were the states, first tightening up the loopholes in the 1994 federal law,[112] then, as the nature of the abuses morphed, acting to curb the new waves of predatory tactics.[113] The mortgage industry fought back with a call for "uniform" national standards, though the real push was for uniformly low standards. Because states see the effects of problems sooner, they can respond more nimbly than Congress. Most federal consumer protection laws have had their genesis in state laws: states are, indeed, "laboratories of democracy," closer to the people and more willing to find useful innovations in public policy.[114]

As recently as the mid-1990s, state attorneys general were able to enforce state consumer protection laws of general applicability against national banks. However, in recent years, the OCC and OTS have been aggressive in preempting state laws and in expanding the traditional definition of "visitation" so that the institutions under their watch have little or no oversight, even as to matters beyond the traditional expertise of those agencies.[115]

The economic crisis of recent months vividly illustrates that the vacuum left by excessive preemption and too little enforcement has hurt not only consumers, but also financial institutions and the broader economy. We suggest that the following moves be made to put the state "cops" back on the beat.

- The OCC's general standard for preemption should conform to the Supreme Court rule spelled out in *Barnett Bank of Madison County v. Nelson*,[116] which says that state laws apply unless they "prevent or significantly impair" banking functions.

- The OCC's expansion of the definition of "visitation" should be reversed. This will allow state attorneys general to enforce consumer protection laws of general applicability.

- The agencies have also expanded the rights of third parties with whom they deal to assert the benefit of preemption, which could create a regulatory "vacuum" for brokers, settlement agents, and others. This is particularly important in the case of mortgage brokers. For example, insurance companies owning banks or thrifts are asserting that independent contractors who broker mortgage loans count as "employees" and are therefore exempt from the recently-passed state mortgage broker registries; OTS and OCC should not permit this.

3. Mortgage lending must be based on sound underwriting.

Congress and the states are currently engaged in the difficult task of writing laws to create a solid framework that will protect the interests of homeowners and prevent another mortgage disaster in the future. The market should be governed by sensible rules aimed at reversing the "anything-goes" ethos that in recent years has dominated both federal regulations and on-the-ground practices in the mortgage industry.

State and federal laws should require that:

- Lenders carefully assess borrowers' ability to repay their loans, taking the following into account:

    a. Borrowers' debt-to-income ratio must be set at a reasonable level and should take account of all debt payments, including principal, taxes and insurance, any other mortgages, and other household debt. On option ARM and interest-only loans, the debt-to-income ratio should be calculated based on fully indexed and fully amortizing payments.

    b. Loans should be documented, with verification based on W-2 and 1099 forms, tax returns, bank records and other reasonable third-party documents.

    c. Loan-to-value ratios should not be used to determine borrowers' ability to repay.

- Prepayment penalties should be banned on all subprime and nontraditional loans.

- Escrow of taxes and insurance should be required on all subprime and nontraditional loans.

4. Market incentives should be aligned to ensure that no party can shirk responsibility for making responsible lending and investment decisions.

As FDIC Chairman Bair recently noted, referring to the separation of origination, funding and servicing segments in the securitization model: "If we want private securitization to ever work again, we need a workable compensation scheme that aligns the interests of all the players in the game."[117] In short, there must be skin in the game all the way up the chain.

A. Assignee liability

The current mortgage meltdown has shown that Wall Street firms and securities investors will bankroll loan structures that are best for their short-term financial interests, and that originators will supply the loans for which they are paid the most. Borrowers' long-term interests were irrelevant in this process.

The best way to re-align the interests of borrowers and lenders is for Congress to insist on meaningful assignee liability.[118] An assignee is an investor or company that had bought the rights to collect on the loan, or sell it to other investors. When assignee liability exists, the borrower is allowed to pursue legal claims against the assignee when the loan transaction involves illegal actions or abusive terms. In the case of the mortgage market, strong assignee liability would mean that when a trust purchases mortgages, with all the corresponding financial benefits, it also accepts reasonable liability in cases when mortgages are proven in court to be abusive and harmful to homeowners.

