United States Senate
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Committee on Homeland Security and Governmental Affairs

Carl Levin, Chairman
Tom Coburn, Ranking Minority Member

E X H I B I T S

Hearing On

WALL STREET AND THE FINANCIAL CRISIS: THE ROLE OF BANK REGULATORS

April 16, 2010

199 Russell Senate Office Building, Washington, D.C. 20510

Carl Levin, Chairman
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1. a. Memorandum from Permanent Subcommittee on Investigations Chairman Carl Levin and Ranking Minority Member Tom Coburn to the Members of the Subcommittee.
   b. *Washington Mutual Practices That Created A Mortgage Time Bomb*, chart prepared by the Permanent Subcommittee on Investigations.
   c. *Office of Thrift Supervision Comments on WaMu and Long Beach Underwriting/Lending Deficiencies*, chart prepared by the Permanent Subcommittee on Investigations.
   d. *Excerpts from Documents Showing OTS Repeatedly Identified Washington Mutual and Long Beach Underwriting/Lending Deficiencies*, chart prepared by the Permanent Subcommittee on Investigations.
   e. *Excerpts from Documents Showing OTS Repeatedly Identified Washington Mutual and Long Beach Risk Management Deficiencies*, chart prepared by the Permanent Subcommittee on Investigations.
   f. *Excerpts from Documents Showing Slow and Weak OTS Enforcement at Washington Mutual,* chart prepared by the Permanent Subcommittee on Investigations.
   g. *Excerpts from Documents Showing OTS Impeding FDIC's Oversight*, chart prepared by the Permanent Subcommittee on Investigations.
   h. *Excerpts from Documents Showing OTS Internal Views on Inability to Stop Poor Quality Lending Practices*, chart prepared by the Permanent Subcommittee on Investigations.
   i. *WaMu Dodging Compliance with Tougher Lending Standards: Nontraditional Mortgage Guidance*, chart prepared by the Permanent Subcommittee on Investigations.
   j. *Washington Mutual Regulators Timline*, chart prepared by the Permanent Subcommittee on Investigations.

Documents Related to OTS Failure to Address Long Term Safety and Soundness:

2. *Office of Thrift Supervision, 2004 Examination Handbook (Proactive regulatory supervision should evaluate future needs and potential risks to ensure the success of the thrift system in the long term.)*(excerpt).

3. OTS internal email, dated June 2005, re: *Revised ALLL Finding Memo Response (In summary, the extended time frames (1-2 month extensions) for implementation of various portions of the response to not appear to be significant due to the fact that they are only 1-2 month extensions of management's own initiatives and we don't want to penalize management for their own initiatives.).*

4. OTS internal email, dated July 2005, re: *Mortgage Survey (I would not send this to WAMU without more preparation. ... But the bottom line is that we reviewed the risk and communicated our concerns to management already. To ask for this similar information in the survey would almost be like one hand didn't know what the other was doing. My preference would be shorten the survey quite a bit and start with higher level information, and then drill down on individual exams.).*

5. OTS internal email, dated September 2005, re: *WSJ Article: re: tightening mtg stds (As I have mentioned to some, by the time we come out with regulatory guidance, moral suasion and market/media attention will have already done the trick, at least for the regulated entities!).*

6. OTS internal email, dated September 2005, re: *Meeting (It has been hard for us to justify doing much more than constantly nagging (okay, "chastising") through ROE and meetings, since they have not been really adversely impacted in terms of losses.).*

7. OTS internal email, dated June 2006, re: *Talk (My own fear is that we may not have done enough to communicate to you why we feel that the few negative things we have brought up through findings memos and meetings . . . are not so serious they . . . negate the ongoing good progress in making improvements in a manner that seems reasonable given the size, complexity, and status of the institution.).*

8. OTS internal email, dated May 2007, re: *Fair Lending Findings Memo (Apropos the lack of tools - that is a reality. I'm willing OK with your changes, but you need to realize that I feel very strongly about this. If the agency could be subject to criticism for the lack thereof, my feeling is that is appropriate and it is high time we got such tools. ... I do not believe that sweeping this under the rug is necessary.).*

9. Draft OTS Exam Findings Memo of Washington Mutual Bank, dated May 31, 2007, re: *Compliance Management Program (WaMu's compliance management program has suffered from a lack of steady, consistent leadership. Dick Stevenson ... is the bank's ninth compliance leader since 2000.).*

10. OTS Exam Findings Memo of Washington Mutual Bank, dated June 7, 2007, re: *Broker Credit Administration (There are 14 FTEs in BCA handling approximately 34,283 brokers.).*

11. OTS internal email, dated October 2007, re: *May 3 memo (...I sent out an e-mail on May 3, 2007, that announced a number of changes.... Now that we are 5 months into this new process, I am not yet comfortable that we have made sufficient progress toward accomplishing these goals.).*

12. a. OTS Exam Findings Memo of Washington Mutual Bank, dated June 19, 2008, re: *Loan Fraud Investigation (..."control gaps were identified ... that did not sufficiently mitigate loan fraud exposure." ...raised questions as to whether similar conditions are systemic throughout the organization, particularly since many of the issues raised have either*

previously been raised internally or have been noted at the current or at prior OTS examinations ....).

b. *Meeting with Board of Directors, July 15, 2008, OTS Comprehensive Examinations of Washington Mutual Bank, (Management/Board Performance and Oversight Unsatisfactory . . . performance exacerbated by condition within management's control.)*(excerpt).

13. OTS correspondence to Washington Mutual Bank, dated September 25, 2008, re: *Appointment of a Receiver*.

14. OTS internal email, dated October 2008, re: *West Region Update (You know, I think that once we (pretty much all the regulators) acquiesced that stated income lending was a reasonable thing, and then compounded that with the sheer insanity of states income, subprime, 100% CLTV, lending, we were on the figurative bridge to nowhere.)*.

Documents Related to Slow and Weak OTS Enforcement:

15. OTS internal email, dated June 2003, re: *OTS Memo 7 (It is clear from my experience that changes seem to progress slowly at WAMU so I don't know if we can expect faster progress.)*.

16. OTS *High risk Meeting Notes, West Region,* undated*, (The Director (while pacing) was very concerned over all the management changes and putting inexperienced people in charge of critical areas. Region agreed with concerns.)*.

17. OTS Exam Findings Memo of Washington Mutual Bank, dated May 12, 2004, re: *SFR Loan Origination Quality (Several of our recent examinations concluded that the Bank's single family loan underwriting was less than satisfactory due to excessive errors in the underwriting process, loan document preparation, and in associated activities.)*.

18. OTS internal email, dated April 2004, re: *Locale (In any event, a paragraph very clearly tells WAMU they need to identify originated subprime in both home and consumer loans and demonstrate compliance with the interagency policy statement as amended Jan 31, 2001.)*.

19. OTS internal email, dated April 2005, re: *Fitch - LBMC Review (Some insight on the subprime product at LBMC for ALLL and high risk lending initiative.)*.

20. OTS internal email, dated May 2005, re: *LBMC Fair Lending (I would not, however, say that we could feel comfortable with their moving LBMC under the thrift without some conditions.... Completion of that plan - and satisfactory corrective actions - would be an appropriate condition.)*.

21. FDIC/Washington State Exam Findings Memo of Washington Mutual Bank, dated May 20, 2004, re: *Single Family Residential Review (The loan file review reflected inconsistencies in underwriting and documentation practices, particularly in the brokered channel. Additionally, examiners noted that Washington Mutual's SFR portfolio has an elevated level of risk due to*

a significant volume of potential negative amortization loans, high delinquency and exception rates, and a substantial volume of loans with higher risk characteristics, such as low FICO scores.).

22. OTS Exam Findings Memo of Washington Mutual Bank, dated May 20, 2005, re: *Allowance for Loan and Lease Loss Modeling (Management is in process of validating and calibrating LPRM version 3.1, but the validation continues to show a significant disparity in actual and projected SFR loss rates.).*

23. OTS Exam Findings Memo of Washington Mutual Bank, dated June 1, 2005, re: *Corporate Risk Oversight (Corporate Risk Oversight (CRO) is responsible for independently evaluating credit and compliance risk across the company and assessing the effectiveness of risk management processes relative to established strategic and risk tolerance objectives. ... Most of the findings are considered "criticisms" due to the overall significance of CRO activities and the fact that we have had concerns with quality assurance and underwriting processes within home lending for several years.).*

24. OTS Exam Findings Memo of Washington Mutual Bank, dated June 2, 2005, re: *LBMC Underwriting Review (Our review disclosed underwriting deficiencies that require management's attention.).*

25. OTS internal email, dated June 2005, re: *LBMC downgrades (...this business is simply too high profile for us not to be sure that processes are in place to assure there will be no repeat of the performance of these earlier vintages....both in securitizations and in the originations they will hold for investment.).*

26. OTS Exam Findings Memo of Washington Mutual Bank, dated June 3, 2005, re: *Single Family Resident Home Loan Review (We continue to have concerns regarding the number of underwriting exceptions and with issues that evidence lack of compliance with Bank policy.).*

27. OTS Exam Findings Memo of Washington Mutual Bank, dated June 3, 2005, re: *Loan Origination Quality (The redesigned incentive compensation program for LFCs still does not satisfactorily reward excellence in loan origination quality. Finding 3 in the 2004 OTS Memo No. 5 was closed because an improved design for the incentive compensation program was devised. However, the program was not implemented as designed.).*

28. OTS internal memorandum, dated June 3, 2005, re: *Long Beach Mortgage Corporation (LBMC) Review (Because of the high profile nature of the business of LBMC and its problematic history, we believe that any and all concerns regarding the subprime operation need to be fully addressed prior to any move.).*

29. OTS internal email, dated June 2005, re: *S-S 2 response (They agree to take all action required to correct the problem. The Target Completion Dates are not real timely but fine for WAMU.)*

30. OTS internal email, dated November 2005, re: *Meeting (While we may (and have) questioned the reasonableness of these standards, they are all we have at this time. If our tolerance for some reason is now a lot lower than our handbook standards, it would be nice to have this clarified.)*.
31. OTS internal memorandum, dated December 21, 2005, re: *Long Beach Mortgage Corporation (LBMC))*.

32. OTS internal email, dated January 2006, re: *WAMU Commitment letter (At some level, it seems we have to rely on our relationship and their understanding that we are not comfortable with current underwriting practices and don't want them to grow significantly without having the practices cleaned up first.)*.

33. OTS Exam Findings Memo of Washington Mutual Bank, dated May 23, 2006, re: *Home Loan Underwriting (...we did note various underwriting errors that continue to require management's attention.)*.

34. WaMu internal email, dated May 2006, re: *OTS Memo 12 - Home Loans Underwriting (...John was able to get the OTS to see the light and revise the Underwriting rating to a Recommendation.)*.

35. OTS Exam Findings Memo of Washington Mutual Bank, dated May 25, 2006, re: *Loan Underwriting Review - Long Beach Mortgage (Overall, we concluded that the number and severity of underwriting errors noted remain at higher than acceptable levels.)*.

36. OTS internal email, dated June 2006, re: *Findings Memo (We gave them the benefit of the doubt based on commitments and some progress when we allowed them to bring LBMC into the bank, but if I am understanding the finding from this exam correctly, we have the same type of concerns remaining 6 months later.)*.

37. Draft OTS Exam Findings Memo of Washington Mutual Bank, dated May 31, 2007, re: *Compliance Management Program*.

38. OTS Exam Findings Memo of Washington Mutual Bank, dated June 19, 2007, re: *Allowance for Loan and Lease Losses on the 1-4 Single Family Residential Loan Portfolio.*

39. OTS internal email, dated June 2007 re: *Compliance rating (They aren't interested in our "opinions" of the program. They want black and white, violations or not.)*.

40. OTS internal email, dated November 2007, re: *Wamu appraisal review (The fact that coo rotella runs the business units, was the champion of cost cutting and use of third party appraisal outsourcing, and continues to downplay the various business units' failing (compliance, bsa, flood and now maybe appraisal) by diverting blame to others (risk management and now counsel) leaves me uncomfortable.)*.

41. OTS correspondence to Washington Mutual Bank, dated February 27, 2008 (*This letter is to advise you that the Office of Thrift Supervision (OTS) is adjusting downward the composite rating for Washington Mutual Bank ... from a "2" to a "3" effective today.)*.

42. OTS internal email, dated February 2008, re: *Kerry Killinger (...my feeling that OTS would be reasonable in providing adequate times over the business cycle for WAMU management to make improvements, particularly in earnings, and that it would be my hope that we would not place unrealistic expectations or demands to make changes/improvements over unrealistic time periods.)*.

43. OTS internal email, dated June 2008, re: *Call from Killinger (I further told Kerry that as a matter of policy, OTS believes that "3" rated institutions, especially repeat "3"s, warranted informal supervisory action and consideration of formal action.*

44. OTS/WaMu email, dated July 2008, re: *MOU vs. Board Resolution (We almost always do an MOU for 3-rated institutions, and if someone were looking over our shoulders, they would probably be surprised we don't already have one in place.)*.

45. OTS internal email, dated July 2008, re: *WAMU MOU (It is, unfortunately, another example of a benign supervisory document.)*.

46. OTS internal email, dated August 2008, re: *Wamu MOU-Board provisions (He* [Ben] *is concerned that the board is not getting sufficient, consistent, or understandable information/reports from management. This was confirmed by the board's self-assessment where they acknowledged that they did not have a full understanding of the bank's risks.)*.

47. OTS internal email, dated August 2008, re: *WAMU (What is the status of the ROE? When will it be mailed? What is the status of the MOU? I feel like we are stuck in quicksand here.)*.

48. *OTS, WaMu Ratings of 3/343432, September 11, 2008 (The bank's overall unsatisfactory condition is primarily the result of the poor asset quality and operating performance in the bank's major Home Loan Group line of business. ... The deteriorating asset quality in the Home Loans Group is accompanied by inadequacies in risk management, internal controls, and oversight that made the bank more vulnerable to the current housing and economic downturn. The examination criticized past liberal home loan underwriting practices and the concentrated delivery of nontraditional mortgage products to higher risk geographic markets.)*.

Documents Related to OTS Impeding FDIC's Oversight:

49. OTS internal email, dated January 2006, re: *FDIC participation (The message was crystal clear today. Absolutely no FDIC participation on any OTS 1 and 2 rated exams.)*.

50. OTS internal email, dated June 2006, re: *wm board meeting (Didn't even cross my mind that we would have an issue with their attendance at the board meeting.)*.

51. a. FDIC internal memorandum, dated June 14, 2005, re: *Potential Impact of a Possible Housing Bubble on Washington Mutual Bank.*
    b. FDIC internal memorandum, dated July 5, 2005, re: *Insured Institutions' Exposure to a Housing Slowdown.*
    c. FDIC internal email, dated September 2006, re: *OTS re: WAMU (The OTS must really be afraid of what we might come across, but bottom line is we need access to the information.)*.

52. a. - d. Correspondence between FDIC and OTS, dated October 2006 - January 2007 regarding FDIC participation in OTS examinations of Washington Mutual Bank.

53. FDIC internal email, dated October 2006, re: *wamu quarterly (Please read info about denying us space and access to information. The situation has gone from bad to worse.)*.

54. FDIC internal email, dated January 2007, re: *wm exam (I'm just not relishing another round of "No." Well, let them make fools of themselves again.*).

55. FDIC internal email, dated February 2007, re: *wamu (...here we go again. This is unnecessary hair splitting by OTS Seattle, and does not comport with the approval we got from RD Finn on participation.)*.

56. OS internal email, dated March 2008, re: *Call from Shelia this evening (Shelia was complimentary of OTS's presentation and commented about our being on top of the issues. I would like to think she meant it, but I'm always a bit skeptical of her compliments.)*.

57. FDIC internal email, dated April 2007, re: *Meeting with OTS Regional Management (...Finn pushed back on his previous approval of our participation in the 2007 exam targets, specifically as to our ability to work loan files alongside OTS examiner, and we were particularly interested in WAMU's compliance with nontraditional mortgage guidance.)*.

58. OTS internal email, dated March 2008, re: *WAMU (...could you...have someone on your staff put together a position paper on the need for Treasury to stay removed from the supervision of wamu, including any attempt to influence our supervision of wamu's capital raising process.)*.

59. OTS internal email, dated July 2008, re: *Updates (I have read the attached letter from the FDIC* [to OTS, dated July 21, 2008] *regarding supervision of Wamu and am once again disappointed that the FDIC has confused its role as insurer with the role of the Primary Federal Regulator. Its letter is both inappropriate and disingenuous.)*.

60. OTS internal email, dated July 2008, re: *Response to July 21 letter RE: WAMU* (attaching July 22, 2008 letter from OTS to FDIC).

61. FDIC internal email, dated July 2008, re: *WAMU Briefing Paper (The bank's credit culture emphasized home price appreciation and the ability to perpetually refinance, including the ability to sell non performing assets. The bank's underwriting standards were therefore lax as management originated loans under a securitization model to transfer risk to the market.)*.

62. OTS internal email, dated August 2008, re: *WaMu (Sheila Bair just reported on a conference call that there was a rating difference on this exam. Can you fill us in.)*.

63. FDIC/OTS email, dated August 2008, re: *WaMu Rating (You asked me to hear out wamu. I hope that you would also hear out our examination staff if it comes to that.)*.

64. FDIC internal email, dated August 2008, re: *WAMU (Major ill will at WAMU meeting yesterday caused by FDIC suggestion in front of WAMU management that they find a strategic partner. Reich reportedly indicated that was totally inappropriate and that type of conversation should have occurred amongst regulatory agencies before it was openly discussed with management)*.

65. OTS internal email, dated August 2008, re: *WAMU Update and FW: FDIC Ratings (The headbutting is currently going on in DC between myself and Shelia Bair.)*.

66. FDIC/OTS email, dated August 2008, re: *W (I should not have to remind you that FDIC has no role until the PFR (i.e. the OTS) rules on solvency and the PFR utilizes PCA.)*.

67. FDIC internal email, dated August 2008, re: *Undated Earnings Assessment/Capital Analysis (FYI, it looks like the region will be well armed for Thursday's discussion with the OTS. ... I find it troubling that the primarily* [sic] *regulator is able to conclude on capital without digging into these numbers. We have been asking for the forecasted balance sheet for months now and this is the first we have them. Our skeptical assessment is essentially forcing them to dig deeper behind the numbers. Which they should have done in the first place before deciding on a capital rating.)*.

68. FDIC/OTS email, dated September 2008, re: *Rating Disagreement (I cannot believe the continuing audacity of this woman.)*.

69. OTS internal email, dated September 2008, re: *Wamu - need your help (The purpose of the meeting would be to discuss the various views of the institutions's risk profile, current actions under consideration by the FDIC, and possible capital considerations. We would control the meeting and ensure that we have no repeat of the inappropriate behavior displayed by some of the FDIC in our last session with the bank. This is my idea, not the FDIC's idea.)*.

<u>Documents Relating to Nontraditional Mortgage Guidance</u>:

70. OTS internal email, dated March 2006, *(I am nervous about us putting disproportionate pressure on institutions to increase start rates and decrease the start rate/fully-indexed rate differential.)*.

71. OTS internal email, dated July 2006, re: *NTM Open Issues (We should consider going on the offensive, rather than defensive to refute the OCC's positions.)*.

72. OTS internal email, dated August 2006, re: *Latest AMP Guidance (Market impact - MTA hybrid IO ARMS are a huge product for Wamu (I'm trying to get current stats as we speak). I would imagine there would be a fairly big impact on their lending in this product if they were required to underwrite to full neg-am over the life of the loan, assuming borrower makes minimum payment ALWAYS. We have dealt with this product longer than any other regulator and have a strong understanding of best practices. I just don't see us taking a back seat on guidance that is so innate to the thrift industry. I wouldn't feel one bit disappointed if we had to go it alone on this one.)*.

73. *Washington Mutual, Alternative Mortgage Guidance Implementation Plan, October 2006 (Recap of OTS Meeting - A: OTS is still gathering FAQ from their constituency and expects they may issue a position paper (at some undetermined future date), however their initial response was that they view the guidance as flexible. They specifically pointed out that the language in the guidance say "should" vs. "must" in most cases and they are looking to WaMu to establish our own position on how the guidance impacts our business processes.)*.

74. OTS *Option ARM Neg Am Review, Workprogram (212A(1) & Nontraditional Mortgage Guidance Review,* undated, (*Wamu stated that they do not engage in underwriting practices that heighten the need for a borrower to rely on the sale or refinancing of the property to make amortizing payment on the loans; and therefore they are not making collateral based loans. However the liberal use of the Low-Doc/State Income loans raises the question of reliability of the declared income as being the primary repayment source.)*

75. WaMu internal email, dated March 2007, re: *Follow-up information to last evening's call regarding subprime interagency guidance, etc. (If we implement the NTM changes to all loans, then we'll see additional drop of 33% of volume.)*.

76. OTS internal email, dated March 2007, re: *NTM Gap Analysis (I noted that several of our institutions make NINA loans. That, in my humble opinion is collateral dependent lending and deemed unsafe and unsound by all the agencies.)*.

77. OTS internal email, dated April 2007, re: *NTM Gap Analysis (...its only been a few months since the guidance came out so they may need more time to make the necessary adjustments.)*.

<u>Other Documents</u>:

78. OTS internal email, dated May 2007, re: *Lunch Friday (Kerry Killinger, the CEO of Washington Mutual (WaMu) will be in town Friday and wants to have a lunch meeting. He's my largest constituent assetwise.)*.

79. OTS internal email, dated May 2007, re: *NINA Loans (I note that WAMU makes a significant amount of No-doc loans. OTS policy states that no-doc loans are unsafe and unsound.)*.

80. SEC correspondence to OTS, dated June 24, 2008, re: *In the Matter of Washington Mutual, Inc. (...the SEC staff was advised by Washington Mutual's counsel, Josh Levine, that the OTS instructed Washington Mutual not to provide documents to the Commission relating to OTS's review of Washington Mutual's appraisal processes or any communications between the OTS and Washington Mutual.).*

81. FDIC internal email, dated April 2008, re: *Findings from Review of WAMU Basel II models (HELOC and credit cards) (It is clear, however, that OTS at all levels is very aware of the political clout of WAMU within their agency.)*.

82. *Office 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.

83. U.S. Government Accountability Office Testimony, *FINANCIAL REGULATION: Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions,* March 18, 2009, GAO-09-499T, (*...regulators had identified numerous weaknesses in the institutions' risk management systems before the financial crisis began… However, the regulators said that they did not take forceful actions to address these weaknesses, such as changing their assessments, until the crisis occurred because the institutions had strong financial positions and senior management had presented the regulators with plans for change.)*.

84. Center for Responsible Lending Report, *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.

85. WaMu internal email, dated, February 2005, re: *Moving to Closure on Alliance Agreement (We agreed that the Freddie 65% minimum share (100% of option arms) proposal offers us between 26MM and 37MM on benefit depending on volume. ... 39% of our 2005 home loans gain on sale comes from conforming option arms sales.)*.

86. *Washington Mutual, Pre-Meeting for Fannie Mae, March 12, 2004.*

87. *Freddie Mac - WaMu Meeting,* July 28, 2005.

88. WaMu internal email, dated December 2004, re: *Risks/Costs to Moving GSE Share to FH*.

89. WaMu internal email, dated April 2006, re: *Business Arrangement w/Freddie Mac (Highlights of 2006 Freddie Mac Business Proposal)*.

90. *Washington Mutual, Fannie Mae Alliance and Freddie Mac Business Relationship Proposal*.

91. *GSE Forum, September 25, 2005 (Objectives of the Freddie/Fannie Business Agreement)*.

92. *WaMu - Excess Liquidity Forecast - 'Break the Bank' (Total excess liquidity was $47BN at the end of June 2008 which is consumed by the end of October as a result of significant deposit runoff and loss of wholesale funding sources)*.

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MEMORANDUM

To: Members of the Permanent Subcommittee on Investigations

From: Senator Carl Levin, Subcommittee Chairman
Senator Tom Coburn, Ranking Member

Date: April 16, 2010

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

On Friday, April 16, 2010, beginning at 9:30 a.m., the Permanent Subcommittee on Investigations will hold the second in a series of hearings examining some of the causes and consequences of the recent financial crisis. This hearing will focus on the role played by federal bank regulators, using as a case history Washington Mutual Bank, the largest bank failure in U.S. history.

Subcommittee Investigation. In November 2008, the Permanent Subcommittee on Investigations initiated a bipartisan investigation into some of the causes and consequences of the financial crisis. Since then, the Subcommittee has engaged in a wide-ranging inquiry, issuing numerous subpoenas; conducting over 100 interviews and depositions; and consulting with dozens of government, academic, and private sector experts on banking, securities, financial, and legal issues. The Subcommittee has also accumulated and initiated review of over 50 million pages of documents, including court pleadings, filings with the Securities and Exchange Commission, trustee reports, prospectuses for securities and private offerings, corporate board and committee minutes, mortgage transactions and analyses, memoranda, marketing materials, correspondence, and email. The Subcommittee has also reviewed documents prepared by or sent to or from banking and securities regulators, including bank examination reports, reviews of securities firms, enforcement actions, analyses, memoranda, correspondence, and email.

To provide the public with the results of its investigation, the Subcommittee is holding a series of hearings addressing the role of high risk lending, regulators, credit rating agencies, investment banks, and others in the financial crisis. These hearings will examine issues related to mortgage backed securities, collateralized debt obligations, credit default swaps, and other complex financial instruments. After the hearings, a report on the investigation will be prepared.

Washington Mutual Case History. The initial hearing in the series, on April 13, used Washington Mutual Bank as a case study to examine the role of high risk loans in the U.S. financial crisis. Headquartered in Seattle, with branches and loan centers across the country, Washington Mutual Bank had over 100 years of experience in the home loan business and had grown to become the nation's largest thrift with more than $300 billion in assets, $188 billion in deposits, and 43,000 employees. Washington Mutual's thrift charter required the bank to concentrate on home loans and maintain most of its assets in mortgage related activities. Each year, it originated or acquired billions of dollars of home loans through multiple channels, including loans originated by its own loan officers, loans brought to the bank by third party mortgage brokers, and loans purchased in bulk from other lenders or firms. In addition, its

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affiliate, Long Beach Mortgage Company ("Long Beach"), originated billions of dollars in home loans brought to it by third party mortgage brokers specializing in subprime lending.

Washington Mutual kept a portion of its home loans for its own investment portfolio, and sold the rest either to Wall Street investors, usually after securitizing them, or to Fannie Mae and Freddie Mac. At first, Washington Mutual worked with Wall Street firms to securitize its home loans, but later built up its own securitization arm, Washington Mutual Capital Corporation.

Until 2006, Washington Mutual's operations were profitable. In 2007, many of its high risk loans began experiencing increased rates of delinquency and loss, and after the subprime mortgage backed securities market collapsed in September 2007, Washington Mutual was unable to sell its subprime loans. In the fourth quarter of 2007, the bank recorded a loss of $1 billion. In 2008, Washington Mutual's stock price plummeted against the backdrop of a worsening financial crisis, including the forced sales of Countrywide Financial Corporation and Bear Stearns, government takeover of IndyMac, bankruptcy of Lehman Brothers, taxpayer bailout of AIG, and conversion of Goldman Sachs and Morgan Stanley into bank holding companies. In the first half of 2008, Washington Mutual lost another $4.2 billion, and its depositors withdrew a total of over $26 billion from the bank. On September 25, 2008, Washington Mutual Bank was placed into receivership by its primary regulator and was immediately sold to JPMorgan Chase for $1.9 billion.

Washington Mutual's Regulators. Washington Mutual's primary federal regulator was the Office of Thrift Supervision ("OTS"). OTS was created in 1989, in response to the savings and loan crisis to charter and regulate the thrift industry. It is part of the U.S. Department of the Treasury and headed by a Presidentially-appointed Director. Like other bank regulators, OTS is charged with ensuring the safety and soundness of the financial institutions it oversees. Its operations are funded through semiannual fees assessed on the institutions it regulates, with the fee amount based on the size, condition, and complexity of each institution's portfolio. Washington Mutual provided 12-15% of OTS revenue from 2003 to 2008.

OTS supervises its thrifts through four regional offices led by a Regional Director, Deputy Director, and Assistant Director. The regional offices assign an Examiner In Charge, supported by other examination personnel, to each thrift. OTS currently oversees about 765 thrift-chartered institutions. In all, approximately three-quarters of the OTS workforce reports to the four regional offices, while the remaining quarter works at the OTS Washington headquarters. Washington Mutual was supervised by the West Region whose office was, through the end of 2008, based in Daly City, California.

In addition to OTS, Washington Mutual was regulated by the Federal Deposit Insurance Corporation ("FDIC"). The mission of the FDIC is to maintain stability and public confidence in the nation's financial system by insuring deposits, examining and supervising financial institutions for safety and soundness and consumer protection, and managing failed institutions placed into receivership. To carry out these responsibilities, FDIC has backup supervisory authority over approximately 3,000 federally insured depository institutions whose primary regulators are the OTS, Office of the Comptroller of the Currency, or Federal Reserve. The

Deposit Insurance Fund is financed through fees assessed on the insured institutions, with assessments based on the amount of deposits requiring insurance and the degree of risk posed by each institution to the insurance fund.

For the eight largest institutions, the FDIC assigns at least one Dedicated Examiner to work on-site at the institution. The examiner's obligation is to evaluate the institution's risk to the Deposit Insurance Fund and work with the primary regulator to lower that risk. The FDIC has entered into a 2002 inter-agency agreement with the primary bank regulators to facilitate and coordinate their respective oversight obligations and ensure the FDIC is able to protect the Deposit Insurance Fund. Pursuant to that agreement, the FDIC may request to participate in examinations of large institutions or higher risk financial institutions, recommend enforcement actions to be taken by the primary regulator, and if the primary regulator fails to act, take its own enforcement action with respect to an insured institution. Washington Mutual had a FDIC-assigned Dedicated Examiner who worked with OTS examiners to oversee the bank.

Federal bank regulators have a wide range of informal and formal enforcement actions that may be used to ensure the safety and soundness of a financial institution. Informal enforcement actions, which are not made public, include issuing examination findings to the bank and both recommending and requiring corrective action, notifying the Board of problems, and requiring the Board to issue a resolution with commitments for corrective actions. Formal enforcement actions, which become public, include requiring the bank to enter into a Memorandum of Understanding with commitments for corrective action, imposing monetary fines, issuing cease and desist orders, and removing bank personnel.

The Examination Process. The stated mission of the OTS is "[t]o supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs." The OTS Examination Handbook, in section 10.2, requires "[p]roactive regulatory supervision" with a focus on evaluation of "future needs and potential risks to ensure the success of the thrift system in the long term."

To carry out its mission, OTS traditionally conducted an examination of its thrifts every 12-18 months and provided the results in an annual Report of Examination ("ROE"). In 2006, OTS initiated a "continuous exam" program for its largest thrifts, requiring its examiners to conduct a series of specialized examinations during the year with the results from all of those examinations included in an annual ROE. The Examiner in Charge led the examination activities which were organized around a rating system called CAMELS that is used by all federal bank regulators. The CAMELS rating system evaluates a bank's: (C) capital adequacy, (A) asset quality, (M) management, (E) earnings, (L) liquidity, and (S) sensitivity to market risk. CAMELS ratings use a scale of 1 to 5, with 1 being the best rating and 5 the worst. In the annual ROE, OTS provided its thrifts with an evaluation and rating for each CAMELS component, as well as an overall composite rating on the bank's safety and soundness.

At Washington Mutual, OTS examiners conducted both on-site and off-site activities to review bank operations, and maintained frequent communication with bank management through

emails, telephone conferences, and meetings. Washington Mutual formed a Regulatory Relations office charged with overseeing its interactions with OTS, the FDIC, and other regulators. During the year, OTS examiners issued "findings memos," which set forth particular examination findings, and required a written response and corrective action plan from Washington Mutual management. The findings ranged from "observations," to "recommendations," to "criticisms." The most serious findings were elevated to the Washington Mutual Board of Directors through designation as a Matter Requiring Board Attention ("MRBA"). MRBAs were set forth in the ROE and presented to the Board in an annual meeting attended by OTS and FDIC personnel. Washington Mutual tracked OTS findings and its responses through its Enterprise Issue Tracking System ("ERICS"). In a departure from its usual practice, OTS did not maintain a separate tracking system but simply relied on Washington Mutual's ERICS system to identify past examination findings and the bank's responses.

The FDIC also examined Washington Mutual, relying primarily on the examination findings and ROEs developed by OTS. The FDIC assigned its own CAMELS ratings to the bank. In addition, for institutions with assets of $10 billion or more, the FDIC has established the Large Insured Depository Institutions ("LIDI") Program to assess and report on emerging risks that may pose a threat to the Deposit Insurance Fund. Under this program, the Dedicated Examiner and other regional case managers perform ongoing analysis of emerging risks within each insured institution and assign a quarterly risk rating, using a scale of A to E, with A being the best rating and E the worst. In addition, senior FDIC analysts within the Complex Financial Institutions Branch analyze specific bank risks and develop supervisory strategies.

Washington Mutual's Examination History. From 2003 to 2008, OTS repeatedly identified significant problems with Washington Mutual's lending practices, risk management, and asset quality, and requested corrective action. Washington Mutual promised year after year to correct identified problems, but failed to do so. OTS failed to respond with meaningful enforcement action, resisted FDIC recommendations for stronger measures, and even impeded FDIC examination efforts.

OTS findings memoranda and ROEs repeatedly identified serious underwriting and risk management deficiencies at Washington Mutual. OTS elevated these issues to Washington Mutual's board by issuing MRBAs on underwriting deficiencies every year from 2003-2008. For most of those years, OTS determined that either Single Family Residential loan underwriting at Washington Mutual or subprime underwriting at Long Beach was "less than satisfactory." It also issued MRBAs on the need for stronger risk management from 2004-2008. In 2007, an OTS examiner noted that WaMu had nine different compliance officers in the past seven years, and that "[t]his amount of turnover is very unusual for an institution of this size and is a cause for concern."[1]

[1] Draft OTS Exam Findings Memo, "Compliance Management Program," May 31, 2007, Franklin_Benjamin-00020408_001.

In January 2005, Washington Mutual made a strategic decision to shift its focus from low risk fixed rate and government-backed loans to higher risk subprime, home equity, and Option ARM loans. OTS examiners expressed concern about but did not restrict a number of high risk lending practices at the bank, including accepting stated income loans without verifying the borrower's assets or ability to repay the loan, low documentation loans, loans with low FICO scores and high loan-to-value ratios, loans that required interest only payments, and loan payments that did not cover even the interest owed, much less the principal.[2] When one OTS examiner attempted to restrict "No Income No Asset (NINA loans)" in which the lender did not have to verify information about a borrower's income or assets, the OTS West Region overruled him and ignored an OTS policy official in Washington, D.C., discouraging use of such loans, calling him a "lone ranger" within the agency.

When Washington Mutual announced its shift to higher risk loans, OTS examiners observed that robust risk management practices would be necessary to function as a check and balance on the high-risk lending strategy. Yet from 2005 through 2008, OTS examiners consistently found Washington Mutual's risk management practices lacking. In addition, as noted above, throughout this period, OTS examiners continuously criticized Washington Mutual's underwriting standards and practices as "less than satisfactory" and the amount of underwriting errors as "higher than acceptable." OTS also observed over the years loans with erroneous or fraudulent information, loans that did not comply with the bank's credit requirements, or loans that contained other problems. Notwithstanding the many control weaknesses the bank's underwriting and risk management practices, OTS examiners took no action to bring about change in these areas.

OTS examiners were also aware that many Washington Mutual and Long Beach loans were brought to the bank by third party mortgage brokers or lenders over which the bank exercised weak oversight, but again took little action. For example, when OTS examiners noted in a 2007 findings memo that Washington Mutual had only 14 full-time employees overseeing over 34,000 third-party brokers, the examiners made only the following observation: "Given the . . . increase in fraud, early payment defaults, first payment defaults, subprime delinquencies, etc., management should re-assess the adequacy of staffing."[3] Washington Mutual management agreed with the finding, but provided no corrective action plan, stating only that "[s]taffing needs are evaluated continually and adjusted as necessary."

In 2006, due to increasing concerns about lax lending practices and exotic high-risk mortgages, federal bank regulators worked together to draft inter-agency guidance on

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[2] *See, e.g.*, OTS Report of Examination for Washington Mutual Bank, March 14, 2006, at 19, OTSWMEF-0000047030 ("We believe the level of delinquencies, 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 ARMS 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.").

[3] OTS Examination Findings Memo, "Broker Credit Administration," June 7, 2007, Hedger_Ann-00027930_001.

nontraditional mortgage products ("NTM guidance"). During the drafting process, OTS argued for less stringent lending standards than other regulators were advocating, using data supplied by Washington Mutual in order to protect the bank's loan volume. Once the guidance was issued in October 2006, while other bank regulators told their institutions that they were expected to come into immediate compliance, OTS took the position that compliance was something institutions "should" do, not something they "must" do, and allowed its thrifts over a year to comply.

For example, the NTM guidance required banks to evaluate a borrower's ability to repay a mortgage using a fully-indexed interest rate and fully-amortized payment amount. Washington Mutual, after learning that compliance with that requirement would lead to a 33% drop in loan volume due to borrowers who would no longer qualify for the loans, determined to "hold[] off on implementation until required to act for public relations … or regulatory reasons."[4] OTS allowed Washington Mutual to continue qualifying borrowers using lower loan payment amounts for another year, resulting in the bank's originating many Option ARM loans that would later suffer significant losses.

OTS justified its regulatory stance in part by pointing to Washington Mutual's profits and low level of mortgage delinquencies during the height of the mortgage boom, reasoning that the lack of losses made it difficult to require the bank to reduce the risks threatening the bank's safety and soundness. The OTS Examiner in Charge put it this way in a 2005 email: "It has been hard for us to justify doing much more than constantly nagging (okay, 'chastising') through ROE and meetings, since they have not been really adversely impacted in terms of losses."[5] Another examiner concerned about the bank expressed her frustration this way: "I'm not up for the fight or the blood pressure problems. . . . It doesn't matter that we are right . . . They [Washington Mutual] aren't interested in our 'opinions' of the program. They want black and white, violations or not."[6]

FDIC evaluations of Washington Mutual were consistently more negative than those of the OTS, with LIDI ratings that showed a higher degree of bank risk than OTS CAMELS ratings indicated, creating friction between the two agencies. In 2006, OTS began to exclude FDIC staff from active bank oversight by limiting the number of staff allowed on site, temporarily disrupting FDIC access to office space and bank information, and refusing to allow FDIC to review loan files, even for higher risk loans that could affect the FDIC's assessment of insurance fees on Washington Mutual or pose a threat to the deposit insurance fund. In February 2007, OTS refused to allow the FDIC to review loan files to evaluate Washington Mutual's compliance with the NTM guidance. In April 2007, when FDIC officials raised the issue with the OTS West Region Director, he disclosed for the first time to the FDIC that OTS was allowing the bank additional time to comply with the guidance before conducting file reviews.

[4] Email from Ron Cathcart to David Schneider, dated March 19, 2007, JPM_WM02571598.

[5] EIC Lawrence Carter email to West Region Deputy Director Darrel Dochow, Sept. 15, 2005, OTSWMS05-002 0000535.

[6] Email from Mary Suzanne Clark to EIC Ben Franklin, dated June 3, 2007, OTSWMS07-013 0002576.

When asked why the FDIC did not use its independent enforcement authority at Washington Mutual, one senior FDIC official told the Subcommittee that the agency had never used that authority because its fellow banking agencies would view an independent enforcement action as "an act of war" – an invasion of their regulatory turf that would irreparably harm the FDIC's working relationships with those agencies. Rather than take independent enforcement action, the FDIC had restricted itself to urging action by the primary bank regulator.

In July 2007, U.S. financial markets took a turn for the worse. Credit rating agencies suddenly downgraded hundreds of subprime mortgage backed securities, including over 40 Long Beach securities, and the subprime market collapsed. Washington Mutual was suddenly stuck with billions of dollars in unmarketable subprime loans and securities, and reported a $1 billion loss in the fourth quarter of 2007. In late February 2008, OTS downgraded Washington Mutual for the first time, changing its CAMELS rating from a 2 to a 3, signifying a troubled bank. At that point, consistent with its own practice, OTS should have concomitantly issued an enforcement action, but did not do so. Washington Mutual lost another $1 billion in the first quarter of 2008, and $3.2 billion in the second quarter. Its stock price plummeted, and depositors began withdrawing substantial sums.

In March 2008, at the urging of the FDIC, Washington Mutual invited potential buyers of the bank to review its information. Several institutions responded, and JPMorgan Chase made an offer which Washington Mutual turned down. The bank raised additional capital of $7 billion instead to reassure the market. In July 2008, IndyMac, another thrift with high risk loans, failed and was taken over by the FDIC. In response, Washington Mutual depositors began to withdraw more funds from the bank, eventually removing over $9 billion.

During this liquidity run on the bank, the FDIC formally challenged the OTS CAMELS rating, advocating a downgrade to a 4, indicating significant concern about the bank's long-term viability. The two agencies argued amongst themselves over the rating for weeks during the summer of 2008, as the bank's condition continued to deteriorate. Finally, in September 2008, as the FDIC's judgment of Washington Mutual's risk profile became more severe, the FDIC independently downgraded the bank to a 4. In response, mere days before the bank's failure, OTS agreed to the 4 rating. In addition, on September 7, 2008, OTS took its first formal enforcement action, requiring the bank to enter into a Memorandum of Understanding. Even then, the MOU did not require the bank to strengthen its lending or risk management practices, instead directing it to hire a consultant to revise its business plan. FDIC contributed the strongest measure, requiring development of a plan to increase the bank's capital. Apart from the capitalization plan, OTS' Chief Operating Officer described the MOU as a "benign supervisory document."

After Washington Mutual failed, the OTS Examiner in Charge at the bank expressed his frustration with the role played by the bank regulators, writing to an OTS colleague: "You know, I think that once we (pretty much all the regulators) acquiesced that stated income lending was a reasonable thing, and then compounded that with the sheer insanity of stated income, subprime, 100% CLTV [Combined Loan-to-Value], lending, we were on the figurative bridge to nowhere. Even those of us that were early opponents let ourselves be swayed somewhat by

those that accused us of being 'chicken little' because the losses were slow in coming, and let[']s not forget the mantra that 'our shops have to make these loans in order to be competitive'. I will never be talked out of something I know to be fundamentally wrong ever again!!"[7]

OTS' failure to act allowed Washington Mutual to engage in unsafe and unsound practices that cost borrowers their homes, led to a loss of confidence in the bank, and sent hundreds of billions of dollars of toxic mortgages into the financial system with its resulting impact on financial markets at large.

Findings. Federal bank regulators are supposed to ensure the safety and soundness of individual U.S. financial institutions and, by extension, the U.S. banking system. Washington Mutual was just one of many financial institutions that federal banking regulators allowed to engage in such high risk home loan lending practices that they resulted in bank failure and damage to financial markets. The ineffective role of bank regulators was a major contributor to the 2008 financial crisis that continues to afflict the U.S. and world economy today.

Based upon the Subcommittee's ongoing investigation, we make the following findings of fact regarding the role of federal regulators in the Washington Mutual case history.

(1) **Largest U.S. Bank Failure.** From 2003 to 2008, OTS repeatedly identified significant problems with Washington Mutual's lending practices, risk management, and asset quality, but failed to force adequate corrective action, resulting in the largest bank failure in U.S. history.

(2) **Shoddy Lending and Securitization Practices.** OTS allowed Washington Mutual and its affiliate Long Beach Mortgage Company to engage year after year in shoddy lending and securitization practices, failing to take enforcement action to stop its origination and sale of loans with fraudulent borrower information, appraisal problems, errors, and notoriously high rates of delinquency and loss.

(3) **Unsafe Option ARM Loans.** OTS allowed Washington Mutual to originate hundreds of billions of dollars in high risk Option Adjustable Rate Mortgages, knowing that the bank used unsafe and unsound teaser rates, qualified borrowers using unrealistically low loan payments, permitted borrowers to make minimum payments resulting in negatively amortizing loans (*i.e.*, loans with increasing principal), relied on rising house prices and refinancing to avoid payment shock and loan defaults, and had no realistic data to calculate loan losses in markets with flat or declining house prices.

(4) **Short Term Profits Over Long Term Fundamentals.** OTS abdicated its responsibility to ensure the long-term safety and soundness of Washington Mutual by concluding that

[7] OTS EIC Benjamin Franklin email to OTS Examiner Thomas Constantine, Oct. 7, 2008, Franklin_Benjamin-00034415.

short-term profits obtained by the bank precluded enforcement action to stop the bank's use of shoddy lending and securitization practices and unsafe and unsound loans.

(5) **Impeding FDIC Oversight.** OTS impeded FDIC oversight of Washington Mutual by blocking its access to bank data, refusing to allow it to participate in bank examinations, rejecting requests to review bank loan files, and resisting FDIC recommendations for stronger enforcement action.

(6) **FDIC Shortfalls.** FDIC, the backup regulator of Washington Mutual, was unable to conduct the analysis it wanted to evaluate the risk posed by the bank to the Deposit Insurance Fund, did not prevail against unreasonable actions taken by OTS to limit its examination authority, and did not initiate its own enforcement action against the bank in light of ongoing opposition by the primary federal bank regulators to FDIC enforcement authority.

(7) **Recommendations Over Enforceable Requirements.** Federal bank regulators undermined efforts to end unsafe and unsound mortgage practices at U.S. banks by issuing guidance instead of enforceable regulations limiting those practices, failing to prohibit many high risk mortgage practices, and failing to set clear deadlines for bank compliance.

(8) **Failure to Recognize Systemic Risk.** OTS and FDIC allowed Washington Mutual and Long Beach to reduce their own risk by selling hundreds of billions of dollars of high risk mortgage backed securities that polluted the financial system with poorly performing loans, undermined investor confidence in the secondary mortgage market, and contributed to massive credit rating downgrades, investor losses, disrupted markets, and the U.S. financial crisis.

(9) **Ineffective and Demoralized Regulatory Culture.** The Washington Mutual case history exposes the regulatory culture at OTS in which bank examiners are frustrated and demoralized by their inability to stop unsafe and unsound practices, in which their supervisors are reluctant to use formal enforcement actions even after years of serious bank deficiencies, and in which regulators treat the banks they oversee as constituents rather than arms-length regulated entities.

Washington Mutual Practices That Created A Mortgage Time Bomb

- Targeting Higher Risk Borrowers
- Steering Borrowers to Higher Risk Home Loans
- Increasing Sales of High Risk Home Loans to Wall Street
- Offering Teaser Rates
- Offering Interest Only and "Pick a Payment" Loans
- Offering Negative Amortizing Loans
- Not Verifying Income (Accepting Stated Income or "Liar" Loans)
- Requiring Low or No Documentation
- Qualifying Borrowers By Ability to Make Initial Low Payments
- Ignoring Signs of Fraudulent Borrower Information
- Presuming Rising Home Prices When Approving Loans
- Making Loans That Are Dependent on Refinancing to Work
- Using Lax Controls over Loan Approvals
- Offering Higher Pay for Making Higher Risk Home Loans
- Offering Higher Pay for Charging Excess Interest Rates or Points
- Rewarding Employees for Loan Volume over Loan Quality
- Securitizing Home Loans Identified as Likely to Fail
- Securitizing Home Loans Identified as Fraudulent

Prepared by U.S. Senate Permanent Subcommittee on Investigations, April 2010

Permanent Subcommittee on Investigations
EXHIBIT #1b

Office of Thrift Supervision Comments On WaMu and Long Beach Underwriting/Lending Deficiencies

2004:

- "Underwriting … remains less than satisfactory." *September 2004*
- "[N]ot … successful in effecting change." *September 2004*

2005:

- "[U]nderwriting exceptions [are] evidence [of] lack of compliance with bank policy." *June 2005*
- "[D]eficiencies, if left unchecked, could erode the credit quality of the portfolio. Our concerns are increased with the risk profile of the portfolio." *August 2005*
- "[D]eterioration in these [Long Beach] older securitizations is not unexpected." *October 2005*

2006:

- "[C]ontinuing weakness in … loan underwriting at Long Beach." *March 2006*
- "[N]umerous instances of underwriter exceeding underwriting guidelines … [and] errors." *May 2006*

2007:

- "[T]oo much emphasis was placed on loan production … at the expense of loan quality." *September 2007*
- "[S]ubprime underwriting practices remain less than satisfactory." *September 2007*
- "[U]nderwriting exceptions and errors remain above acceptable levels." *September 2007*

2008:

- "[N]ot in compliance with the Interagency Guidance on Nontraditional Mortgages." *June 2008*
- "High SFR [single family residential loan] losses due in part to … poor underwriting." *July 2008*
- "[A]ctions should have been taken sooner." *July 2008*

Permanent Subcommittee on Investigations
EXHIBIT #1c

Excerpts from Documents Showing OTS Repeatedly Identified Washington Mutual and Long Beach Underwriting/Lending Deficiencies

2004

"Underwriting of SFR loans remains less than satisfactory." One of the three causes of underwriting deficiencies was "a sales culture focused on building market share." 2004 Report of Examination (ROE), 9/13/04, OTSWMS04-0000001497. (Full exhibit sealed.)

"Notwithstanding satisfactory asset quality overall, some areas still require focused management and Board attention. Most important is the need to address weaknesses in single-family residential (SFR) underwriting, which is an ongoing issue from prior exams." 2004 ROE, 9/13/04, OTSWMS04-0000001492. (Full exhibit sealed.)

"The level of SFR underwriting exceptions in our samples has been an ongoing examination issue for several years and one that management has found difficult to address." Field Visit ROE, 10/18/04, OTSWMEF-00000047576. (Full exhibit sealed.)

"[Residential Quality Assurance]'s review of 2003 originations disclosed critical error rates as high as 57.3 percent of certain loan samples, thereby indicating that SFR underwriting still requires much improvement. While this group has appropriately identified underwriting deficiencies, it has not been as successful in effecting change." 2004 ROE, 9/13/04, OTSWMS04-000001498. (Full exhibit sealed.)

2005

"SFR Loan Underwriting – This has been an area of concern for several exams. As management continues to make change in organization, staffing, and structure related to SFR loan underwriting, delays in meeting target dates become inevitable. The board should closely monitor these delays to ensure they do not become protracted." MRBA, OTS Letter to Washington Mutual Board of Directors, 2/7/05, OTSWMEF-0000047591. (Full exhibit sealed.)

"[Securitizations] prior to 2003 have horrible performance. . . . LBMC finished in the top 12 worst annualized [Net Credit Losses] in 1997 and 1999 thru 2003. . . . At 2/05, LBMC was #1 with a 12% delinquency rate. Industry was around 8.25%." Internal OTS email, 4/14/05, OTSWME05-012 0000806. Exhibit 19.

"We continue to have concerns regarding the number of underwriting exceptions and with issues that evidence lack of compliance with Bank policy." OTS Exam Findings Memo, 6/3/05, "Single Family Residential Home Loan Review," OTSWME05-004 0000392. Exhibit 26.

"[W]e remain concerned with the number of underwriting exceptions and with issues that evidence lack of compliance with bank policy .... [T]he level of deficiencies, if left unchecked, could erode the credit quality of the portfolio. Our concerns are increased with 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." 2005 ROE, 8/29/05, OTSWMS05-004 0001794. (Full exhibit sealed.)

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EXHIBIT #1d

"Older securitizations of [LBMC] continue to have some issues due to previously known underwriting issues in some vintages. The deterioration in these older securitizations is not unexpected." 2005 Holding Company Field Visit ROE, 10/3/05, OTSWMS06-010 00002532. (Full exhibit sealed.)

2006

"During the prior examination, we noted numerous instances of underwriters exceeding underwriting guidelines, errors in income calculations, errors in debt-to-income (DTI) calculations, lack of sufficient mitigating factors for credit-quality related issues, and insufficient title insurance coverage on negative amortization loans. . . . . [U]nderwriting errors [] continue to require management's attention." OTS Exam Findings Memo, 5/23/06, "Home Loan Underwriting," OTSWMS06-008 0001299. Exhibit 33.

"Overall, we concluded that the number and severity of underwriting errors noted remain at higher than acceptable levels." OTS Exam Findings Memo, 5/25/06, "Loan Underwriting Review - Long Beach Mortgage," OTSWMS06-008 0001243. Exhibit 35.

"Subprime underwriting practices remain less than satisfactory. . . .[T]he number and severity of underwriting exceptions and errors remain at higher than acceptable levels. . . . The findings of this judgmental sample are of particular concern since loans with risk layering . . . should reflect more, rather than less, stringent underwriting. Borrowers in this category generally have debt ratios that are near the maximum rations allowed by LBMC's policy; thus, any DTI ratio calculation errors made by LBMC underwriters for such borrowers are likely to push these loans outside LBMC's underwriting guidelines for DTI ratios." 2006 ROE, 8/29/06, OTSWMS06-008 0001680. (Full exhibit sealed.)

2007

"Underwriting policies, procedures, and practices were in need of improvement, particularly with respect to stated income lending. Based on our current findings, and the fact that a number of similar concerns were raised at prior examinations, we concluded that too much emphasis was placed on loan production, often at the expense of loan quality." 2007 ROE, 9/18/07, OTSWMEF-0000046679. (Full exhibit sealed.)

"Based on our review of 75 subprime loans originated by LBMC, we concluded that subprime underwriting practices remain less than satisfactory . . . . Given that this is a repeat concern and MRBA, we informed management that underwriting must be promptly corrected, or heightened supervisory action would be taken, including limiting the Bank's ability to continue SFR subprime underwriting." 2007 ROE, 9/18/07, OTSWMEF-0000047146. (Full exhibit sealed.)

2008

"High SFR losses due in part to downturn in real estate market but exacerbated by: geographic concentrations, risk layering, liberal underwriting policy, poor underwriting." OTS Presentation to WaMu Board of Directors based on Comprehensive Examinations, 7/15/08, Polakoff_Scott-00061303_007. Exhibit 12.

"Discontinuing higher risk lending and tightened underwriting policy should improve asset quality; however, actions should have been taken sooner." OTS Presentation, 7/15/08, Polakoff_Scott-00061303_012. Exhibit 12.

Excerpts from Documents Showing OTS Repeatedly Identified Washington Mutual and Long Beach Risk Management Deficiencies

2004

"Board oversight and management performance has been satisfactory ... but ... increased operational risks warrant prompt attention. These issues limit the institution's flexibility and may threaten its ability to remain competitive and independent." 2004 Report of Examination (ROE), 9/13/04, OTSWMS04-0000001504. (Full exhibit sealed.)

"[P]rimary risks associated with Long Beach Mortgage Company remain regulatory risk, reputation risk, and liquidity of the secondary market in subprime loans." 2004 Holding Company ROE, 4/5/04, OTSWMEF-0000047477. (Full exhibit sealed.)

"Ensure cost-cutting measures are not impacting critical risk management areas." 2004 ROE, 9/13/04, OTSWMS04-000001488. (Full exhibit sealed.)

2005

"Monitor and obtain reports from management on status of [Enterprise Risk Management] in terms of effectiveness and resource adequacly. ... ERM provides an important check and balance on the company's profit-oriented units and warrants ongoing strong Board commitment given the institution's current strategic direction." MRBA, 2005 ROE, 8/29/05, OTSWMS05-004 0001783. (Full exhibit sealed.)

"Until full exception data collection, reporting, and follow-up processes are in place and stabilized, senior management and the Board cannot fully assess whether quality assurance processes are having a meaningful impact on line activities, including loan underwriting. We are particularly concerned with the establishment of good quality assurance process for SFR underwriting, which has been an issue for the past several examinations." 2005 ROE, 8/29/05, OTSWMS05-004 0001792. (Full exhibit sealed.)

"We criticized the lack of Trend and Dashboard Report to senior management and the board, without which it is impossible to determine whether line functions are performing acceptably and, more specifically, whether the quality assurance process is having a meaningful impact on improving loan underwriting." 2005 Field Visit ROE, 10/3/05, OTSWMEF-0000047602. (Full exhibit sealed.)

2006

"Continue to monitor and obtain reports from management on the status of ERM to ensure its effectiveness and adequacy of resources. . . . ERM should provide an important check and balance on profit-oriented units ... particularly given the bank's current strategy involving increased credit risk." MRBA, 2006 ROE 8/29/06, OTSWMS06-008 0001671. (Full exhibit sealed.)

"Within ERM, fraud risk management at the enterprise level is in the early stage of development." 2006 ROE, 8/29/06, OTSWMS06-008 0001687. (Full exhibit sealed.)

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EXHIBIT #1e

2007

"Risk management practices in the HLG (Home Loans Group) during most of the review period were inadequate .... We believe that there were sufficient negative credit trends that should have elicited more aggressive action by management with respect to limiting credit exposure. In particular, as previously noted, the risk misrepresentation in stated income loans has been generally reported for some time. This information should have led management to better assess the prudence of state income lending and curtail riskier products well before we indicated during this examination that we would limit the Bank's ability to continue such lending." 2007 ROE, 9/18/07, OTSWMEF-0000046681. (Full exhibit sealed.)

"Board oversight and management's performance was less than satisfactory. ... Contributing factors should have been more proactively managed by the Board and management. The most significant of these factors include Matters Requiring Board Attention that were noted in prior examinations but were not adequately addressed, including ... an ERM function that was not fully effective." 2007 ROE, 9/18/07, OTSWMEF-0000046690. (Full exhibit sealed.)

"The ERM function has been less than effective for some time. ... ERM has not matured in a timely manner and other ERM functions have been generally ineffective." 2007 ROE, 9/18/07, OTSWMEF-0000046691. (Full exhibit sealed.)

2008

"Poor financial performance due in part to market conditions; however, performance exacerbated by conditions within management's control: poor underwriting quality, geographic concentrations in problem markets, liberal underwriting policy, risk layering." OTS Presentation to WaMu Board of Directors based on Comprehensive Examinations, 7/15/08, Polakoff_Scott-00061303_027. Exhibit 12.

"An adequate [Enterprise Risk Management] function still does not exist although this has been an MRBA for some time." OTS Presentation, 7/15/08, Polakoff_Scott-00061303_028. Exhibit 12.

Excerpts from Documents Showing Slow and Weak OTS Enforcement at Washington Mutual

2003

"It is clear from my experience that changes seem to progress slowly at WaMu so I don't know if we can expect faster progress .... If any target is missed, as happens at WaMu, then we may not be in a position to determine the effectiveness of the corrective actions." Email from Dennis Fitzgerald, OTS Examiner, to Lawrence Carter, 6/27/03, OTSWEM04-0000006748. Exhibit 15.

2004

"In any event, a paragraph very clearly tells WaMu they need to identify originated subprime in both home and consumer loans and demonstrate compliance with the interagency policy .... Ken Kroemer from the FDIC is pushing toward some arbitrary FICO score cutoff and I think he is going to hit a brick wall. I'd like us to have our ducks in order so we can head him off at the pass." Email from Lawrence Carter to Benjamin Franklin, et al, 4/8/04, Franklin_Benjamin-00001837_001. Exhibit 18.

2005

"The response looks good. They agree to take all action required to correct the problem. The Target Completion Dates are not real timely but fine for WaMu." Email from Verlin Campbell, OTS Examiner, to Zalka Ancely, OTS Examiner, 6/8/2005, OTSWME05-003 0000634. Exhibit 29.

"Agree, but I think this is just one of several symptoms of the ongoing broader problem of getting their house in order from an underwriting standpoint. It has been hard for us to justify doing much more than constantly nagging (okay, "chastising") through ROE and meetings, since they have not been really adversely impacted in terms of losses." Email from Lawrence Carter to Darrel Dochow, September 15, 2005, OTSWMS05-002 0000535. Exhibit 6.

"While we may (and have) questioned the reasonableness of these standards, they are all we have at this time. If our tolerance for some reason is now a lot lower than our handbook standards, it would be nice to have this clarified. ... Obviously, we should have higher expectations for ... a subprime portfolio. ... It would be nice if they could meet even higher expectations, but that would require us to agree on what the standard should be." Email from Lawrence Carter to Benjamin Franklin, Darrel Dochow, and Gail Croil, 11/21/05, OTSEMS05-004 0001911. Exhibit 30.

2006

"The letter seems okay. They obviously want to leave it a little squishy, of course, on the growth plans, but at least they make a firm commitment to clean up the underwriting issues. At some level, it seems we have to rely on our relationship and their understanding that we are not comfortable with current underwriting practices and don't want them to grow significantly without having the practices cleaned up first." Email from Lawrence Carter to Darrel Dochow, 1/27/06, OTSWMS06-008 0001082. Exhibit 32.

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EXHIBIT #1f

"Good news - John was able to get the OTS to see the light and revise the Underwriting rating to a Recommendation." Email from Wayne Pollack, SVP at WaMu, to David Schneider, et al, 5/30/06, JPM_WM02619434. Exhibit 34.

"OTS confirmed today that they will re-issue this memo without the 'Criticism.' It will be a 'Recommendation.'" Email from John Robinson, VP of Regulatory Relations at WaMu, to colleagues, 5/30/06, JPM_WM02619435. Exhibit 34.

"... [W]e feel that the few negative things we have brought up through findings memos and meetings, while important to keep in front of management, are not so serious they wipe out all the right things the institution is doing in all those areas we reviewed and did not have any issues, nor should they negate the ongoing good progress in making improvements in a manner that seems reasonable given the size, complexity, and status of the institution." Email from OTS examiner Lawrence Carter to OTS Regional Director Darrel Dochow, 6/15/06, Dochow_Darrel-00022908_001. Exhibit 7.

"[OTS'] initial response was that they view the guidance as flexible. They specifically pointed out that the language in the guidance says 'should' vs. 'must' in most cases and they are looking to WaMu to establish our own position of how the guidance impacts our business processes." Washington Mutual, Alternative Mortgage Guidance Implementation Plan, October 2006, JPM_WM02549037. Exhibit 73.

2007

"WaMu's compliance management program has suffered from a lack of steady, consistent leadership. Dick Stevenson, who took over as Chief Compliance Officer on March 2, 2007, is the bank's ninth compliance leader since 2000...The OTS is very concerned that this lack of consistent, stable leadership leaves the program vulnerable. This amount of turnover is very unusual for an institution of this size and is a cause for concern. The Board of Directors should commission an evaluation of why smart, successful, effective managers can't succeed in this position. If you would like my opinion, just ask. (HINT: It has to do with top management not buying into the importance of compliance and turf warfare and Kerry not liking bad news.)" Draft Compliance Memo from Susie Clark, OTS Compliance Specialist, 5/31/07, Franklin_Benjamin-00020408_001. Exhibit 9.

"Regulatory Relations [WaMu office that deals with regulators] is a joke. The purpose of this group seems to be how can we give the regulators the bare minimum without them raising a fuss." Draft Compliance Memo from Susie Clark, OTS Compliance Specialist, 5/31/07, Franklin_Benjamin-00020408_002. Exhibit 9.

2008

"We almost always do an MOU for 3-rated institutions, and if someone were looking over our shoulders, they would probably be surprised we don't already have one in place." Email from OTS Executive Director to Kerry Killinger, 7/3/08, OTSWMS08-014 0000912. Exhibit 44.

"[The Memorandum of Understanding] is, unfortunately, another example of a benign supervisory document." Email from OTS Senior Deputy Director Scott Polakoff to OTS Deputy Director Tim Ward, 7/28/08, Polakoff_Scott-00060660_001. Exhibit 45.

Excerpts from Documents Showing OTS Impeding FDIC's Oversight

2006

"The message was crystal clear today. Absolutely no FDIC participation on any OTS 1 and 2 rated exams. . . . We should also deny FDIC requests to participate on HC or affiliate exams." Email from OTS senior official Michael Finn to Edwin Chow and Darrel Dochow, 1/24/06, OTSWM06-006 0000129. Exhibit 49.

"The OTS must really be afraid of what we might come across, but bottom line is we need access to the information. . . . [T]his is the second access issue that has come up on WaMu in a relatively short period of time . . . ." Email from FDIC senior official John Carter to Regional Director George Doerr, 9/7/06, FDIC-EM_00252239. Exhibit 51(c).

"I have received your response to our August 14 2006 letter in which we request permission to participate in aspects of the upcoming examination of Washington Mutual Bank. Regarding 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 concerns regarding supervisory activities at Washington Mutual. Such criteria are not prerequisite for requesting – or for the OTS granting – FDIC staff participation in target examination activities." Letter from FDIC senior official John Carter to OTS senior official Michael Finn, 10/6/06, FDIC_WAMU_000014445. Exhibit 52(a).

"Please read info about OTS denying us space and access to information. The situation has gone from bad to worse." Email from FDIC Regional Director George Doerr to FDIC senior official John Carter and others, 10/13/06, FDIC_WAMU_000014449. Exhibit 53.

2007

"I'm just not relishing another round of 'No.' Well, let them make fools of themselves again!" Email from FDIC Regional Director George Doerr to FDIC examiner Stephen Funaro, 1/5/07, FDIC-EM_00252316. Exhibit 54.

"John, here we go again. This is unnecessary hair splitting by OTS Seattle. . . . When it comes to non traditional mortgages, proper risk assessment would involve getting a feel for how the bank ensures compliance with non traditional mortgage guidance, and to do that, you do some file review." Email from FDIC Regional Director George Doerr to FDIC senior official John Carter, 2/6/07, FDIC_WAMU_000014456. Exhibit 55.

"[OTS Regional Director] Finn pushed back on his previous approval of our participation in the 2007 exam targets, specifically as to our ability to work loan files alongside OTS examiner, and we were particularly interested in WAMU's compliance with nontraditional mortgage guidance. . . . Mr. Finn and his examiner, Ben Franklin, stated that OTS did not intend to look at files for purposes of testing nontraditional mortgage guidance until after the bank made a few changes they had agreed to. I asked if we could then join the file review whenever OTS did look at this, and he said, 'No.'" Email from FDIC

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EXHIBIT #1g

West Region Assistant Director George Doerr to FDIC official David Collins, 4/30/07, FDIC_WAMU_000014457. Exhibit 57.

2008

"I have read the attached letter from the FDIC regarding supervision of WaMu and am once again disappointed that the FDIC has confused its role as insurer with the role of the Primary Federal Regulator. Its letter is both inappropriate and disingenuous. I would like to see our response to the FDIC, which I assume will remind it that we, as the PFR, will continue to effectively supervise the entity and will continue to consider FDIC's views." Email from OTS senior official Scott Polakoff to Darrel Dochow and Edwin Chow, 7/22/08, OTSWMS08-014 0000936. Exhibit 59.

"We will follow the appropriate procedures if the staff cannot agree. You asked me to hear out wamu. I hope that you would also hear out our examination staff if it comes to that." Email from FDIC Chairman Sheila Bair to OTS Executive Director John Reich, 8/1/08, Reich_John-00050932_001. Exhibit 63.

"Major ill will at WaMu meeting yesterday caused by FDIC suggestion in front of WaMu management that they find a strategic partner. Reich reportedly indicated that was totally inappropriate and that type of conversation should have occurred amongst regulatory agencies before it was openly discussed with management." Email from FDIC senior official David Promani to FDIC colleague Stan Ivie, 8/1/08, FDIC-EM_00246958. Exhibit 64.

"The headbutting is currently going on in DC between myself and Sheila Bair." Email from OTS Executive Director John Reich to OTS colleagues Darrel Dochow, Scott Polakoff, and Tim Ward, 8/6/08, Ward_Timothy-00005346. Exhibit 65.

"I should not have to remind you the FDIC has no role until the PFR [Primary Federal Regulator] (i.e. the OTS) rules on solvency and the PFR utilizes PCA [Prompt Corrective Action]." Email from OTS Director John Reich to FDIC Chairman Sheila Bair, 8/6/08, FDIC-EM_00110089. Exhibit 66.

"The purpose of the meeting would be to discuss the various views of the institution's risk profile, current actions under consideration by the FDIC, and possible capital considerations. We would control the meeting and ensure that we have no repeat of the inappropriate behavior displayed by some of the FDIC in our last session with the bank. This is my idea, not the FDIC's idea." Email from OTS senior official Scott Polakoff to OTS Executive Director John Reich, 9/10/08, Reich_John-00049195_001. Exhibit 69.

"I cannot believe the continuing audacity of this woman." Email from OTS Executive Director John Reich to OTS senior official Scott Polakoff (referring to FDIC Chair Sheila Bair), 9/10/08, Polakoff_Scott-00065461_001. Exhibit 68.

Excerpts from Documents Showing OTS Internal Views on Inability to Stop Poor Quality Lending Practices

2005

"It has been hard for us to justify doing much more than constantly nagging (okay, 'chastising') through [Reports of Examination] and meetings, since they have not been really adversely impacted in terms of losses." Email from OTS Examiner Lawrence Carter to OTS supervisor, 9/15/05, OTSWMS05-002 0000535. Exhibit 6.

"As I have mentioned to some, by the time we come out with regulatory guidance, moral suasion and market/media attention will have already done the trick, at least for the regulated entities!" Email from OTS Examiner Lawrence Carter to OTS West Region Assistant Director Darrel Dochow, 9/29/05, OTSWMS05-002 0000403. Exhibit 5.

2007

"I noted that several of our institutions make NINA loans. That, in my humble opinion is collateral dependent lending and deemed unsafe and unsound by all the agencies. ... What would ever possess those institutions to make such loans widely available. I could see it if they required a 760 Fico and lots of equity? Why would our examiners not question such practices? It is not at all surprising that delinquencies are up, even among Alt-A. In my opinion, credit standards have gone too low." Email from Bill Magrini to OTS supervisor and colleagues, 3/27/07, Quigley_Lori-00110324. Exhibit 76.

"Apparently Bill Magrini is the lone ranger in his view that NINA's are imprudent. West region position seems to be that FICO, appraisal, and other documentation such as application etc. is sufficient to assess the borrower's ability to repay in all but subprime loans. While I probably fall more into the Magrini camp (until we get empirical data to support NINAs are not imprudent) we will just document our findings...until the 'official' policy has been worked out." Email from OTS examiner Ben Franklin to OTS colleagues, 5/16/07, Franklin_Benjamin-00020056_001. Exhibit 79.

"Considering the meeting on Friday, I'm of a mind to go with a '2.' I'm not up for the fight or the blood pressure problems. ... Since we weren't able to do a separate evaluation of the process, they will fight it. It doesn't matter that we are right, what matters is how it is framed. And all we can do is point to the pile of complaints and say there is a problem." Email from OTS examiner Mary Clark to OTS colleagues, 6/3/07, OTSWMS07-013 0002576. Exhibit 39.

2008

"You know, I think that once we (pretty much all the regulators) acquiesced that stated income lending was a reasonable thing, and then compounded that with the sheer insanity of stated income, subprime, 100% CLTV, lending, we were on the figurative bridge to nowhere. Even those of us that were early opponents let ourselves be swayed somewhat by those that accused of being "chicken little" because the losses were slow in coming, and lets not forget the mantra that 'our shops have to make these loans in order to be competitive.'" Email from OTS examiner Ben Franklin to OTS colleague, OTS, 10/7/08, Franklin_Benjamin-00034415_003. Exhibit 14.

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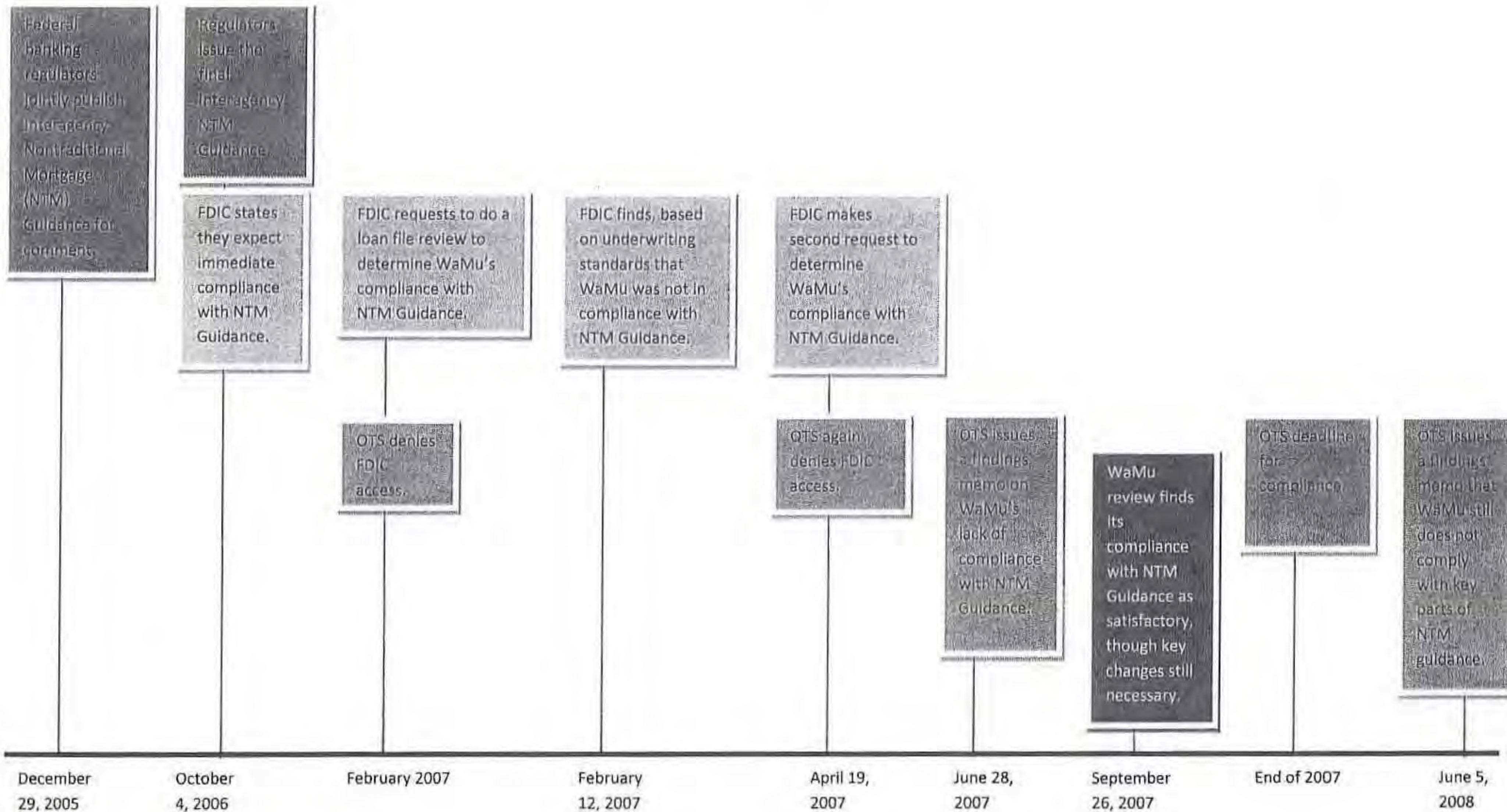
EXHIBIT #1h

"Kurt and Steve G laughed at my projections of gloom and doom for stated [income loans] since 2003 and started calling me the housing 'bubble' boy. … When I told Scott Polakoff in April 2007 that stated income subprime should not be made under any circumstance, I was corrected by Mike Finn that that was not the West Region's position. I rest my case. … [N]ot one regulatory agency had a rule or guideline saying you couldn't do stated income lending, even to this day. That, I find incredible. … [I]n hindsight, I'm convinced that it is just a flawed product that can't be fixed and never should have been allowed in the first place. How do you really assess underwriting adequacy when you allow the borrower to tell you what he makes without verification. We used to have documentation requirements for underwriting in the regs, but when those were taken out, the industry slowly migrated to an anything goes that got us into this mess." Emails from OTS examiner Ben Franklin to OTS colleague Thomas Constantine, 10/7/08, Franklin_Benjamin-00034415_001-002. Exhibit 14.

"My big problem is with us allowing people with W-2 incomes to go stated. How hard is it to send that in. Everyone has it. Also, I can't believe we allowed 100% financial of anything. What a joke. … We were satisfied that the loans were originated for sale. SEC and FED asleep at the switch with the securitization and repackaging of the cash flows, irrespective of who they were selling to. The lack of transparency caused the general panic we live with today." Email from OTS examiner Thomas Constantine to OTS colleague Ben Franklin, 10/7/08, Franklin_Benjamin-00034415_001. Exhibit 14.

WaMu Dodging Compliance with Tougher Lending Standards:

Nontraditional Mortgage Guidance



Permanent Subcommittee on Investigations

EXHIBIT #1i

Prepared by U.S. Senate Permanent Subcommittee on Investigations, April 2010

Washington Mutual Regulators Timeline

DATE	EVENT
1/2005	WaMu Board approved High Risk Lending Strategy.
8/29/05	OTS sent Report of Examination to WAMU for 3/14/05 exam, with "2" CAMELS rating. FDIC participated as back-up regulator. Matters Requiring Board Attention (MRBAs) included: 1) need for strong Executive Risk Management function; 2) continued weak loan underwriting; 3) need to enhance Board supervision of Corporate Risk Oversight group.
1/10/06	WAMU announced lower earnings in 4Q2005 due to increased loss reserves at Long Beach. Long Beach early payment defaults had increased due to loosened credit standards, requiring repurchase of about $875 million in whole loans and a $107 million loss. Long Beach management fired.
3/1/2006	With OTS approval, Washington Mutual Bank acquired Long Beach Mortgage Company from its parent holding company, Washington Mutual Inc.
4/18/06	WaMu Finance Committee approved plan to reduce low risk loans and originate more high risk loans due to higher gain on sale figures.
6/21/06	WaMu CEO Kerry Killinger released memo on change in the Bank's strategic direction, directing Home Loans group to grow its market share in Option ARMs, Alt-A, and subprime loans, while curtailing low-margin government and fixed rate loans.
8/30/06	OTS sent Report of Examination for 3/13/06 exam, with "2" rating. MRBAs included: 1) weak subprime underwriting at Long Beach and marginally satisfactory prime underwriting; and 2) need to ensure Enterprise Risk Management's effectiveness and adequacy of resources.
10/5/06	Nontraditional Mortgage Guidance released by banking regulators, highlighting loan risks; need for sufficient loan loss reserves and risk management practices; need to assess borrowers' ability to repay even after a payment increase; and plan for bank examiners to scrutinize bank procedures to ensure compliance with guidance.
4/30/07	FDIC repeated request to OTS to evaluate WaMu compliance with NTM Guidance; OTS refused and said it was allowing WaMu more time to comply.
7/07	Bear Stearns hedge funds failed; credit rating agencies downgraded hundreds of subprime mortgage backed securities, including 40 at Long Beach; subprime MBS market slowed and stopped two months later, in September.
9/17/07	OTS sent Report of Examination for 1/8/07 exam, with "2" Rating. MRBAs included: 1) continued weak subprime lending and instruction to Board to reduce underwriting deficiencies; and 2) continuing need to monitor Enterprise Risk Management effectiveness, resources, and support. WaMu ended subprime lending.
1/2008	Credit rating agencies downgraded 7,000 residential mortgage backed securities. Countrywide closed and sold to Bank of America. WaMu announced $1 billion loss from 2007 fourth quarter.
2/27/08	OTS downgraded WaMu to a "3," and required a Board resolution to address deteriorating conditions.
3/08	At regulators' urging, WaMu invited potential buyers of bank to review info. JPMorgan Chase made an offer that WaMu turned down.
4/8/08	WaMu announced first quarter loss of $1 billion. WaMu parent holding company

Permanent Subcommittee on Investigations

EXHIBIT #1j

	raised $7.0 billion in capital from investment group Texas Pacific Group.
6/25/08	Darrel Dochow, OTS West Region Director, met with WaMu CEO Kerry Killinger, who asked if OTS could avoid issuing a Memorandum of Understanding (an informal enforcement action) to bank. OTS said no. Later in the summer, OTS and FDIC negotiated over MOU provisions with FDIC pressing for tougher provisions.
7/08	IndyMac failed; WAMU announced second quarter loss of $3.2 billion; WaMu depositors withdrew $9 billion from bank.
7/15/08	OTS presented Report of Examination to WaMu Board with downgraded capital, asset quality, and management CAMELS ratings, but an overall rating of "3" for bank. FDIC agreed with overall rating.
8/1/08	OTS and FDIC met with Killinger and other execs, who presented WaMu's long-term forecast. FDIC suggested WaMu find a "strategic partner" to meet its capital needs. OTS upset with FDIC's suggestion.
8/1/08	FDIC informed OTS it planned to downgrade WaMu to a "4."
9/7/08	WaMu Board signed MOU with OTS. Kerry Killinger resigned.
9/15/08	Lehman declared bankruptcy. WaMu depositors pulled $17 billion over next 8 days.
9/18/08	OTS and FDIC downgraded WaMu to a "4."
9/08	AIG given bailout; Goldman Sachs & Morgan Stanley convert to bank holding co's.
9/25/08	OTS closed WAMU and assigned FDIC as receiver. FDIC facilitated immediate sale to JP Morgan Chase for $1.9 billion. WAMU had $307 billion in assets, $188 billion in deposits, and 43,000 employees – largest U.S. bank failure ever.

Prepared by the U.S. Senate Subcommittee on Investigations, April 2010

Office of Thrift Supervision

2004 Examination Handbook

Permanent Subcommittee on Investigations
EXHIBIT #2

OTSWMEF-0000031967

Handbook and Program Use

The Examination Handbook is a new Handbook that integrates safety and soundness (S&S) and compliance guidance. This Handbook replaces the Thrift Activities and Compliance Activities Handbooks. We retained the general layout of the handbooks with a chapter for each CAMELS component and a chapter for Compliance and the Community Reinvestment Act (CRA).

The Examination Handbook is a guide for the examination of savings associations regulated by the Office of Thrift Supervision (OTS). Specifically, the Handbook aids OTS regulatory staff and the savings and loan industry in the regulatory process. The Handbook provides uniform standards for planning and conducting examinations and addressing supervisory issues. It also serves as a reference tool, training aid, and guide to national policies and procedures.

The Handbook illustrates and describes, for examiners and the thrift industry, certain standards of conduct and prudent operation that OTS views as important to the safe and sound operation of savings associations. These standards should be consistent with the respective fiduciary duties of those individuals associated with them.

This Handbook Section explains how to use the Handbook and the programs in the examination process. It describes the organization of the Handbook chapters and sections, and sets forth objectives and procedures common to all phases of the examination.

REGULATORY PROCESS

The regulatory process allows you to meet the following objectives:

- Assess an association's degree of safety and soundness.
- Assess the adequacy of the association's compliance management program.
- Assess how well an association manages compliance with consumer protection and public interest-related laws and regulations (Compliance).
- Evaluate an association's condition.
- Identify the association's strengths.
- Identify existing regulatory violations.

OTSWMEF-0000031968

- Identify potential problems.
- Prevent the development or continuation of unsafe operating practices.
- Report findings.
- Inform directors of association strengths and weaknesses.
- Facilitate corrective action where needed.

Proactive regulatory supervision should evaluate future needs and potential risks to ensure the success of the thrift system in the long term. This Handbook provides a framework for the successful completion of that process.

The Handbook encourages independent reasoning, objectivity, efficiency, and professionalism in the examination process.

The Handbook encourages independent reasoning, objectivity, efficiency, and professionalism in the examination process. To promote consistency among the OTS regional offices, the Handbook sets forth national minimum standards for examination objectives and procedures. While this process promotes standardization of the examination process, we encourage you to modify programs to fit the association's specific needs.

We are designing the Examination Handbook to cover S&S, compliance, and CRA for both new and experienced examiners. Background information, applicable references, and expanded procedures within the text serve to help in the learning process.

You should supplement your use of the Handbook and associated programs with your education, experience, and judgment. We will periodically update the Handbook and issue individual sections as necessary. Separate manuals are available for Compliance Self-Assessment, Holding Companies, Trust and Asset Management Activities, Information Technology (IT), and Applications Processing. These Handbooks are available via the OTS website.

HANDBOOK ORGANIZATION

The Examination Handbook will contain a table of contents, one chapter for each CAMELS element, a chapter on other activities, and a chapter for Compliance and CRA. A brief discussion of the Handbook's organization appears below.

Table of Contents

The table of contents lists each Handbook chapter, section number and title, and, if applicable, programs, questionnaires, and appendices.

OTSWMEF-0000031969

000 Administration

This chapter gives a general overview of the administration and coordination of the regulatory process. It includes instructions on determining the scope of an examination, monitoring the regulatory profile process, assigning component and composite CAMELS ratings, and Compliance and CRA ratings, and devising an examination strategy.

100 Capital Adequacy

This chapter provides useful information for assessing whether an association's capital position is sufficient, given the risk level, to ensure ongoing viability. Discussions of minimum regulatory capital requirements, prompt corrective action (PCA) categories, and stock ownership and control help you determine the adequacy and composition of an association's capital.

200 Asset Quality

This chapter addresses the following two issues:

- The determination of risks related to the association's assets.
- The association's management, administration, and evaluation of the quality of these assets.

It also provides guidance in assessing credit risk and reviewing asset portfolios (including loans, investments, and other assets). This chapter focuses on three areas:

- The quality of loan underwriting and portfolio management.
- Affirmation of classified asset levels.
- Adequacy of valuation allowances.

There are also sections discussing real estate appraisals, loan sampling, the Qualified Thrift Lender Test, and margin securities.

300 Management

This chapter provides guidance in evaluating the capability of executive management and the board of directors. It covers objectives, procedures, and references for examining compliance management, internal controls, internal and independent audits, fraud and insider abuse, and transactions with affiliates and insiders.

OTSWMEF-0000031970

400 Earnings

This chapter will assist in analyzing an association's financial condition. It covers objectives, procedures, and references for examining the association's financial record keeping and reporting methods and operations analysis. The chapter also discusses present value analysis.

500 Liquidity

This chapter provides assistance in assessing liquidity and the funding risk confronting an association. It includes material on funds management, liquidity management, and investment activities. The chapter also discusses the Government Securities Act, Payments Systems Risk, and Regulation D.

600 Sensitivity to Market Risk

This chapter provides assistance in assessing the market risk confronting an association. It includes guidance on managing interest rate risk and hedging.

700 Other Activities

This chapter addresses review of the thrift's or subordinate organization's activities in insurance, real estate development, and networking arrangements.

This chapter also provides guidance in the evaluation of risk that operating subsidiaries, service corporations, and lower-tier entities (such as joint ventures or limited partnerships) pose to the association and thereby the insurance fund.

1000 Compliance

The Compliance chapter covers the new Compliance Oversight Examination Program (COEP); fair lending laws and regulations such as the Equal Credit Opportunity Act and the Fair Housing Act; the consumer protection laws and regulations such as the Truth in Lending Act, Real Estate Settlement Procedures Act, and the Electronic Funds Transfer Act; the laws and regulations such as the Bank Secrecy Act, the Bank Protection Act, and the Community Reinvestment Act and regulations.

FFIEC-Approved Procedures

In many instances, you will notice that the Federal Financial Institution Examination Council (FFIEC) logo and approval appears at the bottom of the first page of a Compliance section addressing a law or regulation. This indicates that the entire section, including the examination objectives and procedures, has been approved for use by all the agencies represented on the FFIEC (the Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, OTS, and the National Credit Union Administration).

OTSWMEF-0000031971

Ancely, Zalka A

From: Hickok, Bruce I
Sent: Monday, June 27, 2005 3:37 PM
To: Ancely, Zalka A
Subject: RE: Revised ALLL Findings Memo Response

Sensitivity: Private

Zalka,

In summary, the extended time frames (1 - 2 month extensions) for implementation of various portions of the response do not appear to be significant due to the fact that they are only 1-2 month extensions of management's own initiatives and we don't want to penalize management for their own initiatives. Also, the overall level of ALLL was considered to be a conservative level so its not critical to implement new models or procedures in order to get an increase in ALLL to an adequate level.

However, it does bring up the questions if implementation of LPRM v3.1 will be delayed until the 3rd party validation is completed (by January 31, 2006) or will the 3rd party validation be done after the fact since Joe Mattey's group has already done a validation separate from the vendors validation? Also, is there a bigger reason why they are delaying some items? Do they need some more recoveries at June 30, 2005 to offset poorer operating results, or will implementation of LPRM v3.1 result in a recovery of ALLL that management wants to delay since preliminary 2nd quarter operating results look to be stronger than expected? These are just larger questions about managements underlying reasons for the extensions. The extensions are understandable if they are actually due to operational issues (time needed by management to actually complete the expanded support for the unallocated standards and further validation of the model).

Bruce
208.468.5039

-----Original Message-----
From: Ancely, Zalka A
Sent: Monday, June 27, 2005 1:30 PM
To: Hickok, Bruce I
Subject: Revised ALLL Findings Memo Response
Sensitivity: Private

Bruce,

As noted in the email sent by Cathy D., management has revised their response which includes time frames. Please let me know if this is acceptable.

Thanks!
Z

<< File: OTS Memo 3 - ALLL Modeling (Final).doc >>

Important Notice - Please Read

This electronic message, along with any attachments, is an official United States government communication and is intended solely for the identified recipients. This communication may contain unpublished OTS information within the scope of 12 C.F.R. § 510.5. Unpublished OTS information is subject to restrictions on use and disclosure as set forth therein. You may not use or disclose unpublished OTS information except as provided in 12 C.F.R. § 510.5. Unauthorized access or release of this communication may result in civil and criminal sanctions.

If you received this communication in error, please permanently delete it from your system, destroy any paper copies, and notify the sender promptly.

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Permanent Subcommittee on Investigations
EXHIBIT #3

OTSWME05-004 0000343

8551
40.20 TO

Dochow, Darrel W

From:	Carter, Lawrence D
Sent:	Thursday, July 21, 2005 7:36 AM
To:	Kirch, Kurt J
Cc:	Dochow, Darrel W
Subject:	Mortgage Survey
Sensitivity:	Private

Kurt, thank you for getting my input on the affordability products survey. Darrel gave me a copy during our meeting yesterday, but I didn't realize it was such a monster with such a short turnaround time. It's hard to believe we've only had it for a couple of days and people are trying to get it out this week.

I would not send this to WAMU without more preparation. First, I think it asks for too much detailed information. It reads more like an exam program than a survey. I wish we would have had it at the beginning of our exam. It looks as though we have asked for everything we could think of without perhaps thinking through exactly what we were going to do with all the information. I think what might happen is that institutions will have to do a lot of footnoting of proxy information because they will have a difficult time meeting the needs of the matrix exactly. This would mean we would not have apples to apples comparative data, which would kind of defeat our purpose I think. Second, this seems more geared to institutions for which this information has never been collected before (OCC, Fed?). We have been doing our neg am survey for a while and we have been getting other information about the so called affordability products during our regular exams. Third, we just did an exam and obtained all kinds of information. We probably have similar, though not exact, information as requested in the survey. But the bottom line is that we reviewed the risk and communicated our concerns to management already. To ask for this similar information in the survey would almost be like one hand didn't know what the other was doing. My preference would be to shorten the survey quite a bit and start with higher level information, and then drill down on individual exams.

My own personal opinion, of course, is that we are late to the party. The yield curve, the media, and particularly the rating agencies are already having an effect. I think the excitement over Option ARMs will dwindle and underwriting will probably tighten.

With all that said, I would at least make the following changes to the survey: when we ask for things from the past "several" years, I would change that to "three." I would change "investor owned property" loans to "non-owner occupied loans." #4-stress testing is not clear. #5-we are asking for too much--almost exam-like request. #6-we need to ask them to describe, "in general," the controls and procedures... #7-Again describe "in general" pricing methodology ... #8--Again, too much--exam-like request. #10--what about ARM and neg am disclosures, or other special compliance disclosures--did anyone from compliance look at this request? #11--add borrowers with FICO scores below 620, borrowers on higher LTV (greater than 85%) loans, etc.???

MOST IMPORTANT is that I have a meeting with Jake Domer this morning and would like to get permission from whomever I need to get permission from to give him a draft copy of this survey and ask how difficult it would be to compile some of the information. This would be a perfect opportunity to give some verbal guidance on what we are trying to achieve rather than the institution just getting a form letter.

Thanks again for working through me. I think it is really important that these kinds of things get channeled properly so this gets handled professionally and effectively..

Permanent Subcommittee on Investigations

EXHIBIT #4

OTSWMS05-002 0000083

8551 / 40:20

Dochow, Darrel W

From: Carter, Lawrence D
Sent: Thursday, September 29, 2005 8:11 AM
To: Dochow, Darrel W
Subject: FW: WSJ Article re: tightening mtg stds

Sensitivity: Private

As I have mentioned to some, by the time we come out with regulatory guidance, moral suasion and market/media attention will have already done the trick, at least for the regulated entities! Also of note is that the big lenders like to move in unison. I can assure you WAMU always checks what others are doing before it acts on its own (which is why I really have skepticism on what Countrywide has REALLY been doing). If WAMU ever leads the market, it is by centimeters, not by yards, which is why it is not garnering market share.

Interesting to note here is that the article reflects WAMU's claim that it has been qualifying borrowers at "roughly" 5.25 percent. Where did that figure come from??? Does one hand know what the other is doing?

-----Original Message-----
From: Adams, Jeff I
Sent: Thursday, September 29, 2005 7:17 AM
To: Dochow, Darrel W; Dyer, Nicholas J; Lane, Timothy J; Buting, Michael W; Potthast, John W; Swanson, Kevin B; Carter, Lawrence D; Chen, Dennis; Hearick, Laura L
Cc: Haakinson, Joanne J; Lake, Stephen A
Subject: WSJ Article re: tightening mtg stds
Sensitivity: Private

Below is the text of a WSJ article discussing heightened approval standards or raised rates, including Wamu, World, & Downey. I don't believe this made it to the News Clips today.

Jeff

Mortgage Lenders Tighten Standards

Amid Concern Over Rising Risk, Banks Make
It Harder to Qualify for Certain Home Loans

By **RUTH SIMON** and **JAMES R. HAGERTY**
Staff Reporters of THE WALL STREET JOURNAL
September 29, 2005; Page D1

After years of easy money, some mortgage lenders are beginning to tighten their standards.

Lenders have rolled out a raft of new mortgage products in recent years that have made housing purchases more affordable and allowed many people to extract cash from their homes' equity without boosting their monthly payments.

Now, in what could be the first signs of a reversal, some lenders are starting to raise the bar on making these products available to new borrowers. To be sure, rates for many types of mortgages have been rising anyway as the Federal Reserve has boosted short-term interest rates. But some mortgage lenders are going further by making it harder for borrowers to qualify for certain loans. Other lenders also are cutting back on the number of riskier mortgages they make or raising rates.

Last week, **Washington Mutual** Inc., one of the nation's biggest mortgage lenders, told mortgage

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EXHIBIT #5

OTSWMS05-002 0000403

brokers that it will make it more difficult for borrowers to qualify for its option ARMs, which carry an introductory rate of as low as 1.25%. Under the new rules, which are expected to take effect next month, borrowers will have to show they can afford the monthly payment if the interest rate on the loan is 6% -- or 6.25% for borrowers purchasing a second-home or investment property -- after the introductory rate expires. Currently, the bank's rate for qualifying borrowers for these loans is roughly 5.25%.

New Century Financial Corp., a mortgage lender in Irvine, Calif., last week said it was aiming to reduce the amount of interest-only loans it grants to less than 25% of total loan production from 33% in the year's first half. New Century said it was making the move in an effort to boost profit margins.

Some lenders are making their loans more costly, which could discourage borrowing. This month, Option One Mortgage, a unit of **H&R Block** Inc., boosted the rates on all of its mortgage products by 0.40 percentage point. Option One says the move reflects both rising interest rates and changes in investor appetite for its loans.

The moves come as bank regulators are sounding the alarm bells about rising risks in the mortgage market. Federal Reserve Chairman Alan Greenspan said in a speech this week that "the apparent froth in housing markets may have spilled over into mortgage markets" and called the "dramatic increase" in interest-only mortgages and "more exotic forms of adjustable-rate mortgages ... developments that bear close scrutiny."

The chairman's remarks echo the concerns of other bank regulators who fear that some borrowers are using exotic mortgage products to purchase houses they couldn't otherwise afford. If the housing market stalls, regulators are concerned that defaults could climb.

For consumers, tighter lending standards and higher costs could make it harder to afford homes and ultimately could help cool some hot housing markets. "It will take a lot of people out of the market and take some of the speculative fervor out of the market," says Kenneth Rosen, chairman of the Fisher Center for Real Estate at the University of California at Berkeley.

The tightening in mortgage lending is not yet widespread and some mortgage brokers say they haven't yet seen any indications that banks have pulled back. But the recent changes are particularly noteworthy because they follow a long trend of loosening that was apparent as recently as this summer.

GETTING TOUGHER

*Some mortgage lenders have begun **tightening standards** on some popular loans that have helped fuel the housing boom in recent years.*

- *Washington Mutual has told brokers it plans to **make it more difficult** for borrowers to qualify for its option ARMs.*

- *Countrywide Financial is **raising the bar** for borrowers who want the lowest teaser rate for option ARMs.*

- *New Century Financial **plans to limit interest-only loans** to below 25% of total loans, from 33% in the year's first half.*

Among other changes, Countrywide Financial Corp., another big lender, earlier this month made it tougher for borrowers to qualify for a 1% teaser rate on its option ARMs. Countrywide now considers a number of factors in setting the introductory rate, including the size of the loan, how much documentation the borrower provides, and whether the property is a second home or for investment. The teaser rate for borrowers with multiple risk factors can be as high as 3%, the company says.

Other lenders are also boosting their charges. Golden West Financial Corp. says that next month it will raise the introductory rate for its option ARMs to 2.20% from 1.95%. The rise "will be the first of several moves," says Golden West Chairman and CEO Herbert Sandler. "I don't know how high it will go, but it should go higher," he adds.

Raising the teaser rate on an option ARM boosts the minimum payment a borrower must make, particularly in the loan's early years. The teaser rate is used to determine the minimum payment in the first year; after that there's a cap in the first few years on how much the minimum payment can increase, unless the loan balance climbs beyond a certain threshold.

The tighter lending standards also come as profit margins on some loans are being squeezed. Credit rating agencies have tightened their standards for certain mortgages, and investors who buy pools of mortgages are beginning to demand higher yields for purchasing riskier loans.

Other changes may be less noticeable to borrowers, at least initially. Several lenders that offer option ARMs have raised the "margin" used to determine the interest rate on the loan once the introductory-rate period ends. To set the rate on the loan, lenders each month typically add the margin to an index that measures short-term interest rates. Since the index rises along with market rates, the banks' wider margins represent additional costs to new borrowers beyond increases in short-term interest rates.

In mid-August, Washington Mutual increased the margin on its option ARMs by 0.20 percentage point to 2.5%. As a result, a borrower who took out an option ARM tied to one popular index -- the 12-month Moving Treasury Average -- might pay 5.52% instead of 5.32%. Also last month, Countrywide boosted the margin on its option ARMs by between 0.125 and 0.375 percentage point, depending on how risky the loans are. **Downey Financial** Corp. and Secured Bankers Mortgage Co., California-based lenders, also raised the margins on some option ARMs, company executives said.

Because the introductory rate on an option ARM is so low, the minimum payment generally isn't enough to cover even the interest that is due in the loan's early years. That means borrowers who choose to pay the minimum amount can make regular payments and still see their loan balance swell, also known as "negative amortization." Borrowers could also be hit with sharply higher monthly payments down the road when the monthly payment is reset so that the loan can be repaid over a 30-year period.

Even before the recent changes, rising short-term interest rates were making products such as option ARMs less attractive. A borrower with an option ARM tied to the Moving Treasury Average that currently carries a rate of 5.52%, after the introductory rate expired, would have paid about 4% in June 2004, according to HSH Associates in Pompton Plains, N.J. Rates on loans tied to other popular indexes can be well above 6%, HSH says. That compares with a current average of 5.97%

for a 30-year fixed-rate mortgage.

At the same time, some lenders are pushing more borrowers who take out option ARMs into loans that carry prepayment penalties. In a conference call with investors in July, Countrywide said that nearly three-quarters of its option ARMs carried prepayment penalties, up from 18% in 2003. GreenPoint Mortgage, a unit of North Fork Bancorp, recently modified its option ARM program to make loans without prepayment penalties less attractive. More than half of the option ARMs GreenPoint grants now carry prepayment penalties, up from less than one-third a year ago.

Write to Ruth Simon at ruth.simon@wsj.com <mailto:ruth.simon@wsj.com>[1] and James R. Hagerty at bob.hagerty@wsj.com <mailto:bob.hagerty@wsj.com>[2]

URL for this article:
http://online.wsj.com/article/0,,SB112795905459255441,00.html

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From: "Dochow, Darrel W" <darrel.dochow@ots.treas.gov>
To: [redacted]
Subject: FW: Meeting
Date: Sun, 18 Sep 2005 17:07:31 +0000

[redacted] = Redacted by the Permanent Subcommittee on Investigations

-----Original Message-----
From: Carter, Lawrence D
Sent: Friday, September 16, 2005 9:07 AM
To: Dochow, Darrel W
Subject: RE: Meeting
Sensitivity: Private

Ok, I'll play good cop.

Historically, they have always had some problem setting up systems and procedures to consistently and automatically comply with our policy of underwriting at or near the fully indexed rate. Recently, we have relied on the fact that the administrative rate was higher than fully indexed and that they were going to monitor their qualifying rates to make sure they were in compliance with our policy. We did not choose to spend resources getting to the bottom of whatever systems issues they had because we knew they were in the process of making wholesale systems changes in home lending (still in process). We did point out (orally I think) that there were cases in which they underwrote below the fully indexed rate because of the varying margin). We also did not, as far as I know, ask whether they had made changes to the administrative rate during our exam, even though we knew rates were rising. If we had, we would have identified this issue as it was emerging. But, like happens with other emerging issues sometimes, we were focused on resolving the issues we had already identified and not updating the whole exam to June!

By the way, in terms of policy, I am not sure we have ever had a really hard rule that institutions MUST underwrite to the fully indexed rate. I remember going back and forth with Bill Magrini over the years on this. In fact, I remember when we did Home Savings years ago, we allowed: (1) loans held for sale could be underwritten to secondary market standards (which I believe was 200 bp above start rate or basically to first adjustment on an ARM that adjusted annually — FHA, I believe, now still has a similar standard) -- I think they had to have firm commitments to sell in place, but I don't recall for sure; and (2) an interpretation of "near" I believe to be no more than 25 to 50 bp below the fully indexed rate. I believe we would still find that secondary market requirements are more lax than our policy on underwriting to fully indexed rates. Additionally, I think our guidance has always been to underwrite at initial or "start" rate on hybrid ARM (3-, 5-, 7-, 10-year products; these products have traditionally not had "teasers." Of course, this guidance was before the interest only hybrid products started coming out.

What all this means is, if you allow them the exception for loans held for sale and you allow them 25 to 50 basis points below fully indexed, they probably do not have a ton of loans that fall far outside our policy guidance--only loans underwritten in recent months. The issue of competitors taking the holier-than-thou position is different, though. If WAMU is really garnering market share by more lax underwriting standards, this is a problem. But I really am curious as to whether the competitors are as holy as they proclaim. I have heard that IndyMac is, but WaMu's primary competitor is Countrywide. Remember, Countrywide would not follow in a teaser rate increase tried by WaMu earlier in the year. I would like to see the communications from Countrywide to its loan agents/brokers, and I would be interested in what a loan file review at Countrywide would turn up. I realize we can't regulate WaMu based on Countrywide, but I think it would provide insight into a lot of management's actions on

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OTSWMS05-002 0000535

the production side. Countrywide has been taking loan agents and market share from WaMu over the last year or so, so the incentive to compete head-to-head is significant.

In terms of the facts below,

1. I think the sheet you obtained says higher of 4.25 percent or start rate. Based on our loan sample and systems issues, I think it is likely they are actually underwriting simply at the administrative rate.

2. Administrative rate "significantly" less than fully-indexed -- probably.
3. Accurate, but I would say "at or near" fully indexed rate -- I think we would not have criticized them for 25 bp below, and would have been on the fence as they approached 50 bp below -- at least this has been my interpretation of our policy over the years.

4. Accurate on not letting us know. My take, and you can tell from Joe's diatribe, is that they don't think the qualifying rate is all that important in terms of credit risk. But I doubt they thought about reputation risk in much detail.

5. Accurate. I don't remember ever hearing during the exam that Rotella made a decision to keep qualifying rates as they were or anything about production saying they needed to do so. However, in January/February, the administrative rate was still probably not that far below fully indexed. (Ben may have more insight here.)

6. Accurate. Especially for loans held for sale. As I mentioned earlier, we used to treat these loans differently. Also, for sure they think DTI's don't matter until you get into upper ranges. I think everyone is underwriting primarily to LTV and FICO now.

7. Very accurate. Credit Risk Management has always had to pick their battles.
8. Agree, but I think this is just one of several symptoms of the ongoing broader problem of getting their house in order from an underwriting standpoint. It has been hard for us to justify doing much more than constantly nagging (okay, "chastising") through ROE and meetings, since they have not been really adversely impacted in terms of losses. It has been getting better and has not recently been bad enough to warrant any ratings downgrades. And we have considered this issue in our assessment of capital, clearly. What is really effective is when people like Rick Riccobono, Mike, and you add weight. That sends the signal that what we say at the examination level is important. They are obviously quicker to act when you weigh in!

Depending on how important you think it is that we get the facts perfect, we may want to get Ben's perspective. But I think Mark and Joe corroborated our assessment of the situation yesterday.

Sorry for the long note, but I thought it was important that you understand our thought processes at the exam level so we can make adjustments in our approach if necessary.

-----Original Message-----
From: Dochow, Darrel W
Sent: Thursday, September 15, 2005 6:44 PM
To: Carter, Lawrence D
Cc: Finn, Michael E
Subject: RE: Meeting
Sensitivity: Private

Lawrence:

Thank you for joining the meeting via phone. I held Mark Hillis and John

Robinson back for a private session. Please review the below and let me know if any of this does not capture the substance of the meeting as you heard it. Mark Hillis confirmed that Rotella made the business decision to not do the manual adjustments to the qualifying rates in anticipation of the system fix being implemented in August 2005.

- WAMU has been underwriting ARMs (1,3,6 & 12 month MTA Option ARMS) at the higher of the administrative rate or start rate.

- The administrative rate has not been manually increased since at least October 2004 despite numerous increases in rates, such that the administrative rate is now significantly less than the fully indexed rate.

- Management made a conscious decision to not manually adjust the administrative rate and to wait for a systems fix that is now expected to be in place in December 2005. They are to provide me with the exact date for the system fix, exact date when the interim rate change will occur in October, and confirm that they are going to put in place a manual fix now. In addition, they will provide their internal analysis supporting the assertion that the credit quality of such products has not deteriorated during the period that borrowers were qualified at less than a fully indexed rate. They are also to provide their analysis of payment shock stress testing over wider interest rate cycles, and information to address my questions about HELOC quality given lower auto approval levels and an increased marketing campaign. They also acknowledged that they understood that the regulatory expectation has been and continues to be that loan qualification should be at the fully indexed rate for these products, and that it was their intention that this be done when they talked with the examiners.

- I think that the concerns we raised hit home (predatory/affordability issues, only major lender not using fully indexed rates, not complying with well understood regulatory expectations, not informing us that the administrative rate - manual change was not done and would in fact not be done, reputation risk, etc.)

- The management decision was made in January/February (Rotella is credited with this decision at a time that he reportedly was hearing from the production folks that pricing/qualifying rates needed to be maintained). The information previously provided to and upon which the examiners relied indicated that borrowers would be qualified at the higher of the administrative rate or the fully indexed rate. This change was not communicated back to the examination team.

- The credit risk of the decision to not use fully indexed rates or to not manually adjust the administrative rate may not be high due to sale of much of this product, no relaxation of the DTI ratios, and minimal importance of DTI in predicting loss until the DTI ratio moves above 55%, etc.

- Credit Risk Management folks, feeling some tension/pressure, made a judgment to not dig in on the management decision to wait for a systems fix because they had gained much in other respects, would monitor the credit quality, and felt there were mitigating circumstances such as not lowering the DTI ratio standards.

- I believe that my chastising of this group was effective, and I intend to discuss this matter with Jim Vanasek on 9/26 and with Steve Rotella next chance that I get.

Darrel

-----Original Message-----

From: Carter, Lawrence D
Sent: Thursday, September 15, 2005 5:45 PM
To: Dochow, Darrel W
Subject: Meeting
Sensitivity: Private

I hope I didn't hinder you getting your questions answered during the meeting today. I tried to avoid cutting in too much. This was a good example of what the examiners go through when they are trying to get to the bottom of things during the exam! A lot of gobbledegook. The bottom line, though, is that Mark and Joe are both fully aware that our policy requires underwriting at or near the fully indexed rate, whether they believe it is correlated with performance or not. I was glad that they stated that their intention all along has been to require underwriting to the higher of the administrative or fully indexed rate, not the start rate. They were supposed to be monitoring the qualifying rate and making changes when necessary to make sure they were always near the fully-indexed rate, but obviously this didn't happen as they had hoped in recent months.

[Back]

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From: Dochow, Darrel W
Sent: Friday, June 16, 2006 10:04 AM
To: Carter, Lawrence D <carterld@office of thrift supervision.com>
Subject: RE: Talk

I am available after the call.

-----Original Message-----
From: Carter, Lawrence D
Sent: Thursday, June 15, 2006 5:01 PM
To: Dochow, Darrel W
Subject: Talk
Sensitivity: Private

Can we talk tomorrow for a half-hour or so, maybe right after the Austin Hong call? I've talked to Ben and Rich and we still have some strong feelings on some items that I'd like to "push back" (just call me Scott Jr.) some on. Generally, we feel that we are quite balanced and do not have any gloves on in our approach to our findings and conclusions at WAMU. We have some concern that if we press forward with some things in our meetings and ROE that we may run the risk of losing some credibility in terms of understanding the size and complexity of their business and looking as though we do not have a balanced perspective. My own fear is that we may not have done enough to communicate to you why we feel that the few negative things we have brought up through findings memos and meetings, while important to keep in front of management, are not so serious they wipe out all the right things the institution is doing in all those areas we reviewed and did not have any issues, nor should they negate the ongoing good progress in making improvements in a manner that seems reasonable given the size, complexity, and status of the institution. And, although they certainly will argue at times, they have historically been very responsive to all of our concerns. So these are the things I'd like to talk more about:

1. Long Beach -- natural evolution internally will address a number of issues -- they are aligning LBMC processes with prime Home Loans and, at the same time, continuing to improve the processes in prime Home Loans -- they are working at a deliberate, reasonable pace -- yes, it will take time because of size and complexity, but controlled growth in the meantime and our continuing to raise issues will keep them on the right path. We don't feel demanding more than providing us with an acceptable action plan with realistic timelines is appropriate or necessary at this time.

2. Corrective Actions in ROE -- We use the memo process to communicate everything we think worthwhile, not always necessarily thinking everything should go in the ROE given the findings' significance in the grand scheme of things. This is actually a very good PROACTIVE process because we can get items in front of management that may not yet have risen to a high level of concern. If we start putting ALL these items in the report, more important findings will get lost. We have a very good memo distribution, response, tracking, and signoff process that operates well without having everything duplicated in the ROE. If examiners on other exams are merely citing findings memos and they don't have the same tracking process we have, then I would agree they might need more in the ROE, but we feel strongly that we should not cite all findings and corrective actions within the body of the ROE. The body of the ROE is already not getting read I believe.

3. Compliance Violations -- I need to go back and look at our official guidance myself on this one, as I have relied on Rich and Suzie to make sure we comply. I think Suzie feels strongly though that we are citing violations appropriately and are taking the time to have full discussion in 'gray areas."

Additionally, I need to talk about the meetings next week since we are starting to "over-meeting" the institution -- we really don't have a whole lot to add to what we have already told them. Also, if you attend all the meetings with execs and Mike goes to the meeting with Kerry and Steve, we probably need to

regroup on what we want to accomplish in the exit meeting so we are efficient -- i.e., the exit meeting starts to almost become unnecessary. We can discuss this.

Finally, MRBAs -- I said I was somewhat indifferent on having any MRBAs, because I could see a strategy where we decide to give management a break to fix things they are already working on, and I could also see a strategy where we want to keep those things that we still feel strongly about front and center. At this point, it sounds like we want to have Long Beach, Flood and ERM in the MRBA section, with ERM as a "monitor" item as we did last year. I don't take issue with this as I can see us going either way, but we will need to have a discussion with them on what it takes NOT to have a MRBA. They may start to feel like, as we have less and less findings, that we start to just take the top priorities and make them MRBAs. I certainly don't think we are there yet, but we do need to be prepared to have that discussion with them.

Anyway, let me know if we can talk after the Hong call.