Assignee liability can be tightly drawn but must satisfy the principle that an innocent borrower who has received an illegal loan should be able to defend that loan in foreclosure. This should be so for two reasons: first, the assignee can spread any loss across thousands of other loans, while the borrower has but one home. Second, assignees can

choose what lenders they buy loans from; they can choose only reputable lenders that are likely to make quality mortgages and are strong enough to purchase a loan back if the loan was clearly illegitimate, thus saving the assignee from suffering losses.

Public enforcement can never be adequate: there is a shortage of resources to match the millions of loans made to borrowers. As the Federal Reserve recently noted, "a securitized pool of mortgages may have been sourced by tens of lenders and thousands of brokers," making it difficult for regulators to protect borrowers from "abusive and unaffordable loans."[119]

Investigations are almost always too slow for the homeowners who face foreclosure. Even when public enforcement does achieve some relief, it will rarely be enough to make individual borrowers whole. Assignee liability uses market principles to decentralize oversight of loans purchased on the secondary market—no one will better ensure that mortgages are originated to acceptable standards than investors who carry the eventual financial and legal risk. Assignee liability also helps to protect responsible investors from misperceived risks and provides incentives for the market to police itself, curbing market inefficiencies.

B. Prohibition of abusive yield-spread premiums

Banning yield-spread premiums for subprime and nontraditional mortgages would reduce motivation for brokers to "up sell" borrowers into more expensive and riskier loans than those for which they qualify.

Absent a ban on yield-spread premiums, any payment of such a premium by a lender should be recognized as an acknowledgment of business relationship between the broker and originating lender, with liability for brokers' misdeeds attaching to the originating lender and subsequent holders of the note.

C. Making lenders' duties clear

Clarifying the duty of care that mortgage originators have toward their borrowers is a critical step in promoting sustainable mortgage lending. Loan originators–whether lender or broker–should be deemed to have duties to assure that they do not place their own self-interests above the interests of borrowers.

D. Requiring that investors pay rating agencies instead of issuers.

The only way to make sure that rating agencies provide unbiased and accurate ratings is to change their relationship with the issuers of mortgage-backed securities. Securities issuers have an incentive to distort the truth about what's in these securities pools. Investors, on the other hand, have an incentive to get the best information possible about the makeup of the deals they put their money into. So it should be the investors—not the issuers—who pay the rating agencies for their evaluations of mortgage-backed securities.

An Opportunity for Change

The problems in our nation's mortgage markets are severe, and the damage that's been done has been historic in scope. Reversing years of regulatory inattention will require forceful action in the near term and strong follow-through in the long term. This report is part of the Center for Responsible Lending's continuing effort to analyze and address the problems faced by the nation's homeowners and families. The reforms outlined in this paper represent a beginning point in the effort to bring common sense and fairness back to the nation's mortgage markets.

The lessons of the first S&L scandal were clear: Weak regulation and reckless lending practices will, sooner or later, end with financial disaster. Forgetting those lessons help produce a second S&L debacle, as well the related subprime and Wall Street meltdowns.

Now, once again, we have an opportunity to put these lessons to work. If citizens and policymakers can't achieve real change this time around, history will inevitably repeat itself–with still more banking institutions going under, more financial crises, and millions more Americans buried in debt and facing the loss of their homes.

Notes

1 Based on data from SNL Financial.

2 SNL data at note 1. Among these was Countrywide Bank, which was sold in early 2008 to Bank of America along with its parent, Countrywide Financial.

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8 For more on the failures of the OCC and the Fed, see Eric Stein, Center for Responsible Lending, "Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis," testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs (October 16, 2008).

9 The OCC's aggressive efforts to preempt state laws and to limit state oversight of financial institutions reduced the number of "cops on the beat" at the worst possible time, allowing abusive practices to continue even as state regulators were raising significant concerns. For this reason, increasing attention to consumer protection is a critical component of any regulatory reform effort that includes merging the OTS into the OCC, as well as rolling back preemption interpretations to ensure that federal rules are a floor, not a ceiling for lending standards, and to ensure increased cooperation between federal and state officials in conducting oversight of federal institutions.

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33 Ferguson v. IndyMac Bank, U.S. District Court for the Eastern District of New York, filed February 14, 2008.

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