My management class this week has made me feel empowered! Can you tell? Please don't fire me!

855 f
90.10

Dochow, Darrel W

From: Rexroth, Mariana
Sent: Friday, May 11, 2007 9:48 AM
To: Dochow, Darrel W; Bisset, John K; Fiene, Laura M
Cc: Franklin, Benjamin D; Clark, Mary Suzanne; Archibald, Robert D
Subject: RE: Fair Lending Findings Memo

Thanks, Darrel -

I have a copy of an internal DOJ memorandum that outlines the circumstances in which it will pursue a fair lending pattern or practice case. I feel quite confident that this situation would within those guidelines. I will bring the memo on Wednesday (it's hard copy).

Apropos the lack of tools - that is a reality. I'm willing OK with your changes, but you need to realize that I feel very strongly about this. If the agency could be subject to criticism for the lack thereof, my feeling is that is appropriate and it is high time we got such tools. Indeed, one of the few positives of this whole thing has been that we are now able to demonstrate that the "tool" provided is not workable. I do not believe that sweeping this under the rug is necessary.

Given that the information requested for the HMDA outlier review included a huge customized LAR with appended data, with the obvious implication that we were going to use it ... and we obviously didn't ... it seems minimally courteous to acknowledge the limitations. Plus, they knew (and I did) even as they were putting together the response to the data request that FLWiz would break. They'd tested it when they were evaluating tools for their own use. I've talked to other large lenders and they describe similar failures when testing the software. The truth is that PCI (the developer) wants to get lenders to switch over to their server based programs (much more expensive). (If you ask about Countrywide's use of the program - it is not for analysis, but only as a filter on subsets of data.)

The good news on this front: I had told Montrice that it would be altogether excellent if they could get Bernie Siskind to do some training about the use of statistics in fair lending analysis. (He is an economist who has worked in this field - for plaintiffs, advocacy groups, lenders, and DOJ - and also loves to teach and able to explain pretty complex statistical concepts to the non-PhD.) I'd given Montrice his phone number and address, and she was able to get him to give a presentation at this week's training. It was, as I expected, excellent and VERY well received. So ... Montrice is starting to talk with him about his building the analytical model for OTS!!!! (She asked me to participate.) Anyway, the extra good news is that since he just built such a model for DOJ, I would expect that it wouldn't take that long! Then we can have a real analytical tool and won't have to pretend (as DC has been) that the person who is working on Basel and interest rate risk - and totally uninterested in fair lending - will ever get around to even thinking about it.

Mariana

-----Original Message-----
From: Dochow, Darrel W
Sent: Friday, May 11, 2007 9:24 AM
To: Bisset, John K
Cc: Rexroth, Mariana; Franklin, Benjamin D; Clark, Mary Suzanne; Archibald, Robert D
Subject: Fair Lending Findings Memo

John:

We have a follow-up discussion on WAMU with Mike Finn scheduled for May 16 at 2:30 PM at which time we hope to reach final agreement that no pattern or practice exists. I am comfortable that it doesn't and believe that Mariana did a nice job supporting such. I understand that Laura and Edwin also concur. The exception memo is basically silent on that issue, but implies all is well with an effective program. While there is a small chance that Mike may feel otherwise and that we may need to revise the memo, I am OK with issuing the exception memo either now or after the May 16 meeting.

p.s. I did a stylistic edit that you can accept or not. OTS could be criticized for not having tools that can handle this analyses and we need to pursue getting them.

<< File: WAMU Findings Memo FL Home Loans April 07.doc >>

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Permanent Subcommittee on Investigations
EXHIBIT #8

OTSWMS07-013 0002479

WMI
March 5, 2007
Consumer Compliance Examination
OTS COMPLIANCE MEMO 6

DATE:	May 31, 2007
TO:	Dick Stevenson, Corporate Compliance Officer
FROM:	Susie Clark, OTS Compliance Specialist
SUBJECT:	Compliance Management Program
CC:	Cathy Doperalski, Regulatory Relations

BACKGROUND INFORMATION

WaMu's compliance management program has suffered from a lack of steady, consistent leadership. Dick Stevenson, who took over as Chief Compliance Officer on March 2, 2007, is the bank's ninth compliance leader since 2000. The previous compliance officer, Richard Lewis, was in the position for less than a year before leaving the bank without another position lined up. Most previous persons in this position have either left the institution or been fired. The OTS is concerned that this lack of consistent, stable leadership leaves the program vulnerable. This amount of turnover is very unusual for an institution of this size and is a cause for concern. The Board of Directors should commission an evaluation of why smart, successful, effective managers can't succeed in this position. If you would like my opinion, just ask. (HINT: It has to do with top management not buying into the importance of compliance and turf warfare and Kerry not liking bad news.)

SMAART

Since the OTS is now the sole regulator for both charters, the OTS requests that WaMu adopt the SMAART format for compliance management oversight. The "Working SMAART" framework, as detailed in the OTS Examination Handbook, categorizes the basic components of sound compliance management to include the following: Systems, Monitoring, Assessment, Accountability, Response, and Training. By setting up the compliance management functions and reporting to conform to this framework, it will not only assist the OTS in evaluating the program, but it will help to highlight areas in need of management attention. If WaMu's system was better than SMAART, we wouldn't ask for this change. It isn't.

LEGAL DEPARTMENT INTERFERENCE

The legal department should partner with the Compliance department, not run it. Managing a compliance program to meet the bare minimums of legal responsibility may have the dubious benefit of ensuring full employment for the legal department, but it is not the OTS approved way of managing compliance risk. While the certain bank executives have stated to regulators that "reputation risk" is a primary concern of the organization as a whole, managers of the compliance department apparently didn't get that memo. In numerous meetings, various compliance managers have made it clear that they do not plan to implement recommendations to enhance customer service or disclosures "unless we plan to cite a violation." This attitude is not a hallmark of a good compliance program. It is, in fact, a hallmark of a poor compliance program.

The risk landscape has changed for banks in the past few years. Fair Lending and compliance risks, including HMDA pricing data, Subprime lending, Predatory lending, Non-traditional ARMs, increased use of the Unfair and Deceptive acts and practices law, and congressional scrutiny of credit card practices, have increased in the past few years, not decreased. Other sources of risk proliferation comes from the New Congress, the presidential campaign, increased regulatory scrutiny and "guidance", consumer advocates, state attorneys general, litigation, the media, and the internet. Risks are evolving from "black and white" (are we in legal compliance?) to lots of different shades of gray.

Instead of asking whether or not the bank is in strict compliance with the laws and regulations, management should be asking "is this disclosure or practice abusive, predatory, unfair, deceptive, or unsuitable"? The standard of what is acceptable shouldn't be "where is the line of what is legal or not legal". It should be about managing risk. And focusing on fairness, not compliance. Management's attitude toward compliance shows that they have not made this leap in thinking. This change must come from the top of the organization and permeate the culture before effective change can happen.

Permanent Subcommittee on Investigations
EXHIBIT #9
Franklin_Benjamin-00020408_001

REGULATORY RELATIONS

Is a joke. The purpose of this group seems to be how can we give the regulators the bare minimum without them raising a fuss. And let's give them a Findings Memo template that is so hard to manage that they will spend half the exam time messing with it. Here is how regulators should be managed: if they ask for information in a certain area, do a SMAART presentation. For example, if the OTS examiner asks for a meeting on Regulation E, provide a presentation of the following:

the bank's **system** of ensuring compliance with this area,
how this area is **monitored** for compliance,
how does the business self-**assess** compliance,
how is **accountability** built into the system,
how have previous audit or regulatory concerns been **responded** to, and
what **training** is provided to ensure your employees know what the hell they are doing.

This is not rocket science. While I find the blank stares I usually get endearing, it isn't very effective. If it takes you a week to figure out locations where certain functions take place, that doesn't give me a good comfort level feeling that you are properly managing the part of the program. If the bank has a program it is proud of, then show it off.

The compliance program should have their own regulatory relations group with compliance and bank process expertise. Shannon Altug, who is a rock star in my book, can't do this function on her own. This isn't an administrative function. It should function as a liaison group to organize the exam and meetings and personnel in such a way as to put the bank's program in the best (but honest) light.

CONTROL VALIDATION PROJECT

Richard Lewis, the previous compliance officer, stated in a meeting at the last exam that he would implement a control validation project at corporate compliance, which would be similar to the function on-going at Card Services. The purpose of this project would be to look at all the processes, find the regulatory (or reputation) risks, and then employ mechanisms to mitigate or eliminate the risks. The OTS encourages the rapid implementation of this project with high-risk areas evaluated first.

The OTS examiner should come into this institution and find NOTHING wrong. Bank management should be managing these processes down to a granular level. When we come in with our minimal resources and find Section 8 RESPA violations, absolute abject failures in the flood insurance program, and an abysmal compliant processing program that management thinks is just great, you should be embarrassed. These reflect fundamental weaknesses in the entire compliance management function, from systems to training.

WaMu should have state-of-the-art risk assessment processes at identifies ALL risk, has a method to weigh and prioritize them, control them, meaningfully report them, and manage the risks proactively. Management shouldn't wait for the OTS to find the problems. We are not your audit or QC department.

EXAM FINDINGS DEFINITIONS

Observation:	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation:	A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.
Criticism:	A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

EXAM FINDING 1 ☐ **Observation** ☐ **Recommendation** ☐ **Criticism**

Topic:

Finding:

Action:

WMB, WMBfsb
January 8, 2007
Safety & Soundness Examination
OTS ASSET QUALITY MEMO 11

DATE: June 7, 2007

TO: Richard McCoppin, Senior Manager—Credit Services, Home Loans Risk Management

FROM: Rosanne Sinclair, Examiner, OTS

SUBJECT: Broker Credit Administration

CC: Cheryl Feltgen, Chief Risk Officer—Home Loans, Home Loans
Cathy Doperalski, FVP, Regulatory Relations Senior Manager

BACKGROUND INFORMATION

Broker Credit Administration (BCA) is responsible for approving third party brokers, and performing annual license verifications, annual IRS 1099 reporting, and monthly broker reviews based on a broker scorecard. Third Party Oversight (TPO) maintains broker performance metrics, the broker watch list, and the unacceptable third party list.

Since the last exam, FTEs have declined (from fifteen to fourteen in BCA, and from three to two in TPO) although the number of brokers has increased. There are 14 FTEs in BCA handling approximately 34,283 brokers. Given the large number of brokers, a TPO score for each broker was developed to facilitate review of brokers through automation. Also, management revised the broker scorecard.

EXAM FINDINGS DEFINITIONS

Observation: A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.

Recommendation: A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.

Criticism: A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

EXAM FINDING 1 ☑ Observation ☐ Recommendation ☐ Criticism

Topic: BCA Policies and Procedures

Finding: We have reviewed the latest version of the BCA policies and procedures (Policy) and have the following comments:

(1) Page 30 of the Policy states there is a monthly license validation verification process wherein the BCA manager or his designee, on a monthly basis, will randomly select five licenses from the WAMU wholesale and Long Beach wholesale channels to verify the current status of the license with the state versus how it is reported in the broker database, MLCS, Loanworks, and FiTech as applicable. Management verbally indicated that licenses are also selected from other broker channels such as WAMU retail and WAMU retail builder. We have no information to determine whether this is a statistically significant sample given the number of brokers. The "Monthly License Validation Verification" section of the Policy should be amended to clarify that a statistically significant sample of licenses per month from each of the broker channels will be selected for verification.

(2) Page 30 of the Policy states there is also a random audit process of the analysts' work for new broker or branch files of two files per month. Management verbally indicated this review consists of two files per analyst per month. However, we have no indication as to the percentage of the analysts' work two

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EXHIBIT #10

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EXAM FINDING 1 ☑ Observation ☐ Recommendation ☐ Criticism

files/month represents. Given this, as well as the fact that this is a component of the analysts' yearly performance review, it appears that a percentage threshold (e.g., 10 percent of each analyst's work) should be used for sampling. The "Random Audit Process" section of the policy should be amended to define a stated percentage of each analyst's monthly work that will be audited.

(3) The annual certification process consists solely of an annual license validation. However, a form should be sent to the broker on an annual basis which: (a) requests whether there were any changes in officers, directors, and principals/owners (if sole proprietorship or closely held company), as well as dba or company name. Any changes in such individuals/entity should be checked against the Mortgage Asset Research Institute (MARI), the internal unacceptable list, and the internal broker watch list as applicable; and, (b) includes the six disclosure items regarding suspension, bankruptcy, complaints, lawsuits, etc. that appear on page 3 of the current LBMC broker application.

(4) Page 32 of the Policy states that if during the evaluation period, Risk Mitigation (RM) has found confirmed fraud, the broker will be recommended for immediate termination. Since RM is no longer the only department detecting fraud (see Exam Finding No. 4 below), the "Broker Eligibility" section of the Policy should be changed to state: "If at any point during the evaluation period fraud has been confirmed, the broker will be recommended for immediate termination."

(5) Page 32 of the policy states that Sales may appeal any scorecard-based watch list decision to the Third Party Approvals and Monitoring Manager. Further, the Policy states that Sales may appeal any scorecard-based termination decision to the Senior Manager Credit Services. Lastly, the Policy states that all RM confirmed fraud appeals must be reviewed by and only can be overturned by the Senior Manager, Credit Services. This is all one and the same person. We raised concerns about Sales having too much leverage regarding these decisions. Management verbally indicated that if BCA and Sales cannot agree on a decision on a broker, the matter goes to the Third Party Oversight (TPO) Committee for a vote, and the decision is final. However, this process is not stated in the BCA Policy. The "Exception Process" of the Policy should be amended to indicate that any watch list, termination, or fraud decision appealed by Sales should go to the TPO Committee for a vote.

(6) Management indicates that any broker for which a license is expired, revoked, or inactive is automatically terminated in the system and the applicable loan systems will not accept any loans from this broker. The Policy should state this.

Under the Section of the Policy entitled: "Annual License Validation," Firstline Data is referenced as the vendor used for verifying license information; however, the company used is Regsdata. The policy should be amended.

(7) With regard to the initial approval of brokers in all channels, we noted that no reference checks are required. Management indicated that they have, however, implemented an Industry scorecard (CRM or Corelogic) provided by a third party vendor, and that they are addressing length of time in business for each broker. The BCA Policy does not include these processes. Further, it is not clear whether this scorecard addresses our concern regarding reference checks. The Policy for initial approval of brokers in all channels should be amended to require that reference checks be performed to determine the broker's performance history. The policy should also specify the required processes and documentation.

The Policy does not require that certain LoanSafe scores such as the broker lender score and broker industry score be run for initial approval of brokers. If these are different from the CRM score, the Policy should be amended to require this for initial approval in all channels.

(8) The Policy is inconsistent with regard to retail brokers versus brokers in other channels concerning documentation requirements for approval. Specifically, the Policy should require the following documents for approval of retail brokers: (a) IRS Form W-9; (b) broker application; (c) broker agreement; (d) company certification or corporate resolution; and (e) Articles of Incorporation/Organization or Partnership Agreement.

Action: Amend the BCA Policy to address the underlined items in Nos. 1 through 8 above.

Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [12/31/07]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

EXAM FINDING 1	☑ Observation	☐ Recommendation	☐ Criticism

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the observations and will implement corrective actions by the end of 2007.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. BCA will validate 100% of licensing to ensure accuracy. This will be accomplished by: When a channel or branch Add request is received by BCA the analyst validates the license. A weekly report is received from our licensing vendor and an analyst works report by going directly to the state website. The Policy and Procedures will be updated with this information. (Kelly Routier-Kane) (09/30/07)
2. The Quality Assurance procedures have been recently updated. The Quality Audit Definitions are in place and the template has been prepared for use. The Team lead will review 10 files (including new application, channel adds, changes and branch adds) for each analyst per month. There will also be a peer review. The analyst will review two files a month for their back up. The template incorporates each individual analyst, team level and department level. This will ensure BCA management captures trends at the individual analyst level as well as department. (Kelly Routier-Kane) (07/31/07)
3. BCA will create a team of analyst to work with Legal and the Third Party Oversight group to develop and implement an annual recertification letter and form. This additional certification will be performed by the Third Party Oversight group. (Watchlist, Unacceptable list, MARI, Secretary of State, Licensing, Bankruptcy, Mortgage Fraud Blogs, Lexis/Nexis Search) The Policy and Procedures will be updated with this information. (Kelly Routier-Kane) (12/31/07)
4. Suspicious activity reporting (SAR) on confirmed fraud has been centralized in the Risk Mitigation department. If the loan fulfillment personnel (underwriters/processor) suspects or confirms fraud the loans are sent to Risk Mitigation to validate and file the requisite SAR documents. The Policy and Procedures will be updated with this information. (Kelly Routier-Kane) (12/31/07)
5. All appeals will be presented to the TPO Committee which currently meets monthly beginning with the July TPO Meeting. The Policy and Procedures will be updated with this information. (Kelly Routier-Kane) (07/31/07)
6. The Policy and Procedures will be updated with this information. (Kelly Routier-Kane) (09/30/07)
7. The CRM Score (Corelogic) is the third party score used to determine the lenders performance in the industry. The CRM incorporates loan data information from Corelogics Clients (which includes 6 of the top 10 Prime lenders and 3 of the top 10 subprime lenders). Corelogic utilizes the brokers Foreclosure rate, pull through rate, Market area to determine their third party score. This score is one of several items reviewed to determine the brokers performance in the industry. The Policy and Procedures will be updated with this information. (Kelly Routier-Kane) (09/30/07)
8. BCA Management will work with the Retail Channel and Legal to ensure the broker documentation requirements for the approval process are consistent as applicable throughout all channels. (Kelly Routier-Kane) (12/31/07)

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Hedger_Ann-00027930_003

EXAM FINDING 2	☑ Observation*	☐ Recommendation*	☐ Criticism*

Topic: Broker Scorecard

Finding: We reviewed the latest version of the broker scorecard and have the following comments:

(1) While the pull through (closure) rate is now on the scorecard, which measures the percentage of approved loans that closed, the scorecard still does not contain a metric for loan denial rates which would measure the percentage of loans that were denied and not approved.

(2) While there are metrics for repurchases (which should measure those attributable to the broker's fault), there are no metrics for indemnifications (attributable to the broker's fault).

(3) The metrics for early payment and first payment defaults, and pull through rates only measure the last twelve months. The metrics for repurchases, loan to values (LTV), and FICO scores are only measured on a year-to-date basis. The metrics for loan type, salability, and product mix are measured for a three year combined timeframe and not for separate timeframes. These factors hinder time series and trend analysis. We recommend that all metrics on the scorecard be measured for the past two years and year-to-date in separate timeframes.

(4) Churning (e.g., repayment of the loan within a defined time period) should be defined in the BCA Policy. We note that the performance trigger for churning for purposes of the TPO score (see Exam Finding No. 3 below) is whether churning is greater than 10 percent of loans within the first six months. However, it is not clear whether all churning is being measured on the scorecard or just churning that is greater than the 10 percent threshold. All churning should be measured on the scorecard, not just whether churning is greater than 10 percent of loans.

(5) The LTV distribution on the scorecard has no indicator for whether the loan has PMI, which could skew concern if a large portion of the loans are shown to have LTVs over 90 percent. There should be separate metrics in the LTV distribution for loans with LTVs> 90 percent and no PMI and loans with LTVs>90 percent with PMI to provide a more accurate measurement of risk.

(6) Since the FICO threshold for subprime loans secured by real estate is 620 or below, the FICO distribution lower limit shown on the scorecard should be expanded beyond < 620 so that the FICO distribution of sub prime loans can be ascertained.

(7) MARI results do not appear on the scorecard.

(8). The rate of significant underwriting and documentation deficiencies (attributable to the broker's fault) identified from quality control reviews performed by Corporate Credit Risk and other units are not included on the scorecard.

(9) The BCA Policy indicates that the salability metric measures the percentage of loans that are salable within the last six months. However, there are two columns (portfolio and sale) which could also mean it measures whether the loan was placed in the held for sale or held for investment portfolio regardless of whether the loan had defects which made it unsalable. The scorecard should have a metric that measures the percentage of unsalable loans due to loan defects (attributable to the broker's fault).

(10) There are two scores which appear on the scorecard that are not defined—BMP score and Tier Score. For one of these (tier score) we believe it is the production tier ranking we received in management's response but that is not for certain. All metrics that appear on the scorecard should be defined in the BCA Policy.

(11) There are no channel norm metrics (e.g., mean) on the scorecard as a basis of comparison by which to gauge performance for pull through rates, loan denial rates, repurchases, indemnifications, FICO and LTV distribution, and unsalable loans. Further, there are no industry metrics on the scorecard as a basis of comparison for the key performance indicators (KPIs). Finally, the derivation of all channel norms that are shown on the scorecard should be defined in the BCA Policy.

(12) There may be data integrity issues on the scorecard (for example, under "product mix," the LBMC scorecard shows conventional ARMs, conventional fixed, Option ARMs, Interest Only, ALT A and Equity under the sub prime row. However, the combined percentages for these products add up to over 100 percent for the sub prime row. The additive effects of the metrics are not clear). The scorecard should be reviewed for data integrity issues.

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EXAM FINDING 2 ☑ Observation* ☐ Recommendation* ☐ Criticism*

(13) Certain metrics are not yet populated with data (e.g., "count of reviews" which measures the number of times the broker has been reviewed for performance is blank).

(14) There should be separate TPO scores and CRM (Core Logic) scores for prime versus sub prime if separate scores exist and are available.

(15) The risk weighting of the performance triggers in the scorecard do not coincide with those in the latest version of the BCA Policy (Performance Monitoring section).

(16) The scorecard does not appear to contain certain LoanSafe scores such as broker lender score and broker industry score. If these are different than the CRM score, the scorecard should contain these metrics (including separate scores for prime and sub prime if separate scores exist and are available).

Action: Address the underlined items in Nos. 1 though 16 above.

Management Response Requested ☑ **Yes** ☐ **No**

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [12/31/07]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the observations and will consider the merits of each requested action by the end of 2007.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Management will consider broker scorecard key performance metrics described in items 1 through 8, 11, 12, and 13 above. (8/31/07)
2. Management will then implement the new identified broker scorecard key performance metrics. (12/31/07)
3. The BCA Policy & Procedure manual will be updated with the correct information to remediate items 9 and 15 above. (Kelly Routier-Kane) (09/30/07)
4. The Broker Management Process (BMP) is a broker rewards program designed as an incentive for brokers with good performance and no longer has an impact on BCA's process. The prior BMP process required BCA to terminate broker for lack of production, but allowed the Sales Managers to approve reactivation. The termination process is no longer a part of the program and no longer requires BCA support. The Tier Score ranking is based on 3 years Production (Tier 1 – More Than 300 Loans Produced; Tier 2 between 300 and 200; Tier 3 between 199 and 100; Tier 4 between 99-50; Tier 5 less than 50. This tier ranking helps the analyst understand the overall relationship WAMU has with the broker based on their production. BCA's Policy & Procedure manual will be enhanced to describe these metrics to remediate item 10 above. (Kelly Routier-Kane) (09/30/07)
5. Separate TPO/CRM scores are available for Prime and Subprime at the channel level. Scores are also produced for Branch (Location –which will include all broker codes associated with the specific location) and for the company as a whole. BCA's Policy & Procedures manual will be updated with instructions and definitions to remediate item 14 above. (Kelly Routier-Kane) (09/30/07)
6. The CRM score is the same as the TPO (also known as the Loans Safe Score). BCA's Policy & Procedures manual will be updated to describe this metric. (Kelly Routier-Kane) (09/30/07)

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Hedger_Ann-00027930_005

EXAM FINDING 3	☑ Observation	☐ Recommendation	☐ Criticism

Topic: TPO Score

Finding: (1) The latest revision to the BCA Policy (pages 31 and 32) contains the derivation of the TPO score used to monitor each broker. Ideally, each of the performance metrics in the broker scorecard should be reviewed individually against separate KPI benchmarks and thresholds for triggering watch list and/or termination. However, it appears due to resource constraints, management developed one TPO score to include these performance triggers to facilitate review of the thousands of brokers with which WMB conducts business. While these performance metrics continue to be measured on the scorecard, the triggers for being placed on the watch list or termination are all tied to the TPO score (except for fraud). The risk with having one TPO score rather than reviewing each metric individually is that one metric could be very problematic but still result in an overall TPO score that would not trigger any action if the other performance measures included in the score are satisfactory since it is only one portion of the score. We suggest that management re-assess the current TPO score process and re-evaluate the ability to have separate KPI benchmarks/thresholds for each metric on the scorecard and tie these individual criteria into the watch list and/or termination triggers.

(2) If staffing and resource constraints are such that No.1 above is not possible, we have the following comments regarding the TPO score:

- The performance triggers used in the calculation of the TPO score do not include repurchases, indemnifications, and unsalable loans (attributable to the broker's fault). Further, they do not include loan denial rates, or closure rates of approved loans. Lastly, they do not include significant documentation defects or underwriting deficiencies stemming from post-funding Corporate Credit Review (CCR) reviews or other underwriting reviews (where it was determined to be the broker's fault). These should be included in the TPO score.

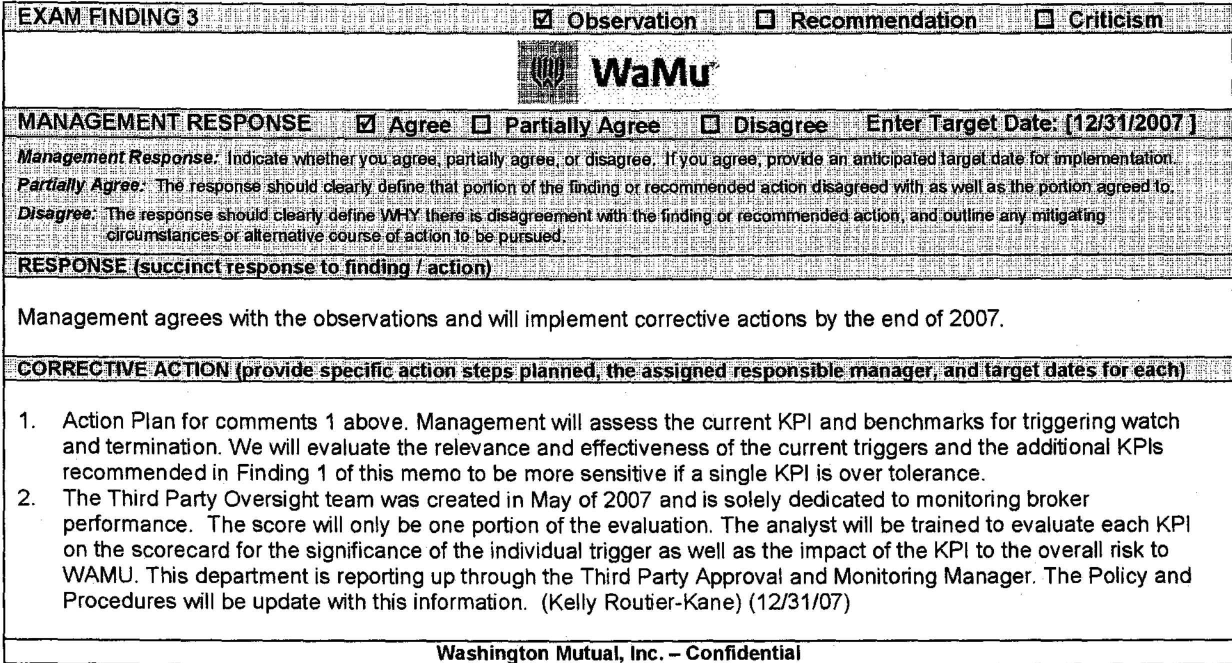
- The delinquency, early payment default, and first payment default performance triggers only result in a deduction from the TPO score if the broker's performance is 1.5 times higher than the channel norm. However, this trigger threshold is too high since a deduction from the score may not even necessarily result in TPO score for which action is taken (e.g., watch list or termination) since there are other components of the score. We note that the FHLMC Guide indicates it will terminate sellers solely if the delinquency is 50 percent higher than the average delinquency rate for all sellers (by product) in the same statistical metropolitan areas, state, or region, in which the mortgages are located. A reasonable threshold for a deduction in the TPO score for these performance triggers would be if the performance statistics for delinquency, early payment default, and first payment default were higher than the channel norm (mean) and/or industry mean for that particular product and in that particular geographic region.

- There are certain performance triggers that should not be part of the TPO score and should be reviewed as triggers for action (e.g., termination) in and of themselves since by being a part of the score, even if there were significant problems with regard to these items, they are only a portion of the score and thus the broker could still have a TPO score that would not trigger action. Churning and derogatory MARI findings are two of these triggers, and should have separate KPI benchmark thresholds that trigger termination in and of themselves. Further, the trigger for churning for purposes of a deduction in the TPO score of greater than 10 percent of loans churning within the first six months is too liberal.

- While page 32 of the BCA Policy states that confirmed fraud is grounds for termination, the TPO score incorporates as a component in Risk Mitigation (RM) any fraud or misrepresentation referral to identify potential trends of files being referred to fraud. The weighting in the TPO score of this performance trigger is 10 percent; given the significance of this performance trigger, it appears the risk weighting of RM within the TPO score should be higher.

Action: Address the underlined items in Nos. 1 and 2 above.

Management Response Requested ☑ **Yes** ☐ **No**



EXAM FINDING 3	☑ Observation	☐ Recommendation	☐ Criticism

WaMu

MANAGEMENT RESPONSE	☑ Agree	☐ Partially Agree	☐ Disagree	Enter Target Date: [12/31/2007]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the observations and will implement corrective actions by the end of 2007.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Action Plan for comments 1 above. Management will assess the current KPI and benchmarks for triggering watch and termination. We will evaluate the relevance and effectiveness of the current triggers and the additional KPIs recommended in Finding 1 of this memo to be more sensitive if a single KPI is over tolerance.
2. The Third Party Oversight team was created in May of 2007 and is solely dedicated to monitoring broker performance. The score will only be one portion of the evaluation. The analyst will be trained to evaluate each KPI on the scorecard for the significance of the individual trigger as well as the impact of the KPI to the overall risk to WAMU. This department is reporting up through the Third Party Approval and Monitoring Manager. The Policy and Procedures will be update with this information. (Kelly Routier-Kane) (12/31/07)

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EXAM FINDING 4 ☑ **Observation** ☐ **Recommendation** ☐ **Criticism**

Topic: Watch list Process

Finding: (1) Page 32 of the BCA Policy indicates that if the broker TPO score is >50 but <=75, then the broker is recommended for the watch list. Further, if the broker TPO score is<=50, then the broker is terminated. In this regard, since the highest TPO score available is 100, these thresholds seem too low, especially since loans continue to be accepted from the broker during the time the broker is on the watch list and thus WMB is at risk. Since a score below 80 would appear to indicate some type of material shortfall, a TPO score of >=70 but <80 should trigger a watch list recommendation and a TPO score <70 should trigger a termination. Further, as additional criteria, any broker who was a higher than benchmark level of early payment defaults and first payment defaults or other indications of potential fraud should be placed on the watch list regardless of the TPO score.

(2) At the last exam, a separate department, Risk Mitigation (RM), was performing a pre funding loan review of a sample of loans from each broker on the watch list for ninety days. This exam, management has provided a TPO Watch process for Long Beach Mortgage Company which management indicates is going to be rolled out to all the other broker channels. This new process indicates that an underwriter with a Risk Level Authority of 4 or higher from the loan fulfillment center (LFC), not RM, will be reviewing 100 percent of loans from brokers on the watch list on a pre funding basis during the ninety day timeframe. If, during the review, misrepresentation and/or fraud are suspected, the reviewer must review the findings with the underwriter or team manager and investigate this. If discrepancies cannot be resolved, the file is then sent to RM.

While we acknowledge that this new process provides more coverage of loans of brokers on the watch list by reviewing 100 percent of the loans versus a sample, we indicated to management that the concern is that RM is specifically trained to detect fraud and fraud detection entails a different skill set than just underwriting. Therefore, in order to mitigate risk to WMB for early payment defaults and first payment defaults and other fraud risks, this new process should be supplemented. Management's response indicated that RM would perform a random audit of files reviewed by the LFC; however, this appears to be a post-funding review and would be too late to prevent fraud. Specifically, in addition to the LFC process, for each broker that is on the watch list for early payment defaults and first payment defaults or other potential fraud indicators, RM should perform a statistically significant pre-funding sampling of loans for review purposes

(3) The section of the TPO Watch Process entitled: "Removal of Broker on Watch" uses the nomenclature "Risk Mitigation finding" to refer to fraud. However, since fraud can be found by either RM or the LFC, the use of the term "Risk Mitigation finding" should be replaced with "fraud finding" under the section "Removal of Broker on Watch" of the TPO Watch Process P&Ps.

Further, under this same section of the TPO Watch Process, it is stated that if the broker was placed on watch status due to a RM finding, and one or more RM findings occurs in the 90-day period, the broker will be terminated. However, regardless of the reason for being placed on the watch list, if there is a confirmed fraud finding, the broker should be terminated; this is also consistent with page 32 of the BCA Policy. Thus, the "Removal of Broker Watch" section of the TPO Watch Process P&Ps should state: "If there is one or more confirmed fraud findings during the 90 period, the broker will be terminated."

Action: (1) Amend the BCA Policy to address the underlined items in No. 1 above.

(2) Revise the TPO Watch Process P&Ps to address the underlined items in Nos. 2 and 3 above

Management Response Requested ☑ **Yes** ☐ **No**

MANAGEMENT RESPONSE ☑ **Agree** ☐ **Partially Agree** ☐ **Disagree** **Enter Target Date: [10/31/07]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the observations and will implement corrective actions by the end of 2007. Please note that the

EXAM FINDING 4	☑ Observation ☐ Recommendation ☐ Criticism
watchlist process is undergoing a significant update with the pending implementation of third party vendor fraud software (Dataverify). The new watchlist process will be rolled out to all channels by September 2007.	

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each

1. Management will evaluate increasing the threshold trigger for admission of a broker to the watchlist. (Kelly Routier-Kane) (08/31/07)
2. If applicable, the new threshold will be implemented and documented in the BCA Policy. (Kelly Routier-Kane) (9/30/07)
3. Management will evaluate and enhance the termination section of the TPO watch process for handling of reported and confirmed fraud. (Kelly Routier-Kane) (09/30/07)
4. Risk Mitigation will implement an independent review of 100% of watch listed brokers pre-funded pipeline when the loan is approved by Underwriting prior to funding Risk Mitigation will notify BCA if misrepresentation is confirmed in a single instance following placement on the watchlist. The broker is automatically terminated. All Washington Mutual Home Loans employees are responsible for detecting and reporting suspicious activity to Risk Mitigation. Risk Mitigation is responsible for investigating and reporting the incident to FINCEN. (Chris Johnson)(Rich McCoppin) (10/31/07)
5. The BCA Policy & Procedures manual will be updated as needed. (Kelly Routier-Kane) (9/30/07)

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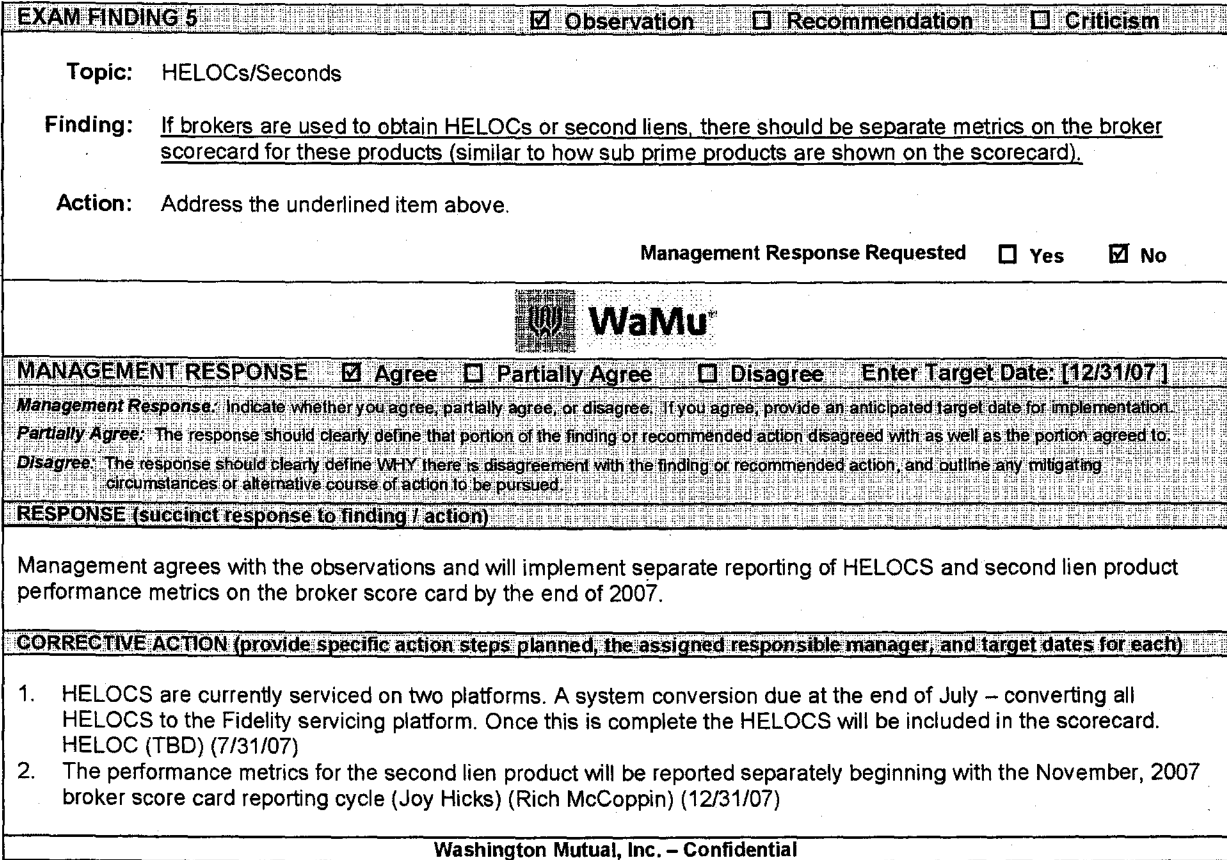
Hedger_Ann-00027930_009



EXAM FINDING 5 ☑ Observation ☐ Recommendation ☐ Criticism

Topic: HELOCs/Seconds

Finding: If brokers are used to obtain HELOCs or second liens, there should be separate metrics on the broker scorecard for these products (similar to how sub prime products are shown on the scorecard).

Action: Address the underlined item above.

Management Response Requested ☐ Yes ☑ No

WaMu

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [12/31/07]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

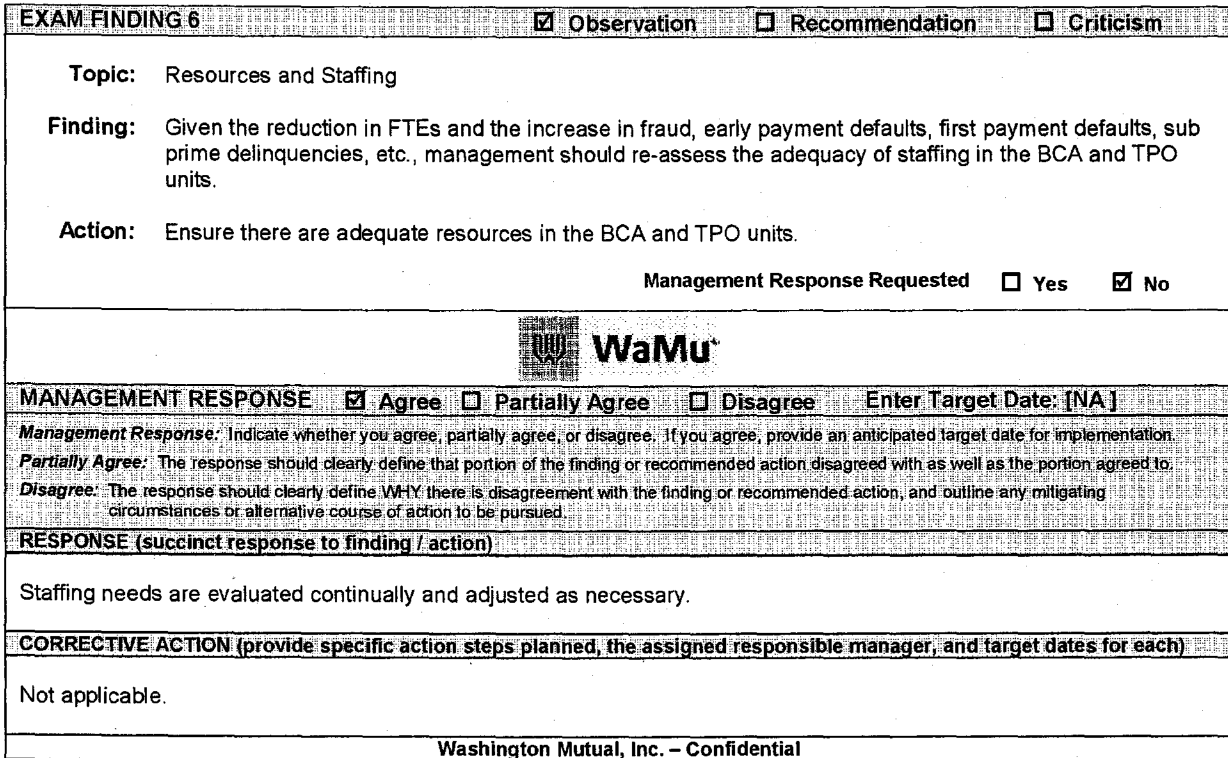
Management agrees with the observations and will implement separate reporting of HELOCS and second lien product performance metrics on the broker score card by the end of 2007.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. HELOCS are currently serviced on two platforms. A system conversion due at the end of July – converting all HELOCS to the Fidelity servicing platform. Once this is complete the HELOCS will be included in the scorecard. HELOC (TBD) (7/31/07)
2. The performance metrics for the second lien product will be reported separately beginning with the November, 2007 broker score card reporting cycle (Joy Hicks) (Rich McCoppin) (12/31/07)

Washington Mutual, Inc. – Confidential

Hedger_Ann-00027930_010



EXAM FINDING 6	☑ Observation ☐ Recommendation ☐ Criticism
Topic:	Resources and Staffing
Finding:	Given the reduction in FTEs and the increase in fraud, early payment defaults, first payment defaults, sub prime delinquencies, etc., management should re-assess the adequacy of staffing in the BCA and TPO units.
Action:	Ensure there are adequate resources in the BCA and TPO units.
	Management Response Requested ☐ **Yes** ☑ **No**

WaMu

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [NA]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Staffing needs are evaluated continually and adjusted as necessary.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

Not applicable.

Washington Mutual, Inc. – Confidential

From: Lee, C K
Sent: Friday, October 12, 2007 9:57 AM
To: Finn, Michael E <finnme@office of thrift supervision.com>
Subject: Re: May 3 memo

Mike -

Thanks for this. We're meeting with SEC next Thurs to discuss where we go from here. I'll keep you posted. ck/

----- Original Message -----
From: Finn, Michael E
To: Polakoff, Scott M
Cc: Ward, Timothy T; Lee, C K; Simone, Michael L
Sent: Fri Oct 12 09:53:02 2007
Subject: RE: May 3 memo

Scott,

I'm sure much of your message was directed towards the NE region. Any lapse in the NE not meeting your expectations is my fault. I have spent much of my first month back here trying to assess our regional risks, work processes and supervisory approach. While I'm much more informed on our efforts in the region, I have not focused enough energy on sharing my views with CK and coordinating our efforts. We can and will do better.

I talked at length with CK yesterday about the NE region's approach on Morgan, Merrill, Lehman, ING and SocGen and enhancing coordination with CIO. We are progressing towards a more complete continuous supervision process on these cases to include deeper CIO input and participation. Based on my discussion with CK, I'm confident that we will meet your expectations regarding our work with these firms. I have meetings scheduled for Monday and Tuesday with the NE senior management team to discuss our regional priorities and processes. We will discuss our approach on these cases and review expectations regarding CIO involvement in our supervisory planning, monitoring and meetings for these firms.

We will also need a strong influence in DC to gain greater access to information and analysis from the SEC on the three broker/dealers. CK indicated that he would work with you in the coming days to identify next steps in our approach with the SEC to break the log jam in getting information that the SEC uses in the CSE supervision process. CK and I were also able to discuss our work on ING, which is progressing smoothly, and some recent discussions regarding SocGen's interest in modifying its business model. We are committed to working closely with the CIO unit to ensure that we have a strong supervisory framework in place at each of our internationally active firms.

Mike

From: Polakoff, Scott M
Sent: Tuesday, October 09, 2007 5:39 PM
To: Ward, Timothy T; Finn, Michael E; Dochow, Darrel W; Lee, C K; Quigley, Lori G
Cc: Polakoff, Scott M
Subject: May 3 memo

Tim, Mike, Darrel, CK, Lori - as you may recall, I sent out an e-mail on May 3, 2007, that announced a number of changes (see below). Now that we are 5 months into this new process, I am not yet comfortable that we have made sufficient progress toward accomplishing these goals. Please consider this e-mail as a gentle reminder of my expectations, and that I need all of

Permanent Subcommittee on Investigations
EXHIBIT #11

you to help make this happen:

CK, Lori - please know that I hold you accountable to fulfill your obligations with the below mandate. Remember that you are expected to be equipped to follow trends and answer questions that may arise on matters facing the below firms. You must not, however, disrupt the examination process for these companies, which currently remains the domain of the regions.

Darrel, Mike - please know that I hold you accountable to invite Lori and CK to participate in the risk assessment, supervisory planning, offsite monitoring, and management meetings with the below companies. Remember that you are expected to include them in a timely manner and incorporate their views into your process. You must not hold important management meetings or strategic planning sessions without inviting Lori or CK to participate.

Please let me know if you have any questions.

Thanks.

Scott

Fifth, we will implement the process contemplated in New Directions Bulletin 06-12, issued in September of last year, in the most complex companies subject to OTS supervision. In particular, headquarters staff will be more involved than in the past with the risk assessment, supervisory planning, offsite monitoring, and management meetings with respect to this population of companies. This will ensure we have another set of eyes following our large, complex enterprises and will ensure that we are equipped in headquarters to follow trends and answer questions that may arise on the matters facing these firms. Lori Quigley□s group will follow those firms with a domestic focus. C.K. Lee□s group will follow those firms with extensive international involvement - in addition to his group□s current responsibilities, which will not change. The breakdown of companies is as follows:

Lori Quigley: Washington Mutual
Countrywide

CK Lee: Morgan Stanley
Merrill Lynch
Lehman Brothers
ING
Societe General
American Express

WMB	WMBfsb	WMI

January 7, 2008

X Asset Quality	Safety and Soundness	Consumer Compliance	Information Technology

AQ | Memo # | 22

DATE:	**June 19, 2008**
TO:	**David Schneider, President Home Loans**
FROM:	**Ann Hedger, OTS Examiner; Ben Franklin, OTS EIC**
SUBJECT:	**Loan Fraud Investigation**
CC:	**Cathy Doperalski, FVP, Regulatory Relations** **John McMurray, Chief Enterprise Risk Officer**

BACKGROUND INFORMATION

We reviewed an internal memorandum dated April 4, 2008, documenting a review that resulted from an allegation by PMI company AIG/UG that suspected loan fraud had occurred in one of the Bank's lending offices. AIG/UG also referred the matter to OTS.

The internal review disclosed that fraud/misrepresentation did occur at the specific office raised in AIG/UG's allegation. Further, the review noted that "control gaps were identified within the HL origination and risk management processes that did not sufficiently mitigate loan fraud exposure." While this review focused on one office in particular, it raised questions as to whether similar conditions are systemic throughout the organization, particularly since many of the issues raised have either previously been raised internally or have been noted at the current or at prior OTS examinations, such as:

- The Internal Risk Mitigation process identified this specific office (along with the Retail Broker Program and one other specific office) as having heightened fraud exposure in 2005 and 2007 reviews. These concerns were not acted upon in a timely manner
- The internal review noted that a formalized process did not exist to identify, monitor, resolve, and escalate third party complaints similar to the one raised by AIG. Similar issues have been raised in the 2007 OTS compliance exam and in the Banks 2008 internal investigation into the appraisal process
- The review raised concerns regarding "sales focused/incented originations with limited focus on individual accountability." Essentially, the review defines an origination culture focused more heavily on production volume rather than quality. An example of this was a finding that production personnel were allowed to participate in aspects of the income, employment, or asset verification process; a clear conflict of interest. The review also notes that systems and processes support incentive compensation programs rather than measuring individual performance (e.g., loans recorded under one originator rather than the person who actually originated the loan. This practice was found to occur at other offices). Prior OTS examinations have raised similar issues including the need to implement incentive compensation programs to place greater emphasis on loan quality.
- The review noted that loan origination processes did not mitigate misrepresentation/fraud. Many of the issues noted in the internal review such as those related to income reasonableness, overlooking "red flags", etc. have been raised at this and prior OTS examinations.

While we recognize that management has recently taken a number of actions to improve the quality of originations, this investigation, by raising concerns that are reoccurring in nature or that have not been adequately addressed, highlight the need for ongoing vigilance and commitment by management and the board to maintain a production environment in the Home Loans Group that is committed to quality production.

Permanent Subcommittee on Investigations
EXHIBIT #12a

Bisset_John-00046124_001

EXAM FINDINGS DEFINITIONS	
Observation:	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. Observations are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation:	A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.
Criticism:	A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination, warrant increased attention by Senior Management and the Board of Directors, and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

EXAM FINDING # 1 ☐ Observation ☐ Recommendation ☒ Criticism

Topic: Origination controls in Home Loans

Finding: The internal investigation discussed in the background section above, noted a number of origination control issues that impacted the Office under review and may be systemic in the origination process. Management should address the issues raised in the investigation including:

1. The lack of a formalized process to identify, monitor, resolve, and escalate third party complaints.
2. Inadequate issue escalation and untimely management response to "unfavorable patterns of operational and employee practices" such as those identified in the investigation
3. Incentives based on volume of originations with limited focus on individual accountability, and in particular, any processes that allow production personnel to participate in verifying borrower financial information.
4. Loan origination processes that do not adequately mitigate misrepresentation/fraud.

Action: Evaluate and correct any control issues whether isolated or systemic and report the extent of these issues to OTS.

Management Response Requested ☒ Yes ☐ No

MANAGEMENT RESPONSE: ☐ Agree ☒ Partially Agree ☐ Disagree Enter Target Date: [12/31/2008]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

There are many controls that have been put into place in Home Loans since this investigation was done, as well as a significant change in Home Loans' business strategy that mitigate many of the issues identified in this memo. These changes include, but are not limited to: the implementation of a comprehensive pre-funding fraud tool and pre-funding evaluation process, the elimination of all third-party lending channels including retail broker, and post-funding file quality reviews held on a weekly basis with senior management and channel leaders to address loan quality issues.

WaMu Home Loans is currently beginning to design compensation plans for 2009. Included in the planning discussions are incentives tied to loan quality.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Formalize the third-party complaint process to ensure that significant issues are escalated to Home Loans Operational Risk and where appropriate, tracked in a centralized issues tracking system. The process will include the definition of a significant issues and clear ownership responsibility. (McCoppin, Wagner, Struck) – September 30, 2008
2. Formalize issue escalation process and follow-up procedures and actions that result from findings from Risk Mitigation reviews. (McCoppin) - August 31, 2008
3. Require fraud training and certification of all fulfillment personnel. (McCoppin, Brown) – December 31, 2008

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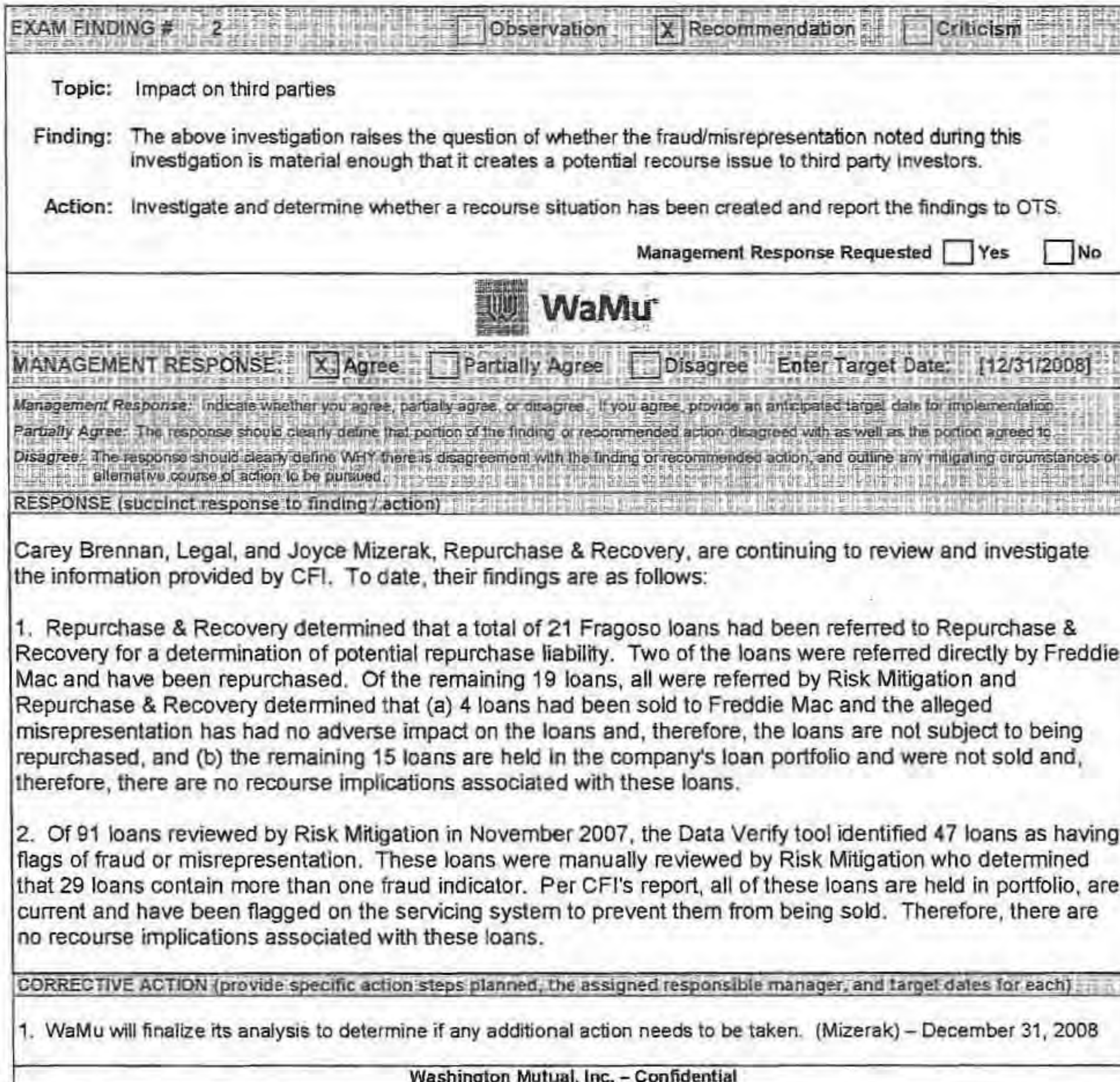
AQ MEMO #22



EXAM FINDING # 2 ☐ Observation ☒ Recommendation ☐ Criticism

Topic: Impact on third parties

Finding: The above investigation raises the question of whether the fraud/misrepresentation noted during this investigation is material enough that it creates a potential recourse issue to third party investors.

Action: Investigate and determine whether a recourse situation has been created and report the findings to OTS.

Management Response Requested ☐ Yes ☐ No

WaMu

MANAGEMENT RESPONSE: ☒ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [12/31/2008]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Carey Brennan, Legal, and Joyce Mizerak, Repurchase & Recovery, are continuing to review and investigate the information provided by CFI. To date, their findings are as follows:

1. Repurchase & Recovery determined that a total of 21 Fragoso loans had been referred to Repurchase & Recovery for a determination of potential repurchase liability. Two of the loans were referred directly by Freddie Mac and have been repurchased. Of the remaining 19 loans, all were referred by Risk Mitigation and Repurchase & Recovery determined that (a) 4 loans had been sold to Freddie Mac and the alleged misrepresentation has had no adverse impact on the loans and, therefore, the loans are not subject to being repurchased, and (b) the remaining 15 loans are held in the company's loan portfolio and were not sold and, therefore, there are no recourse implications associated with these loans.

2. Of 91 loans reviewed by Risk Mitigation in November 2007, the Data Verify tool identified 47 loans as having flags of fraud or misrepresentation. These loans were manually reviewed by Risk Mitigation who determined that 29 loans contain more than one fraud indicator. Per CFI's report, all of these loans are held in portfolio, are current and have been flagged on the servicing system to prevent them from being sold. Therefore, there are no recourse implications associated with these loans.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. WaMu will finalize its analysis to determine if any additional action needs to be taken. (Mizerak) – December 31, 2008

Washington Mutual, Inc. – Confidential

Bisset_John-00046124_003

Meeting with Board of Directors
July 15, 2008

Office of Thrift Supervision (OTS)
September 10, 2007 – June 30, 2008
Comprehensive Examinations of

Washington Mutual Inc.

Washington Mutual Bank

Washington Mutual Bank, fsb

Polakoff_Scott-00061303_001

Permanent Subcommittee on Investigations
EXHIBIT #12b

Asset Quality (continued)

- The small business lending portfolio, a relatively smaller and newer portfolio, is also experiencing a high loss rate
- The commercial lending portfolio remains fairly stable
- High SFR losses due in part to downturn in real estate market but exacerbated by:
  - geographic concentrations
  - risk layering
  - liberal underwriting policy
  - poor underwriting

Polakoff_Scott-00061303_007

Asset Quality (continued)

- Discontinuing higher risk lending and tightened underwriting policy should improve asset quality; however, actions should have been taken sooner
- Other SFR underwriting control deficiencies identified internally that should be addressed included:
  - Sales incented originations with limited focus on individual accountability
  - Origination personnel participating in verification of borrower data
  - Inadequate process for escalation of problems and complaints
  - Origination process that does not adequately mitigate fraud

Management/Board Performance and Oversight Unsatisfactory

- Poor financial performance due in part to market conditions; however, performance exacerbated by conditions within management's control:
  - Poor underwriting quality
  - Geographic concentrations in problem markets
  - Liberal underwriting policy
  - Risk layering
- Significant underwriting and process weaknesses noted again in the Home Loans Group
- Reducing higher risk lending products and practices should have been done sooner

Management/ Board Oversight (cont'd)

- While progress has been made to improve compliance weaknesses, significant concerns remain, particularly for BSA/AML
- An adequate ERM function still does not exist although this has been a MRBA for some time
  - Critical as a check and balance for profit oriented units
  - Necessary to ensure that critical risks are identified, measured, monitored and communicated
  - Even more critical given increased credit, market, and operational risk

Polakoff_Scott-00061303_028

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

Pacific Plaza, 2001 Junipero Serra Boulevard, Suite 650, Daly City, CA 94014-1976
P.O. Box 7165, San Francisco, CA 94120-7165 • Telephone: (650) 746-7000 • Fax: (650) 746-7001

Hand Delivered

September 25, 2008

OTS No. 08551

Washington Mutual Bank
1301 Second Avenue
Seattle, Washington 98101

Re: Appointment of a Receiver

Dear Sirs/Madam:

This is to notify you that the Director, Office of Thrift Supervision, by Order Number 2008-36, dated September 25, 2008, appointed the Federal Deposit Insurance Corporation as receiver (Receiver) for Washington Mutual Bank, Henderson, Nevada (Bank), and authorized the undersigned to deliver notice of such appointment.

The Receiver is now taking possession of the Bank pursuant to the terms of its appointment as set forth in Order No. 2008-36, a copy of which is attached. In connection with the appointment of the Receiver, we respectfully call your attention to Section 5(d)(4) of the Home Owners' Loan Act of 1933, 12 U.S.C. § 1464(d)(4), which establishes criminal penalties for refusal to comply with the Receiver's demand for possession of the property, business and assets of an association in receivership.

Please countersign a copy of this letter and indicate the time and date of your receipt of the letter and attachment in the space provided on the following page and return such copy to me.

Sincerely,

Darrel W. Dochow
Regional Director

Permanent Subcommittee on Investigations
EXHIBIT #13

Attachment

Received by: STEPHEN E. FRANK CHAIRMAN
Print Name and Title

At 6:15, P.M., P.D.T., on Thursday, September 25, 2008

Signature: S. E. Frank

Accepting Appointment of FDIC as Receiver for Washington Mutual Bank, Henderson, NV:

ROBERT SCHOPPE
Print Name and Title ATTORNEY-IN-FACT

At 6:15, P.M., P.D.T., on Thursday, September 25, 2008

Signature: ________________

FDIC

Division of Resolutions and Receiverships
Dallas Regional Office
1601 Bryan Street
Dallas, Texas 75201

Telephone (214) 754-0098

September 25, 2008

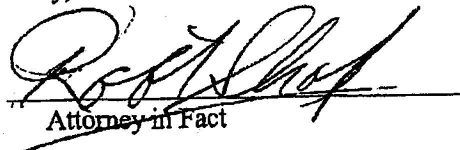
Office of Thrift Supervision
Washington, D.C.

Subject: **Washington Mutual Bank**
Henderson, NV – In Receivership
Acceptance of Appointment as Receiver

Dear Sir or Madam:

Please be advised that the Federal Deposit Insurance Corporation accepts its appointment as Receiver of the captioned depository institution, in accordance with the Federal Deposit Insurance Act, as amended.

Sincerely,

By: 
Attorney in Fact

Printed Name: Robert Schoppe

Office of Thrift Supervision

Department of the Treasury

I certify that annexed hereto is a true copy of the document described below made from records of the Office of Thrift Supervision, Department of the Treasury.

Copy of the Office of Thrift Supervision Order Number 2008-36, executed on September 25, 2008, appointing a receiver for Washington Mutual Bank, Henderson, Nevada, consisting of three (3) pages.

Signed this 25th day of September, 2008

Darrel W. Dochow
Regional Director
West Region

OFFICE OF THRIFT SUPERVISION

Receivership Of A Federal Savings Association

Date:	September 25, 2008
Order No.:	2008-36
OTS No.:	08551

The Director of the Office of Thrift Supervision (OTS), or his designee, in cooperation with the Federal Deposit Insurance Corporation (FDIC), has determined to appoint the FDIC as receiver of Washington Mutual Bank, Henderson, Nevada (Savings Bank).

GROUNDS FOR APPOINTMENT OF FDIC AS RECEIVER FOR THE SAVINGS BANK

The Director, or his designee, based upon the administrative record finds and determines the following:

(i) The Savings Bank is likely to be unable to pay its obligations or meet its depositors' demands in the normal course of business; and

(ii) The Institution is in an unsafe or unsound condition to transact business.

The Savings Bank is a Federally chartered savings bank, the accounts of which are insured by the Deposit Insurance Fund (DIF). The Savings Bank has its home office in Henderson, Nevada. As of June 30, 2008, the Savings Bank reported total assets of $307 billion.

DISCUSSION OF GROUNDS FOR APPOINTMENT OF A RECEIVER FOR THE SAVINGS BANK

Section 5(d)(2)(A) of the Home Owners' Loan Act (HOLA), 12 U.S.C. § 1464(d)(2)(A), provides that the Director may appoint a receiver for any insured savings association if the Director determines that one or more grounds specified in section 11(c)(5) of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. § 1821(c)(5), exist.

Under section 11(c)(5)(F) of the FDIA, the Director may appoint a receiver if a savings association is likely to be unable to pay its obligations or meet its depositors' demands in the normal course of business because it does not have sufficient liquid assets to fund expected withdrawals. The Savings Bank has insufficient cash and liquid assets convertible to cash necessary to pay its obligations and the expected withdrawal demands of its depositors. The Savings Bank has suffered significant cash outflows, exceeding

$22 billion since July 2008, in part because of adverse publicity. The Savings Bank has limited and diminishing liquidity sources available to it and the current rate of outflow will deplete the Savings Bank's cash resources and liquidity within a short period of time.

Therefore, the Director concludes that the Savings Bank is likely to be unable to pay its obligations or meet its depositors' demands in the normal course of business because it does not have sufficient liquid assets to pay those obligations and fund the expected withdrawals.

Under section 11(c)(5)(C) of the FDIA, the Director may appoint a receiver if a savings association is in an unsafe or unsound condition to transact business. The Savings Bank is in an unsafe and unsound condition as a result of its severe liquidity strain, deteriorating asset quality, and continuing significant negative operating earnings with no realistic prospects for raising capital to ensure that it can repay all of its liabilities, including deposits.

The Director, or his designee, therefore, has determined that grounds for the appointment for a receiver for the Savings Bank exist under section 5(d)(2) of the HOLA, and sections 11(c)(5)(C) and (F) of the FDIA, 12 U.S.C. §§ 1821(c)(5)(C) and (F).

ACTIONS ORDERED OR APPROVED

Appointment of a Receiver

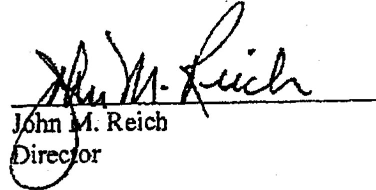
The Director, or his designee, hereby appoints the FDIC as receiver for the Savings Bank, for the purpose of liquidation, pursuant to section 5(d)(2) of the HOLA, and section 11(c)(6)(B) of the FDIA, 12 U.S.C. § 1821(c)(6)(B).

Delegation of Authority to Act for OTS

The Director, or his designee, hereby authorizes the OTS West Regional Director, or his designee, and the Deputy Chief Counsel for the Business Transactions Division of the Chief Counsel's office, or his designee, to: (i) certify orders; (ii) sign, execute, attest, or certify other documents of OTS issued or authorized by this Order; (iii) designate the persons or entity that will give notice of the appointment of a receiver for the Savings Bank and serve the Savings Bank with a copy of this Order pursuant to 12 C.F.R. § 558.2; and (iv) perform such other functions of OTS necessary or appropriate for implementation of this Order. All documents to be issued under the authority of this Order must be first approved, in form and content, by the Chief Counsel's Office. In addition, the Director, or his designee, hereby authorizes the Deputy Chief Counsel for the Business Transactions Division of the Chief Counsel's office, or his designee, to

make any subsequent technical corrections, that might be necessary, to this Order, or any documents issued under the authority of this Order.

By Order of the Director of OTS, effective September 25, 2008.



John M. Reich
Director

From: Constantine, Thomas M <thomas.constantine@ots.treas.gov>
Sent: Tuesday, October 7, 2008 7:54 PM
To: Franklin, Benjamin D <franklinbd@office of thrift supervision.com>
Subject: RE: West Region Update

If you were hoping like me that the IG would figure out what happened and force out the asswipes in this organization that ridiculed us and "couldn't imagine that we would be in this position" despite the fact that's what we are supposed to be imagining and preparing for, you will be sadly mistaken. The IG is as good as the folks that let this happen. Nothing but a bunch of incompetents. Maybe you will get a better crew, but my 4-year old son asks me more probing questions. The world will never know. I can't stand it when I hear these people talk about this mess. It started at Guardian. Ground Zero, baby. We spawned this disaster when we f'd up and put them in receivership. How much longer will we have to pay? Now it's going to cost me my job. Thanks Jed.

-----Original Message-----
From: Franklin, Benjamin D
Sent: Tuesday, October 07, 2008 4:48 PM
To: Constantine, Thomas M
Subject: RE: West Region Update

Kurt and Steve G laughed at my projections of gloom and doom for stated since 2003 and started calling me the housing "bubble" boy. I even predicted that the end would come in July 2007 (based on a report that I got at a Servicing seminar the reported the massive number of 2/28 and 3/27 subprime loans that would come due). When I told Scott Polakoff in April 2007 that stated income subprime should not be made under any circumstance, I was corrected by Mike Finn that that was not the West Region's position. I rest my case.

P.S. I concur totally on the W-2 borrowers. The worst cases I saw wwere instances where the W-2 was in the file and the information was redacted out!

-----Original Message-----
From: Constantine, Thomas M
Sent: Tuesday, October 07, 2008 3:43 PM
To: Franklin, Benjamin D
Subject: RE: West Region Update

My big problem is with us allowing people with W-2 incomes to go stated. How hard is it to send that in. Everyone has it. Also, I can't believe we allowed 100% financing of anything. What a joke. The problem is the regulators are set up by license instead of function. If you had one regulator in charge of the origination and sale and servicing of SFRs, then you wouldn't have had these problems. We were satisfied that the loans were originated for sale.

SEC and FED asleep at the switch with the securitization and repackaging of the cash flows, irrespective of who they were selling to. The lack of transparency caused the general panic we live with today. I didn't no what a undercapitalized CDO was before last year.

I forgot to mention that Scott and I uncovered damaging evidence against the CFO of Union that facilitated a rapid recovery for the D&O insurance carrier that recapitalized Union bank and kept it from being the first failure. Rosanne, You, Scott, and I. Is there anyone else to add to this list? Probably, but they also have greater personality issues than us.

thanks

FYI - I'm adding you to the list based on your work at Guardian. I have no idea what the hell you've been doing since, except what you tell me below. Why is that?

Permanent Subcommittee on Investigations
EXHIBIT #14

Franklin_Benjamin-00034415_001

-----Original Message-----
From: Franklin, Benjamin D
Sent: Tuesday, October 07, 2008 1:15 PM
To: Constantine, Thomas M
Subject: RE: West Region Update

When I say acquiesced, I mean not one regulatory agency had a rule or guideline saying you couldn't do stated income lending, even to this day. That, I find incredible. We criticized stated income lending at WaMu but they never got it completely fixed, I also criticized IndyMac in 03, Downey and First FED in later years, but in hindsight, I'm convinced that it is just a flawed product that can't be fixed and never should have been allowed in the first place. How do you really assess underwriting adequacy when you allow the borrower to tell you what he makes without verification. We used to have documentation requirements for underwriting in the regs, but when those were taken out, the industry slowly migrated to an anything goes that got us into this mess.

-----Original Message-----
From: Constantine, Thomas M
Sent: Tuesday, October 07, 2008 12:33 PM
To: Franklin, Benjamin D
Subject: RE: West Region Update

I never acquiesced. I helped put SLC trust under a Supervisory Agreement in 2005-6 due to lack of cash equity in their construction loans. I also heavily criticized the underwriting at First Fed of Cal in 2005 on their expansion into N. California on these stated income loans (removed by EIC Henry Lee). I warned Downey in 2004 not to count their chickens before they were hatched (comment tamed down by someone EIC Williams or FM Buting) and they weren't ready for the onset of adverse business conditions with servicing of loans.

My examination history here is filled with the editing and removal of my comments as well as predictions (that turned out to be true) by EICs. No system in place to keep that from happening. Instead we put whitewashers and scaredity cats in charge of the most problematic shops. I don't know what happened to you at WAMU, but I was critical of their accounting at Card Services and the AP. Fortunately, I think I made the "don't let him come back here" list. I've heard stories of things that happened, but no confirmation.

There was an article in the WSJ (the only positive article on the OTS that I've seen in the last couple of years) on Ray Lamb and the thrift that they opened in New Mexico. Mike Finn told me to get the charter back. The article says it was because they deviated from the business plan. It didn't happen that way, completely. I went in there and aggressively criticized their underwriting on the CRE (the 2 of the 3 other examiners they gave me found nothing - surprise). I then basically threatened them to get the charter back and they caved. Lots of help from Finn, but it wasn't going to happen without me pressuring them. Lamb's empire collapsed and all banks failed with huge multimillion dollar losses to insurance fund (I got an on the spot award - yippie).

In 2003, I did the capital review of Lehman Brothers (the holding company). Most highly leveraged company I've ever been to and they kept us from reviewing their liquidity and capital models. My criticisms made the report. They just changed my characterization from highly leveraged to moderately leveraged. I knew it was going to blow up then. Just a matter of time. They counted all long term debt as capital. I am not kidding.

I also help set up Nordstrom's Credit Card Securitization from off-balance sheet to on balance sheet to affiliates. We secured independent line. Credit cards are the next thing to blow up. Nobody is listening to me here. I'm totally pissed off that our leadership screwed us and can't acknowledge it. They should resign.

You know what happened at Indymac already. EICs Reiley and Hughes squashed my findings and get promoted and congratulating for f'ing up. Now they cancel the FM positions (I applied for SF position). Now I'm capped out with promotion and salary freezes coming. I won't be able to afford to stay, assuming we actually are around. Thanks to our leader, we are toast.

I'm feeling underappreciated and double crossed by our leadership. You know who I mean.

Thanks

PS now I feel a little better. I'm prepared to say this word for word to DD and EC. I could be gone soon.

-----Original Message-----
From: Franklin, Benjamin D
Sent: Tuesday, October 07, 2008 8:11 AM
To: Constantine, Thomas M
Subject: RE: West Region Update

You know, I think that once we (pretty much all the regulators) acquiesced that stated income lending was a reasonable thing, and then compounded that with the sheer insanity of stated income, subprime, 100% CLTV, lending, we were on the figurative bridge to nowhere. Even those of us that were early opponents let ourselves be swayed somewhat by those that accused us of being "chicken little" because the losses were slow in coming, and lets not forget the mantra that "our shops have to make these loans in order to be competitive". I will never be talked out of something I know to be fundamentally wrong ever again!!

-----Original Message-----
From: Constantine, Thomas M
Sent: Tuesday, October 07, 2008 7:58 AM
To: Franklin, Benjamin D
Subject: Re: West Region Update

Do you mean the whitewashers that got us into this mess, the dead wood that are in FIRF waiting for retirement, the kids that cant wipe their asses, or the 6 or 7 of us that actually understand and do the right thing?

From Tom Constantine's Blackberry (760) 799-9720

----- Original Message -----
From: Franklin, Benjamin D
To: Constantine, Thomas M
Sent: Tue Oct 07 10:44:31 2008
Subject: RE: West Region Update

Picking up what slack. With all the people we have now, there is no slack.

From: Constantine, Thomas M
Sent: Monday, October 06, 2008 5:49 PM
To: Franklin, Benjamin D
Subject: FW: West Region Update

I see where you will be picking up the slack going forward. Congrats.

From: Dochow, Darrel W
Sent: Monday, October 06, 2008 4:53 PM
To: #R5USERS
Cc: #Regional.Directors; Polakoff, Scott M; Ward, Timothy T; Reich, John M; Bowman, John E; Shycoff, Barbara; Russell, Robert W; Ruberry, William M; Quigley, Lori G; Yakimov, Montrice G; Gardineer, Grovetta; Luk, Alexandria T. Y.; Casteel, Frederick R

Subject: West Region Update

To West Region Employees:

We have seen significant stress in the financial and housing markets over the past year. This stress has been amplified by unprecedented deposit outflows at some institutions due to a loss of depositor and investor confidence. At the same time, borrowing capacity has been constrained by falling collateral values and credit tightening. The illiquidity in the financial markets for housing related securities and loans has now spread to other sectors and Congress recently passed a rescue package in an effort to restore the markets.

As you know, the severity of decline in home prices, asset quality and liquidity including deposit outflows has been very pronounced in many parts of the West Region. Both IndyMac and Washington Mutual were closed, with WAMU's banking operations sold to J P Morgan Chase. The loss of these companies, along with the anticipated merger of several other significant thrifts within the next six months, means that some West Region examiners will have the opportunity to help the other regions and Washington DC in 2009. In addition, given that approximately 40 percent of our examiners are on the accreditation track, I anticipate increased training opportunities at some out of region assignments.

The Regional Directors met in Washington D C last week with Director John Reich, Scott Polakoff, and Tim Ward to discuss staff planning among other things. A summary of the topics discussed will be available on the OTS Intranet. Of particular importance are several key points and decisions affecting the West Region that I want to ensure that everyone understands.

First and foremost, OTS continues to have a healthy, positive fiscal year 2009 budget based on no additional revenue from IndyMac and WAMU, or from Countrywide beyond March 2009. Expenses and related staff levels need to remain aligned with revenue going forward and multi-year planning is underway to ensure that OTS remains financially strong.

It is apparent that the West region currently has more examiners than required for our projected 2009 examinations. The difference in amount of projected work versus our current examiner resources is, however, less than may initially be thought because we have a large percentage of staff in the accreditation track, many of our thrifts continue to deteriorate and require additional time, and our geographic diversity requires disproportionately more travel. Director Reich emphasized that there will be no reduction-in-force (RIF)in 2009 but indicated that examination staff are not necessarily located where the projected work is next year. The West region will provide examiner help to the other regions and Washington DC in 2009. This may mean increased travel for some but also means increased opportunity to do interesting work in new locations, receive additional training assignments, and allow us to share our experiences and lessons learned with others. In addition, there will likely be increased opportunity to relocate to places with acute needs and to volunteer for details of six months to one year in our Washington headquarters. More specifics about these opportunities should be available in November.

An analysis of workloads and staffing is underway within each region and Washington DC. The Regional Directors are working with Tim Ward to do this analysis on a consistent basis during the next month. We have decided to continue hiring some entry-level examiners in each region during the summer of 2009. In the West region, we have stopped hiring additional examiners from the outside while we analyze the workload and anticipated attrition from retirements, job changes and relocations. What this means is that we are not hiring any permanent, term, or contractor examiners from outside of OTS for the West region. In addition, instead of filling the posted Field Manager position for Seattle and Daly City, I intend to assign those responsibilities to current Regional/National Supervisory Examiner(s) or Field Manager(s).

At the RMG meeting, we also concluded that no adjustment to the current five region alignment and structure is necessary, and that the West region will continue to maintain field offices in Seattle and Santa Ana. The lease for the Seattle office contains an early buyout option, and continues the existing space and planned build-out of two offices instead of expanding into the adjacent space.

Some of you may have questions so we established a conference call telephone line for Tuesday October 7, 2008 from 3PM to 4PM where you can ask me any questions. The call in number is (866) 807 9539 and the pass code is 9137655. I will continue to do my best to keep everyone informed.

I know that the speed of change can be unsettling, but I am confident that all of us will remain focused on the important work at hand. There is plenty to do and the issues within the industry require us to remain fully engaged to ensure that institutions take appropriate and prompt corrective actions.

Darrel Dochow

Ancely, Zalka A

From: Fitzgerald, Dennis J
Sent: Friday, June 27, 2003 8:28 AM
To: Carter, Lawrence D
Cc: Ancely, Zalka A; Kuczek, Richard A; Potthast, John W
Subject: RE: OTS Memo 7

Lawrence,

Thanks, since I am all buttered up, I have reviewed the response, in spite of grief from Al. He is quite offended that you did not ask him if I could take time away from his all important examination in Santa Fe.

Since they agree with us, in the same spirit of cooperation toward the common goal I would agree that the response is adequate. It is clear from my experience that changes seem to progress slowly at WAMU so I don't know if we can expect faster progress. I would only suggest that we might want the responses to include additional target dates for the various stages of corrective actions in order to facilitate monitoring of the progress by management and the "dedicated" examiner and for determining causes for delays. For example, target for identification of causes of underwriting deficiencies, targets for new policies or plans, target for training completion,and targets for implementation. For the loan review/audit, the timeframe is tight given that the implementation is 90 days after training and training cannot commence until the underwriting/credit policies and plans are complete. In addition, the initial review with results is to be completed only 4 months after the target for implementation of the corrective actions, so details would help there also.

My only concern would be the timing of the corrective action for the major activities and our next examination date if it is March of 2004. Any loan scope should concentrate on loans made under the new policy and procedures. Thus, we would need to sample loans that were applied for and closed in 2004, if the implementation is the end of the year. Initial RQA on these new loans would also be very limited or not yet complete. Given the target date of 4/30/04 for RQAs initial review, they might not have any results at the start of our next examination. If any target is missed, as happens at WAMU, then we may not be in a position to determine the effectiveness of the corrective actions.

Also, I assume that the response regarding appraisal deficiencies is also part of the response to Bruce's memo. He might be in a better position to discuss that response and the long timeframe related to that area.

I hope all else is going well.

Dennis

[Fitzgerald, Dennis J]
-----Original Message-----
From: Carter, Lawrence D
Sent: Thursday, June 26, 2003 6:59 PM
To: Fitzgerald, Dennis J
Cc: Ancely, Zalka A; Kuczek, Richard A; Potthast, John W
Subject: FW: OTS Memo 7

> Dennis, I just finished looking through some of your workpapers. Nice job. Now that I've buttered you up, can you take a look at the attached response to your wonderful memo and let me know if it seems acceptable. They are all "agrees"!!! However, they do state some things they plan to do with some lengthy time horizons extending into mid-2004. Personally, I'd rather seem them take the time to fix things right.

Permanent Subcommittee on Investigations
EXHIBIT #15

OTSWME04-0000006748

Let me know if you are okay with this and I will have management issue it as a final.

-----Original Message-----
From: Wedell, Matthew N. [mailto:Matthew.Wedell@wamu.net]
Sent: Thursday, June 26, 2003 4:22 PM
To: lawrence.carter@ots.treas.gov; richard.kuczek@ots.treas.gov; Ancely, Zalka
Subject: OTS Memo 7

Here is the draft of OTS Memo 7....subject to Jim Vanasek's review & approval. Please review and let me know if you find the responses to be satisfactory. mw

Matt Wedell
Washington Mutual
Regulatory Relations
206-377-2884

High Risk Meeting Notes

West Region

BankPacific-No real items except plan on a field visit in March 2004.

Citibank(West)-

Davidson Trust-

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Downey

IndyMac

Permanent Subcommittee on Investigations
EXHIBIT #16

Wamu

The Director was concerned over how we are communication our exam findings to the board. Our field visit review went to only Kerry Killinger; however, the Washington State & FDIC reports went to the Board.

The Director (while pacing) was very concerned over all the management changes and putting inexperienced people in charge of critical areas. Region agreed with concerns. The Director then wanted to know how they communicate these valid concerns via Board or Audit Committee. Region noted that they hold meeting with each committee chair and discuss these changes. The Director noted that experience management is the only way to oversee operations given his experience verse Wamu practice of putting people in who may only be good managers. Region noted Wamu has good middle management and new Corporate Enabler Good made up on CFO, CCR & ERM people with GE and Norwest backgrounds.

The Director wants more reporting to Board an/or Audit Committee of our concerns and also questions the continued branch expansion while attempting to cut costs.

Tim S. did a brief summary of the GMNA Buy-Back program and Wamu affect with public and regulatory reporting.

LBMC is gretting ready to go to the ABS market on a $4.5 billion deal .

Western

Redacted by Permanent Subcommittee on Investigations

Washington Mutual

WMBFA, WMBfsb
March 15, 2004
Safety & Soundness Examination
OTS MEMO 5

DATE:	May 12, 2004
TO:	Tony Meola, EVP, Production
	Mark Hillis, Deputy Chief Credit Officer
FROM:	Bill Durbin, OTS
SUBJECT:	SFR Loan Origination Quality
CC:	Deanna Oppenheimer, President WAMU Consumer Group

BACKGROUND INFORMATION

Several of our recent examinations concluded that the Bank's single family loan underwriting was less than satisfactory due to excessive errors in the underwriting process, loan document preparation, and in associated activities. Similar findings noted in internal audits and quality control reports supported our examination conclusion. The overt causes for past underwriting concerns were many, but included: (1) A sales culture focused heavily on market share via loan production, (2) extremely high lending volumes fueled by the low interest rate environment, and (3) a less than optimal organizational structure that included multiple loan origination platforms, in part due to recent merger activity, and a variety of origination procedures that varied by origination office (i.e., loan fulfillment center (LFC)).

During our review period, management began several initiatives aimed at correcting the overt causes of underwriting deficiencies discussed above. Specifically, initiatives are underway to simplify the origination structure by reducing origination platforms from nine to two while developing a single origination model to be implemented in all LFCs. Other current initiatives to improve underwriting quality include: (1) de-emphasizing the Bank's position as the pricing leader with more emphasis on maintaining manageable capacity and originating higher quality loans, and (2) installing Credit Risk Teams in LFCs aimed at increasing the credit risk management group's influence over underwriting while reducing the influence of production management. Since these and other management initiatives are in process, we cannot yet opine on their effectiveness; however, the steps taken are considered appropriate and should eventually have a positive impact on underwriting. Given the breadth of changes being made such as:,(1) computer system changes (loan origination platforms and termination of OPTIS.2) and (2) restructuring and consolidation of the loan fulfillment centers, with its attendant relocations and staff reductions, the near term result may be an environment where other types of errors may become prevalent. As such, we encourage heightened management oversight of all ongoing initiatives and careful consideration of findings discussed in this memorandum.

Our past reviews concentrated on assessing underwriting analysis documented in loan files. Since prior examinations and internal reports have already established that underwriting concerns exist, we decided to forego some file review at this examination to instead concentrate on reviewing and improving internal processes that may contribute to underwriting concerns. The following discussions relay our findings with respect to these processes.

EXAM FINDINGS DEFINITIONS

Observation:	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation:	A secondary concern for which immediate corrective action is left to management's discretion. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and are generally mentioned in Exit and Board Meetings. Examiners will usually request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations to assess any changes in risk exposure.
Criticism:	A primary concern that if left uncorrected, the Agencies may consider stronger action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and typically require a written response. They are subject to formal follow-up by examiners.

Permanent Subcommittee on Investigations
EXHIBIT #17

OTSWME04-0000004883

EXAM FINDING 1	☐ Observation*	☑ Recommendation*	☐ Criticism*

Topic: Consumer Group Goals

Finding: The Consumer Group's overall goals do not expressly state a goal with respect to the desired quality of loan originations/acquisitions. We believe that this issue is of sufficient materiality, complexity, and duration that it should be clearly stated as a goal with quantified expectations of those involved in the origination process.

Action: Establish and quantify a Consumer Group goal with respect to desired asset quality and communicate this expectation to those involved in the production process.

☐ **Repeat Finding** — **Management Response Requested** ☑ **Yes** ☐ **No**

MANAGEMENT RESPONSE	☐ Agree	☑ Partially Agree	☐ Disagree	Enter Target Date: [9/30/04]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees it is important to have specific goals and targets for portfolio performance. Consumer Group Credit Risk Management has established a target Non-performing Loan/Total Loan ratio of less than 1% as a target performance level. Management needs to communicate this target broadly as part of the overall Consumer Group strategic objectives/goals.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Management will establish, quantify, and communicate a Consumer Group goal with respect to desired asset quality as part of the overall strategic objectives/goals.
   a. Manager Accountable: Mark Hillis, Chief Credit Officer, Consumer Group
   b. Target Date: 9/30/04

OTSWME04-0000004884

EXAM FINDING 2	☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: Metrics used to monitor performance in the loan fulfillment centers.

Finding: There are 16 measures of performance in the Home Loans Production Scorecard (11 for the Correspondent channel). Only one of these, the Optimal Performance Score, measures overall quality. (The Optimum Performance score is obtained quarterly for most LFCs but is not available for the Correspondent channel.) In addition, the measurement of Home Mortgage Disclosure Act (HMDA) performance is not measured by LFC; rather, this is measured only by loan channel. The current performance measurements do not appear to be either sufficiently detailed or sufficiently frequent to effectively monitor and promote desirable loan origination and acquisition quality.

Action: Track performance with sufficient detail and frequency to effect the desired change in underwriting. Ideally, performance measures should be provided monthly and in sufficient detail to trace problems to the specific channel, and LFC.

☐ Repeat Finding — Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [9/30/04]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

The Risk Oversight team will work with the Home Loans team, to further refine risk metrics that are used to evaluate and manage: Credit, Compliance and Data Integrity risk elements in conjunction with ongoing process refinements. Management is supportive and has requested continuous feedback to support business execution and risk management activities. The Risk Oversight Group is in process of developing testing capabilities to provide monthly feedback for all LFC's.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Identification of risk metrics will be performed in collaboration with Home Loans.
   a. Manager Accountable: Melissa Martinez, Risk Oversight & Compliance
   b. Target Date: 7/30/04

2. Establishment of risk tolerance and performance standards will be developed in collaboration with Home Loans.
   a. Manager Accountable: Melissa Martinez, Risk Oversight & Compliance
   b. Target Date: 7/30/04

3. Full implementation of revised performance measurement standards will be implemented no later than September 30, 2004.
   a. Manager Accountable: Melissa Martinez, Risk Oversight & Compliance
   b. Target Date: 9/30/04

EXAM FINDING 3	☐ Observation*	☑ Recommendation*	☐ Criticism*

Topic: Incentive compensation for loan fulfillment centers

Background:

The incentive compensation plan with respect to managers incorporates four performance measures including: (1) productivity, (2) customer service, (3) management objectives, and (4) quality. This discussion primarily focuses on the quality measure that generally accounts for 20.0 to 40.0 percent of incentive compensation. Within the quality measure, there are four components: (1) HMDA results, (2) Optimum Performance review results [1], (3) RQA review results, and (4) percentage of unsaleable loans. The plan indicates that one or two of these components may be used in determining the quality portion of incentive compensation; however, in practice, only two measures are used: HMDA and Optimum Performance review results. Both components are currently used for each consumer direct, wholesale and retail LFC. As expressed in the plan, the program can generate the following compensation for various levels of achievement in the Optimum Performance reviews.

RPI Category	RPI Score	Minimum Incentive Award as a % of Salary	Maximum Incentive Award as a % of Salary
Unsatisfactory	Below 60%	0%	0%
Unsatisfactory	60% to 69%	1.1%	2.6%
Marginal	70% to 79%	1.3%	3.0%
Satisfactory	80% to 89%	1.5%	3.4%
Commendable	90% to 100%	1.7%	3.8%

The foregoing assumes: (1) the quality portion of the incentive compensation plan ranges from 20% of the total (the minimum incentive assumption) to 40% (the maximum incentive assumption), (2) an Optimum Performance score of 80% equates to achieving 100% of the goal, and (3) two measures are used for quality, HMDA and Optimum Performance score.

In practice, we were informed that some channels use a minimum standard of 70.0 percent for the quality portion of an incentive award, notwithstanding the provisions in the plan. One channel augments the core results with a portion of the Management Objective component of the incentive plan.

Finding: We do not believe that the current incentive compensation program for SFR loan underwriting provides effective incentive to maximize satisfactory or superior loan quality. This results in part from the fact that credit and underwriting quality does not appear to be sufficiently weighted in determining incentive compensation. In addition, the plan allows for significant tailoring by LFC management and is not consistently applied across channels and LFCs. Further, current methodology makes it difficult to trace responsibility and appropriately affect incentive compensation. These findings pertain primarily to the LFC manager position, but are generally applicable to other positions in the LFC.

The Optimum Performance or RPI score is an average of the score for three components: compliance, underwriting, and process. An LFC could perform at an unacceptable level in one component but qualify for an incentive compensation award because performance in the other components is better. (For example, one LFC scored 65 for credit but received an 82 overall and would thus have earned more than 100% of its incentive plan target for quality even though its credit quality performance was unsatisfactory.)

The HMDA quality measure is not available by LFC; instead, the incentive compensation for the LFCs is based on the performance for the entire channel. As a consequence, the LFC managers can influence, but not control, their ability to meet the incentive compensation standard for HMDA quality.

Action: Management should consider enhancing the incentive compensation plan with respect to the loan fulfillment center manager position to more heavily emphasize credit quality concerns. Our recommendations include: (1) Revising the incentive compensation plan to track quality performance using only items that can be measured at the LFC level; (2) Measuring performance based on four criteria: quality of compliance, documentation, underwriting, and data quality, including rate lock quality; (3) Working with the Consumer Risk Oversight Group to obtain performance measures in the four categories; (4) Establishing minimums in each category that reflect an acceptable level of quality, or that temporarily

[1] Optimum Performance results are also referred to internally as a Risk Performance Indicator (RPI) score. This score is determined as a result of file reviews conducted by one of the quality control functions within the Bank (separate from RQA). The score is a composite measure of file review results that assess compliance, processes, and credit quality.

EXAM FINDING 3	☐ Observation* ☑ Recommendation* ☐ Criticism*

accept a lesser level but reward progress toward an acceptable level; (5) Establishing a level and range of reward that provides a meaningful incentive to achieve excellent quality in loan origination and acquisition, and disincentives for poor quality; and (6). Centrally administering or overseeing the quality portion of the incentive compensation to ensure the objectives of the program are being met in all channels and LFCs.

In addition, review the quality aspects of the incentive compensation plans with respect to other positions affecting loan quality and, where appropriate, revise the plans to serve as an effective incentive to improve performance.

☐ Repeat Finding   Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [1/01/05]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Washington Mutual management is in agreement with the recommendations for Exam Finding 3 and will take steps as defined below to comply with actions as stated. Target implementation dates are defined below.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Identify existing credit quality performance measure(s) to be used within the LFC Incentive Plan management plan as part of the management objective component of the plan.
   a. Manager Accountable: Mark Hillis, Consumer Credit Risk Oversight
   b. Target Date: 8/31/04

2. Utilize the management objective component of LFC management plan to focus on credit quality measure (Measure as identified in corrective action #1). This will result in 6.3% of management pay linked to credit quality.
   a. Manager Accountable: John Schleck, Kim Yezbak and Arleen Scavone, LFC Sr. Leaders
   b. Target Date: 10/1/04

3. Increase incentive weight of existing quality measures for LFC management from 25% to 35%. This coupled with corrective action #2 will result in 15% of LFC management pay linked to quality.
   a. Manager Accountable: Peggy Ohlhaver, Consumer Rewards
   b. Target Date: 10/1/04

4. Risk weight the Optimum Performance or RPI components: compliance, underwriting, and process to better reflect impact of achievement.
   a. Manager Accountable: Peggy Ohlhaver, Consumer Rewards
   b. Target Date: 7/1/04

5. Working with Consumer Credit Risk Oversight, establish agreed upon achievement thresholds for existing quality measures within the LFC plan and revise incentive tables.
   a. Manager Accountable: Peggy Ohlhaver, Consumer Rewards
   b. Target Date: 10/1/04

6. Establish strategy for identifying credit quality metric accountability, tracking and incentive link for the four areas identified within the exam findings: quality of compliance, documentation, underwriting and data quality, including rate lock quality.
   a. Manager Accountable: Mark Hillis, Consumer Credit Risk Oversight & Tony Meola, Production (for rate lock quality)
   b. Target Date: 1/1/05

7. Launch study to identify drivers and accountability of quality excellence in loan origination and acquisition and determine appropriate incentive link.
   a. Manager Accountable: Peggy Ohlhaver, Consumer Rewards
   b. Target Date: 7/1/04

8. Centralize oversight of LFC quality metrics to the Consumer Credit Risk Oversight function.
   a. Manager Accountable: Mark Hillis, Consumer Credit Risk Oversight
   b. Target Date: 8/31/04

OTSWME04-0000004887

EXAM FINDING 4	☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: Management Support for the Loan Fulfillment Centers

Finding: LFCs are inundated with changes in loan origination procedures and policies, to the extent that they have difficulty complying with the changes.

Action: Management should provide additional support to the LFCs to help them implement policy and procedure changes as expected. One suggestion is to write model desk procedures for each position in the loan fulfillment centers and to revise these desk procedures concurrently with each notice of a procedural or policy change. When the LFC receives notice of a new policy or procedure, it should also receive a revised desk procedure for each affected position in the LFC. This will improve compliance with standards in the LFC and promote consistency among the LFCs, a stated management expectation. The timeliness and adequacy of training should also be reviewed.

☐ Repeat Finding — Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [7/31/04]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Partially Agree: Although we agree that there has been a large amount of changes in policies and procedures and it is difficult at times to comply/keep up with changes, we do feel that change is relative to the nature and the core of our business. In addition, there are several techniques in place to lessen the impact of changes to both LFC management and staff, including following up large impact changes with meetings and training to ensure the changes are communicated to all applicable levels.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Continue to work with Policy Administration to ensure all policies are rolled out with as much notice as possible, and channel managers will ensure that LFC management has input on policy changes as needed.
   a. Manager Accountable: Arleen Scavone, John Schleck, Kim Yezbak
   b. Target Date: 7/31/04

2. Utilize Loan Fulfillment Center management facilitate twice daily/weekly team meetings to review and train on new policies and procedures.
   a. Manager Accountable: Arleen Scavone, John Schleck, Kim Yezbak
   b. Target Date: 7/31/04

3. Continue to issue HLPAs developed by the Policy Administration group weekly (each Friday) with a two week implementation window prior to effective date of a change.
   a. Manager Accountable: Arleen Scavone, John Schleck, Kim Yezbak
   b. Target Date: 7/31/04

4. Utilize channel management communication avenues to refresh and re-enforce policy communications on a monthly basis.
   a. Manager Accountable: Arleen Scavone, John Schleck, Kim Yezbak
   b. Target Date: 7/31/04

From: Durbin, William J
Sent: Thursday, April 8, 2004 12:08 PM
To: Carter, Lawrence D <carterld@office of thrift supervision.com>; Franklin, Benjamin D <franklinbd@office of thrift supervision.com>
Cc: Ancely, Zalka A <ancelyza@office of thrift supervision.com>
Subject: RE: Locale

I could find no work papers indicating follow-up from the 2001 ROE comment in the sub prime work papers but there may be work papers elsewhere documenting follow up on all previous findings.

Bill

-----Original Message-----
From: Carter, Lawrence D
Sent: Thursday, April 08, 2004 8:02 AM
To: Franklin, Benjamin D; Durbin, William J
Cc: Ancely, Zalka A
Subject: FW: Locale
Sensitivity: Private

I looked at 217 workpapers that Zalka has from last year's exam and casually discussed originated subprime issue with her last night. One of the workpapers is a portion of the AQ comment out of the 2001 exam ROE (Al's got it labeled 1999 ROE of course!). In any event, a paragraph very clearly tells WAMU they need to identify originated subprime in both home and consumer loans and demonstrate compliance with the interagency policy statement as amended Jan 31 2001. I don't recall exactly what they did, but I know they did some stuff to address this comment. And I don't know exactly what we did to follow up in 2002 and 2003 exams. I talked to Matt Wedell and he is going to follow up on his end to find the chain of responses since 2001 to see where the ball may have been dropped. We need to do the same. Unfortunately, WAMU has had so many changes in that area, people in the know may be gone, so we may need to recreate what happened for them! My goal is to pick this issue up wherever it got left off rather than to start from scratch. Ken Kroemer from the FDIC is pushing toward some arbitrary FICO score cutoff and I think he is going to hit a brick wall. I'd like us to have our ducks in order so we can head him off at the pass.

-----Original Message-----
From: Franklin, Benjamin D
Sent: Wednesday, April 07, 2004 8:41 AM
To: Carter, Lawrence D
Subject: RE: Locale
Sensitivity: Private

OK

-----Original Message-----
From: Carter, Lawrence D
Sent: Wednesday, April 07, 2004 8:06 AM
To: Franklin, Benjamin D
Subject: FW: Locale
Sensitivity: Private

Bill got the stuff but I'd like to look at it to jog my memory. Can the three of us sit down with the files on Monday afternoon and see what we got? Can Bill get a hold of a hard copy of the interagency policy statement on subprime lending as well? I think we can come up with a painless game plan pretty quickly.

Permanent Subcommittee on Investigations
EXHIBIT #18

-----Original Message-----
From: Franklin, Benjamin D
Sent: Tuesday, April 06, 2004 9:52 AM
To: Carter, Lawrence D
Subject: RE: Locale
Sensitivity: Private

I will have Bill follow this up.

-----Original Message-----
From: Carter, Lawrence D
Sent: Monday, April 05, 2004 2:29 PM
To: Franklin, Benjamin D
Subject: RE: Locale
Sensitivity: Private

I mentioned to Z this morning that we really want to make sure we proactively dive into the "originated subprime" pot the FDIC is beginning to stir. Apparently, a focus on the famous 660 FICO created quite a headache between Henry and the FDIC at Downey, and we have one of the players, Dave Pfeifer, on this exam ... and I keep overhearing Ken Kroemer talking about it. Durbin also mentioned to me this morning he was going to do some analysis on FICO 660 and below for WAMU. I know I already mentioned that we did something on this an exam or two ago, but my memory is slowly coming back and I think more specifically Tim Martin did some work on it two exams ago. We should try to locate those workpapers ... maybe in the Seattle office. Durbin might be able to find them. I am pretty sure we addressed the interagency policy statement and required the institution to do something, I just don't remember exactly what. We may even have done some follow-up last exam and maybe there is something in those workpapers. I don't want to make a lot of work. Instead, I am hoping we will be in a position to head them off at the pass. If not, we'll just have to deal with it as it unfolds.

-----Original Message-----
From: Franklin, Benjamin D
Sent: Monday, April 05, 2004 11:45 AM
To: Carter, Lawrence D
Subject: RE: Locale
Sensitivity: Private

For some of them and Z is working on the others.

-----Original Message-----
From: Carter, Lawrence D
Sent: Monday, April 05, 2004 10:44 AM
To: Franklin, Benjamin D
Subject: RE: Locale
Sensitivity: Private

Thanks Ben. Are you set with call-in numbers for meetings you are "attending" this week?

-----Original Message-----
From: Franklin, Benjamin D
Sent: Monday, April 05, 2004 10:40 AM
To: Durbin, William J; Johnson, Devon L; Lim, George A; Melanson, Michelle; Orban, M Liz; Sinclair, Rosanne C
Cc: Ancely, Zalka A; Carter, Lawrence D
Subject: Locale
Sensitivity: Private

My telecommuting number is (909) 463-2922. I have a 2:pm doctors appointment today but should be back by 4:pm

Hickok, Bruce I

From: Ancely, Zalka A
Sent: Thursday, April 14, 2005 10:03 AM
To: Hickok, Bruce I
Subject: FW: Fitch - LBMC Review

Sensitivity: Private

FYI. Some insight on the subprime product at LBMC for ALLL and high risk lending initiative.

-----Original Message-----
From: Henry, David R
Sent: Thursday, April 14, 2005 9:51 AM
To: Kuczek, Richard A; Glaser, Howard M; Reiley, Mark E; Franklin, Benjamin D; Ancely, Zalka A
Subject: FW: Fitch - LBMC Review
Sensitivity: Private

-----Original Message-----
From: Bielik, Steve J
Sent: Thursday, April 14, 2005 9:32 AM
To: Henry, David R
Subject: RE: Fitch
Sensitivity: Private

As expected big difference in performance based on vintage year. Performance improves noticeably in 2003 and 2004 due to higher FICO scores. Data indicates that minimum cutoff FICO scores were raised substantially by a magnitude of 75 to 100bp. Interestingly, performance improves dramatically after 2001 for the first lien FR portfolio. However, performance improvement for the junior FR and ARM portfolios does not occur until after 2002. Average FICO score highest for junior liens. Average FRM FICO score about 25bp higher then average ARM FICO. This suggests that there are different minimum FICO cut off scores for each product line. Performance data for 2003 and 2004 vintages appear to approximate industry average while issues prior to 2003 have horrible performance.

For FRM losses, LBMC finished in the top 12 worst annualized NCLs in 1997 and 1999 thru 2003. LBMC nailed down the number 1 spot as top loser with an NCL of 14.1% in 2000 and placed 3rd in 2001 with 10.5%. Number of issuers ranged from 21 to 50. The Deutsche Bk report did not have any data for 2004 for FRMs or ARMs. For ARM losses, LBMC really outdid themselves with finishes as one of the top 4 worst performers from 1999 thru 2003. For specific ARM deals, LBMC made the top 10 worst deal list from 2000 thru 2002. LBMC had an extraordinary year in 2001 when their securitizations had 4 of the top 6 worst NCLs (range:11.2% to 13.2%).

Although underwriting changes were made from 2002 thru 2004, the older issues are still dragging down overall performance. Despite having only 8% of UPB in 1st lien FRM pools prior to 2002 and only 14.3% in 2002 jr. lien pools, LBMC still had third worst delinquencies and NCLs for most of period graphed from 11/02 thru 2/05 and was 2nd worst in NCLs in 2005 out of 10 issuers graphed. Despite having only 27.5% of UPB in issues prior to 2003, LBMC managed to stay at the top of the leader board for most of the period in serious delinquencies and NCLs. At 2/05, LBMC was #1 with a 12% delinquency rate. Industry was around 8.25%. At 3/05, LBMC had a historical NCL rate of 2% smoking their closest competitor by 70bp and tripling the industry average.

Have a mystery on seasoning charts. In reviewing cumulative loss rates and annual NCLs. For some unknown reason there is a steep drop in the loss curve around month 55 for both ARMs (140bp) and FRMs (70bp), which I am at a loss to explain.

I am reviewing the Option One data now and will send you another e-mail later today. Say hello to Roy, Dennis and Kirk for me if they are still around.

Steve B.

Permanent Subcommittee on Investigations
EXHIBIT #19

H 2352
FD.20 10

Dochow, Darrel W

From:	Rexroth, Mariana
Sent:	Thursday, May 19, 2005 9:33 AM
To:	Kuczek, Richard A
Cc:	Carter, Lawrence D; Dochow, Darrel W
Subject:	RE: LBMC Fair Lending
Sensitivity:	Private

Rich -

Sorry not to get back to you sooner - I was in St. Louis at CMI. Generally what you've described is correct. I would not, however, say that we could feel comfortable with their moving LBMC under the thrift without some conditions - I had talked to Darrel about this when I gave him an update. They do have considerable work still to do to resolve these issues and will be providing a plan. Completion of that plan - and satisfactory corrective actions - would be an appropriate condition.

Mariana

-----Original Message-----

From:	Kuczek, Richard A
Sent:	Tuesday, May 17, 2005 6:47 AM
To:	Rexroth, Mariana
Cc:	Carter, Lawrence D
Subject:	LBMC Fair Lending
Sensitivity:	Private

Hi,

Quick question.

Need an update for Darrel this AM and I'm trying to consolidate our thoughts on LBMC.

From our meeting last week, it seemed that LBMC had done some work in providing an explanatory analysis for the underwriting portion of the internal June '04 fair lending report. But it seemed there was still some additional explanation required on that portion and also, they still needed to do manual reviews on pricing disparity findings. Additionally, I think you were looking to Dave for some comparative analysis once they finished explaining the June report disparities.

Further, LBMC and corporate need to provide an analysis or analyses regarding the public ally disclosed HMDA data and those disparities.

Is that a correct summary of your findings?

If so, what will we require for us to say they have their act together on this and for us to feel ok about moving LBMC under the bank?

Any thoughts would be appreciated.

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Permanent Subcommittee on Investigations
EXHIBIT #20

OTSWMS05-005 0002002

I may have mis-understood our discussion about the mortgage product that you are most concerned with (12 Mat?). I did not see a product on your web-site that had a cap on the interest rate change of 7% per year for the first five years. I see the FlexPay Arm with a 7.5% payment cap, 5 year recast, 12 month CMT, and 110% negative amortization but could not tell if these were teaser rate or not.

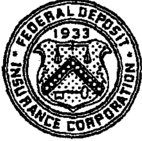
I thought you had indicated that if a start rate was 1.0% then at year one the interest rate could only be 1.07% and thereon, resulting in a recast in 4 1/2/years if rates rose 250 bp and a payment shock of about 100%.

Were you referring to the FlexPay ARM? Under the Flex Pay ARM, the cap is on the payment increase not the interest rate.

Can you also give me a sense of what types of start rates are typical and how the estimated payment shock is calculated. If I am understanding the product, I agree that it carries considerable uncertainty and risk. Previously, borrowers have been able to rely on growing home values to refinance out of these at time of recast, but that may not continue.

Thanks,

Darrel Dochow
(206) 829-2601



Washington Mutual

WMB
March 15, 2004
Safety & Soundness Examination
FDIC-DFI MEMO 3

DATE: May 20, 2004
TO: Mark Hillis, Deputy Chief Credit Officer
Tony Meola, EVP, Production
FROM: Trina Dong, FDIC and Erin Burr, DFI
SUBJECT: Single Family Residential Review
CC:

BACKGROUND INFORMATION

FDIC and State examiners reviewed a sample selection of 220 loans during this examination, primarily loans originated in 2003: 75 brokered loans, 65 loans originated in house, 20 subprime/niche loans, 20 low doc, 20 custom construction, 10 residential lot loans, and 10 advantage 90/high LTV loans. **The loan file review reflected inconsistencies in underwriting and documentation practices, particularly in the brokered channel. Additionally, examiners noted that Washington Mutual's SFR portfolio has an elevated level of risk due to a significant volume of potential negative amortization loans, high delinquency and exception rates, and a substantial volume of loans with higher risk characteristics, such as low FICO scores** (see Joint Memo #8).

EXAM FINDINGS DEFINITIONS

Observation: A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.

Recommendation: A secondary concern for which immediate corrective action is left to management's discretion. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and are generally mentioned in Exit and Board Meetings. Examiners will usually request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations to assess any changes in risk exposure.

Criticism: A primary concern that if left uncorrected, the Agencies may consider stronger action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and typically require a written response. They are subject to formal follow-up by examiners.

EXAM FINDING 1 ☐ **Observation*** ☑ **Recommendation*** ☐ **Criticism***

Topic: Inconsistent Underwriting and Documentation Practices

Finding: The loan file review of WMB's portfolio revealed the following inconsistencies.

- A substantial number of loans (17 of 75 brokered loans, 9 of 65 originated in house, and 8 of 20 low doc loans) granted to borrowers with derogatory credit ratings or with higher risk characteristics were graded a "0" or "prime." The assigned credit classification is inconsistent with the bank's policy and credit grading guidelines. As a result, these loans were not accurately priced for risk as loans with 2-4 credit codes (niche loans) which are priced at a premium rate. Additionally, the inconsistency in credit grading resulted in an inaccurate level of loan loss reserve for the niche portfolio.
- The full doc loans in the brokered portfolio (21 of 75 loans reviewed) were not fully documented and did not meet the criteria for appropriate verifications. Missing employment, asset, and income verifications were noted in the review.
- FICO scores were not consistently reported on the Loan Approval Summary Sheet for a majority of the loans reviewed. The underwriting guidelines specify which score to use when multiple credit reports were obtained, but it has not been applied uniformly.
- There is often lack of support for income calculations in the underwriting analysis, especially when multiple credit applications are in the file.
- Some of the title policies for the NegAm loans have the insurance amount of 110% of the original loan

Permanent Subcommittee on Investigations
EXHIBIT #21

OTSWME04-0000004889

EXAM FINDING 1	☐ Observation*	☑ Recommendation*	☐ Criticism*

balance and some have 100% of the loan amount.

During the examination, management began several initiatives to enhance the credit culture and correct underwriting deficiencies through the implementation of minimum credit standards, Credit Risk Teams, and a proprietary credit scoring model (version 2). However, examiners cannot yet opine on the effectiveness of these initiatives.

Action: Develop a process and system to ensure that underwriting guidelines are consistently applied.

☐ **Repeat Finding** — **Management Response Requested** ☑ **Yes** ☐ **No**

MANAGEMENT RESPONSE ☑ **Agree** ☐ **Partially Agree** ☐ **Disagree** **Enter Target Date: [12/31/04]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the Recommendation. As noted above, Consumer Credit Risk Management, in collaboration with the Consumer Group Production channels, have developed and begun several initiatives to enhance credit culture and correct underwriting deficiencies. In addition, the credit class 2-4 program has been eliminated effectively Q3 '04. This coupled with Credit Risk Team (CRT) monitoring, training, and control should also add to the improvement of these processes and overall quality. Please Note: FICO score discrepancies are predominantly caused by inefficiencies in our loan origination systems which cause loans to be manually boarded and may, in some cases, result in a new credit score to be drawn which could conflict with the score used at origination and underwriting.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. MINIMUM CREDIT STANDARDS PROJECT: Consumer Credit Risk Management implemented the new Minimum Credit Standards, which supplements the existing underwriting process for loans that receive a WaMu AUS-Refer. These Standards include a FICO/LTV-CLTV Matrix that determines which underwriting path a loan will follow. Loans falling below the matrix that may present an unacceptable level of risk will be quickly passed on to a credit approver with the appropriate level of authority and experience to explore all options prior to a decision being rendered. All AUS-Referred loans, however, will be reviewed in accordance with manual underwriting credit guidelines, regardless of the FICO score. This policy is currently in effect and applies to all loan applications or loan submissions made on or after April 1, 2004.

2. CREDIT RISK TEAMS (CRTs): These teams of senior underwriters who are managed outside the fulfillment operation are being deployed in all Loan Fulfillment Centers (LFCs). Four pilot sites have been operating since May 17 and CRTs will be operational in all LFCs by July 31 and fully implemented by the end of the third quarter. These teams in addition to handling more complex and high risk transactions will also monitor the performance of all credit approvers in the centers. A new Residential Lending Authority Policy and Performance Improvement Plan will be introduced in June and all credit grantors will be re-certified by year end. **Responsible Manager: Barry Wolfgram, Consumer Credit Risk Management. Target Date: 12/31/2004**

3. PROPRIETARY CREDIT SCORING MODEL (version 2): The Enterprise Modeling and Decision Systems group is currently redeveloping the Home Loans Proprietary Model (PM2). The PM2 is expected to be significantly more robust in risk prediction than the Transitional Proprietary Model (TPM) that is currently in place and will be much more reliant on credit file information than its predecessors. The development is based on WaMu's new credit file attribute superset, which consists of approximately 490 different credit attributes in addition to the added incremental predictivity of application attributes, loan purpose, and other significant characteristics. The PM2 is scheduled to be completed in 3rd quarter 2004.

   As a result, enhanced services should be able to be offered more confidently to lower-risk borrowers, improving service and pull-through rates for more desirable risk profiles. At the higher risk end of the spectrum, more accurate identification of risky loans and associated automation to achieve "quicker no's" on these loans will assist in fewer opportunities for errors associated with manual processes. **Responsible Manager: Tim Bates, Corporate Credit Risk Management. Target Date: 9/30/2004**

OTSWME04-0000004890

EXAM FINDING 2 ☐ **Observation*** ☑ **Recommendation*** ☐ **Criticism***

Topic: Underwriting for Low Documentation Loans

Finding: The bank's underwriting guidelines indicate that the low doc loan program is designed to expedite processing of low risk loans. **Eight of the 20 low doc loans reviewed were to borrowers with credit scores lower than 660 who had major derogatory ratings or current past due problems listed on their credit reports. Granting loans to these borrowers would appear contrary to the low risk characteristics.** Additionally, no compensating factors were noted in the underwriting analysis when approving such loans.

Limited income or employment verification within this loan program was also noted, as verification is not required for low doc loans according to the bank's underwriting guidelines. The applicants may qualify using stated income and verify their own employment. However, such guidelines appear contradictory to the low risk criteria.

Action: Reevaluate the documentation and underwriting guidelines and establish acceptable credit quality and underwriting parameters for the low doc loan program that are consistent with the low risk characteristics.

☐ **Repeat Finding** **Management Response Requested** ☑ **Yes** ☐ **No**

MANAGEMENT RESPONSE ☑ **Agree** ☐ **Partially Agree** ☐ **Disagree** **Enter Target Date: [12/31/04]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the Recommendation. In order to further drive credit quality consistency and acceptable level of risks on Low Doc transactions we will monitor their performance and reevaluate the documentation and underwriting guidelines and establish acceptable credit quality and underwriting parameters for the Low Doc Loan Program that are consistent with the low risk characteristics.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Thus far all of our analyses conclude that Low Doc loans significantly outperform Full Doc loans. This is also seen when comparing the other Low Doc qualifying criteria (CLTV, DTI, etc.). These loans are sent through our predictive models (LPRM) which show these to have lower loss expectations. Overall NPL rate from Low Doc loans with FICOs less than 660 is 1.00% compared to Full Docs with FICOs less than 660 which have a rate of 1.64%. The Credit Information and Analytics team will continue to monitor these through regular audit reports that screen for high risk Low Doc loans. The results will then be communicated to National Underwriting for review and to implement necessary corrective actions. **Responsible Manager: Alan Newstead, Consumer Credit Risk Management. Target Date: 09/30/04**

2. National Underwriting will use these reports to evaluate, control, and improve the underwriting process for Low Doc loans. Consumer Credit Policy will review and revise the applicable sections of the Conventional Underwriting Guideline, the Home Loans Online Lending Manual, and the Product and Pricing Guide to ensure all areas of evaluating the applicant are addressed. Also included in this review will be the overall credit review process, income and asset analysis, and the documenting of the risk decision. In addition, the sections regarding Verbal Verifications of Employment will be reviewed to ensure that they provide clear and concise direction when verbally verifying self employed applicants, as well as those borrowers with unusual income sources.

   Following the review and necessary revision, National Underwriting will drive the operational execution with the new Credit Risk Teams (CRTs) who will oversee and monitor the implementation of the new policy and training. **Responsible Manager: Barry Wolfgram, Consumer Credit Risk Management. Target Date: 12/31/04**

OTSWME04-0000004891

EXAM FINDING 3	☑ Observation*	☐ Recommendation*	☐ Criticism*

Topic: Risk in SFR Portfolio

Finding: **Our review, as well as that of Corporate Credit Review identified that Washington Mutual's held-for-investment SFR portfolio has an above average risk profile: higher delinquencies and exception rates, 69% of WMI's SFR portfolio has the potential to negatively amortize; and 17% of WMI's SFR portfolio, or 135% of Tier 1 Capital, reflects current FICO scores less than 620.**

WMB's SFR loans with the potential NegAm feature represent 96% of the Option ARM loans or 74% of the SFR portfolio in 2003, an increase from 88% of the Option ARM loans or 38% of the SFR portfolio in 2002. These loans increase credit risk in a rising interest rate environment due to borrowers' uncertain ability to service a higher monthly payment, a potential increase in principal balance, and potential LTV concerns. The September 2003 internal analysis concluded that NegAm loans make up a significantly larger proportion of loans in the lower FICO bands, have higher delinquencies, and higher current LTVs than the loans in the rest of the portfolio.

WMI's loans with FICO scores less than 620 totaled approximately $19 billion, or 135% of WMI's Tier 1 Capital. Loans in this category show a higher delinquency rate compared to the rest of the portfolio. Of the $19 billion, approximately $1.98 billion is currently more than 30 days past due, which represents 85% of the $2.33 billion delinquent loans for the entire SFR portfolio.

The June 2003 Credit Review Report concluded that the level of Washington Mutual's non-performing loans is considered high and the probability of improvement in overall performance is not likely. Additionally, the review identified excessive error rates in documentation.

Action: Monitor the effectiveness of management's new initiatives: the establishment of minimum credit standards, formation of Credit Risk Teams, and launching of a new proprietary credit scoring model. Measure the underwriting quality that results from the above initiatives and take corrective action if necessary to enhance the process.

☐ Repeat Finding — Management Response Requested ☐ Yes ☑ No

MANAGEMENT RESPONSE	☑ Agree	☐ Partially Agree	☐ Disagree	Enter Target Date: [N/A]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the Observation and is carefully monitoring the progress and effectiveness of the noted initiatives. As discussed in the Management Response for Finding 1, the establishment of Minimum Credit Standards, the formation and implementation of the Credit Risk Teams, and the launch of the new proprietary credit scoring model are currently in progress and should result in overall underwriting quality improvements.

Regarding the SFR loans with the potential NegAm feature, the Credit Information and Analytics group currently runs stress testing for NegAm and potential NegAm loans. The greatest risk to the organization is not a rising rate environment, but a declining housing price environment. The multiple stress tests that are performed, however, indicate that while the losses could be much greater than what we currently are experiencing, our loan loss reserve is adequate to cover those possible losses.

For the proportion of the total HFI population mentioned with FICOs less than 620, about $1 billion (or 5%) were originated by acquired institutions and about $3 billion (or 15%) have LTVs less than 60 percent. A small amount of the acquired is less than 60 CLTV (about $127 million). Thus, of the population:

- 4% Acquired and >60 LTV
- 14% Not Acquired and < 60 LTV
- 1% Acquired and <60 LTV

Please note that the establishment of the Minimum Credit Standards will sharply reduce the highest risk tail, in addition to assisting in the improvement of underwriting quality, as will the elimination of credit classification codes 2-4.

With regard to the section of the June Credit Review Report stating that the probability of improvement is not likely; the reference is misleading. Without the changes to the front-end, CRT implementation and active portfolio management

OTSWME04-0000004892

EXAM FINDING 3	☑ Observation* ☐ Recommendation* ☐ Criticism*

(loan sales), this would be true. There has been significant improvement in default servicing management and oversight. In early 2004, Consumer Credit Risk Management began working with the Default Servicing group to focus on improving and reducing the outstanding balance of Non-Performing Loans (NPLs). The reduction in NPLs has been principally achieved with the quarterly sale of Non-Performing and Sub-Performing loans; this is not the long-term strategy for managing NPLs. The Default Collections team has implemented a focused calling campaign on the asset portfolio. Delinquent loans are called on by the fifth business day of the month, the right party contact rate is improving, and we are seeing deeper penetration within the portfolio. Performance is monitored and measured each month with a comparison to prior year's performance. Considerable improvement has shown in the following areas with an overall reduction in delinquency:

- Cure Ratio of 4+ Payment DQ – As of April 2004 Cure Rate was 12.2% in comparison to the average cure rate of 6.3% in 2003.
- 3 – 4 Payment Roll Rates - The level of loans rolling from 3 to 4 payments delinquent was 41.4% in April 2004 in comparison to the 2003 average of 55.1%.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

As stated in Finding 1, the following are the corrective actions as they relate to Minimum Credit Standards Project, Credit Risk Teams, and proprietary credit scoring model (version 2):

1. MINIMUM CREDIT STANDARDS: This policy is currently in effect and applies to all loan applications or loan submissions made on or after April 1, 2004.

2. CREDIT RISK TEAMS: Four pilot sites have been operating since May 17 and additional expansion to more sites will take place through June 14. CRTs will be operational in all fulfillment centers by the end of July and fully implemented by the end of the third quarter. A new Residential Lending Authority Policy and Performance Improvement Plan will be introduced in June and all credit grantors will be re-certified by year end. **Responsible Manager: Barry Wolfgram, Consumer Credit Risk Management. Target Date: 12/31/2004**

3. PROPRIETARY CREDIT SCORING MODEL (version 2): The Enterprise Modeling and Decision Systems group is currently redeveloping the Home Loans Proprietary Model (PM2). **Responsible Manager: Tim Bates, Corporate Credit Risk Management. Target Date: 9/30/2004**

Washington Mutual

WMBFA, WMBfsb
March 14, 2005
Safety & Soundness Examination
OTS MEMO 3

DATE: May 20, 2005
TO: Mark Hillis, Chief Credit Officer
FROM: Bruce Hickok, OTS
SUBJECT: Allowance for Loan and Lease Loss Modeling
CC: William Green, Jr., Deputy CCO, Corporate Commercial Credit
Joseph Mattey, Deputy CCO, Credit Portfolio Strategies

BACKGROUND INFORMATION

We reviewed the Allowance for Loan and Lease Losses (ALLL) methodology and the policies and procedures that govern the ALLL process. Our review included: 1) the status of the proposed use of version 3.1 of the Loan Performance Risk Model (LPRM) that calculates loss factors for SFR prime and subprime mortgage loans, 2) plans to update the empirical data used to calculate loss factors for home equity loans, and 3) the work in progress to support the unallocated portion of the ALLL.

In 2005, management implemented initiatives to enhance the ALLL methodologies. Indications are that the revised ALLL methodology will result in little change to the total estimated amount of ALLL, but it is likely to shift more of the allowance from unallocated reserves to the allocated portion. Projected results of the enhancements are not expected until the end of the second quarter 2005. Management has stated a decision to employ the revised version 3.1 of LPRM has not been made.

The overall level of ALLL has remained adequate. Enhancements to the bank's ALLL methodology and analysis are appropriate due to an increasing disparity between actual and projected loan losses, the significant growth of option ARMS and other hybrid mortgage loan products in the portfolio, and the increasing level of subprime loans and loans to other higher risk borrowers. The last two external independent audits also noted the need to increase the support and documentation for ALLL methodologies and to independently validate the bank's ALLL models. This is being addressed in the new ALLL initiatives.

Based on the initiatives to enhance the reserve allocation processes, we offer the following recommendations to further augment the ALLL methodology.

EXAM FINDINGS DEFINITIONS

Observation: A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.

Recommendation: A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.

Criticism: A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

Permanent Subcommittee on Investigations
EXHIBIT #22

EXAM FINDING 1 ☐ Observation ☑ Recommendation ☐ Criticism

Topic: ALLL Initiatives

Finding: **During this examination, we were unable to assess the adequacy of projected results from the latest ALLL initiatives, as the results from Phase I of the initiatives are not expected until the end of the second quarter of 2005.**

Preliminary results of Phase I, including projected use of version 3.1 of LPRM, was not available during the examination. However, the latest ALLL initiatives and implementation timeline appear to be realistic. ALLL Initiatives

Action: Ensure timely completion of the latest ALLL initiatives, including Phase I by the end of the second quarter of 2005.

☐ Repeat Finding — Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [9/30/2005]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management is committed to completing the ALLL initiatives by the dates specified in our Steering group planning documents. Phase I will be completed by 7/1/05, including the decision on whether to implement the calibrated version of LPRM 3.1 for SFR and Subprime loans.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Finalize Phase 1 estimation procedures for the Allocated Reserve and enhance controls – Joe Mattey – 7/1/05
2. Obtain Credit Policy Committee (CPC) Approval of any needed revisions to Credit Standards for Allocated Reserve. Joe Mattey – 9/30/05
3. Establish a new CPC subcommittee governing mechanism for review of credit model validations and assumption change controls – Joe Mattey – 8/1/05

EXAM FINDING 2 ☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: LPRM version 3.1.

Finding: **Management is in process of validating and calibrating LPRM version 3.1, but the validation continues to show a significant disparity in actual and projected SFR loss rates. It is unknown if the amount of difference is an acceptable disparity to validate the revised model.**

The latest ALLL initiative includes the proposed use of LPRM version 3.1 for SFR prime and subprime mortgage loans. In order to validate the model, several groups of actual loans were taken from selected time periods, but the fit of projected losses from the model to actual historical performance is far from perfect.

For example, using a sample of loans outstanding at January 1999, the difference in projected and actual SFR loss rates at 24 months is 10 basis points (bps). Applying actual housing prices and interest rates into the model the difference is reduced to 9 bps (a reduction of 1 bp or 10 percent). Then, after calibrating the model for prepayment and default assumptions, the difference is further reduced to 6 bps (a cumulative reduction of 4 bps or 40 percent), which still leaves 60 percent unexplained. Although this is only one example, it is unknown if this is still a significant disparity to validate the model.

Action: Have a third party independently validate the bank's ALLL models, including this LPRM version 3.1, should this revised model be implemented.

☐ **Repeat Finding** **Management Response Requested** ☑ **Yes** ☐ **No**

MANAGEMENT RESPONSE ☐ **Agree** ☑ **Partially Agree** ☐ **Disagree** **Enter Target Date: [1/31/06]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

The substantial validation work completed to-date supports the validity of the LPRM v3.1 model for the ALLL loss modeling purpose, particularly in the calibrated form. Validation of the model was conducted by Washington Mutual staff independent of the vendor's model developers.

As the Washington Mutual staff who conducted the existing LPRM v3.1 validation includes prospective users of the model for ALLL loss modeling purposes, management agrees to complete an additional third party validation of the LPRM 3.1 model. The CPC subcommittee with responsibility for credit model validation and assumption change review will supervise selection of qualified third parties for analysis in support of validation of ALLL models.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Validation and Calibration Analysis of LPRM 3.1 provided by ALLL Loss Modeling Staff – Joe Mattey – 7/1/05
2. Third-party LPRM 3.1 validation – John Carnahan (acting Chair of CPC subcommittee/workgroup on Credit Model Validation and Assumption Change Review) 1/31/06

EXAM FINDING 3 ☐ Observation ☑ Recommendation ☐ Criticism

Topic: Methodology and Documentation for Unallocated ALLL

Finding: **The ALLL initiative also includes a proposal to expand the methodology and documentation used to support the unallocated portion of the ALLL to include risk weighting of six qualitative factors.**

Currently, only general items such as data integrity issues, newly developed loan products, or exogenous variable trends, are included as factors to be considered for the unallocated portion of ALLL and there are no guidelines as to how the factors are to be applied. At the end of 2004 the unallocated portion of ALLL had increased to 30 percent of total allowances up from 23.9 percent a year earlier.

The latest external independent audit also noted the need to strengthen the documentation supporting the unallocated portion of ALLL.

Action: Management should ensure completion of the expanded methodology and documentation for the unallocated portion of ALLL.

☐ Repeat Finding — Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [9/30/2005]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management has completed a draft of enhanced procedures for estimated unallocated reserve needs. New policies have been drafted for approval on appropriate unallocated percentage target ranges.

Management has developed a Scorecard to aid in the defining of the unallocated reserve. The Scorecard contains seven qualitative factors (Q Factors): 1) National and Economic Trends, 2) Mortgage and Housing Market/ Financial Services Sector Conditions, 3) Velocity and Pace of Change in Delinquencies, Classified Loans, Net Charge Off's and Recoveries, 4) Velocity and Pace of Loan Growth, 5) Level of and Trends in Concentrations, 6) Changes in Quality of Lending and Underwriting Staff, and Compliance with Policy, 7) Regulatory and Public Policy Environment. The seven Q Factors are assigned a weighting range. Each factor is analyzed in detail to determine a risk level and assigned a weighting for the quarter. The quarterly application of the weighting determines a percentage for the overall unallocated reserve amount, which can range from 10-25% of the total reserve.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Implement the Qualitative Scorecard for analysis of 2nd quarter 2005– Biff Green – 7/1/05
2. CPC Approval of Unallocated Standards – Biff Green – 9/30/05

EXAM FINDING 4	☐ Observation ☑ Recommendation ☐ Criticism
Topic:	HELOC, Home Equity, and Unsecured Consumer Loan Loss Factors
Finding:	**The odds charts used in the customized calculation of loss factors for HELOC, Home Equity, and Unsecured Consumer loans are based on consumer behavior that is 3-5 years old.** The bank's consumer portfolio demographics, interest rates, and the general economic conditions have experienced significant changes since the model was developed. Management plans to address the modeling for these loans in the second half of 2005 as a part of Phase II of the ALLL initiatives. Indication is that updated data will be obtained from Experian rather than Equifax, which was originally used to produce the odds charts.
Action:	By the second half of 2005, complete the update of odds charts and empirical data used in the calculation of loss factors for HELOC, Home Equity, and Unsecured Consumer loans.
☐ Repeat Finding	Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [1/31/06]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Enhancements to estimation procedures for HEL, HELOC and unsecured consumer loans will be completed in Phase II of the ALLL Allocated loss modeling initiative. At a minimum, this will include updating the empirical data used in calculating the loss factors (switching to Experian from Equifax). However, an update of the "odds charts" will not be provided if the recommended new modeling procedures no longer incorporate "odds charts" in the modeling method.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Update empirical data to incorporate Experian credit bureau information – Joe Mattey – 7/1/05
2. Complete Phase II redesign of HEL, HELOC and other consumer ALLL modeling – Joe Mattey – 1/31/06

OTSWME06-050 0000075

Washington Mutual

WMBFA
March 14, 2005
Safety & Soundness Examination

DATE:	June 1, 2005
TO:	Melissa Martinez, Chief Compliance & Risk Oversight Officer
FROM:	Joe Knorr, Ann Hedger, Al Avila; OTS Examiners
SUBJECT:	Corporate Risk Oversight
CC:	James Vanasek, EVP, Chief Enterprise Risk Officer
	Ken Kroemer, FDIC

BACKGROUND INFORMATION

Corporate Risk Oversight (CRO) is responsible for independently evaluating credit and compliance risk across the company and assessing the effectiveness of risk management processes relative to established strategic and risk tolerance objectives. In fulfilling this responsibility, CRO has an important role in the company's compliance management and internal asset review processes.

Since the prior examination, CRO has grown significantly as a result of a major expansion of its responsibilities, including: (1) centralization of responsibility for enterprise-wide compliance management under CRO; (2) relocation and consolidation of five separate Quality Assurance (QA) functions from the business units under CRO; and (3) assumption of responsibility for the Servicing QA function (now referred to as Servicing Risk Oversight) by CRO. The consolidation of the QA functions was a particularly challenging process and involved not only physical relocations, but integration of compliance testing and implementation of process changes at the same time. In general, this consolidation seems to have gone well.

Notwithstanding the general success of CRO's expansion activities, CRO faced a number of resource and other challenges that affected the execution of its 2004/2005 Performance Plan. For instance, executive management concerns with CRO risk definitions resulted in suspension of monthly and quarterly trend reporting in December 2004, at which time CRO embarked on a protracted recalibration project. Additionally, CRO does not yet have in place fully functional continuous comprehensive review processes where planned, is not up-to-date on periodic process reviews, and has not finalized monthly and quarterly dashboard trend reporting. Ultimately, until full exception data collection, reporting, and follow-up processes are in place and stabilized, senior management and the Board cannot really assess whether the QA process is having a meaningful impact on line processes, including loan underwriting.

The findings in this memo primarily relate to the need for CRO to complete the activities prescribed in its 2004/2005 Performance Plan, and to improve execution on future annual performance plans. Additional findings relate to excessive review cycle timeframes and the need to improve documentation of enterprise-wide asset review processes. Most of the findings are considered "criticisms" due to the overall significance of CRO activities and the fact that we have had concerns with quality assurance and underwriting processes within home lending for several years.

Note that findings related to Servicing Risk Oversight are covered in a separate memo.

EXAM FINDINGS DEFINITIONS

Observation	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation	A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.
Criticism	A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination, warrant increased attention by Senior Management and the Board of Directors, and require a written response. They are subject to formal follow-up by examiners and if left uncorrected, may result in stronger action.

Permanent Subcommittee on Investigations
EXHIBIT #23

EXAM FINDING 1 ☐ Observation ☐ Recommendation X Criticism

Topic: Attainment of Performance Plan Goals

Finding: During our prior examination, in Joint Memo 19, Finding #2 ("Recommendation"), we noted CRO did not meet the review timeframe objectives set forth in its 2003/2004 Performance Plan. However, we acknowledged this was the first Performance Plan adopted under the newly structured department and that there were other significant projects and resource requirements that affected the completion of this Performance Plan. The 2003/2004 Performance Plan primarily consisted of annual process reviews, which focused on identifying systemic issues.

With the assumption of QA function responsibilities in mid-2004, several changes to the structure of CRO, its Performance Plan goals, and scheduled review dates were required. The 2004/2005 Performance Plan (the Plan) was changed to provide for more continuous transaction testing for all residential lending, multi-family and commercial real estate loan originations as part of a new Continuous Comprehensive Review process. Subsequent to this revision, additional changes were made to the Plan, which appeared to have been made to at least partially address execution delays. For instance, many annual Periodic Process Reviews, which were behind schedule, were combined into upcoming Continuous Comprehensive Reviews.

Although some revisions to the 2004/2005 Performance Plan objectives may have been appropriate given changing priorities and risks, some changes seem to have been made because of execution difficulties. Various important Periodic Comprehensive Reviews, Periodic Process Reviews, and Continuous Comprehensive Reviews were not conducted in the manner or timeframes originally envisioned. Therefore, we believe CRO ultimately fell short of attaining its original Plan goals.

We understand that consolidation of the QA function was a significant project undertaken by CRO, and that resource constraints and a host of other issues may have impacted CRO's ability to fully execute on its plans. We also acknowledge that CRO deserves credit for putting a good basic oversight framework in place. Notwithstanding the issues impacting CRO's plans and the recognition of the good work done so far, we believe CRO needs to do a better job executing its Performance Plans.

Action: Ensure timeframes and resources are sufficient to finish 2004/2005 Performance Plan (now, just "2005 Performance Plan") objectives. More generally, improve the planning process to ensure future Performance Plans not only appropriately address risk oversight objectives, but also are reasonably attainable from a time and resource standpoint.

X Repeat Finding — Management Response Requested X Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

EXAM FINDING 2 ☐ Observation* ☐ Recommendation* X Criticism*

Topic: Monthly and Quarterly Trend Reports on Continuous Comprehensive Review Results

Finding: **Senior management and the Board have not been provided monthly and quarterly trend or dashboard reports on the results of Continuous Comprehensive Reviews since December 2004, when reporting was suspended while CRO recalibrated risk definitions. Without the trend reports, senior management and the Board are unable to ascertain whether line functions are performing acceptably and, more specifically, whether the QA process is having a meaningful impact on**

OTSWMS05-005 0002047

EXAM FINDING 2 ☐ Observation* ☐ Recommendation* x Criticism*

improving loan underwriting.

In December 2004, the issuance of monthly trend reports covering Continuous Comprehensive Reviews was suspended, due to executive management concerns with risk definitions, particularly as those definitions related to loan salability. At that time, CRO stopped providing dashboard trend reports to senior management and the Board. Despite the suspension of trend reporting, however, results of weekly sampling and Continuous Comprehensive Reviews of new loan production, where conducted, continued to be provided in weekly event reports to line management at the LFC level, and constructive interaction was apparently occurring between reviewers and line personnel. Also, although documented trend reporting was suspended, CCRO Martinez continued to attend appropriate meetings and discuss CRO activities at senior management and Board levels.

CRO has worked to recalibrate the risk definitions to not only address the internal concerns, but to improve the process overall. The recalibration efforts focused on three sets of risk definitions: Compliance, CRO risk rating, and Securitization (loan salability). All event codes were reviewed across all channels to refine terminology and eliminate redundancy where applicable. Revisions to reporting templates are now being completed to enhance monthly trending reports with more meaningful information.

Action: Monthly and quarterly CRO trend and dashboard reports for Continuous Comprehensive Reviews should resume as quickly as possible and be issued to senior management and the Board. The reports should contain not only exception trends, but also show the status of management's corrective action plans in cases where exception rates exceed acceptable thresholds. The reports should also identify systemic issues, such as specific underwriting practice weaknesses that impact the quality of the bank's asset portfolios.

☐ Repeat Finding **Management Response Requested X Yes ☐ No**

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

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2.
3.

EXAM FINDING 3 ☐ Observation ☐ Recommendation X Criticism

Topic: Excessive Review and Reporting Cycle Timeframes

Finding: **Periodic review process cycle time, from fieldwork to management response, seems excessive. CRO's review tracking report showed that management has generally been responding to CRO reports within acceptable timeframes ~~to reports issued by CRO~~. The same tracking report showed, however, that the timeframe for the CRO review cycle, from fieldwork to exit meeting, to initial report draft, to final report, was excessive, The report suggested, for example, that it sometimes took several months after fieldwork was complete to issue a final report.**

X

Action: Management and the Board need to ensure that appropriate review cycle and management response timeframes are in place for all types of CRO reviews in order to ensure timely communication and correction of weaknesses. Management and the Board need to closely monitor compliance with the timeframes and ensure that appropriate follow-up takes place to ascertain that corrective actions are being implemented. CRO should therefore provide appropriate reporting that tracks performance relatively to the timeframes.

☐ Repeat Finding **Management Response Requested X Yes ☐ No**

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
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3.

OTSWMS05-005 0002049

EXAM FINDING 4	☐ Observation ☐ Recommendation X Criticism

Topic: Continuous Comprehensive Reviews for Specialty Channel

Finding: **Lack of staff resources to perform Continuous Comprehensive Reviews of Long Beach Mortgage Corporation (LBMC) and Specialty Mortgage Finance (SMF) new loan originations has resulted in these reviews being delayed. Transaction testing of the December 2004 LBMC loan sample is just now nearing completion, but Continuous Comprehensive Reviews for the SMF portfolio have not yet commenced. Furthermore, policies and procedures for conducting reviews of SMF purchases have not yet been drafted.**

Full staffing for the QA function for the Specialty Channel located in Anaheim, CA presented challenges when the relocation of the National Post Closing Center was being debated (ultimately, it was relocated to Stockton, California). Management has represented that policies and procedures are in place for the LBMC review process, and that permanent staffing and training of the Stockton staff were completed in the first quarter of 2005. However, QA teams from Jacksonville, FL continue to assist the Stockton transaction team in its efforts to bring transaction loan testing for LBMC to a current status by July 2005. QA credit analysts hired to review the SMF portfolio have also been assisting in the QA reviews of LBMC originations, which has delayed starting the SMF reviews.

Action: LBMC reviews need to be brought current. Policies and procedures for performing reviews of SMF loan purchases should be completed, and transaction testing for SMF loans should be started as soon as possible. Timeframes for fully implementing CRO reviews of SMF purchase activities need to be established.

Repeat Finding — Management Response Requested X Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

EXAM FINDING 5	☐ Observation	X Recommendation	☐ Criticism

Topic: Commercial Risk Oversight – Seasoned Loan Reviews

Finding: **During implementation of the Continuous Comprehensive Reviews for the new originations of multi- and single-family residential loans, the review of seasoned multi-family residential (MFR) and commercial real estate (CRE) loans was temporarily suspended. In the interim, management developed procedures for performing the MFR seasoned loan review as part of the Continuous Comprehensive Review process, but did not develop updated procedures for performing the CRE seasoned loan review as part of the new Continuous Comprehensive Review process. Review of seasoned MFR loans is anticipated to begin again in July 2005, while the review of seasoned CRE loans is anticipated to begin in October 2005.**

Neither MFR nor CRE seasoned loans have been reviewed by CRO since mid-2004.

Action: Commence review of MFL seasoned loans no later than July 2005 and seasoned CRE loans no later than October 2005. Complete updated procedures for seasoned CRE loan review process.

☐ Repeat Finding — **Management Response Requested** X Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

EXAM FINDING 6 ☐ Observation X Recommendation ☐ Criticism

Topic: Documentation of Asset Review Processes

Finding: **Although the Board-approved CRO Policy provides broad guidance for CRO to execute its independent asset review activities throughout the bank, it does not describe how CRO fits into the asset review/risk-grading process for each of the bank's asset portfolios.** Such documentation is important since CRO's role may be different, depending on the portfolio. The documentation would form the linkage between the CRO Policy and various asset review/risk-grading standards and procedures in existence in various line units of the institution. Finally, the documentation would provide a basis for third parties to better understand the fundamental framework of the bank's asset review processes across all asset portfolios.

During the exam, CRO began to develop a graphic depiction of the bank's asset review activities, by portfolio, but much work remains to be done to develop complete, formalized documentation.

Action: The bank should prepare documentation showing graphically and describing narratively not only CRO's general asset review oversight role, but also how it fits into the asset review activities performed for each asset portfolio in the bank, including non-loan portfolios like investment securities, real estate investments, and real estate owned. Such documentation should include graphic and narrative descriptions of asset review processes, at a somewhat general level, on a portfolio-by-portfolio basis, pointing out whether reviews are independent of line functions and, if so, the level of independence achieved. The documentation should reference all pertinent policies, standards and procedures that govern each portfolio's asset review and risk-grading activities. The documentation could be a part of the CRO Policy or an attachment thereto, or it could be made a part of the CRO Policy's implementing standards and procedures.

☐ Repeat Finding — Management Response Requested X Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

4.
5.
6.

Washington Mutual

WMBFA
March 14, 2005
Safety & Soundness Examination
OTS MEMO 13

DATE: June 2, 2005
TO: Troy Gotschall, President, LBMC
FROM: Ben Franklin and Gail Croil, OTS Examiners
SUBJECT: LBMC Underwriting Review
CC: Craig Chapman, President, Commercial Group
Keith Johnson, Commercial Group - LBMC/SMF
Ken Kroemer, FDIC

BACKGROUND INFORMATION

We reviewed subprime lending activity conducted through WMBFA's affiliate, Long Beach Mortgage Company (LBMC). We assessed LBMC's overall lending operations as well as credit quality and underwriting through a review of samples of randomly selected loans originated by LBMC as follows: (1) 25 first trust deed (TD) loans from the held-for-sale (HFS) portfolio at December 31, 2004, (2) 25 2nd TD loans from the HFS portfolio at December 31, 2004, (3) 22 first TD loans from the $2.48 billion transferred from HFS to the held-for-investment (HFI) portfolio during March 2005, and (4) 10 loans from the scratch and dent portfolio at December 31, 2004.

We assessed underwriting and credit quality for compliance with LBMC underwriting policy and procedures as well as regulatory safety and soundness guidelines. Our findings and recommendations are discussed below (scratch and dent loans were reviewed for credit quality only and are excluded from the underwriting discussion below).

EXAM FINDINGS DEFINITIONS

Observation: A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.

Recommendation: A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.

Criticism: A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

Permanent Subcommittee on Investigations
EXHIBIT #24

OTSWME05-004 0000386

EXAM FINDING 1	☐ Observation	☐ Recommendation	☑ Criticism

Topic: LBMC Underwriting Quality

Finding: ~~**Our review disclosed underwriting deficiencies that require management's attention.** Twenty-five of~~ the seventy-two loans (34.0 percent) had at least one credit related exception that occurred more than once in the sample population. **The most prevalent error was miscalculation of borrower debt-to-income (DTI) ratios due to overstatement of income/understatement of debts or inadequate support for income used.** Other material deficiencies that occurred less frequently included: (1) inadequate explanation of the reasonableness of income or assets for some stated income borrowers; (2) the use of bank deposits to support income for salaried borrowers without explaining the source of the deposits, or failing to adjust for expenses when bank deposits were used to support income for self employed borrowers; and (3) inadequate explanation on how some stated income borrowers will handle the significant payment shock between their existing mortgage or rent payment and the new LBMC payment. These concerns are discussed in greater detail below.

Miscalculation of DTI

We noted 12 exceptions (48.0 percent) in the 2nd TD sample, 5 exceptions (22.0 percent) in the HFI sample and 2 exceptions (8.0 percent) in the HFS sample. The exceptions resulted from a variety of factors such as: (1) including income that was not adequately supported or verified, (2) excluding consumer debt from calculation without explanation, (3) improper handling of rental income or negative rents in DTI calculations, and (4) omitting taxes and insurance from borrower debts or including lower amounts than indicated by more current documentation in the file.

Inadequate explanation of reasonableness of income/assets

We noted 3 exceptions (13.0 percent) in the HFI sample and 1 exception (4.0 percent) in the 2nd TD sample. These exceptions apply to stated income borrowers and obviously could have serious impact on borrower ability to repay. LBMC policy indicates that an explanation or other documentation should be in the file when a borrower's occupation, income and/or assets appear out of sync. In the exceptions we noted, the conditions that required an explanation per policy were present, along with other factors that should have been questioned by the underwriter; however, no explanation was provided in the file.

Use of bank deposit statements to verify income

We noted 3 exceptions (12.0 percent) in the 2nd TD sample and 1 exception (4.0 percent) in the HFI sample. LBMC's policy allows underwriters to use bank deposits per published bank deposit statements to verify income for both borrowers who are business owners as well as those who are salaried. When bank deposits are used for business owners, the income should be adjusted for business expenses. When bank deposits are used for salaried borrowers, the underwriter should explain why deposits should be counted as income, particularly when it exceeds the borrower's documented salary. The cases we noted did not comply with LBMC policy. **We also question the prudence of the policy of allowing the use of bank deposits as a source of income for salaried borrowers, particularly when file documentation conflicts with the higher income derived by analyzing deposits. Management should consider revising this policy.**

Loan with significant payment shocks

We noted 4 instances (18.0 percent) in the HFI sample where borrowers experienced significant payment shock between their existing mortgage or rental payments and their new payments on LBMC's loan. Payment shocks ranged from a 90.0 percent increase (from $870 to $1685 per month) to a 240.0 percent increase (from $1700 to $5705 per month). In all instances, the loans were stated income/stated asset programs and there was no explanation of why such significant payment increases were reasonable. Current policy is somewhat general in this area but it does indicate that underwriters should explain and document why it is reasonable to expect borrowers to handle payment shocks of this magnitude.

Management promptly responded to our findings shortly after we presented them orally and agreed to implement corrective measures in the form of various job aids and additional training.

Action: Implement corrective measure to ensure more consistency in:

- Analyzing and determining borrower income and expenses in the areas where deficiencies were noted,
- Explaining and documenting the reasonableness of stated income/assets,
- Complying with LBMC policy when using bank deposits to verify borrower income,

EXAM FINDING 1	☐ Observation	☐ Recommendation	☑ Criticism

- Reassessing the practice of using bank deposits to verify income for salaried borrowers, particularly when contradictory information exists, and
- Explaining and documenting the reasonableness of loans with significant payment shock.

☐ Repeat Finding   **Management Response Requested** ☑ Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [10/1/05]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Overall, Long Beach management (LB) **partially agrees** with the findings cited for Underwriting Quality.

- LB **agrees** that underwriting decisions made subject to LBMC policies related to DTI ratios, income validation and potential borrower payment shock need to be more consistent and better documented for transparency and reviewability.
- LB **disagrees** with the suggestion that the use of bank statements to verify income is imprudent, but it is willing to review its policy and guidelines on this subject.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Training conducted to address specific items outlined in the finding – recording of decision rationale, documentation of exceptions, consistency in the files, use of the communication log, accuracy of data in the loan system, use of new job aids; use of existing checklists and document placement in files.
   Responsible manager: Chris Coombes; Target Date: 9/1/2005
2. Creation and deployment of the following job aids to assist decisioning and documentation.
   Responsible manager: Amy Marcussen; Target Date: 10/1/2005
   a. Assessing income for self-employed borrowers
   b. Reasonability testing for stated income
   c. Using bank statements for income verification
   d. Reading a credit report / DTI inclusion and exclusion rules
   e. Calculating and verifying income
   f. Tax and insurance
3. Introduce a single sheet solution that will be included in loan files. The single sheet would combine existing screens and forms to create a clearer record of loan decisions.
   Responsible manager: Amy Marcussen; Target Date: 10/1/2005
4. Enhance the QA process to check adequacy of decision documentation within the paper loan file.
   Responsible manager: Amy Marcussen; Target Date: 9/1/2005
5. Enhance regular tracking, monitoring and analyzing of U/W decision and documentation quality by converting data to regular scorecard reporting. Responsible manager: Charles Freeman; Target Date: 10/1/2005
6. Conduct underwriting policy and guideline review regarding the use of bank statements as validation for income, with amendments to policy if warranted.
   Responsible manager: Charlie Freeman; Target Date: 10/1/2005

OTSWME05-004 0000388

EXAM FINDING 2	☐ Observation* ☑ Recommendation* ☐ Criticism*
Topic:	Pre-funding quality control
Finding:	**Given the types of deficiencies noted in our loan review, we believe that LBMC's underwriting quality would benefit from a pre-funding quality control review that focuses on credit quality and credit underwriting issues.** This program could be similar to the Credit Quality Team approach recently implemented at WMBFA. While LBMC already has a pre-funding quality review function, we understand that this function's primary focus is on salability and loan program compliance rather than credit quality.
Action:	Implement a pre-funding credit quality function at LBMC.
☐ Repeat Finding	Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [10/1/05]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management **agrees** with the finding and will explore the potential adoption of the WMB Credit Quality Team approach or an equivalent pre-funding process.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Evaluation and recommendation to senior management of next steps in regards to a WMB CQT or equivalent approach for LBMC.
   Responsible manager: Charles Freeman; Target Date: 8/15/2005
2. Implementation of recommendations.
   Responsible manager: Amy Marcussen; Target Date: 10/1/2005

OTSWME05-004 0000389

EXAM FINDING 3	☐ Observation ☑ Recommendation ☐ Criticism
Topic:	Loan FICO Specials
Finding:	**We noted five loans in our HFI sample where the FICO score was below the level required for the respective loan program. Apparently, these loans were granted as part of periodic FICO Specials. Information on the number and performance of these loans was not readily available. Going forward, management agreed to track the number of FICO Specials made as well as monitor their performance.**
Action:	Management should track the number and performance of FICO Specials to determine whether the quality of loans generated warrant continuation of these periodic offerings.
☐ Repeat Finding	Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [9/1/05]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees to the finding in its entirety.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Deploy a tracking mechanism to tag and monitor the performance of FICO special loans with regular reporting to management. Responsible Manager: Glenn Rothenberg ; Target Date: 9/1/2005

EXAM FINDING 4	☑ Observation ☐ Recommendation ☐ Criticism
Topic:	Tangible Benefit Forms
Finding:	**Tangible Benefit Forms were not always properly completed.** We noted 1 exception (4.0 percent) in the HFS sample and 2 exceptions (9.0 percent) in the HFI sample. These forms are required in some states to justify that refinance loans to subprime borrowers provide a tangible benefit to the borrower. The exceptions usually resulted when the forms were not changed to reflect a change in loan terms after the loan was initially submitted. Management agreed to make a programming change that would update this form when changes were made in loan terms after the initial submission.
Action:	Ensure that forms are revised to reflect a change in loan terms after the loan is initially submitted.
☐ Repeat Finding	Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [10/1/05]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees to the finding in its entirety.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Change process to require a revised and updated NTB form to be included in the loan file matching the final loan documents and include monitoring the use of NTB form through the pre-funding review process. Responsible manager: Amy Marcussen; Target Date: 10/1/2005

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Dochow, Darrel W

From:	Kuczek, Richard A
Sent:	Thursday, June 02, 2005 7:32 AM
To:	Dochow, Darrel W
Cc:	Carter, Lawrence D; Glaser, Howard M; Henry, David R
Subject:	LBMC downgrades
Sensitivity:	Private

Darrel,

just an fyi..... we checked into the downgrades and its pretty much the same culprits. Of the 26 downgrades, 17 related to the classes in 2000 and 2001 which had also been previously downgraded in November 2004. The other 9, however, relate to two 2002 transactions so there is some creep .... but in looking at the performance measures, the 2002 securitizations and later have demonstrated improved performance in terms of cumulative loss, loss severity, and delinquency compared to 2001 and earlier securitizations.

Even though performance indicators suggest improvement in the product, this business is simply too high profile for us not to be sure that processes are in place to assure there will be no repeat of the performance of these earlier vintages.... both in securitizations and in the originations they will hold for investment. So I believe our current thinking on Long Beach that we shared with you last week is prudent.

Daviid has asked the CFO for further insight into these current downgrades and their prospective take on it.... I'll keep you posted on anything newsworthy. Rich.

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OTS/WEST

Permanent Subcommittee on Investigations
EXHIBIT #25

Washington Mutual

WMBFA
March 14, 2005
Safety & Soundness Examination
OTS MEMO 15

DATE:	June 3, 2005
TO:	Mark Hillis, SVP, Chief Credit Officer
	Wayne Pollack, SVP Home Loan Production
FROM:	Gail Croil and Ben Franklin, OTS Examiners
SUBJECT:	Single Family Residential Home Loan Review
CC:	Steve Rotella, President and COO
	Jim Vanasek, EVP, Chief Enterprise Risk Officer
	Melissa Martinez, SVP, Chief Compliance & Risk Management Officer
	Ken Kroemer, FDIC

BACKGROUND INFORMATION

We assessed the Bank's underwriting by reviewing random samples of 185 single-family residential (SFR) loans originated in the fourth quarter of 2004, including samples of: (1) prime full and low doc loans, (2) higher risk (i.e., loans with FICO scores below 620) full and low doc loans, (3) Advantage 90 higher risk and prime loans, (4) correspondent higher risk and prime full doc loans, (5) custom construction loans, and (6) residential lot loans.

The Bank's underwriting has been criticized as less than satisfactory at prior examinations as well as in internal reviews. To address these issues, management embarked on several initiatives to improve both underwriting and overall loan quality following the 2004 examination. These initiatives included implementing minimum credit standards, simplifying the number and structure of loan origination platforms, and installing credit review teams in Loan Fulfillment Centers (LFCs).

To date, the success of the initiatives has been mixed. We found evidence that the minimum credit standards implemented began to positively impact loan quality (in terms of lower LTV ratios and higher FICO scores) in the third and fourth quarters of 2004. On the other hand, efforts to restructure the loan origination platform were re-vamped during the review period, so only limited progress has been made in loan origination platform simplification. Similarly, credit review teams (now restructured as credit quality teams (CQTs)) only recently started performing the types of pre-funding reviews originally envisioned almost a year ago. Consequently, although we noted that portfolio risk in general appears to be decreasing in response to the initiatives that were effectively implemented, we did not see much change in loan quality in our fourth quarter loan origination samples. Since these initiatives have had only limited success, our concerns with underwriting quality have changed little since the 2004 examination, and loan underwriting remains less than satisfactory.

We continue to have concerns regarding the number of underwriting exceptions and with issues that evidence lack of compliance with Bank policy. We acknowledge that some of the individual exceptions may not have altered the original underwriting decision; however, we believe that the deficiencies noted impact the overall credit quality of the portfolio. Our concerns are heightened by the effect of risk layering attributes evident in the Bank's portfolio. These attributes include subprime characteristics associated with higher risk loans, a predominance of Option ARM neg am loans, and significant quantities of low doc and other limited documentation loan types. We understand that increases in loans with these characteristics are becoming an industry-wide phenomenon and therefore are not unique to the Bank. Just the same, we are concerned that the uniqueness of these products and the current environment makes it difficult to project how the portfolio will perform over varying rate and real estate cycles. Consequently, sound underwriting is critical.

In addition to credit-related underwriting concerns, we also noted exceptions or made observations related to: (1) Bank policy regarding title insurance endorsements, (2) risk-based pricing, (3) hazard insurance requirements, and (4) private mortgage insurance requirements. Our specific concerns and recommendations are discussed in greater detail below.

EXAM FINDINGS DEFINITIONS

Observation:	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation:	A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.
Criticism:	A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

EXAM FINDING 1 ☐ Observation ☐ Recommendation x Criticism

Topic: Loan Underwriting

Finding: **We identified numerous instances in which underwriters did not comply with Bank-established guidelines.**

Income Calculations:

We noted approximately 41 exceptions (22.0 percent) related to calculation of borrower income. Since borrower income directly impacts repayment ability and overall loan credit quality, we believe that the frequency and types of income errors noted warrant additional management attention.

We found that income calculated by underwriters often could not be reconciled to file documentation. Underwriters were not always mindful of pay periods on payroll stubs, resulting in overstating or understating income. We noted instances where income was only partially verified or documentation used to support income was not from a source independent of the borrower. In other instances, income information on the Loan Approval Summary (LAS) used for approval was not updated to reflect the most current information provided to verify income.

Stated income loans presented unique challenges in assessing the reasonableness of the income claimed by the borrower. Some files lacked sufficient documentation to support reasonableness, including instances where the borrower's stated income, profession, and personal assets were not consistent.

Rental Income:

Rental income calculation errors were also noted with approximately 20 exceptions (11.0 percent) in our sample. Underwriters did not consistently calculate and verify rental income as required by the Bank's underwriting guidelines. We noted instances where properties did not appear to support the rental income reported and reported amounts were not supported by tax returns. Some errors resulted from underwriters double-counting rental-related debt when manual adjustments were made to system-calculated rental income. In other instances, underwriters did not document their calculations so that rental income could be reconciled to file documentation.

Debt Calculations:

We noted 42 exceptions (23.0 percent) related to errors noted in debt-to-income (DTI) ratio calculations, which were obviously impacted by the income-related errors discussed above. In addition to income-related factors, DTI errors also resulted from omission of debts, errors in housing expenses, and, the most common, errors in taxes and insurance amounts used. Underwriters sometimes omitted taxes and insurance from calculations and often included amounts that were not supported by documentation in the file. In addition, underwriters often did not document the rationale for their calculations.

Credit Concerns:

Our review disclosed instances where underwriters did not provide sufficient mitigating factors for credit-quality related issues. We noted instances where underwriters did not explain FICO scores below the policy minimum, dismissed low FICOs without adequate justification, cited reserves as compensating factors in error (per policy), and failed to address DTI exceptions. There were approximately 42 (23.0 percent) of these types of exceptions.

OTSWME05-004 0000393

EXAM FINDING 1	☐ Observation ☐ Recommendation x Criticism
Action:	Ensure that underwriters adhere to Bank policy and fully document the methodology used in determining income and debt calculations. In addition, ensure that sufficient processes and controls are in place to provide an independent review of underwriter's calculations and adherence to Bank underwriting guidelines.
x Repeat Finding	Management Response Requested x Yes ☐ No
MANAGEMENT RESPONSE	☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

OTSWME05-004 0000394

EXAM FINDING 2	☐ Observation* x Recommendation* ☐ Criticism*
Topic:	Title Insurance
Finding:	**The Bank's policy requires title insurance of 110.0 percent of the original loan amount for certain loan products. Our review disclosed that some loans with negative amortization (neg am) potential had title insurance coverage only for the original loan amount. In addition, other loans that allow neg am up to 125.0 percent had coverage up to 110.0 percent of the original loan amount. This practice appears to leave a portion of the Bank's loans uncovered and potentially exposed to loss.**
Action:	Management should ensure consistency between Bank policy requirements and actual practice for obtaining title insurance for all loan products, but particularly those with neg am potential.
☐ Repeat Finding	Management Response Requested x Yes ☐ No
MANAGEMENT RESPONSE	☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

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Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

OTSWME05-004 0000395

EXAM FINDING 3	☐ Observation	x Recommendation	☐ Criticism

Topic: Risk-Based Pricing

Finding: **Some of the loans in our sample did not reflect risk-based pricing based on varying credit risk; consequently, the Bank is not being adequately compensated for the additional risk associated with some loans.**

For example, a purchase loan with an LTV of 80.0 percent can be priced the same for borrowers with a FICO of 560 or 760, despite the higher risk indicated by the lower FICO score. This concern was also evident when we analyzed the entire portfolio by FICO score ranges. Our portfolio analysis indicated that loan margins did not reflect price differentiation between low to high FICO ranges. We acknowledge that analysis based on loan margin alone does not take other pricing factors into account (e.g., buydowns, prepayment penalties), so some of the loans in the portfolio may be differentiated based on these other pricing factors.

Management indicated that recent initiatives incorporate a risk-based factor into loan pricing, which was not reflected in the loan sample. Based on discussions with management, current initiatives may address our concerns regarding pricing for credit risk. However, we are unable to opine on these initiatives at this examination.

Action: Management should ensure that risk-based pricing initiatives are documented, communicated to lending staff, and expanded, as appropriate, throughout the Bank.

☐ **Repeat Finding** **Management Response Requested** **x Yes** ☐ **No**

MANAGEMENT RESPONSE	☐ Agree	☐ Partially Agree	☐ Disagree	Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

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Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

EXAM FINDING 4	☐ Observation	x Recommendation	☐ Criticism

Topic: Hazard Insurance Requirement

Finding: **There appears to be a conflict between one of the Bank's underwriting guidelines and California Civil Code (Civil Code) Section 2955.5 regarding the amount of hazard insurance required for SFR loans. The Bank's hazard insurance requirement for California is 125.0 percent of replacement costs. This does not appear to be in compliance with the Civil Code requirement mandating coverage of no more than the replacement cost of improvements.**

Action: Management should ensure consistency between bank underwriting guidelines and California Civil Code requirements regarding the amount of hazard insurance required for SFR loans. Management should address the steps to be taken to address the potential exposure to the Bank from less than adequate hazard insurance coverage.

☐ Repeat Finding — Management Response Requested X Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

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RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

EXAM FINDING 5	☐ Observation	x Recommendation	☐ Criticism

Topic: Private Mortgage Insurance (PMI)

Finding: **Our loan review disclosed inconsistency between Bank policy and actual practice regarding how much PMI coverage is required for loans with neg am potential. We were informed that the standard PMI policy covers any risk associated with increases in loan balance due to negative amortization; however, some of the loan files appeared to have explicit PMI coverage for loans that negatively amortize up to 110.0 percent of the original loan balance.**

Action: Management should ensure consistency with Bank underwriting guidelines pertaining to PMI coverage for SFR loans. Clarify the Bank's policy regarding the level of PMI coverage required for loans with neg am potential.

☐ Repeat Finding　　　　Management Response Requested　x Yes　☐ No

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [ ]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

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RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

Washington Mutual

WMBFA
March 14, 2005
Safety & Soundness Examination
OTS MEMO 16

DATE:	June 3, 2005
TO:	Wayne Pollack, SVP, Home Loan Production
	Mark Hillis, SVP, Chief Credit Officer
	Melissa Martinez, Chief Compliance & Risk Oversight Officer
FROM:	William Durbin, OTS Examiner
SUBJECT:	Loan Origination Quality
CC:	Steve Rotella, President & COO
	James Vanasek, Chief Enterprise Risk Officer
	Ken Kroemer, FDIC

BACKGROUND INFORMATION

The intent of OTS Memo No. 5 at the 2004 examination was to address continuing high levels of errors in the loan origination process. While our current review disclosed some progress in implementing various loan quality improvement initiatives, these efforts, to date, have not yet achieved significant reduction in loan origination error rates. In addition, management cannot yet sufficiently document error rate levels or trends. For this reason, we recommend re-opening and expanding Issues 1 (quantifying loan quality goals) and 3 (incentive compensation) from OTS Memo No. 5.

EXAM FINDINGS DEFINITIONS

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EXAM FINDING 1 ☐ **Observation** ☑ **Recommendation** ☐ **Criticism**

Topic: Consumer Group Goals

Finding: Our Exam Finding 1 in 2004 OTS Memo No. 5 stated the Consumer Group's overall goals do not expressly state a goal with respect to the desired quality of loan originations/acquisitions. We believe that this issue is of sufficient materiality, complexity, and duration that it should be clearly stated as a goal with quantified expectations of those involved in the origination process.

We believe this issue should be revisited and the goals expanded. Understandably, management responded to our concern during the prior examination by implementing a goal that attempts to measure loan quality on a macro basis (non performing loans should not exceed 1 percent of total loans). **However, the single, 1 percent goal for the Consumer Group does not provide sufficient guidance to the loan origination function regarding what is expected in terms of underwriting quality as measured by areas such as: (1) compliance with loan underwriting standards, (2) adherence with regulatory compliance matters, (3) maintaining data quality, and (4) ensuring adequate loan documentation. We continue to believe that specific measurable goals in these areas should be defined, communicated to staff, and incorporated into the oversight of the loan origination function. Compliance with goals should be included in reports to senior management to better document the success in improving loan origination quality.**

Action: Specific measurable goals in these areas should be defined, communicated to staff, and incorporated into the oversight of the loan origination function. Compliance with goals should be included in reports to senior management to better document the success in improving loan origination quality

☐ Repeat Finding **Management Response Requested** ☑ **Yes** ☐ **No**

MANAGEMENT RESPONSE ☑ **Agree** ☐ **Partially Agree** ☐ **Disagree** **Enter Target Date: [8/31/05]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the finding. As stated in Management's response to Finding 2, Production Operations, Credit Risk Management, and Corporate Risk Oversight & Compliance collaborated with HR-Rewards and successfully redeveloped a more robust incentive compensation plan for the LFC and underwriting staff to better promote desired behaviors. This new plan incorporates results from independent loan file reviews of Consumer Risk Oversight (CRO), the Credit Quality Teams (CQTs), and will also include results of future file reviews performed by the Production Operations Quality Review Teams. These comprehensive reviews test and measure both the Loan Fulfillment Center and the individual employee's performance in terms of overall loan origination quality.

Please see Management's Response and Corrective Actions to Finding 2 for additional details on the overall Remediation Plan.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Issue appropriate legal disclosures to all impacted LFC staff describing the changes in the new incentive compensation plan. **Responsible Manager: Wayne Pollack, Target Date: 7/31/05**
2. Consumer Risk Oversight (CRO) to issue monthly reports beginning in July 2005 reflecting the Event Code responsibility assignments and associated credit, compliance, and process quality grades for each LFC. **Responsible Manager: Lorri Evans, Target Date: 7/31/05**
3. Credit Risk Management's Credit Quality Teams (CQTs) to issue bi-monthly reports beginning in August 2005 reflecting the revised credit quality incentive metrics for all underwriting staff. **Responsible Manager: Diane Ludlow, Target Date: 8/31/05**

OTSWME05-004 0000404

EXAM FINDING 2 ☐ **Observation*** ☐ **Recommendation*** ☑ **Criticism***

Topic: Incentive Compensation in Loan Fulfillment Centers (LFCs)

Finding: **The redesigned incentive compensation program for LFCs still does not satisfactorily reward excellence in loan origination quality.**

Finding 3 in the 2004 OTS Memo No. 5 was closed because an improved design for the incentive compensation program was devised. However, the program was not implemented as designed. The only measure of quality used was based on HMDA error rates. This was used in the first quarter of 2005, the initial period for the new program. The other three measures contemplated in the program, unsaleable percentage, CRT (now CQT) reviews, and exception rates, had not yet been used.

Measures used to oversee the LFCs (Issue 04-SS-0106), the incentive compensation program measures, and the Consumer Group quality goals (see Finding 1) should be consistent with each other. Also, all measures that may be used to measure and reward quality in loan origination should be recorded and distributed on a regular basis.

This issue should not be closed until the incentive compensation program is fully functional.

Action: Ensure the incentive compensation program for the LFCs addresses loan origination quality.

☑ Repeat Finding **Management Response Requested** ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ **Agree** ☐ **Partially Agree** ☐ **Disagree** **Enter Target Date: [9/30/05]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with finding. Production Operations, Credit Risk Management, and Corporate Risk Oversight & Compliance collaboratively worked with HR-Rewards and successfully redeveloped a more robust incentive compensation plan for the LFC and underwriting staff to better promote desired behaviors. This new plan incorporates results from independent loan file reviews of Consumer Risk Oversight (CRO), the Credit Quality Teams (CQTs), and will also include results of future file reviews of Production Operations Quality Review Teams. These comprehensive reviews test and measure both the Fulfillment Center and the individual employee's performance in terms of overall loan origination quality.

Numerous aspects of each sampled loan are reviewed for compliance with loan underwriting standards, adherence with regulatory compliance, adequacy loan documentation, and various other loan level characteristics. LFC and underwriting staff will earn a payout for each incentive component (Quality, Productivity, Customer Service, etc.) only if minimum achievement thresholds are met within each measurement. The first incentive compensation payouts under the newly redeveloped plan will be based on CRO review data of July 2005 funded loans, and CQT and Production Operations Quality Review Team review data of August 2005 funded loans.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Credit Quality Teams (CQTs) begin reporting and communicating results of loan file reviews bimonthly. Reporting is designed to be dynamic and available on demand to the Production Underwriting team. Reporting and communication will be distributed bimonthly. **Responsible Manager: Diane Ludlow, Target Date: 8/31/05**
2. CQTs will deliver communication and reports of final results/findings for August 2005 loan file reviews to Production Underwriting and HR-Rewards/Finance Incentive Teams. (Incentive Payout will be subsequently delivered to underwriting employees on 9/30/05). **Responsible Manager: Diane Ludlow, Target Date: 8/31/05**
3. Consumer Risk Oversight (CRO) will issue reports in September 2005 to Production Operations and HR-Rewards/Finance Incentive Teams reflecting the approved Event Code responsibility assignments on loans that funded in May, June, and July 2005 (Incentive Payout will be subsequently delivered to LFC management employees on 10/31/05). **Responsible Manager: Lorri Evans, Target Date: 9/30/05**
4. Validate CQT and CRO loan file reviews were used in staff Incentive Compensation Plan and fully incorporated within the applicable staff Incentive Payouts. **Responsible Manager: Wayne Pollack, Target Date: 9/30/05**

142358

TO: Darrel Dochow June 3, 2005

FROM: Rich Kuczek

SUBJECT: Long Beach Mortgage Corporation (LBMC) Review

At the start of this examination, it was our intent to perform a review of the operation of LBMC with the expectation that WMI or the bank would be requesting approval to move LBMC as an operating subsidiary of the bank. Such a move would obviously place the heightened risks of a subprime lending operation directly within the regulated institution structure. Because of the high profile nature of the business of LBMC and its problematic history, we believe that any and all concerns regarding the subprime operation need to be fully addressed prior to any move.

Based on the above attitude, at this point in our examination, our review of LBMC has resulted in findings which require resolution prior to our feeling confident that approval of a move is warranted.

Findings from the fair lending review were the first to question whether a move was warranted at this time. Essentially, an internal June 2004 corporate fair lending report of LBMC resulted in unexplained underwriting and pricing disparities which had yet to be resolved. Even though our general sense was that these disparities were explainable, the lack of action coupled with the increased scrutiny of enhanced HMDA public disclosures, substantially raised our level of concern. The June report is currently being analyzed and we should have results shortly; however, because of our raised concern, we have asked for additional analyses to be completed which will probably have target dates of July or August. What is somewhat unfair to LBMC is that the inaction was not on their part. When told of the need for manual file review, LBMC staff has acted promptly. However, because LBMC was the focus of the report and a move under the bank would place them in a position of more immediate corporate oversight, we believe these issues need satisfactory resolution prior to approving a move.

The second significant finding was the results of our loan underwriting review. Of our random sample of 72 loans, 34 percent had at least one credit related exception, most dealing with income determination and resulting ratio analyses. Although the errors are not deemed critical because of the wide acceptable range of subprime borrower income ratios, they are telling of a concern for underwriting accuracy and for determining the true risk characteristic of the loan. Our findings were supported by a May 2005 draft report by corporate Consumer Risk Oversight (CRO)which indicated a substantial number of underwriting exceptions in a review of loans funded in December 2004 and January and February 2005. These exceptions give rise to a concern whether the underwriting process has been fully developed. It also gives rise to a concern as to whether quality controls are sufficient and effective.

The CRO function is a post closing review which is still being built for Long Beach in the Stockton, California facility. The December review was performed with the

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assistance of other CRO personnel. Although it seems that the file reviews are complete and valuable, it is obvious that the results are very delinquent. Each of the months of the review had a sample population target of 200 loans. The loans actually reviewed for the months of December, January, and February were 142, 23, and 33 respectively. We believe that this important function should be complete and in place prior to moving a high risk lending operation under the bank.

Additionally, the bank has effectively instituted a pre-funding quality review though its Credit Policy department. Credit Quality Teams (CQTs) have been placed in every prime production loan fulfillment center (LFC) and are sampling production of every underwriter and providing immediate feedback. However, this function has not been implemented in the Long Beach LFCs. The senior credit officer for credit policy/subprime has notified us that she has discussed implementing this function with LBMC management and a process similar to the bank's will be created. We believe this function coupled with increased training and the post closing review will assure underwriting quality.

When advised of our underwriting exceptions and concerns, LBMC management was prompt to implement corrective actions in additional instruction on credit policy interpretation regarding income and the creation of job aids for appropriate income determination. As laudable as that is, corporate oversight is not in place to evidence any improvement. Further, we must decide whether we want to see any improvement in our own follow-up file review.

All of these findings are made more significant when considered in light of a substantial forecasted increase in originations and the intent to build a held for investment portfolio at LBMC. This portfolio has already been built to $2.6 billion at March 31, 2005.

Notwithstanding these findings, it is important to note that LBMC management has worked diligently to improve its operation and correct significant deficiencies that have been observed and reported in prior years. Security performance trends show definitive improvement and repurchase activity due to contractual reps and warranties violations has been reduced to minimal levels. Both have been troublesome issues for LBMC in the past and, as you know, they are still plagued by continued downgrades of older vintages. Management personnel has been substantially upgraded and there is definitely a new attitude and culture within the entity of optimal operating performance.

Management has been very responsive to our findings. Although acknowledging the exceptions and the incomplete corporate oversight, they believe they have alternative controls in place. From our assessment of these controls, we believe they are focused reviews and do not include the quality assurance that is needed. Also, if they were effective, we would not have found the exceptions we did. Nonetheless, we are continuing to understand these processes and have discussions with management.

At this point, we believe there are issues that need to be addressed. The fair lending and CRO issues can be resolved in the next few months and we are waiting for a tentative

implementation schedule for the CQT function. The longer time requirement would be the validation that these processes are in place and are working. Our thinking at this time is that because of the nature of this entity, we need to be clear there are no pending issues if and when approval is given to move it under the bank. And that would mean full validation of corrective procedures. Approval based on processes being put in place runs the risk of more serious issues in the event of noncompliance.

Campbell, Verlin D

From: Ancely, Zalka A
Sent: Wednesday, June 08, 2005 9:57 AM
To: Kuczek, Richard A
Cc: Campbell, Verlin D
Subject: FW: S-S 2 response

Sensitivity: Private

Rich,

I agree with Verlin regarding the dates but we will nonetheless accept the response since they will immediately review and evaluate the situation.

Zalka

-----Original Message-----
From: Campbell, Verlin D
Sent: Wednesday, June 08, 2005 9:52 AM
To: Ancely, Zalka A
Subject: RE: S-S 2 response
Sensitivity: Private

Z,

The response looks good. They agree to take all action required to correct the problem. The Target Completion Dates are not real timely but fine for WAMU. Devon is filing it in our workpapers.

V

Verlin Campbell
Office of Thrift Supervision
West Region

Notice: The information contained in this message is privileged, confidential and protected from disclosure. If you received this message by mistake please notify me immediately and then delete it from your computer.

-----Original Message-----
From: Ancely, Zalka A
Sent: Wednesday, June 08, 2005 9:32 AM
To: Campbell, Verlin D
Subject: FW: S-S 2 response
Sensitivity: Private

What do you think about the response?

-----Original Message-----
From: Kuczek, Richard A
Sent: Wednesday, June 08, 2005 8:46 AM
To: Ancely, Zalka A
Subject: S-S 2 response
Sensitivity: Private

Here is the response to S-S 2.... please distribute and let me know if we accept. Thanks.

<< File: OTS Memo 2 - Internal Control Deposit Accts (Final).doc >>

Permanent Subcommittee on Investigations
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8551
~~[illegible]~~
90.10

Dochow, Darrel W

From:	Carter, Lawrence D
Sent:	Monday, November 21, 2005 10:02 PM
To:	Franklin, Benjamin D
Cc:	~~Croil, Gail A; Dochow, Darrel W~~
Subject:	RE: Meeting
Sensitivity:	Private

Unfortunately, our sampling standards are 10 years old and we have no standards of acceptance really. It depends on our own comfort levels, which differ. Darrel will have the ultimate say, obviously. However, to give you perspective, existing IAR sampling standards (the most conservative of our sampling standards) allow for 1 exception in 46 loans, 2 exceptions in 61 loans and 3 exceptions in 76 loans and we can still accept the classifications. This translates to a SAMPLE error rate of between 2.1 and 3.9%. It translates to us being 95% sure that the population exception rate is no more than 10%. Extrapolating these error rates to a 224-loan sample I am sure has some mathematical issues, which I am no expert in, but a linear extrapolation would mean you could have up to 8.8 exceptions in that 224 loan sample and still meet our standards.

Our current homogeneous loan guidance allows for 1 exception in 25 loans, 2 exceptions in 34 loans, and 3 exceptions in 43 loans. These translate to SAMPLE error rates of between 4 and 7%. It translates to us being 90% sure that the population exception rate is no more than 15%. Moreover, our guidance requires that an exception be SIGNIFICANT, which means regardless of whether it violated the institution's policy or not, it was just not prudently underwritten, which we have over time interpreted as loans that should not have been made. Again, if you violate all kinds of statistics I am sure and linearly extrapolate these more liberal standards, which would probably only be accepted for prime conforming loans, you could have 15.6 exceptions in the 224 loan sample and still accept the results.

While we may (and have) questioned the reasonableness of these standards, they are all we have at this time. If our tolerance for some reason is now a lot lower than our handbook standards, it would be nice to have this clarified. I have always used these standards as rough benchmarks and not absolutes myself, upping my expectations for higher risk portfolios. Obviously, we should have higher expectations than the homogeneous loan standards for a subprime portfolio. I would lean towards the more stringent IAR/nonhomogeneous asset classification standards. It would be nice if they could meet even higher expectations, but that would require us to agree on what that standard should be.

In any case, I think the above standards are useful for perspective and they are the ones that I have always used to keep my own perspective. So, if all mediums are really highs, then 20% sample error is way too high to be acceptable. On the other hand, your 2.0% exception rate for "highs" (counting the mediums you think should be highs) meets our most egregious standard (1 exception in 46 loans for IAR, 2.2%) and is well below our most liberal standard of 3 exceptions in 43 loans (7%).

This is why, from my perspective, the 9 DTI errors in 224 loans are not alarming on the surface. First, they are errors in one aspect of the loan underwriting, so we still don't know if the loans themselves are "exceptions." Second, we do not know how significant the 9 individual errors are. If all 9 errors are significant and result in loans that are considered "exceptions," then I would be on the fence because we would be just outside the bounds of our tougher IAR/nonhomogeneous sample classification standards (95% confidence population deviation not more than 10%).

I am very tired, so this probably reads like diatribe, but I wanted to make clear my frame of reference while we are in the heat of discussion. We can talk more tomorrow when I drop by. Bottom line, though, is these are all just numbers. There are lots of more subjective pros and cons to LBMC moving under the bank. We will need to lay it all out, discuss it, and make a recommendation to Darrel.

-----Original Message-----

From:	Franklin, Benjamin D
Sent:	Monday, November 21, 2005 2:42 PM
To:	Carter, Lawrence D
Cc:	Croil, Gail A
Subject:	RE: Meeting
Sensitivity:	Private

Lawrence,

The gist of out CRO meeting is as follows:

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EXHIBIT #30

They indicated that they do not have specific standards for total sample errors such as the 9 errors, or 4.0 percent, related to DTI; rather, their acceptance standards are based on the percentage of "High" or "Medium" errors in the sample as follows:

~~High: > 2.5 percent errors results in a criticism~~
Medium: >5.0 percent < 20.0 percent results in a recommendation; > 20.0 percent results in a criticism

Apparently these standards are based on internal analysis (not GSEs or any specific secondary market standards) that takes into account LBMC's saleability/securitization issues (including legal input) as well as credit and reps and warranties concerns. (We asked for documentation that better explains their standards and how they were determined).

We acknowledged that per CRO's review, LBMC's post funding review, and even our file review, to date, that underwriting improvement has been made, but we're still determining how we will categorize the level of improvement. Our biggest concern with CRO's findings is that there are still some exceptions they categorize as medium that we would categorize as high (We believe that there are at least 4 high exceptions in their results (they indicate 1) where the loans should not have been made (this would result in a 2.0 percent error rate versus their 2.5 percent standard) and other questionable ones where employment verification was not performed as required).

We will need additional discussion of acceptable error rates and how we view their standard. Based on their 2005 originations (annualized) approximating $24.0 billion, a 2.5 percent high error rate would mean that approximate $600.0 million could be originated and be within acceptable guidelines. A 20.0 percent medium error rate means that $4.8 billion of loans with these types of errors could be originated without a criticism. The latter seem especially high when you consider that their medium criteria includes loans that we don't think should be made.

-----Original Message-----
From: Carter, Lawrence D
Sent: Monday, November 21, 2005 10:18 AM
To: Franklin, Benjamin D; Croil, Gail A
Subject: Meeting
Sensitivity: Private

Darrel feels that 9 DTI errors in 224 loans is statistically significant. I have suggested to him it depends on the nature of the errors and the statistical thresholds set. Can we find out during the meeting today how the exception rates compare to their own statistically-based standards of acceptance. I believe their sampling and standards are based on the FHLMC/FNMA parameters, which is 95% confidence, 2% precision, but this may not address whether errors are serious or not. We should try to get some sense of this to explain to Darrel. Maybe CRO can write up a quick summary.

OTSWMS05-004 0001912

EXHIBIT 1

Office of Thrift Supervision
Department of the Treasury — *West Region*
101 Stewart Street, Suite 1010, Seattle, WA 98101-2419 — *Seattle Area Office*
Telephone: (206) 829-2600 • Fax: (206) 829-2620

December 21, 2005

MEMORANDUM FOR: Darrel Dochow, Deputy Regional Director

FROM: Lawrence Carter, Examiner
Ben Franklin, Examiner
Mariana Rexroth, Compliance Specialist

SUBJECT: Long Beach Mortgage Corporation (LBMC)

Washington Mutual Bank (WMB) (Docket No. 08551) filed an application on December 12, 2005, to acquire holding company affiliate, Long Beach Mortgage Company (LBMC), a single-family subprime mortgage lender. We have prepared this memo to facilitate the review of that application.

Background

LBMC was acquired by Washington Mutual, Inc. (WMI) (Docket No. H2352) in 1999 as a vehicle for WMI to access the subprime loan market. LBMC's core business is the origination of subprime mortgage loans through a nationwide network of mortgage brokers. Most loans are pooled and sold as mortgage-backed securities. Beginning in 2005, management started to retain a portion of the originations to build an investment portfolio which, at September 30, 2005, totaled $5.2 billion.

At September 30, 2005, LBMC reported $1.2 billion in capital against total assets of $14.0 billion, for a capital-to-assets ratio of 8.5 percent. In terms of income, LBMC reported net income of $101.1 million for 2004 representing a return on average assets of 2.0 percent and a return on equity of 9.6 percent. Year-to-date September 2005, net income was $97.7 million, for a return on assets of 1.2 percent and return on equity of 11.4 percent. Loan originations have increased substantially from $15.9 billion for the full year 2004 to $22.5 billion for the 9 months ended September 30, 2005. Management expects earnings to increase due to increased loan

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volumes, greater operating efficiencies, and improved asset quality. Also, the new held-for-investment (HFI) portfolio should augment and stabilize earnings, compared to prior years.

LBMC's early operations as a subsidiary of WMI were characterized by a number of weaknesses, particularly when the subprime operation was managed as a unit within the prime lending group. This integration led to operational problems, which arose from not fully recognizing the specialized nature of a subprime lending operation and an insufficient depth and breadth of management. Problems included loan servicing weaknesses, documentation exceptions, high delinquencies, and concerns regarding compliance with securitization-related representations and warranties. In 2003, adverse internal reviews of LBMC operations led to a decision to temporarily cease securitization activity. WMI's Legal Department then led a special review of all loans in LBMC's pipeline and held-for-sale warehouse in order to ensure file documentation adequately supported securitization representations and warranties and that WMI was not exposed to a potentially significant contingent liability. Securitization activity was reinstated in early 2004 after the Legal Department concluded there was not a significant liability issue. The review did result, however, in some minor changes to LBMC's standard representations and warranties.

Since that time, significant attention and resources have been devoted to upgrading LBMC operations, including restructuring and strengthening management. The restructuring included moving LBMC out of the prime lending group and managing it independently within WMI's Commercial Group. At the time of our March 14, 2005, examination, WMI believed that LBMC had reached a point where it should be moved under WMB. This move had long been contemplated and desired because of the advantages and synergies that could be obtained, including lower funding costs and administrative expenses, and the reduced burden of individual state regulation. We completed a comprehensive review of LBMC during the examination with this move in mind.

Our examination determined that substantial improvement had been made in LBMC operations. However, we concluded certain underwriting and fair lending program weaknesses needed to be addressed before we could advise management that we would entertain an application by WMB to acquire LBMC. We assessed management's progress in addressing these weaknesses during an October 3, 2005, field visit and concluded sufficient progress was made for us to entertain the application. Additional detail on the two areas of weakness and the results of our field visit are provided later in this memorandum.

Our review of market risk management practices, especially residual valuation and mortgage servicing rights (MSR) valuation, during the March 14, 2005, examination disclosed acceptable

processes. We also were satisfied that securitization practices and controls were consistent with the Interagency Guidance on Asset Securitization Activities (IGASA), dated December 13, 1999. We found that, since the prior examination, additional resources had been employed to validate the residual valuation model and changes to the model, and to ensure appropriate reporting. We found the valuations reasonable, and we were satisfied with the use of market-supported assumptions and improvements in the modeling discipline.

During the October 3, 2005, field visit, we performed a limited updated review of the residuals, which increased from $28.1 million at December 31, 2004, to $114.3 million at September 30, 2005, partially due to writeups. We did not find the valuations unreasonable, nor did we note any changes in processes warranting concern.

MSR at September 30, 2005, was reported at $168.9 million. Internal values have been in line with independent third party value conclusions and, as mentioned above, we have been satisfied with valuation processes.

Prior to 2005, LBMC's business model was to package and sell all of the loans originated and retain servicing on most of the loans sold. Effective in the first quarter of 2005, LBMC initiated a HFI portfolio, which grew to $5.2 billion at September 30, 2005. This portfolio was established as an alternative to WMB's Specialty Mortgage Finance (SMF) program of purchasing subprime loans for portfolio, primarily from Ameriquest. A principal quality control feature of the LBMC HFI portfolio was that the loans were intended to be similar to those purchased through the SMF program.

Since we were satisfied with management of the SMF program and loan quality, we believed a LBMC HFI portfolio of similar quality would be an acceptable risk. Our examination and field visit concluded, however, that the LBMC HFI portfolio had attributes that could result in higher risk than the SMF portfolio. For instance, the LBMC HFI portfolio has a much higher level of stated income loans. Therefore, as discussed later in this memorandum, we advised management that WMB's concentration limits on high-risk activities would need to consider this risk if LBMC were brought under WMB.

Improvements in LBMC operations are reflected in the performance trend of LBMC's servicing portfolio over the past five years. Delinquency peaked at 14.6 percent in December 2001, and has steadily declined from that point. Delinquency levels were approximately 12.2, 9.6, and 6.7 percent at yearends 2002, 2003, and 2004, and 5.8 percent at September 30, 2005. Foreclosures have shown a similar trend, peaking at 7.8 percent in January 2001, and declining to

approximately 3.2, 3.1, and 2.1 percent for the same yearend periods, and to 1.6 percent at September 30, 2005.

Underwriting Issues

LBMC underwriting practices have evolved to include, but are not limited to, credit and ability-to-pay assessment, collateral review, fraud screening, and borrower refinance history review. Tighter underwriting controls are also reflected in higher weighted average FICO scores. For the first quarter of 2000, the weighted average FICO score for the servicing portfolio was 543. For the third quarter of 2004, the same average was 639. The weighted average FICO seems to have stabilized at this level, as the weighted average FICO for year-to-date September 30, 2005, loan production was 638.

Notwithstanding these improvements, our loan file review during the March 14, 2005, examination disclosed underwriting deficiencies that required management's attention. We presented our findings to management in OTS Safety and Soundness Memo 13 (OTS Memo 13). Most of the deficiencies related to debt-to-income (DTI) ratio calculations, such as the inclusion of income or exclusion of debt without adequate support and explanation. Other deficiencies included lack of explanation regarding reasonableness of income on loans without full documentation (primarily stated income loans) and lack of explanation of a borrower's ability to handle an initial payment shock on the new LBMC loan.

Management responded promptly to our examination findings and agreed to implement corrective measures in the form of various underwriter job aids and additional training. Their formal response to our findings memorandum referenced these corrective actions, as well as described additional controls that were to be put in place. Also positive was that the WMI Consumer Risk Oversight (CRO) independent loan review function was going to catch up on its reviews of LBMC production and then stay current. We had criticized CRO for falling behind in its reviews of LBMC loan production during the examination.

During the October 3, 2005, field visit, we assessed LBMC progress in correcting the deficiencies cited in OTS Memo 13. We found that management had invested significant time and effort in developing job aids, conducting training, upgrading loan file documentation, and enhancing quality assurance and tracking and monitoring processes in order to address our concerns. We also noted that CRO had caught up on its review of LBMC loan production.

During the visit, we reviewed 70 LBMC loans originated in August, September and October 2005. We also reviewed the results of the independent reviews performed by CRO. Our review

disclosed that management had made good progress in addressing the DTI errors, but less progress in supporting the reasonableness of income in stated income loans, which comprise about 50 percent of LBMC's business. Furthermore, our review disclosed that underwriting error rates overall remain relatively high. Finally, we encountered two loans that were questionable as to whether they should have been made at all, which causes us to still have some concern with LBMC underwriting practices. We provided management the results of our findings in an update to OTS Memo 13, issued on December 16, 2005. Notwithstanding our ongoing concerns, we concluded that management had made good strides in addressing the underwriting issues, and we would expect improvement to continue.

We met with management at various points during the field visit and presented our conclusions. Management is in the process of responding to our update to OTS Memo 13, and we expect additional actions to be taken with respect to underwriting, including: (1) enhance policies and procedures with better guidance on what documentation is appropriate to thoroughly document reasonableness of stated income; (2) enhance policies and procedures to provide clear direction as to when underwriters have discretion to exceed policy standards and by how much; and (3) improve file documentation with respect to reasonableness of stated income We also expect management to continue to drive down error and exception rates.

Fair Lending Issues

As a subprime mortgage lender, LBMC has high levels of reputation and fair lending risk. Despite this high level of risk, our March 14, 2005, examination disclosed that the corporate compliance function responsible for assessing the management of this risk at LBMC fell behind in fulfilling its responsibilities.

Corporate Compliance completed a file review of LBMC 2003 pricing and underwriting in June 2004. This review raised material concerns of possible disparate treatment by race and ethnicity in both underwriting and pricing. Reinforcing the concerns with possible disparate treatment was the 2004 Home Mortgage Disclosure Act (HMDA) data released publicly in early 2005. Corporate Compliance did not provide its June 2004 review results to LBMC until during our March 14, 2005, examination, so LBMC management validation of and response to the review, actions to address process and control issues, and remediation for adversely affected minority applicants did not begin until the second quarter of 2005. The delay in providing the June 2004 review results to LBMC contributed to an overall examination conclusion that the corporate fair lending program needed attention.

Our fair lending findings with respect to LBMC were communicated to management in OTS Compliance Memo 8 (OTS Memo 8). In response to the memorandum, management committed to timely action to address the results of the 2003 pricing and underwriting file review, including remediation. Management also committed to conduct further fair lending analyses and reviews, and to enhance certain internal controls and oversight mechanisms to ensure fair lending risk management at LBMC is timely and comprehensive.

We followed up on management efforts to address fair lending issues during our October 3, 2005, field visit. With respect to the file review of LBMC 2003 pricing and underwriting, we found that LBMC senior management had initiated corrective actions to improve the consistency and controls for underwriting and pricing loans, and had provided appropriate remediation to those applicants for whom it was likely that differences in pricing may have been related to prohibited bases.

With respect to the need for further analyses and reviews, Corporate Compliance has conducted a variety of analyses of the apparent pricing disparities at both WMB and LBMC, as well as between the two companies, since the March 14, 2005, examination. Based on these statistical analyses, the function has conducted transaction level comparative file reviews of pricing in eight LBMC markets where there appeared to be a statistically significant disparity on the basis of race or ethnicity. In each of these eight reviews, there was some over- or under-pricing of loans, but this was within a limited range and evenly positive and negative across races and ethnicities. Further action was not warranted. Comparative file reviews of LBMC underwriting in the Chicago market (statistically identified as having a high risk of disparity) have been completed, and additional reviews in Chicago and other markets are underway.

The one significant remaining element of the corrective actions undertaken in response to the examination fair lending findings is a comprehensive review of the LBMC and WMB pricing structures. In its response to OTS Memo 8, management committed to have this completed by yearend 2005. We confirmed during our October 3, 2005, field visit that this review was on track for timely completion.

Aside from our examination findings, a significant fair lending concern whenever there is a financial institution, such as WMB, with a subprime affiliate (or division), such as LBMC, is the possibility that steering to less advantageous products at the subprime affiliate might occur on a prohibited basis. To address this concern, WMI's Legal Department developed a "Best Price Offer (BPO)" program. Although it has been in place for some time, the BPO program has not been particularly successful. One of the risk assessment tools that Corporate Compliance has been developing is a tool for evaluating the risk of steering on a prohibited basis between WMB

and LBMC. While still in the development phase, this should be a useful monitoring tool in the future. In addition, Corporate Compliance is evaluating the use of various customer survey information to develop a more focused approach to mystery shopping.

In general, we concluded during our October 3, 2005, field visit that all commitments for corrective or other actions were either completed or on schedule for timely fulfillment. Most important, executive management appears to be taking the company's fair lending risk and the need to manage it seriously.

Conclusion

Since we believed LBMC had made good progress in addressing the concerns raised during our March 14, 2005, examination and no new issues had arisen, we advised management that we would entertain the application to move LBMC under the bank. The application was then filed December 12, 2005. Notwithstanding this conclusion, we should emphasize that LBMC is engaged in a high-risk lending activity and we are not yet fully satisfied with its practices. Therefore, we recommend that management make certain commitments as part of the application process:

1. Concentration Limits. WMB should revisit its high-risk lending concentration limits to consider both WM Card Services and LBMC. WMB should consider increasing granularity in those limits, particularly with respect to loans with higher risk characteristics such as stated income loans with low FICOs and high LTV ratios.
2. Compliance with Guidance. WMB should provide specific assurance that it will ensure that LBMC complies with Interagency Guidance on Subprime Lending (March 1, 1999), Interagency Expanded Guidance for Subprime Lending Programs (January 31, 2001), Interagency Guidance on Asset Securitization Activities (December 13, 1999), and the interagency guidance on affordability loan products, as appropriate, when this guidance is issued.
3. Indemnification. The WMB board should consider whether a holding company indemnification or cash deposit/reserve should be secured for potential liability arising from the transferred assets and liabilities.
4. OTS Memo 13. WMB should commit to ensure that actions are taken in response to our update of OTS Memo 13 and that loan underwriting exception and error rates continue to decline.
5. OTS Memo 8. WMB should commit to address the remaining issues in OTS Memo 8, as well as to more generally ensure that follow-through continues on all fair lending efforts

and that corporate fair lending practices are commensurate with the size and complexity of the organization.

6. Enterprise Risk Management. WMB should commit to ensure that Enterprise Risk Management, through its Consumer Risk Oversight and Internal Audit units, provides an independent and countervailing balance to line management desires to expand subprime lending activities through LBMC when those desires are potentially imprudent. This balance should include frequent and rigorous independent reviews of LBMC operations.

We will complete an examination of LBMC as part of our March 13, 2006, full-scope examination. Should the application by WMB be approved, we will ensure during that examination that management has complied with all commitments made in connection with the application.

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90.10

Dochow, Darrel W

From:	Carter, Lawrence D
Sent:	Friday, January 27, 2006 7:40 AM
To:	Dochow, Darrel W
Subject:	RE: WAMU Commitment letter

Follow Up Flag:	Follow up
Flag Status:	Flagged

The letter seems okay. They obviously want to leave it a little squishy, of course, on the growth plans, but at least they make a firm commitment to clean up the underwriting issues. At some level, it seems we have to rely on our relationship and their understanding that we are not comfortable with current underwriting practices and don't want them to grow significantly without having the practices cleaned up first. I am sure we made that very clear.

With respect to the high risk limit, I keep thinking about them only including the Card Services loans with FICOs under 660. Our acceptance of this calculation might be considered by them to be a step toward our acceptance of Card Services as NOT being a programmatic subprime lender subject to the interagency guidance, a step I am not sure we are ready to take at this point. Furthermore, I think this will also factor into their benchmark "super-risk weighting" capital calculations (or data they provide us -- I am not sure whether they ultimately agreed to do the calculations or just provide us the data). We will need to decide whether ALL of Card Services' loans should be super-risk-weighted for benchmarking purposes -- I would lean towards yes.

Perhaps we should at least let John know that we are considering the appropriateness of this and will address through our examination by considering the high risk lending strategy, existing limits, and plans to do additional analytical work in support of concentration limits overall.

-----Original Message-----
From: Dochow, Darrel W
Sent: Thursday, January 26, 2006 1:23 PM
To: Carter, Lawrence D; Finn, Michael E
Subject: WAMU Commitment letter
Importance: High

I scanned the letter from WAMU that was just delivered so that you could read their commitment relating to LBMC growth and a refer up program. Any reactions? << File: Scan0011.PDF >>

OFFICIAL FILE COPY
OTS/WEST

Permanent Subcommittee on Investigations
EXHIBIT #32

WMB
March 13, 2006
Safety & Soundness Examination
OTS MEMO 12

DATE: May 23, 2006
TO: Wayne Pollock, SVP, Home Loans Operation Strategy
FROM: Mark Reiley and Liz Orban, OTS Examiners
SUBJECT: Home Loan Underwriting
CC: Cathy Doperalski, Regulatory Relations
Steve Funaro, FDIC

BACKGROUND INFORMATION

We sampled 186 newly originated loans to assess Home Loan's compliance with Bank underwriting policy and regulatory safety and soundness guidelines as well as to assess the progress made in addressing the underwriting weaknesses (criticisms) noted in our 2005 OTS Memo 15. The following loan sample was comprised of randomly selected loans originated through the various lending channels (Retail, Wholesale and Correspondent) and originated between November 2005 and January 2006:

- 126 Full-Doc loans;
- 25 Stated Income loans;
- 15 Interest-Only loans;
- 10 Single Family Residential Custom Construction loans*; and,
- 10 Residential Lot loans.

* Custom Construction loans originated during the review period.

Included in the sample above were 67 negative amortization loans (63 Option ARMs and four Flex ARMs).

We categorized our findings as:

- Exceptions – Generally, these loans have such significant deficiencies that we consider them unsafe and unsound. These are loans that probably should not have been made on the terms that the loan was granted. Any Exception in a small random sample will generally lead us to conclude overall that underwriting is less than satisfactory.
- Other Loans with Deficiencies – These are loans with elevated risk due to underwriting deficiencies. Depending on the nature of the deficiencies, a significant number of loans of this type could also lead us to consider underwriting less than satisfactory.

All errors were discussed with the designated Senior Underwriting Team Manager.

During the prior examination, we noted numerous instances of underwriters exceeding underwriting guidelines, errors in income calculations, errors in debt-to-income (DTI) calculations, lack of sufficient mitigating factors for credit-quality related issues, and insufficient title insurance coverage on negative amortization loans. Management's strategy to reduce the level of exceptions and errors was to more effectively utilize the Credit Risk Oversight (CRO) and Credit Quality Team (CQT) reviews to provide continuous feedback, training and coaching to the underwriters. Furthermore, CRO and CQT reviews were used in the staff Incentive Compensation Plan (ICP), to help promote desirable loan quality and underwriter behavior and thereby improve underwriting results. Management also established acceptable targets for DTI error rates (10 percent by June 2006 and 5 percent by December 2006). The combination of these efforts has resulted in a reduction of underwriting exceptions and errors. Recent CRO reviews and our loan sample results validate this conclusion.

Management has made progress in addressing and reducing the level of underwriting exceptions and errors noted in OTS Memo 15, and none of the loans were considered "Exceptions", as defined above. However, we did note various underwriting errors that continue to require management's attention. Specifically, DTI calculation errors, lack of adequate title insurance coverage, inadequate support for borrower income, conditions of approval not supported, documentation errors, and errors on the Bank's Loan Approval Summary (LAS) worksheets were noted during our review. In addition, we made recommendations to enhance the underwriting policy and procedures and data coding process.

Permanent Subcommittee on Investigations
EXHIBIT #33

OTSWMS06-008 0001299

We concluded that management implemented the corrective actions agreed upon at the last examination and while underwriting errors noted still need to be addressed, we concluded that prime underwriting is now considered marginally satisfactory. We believe that the issues discussed in this memo supercede those discussed in our last examination and ~~would not object to Regulatory Relations closing out the issues in the prior memo.~~

EXAM FINDINGS DEFINITIONS

Observation: A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.

Recommendation: A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.

Criticism: A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

EXAM FINDING 1 ☐ Observation ☑ Recommendation ☐ Criticism

Topic: HOME LOAN UNDERWRITING

Finding: **We identified the following underwriting errors.**

DTI Calculation Deficiencies

We noted 17 errors (9 percent) in calculating DTI ratios. DTI errors resulted from omission of expenses, errors in the qualifying rate or tax and insurance amounts used, and unsupported income. Files contained errors that were both favorable and unfavorable to the borrower, with some files containing offsetting errors. Loans with DTI errors were distributed equally amongst the loan origination channels.

Inadequate Title Insurance Coverage

Our review of the 67 negative amortization loan files disclosed that 46 failed to request adequate title insurance coverage at origination. While post closing caught a few of the loans, it appears the remaining loans never received adequate coverage. Management has indicated that in the event adequate coverage is not obtained, the Bank has blanket coverage that covers the short fall but we were unable to verify that. Our position is that the Bank should be requesting and requiring sufficient title insurance coverage at origination, sufficient to cover the entire potential negative amortization amount. This issue was noted in OTS Memo 15 (2005); however, the corrective action failed to address the problem. The corrective action required that the MLCS system be updated to reflect the correct negative amortization percent but that does not ensure that adequate title insurance coverage is obtained. Management indicated that on April 10, 2006, the Bank adopted a policy that requires title insurance coverage to equal the loan's full negative amortization potential. We did not have an opportunity to test for compliance with this new policy.

Borrower Income not Adequately Supported

We noted five instances (3 percent) where borrower income was not supported. These included failure to verify income on a Full-Doc loan, failure to obtain a rental agreement, failure to discuss reasonableness of stated income, and apparent errors in calculation.

Loan Approval – Exception Basis

We noted a lack of sufficient mitigating factors for approving loans that were exceptions to policy. For example, we noted a failure to document reasons why a borrower was allowed $13,000 cash-out on a "no cash-out" refinance. We also noted a high-level loan approval to a borrower with a housing ratio of 40 percent and total debt ratio of 72 percent. There was no discussion of compensating factors for the exception to policy on the LAS.

Documentation Errors

We noted documentation errors in five loan files (3 percent), including missing power of attorney,

EXAM FINDING 1	☐ Observation	☑ Recommendation	☐ Criticism

missing pages of the note, a stale appraisal, and failure to document compliance with the conditions of loan approval. There was no evidence in two files that loans were paid off, which was a required condition for approval of the loans.

Failure to Comply with Septic and Well Requirements on Custom Construction

Four of ten (40 percent) lot loans reviewed failed to comply with policy requirements regarding septic tanks and wells. Management indicated in some cases that the requirements had been waived; however, there was no discussion of the reasons for waiver on the LAS.

LAS Worksheet Errors

Forty-six (25 percent) of the loans sampled had LAS worksheet errors. In 41 instances, the correct qualifying rate was not reported on the LAS worksheet; instead, a rate of 0.0 percent was reported. The remaining 5 errors were related to: (1) start and qualifying rates being overstated, (2) debt amount incorrectly reported, and (3) inaccurate appraisal value.

Action:

- Continue current monitoring and efforts to improve underwriting and reduce error rates, particularly with respect to DTI calculations, rental income, and documentation of compensating factors for exceptions to policy.
- Ensure compliance with the April 10, 2006, policy requiring adequate title insurance on negative amortization loans.
- Continue to monitor the LAS for completion, accuracy, and to ensure that all conditions are sufficiently addressed.
- Continue post-funding transaction testing at the business unit and Loan Fulfillment Centers to ensure progress in improving underwriting and measurement of that progress.

Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree **X Partially Agree** ☐ Disagree **Enter Target Date: [3/31/07]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management partially agrees with this finding.

Quality Underwriting has been and will continue to be a top priority and focus for the Bank. We feel that significant progress has been made in this area evident by the results of our own ongoing loan file review process, internal audits, and the file reviews completed in conjunction with this Safety & Soundness exam.

In 2005 we established target goals for our DTI error rates of 10% by June 2006 and 5% by December 2006. Our internal reporting shows that we are meeting this goal and we are on track to be below 5% in advance of our December target date. It was noted in the finding memo that the Safety & Soundness loan file review found a 3% occurrence where the borrower's income was not supported. While it is our policy to ensure that borrower income is supported, a 3% error rate is within our established DTI error rate target of 5%. We feel that our existing DTI tracking and reporting effectively identifies instances where borrower income is not properly supported.

The deficiency regarding the use of our Loan Approval Summary (LAS) form where the incorrect qualifying rate is being reflected on the form is a result of a MLCS system issue. The Bank has decided that we will not allocate resources to a MLCS system enhancement due to our upcoming migration to Palisades. In advance of our migration to Palisades, we have implemented a manual work around that we will continue to use until the migration. Of the 46 loans identified with LAS worksheet errors, 41 were due to this system error. Although the LAS reflected the incorrect rate, the borrower was qualified at the correct rate. While we do agree that the LAS should reflect the correct rate, this issue poses no material risk to the Bank. The remaining 5 loans with LAS errors reflect a 2.7% error rate based upon the 186 loans reviewed. We feel that this error rate is within tolerance levels, any material errors such as incorrect qualifying rates or DTI errors on the LAS will be identified through our existing DTI monitoring and reporting. In addition to the LAS errors above, two individual loans were identified where the LAS did not reflect the compensating factors that allowed for exception approval. We do feel that exception documentation is important and we will be reinforcing this policy with our Underwriting staff. Due to our desire to track and monitor exception approvals, in addition to notating exception approvals on the LAS, we currently enter all exceptions into our Loan Tracking Database for tracking purposes.

EXAM FINDING 1	☐ Observation	☑ Recommendation	☐ Criticism

We do not feel that the documentation errors cited within the finding memo, 3%, warrant a change to our existing process due to the low error rate. The post-funding transaction testing previously done by CRO and CQT will continue and be managed by the Home Loans Credit Review group. ~~We believe that these loan file and quality reviews will identify and~~ prevent any substantial risks resulting from these types of errors and others that impact underwriting and loan file quality.

While the ordering of Title Insurance is not a function of our Underwriting department, we do agree that there were deficiencies in our process. On April 6, 2006 Home Loans Policy Announcement (HLPA) 06-090 - Title Insurance Coverage for Negative Amortization Loans was issued. The purpose of this policy communication was to clarify the title insurance policy requirements for negative amortization loans.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Continue to monitor and track our DTI error rates to ensure that we meet our established target of 5% error rate by December 2006 (Note: The December 2006 DTI results will be available in March 2007). **Responsible Manager:** Mark Brown, **Target Date:** 3/31/07
2. Provide clarification and reinforcement to our Underwriting staff regarding proper documentation of exception approvals and qualifying rates on the LAS. **Responsible Manager:** Mark Brown, **Target Date:** 10/31/06
3. Complete a review of our existing septic tank and well waiver policy for Lot Loans and publish a reiteration or clarification of policy as deemed necessary by the review. **Responsible Manager:** Mark Brown, **Target Date:** 10/31/06
4. Validate the effectiveness of HLPA 06-090 through our existing loan file review process to ensure that appropriate title insurance coverage is being ordered on negative amortization loans. **Responsible Manager:** Arlene Hyde, Steve Stein, & John Schleck, **Target Date:** 12/31/06

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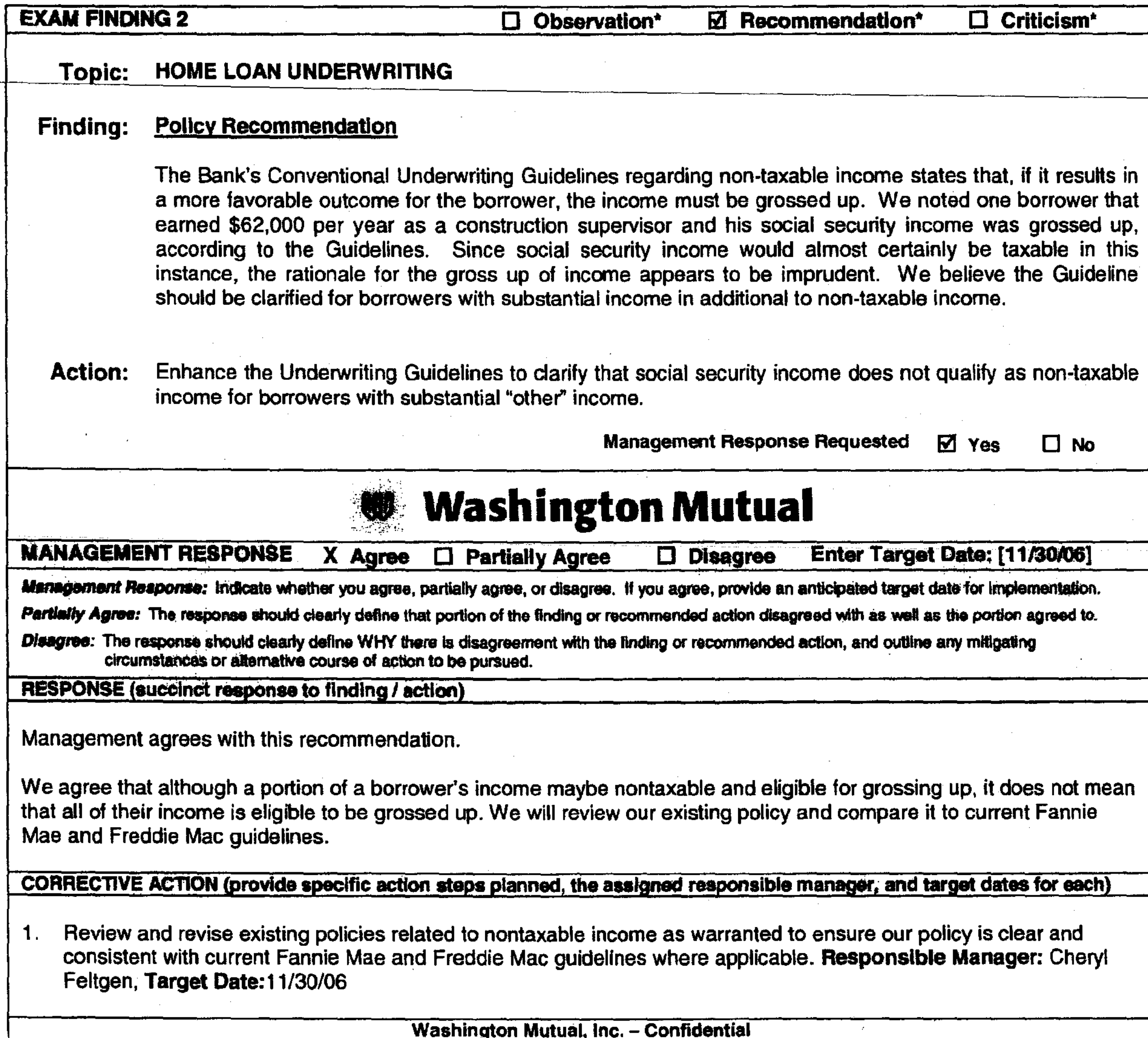

EXAM FINDING 2	☐ Observation* ☑ Recommendation* ☐ Criticism*
Topic:	HOME LOAN UNDERWRITING
Finding:	**Policy Recommendation** The Bank's Conventional Underwriting Guidelines regarding non-taxable income states that, if it results in a more favorable outcome for the borrower, the income must be grossed up. We noted one borrower that earned $62,000 per year as a construction supervisor and his social security income was grossed up, according to the Guidelines. Since social security income would almost certainly be taxable in this instance, the rationale for the gross up of income appears to be imprudent. We believe the Guideline should be clarified for borrowers with substantial income in additional to non-taxable income.
Action:	Enhance the Underwriting Guidelines to clarify that social security income does not qualify as non-taxable income for borrowers with substantial "other" income. Management Response Requested ☑ Yes ☐ No

Washington Mutual

MANAGEMENT RESPONSE X Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [11/30/06]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with this recommendation.

We agree that although a portion of a borrower's income maybe nontaxable and eligible for grossing up, it does not mean that all of their income is eligible to be grossed up. We will review our existing policy and compare it to current Fannie Mae and Freddie Mac guidelines.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Review and revise existing policies related to nontaxable income as warranted to ensure our policy is clear and consistent with current Fannie Mae and Freddie Mac guidelines where applicable. **Responsible Manager:** Cheryl Feltgen, **Target Date:** 11/30/06

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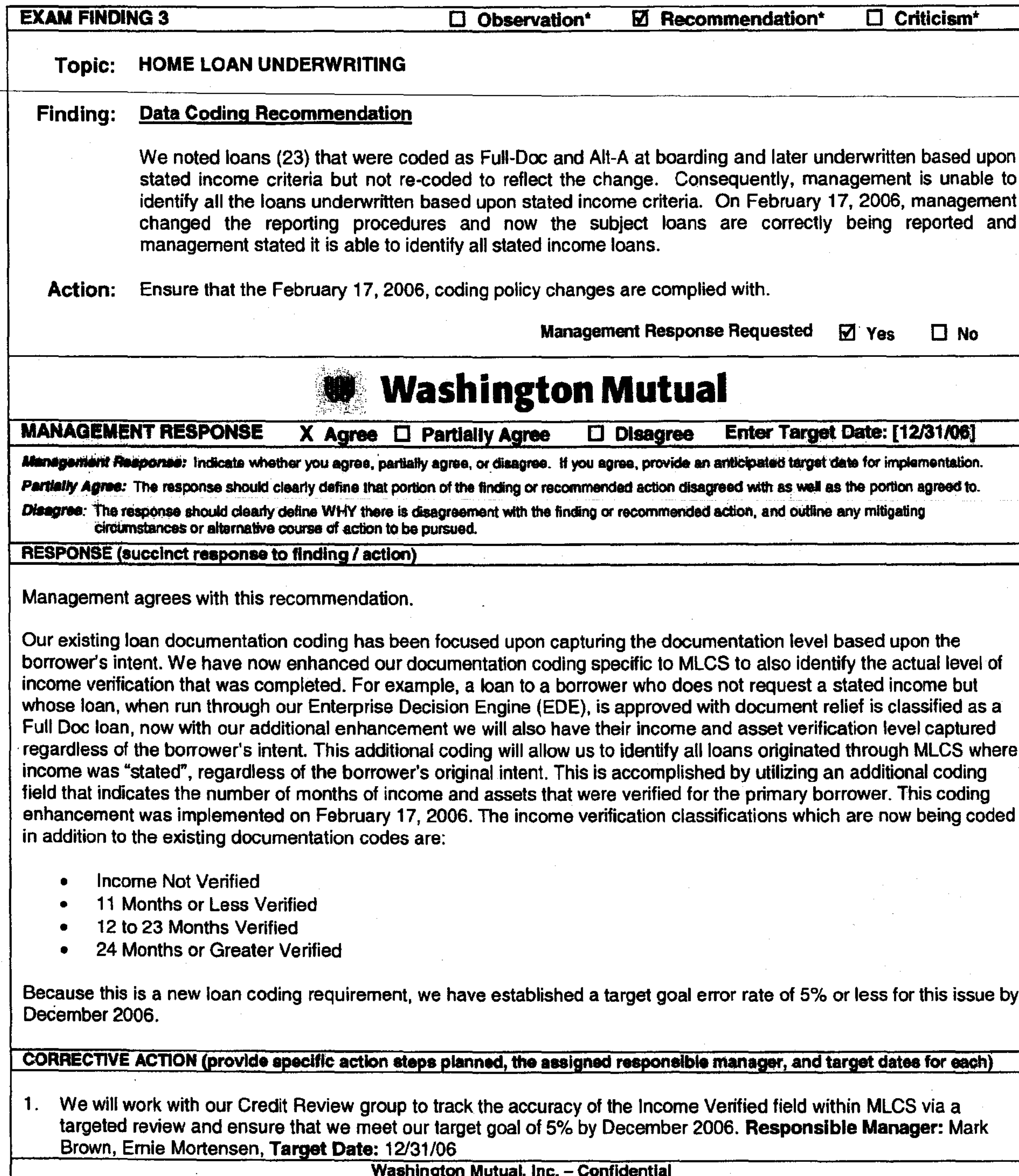

EXAM FINDING 3 ☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: **HOME LOAN UNDERWRITING**

Finding: **Data Coding Recommendation**

We noted loans (23) that were coded as Full-Doc and Alt-A at boarding and later underwritten based upon stated income criteria but not re-coded to reflect the change. Consequently, management is unable to identify all the loans underwritten based upon stated income criteria. On February 17, 2006, management changed the reporting procedures and now the subject loans are correctly being reported and management stated it is able to identify all stated income loans.

Action: Ensure that the February 17, 2006, coding policy changes are complied with.

Management Response Requested ☑ Yes ☐ No

Washington Mutual

MANAGEMENT RESPONSE X Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [12/31/06]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with this recommendation.

Our existing loan documentation coding has been focused upon capturing the documentation level based upon the borrower's intent. We have now enhanced our documentation coding specific to MLCS to also identify the actual level of income verification that was completed. For example, a loan to a borrower who does not request a stated income but whose loan, when run through our Enterprise Decision Engine (EDE), is approved with document relief is classified as a Full Doc loan, now with our additional enhancement we will also have their income and asset verification level captured regardless of the borrower's intent. This additional coding will allow us to identify all loans originated through MLCS where income was "stated", regardless of the borrower's original intent. This is accomplished by utilizing an additional coding field that indicates the number of months of income and assets that were verified for the primary borrower. This coding enhancement was implemented on February 17, 2006. The income verification classifications which are now being coded in addition to the existing documentation codes are:

- Income Not Verified
- 11 Months or Less Verified
- 12 to 23 Months Verified
- 24 Months or Greater Verified

Because this is a new loan coding requirement, we have established a target goal error rate of 5% or less for this issue by December 2006.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. We will work with our Credit Review group to track the accuracy of the Income Verified field within MLCS via a targeted review and ensure that we meet our target goal of 5% by December 2006. **Responsible Manager:** Mark Brown, Ernie Mortensen, **Target Date:** 12/31/06

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From: Schneider, David C. <david.schneider@wamu.net>
Sent: Wednesday, May 31, 2006 2:56 PM
To: Brown, Mark J. <mark.brown@wamu.net>
Subject: RE: OTS Memo 12 -- Home Loans Underwriting

I'll bet you're a happy guy!!! Well done.

ds

-----Original Message-----
From: Brown, Mark J.
Sent: Wednesday, May 31, 2006 8:09 AM
To: Mortensen, Ernie; Case, Lori K.; Pad, Robert L.
Cc: Feltgen, Cheryl A.; Schneider, David C.
Subject: Fw: OTS Memo 12 -- Home Loans Underwriting

Ernie, Lori, and Robert

Couldn't have done it without your partnership.
Thanks to you and the whole cqt team
.Mark J. Brown
Sr. Manager, Mortgage Banking-National Underwriting
Washington Mutual Consumer Group
(630) 437-7774

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Sent from my BlackBerry Wireless Handheld

-----Original Message-----
From: Pollack, Wayne A.
To: Schneider, David C.; Feltgen, Cheryl A.
CC: Plyler, Pamela J.; Brown, Mark J.; Healan, Joe J.; Lee, Doreen; Parres, Crystal
Sent: Tue May 30 14:36:59 2006
Subject: FW: OTS Memo 12 -- Home Loans Underwriting

Good news – John was able to get the OTS to see the light and revise the Underwriting rating to a Recommendation. Our response is already complete.

Wayne Pollack
SVP, Home Loans-Strategic Operations
Washington Mutual
(630) 437-8982

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-----Original Message-----
From: Pollack, Wayne A.
Sent: Tuesday, May 30, 2006 4:36 PM
To: Robinson, John; Domer, Jake; Zarro, Michael R.; Fierling, Jennifer
Cc: Doperalski, Cathy L.
Subject: RE: OTS Memo 12 -- Home Loans Underwriting

John – Thank you for your support on this, the underwriting team that has worked so hard to obtain the current run rate results will appreciate getting the OTS to recognize the progress.

Wayne Pollack
SVP, Home Loans-Strategic Operations
Washington Mutual
(630) 437-8982

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-----Original Message-----
From: Robinson, John
Sent: Tuesday, May 30, 2006 4:31 PM
To: Pollack, Wayne A.; Domer, Jake; Zarro, Michael R.; Fierling, Jennifer
Cc: Doperalski, Cathy L.
Subject: OTS Memo 12 -- Home Loans Underwriting
Importance: High

OTS confirmed today that they will re-issue this memo without the 'Criticism.' It will be a 'Recommendation.' Due to technological difficulties, the re-issue may not happen for a few days.

John
(206)490-6100

8551
90.10

WMB, WMBfsb
March 13, 2006
Safety & Soundness Examination
OTS Memo 9

DATE: May 25, 2006
TO: Michael Giampaolo, President Long Beach Mortgage
FROM: Gail A. Croil and Mark Reiley, OTS Examiners
SUBJECT: Loan Underwriting Review – Long Beach Mortgage
CC: Amy Marcussen, Operations Manager
David Schneider, President Home Loans
Cathy Doperalski, Regulatory Relations
Steve Funaro, FDIC

BACKGROUND INFORMATION

We reviewed 87 newly originated loans to assess Long Beach Mortgage Company's (LBMC) compliance with bank underwriting policy and regulatory safety and soundness guidelines as well as to assess the progress made in addressing underwriting weaknesses (criticisms) noted in our 2005 OTS Field Visit Update Memo 1. The loan sample was comprised of the following:

- 25 loans selected randomly from loans funded between November 2005 and January 2006;
- 25 stated income loans selected randomly from loans funded between November 2005 and January 2006;
- 27 high loan-to-value (LTV)/low FICO loans selected judgmentally from loans funded between November 2005 and January 2006; and
- 10 stated income loans selected judgmentally from loans originated during March 2006.

We categorized our findings as:

- Exception Loans – Generally, these loans have such significant deficiencies that we consider them unsafe and unsound. These are loans that probably should not have been made on the terms that the loan was granted. Any Exception in a small random sample will generally lead us to conclude overall that underwriting is less than satisfactory.
- Other Loans with Underwriting Deficiencies – These are loans with elevated risk due to underwriting deficiencies. Depending on the nature of the deficiencies, a significant number of loans of this type could also lead us to consider that underwriting is less than satisfactory.

It is clear from our review that management has made diligent efforts to address previously identified weaknesses and, in fact, progress has been made in addressing and reducing the levels of certain types of underwriting errors noted in OTS Field Visit Update Memo 1 and at the 2005 examination. Specifically, we noted that underwriters better document and support the reasonableness of stated income, better acknowledge payment shocks, and better identify compensating factors that help mitigate risk. While acknowledging this improvement, our review disclosed that further improvement is still necessary.

Overall, we concluded that the number and severity of underwriting errors noted remain at higher than acceptable levels. Specifically, 26 of the 87 loans reviewed (30 percent) had at least one credit related error that occurred more than once in the sample population. The most prevalent outcome of the errors was miscalculation of DTI ratios (22 percent). We also noted in the loans reviewed that 14 percent exceeded LBMC's approval guidelines after errors were corrected. Of the loans reviewed, the most prevalent errors were: Underwriting Decision Summary (UDS) worksheets failed to provide adequate information or clarification to fully support the credit decision (8 percent), rental income errors (6 percent), and inadequate explanation of the reasonableness of income for stated income loans (5 percent).

We noted that our review results varied depending on the sample selected. We tend to place more emphasis on random samples but augment these with judgmental samples as well. Our random sample of 25 held for sale (HFS) loans disclosed 6 loans (24 percent) with various deficiencies. Our random sample of 25 HFS stated income loans disclosed 6 loans (24 percent) with deficiencies, with one loan considered an Exception. While our random samples appeared to show somewhat improved results, our judgmental sample results were not as positive. In our judgmental sample of 27

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Permanent Subcommittee on Investigations
EXHIBIT #35

OTSWMS06-008 0001243

low FICO/high LTV loans, we noted 10 loans (37 percent) with deficiencies, two of which were considered Exceptions. These judgmental sample results are of particular concern since loans with combined low FICO/high LTV risk layering is an area where underwriting should be more stringent. Any errors with these borrowers are likely to push them outside LBMC's underwriting guidelines for DTI ratios. At any rate, our results indicate that loans in this category require closer scrutiny. Our final judgmental sample of 10 stated income loans disclosed deficiencies in 4 loans (40 percent). No exceptions were identified in this sample.

The level of exceptions, as well as the high occurrence of deficiencies in our samples, particularly in our judgmental samples, led us to conclude that LBMC's underwriting practices remain less than satisfactory.

In addition to noting the underwriting weaknesses, we also made recommendations to enhance underwriting policy and procedures.

We concluded that management implemented the corrective actions agreed upon at the last examination and field visit. While we obviously believe that underwriting problems remain, we believe that the issues discussed in this memo supercede those discussed in our field visit update memo, and would not object to Regulatory Relations closing out the issues in that prior memo.

EXAM FINDINGS DEFINITIONS

Observation:	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation:	A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.
Criticism:	A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

EXAM FINDING 1 ☐ **Observation** ☐ **Recommendation** ☑ **Criticism**

Topic: **LBMC LOAN UNDERWRITING**

Finding: **The following categorizes loans by Exception Loans and Other Loans with Underwriting Deficiencies and outlines the underwriting deficiencies.**

A. Exceptions Loans

One loan in our random sample of 25 stated income loans was considered an Exception because the broker resubmitted the application, 1003, for a stated income loan with an increased amount of stated income. This is contrary to underwriting guidelines and requires disciplinary action. **Two of the loans in our judgmental sample were considered Exceptions because DTI ratios recalculated by examiners were significantly beyond LBMC's guidelines.**

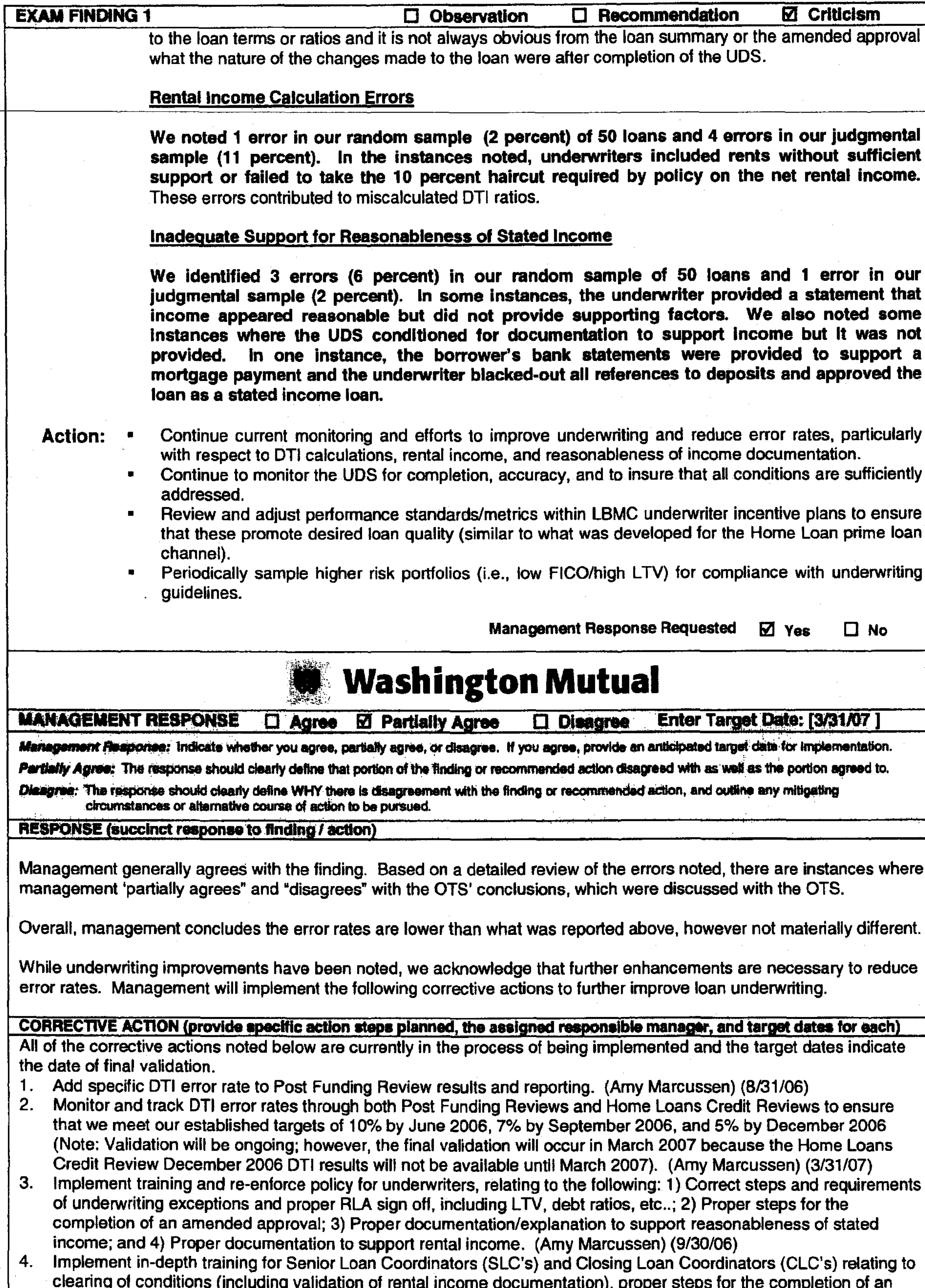
B. Other Loans with Underwriting Deficiencies

Miscalculated DTI Ratios

We noted 8 loans with miscalculated DTI Ratios (16 percent) in our random sample of 50 loans. We noted an additional 11 loans with DTI ratios miscalculated in our judgmental sample of 37 loans (30 percent). The miscalculations resulted from a variety of factors such as including income that was not supported or verified, exclusion of secondary purchase money financing or other debts, failure to verify income as required by the underwriting guidelines, and adjustments required for rental income.

Clarification of information on UDS

We noted 3 errors (6 percent) in our random sample of 50 loans and an additional 3 errors in our judgmental sample of 37 loans (8 percent). The UDS comment sections do not always provide sufficient explanation to explain the underwriter's analysis and mitigating factors that fully support decisions made outside of underwriting guidelines. The UDS is not updated to reflect the final changes



EXAM FINDING 1 ☐ Observation ☐ Recommendation ☑ Criticism

to the loan terms or ratios and it is not always obvious from the loan summary or the amended approval what the nature of the changes made to the loan were after completion of the UDS.

Rental Income Calculation Errors

We noted 1 error in our random sample (2 percent) of 50 loans and 4 errors in our judgmental sample (11 percent). In the instances noted, underwriters included rents without sufficient support or failed to take the 10 percent haircut required by policy on the net rental income. These errors contributed to miscalculated DTI ratios.

Inadequate Support for Reasonableness of Stated Income

We identified 3 errors (6 percent) in our random sample of 50 loans and 1 error in our judgmental sample (2 percent). In some instances, the underwriter provided a statement that income appeared reasonable but did not provide supporting factors. We also noted some instances where the UDS conditioned for documentation to support income but it was not provided. In one instance, the borrower's bank statements were provided to support a mortgage payment and the underwriter blacked-out all references to deposits and approved the loan as a stated income loan.

Action:

- Continue current monitoring and efforts to improve underwriting and reduce error rates, particularly with respect to DTI calculations, rental income, and reasonableness of income documentation.
- Continue to monitor the UDS for completion, accuracy, and to insure that all conditions are sufficiently addressed.
- Review and adjust performance standards/metrics within LBMC underwriter incentive plans to ensure that these promote desired loan quality (similar to what was developed for the Home Loan prime loan channel).
- Periodically sample higher risk portfolios (i.e., low FICO/high LTV) for compliance with underwriting guidelines.

Management Response Requested ☑ Yes ☐ No

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MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [3/31/07]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management generally agrees with the finding. Based on a detailed review of the errors noted, there are instances where management 'partially agrees" and "disagrees" with the OTS' conclusions, which were discussed with the OTS.

Overall, management concludes the error rates are lower than what was reported above, however not materially different.

While underwriting improvements have been noted, we acknowledge that further enhancements are necessary to reduce error rates. Management will implement the following corrective actions to further improve loan underwriting.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

All of the corrective actions noted below are currently in the process of being implemented and the target dates indicate the date of final validation.

1. Add specific DTI error rate to Post Funding Review results and reporting. (Amy Marcussen) (8/31/06)
2. Monitor and track DTI error rates through both Post Funding Reviews and Home Loans Credit Reviews to ensure that we meet our established targets of 10% by June 2006, 7% by September 2006, and 5% by December 2006 (Note: Validation will be ongoing; however, the final validation will occur in March 2007 because the Home Loans Credit Review December 2006 DTI results will not be available until March 2007). (Amy Marcussen) (3/31/07)
3. Implement training and re-enforce policy for underwriters, relating to the following: 1) Correct steps and requirements of underwriting exceptions and proper RLA sign off, including LTV, debt ratios, etc..; 2) Proper steps for the completion of an amended approval; 3) Proper documentation/explanation to support reasonableness of stated income; and 4) Proper documentation to support rental income. (Amy Marcussen) (9/30/06)
4. Implement in-depth training for Senior Loan Coordinators (SLC's) and Closing Loan Coordinators (CLC's) relating to clearing of conditions (including validation of rental income documentation), proper steps for the completion of an

EXAM FINDING 1	☐ Observation	☐ Recommendation	☑ Criticism

amended approval and impacts to the loan file. (Amy Marcussen) (9/30/06)

5. Monitor results of training and policy re-enforcement through ongoing Post Funding Review and Home Loans Credit Review results and provide ongoing feedback and additional training as necessary. (Amy Marcussen) (12/31/06)
6. Conduct targeted Post Funding Reviews quarterly for higher-risk loans (i.e. Low FICO/High LTV), starting in 3rd quarter 2006. (Amy Marcussen) (12/31/06)
7. Provide ongoing feedback and training, as necessary, for deficiencies noted in targeted Post Funding Reviews on higher-risk loans. (Amy Marcussen) (12/31/06)
8. Review Long Beach underwriting incentive plans and make changes or enhancements as deemed necessary to further promote desired loan quality. (Amy Marcussen) (1/31/07)

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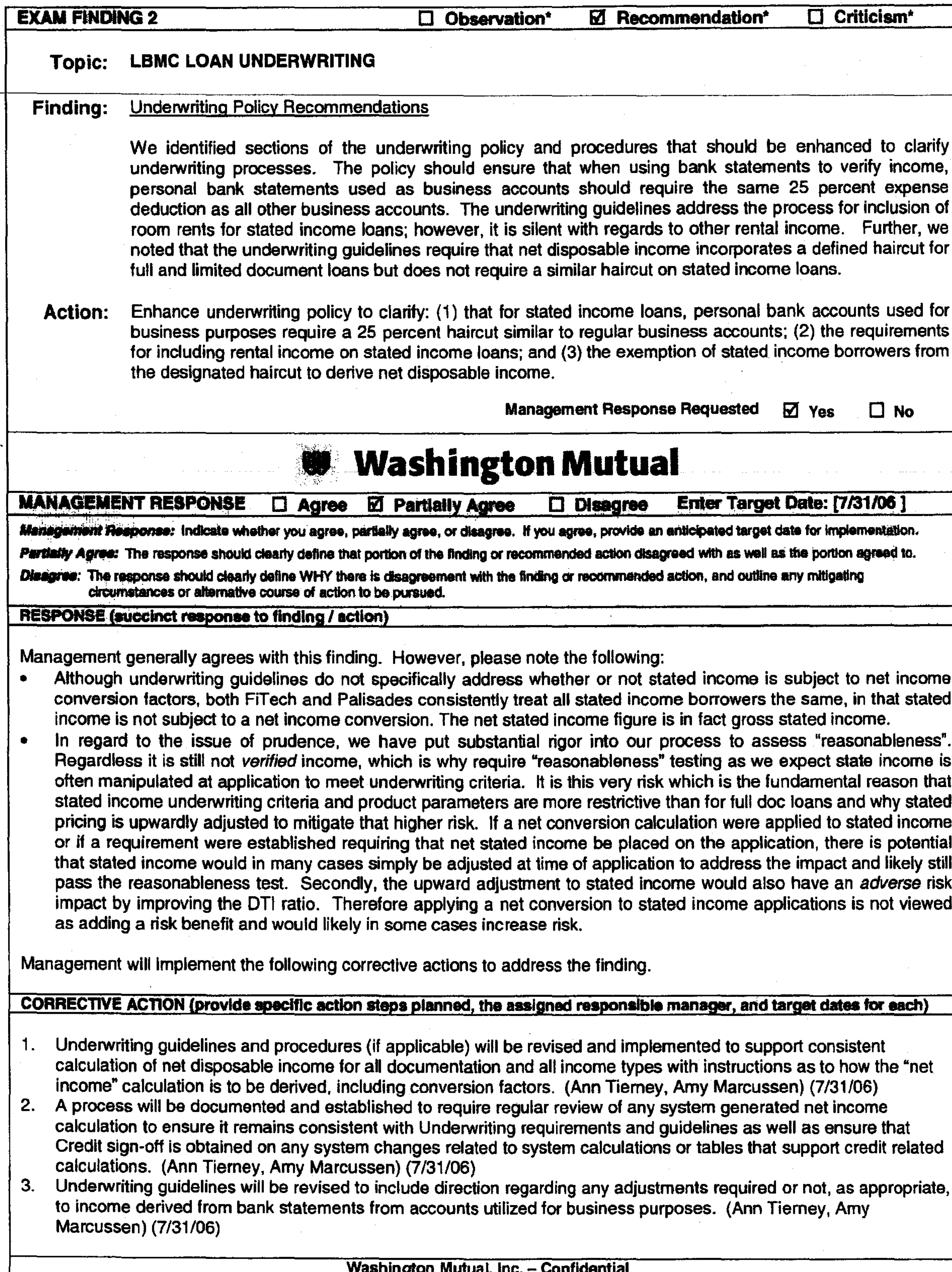

EXAM FINDING 2 ☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: **LBMC LOAN UNDERWRITING**

Finding: Underwriting Policy Recommendations

We identified sections of the underwriting policy and procedures that should be enhanced to clarify underwriting processes. The policy should ensure that when using bank statements to verify income, personal bank statements used as business accounts should require the same 25 percent expense deduction as all other business accounts. The underwriting guidelines address the process for inclusion of room rents for stated income loans; however, it is silent with regards to other rental income. Further, we noted that the underwriting guidelines require that net disposable income incorporates a defined haircut for full and limited document loans but does not require a similar haircut on stated income loans.

Action: Enhance underwriting policy to clarify: (1) that for stated income loans, personal bank accounts used for business purposes require a 25 percent haircut similar to regular business accounts; (2) the requirements for including rental income on stated income loans; and (3) the exemption of stated income borrowers from the designated haircut to derive net disposable income.

Management Response Requested ☑ Yes ☐ No

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MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [7/31/06]**

Management Response: **Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.**

Partially Agree: **The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.**

Disagree: **The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.**

RESPONSE (succinct response to finding / action)

Management generally agrees with this finding. However, please note the following:

- Although underwriting guidelines do not specifically address whether or not stated income is subject to net income conversion factors, both FiTech and Palisades consistently treat all stated income borrowers the same, in that stated income is not subject to a net income conversion. The net stated income figure is in fact gross stated income.
- In regard to the issue of prudence, we have put substantial rigor into our process to assess "reasonableness". Regardless it is still not *verified* income, which is why require "reasonableness" testing as we expect state income is often manipulated at application to meet underwriting criteria. It is this very risk which is the fundamental reason that stated income underwriting criteria and product parameters are more restrictive than for full doc loans and why stated pricing is upwardly adjusted to mitigate that higher risk. If a net conversion calculation were applied to stated income or if a requirement were established requiring that net stated income be placed on the application, there is potential that stated income would in many cases simply be adjusted at time of application to address the impact and likely still pass the reasonableness test. Secondly, the upward adjustment to stated income would also have an *adverse* risk impact by improving the DTI ratio. Therefore applying a net conversion to stated income applications is not viewed as adding a risk benefit and would likely in some cases increase risk.

Management will implement the following corrective actions to address the finding.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Underwriting guidelines and procedures (if applicable) will be revised and implemented to support consistent calculation of net disposable income for all documentation and all income types with instructions as to how the "net income" calculation is to be derived, including conversion factors. (Ann Tierney, Amy Marcussen) (7/31/06)
2. A process will be documented and established to require regular review of any system generated net income calculation to ensure it remains consistent with Underwriting requirements and guidelines as well as ensure that Credit sign-off is obtained on any system changes related to system calculations or tables that support credit related calculations. (Ann Tierney, Amy Marcussen) (7/31/06)
3. Underwriting guidelines will be revised to include direction regarding any adjustments required or not, as appropriate, to income derived from bank statements from accounts utilized for business purposes. (Ann Tierney, Amy Marcussen) (7/31/06)

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Dochow, Darrel W

From: Carter, Lawrence D
Sent: Friday, June 09, 2006 9:22 AM
To: Dochow, Darrel W
Cc: Franklin, Benjamin D; Kuczek, Richard A
Subject: RE: Findings memos

Sensitivity: Private

I can conference in on June 15 afternoon or any time on the 16th, but I am fine if you want to do this without me. You probably want to get Mark Reiley and maybe even Gail Croil's input on LBMC. We apparently had another meeting on response to our LBMC findings, and I don't know the results. I am not sure the perspective on LBMC is entirely accurate. The original commitment was to follow through with action plans that we accepted and all believed would result in improvement. And I believe we concluded there has been tremendous effort put forth on the promised actions and that there has been improvement on many fronts (fair lending was an issue too, which we are now satisfied they have under control). Our findings are similar in some ways, but I don't think we can just simply say "you made a commitment and haven't kept it." I think 90 days to get a completely acceptable exception rate may also be unrealistic, although they should be able to implement additional corrective actions within 90 days. I think we need to focus on making sure they get their own stable process in place to be self-correcting, including a targeted exception threshold, and then make sure that the process is effective in bringing down the exception rate. I think at this point they do have a process that is working somewhat, but they are still fine-tuning the process itself, which includes more alignment with Home Loans in general as well as fine-tuning the division of responsibilities between pre- and post-funding review groups and Corporate Credit Review, and what those groups are specifically looking at. They also need to align incentives with quality, which I believe is on their "to do" list. Some of this will involve systems changes, so will take some time. They also continue to fine-tune exception identification and reporting, and we need to work ourselves to be sure WAMU's self-identification of exceptions is consistent with ours. I still believe we should assess their action plan response to the memo, including timeframes, and set a date based on those timeframes when we should come back in and test. I also believe we should ask them to control growth at LBMC until things are improved further.

Bottom line is I asked "how hard our hammer should be," and did not get the impression from the examiners that this was a case where management did the minimal amount of work necessary to get by. My understanding is they are continuing to work very hard on LBMC underwriting and getting LBMC more aligned with the practices in Home Loans in general. This is all my assessment, of course, and I wholeheartedly recommend talking directly to the examiners involved in the LBMC review. We want the message to be right!

Also, as of now, we are focused on economic capital/BASEL, consumer lending and credit scoring during the fall and don't have a loan review of LBMC scheduled, although we will certainly follow up on internal tracking of LBMC improvements and we are looking at the Corporate Credit Review process. We could still think about working in a small LBMC loan review if we think it is appropriate. We can discuss this, but keep in mind we are trying to avoid doing multiple follow-up reviews, which could end up increasing total exam hours for a continuous exam cycle. We instead are trying to give enough time for management to get things fixed before we come in and look at a particular area again. I don't think we are so concerned with LBMC that we think an immediate follow-up is necessary, especially if it is not growing.

Broader perspective is all the things they have been doing right in the bank. LBMC is an important "corner," but it is a "corner." I think most, maybe not all, examiners will attest to the massive amount of corrective work that has been going on in the bank, the result of which is very few significant findings.

-----Original Message-----
From: Dochow, Darrel W
Sent: Friday, June 09, 2006 7:40 AM
To: Kuczek, Richard A; Carter, Lawrence D; Franklin, Benjamin D
Subject: Findings memos
Importance: High
Sensitivity: Private

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If possible, I would like an electronic set of the final re-numbered findings memos emailed to me and Mike Finn. Lawrence provided me with a hard copy set prior to the re-numbering.

I also want to discuss with you, prior to out pre-exits with executives, what will be discussed as the MRBA, whether

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some of our findings are in reality continuations of similar exceptions from past examinations, and how best to communicate the expectation that exceptions at LBMC have gone on too long and we expect prompt correction such that a 90 day follow-up will confirm correction. We gave them the benefit of doubt based on commitments and some progress when we allowed them to bring LBMC into the bank, but if I am understanding the findings from this exam correctly, we have the same type of concerns remaining 6 months later.

I believe that we should also brainstorm about what we want to communicate as expectations for the organization and especially ERM. My impression is that management is feeling that everything is going well except for the slip up in the flood determination area.

The fact that John Robinson is wanting to meet to discuss our citing the flood matter as a violation in the ROE has me wondering if they are back peddling.

I know that Lawrence is tied up with MDP and TC next week, but I would like to start discussions with Ben and Rich if possible and then re-group with everyone the following week on June 19 or 20. I am currently in the office June 12, 14, 15, 16, 19 and 20 if any of those days work for a discussion.

Let me know what works for you.

thanks,

Darrel

WMB, WMBfsb
March 5, 2007
Consumer Compliance Examination
OTS COMPLIANCE MEMO 7

DATE: May 31, 2007
TO: Dick Stevenson, Corporate Compliance Officer
FROM: Susie Clark, OTS Compliance Specialist
SUBJECT: Compliance Management Program
CC: Cathy Doperalski, Regulatory Relations

BACKGROUND INFORMATION

LACK OF STABLE LEADERSHIP

WaMu's compliance management program has suffered from a lack of steady, consistent leadership. Dick Stevenson, who took over as Chief Compliance Officer on March 2, 2007, is the bank's ninth compliance leader in ten years (according to OTS rough estimates). The previous compliance officer, Richard Lewis, was in the position for less than a year and he left the bank without having secured a position elsewhere. Most previous persons in this position have either left the institution or been fired. The OTS is concerned that this lack of consistent, stable leadership leaves the program vulnerable. The amount of turnover in the Chief Compliance Officer is very unusual and is a cause for concern, especially in an institution of WaMu's size. The Board of Directors should commission an evaluation of why competent and effective managers have not remained. The evaluation should consider the potential impact on turnover of the following reasons, (among others): (1) unclear lines of authority and responsibility between the business lines and corporate compliance, (2) lack of support for the compliance function by senior management, (3) inadequate compliance staff resources, (4) insufficiently delineated compliance roles, responsibilities and mission, (5) inappropriate response of senior management to unfavorable compliance findings.

LEGAL REQUIREMENTS IN THE CONTEXT OF RISK MANAGEMENT

While it is crucial that management understands its legal obligations and that mechanisms are put in place to ensure that mandatory benchmark is met, management of the compliance function also requires judgment to balance the needs of the customers, the bank's resources and profitability goals, regulatory relations, and the risks to the bank's reputation when making decisions. Managing a compliance program to meet the bare minimums of legal responsibility is not a hallmark of a good compliance program. While certain bank executives have stated to regulators that "reputation risk" is a primary concern of the organization as a whole and that they are an industry leader and expect to be "Best in Class," the compliance department mission seems to be only to comply with the minimum of the law. Despite several efforts by OTS examiners to highlight potential "reputation risk" issues, it has been made clear in several cases that they do not plan to implement recommendations or guidance to enhance customer service or disclosures "unless we plan to cite a violation." We do not consider this position within Corporate Compliance to represent "Best Practices," which is the expectation of the OTS for a high-profile, large institution.

The risk landscape has changed for banks in the past few years. Fair Lending and compliance risks, including HMDA pricing data, subprime lending, predatory lending, non-traditional ARM lending, increased citations of the Unfair and Deceptive Acts and Practices (UDAP) law, BSA/AML, flood insurance civil money penalties, and congressional scrutiny of credit card practices, have increased in the past few years. Other sources of risk proliferation comes from the new legislative developments, discussions raised during the presidential campaign, increased regulatory scrutiny and "guidance", consumer advocates, state attorneys general, litigation, HUD, the media, and the internet. Risks are evolving from "black and white" (are we in legal compliance?) to various shades of gray.

Instead of simply asking whether or not the bank is in strict compliance with the laws and regulations, management should also be asking "Is this disclosure or practice abusive, predatory, unfair, deceptive, or unsuitable"? "Is it clear, understandable, and transparent to the customer?" "Are we taking a leading role in developing "Best Practice" disclosures, practices, and customer service goals?" The line between legal and illegal should not solely determine the standard of acceptability. The standard should be about managing risk and understanding risk in terms of bank reputation, as well as industry reputation due to this bank's high-profile role. The focus should be on fairness, clarity, transparency, and customer service, not mere technical compliance. To be most effective, change must come from the top of the organization and permeate the corporate culture.

Permanent Subcommittee on Investigations
EXHIBIT #37

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One example of balancing risk is the early Truth-in-Lending disclosure. WaMu does not consider accuracy problems in the early Truth in Lending disclosures to be a significant problem "since it is not reimburseable" despite evidence that there is a problem in this area and several requests from the OTS over the years to improve the disclosures and to monitor the quality of these disclosures. Yet, compliance management's risk assessment update to ERMC regarding the good faith estimate situation states, "Per VOCALS, upfront accurate fee disclosure is our Home Loans customer's primary concern. Inaccurate disclosure may cause customer dissatisfaction, increased complaints, and reputation damage. Also, there is a potential for regulatory criticism if not corrected." If the customer is concerned about upfront accurate fee disclosure, it seems logical that they would also be concerned about early disclosure of accurate APRs, payments streams, finance charges, prepayment penalties, etc. While management claims that there is no reimbursement risk, there is civil liability and reputation risk that should be acknowledged.

WaMu management should conduct a state-of-the-art risk assessment to identify all compliance risk and develop a method to weigh and prioritize them, control, meaningfully report, and manage proactively the risks identified. Management should not depend on the OTS to identify risks and recommend controls. The Fair Lending program that has evolved under the guidance of Senior Compliance Specialist Mariana Rexroth is a good example of understanding the risk and developing a system to monitor and control the risk.

SMAART FORMAT

Since the OTS is now the sole regulator for both charters, the OTS requests that WaMu adopt the SMAART format for compliance management oversight. The "Working SMAART" framework, as detailed in the OTS Examination Handbook, categorizes the basic components of sound compliance management to include the following: Systems, Monitoring, Assessment, Accountability, Response, and Training. By setting up or defining the compliance management functions and reporting to conform to this framework, it will not only assist the OTS in evaluating the program, but it will help to highlight areas in need of management attention. It would also be helpful to structure certain presentations in this format.

For example, if the OTS examiner asks for a meeting on a process or specific area, it would be helpful if the presentation provided the following information:

The bank's **system** of ensuring compliance with this area,
How this area is **monitored** for compliance,
How does the business line self-**assess** compliance and what is the audit function of this area,
How is **accountability** built into the system,
How have previous audit or regulatory concerns been **responded** to, and
What **training** program has been developed for this area?

EXAM FINDINGS DEFINITIONS

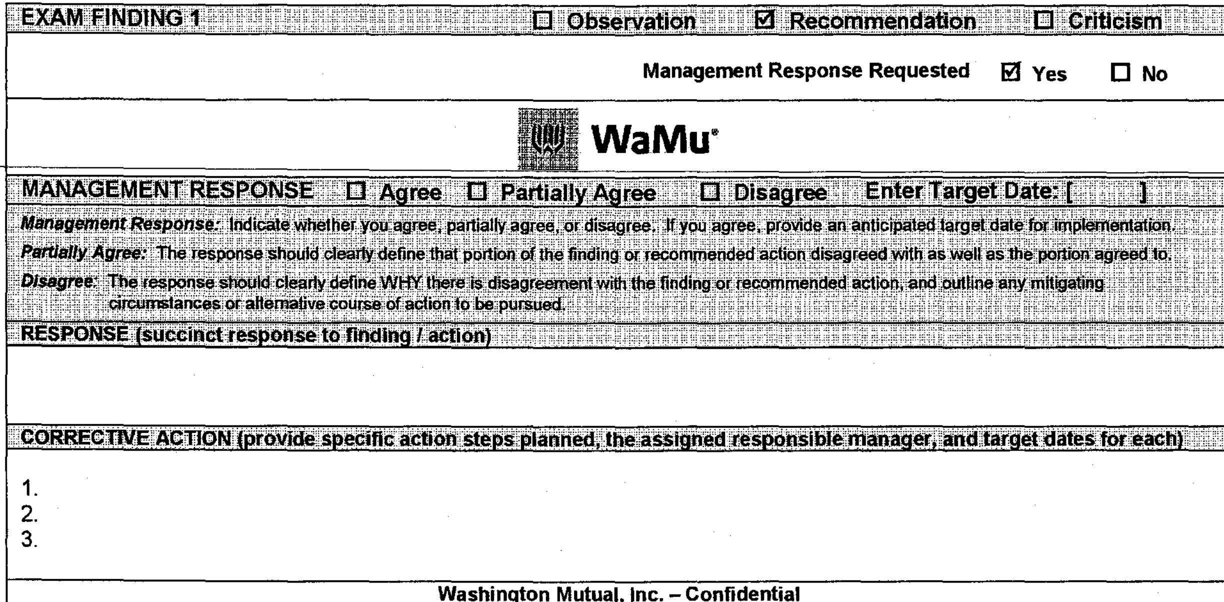
Observation:	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation:	A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.
Criticism:	A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

EXAM FINDING 1 ☐ Observation ☑ Recommendation ☐ Criticism

Topic: Compliance Officer Turnover Rate

Finding: WaMu's compliance management program has suffered from a lack of steady, consistent leadership. The amount of turnover in the Compliance Officer positions is very unusual for an institution of any size and is a cause for regulatory concern.

Action: The Board of Directors should commission an evaluation of why previously successful and effective managers didn't succeed in the position of Compliance Officer and make the necessary changes to support this function.



EXAM FINDING 1	☐ Observation ☑ Recommendation ☐ Criticism
	Management Response Requested ☑ Yes ☐ No

WaMu®

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

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EXAM FINDING 2	☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: Legal Requirements vs. Risk Management

Finding: Managing a compliance program to meet the minimums of legal responsibility is not appropriate and doesn't properly assess or manage actual risk.

Action: WaMu management should develop and implement state-of-the-art compliance risk assessment processes that identifies ALL risk, has a method to weigh and prioritize them, control them, meaningfully report them, and manage the risks proactively.

Compliance culture and emphasis should change from "What are we legally allowed to do?" to "Is this practice or disclosure "fair" to the customer and does it support our customer service goals?"

The relationship between the Legal Department and the Compliance Department should be reevaluated and an acceptable service level agreement be negotiated.

Management Response Requested ☑ Yes ☐ No

WaMu®

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

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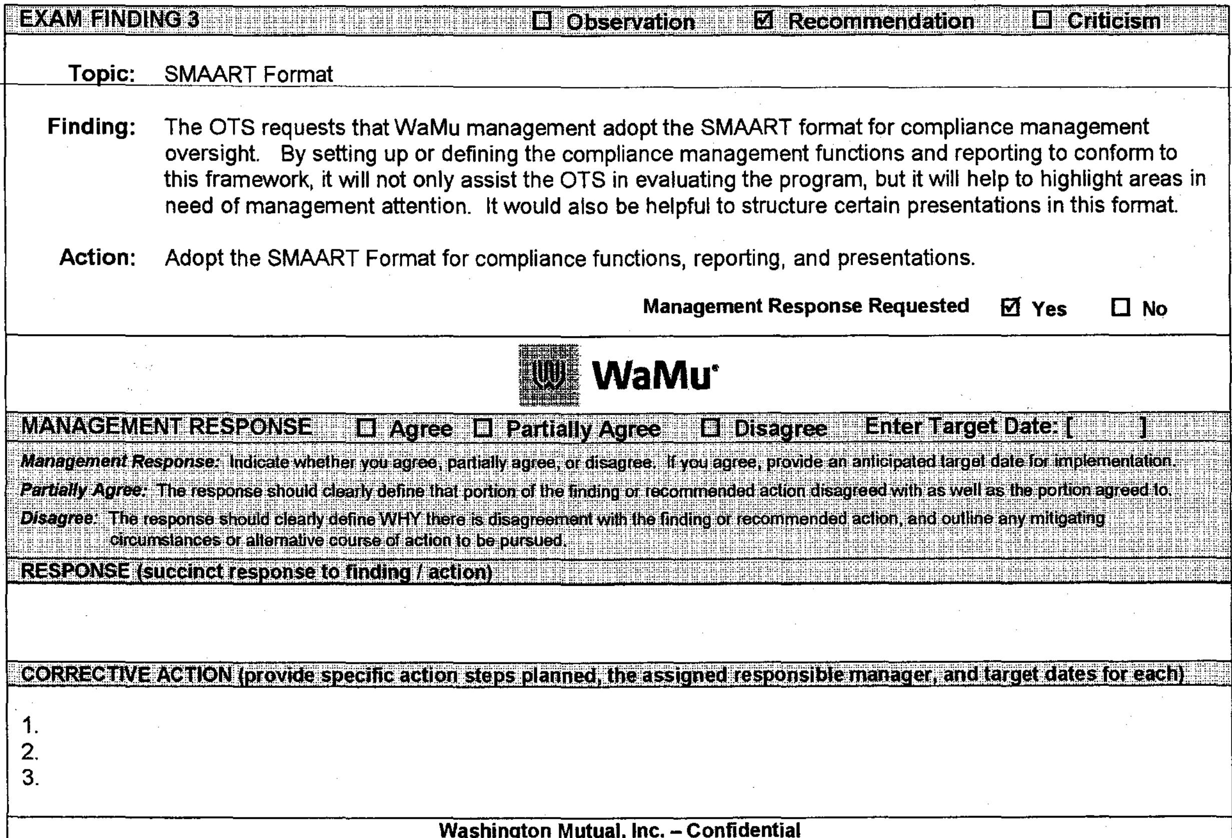

EXAM FINDING 3 ☐ Observation ☑ Recommendation ☐ Criticism

Topic: SMAART Format

Finding: The OTS requests that WaMu management adopt the SMAART format for compliance management oversight. By setting up or defining the compliance management functions and reporting to conform to this framework, it will not only assist the OTS in evaluating the program, but it will help to highlight areas in need of management attention. It would also be helpful to structure certain presentations in this format.

Action: Adopt the SMAART Format for compliance functions, reporting, and presentations.

Management Response Requested ☑ Yes ☐ No

WaMu

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

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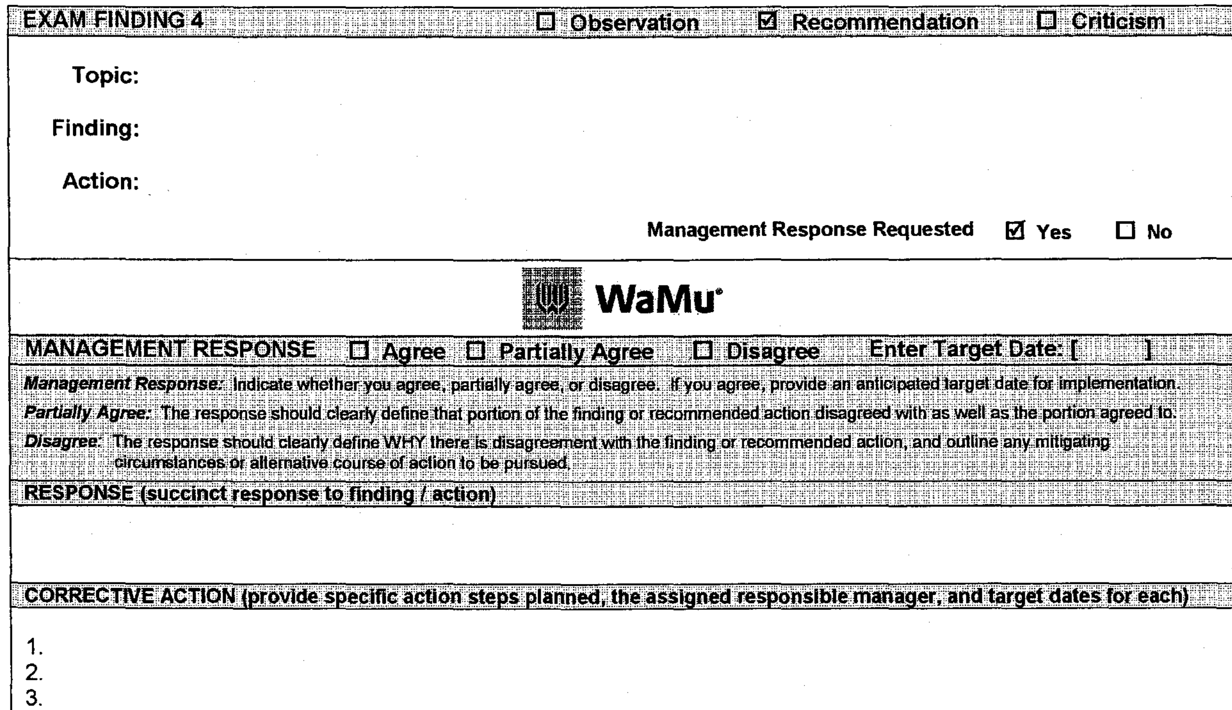

EXAM FINDING 4 ☐ Observation ☑ Recommendation ☐ Criticism

Topic:

Finding:

Action:

Management Response Requested ☑ Yes ☐ No

WaMu

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
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3.

Franklin_Benjamin-00020211_004

EXAM FINDING 4 ☐ Observation ☑ Recommendation ☐ Criticism

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EXAM FINDING 5 ☐ Observation ☐ Recommendation ☐ Criticism

Topic:

Finding:

Action:

Management Response Requested ☐ Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

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EXAM FINDING 6 ☐ Observation ☐ Recommendation ☐ Criticism

Topic:

Finding:

Action:

Management Response Requested ☐ Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

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3.

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Franklin_Benjamin-00020211_005

WMB, WMBfsb
January 8, 2007
Safety & Soundness Examination
OTS ASSET QUALITY MEMO 16

DATE:	June 19, 2007
TO:	Joseph Mattey, Deputy CCO, Portfolio Strategy, Credit Risk
FROM:	Rosanne Sinclair, Examiner, OTS
SUBJECT:	Allowance for Loan and Lease Losses on the 1-4 Single Family Residential Loan Portfolio
CC:	Clifford Rossi, Chief Credit Officer, Credit Risk Cathy Doperalski, FVP, Regulatory Relations

BACKGROUND INFORMATION

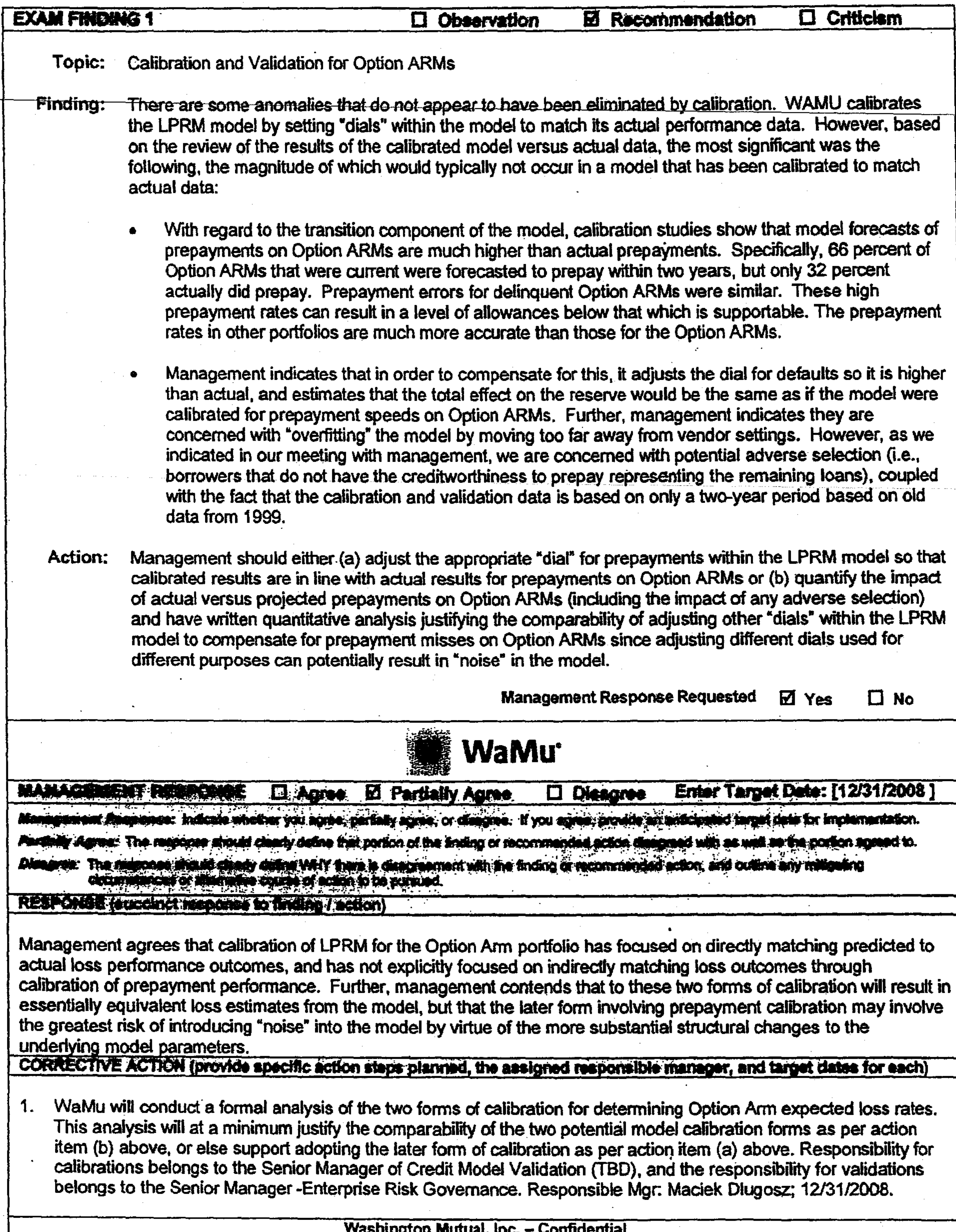
The Allowance for Loan and Lease Loss (ALLL) is only provided for loans in the held for investment portfolio; a credit reserve for loans in the held for sale portfolio is provided through the lower of cost or market (LOCOM) mark, which is not the subject of this memorandum. WAMU currently has data constraints that restrict its ability to establish an internal model using bank specific performance data. As a result, WAMU utilizes the Loan Performance Risk Model (LPRM) as a basis to derive the ALLL on the 1-4 Single Family Residential (SFR) loan portfolio. WAMU recognizes that LPRM data may not be representative of its current mortgage portfolio, so WAMU calibrates LPRM to reflect its own experience. After the model has been calibrated, the model is validated again. The LPRM model is the only vendor in the industry that gathers this type of mortgage data. Other institutions use the LPRM model to stress test their reserves and test their internal models rather than as the sole basis for deriving ALLL reserves.

In addition to the aforementioned number-driven ALLL (allocated reserve), WAMU holds an unallocated ALLL reserve that can range from 0 to approximately 20 percent of the allocated reserve. This unallocated ALLL reserve is driven by a scorecard of macroeconomic factors. At the time of our review, the unallocated ALLL reserve equated to 14 percent of the allocated ALLL reserve.

With regard to prime mortgages (other than Option Adjustable Rate Mortgages (ARMs)), sub prime mortgages, Home Equity Loans (HELs) and Home Equity Lines of Credit (HELOCs), the LPRM model appears to fit WAMU specific actual data fairly well, although there are areas for improvement with regard to model validation and calibration. However, with regard to prime Option ARMs, since the data set used by the vendor to develop the model does not include any significant data on these products, the model does not fit some aspects of WAMU's actual data. This is particularly important since Option ARMs constitute over half of the prime mortgages held for investment at WAMU.

EXAM FINDINGS DEFINITIONS

Observation:	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation:	A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.
Criticism:	A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.



EXAM FINDING 1 ☐ Observation ☑ Recommendation ☐ Criticism

Topic: Calibration and Validation for Option ARMs

Finding: ~~There are some anomalies that do not appear to have been eliminated by calibration.~~ WAMU calibrates the LPRM model by setting "dials" within the model to match its actual performance data. However, based on the review of the results of the calibrated model versus actual data, the most significant was the following, the magnitude of which would typically not occur in a model that has been calibrated to match actual data:

- With regard to the transition component of the model, calibration studies show that model forecasts of prepayments on Option ARMs are much higher than actual prepayments. Specifically, 66 percent of Option ARMs that were current were forecasted to prepay within two years, but only 32 percent actually did prepay. Prepayment errors for delinquent Option ARMs were similar. These high prepayment rates can result in a level of allowances below that which is supportable. The prepayment rates in other portfolios are much more accurate than those for the Option ARMs.
- Management indicates that in order to compensate for this, it adjusts the dial for defaults so it is higher than actual, and estimates that the total effect on the reserve would be the same as if the model were calibrated for prepayment speeds on Option ARMs. Further, management indicates they are concerned with "overfitting" the model by moving too far away from vendor settings. However, as we indicated in our meeting with management, we are concerned with potential adverse selection (i.e., borrowers that do not have the creditworthiness to prepay representing the remaining loans), coupled with the fact that the calibration and validation data is based on only a two-year period based on old data from 1999.

Action: Management should either (a) adjust the appropriate "dial" for prepayments within the LPRM model so that calibrated results are in line with actual results for prepayments on Option ARMs or (b) quantify the impact of actual versus projected prepayments on Option ARMs (including the impact of any adverse selection) and have written quantitative analysis justifying the comparability of adjusting other "dials" within the LPRM model to compensate for prepayment misses on Option ARMs since adjusting different dials used for different purposes can potentially result in "noise" in the model.

Management Response Requested ☑ Yes ☐ No

WaMu

MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [12/31/2008]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees that calibration of LPRM for the Option Arm portfolio has focused on directly matching predicted to actual loss performance outcomes, and has not explicitly focused on indirectly matching loss outcomes through calibration of prepayment performance. Further, management contends that to these two forms of calibration will result in essentially equivalent loss estimates from the model, but that the later form involving prepayment calibration may involve the greatest risk of introducing "noise" into the model by virtue of the more substantial structural changes to the underlying model parameters.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. WaMu will conduct a formal analysis of the two forms of calibration for determining Option Arm expected loss rates. This analysis will at a minimum justify the comparability of the two potential model calibration forms as per action item (b) above, or else support adopting the later form of calibration as per action item (a) above. Responsibility for calibrations belongs to the Senior Manager of Credit Model Validation (TBD), and the responsibility for validations belongs to the Senior Manager -Enterprise Risk Governance. Responsible Mgr: Maciek Dlugosz; 12/31/2008.

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OTSWME08-094 0001495

EXAM FINDING 2	☑ Observation* ☐ Recommendation* ☐ Criticism*

Topic: Data Constraints

Finding: As management is aware, there are data constraints at WAMU that impact the ability to adequately calibrate the LPRM model, as well as hamper the ability to develop an internal model as follows:

(1) The time periods used for calibration and validation of the LPRM model are often shorter than the ALLL reserve horizons. For example, for prime Option ARMs, the calibration and validation was done for a two-year horizon; however, the reserve horizon is four years. For other prime mortgages, the calibration and validation was performed for a two-year horizon versus the reserve horizon of four years. For HELs and HELOCs, the calibration and validation was performed for an eighteen-month horizon, which is half the three-year reserve horizon. For sub prime, the validation and calibration period was commensurate with the reserve horizon.

Management indicates that the aforementioned time horizons used in the calibration and validation of prime loans was due to the sale of non-performing loans (NPLs) starting in 2002 and thus data was used prior to this time period since these sales transformed the timing and magnitude of charge-offs. Management indicates that the aforementioned time horizons used in the calibration of HELOCs and HELs was due to ACLS conversion anomalies and resulting incomplete account history and thus only post-conversion data was used. Further, there were data constraints with regard to not having loan level charge-off data. Management indicates they have commissioned a new calibration and validation study for prime and HELS and HELOCs using different time horizons. Further, management indicates they are currently collecting loan level charge-off data for prime loans, and that collection of loan level charge-off data for sub prime, HELOCs and HELs started in the first quarter of 2007 and will be incorporated into the second quarter 2007 ALLL analysis.

(2) For the prime mortgage portfolio, the validation and calibration sample is based on data from 1999. Management indicates that data is used for this period because it is the latest period for which there is 24 months of performance history. In 2002, , WAMU began selling NPLs which markedly transformed the timing and magnitude of actual net charge-offs in the period from their initiation to now. [1]

For Specialty Mortgage Finance, Long Beach Mortgage Company, HELs, and HELOCs, the calibration and validation sample is based on data from 2003.

Our concern regarding the above is the use of old data for calibration and validation purposes; however, we acknowledge that ongoing and updated validations are scheduled for HELs, HELOCs, prime, and sub prime mortgages during 2007 (according to a February 27, 2007, Credit Risk Committee document entitled: "ALLL Model Validation Inventory and Prioritization Schedule Summary").

(3) The available data does not include separate measurement of actual losses on static pools; net charge-off historical data is available only in more aggregate form, with commingling of losses from pools outstanding at the beginning of any given period with losses from loans subsequently acquired into the portfolio. Ideally, there should be a comparison of projected to actual net charge-off cumulative loss rates over multi-year periods (as long as 48 months) for those static pools of loans outstanding at the beginning of various projection periods.

As indicated above, management has started to collect loan level charge-off data which should facilitate this.

Action: (1) The time period used in the calibration and validation should be commensurate with the time horizon used for ALLL reserve purposes.

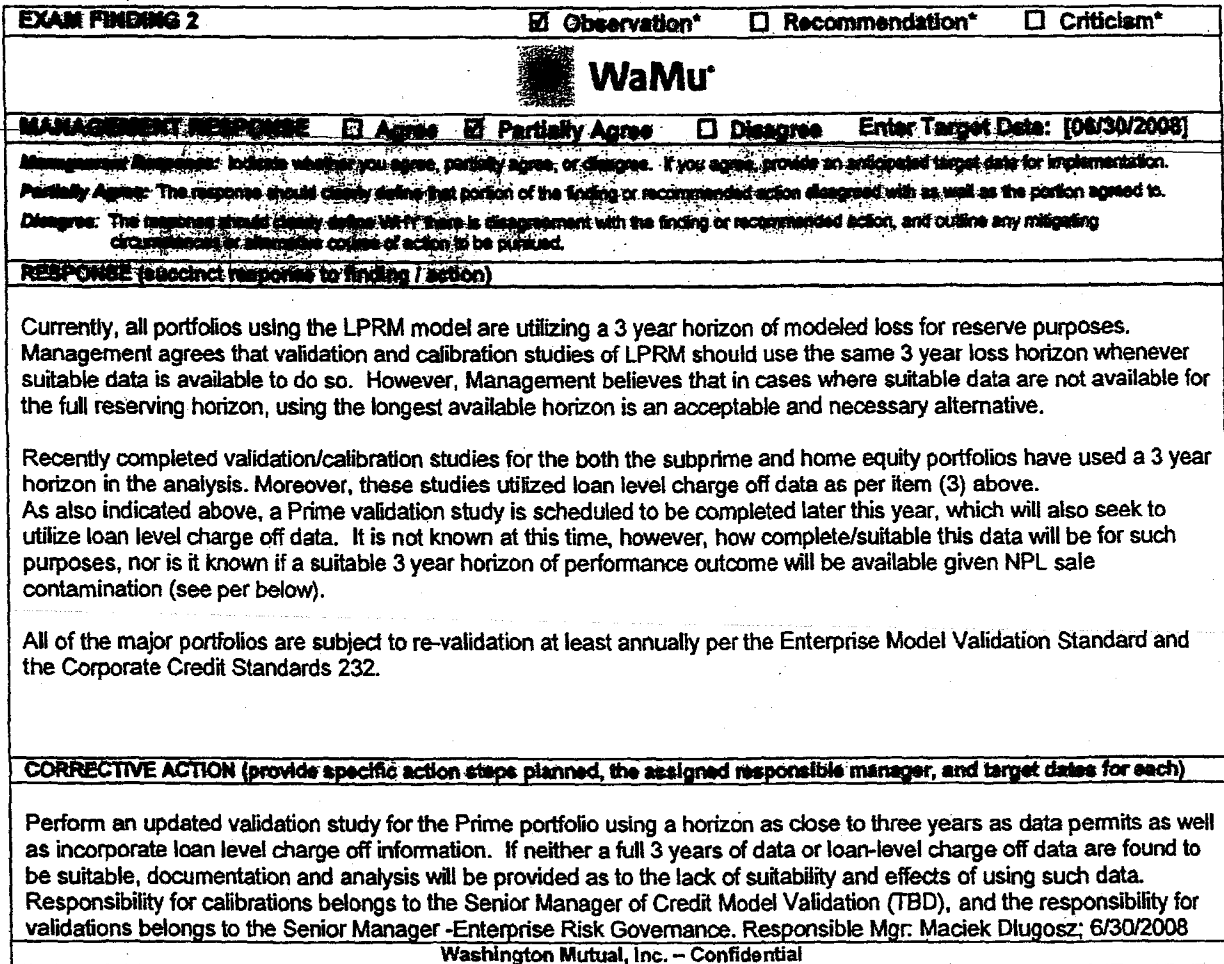
(2) Perform updated calibration and validation studies.

(3) Begin to separate actual losses for multi-year periods as long as 48 months for static pools of loans outstanding at the beginning of various projection periods, without commingling losses from loans subsequently acquired in the portfolio. Use this information to perform updated calibration and validation studies.

Management Response Requested ☑ Yes ☐ No

[1] "Validation of LPRM for SFR and SMF," April 2005.

OTSWME08-094 0001496



EXAM FINDING 2 ☑ Observation* ☐ Recommendation* ☐ Criticism*

WaMu

MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [06/30/2008]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Currently, all portfolios using the LPRM model are utilizing a 3 year horizon of modeled loss for reserve purposes. Management agrees that validation and calibration studies of LPRM should use the same 3 year loss horizon whenever suitable data is available to do so. However, Management believes that in cases where suitable data are not available for the full reserving horizon, using the longest available horizon is an acceptable and necessary alternative.

Recently completed validation/calibration studies for the both the subprime and home equity portfolios have used a 3 year horizon in the analysis. Moreover, these studies utilized loan level charge off data as per item (3) above.
As also indicated above, a Prime validation study is scheduled to be completed later this year, which will also seek to utilize loan level charge off data. It is not known at this time, however, how complete/suitable this data will be for such purposes, nor is it known if a suitable 3 year horizon of performance outcome will be available given NPL sale contamination (see per below).

All of the major portfolios are subject to re-validation at least annually per the Enterprise Model Validation Standard and the Corporate Credit Standards 232.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

Perform an updated validation study for the Prime portfolio using a horizon as close to three years as data permits as well as incorporate loan level charge off information. If neither a full 3 years of data or loan-level charge off data are found to be suitable, documentation and analysis will be provided as to the lack of suitability and effects of using such data. Responsibility for calibrations belongs to the Senior Manager of Credit Model Validation (TBD), and the responsibility for validations belongs to the Senior Manager -Enterprise Risk Governance. Responsible Mgr: Maciek Dlugosz; 6/30/2008

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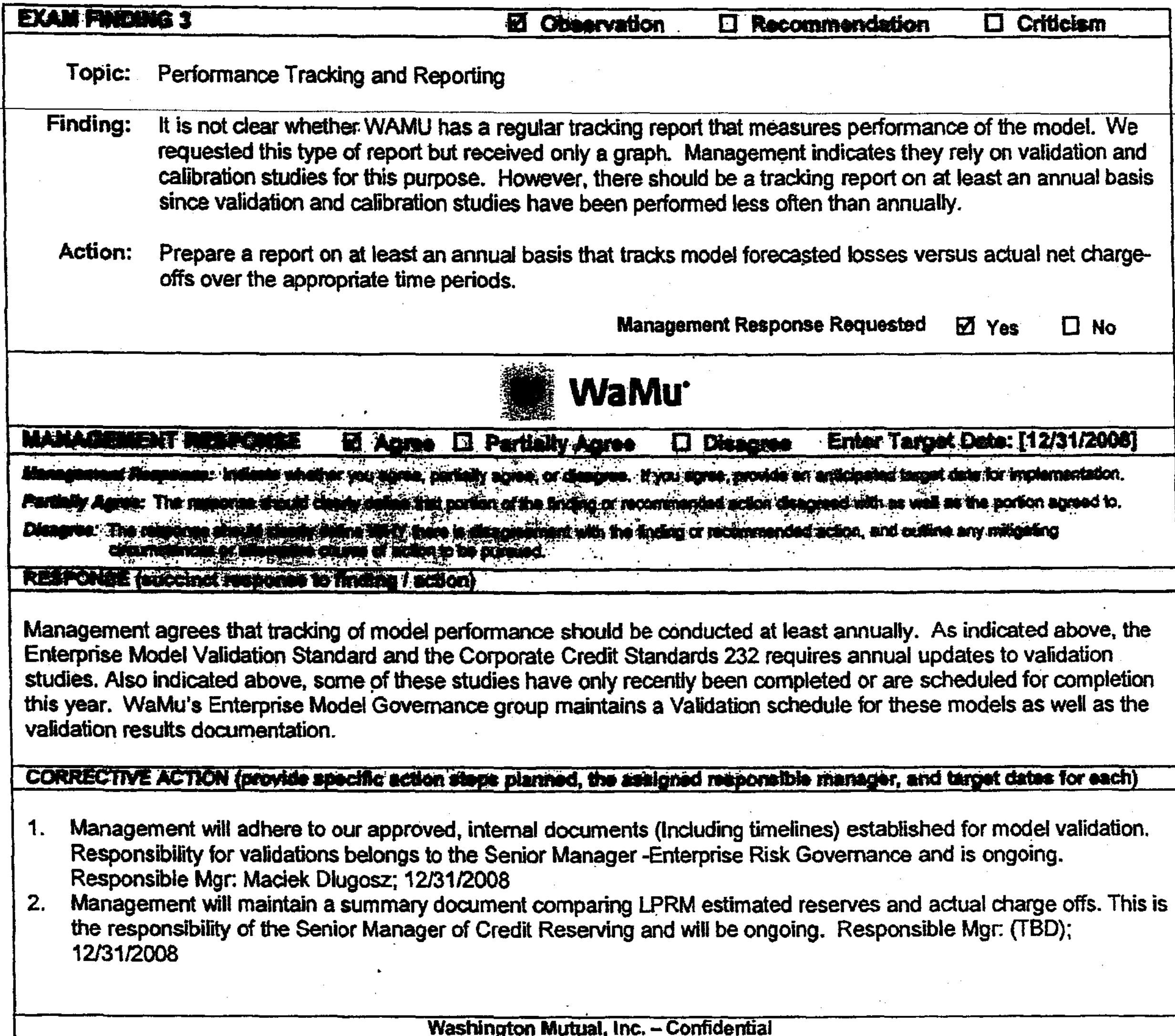

EXAM FINDING 3 ☑ Observation ☐ Recommendation ☐ Criticism

Topic: Performance Tracking and Reporting

Finding: It is not clear whether WAMU has a regular tracking report that measures performance of the model. We requested this type of report but received only a graph. Management indicates they rely on validation and calibration studies for this purpose. However, there should be a tracking report on at least an annual basis since validation and calibration studies have been performed less often than annually.

Action: Prepare a report on at least an annual basis that tracks model forecasted losses versus actual net charge-offs over the appropriate time periods.

Management Response Requested ☑ Yes ☐ No

WaMu

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [12/31/2008]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define why there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees that tracking of model performance should be conducted at least annually. As indicated above, the Enterprise Model Validation Standard and the Corporate Credit Standards 232 requires annual updates to validation studies. Also indicated above, some of these studies have only recently been completed or are scheduled for completion this year. WaMu's Enterprise Model Governance group maintains a Validation schedule for these models as well as the validation results documentation.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Management will adhere to our approved, internal documents (Including timelines) established for model validation. Responsibility for validations belongs to the Senior Manager -Enterprise Risk Governance and is ongoing. Responsible Mgr: Maciek Dlugosz; 12/31/2008
2. Management will maintain a summary document comparing LPRM estimated reserves and actual charge offs. This is the responsibility of the Senior Manager of Credit Reserving and will be ongoing. Responsible Mgr: (TBD); 12/31/2008

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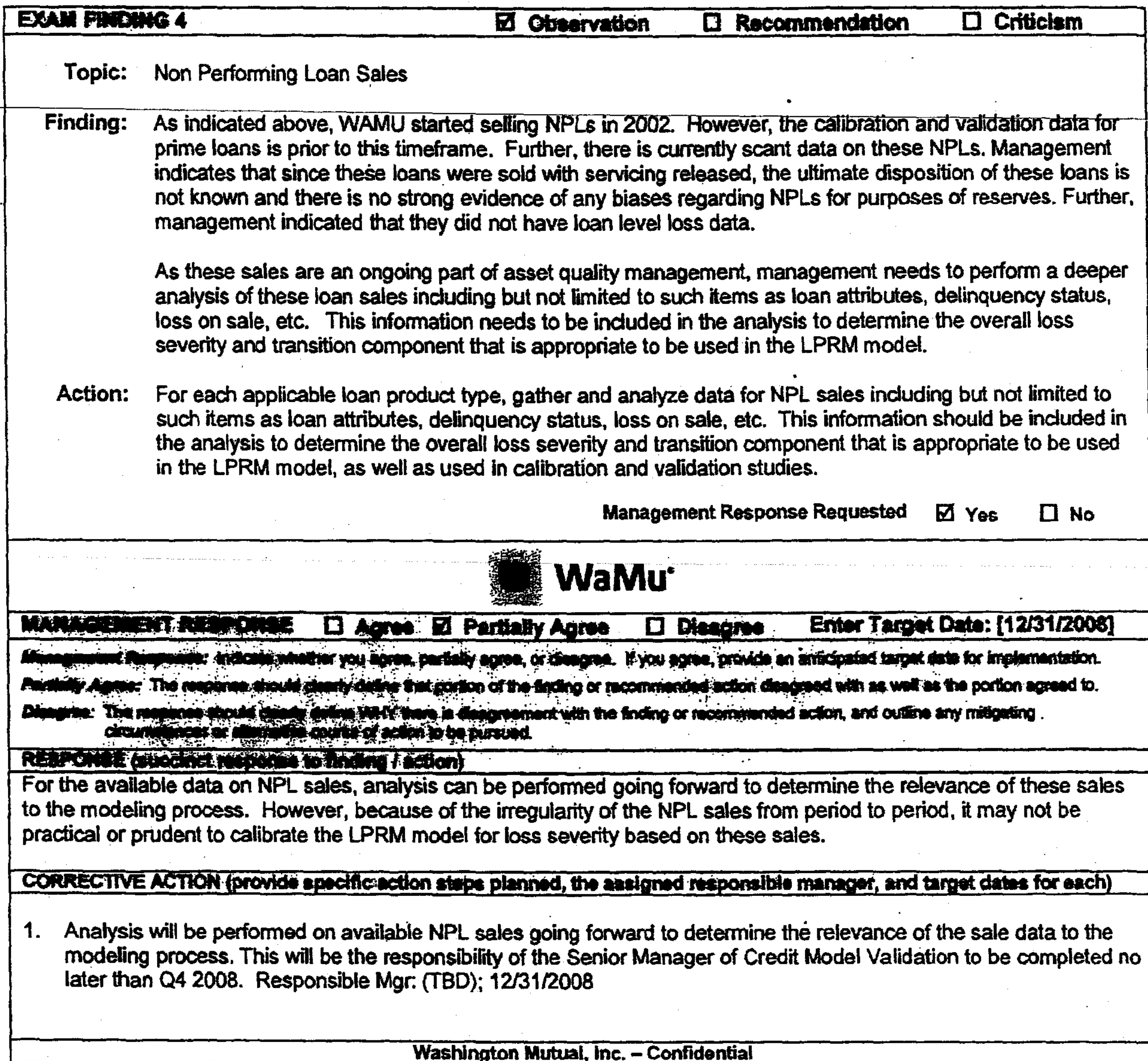

EXAM FINDING 4 ☑ Observation ☐ Recommendation ☐ Criticism

Topic: Non Performing Loan Sales

Finding: As indicated above, WAMU started selling NPLs in 2002. However, the calibration and validation data for prime loans is prior to this timeframe. Further, there is currently scant data on these NPLs. Management indicates that since these loans were sold with servicing released, the ultimate disposition of these loans is not known and there is no strong evidence of any biases regarding NPLs for purposes of reserves. Further, management indicated that they did not have loan level loss data.

As these sales are an ongoing part of asset quality management, management needs to perform a deeper analysis of these loan sales including but not limited to such items as loan attributes, delinquency status, loss on sale, etc. This information needs to be included in the analysis to determine the overall loss severity and transition component that is appropriate to be used in the LPRM model.

Action: For each applicable loan product type, gather and analyze data for NPL sales including but not limited to such items as loan attributes, delinquency status, loss on sale, etc. This information should be included in the analysis to determine the overall loss severity and transition component that is appropriate to be used in the LPRM model, as well as used in calibration and validation studies.

Management Response Requested ☑ Yes ☐ No

WaMu

MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [12/31/2008]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

For the available data on NPL sales, analysis can be performed going forward to determine the relevance of these sales to the modeling process. However, because of the irregularity of the NPL sales from period to period, it may not be practical or prudent to calibrate the LPRM model for loss severity based on these sales.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Analysis will be performed on available NPL sales going forward to determine the relevance of the sale data to the modeling process. This will be the responsibility of the Senior Manager of Credit Model Validation to be completed no later than Q4 2008. Responsible Mgr: (TBD); 12/31/2008

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EXAM FINDING 5 ☑ Observation ☐ Recommendation ☐ Criticism

Topic: Addressing LPRM Model Shortfalls

Finding: As management is aware, the LPRM model has certain shortcomings as follows:

(a). LPRM uses the FICO score at origination; thus, refreshed FICO scores cannot be readily incorporated into the model. As management points out, data is correlated with delinquency status, which is incorporated in the model. Further, management indicated they are not convinced that refreshed FICOs would provide any added benefit for modeling purposes. However, a refreshed FICO score would include additional data beyond delinquency status because the score uses data about other credit relationships.

(b). Most of the sample used in the LPRM model is from 1997 and later and virtually none of the data is drawn from episodes of severe housing declines. Further, sustained periods of above average or below average house appreciations are improbable in the model. However, these types of periods are clearly evident in actual Office of Federal Housing Enterprise Oversight (OFHEO) data.

WAMU recognizes this and has augmented the LPRM model by using a mixture model of house appreciation. Specifically, WAMU has estimated a logit model for sustained downturns in the housing

EXAM FINDING 5 ☑ Observation ☐ Recommendation ☐ Criticism

market. Management indicates they believe they specified a severe downturn as a 15 percent decline in housing prices in a two-year period. However, given that OFHEO data for certain geographic regions show 22 percent or more declines in housing prices in the early 1990's, we recommend a more severe shock be applied either in aggregate or for certain metropolitan statistical areas (MSAs) or standard metropolitan statistical areas (SMSAs) or other appropriate geographic delineations over a sustained period (e.g., five years) for purposes of stress testing the adequacy of ALLL reserves.

Management indicates that with regard to stress testing, they would not likely be using the severe stress testing for purposes of booking reserves for financial statement purposes. While we agree that this type of stress testing is used more for purposes of economic capital, we do want to bring to management's attention that a robust and reasonable stress testing that covers the distribution of expected loss is appropriate for reserving purposes. Further, the importance of this issue is heightened since it is unclear how accurate the LPRM model forecasts are since the model data set has not gone through a severe period of sustained housing declines.

(c). As indicated previously, few, if any, loans used to construct the model are Option ARMs. Thus, the model was developed using data that did not include payment shocks as large as those that are possible to be faced by option ARM borrowers (including payment shocks of 100 percent or more). In this regard, virtually none of the shocks in the LPRM model exceed 30 percent.

Action: (1) The items in (a) through (c) above would need to be addressed by the third party vendor, not by WAMU. We encourage WAMU to use its standing in the industry to encourage the vendor to address these issues.

(2) In lieu of the vendor addressing the issues in (a) through (c) above, we recommend that WAMU commit resources to address these model shortcomings.

Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [12/31/2008]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define why there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

(a) Management believes the current method produces aggregate reserves that are appropriate. Management does not necessarily agree that the use of updated FICOs is a priori the preferable modeling strategy for setting an aggregate reserve on a large portfolio of loans. A presumption is made that updated scores will better forecast mortgage loss performance by including information about other credit relationships. However, we are not aware of empirical evidence that demonstrates this proposition and it may be impossible to disentangle the endogenous effects of past mortgage performance to demonstrate the true effect of other credit relationships. Management believes that the costs of pursuing a modeling strategy must be weighed against the benefits, and doubts that this strategy will meet a cost benefit analysis.

(b) Management does not agree that the use of stress house price simulations in the current reserving process limits house price stresses to a 15 percent decline. Specifically, the stress condition is a 3–year cumulative 15 percent *average* house price decline (5 percent per annum), with simulated variation about that average. These stress simulations include house price decline scenarios well below that average value, including house price declines exceeding 22 percent. The results of these stress scenarios are then probability weighted by the above mentioned logit model for predicting a 15 percent house price decline, and management believes that probability weight to be substantially *larger* than a weight based on the more remote 22 percent decline scenario. Furthermore, management does not agree that scenarios that include stresses over "sustained period (e.g., five years) for purposes of stress testing the adequacy of ALLL reserves" are appropriate for financial statement purposes, as that would transcend the current reserving horizons. Management agrees that it is important to include a realistic representation of the possible house price decline values in calculating expected loss and believe this is met reasonably by the current process. Management also agrees that more extensive stress testing is most appropriate for determining capital adequacy rather than for ALLL purposes.

(c) Management agrees that severe payment shocks are likely underrepresented in model development data, both due to fewer Option Arms and interest rate environments experienced in recent years.

EXAM FINDING 5	☑ Observation	☐ Recommendation	☐ Criticism
CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)			
1. WaMu will explore alternatives for measuring the impact of extreme payment shock in Option Arms. This will be the responsibility of the Senior Manager of Credit Model Validation. Responsible Mgr: (TBD); 12/31/2008			
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OTSWME08-094 000150

Dochow, Darrel W

From: Franklin, Benjamin D
Sent: Sunday, June 03, 2007 9:08 PM
To: Dochow, Darrel W
Subject: FW: Compliance rating

FYI

-----Original Message-----
From: Clark, Mary Suzanne
Sent: Sunday, June 03, 2007 4:47 PM
To: Franklin, Benjamin D; Archibald, Robert D
Subject: Compliance rating

Considering the meeting on Friday, I'm of a mind to go with a "2". I'm not up for the fight or the blood pressure problems.

I continue to stand by the fact that they are not "Best Practices" and it should have been brought to Ron's attention since he has stated that they are. I also feel that it was not good that he "threatened" to move Compliance to Legal (making the situation worse). I don't think that cutting off your nose to spite your face is a very good management practice.

He also brought in the discussion of Dick's competence to the discussion of why there have been so much turnover to the position, even though its not relevant and I never stated he wasn't competent.

We are going to have the same battle on the complaint memo, although I still stand by the findings. Since we weren't able to do a separate evaluation of the process, they will fight it. It doesn't matter that we are right, what matters is how it is framed. And all we can do is point to the pile of complaints and say there is a problem. I found out recently that the Providian CD holder mess was an offshore mishap. And once again I wasn't told about it.

So with our continuously limited resources, we will never be able to do a deep dive and never have the information to give them the "3" rating. They aren't interested in our "opinions" of the program. They want black and white, violations or not.

Today was the first day of the compliance conference, and all the speakers touched on reputation risk. I think I'm ahead of my time and I know this is a problem at WAMU. But they aren't interested. I feel like Darrel and our training always emphasizes "Best Practices" but when it comes down to it, we don't have the resources to show the risk.

I will be back on Thursday to discuss this.

Permanent Subcommittee on Investigations
EXHIBIT #39

OTSWMS07-013 0002576

From: Polakoff, Scott M
Sent: Thursday, November 29, 2007 3:14 PM
To: Dochow, Darrel W <dochowdw@office of thrift supervision.com>
Cc: Reich, John M <reichjm@office of thrift supervision.com>
Subject: Re: Wamu appraisal review

Darrel - thanks for the update and, more importantly, handling the situation appropriately. You are doing a superb job as Regional Director.

John - this e-mails provides an update on our earlier discussion today.

Thanks

Scott

Scott Polakoff

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Dochow, Darrel W
To: Polakoff, Scott M
Cc: Ward, Timothy T; Quigley, Lori G; Franklin, Benjamin D; Johnson, Mark W; Hendriksen, James A; Bowman, John E
Sent: Thu Nov 29 15:10:19 2007
Subject: Re: Wamu appraisal review

Scott:

I just talked with kerry killinger. The outside law firm doing the investigation is and will report directly to kerry and he will make everything available to the audit committee. Kerry is actively engaged as is steve frank, audit committee chair. Outside law firm expects final report in mid january. I am much more comfortable now.

Darrel

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Dochow, Darrel W
To: Polakoff, Scott M
Cc: Ward, Timothy T; Quigley, Lori G; Franklin, Benjamin D; Johnson, Mark W; Hendriksen, James A; Bowman, John E
Sent: Thu Nov 29 13:36:51 2007
Subject: Wamu appraisal review

Scott:

As we briefly discussed, we are trying to leverage, to the extent appropriate, the internal review being done by wamu and its

Permanent Subcommittee on Investigations
EXHIBIT #40

external law firm relating to the nyag appraisal allegations. I am not yet comfortable that we can leverage as much on their review (mostly a quick review to bolster a defense for the main allegation of collusion) as I had hoped given its scope. In addition, we need to be able to defend that we have done our own independent examination. I understand confidentially that steve rotella has told kerry killinger that he was hoping ots would simply endorse/confirm their conclusion and is now concerned that ots has not geared up as fast as desired and does not have sufficient resources to have a quick conclusion. Thus, I have a call into kerry kiillinger to discuss our desire to fully leverage their review as appropriate, and whether it makes sense for their audit committee to be the focal point for their review, especially since the general counsel's office is now a target of the review.

On tuesday this week, rotella was already comfortable that he understood the conclusion that their review would yield (no collusion, damaging emails from eappraiseit and some loan personnel, but isolated and not reflective of collusion or a breakdown, and taken out of context as nyag looked at only 8 instances out of hundreds of thousands, and in those there was actually a adjustment down in value by the review process. Rotella expects final of their review in a week or two. Rotella also implied that conversations are occurring indirectly by their their outside attornies and the nyag office. He sees cuomo as wanting a new appraisal standard/controls that wamu would support. I reminded rotella of the understanding wamu had with ots on conversations with nyag and he said he understood, and that no direct conversations or negotiations were occurring. Is the apparent indirect discussions consistent with the protocol they discussed with ots washington dc? Rotella is focused on getting the nyag to stop "throwing bombs" and to quickly get wamu in a better position, hopefully with an ots endorsement that their was no corporate collusion.. He feels the rest of our review relating to the other third party appraisal firm (lsi) etc can come afterwards.

Confidentially, I am also watching closely cost cutting actions and have discussed my expectation with coo steve rotella and chief risk officer ron cathcart that risk management remain strong and fully staffed with an appropriate budget. This was also a matter for the board's attention in our report of exam. I am seeing hints that coo rotella is not a strong supporter of chief risk officer ron cathcart and is using the appraisal issue to undercut/move out general counsel faye chapman who has challenged him in the past. The fact that coo rotella runs the business units, was the champion of cost cutting and use of third party appraisal outsourcing, and continues to downplay the various business units' failing (compliance, bsa, flood and now maybe appraisal) by diverting blame to others (risk management and now counsel) leaves me uncomfortable.

The regional exam and enforcement staff are working diligently on our review. We have not yet been provided any written findings from the wamu review.

Darrel

Sent from my BlackBerry Wireless Handheld

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

Pacific Plaza, 2001 Junipero Serra Boulevard, Suite 650, Daly City, CA 94014-1976
P.O. Box 7165, San Francisco, CA 94120-7165 • Telephone: (650) 746-7000 • Fax: (650) 746-7001

February 27, 2008

Board of Directors
Kerry Killinger, Chairman and Chief Executive Officer
Washington Mutual Bank
1301 Second Avenue, Seattle, WA 98101

Dear Board of Directors:

This letter is to advise you that the Office of Thrift Supervision (OTS) is adjusting downward the composite rating for Washington Mutual Bank (WMB or Bank) from a "2" to a "3," effective today. We are also adjusting the Asset Quality rating from a "2" to a "3," the Earnings rating from a "2" to a "4," and the Liquidity rating from a "1" to a "3." Each of these changes is discussed below. We are continuing to review the Capital, Management, and Sensitivity to Market Risk component ratings, as well as the Compliance and Holding Company ratings as part of our ongoing continuous examination process.

The composite "3" rating reflects a combination of weaknesses and supervisory concern with earnings, asset quality, and liquidity, in particular. In addition, the current "3" rating in Compliance also reflects ongoing supervisory concern in that area. We ask that the Board of Directors send the undersigned a duly certified Resolution of the Board committing to take all appropriate action to ensure that weaknesses and concerns are promptly addressed. We will be considering whether additional supervisory action is appropriate as part of our ongoing examination and supervisory efforts.

With regards to the rating component downgrades, WMB has experienced considerable deterioration in its asset quality and earnings performance, as well as a stressed liquidity position. Our continuous examination process and off-site monitoring have confirmed conditions that warrant making ratings changes at this time.

- The Bank's nonperforming assets level more than doubled to $7.5 billion (2.29 percent of total assets) as of December 31, 2007, compared to $3.3 billion (0.96 percent of total assets) as of December 31, 2006. Classified assets totaling $8.2 billion represent 32.74% of Tier-1 Capital plus allowances. The level of ALLL, though increased, may be insufficient to cover future losses without continuing significant further provisions.
- For the 3rd and 4th quarters of 2007, the Bank recorded substantial loan loss provisions and mortgage-related write-downs reflecting a significant deterioration in WMB's asset quality. The earnings impact resulted in the Bank recording a 4th quarter 2007 after-tax net loss of $1.8 billion driven by $1.5 billion of loan loss provisions and a $1.8 billion

Permanent Subcommittee on Investigations
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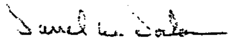
write-down of goodwill related to discontinued lending operations. Projections indicate additional losses are expected in 2008.

- Liquidity has become more stressed. The market disruption and increasing loan defaults resulted in a debt rating downgrade to Baa2 (Moody's) for WMI, and Baa- (Moody's) for WMB, thus increasing funding costs and contraction of available sources. While collateral initiatives are in process to expand the Bank's access to Federal Home Loan Bank advances, the significant reliance on this source of funds reflects a loss of funding flexibility and a concentration risk.

Given the preceding, we consider WMB less able to withstand business fluctuations and more vulnerable to additional negative external and internal events. OTS has a responsibility to ensure that WMB's composite rating reflects our best judgment of its current condition. The decision to change the composite rating to a "3" at this time was made after confirming the situation during the initial portion of our on-going examination and carefully considering the facts and current circumstances. We will continue to assess all CAMELS, Compliance, and Holding Company ratings and will discuss our determinations at the conclusion of our ongoing examination. The roll-up of our targeted examinations will conclude with a meeting with the Board of Directors on July 15, 2008.

We appreciate management's open communication, cooperation, and efforts during these difficult times. This letter considered a Report and is confidential. Except as provided in 12 C.F.R. Section 510.5, the institution's directors, officers, or employees may not disclose the Report, or any portion of it, to unauthorized persons or organizations.

Sincerely,



Darrel W. Dochow
Regional Director

OTSWMEF-0000047647

From: Dochow, Darrel W <darrel.dochow@ots.treas.gov>
Sent: Friday, February 29, 2008 10:19 AM
To: Franklin, Benjamin D <franklinbd@office of thrift supervision.com>; Johnson, Mark W <johnsonmw@office of thrift supervision.com>; Hendriksen, James A <hendriksenja@office of thrift supervision.com>
Cc: Crosley, John M <crosleyjm@office of thrift supervision.com>
Subject: Fw: Kerry Killinger

Fyi

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Ward, Timothy T
To: Polakoff, Scott M
Cc: Dochow, Darrel W
Sent: Fri Feb 29 09:10:04 2008
Subject: RE: Kerry Killinger

Yes. I will find the time on your calendars - Thursday may work for John via phone. Darrel has advised who he would like on from the West.

Tim

-----Original Message-----
From: Polakoff, Scott M
Sent: Friday, February 29, 2008 9:07 AM
To: Ward, Timothy T
Cc: Dochow, Darrel W
Subject: RE: Kerry Killinger

Tim - thanks, I agree with you. Can we find time next week to brief John on Wamu. I'd like to be briefed too, either with John et al or prior.

Thanks.

Scott

-----Original Message-----
From: Ward, Timothy T.
Sent: Thursday, February 28, 2008 6:56 PM
To: Polakoff, Scott M
Cc: Dochow, Darrel W
Subject: Re: Kerry Killinger

Scott,

Permanent Subcommittee on Investigations
EXHIBIT #42

Kerry asked the same question when Darrel and I met with him in January. I replied that we were not patient when it came to fixing problems that were correctable by the board and management - tightening controls, improving processes, discontinuing unsuccessful activities, adopting new plans and strategies, etc. I explained that we were not unrealistic in our expectations regarding the unfolding of results from past practices - asset losses, weak earnings, capital pressure - and that the shareholders would likely have a different time horizon than the regulators.

Tim
Timothy T. Ward
Office of Thrift Supervision
202.285.6405 - cell
202.906.5666 - office

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Reich, John M
To: Polakoff, Scott M; Ward, Timothy T; Dochow, Darrel W
Cc: Russell, Robert W
Sent: Thu Feb 28 18:36:40 2008
Subject: Kerry Killinger

Kerry came in this afternoon to see me - I thought, ostensibly, about doing a domestic covered bond issue and getting a waiver from the FDIC to agree not to repudiate the collateralization - but that was not on his mind. We had a general conversation about the economy and the pressures WAMU is under, and it was clear to me by the end of the conversation that the reason he came in to see me was to see how much trouble he and WAMU are in with me and OTS leadership.

Kerry is feeling pressure from several points - the NY AG (he would just as soon see the Appraisal agreement be signed as is, to get the issue out of the way); the BSA/AML issue; the rising losses in his portfolio and the likelihood that profitability will not return until 2009; the prospect of raising more capital; and the impact and fallout of ratings downgrades. By the end of the conversation he was basically asking me if I thought OTS was going to have the patience to give WAMU time to improve the ratings over a reasonable time period, or should they be considering other options sooner. I told Kerry that I had not received a complete briefing from staff yet, but it was my feeling that OTS would be reasonable in providing adequate time over the business cycle for WAMU management to make improvements, particularly in earnings, and that it would be my hope that we would not place unrealistic expectations or demands to make changes/improvements over unrealistic time periods. Our meeting ended with me telling Kerry that I would call him within a week or 10 days after I had been more fully briefed on the current examination findings.

We need to schedule this and to follow up this conversation.

John

From: Dochow, Darrel W <darrel.dochow@ots.treas.gov>
Sent: Wednesday, June 25, 2008 12:12 PM
To: Polakoff, Scott M <polakoffsm@office of thrift supervision.com>; Ward, Timothy T <wardtt@office of thrift supervision.com>; Reich, John M <reichjm@office of thrift supervision.com>
Cc: Bowman, John E <bowmanje@office of thrift supervision.com>; Blackburn, Dale R <blackburndr@office of thrift supervision.com>; Franklin, Benjamin D <franklinbd@office of thrift supervision.com>; Hendriksen, James A <hendriksenja@office of thrift supervision.com>
Subject: RE: Call from Killinger

Scott:

I told him that I was going through the examination findings and management actions to ensure that I make an appropriate decision on what corrective action to take and what the company needs to do. Clearly I wanted more capital in the bank which they are now moving ahead on. I also wanted the look back on the Alerts completed and SARS process running as a well oiled machine. The main areas of asset quality criticism are largely being addressed by exiting the products. The ALLL is being increased at our request and model is being enhanced. I need to go through the full exam before concluding what the full set of actions are that we will request.

I further told Kerry that as a matter of policy, the OTS believes that "3" rated institutions, especially repeat "3"s, warranted informal supervisory action and consideration of formal action. I told Kerry that it was disappointing to see some exam issues resurface in subsequent examinations and that management's ultimate avenue to remedy some issues has been to exit the product instead of fixing it (e.g. stated income lending was an issue at Long Beach lending, moved to Home lending, and even partly surfaced in the initial small business lending, and that the look back for the Alerts was promised to be completed at 12/31/2007 and now we have had to push somewhat to get this targeted for completion by September 30, 2008 instead of the recently requested December 31, 2008). I told Kerry that I would discuss corrective action with him and the Board at the July 15 board meeting and realized that the company will likely have a disclosure/timing issue if they announce the poor second quarter results and shortly thereafter announce a MOU or other supervisory action.

As an aside, the equity investors voiced concern at time of their due diligence that OTS might take enforcement action following their investment which would drive the value of the company down and sought some comfort on that front. In addition, there is some sentiment that a public supervisory action will drive/result in a change in executive management.

Darrel

From: Polakoff, Scott M
Sent: Wednesday, June 25, 2008 8:34 AM
To: Dochow, Darrel W; Ward, Timothy T; Reich, John M
Cc: Bowman, John E; Blackburn, Dale R; Franklin, Benjamin D; Hendriksen, James A
Subject: RE: Call from Killinger

Darrel - in addition to reassuring him that open communication with DC was reasonable, how did you respond to Q4?

Scott

From: Dochow, Darrel W

Sent: Wednesday, June 25, 2008 11:31 AM
To: Ward, Timothy T; Polakoff, Scott M; Reich, John M
Cc: Bowman, John E; Blackburn, Dale R; Franklin, Benjamin D; Hendriksen, James A
Subject: Call from Killinger

I spoke with WAMU CEO Kerry Killinger this morning. Kerry wanted me to know:

~~1. They had heard me and will look to put more capital into the bank instead of holding so much at the holding~~ company. They have some sensitivity to maintaining enough at the parent for future flexibility (dividends) and rating agency comfort, and they have a tax issue that for a period of time any capital in the bank will be captive and can not be up streamed without triggering a tax event.

2. He encouraged me to spend some personal time with their new General Counsel Mike Solender (from Bear Stearns) and to share perspectives on compliance and issues to help guide him as he brings energy and passion to the legal and compliance role. Compliance now reports to him. I told him that I would and that John Bowman is also planning on having a meeting with him around the RMG in August.

3. They are working very hard to clear the backlog of Alerts in the shortest time period and to ensure that SAR filings are done timely. They are barring no expense and will be bringing in about 400 folks to help get this cleared up by September 30, 2008. I told him that Laura Fiene was meeting with his folks Monday to discuss time frames for filing SARs.

4. He wanted to convey the actions they have taken, reiterate the current board commitment contained in the resolution, *and ask if there were any other actions that they could take to show that a MOU was not needed*. He mentioned the capital infusion, further build up of liquidity to approximately $60 billion in June versus about $37 billion at March 31, their discontinuation and scale back in many lending areas that the examiners had seen past underwriting issues with, their acceleration of provisioning for potential loan losses in response to the exam along with model improvements, and their planned cutting about $1 billion in expenses to facilitate a return to profitability sooner. He asked if he should discuss this with you when he was in Washington DC and I told him that he should always feel free to discuss issues.

5. He asked about the appraisal review we were doing. I told him that we had not reached conclusion but are still hoping to have conclusions in time for discussion at the July 15 board meeting.

Darrel Dochow

8551
20110

Dochow, Darrel W

From: Robinson, John [john.robinson@wamu.net]
Sent: Thursday, July 03, 2008 10:55 AM
To: Dochow, Darrel W
Subject: FW: MOU vs. Board Resolution

FYI.

John
(206)500-4149

-----Original Message-----
From: Killinger, Kerry K.
Sent: Thursday, July 03, 2008 10:34 AM
To: Landefeld, Stewart M.; Solender, Michael S.; Robinson, John; Casey, Tom; Rotella, Steve
Subject: Fw: MOU vs. Board Resolution

FYI. The OTS plans to issue an MOU. We need to plan accordingly. It will be helpful to learn what is likely to be included in an MOU.

Kerry

----- Original Message -----
From: Killinger, Kerry K.
To: 'john.reich@ots.treas.gov' <john.reich@ots.treas.gov>
Sent: Thu Jul 03 10:28:05 2008
Subject: Re: MOU vs. Board Resolution

Thanks John.

I appreciate your time and willingness to give this matter a thorough review.

Kerry

----- Original Message -----
From: Reich, John M <John.Reich@ots.treas.gov>
To: Killinger, Kerry K.
Sent: Thu Jul 03 10:10:47 2008
Subject: MOU vs. Board Resolution

OFFICIAL FILE COPY
OTS/WEST

Kerry,

I'm sorry to communicate by email - I've left a couple of messages on your office phone, but I'm guessing you may be off for a long weekend.

I've been wrestling with the issue of an MOU versus a Board Resolution as a result of our conversation in my office last week. And I've decided that an MOU is the right approach for OTS to do in this situation, and Scott Polakoff will be trying to reach John Robinson today to communicate this decision.

We almost always do an MOU for 3-rated institutions, and if someone were looking over our shoulders, they would probably be surprised we don't already have one in place. The situation with WaMu is a 3-rated institution, with 4's in Asset Quality and Earnings, along with an outstanding C&D on BSA, which frankly seems to have deteriorated a bit, rather than improved; plus, we still have the Appraisal issue outstanding, and the staff input I've received concerning this issue indicates that serious internal control weaknesses exist in this area.

So as much as I would like to be able to say a Board Resolution is the appropriate regulatory response, I don't really believe it is. I do believe we need to do an MOU. We don't consider it a disclosable event, and we also think the investment community won't be

Permanent Subcommittee on Investigations
EXHIBIT #44

surprised if they learn of it, and would probably only be surprised to learn one didn't already exist.

Again, I'm sorry to communicate this decision by email, but I'm scheduled to be out of the office next week myself, and wanted you to have this information.

Best regards, Kerry,

John

John M. Reich, Director
Office of Thrift Supervision
Department of the Treasury
1700 G Street, NW
Washington, DC 20522
Tel: (202) 906-6590

OTSWMS08-014 0000913

From: Polakoff, Scott M
Sent: Monday, July 28, 2008 9:26 AM
To: Ward, Timothy T <wardtt@office of thrift supervision.com>
Subject: RE: WAMU MOU

Tim - thanks for sharing this document. It is, unfortunately, another example of a benign supervisory document. Other than required capital levels, all we are requiring is a business plan and consulting review of risk management and plan to reduce problem assets. I read it quick but don't recall even seeing anything about liquidity. I have no idea how we arrived at the minimum capital levels required in the document.

Having said all of that, I feel that timing gives us no choice but to move forward with it asap. It is representative, though, of Darrel's greater interest in getting the FDIC to review then you/me to review.

Scott

-----Original Message-----
From: Ward, Timothy T
Sent: Friday, July 25, 2008 5:36 PM
To: Polakoff, Scott M
Subject: FW: WAMU MOU
Importance: High

-----Original Message-----
From: Dochow, Darrel W
Sent: Friday, July 25, 2008 1:18 PM
To: Ward, Timothy T
Subject: WAMU MOU
Importance: High

Tim:

You make a good point, I apologize, and attached is the MOU for your review. I will make any changes you want and it has not yet gone to the company. The MOU has been going back and forth with Washington DC through Enforcement for some time at my direction even though I was told that the enforcement policy/procedures does not require such documents to be run through DC Enforcement. The MOU came up yesterday in a call I had with John Reich and Scott Polakoff, and then by John Reich with COB Steve Frank. It went to the FDIC because I committed to Stan Ivie to consider their comments in an effort to minimize their letter writing and posturing.

Again, here is the MOU for your review. I have not provided to WAMU, but was hoping to do so this afternoon. I will hold until I hear back from you.

Darrel

-----Original Message-----
From: Ward, Timothy T
Sent: Friday, July 25, 2008 10:01 AM

To: Dochow, Darrel W
Subject: Meetings till 4:00p EDT

Will call you right after. Couple of items from my side.

Downey C&D with capital provision or PCA notice of intent to reclassify as Adequate.

WaMu MOU - why did we run it by FDIC, but not me?

Timothy T. Ward
Office of Thrift Supervision
202.285.6405 - cell
202.906.5666 - office

Sent from my BlackBerry Wireless Handheld

From: Blackburn, Dale R <Dale.Blackburn@ots.treas.gov>
Sent: Wednesday, August 6, 2008 1:06 PM
To: Dochow, Darrel W <dochowdw@office of thrift supervision.com>; Hendriksen, James A <hendriksenja@office of thrift supervision.com>
Cc: ~~Franklin, Benjamin D <franklinbd@office of thrift supervision.com>~~
Subject: Wamu MOU-Board provisions

I spoke with Ben about the effectiveness of Wamu board oversight/governance. In his presentation to the board, he labeled Management/Board Performance and Oversight as unsatisfactory due to the following:

1. Poor financial performance exacerbated by:
   - Poor underwriting quality
   - Geographic concentrations in problem markets
   - Liberal underwriting policy
   - Risk layering

2. Repeat significant underwriting and process weaknesses in the Home Loans Group
3. Slow response to reducing high risk lending products and practices
4. Continuing Compliance weaknesses, especially BSA (we now consider them in violation of the C&D)
5. Repeat MRBA for inadequate ERM function

Ben stated that the repeat MRBA items were the primary reason for criticizing the board. He is concerned that the board is not getting sufficient, consistent, or understandable information/reports from management. This was confirmed by the board's self-assessment where they acknowledged that they did not have a full understanding of the bank's risks. In addition, Ben expressed concern about the board's committee structure with the mortgage group reporting to the Finance Committee, rather than to a Credit Committee. This deficiency also feeds into the repeat MRBA for an inadequate ERM function. Ben stated that he believes the directors are able to provide adequate oversight with the right information and structure.

Thus, for the proposed MOU, I suggest we do not remove the references to the board's oversight from the Management and Board Oversight section, but that it is more specific as to the review of the board's committee structure/responsibilities and information reporting that it receives/needs from management in order to appropriately govern. This will be consistent with the ROE.

Finally, I recommend we add that the board appropriately address/correct the MRBA items, not just the OTS findings described in the findings memorandums as it is presently worded. I suggested to Ben that he put the board structure/reporting concerns as an MRBA in the ROE. That way if the specific board oversight language in the MOU is too troublesome, then by having them as MRBAs and also requiring in the MOU that the MRBAs be addressed, we accomplish the same thing.

Dale R. Blackburn
Assistant Director

OTS Seattle Office
(206) 829-2603 Office
(206) 902-8191 Mobile

Permanent Subcommittee on Investigations
EXHIBIT #46

From: Dochow, Darrel W
Sent: Monday, August 25, 2008 4:39 PM
To: Polakoff, Scott M <polakoffsm@office of thrift supervision.com>
Cc: Reich, John M <reichjm@office of thrift supervision.com>; Blackburn, Dale R <blackburndr@office of thrift supervision.com>
Subject: RE: WAMU

Scott:

The MOU does reference a requirement to correct all matters requiring board attention in the ROE and all examination findings in the findings memos. The attorneys did push back on that since they have not see the ROE. I instructed Jim Hendriksen to leave the language in the MOU and he provided some verbal assurance that there would be no surprises, but from their perspective, it would be better if the Board had the ROE in hand prior to signing the MOU.

Darrel

From: Polakoff, Scott M
Sent: Monday, August 25, 2008 1:30 PM
To: Dochow, Darrel W
Cc: Reich, John M; Blackburn, Dale R
Subject: RE:

Darrel - thanks. I seem to recall that during one recent conversation with Steve Frank he noted that the MOU referenced the ROE findings and that the BOD might need the ROE in order to sign the MOU. Possibly I misunderstood him, maybe not. You should at least be aware of this possibility and be ready to address it.

Scott

From: Dochow, Darrel W
Sent: Monday, August 25, 2008 4:11 PM
To: Polakoff, Scott M
Cc: Reich, John M; Blackburn, Dale R
Subject: RE:

Scott:

MOU at thrift and holding company is now agreed to by company attorneys and we can request the Board to execute anytime.

ROE is due from EIC Franklin to AD Blackburn today but has not yet been received. Dale is following up. It could take approximately 7 -10 work days to review, upload final and mail to the Board, but we will speed this as much as possible.

Darrel

From: Polakoff, Scott M
Sent: Monday, August 25, 2008 12:48 PM
To: Dochow, Darrel W

Cc: Reich, John M
Subject: RE:

Darrel - as we discussed, the most likely candidate is not deemed highly qualified (at least in my eyes) to run a $300 billion institution.

~~What is the status of the ROE? When will it be mailed?~~
What is the status of the MOU?

I feel like we are stuck in quicksand here. We certainly want to work with Steve but we need to have a game plan for completion of the ROE and enforcement action.

Scott

From: Steve Frank [mailto:steve5865@gmail.com]
Sent: Monday, August 25, 2008 3:43 PM
To: Dochow, Darrel W
Cc: Reich, John M; Polakoff, Scott M
Subject: RE:

Darrel—

Several discussions over the weekend. We put a compensation term sheet in the hands of Fishman's lawyer yesterday afternoon and will probably have another discussion late today or early tomorrow. As I indicated, we also initiated parallel discussions with two other candidates in the event that this doesn't bear fruit. One does not appear appropriate, but the other is very interesting and interested, and I think would bring high credibility. I met with him for several hours yesterday afternoon, and a second meeting is scheduled for tomorrow afternoon in San Francisco with four or more directors attending. The candidate has asked that we not share his name with you until after that meeting. I'll give you an update as soon as practical after tomorrow's meeting. I will be in Los Angeles for meetings over the next two days, but will be able to respond in a timely fashion to any emails picked up on my Blackberry.

Steve

Steve Frank

From: Dochow, Darrel W [mailto:darrel.dochow@ots.treas.gov]
Sent: Monday, August 25, 2008 12:25 PM
To: Steve Frank; Reich, John M; Polakoff, Scott M
Subject: RE:

Steve:

Anything new today?

Darrel

From: Steve Frank [mailto:steve5865@gmail.com]
Sent: Friday, August 22, 2008 3:45 PM

To: Reich, John M; Polakoff, Scott M; Dochow, Darrel W
Cc: dbonderman@tpg.com; Tom Leppert (tleppert@tcco.com); osmith30@comcast.net
Subject:

Dinner meeting that David Bonderman and Orin Smith had with Alan Fishman last night went well, and he continues to display keen interest. We are currently working with his lawyer on contract/compensation. Given our recent experience, we are meeting with two other potential candidates on Sunday. If all goes well with negotiations over the weekend we would endeavor to have you meet Fishman early next week as you suggested, but wanted to have a fallback plan. Will keep you advised.

Steve Frank

No virus found in this outgoing message.
Checked by AVG.
Version: 7.5.524 / Virus Database: 270.6.6/1627 - Release Date: 8/22/2008 6:48 AM

No virus found in this incoming message.
Checked by AVG.
Version: 7.5.524 / Virus Database: 270.6.7/1632 - Release Date: 8/25/2008 7:05 AM

No virus found in this outgoing message.
Checked by AVG.
Version: 7.5.524 / Virus Database: 270.6.7/1632 - Release Date: 8/25/2008 7:05 AM

Office of Thrift Supervision
Department of the Treasury

West Region

101 Stewart Street, Suite 1010, Seattle, WA 98101-2419

Seattle Area Office

Telephone: (206) 829-2600 • Fax: (206) 829-2620

September 11, 2008

WaMu Ratings of 3/343432

Introduction
The FDIC West Region recently informed us that they are moving forward with CAMELS Ratings of 4/444442 for Washington Mutual Bank (WMB or Bank). The OTS West Region assigned ratings of 3/343432 under the Uniform Financial Institutions Rating Systems (UFIRS) definitions at the July 15, 2008 meeting with the Board of Directors. We have agreement with the FDIC regional office on the Asset Quality, Earnings, and Sensitivity component ratings, but are one notch higher on the Capital, Management, Liquidity and therefore the Composite ratings.

OTS and FDIC regional representatives met on several occasions in August after we learned of a potential ratings difference. We share a common perspective about the company's deteriorated financial condition. The OTS regional representatives believed that the discussions allowed us to clarify some important information, particularly around the assumptions used in the FDIC's stress scenarios that showed potential capital deterioration to "undercapitalized" by 2010.

This memorandum highlights our examination findings, enforcement actions, basis for our assigned ratings, and what we understand are the key drivers for the difference in rating at this point in time with the FDIC.

Examination Approach
Our examination of WMB is conducted on a continuous basis using dedicated examination leads and teams of examiners from throughout the West Region and country. During the period of September 10, 2007 to June 30, 2008, we conducted targeted examinations of retail/consumer lending, mortgage lending, credit administration, servicing, and operations. Much of the financial information available at time of the reviews was dated March 31, 2008. Information was updated to June 30, 2008 in key areas as it became available. In addition, we conducted Information Technology and Compliance examinations and assessed the institution's compliance with the outstanding BSA/AML Order to Cease and Desist.

Midway during our continuous examination review period (2/27/2008), we downgraded the composite rating to "3" based on net losses and negative asset quality trends. We re-confirmed this "3" composite rating at completion of the examination on June 30, 2008 and met with the board of directors on July 15, 2008 to discuss our findings, conclusions and anticipated enforcement action. OTS entered into MOUs with both Washington Mutual Bank and Washington Mutual Inc., which became effective concurrently with a change in CEO on

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September 7, 2008. We continuously monitor WMB's condition and will adjust composite and component ratings in accordance with the UFIRS definitions. The OTS examination team worked closely with the FDIC dedicated examiner and his team during the entire examination review period and FDIC participated in the exit meeting with the Board of Directors. Unfortunately, we had not realized until after the meeting with the Board of Directors that the FDIC would have a composite ratings difference.

Enforcement Actions

Cease and Desist Order (C&D). OTS issued a C&D order on October 17, 2007 related to weaknesses in WMB's Bank Secrecy Act/Anti-money Laundering (BSA/AML) programs.

Civil Money Penalty (CMP). OTS issued an order for CMPs totaling $60,448 related to Bank's violation of flood insurance regulations in its Multifamily Loan group on October 17, 2007.

Board Resolution – Required Board Resolution committing to correct concerns at time of mid-exam ratings downgrade to a composite "3" on February 27, 2008.

Memorandum of Understanding (MOU) effective September 7, 2008. Action items include: (1) submission of a 3-year business plan – both base case and stressed scenarios - (within 30 days) for OTS review and non-objection followed by quarterly variance reports, (2) a contingency capital plan (within 90 days), (3) a classified asset reduction plan (incorporated into the business plan), (4) engage an outside consultant to review risk management practices (45 days), and submit a report to OTS (75 days), (5) engage an outside consultant to review the underwriting process for the Home Loans Group (45 days), and submit a report to OTS (75 days), (6) submit a report to OTS to address the consultants' recommendations within 30 days of receipt of the consultants' reports, (7) review alerts for the period April 1, 2006 through June 30, 2008, and file SARs where required (no later than October 31, 2008), and (8) ensure that management corrects all OTS findings specified in the Report of Examination and the Findings Memoranda. Within 55 days of the end of each quarter, the Board shall certify compliance with the MOU and submit a certified copy to the OTS.

Holding Company MOU effective September 7, 2008. Action items include: (1) submission of a consolidated 3-year business plan (within 30 days) for OTS review and non-objection followed by quarterly variance reports, (2) a contingency capital plan (within 90 days).

Ratings Discussion

***Composite Rating-3*:**

In accordance with the UFIRS definitions, the OTS assigned a composite rating to Washington Mutual Bank of "3". The definition of an institution rated in this category is:

> Financial Institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4.

> Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rates a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

By contrast, the UFIRS definition for a "4" says:

> Financial institutions in this group generally exhibit unsafe and unsound practices and conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

With regards to component ratings, the OTS and FDIC concur on the "4" rating for Asset Quality and Earnings and the "2" rating for Sensitivity. The OTS believes that "3" ratings are appropriate for Capital, Management and Liquidity while the FDIC believes that these components should be rated "4".

The composite rating difference between OTS and FDIC regions stems primarily from one's conclusions about the credit cost projections and the timing of such losses, level of prospective core operating income, and adequacy of liquidity during this uncertain time and unprecedented market reaction. In addition, there is an element of potential timing difference as the OTS rating was assigned at completion of the examination on June 30, 2008 and we continue to watch closely the unfolding events and implications of the public disclosure of the enforcement action and the "4" FDIC rating on key funding partners and public confidence. All the above conclusions drive the amount of capital currently needed to support the risk in the institution.

Both OTS and FDIC analyzed and further stressed the Bank's Recession Scenario projections. Under the FDIC's stress analysis, we understand the Bank's capital designation could fall to "undercapitalized" by late 2010. Under the OTS further stress analysis, capital ratios remain above the "well capitalized" thresholds, but dip below the higher Tier 1 Leverage and Total Risk Based Capital thresholds imposed by the MOU of 6.75% and 11.25% respectively by late 2010.

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This potential outcomes contained in our further stress scenarios is one reason why OTS included, and FDIC supported, ~~a requirement in the MOUs that the Bank and holding company~~ submit a contingency capital plan within 90 days. This is intended to ensure that the Bank has in place a clear plan for shoring up capital should their Recession Scenario projections become unattainable. It also allows the new CEO time to assess the situation and submit a business and capital plan intended to ensure the financial turn around of the company. As part of the continuous examination process, we are actively monitoring actual performance against plan projections and the unfolding market events.

Credit Cost Projections

In the first quarter of 2008, management revised its expectations for future life-of-loan SFR losses to $19 billion. In addition to SFR losses, management separately forecasts losses for credit cards and multi-family/commercial loans, plus factors in foreclosure and lost interest expenses. The sum of these credit costs though 2010 total $35 billion in the Recession Scenario. Estimated SFR loan losses take into account changes in home prices, a variable outside of management's control, and one that is difficult to predict accurately. The following chart shows the default frequency and loss severity assumptions that were made in the first quarter 2008 and the implied losses:

Loan Type	1Q08 Balance	Cum. Loss	Frequency of Default	Loss Severity	Losses since 1Q08	Remaining Losses
Option ARM	$52.5	$5.6	27%	40%	$0.5	$5.1
Other Prime	58.7	1.4	6%	40%	0.15	1.3
Home Equity 1st	15.9	0.6	9%	40%	0.06	0.5
Home Equity 2nd	44.8	7.4	17%	100%	0.64	6.8
Subprime 1st	15.1	2.8	46%	40%	0.40	2.4
Subprime 2nd	2.3	1.1	47%	100%	0.15	1.0
Total	**$189.4**	**$18.9**	**18%**	**55%**	**$1.90**	**$17.0**

In order to determine the reasonableness of these assumptions, we looked at the performance of similar loan types in securitizations. In all but the 2007 vintage of home equity loans (9 percent of the portfolio as of June 30), the bank's portfolio performance, in terms of the 90+ day delinquencies, was better than similar loans in securitizations.

Loan Categories by Vintage (in $Billions) as of June 30, 2008							
	Pre-2005	**2005**	**2006**	**2007**	**2008**	**Totals**	
Option ARM	$14.8	$11.6	$11.6	$14.2	$0.2	**$52.4**	**29.2%**
Other Prime	18.0	7.4	4.5	18.6	3.2	**51.7**	**28.9%**
Home Equity 1st	6.7	2.6	1.4	[illegible]	0.4	**15.5**	**8.7%**
Home Equity 2nd	10.3	9.6	11.5	[illegible]	0.6	**43.6**	**24.3%**
Subprime	4.0	3.8	6.3	1.9	0.0	**16.0**	**8.9%**
Totals	$53.8	$35.0	$35.3	$50.7	$4.4	**$179.2**	**100.0%**
Percent	30.0%	19.5%	19.7%	28.3%	2.5%	**100.0%**	

We compared the projected cumulative loss percentages estimated by S&P[1] for 2006-2007 Option ARM and Subprime securitizations and for 2005-2007 Prime Jumbo securitizations to the

[1] July 29, 2008, Ratings Direct, *Standard & Poors Revises U.S. Subprime, Prime, and Alternative-A RMBS Loss Assumptions*

implied cumulative loss percentages estimated by the bank for those loan types. Although the Other Prime category contains Prime Jumbo loans, it also contains other non-jumbo loans with prime characteristics.

Implied Cumulative Losses by Loan Category and Vintage							
	2005		2006		2007		Adjustment to Losses using S&P estimates
	S&P	Bank	S&P	Bank	S&P	Bank	
Option ARM	NA	10.8%	11.0%	10.8%	14.8%	10.8%	570 million
Prime Jumbo	0.32%	2.4%	0.81%	2.4%	1.17%	2.4%	(455 million)
Subprime	NA	22.4%	23.0%	22.4%	27.0%	22.4%	125 million
Net Total							240 million

As the chart above shows, we found in the recent vintages of Option ARMs, that the bank uses lower cumulative losses than S&P. However, since the bank applied a flat loss rate to all vintages, it is also likely that the bank overestimated cumulative losses for pre-2006 vintages. The same holds true for subprime loans. It appears that the bank has overestimated the cumulative losses on its Prime Jumbo loans in all vintages. Moreover, S&P's loss severity component of the cumulative loss calculation includes the costs to foreclose and liquidate, as well as any decline in property value[2]. The bank estimates foreclosure costs separately. Thus, given the better overall performance of 91 percent of the bank's owned portfolio compared to securitizations of similar types and vintages, and that there is no evidence to show that the bank's cumulative losses are understated when compared to S&P's estimated losses for similar types and vintages, we believe that the banks estimated range of SFR life-of-loan losses is reasonable.

FDIC states option ARM loss severity experienced during 2Q08 was 29 cents on the dollar. This is less than the bank projects in their life-of-loan losses. The bank projects a 40% loss severity, not including foreclosure and liquidation expenses that are separately quantified. In addition, the Bank accounts for deferred interest on its Option Arm loan balances in its Recession Scenario forecast.

The bank's overall unsatisfactory condition is primarily the result of the poor asset quality and operating performance in the bank's major Home Loans Group line of business. Multi-family, credit card and retail operations are well run, are not experiencing similar problems to the Home Loans Group, and collectively generate significant core operating income. The deteriorating asset quality in the Home Loans Group is accompanied by inadequacies in risk management, internal controls, and oversight that made the bank more vulnerable to the current housing and economic downturn. The examination criticized past liberal home loan underwriting practices and the concentrated delivery of nontraditional mortgage products to higher risk geographic markets.

Management has ceased making higher risk pay-option ARM loans, stated income loans, and subprime loans. Home equity originations are nominal. In addition, they discontinued the wholesale lending channel, eliminated thousands of positions, and refocused on lower risk GSE-

[2] May 7, 2008, Ratings Direct, *The Anatomy of Loss Severity Assumptions in U.S. Subprime RMBS*

eligible mortgage lending directly to its customers through its retail distribution channels. Nonetheless, there remains a large volume of higher risk, predominantly single family assets on the balance sheet with deteriorating credit quality that need to be resolved.

The bank is actively addressing the recast risk in its Option ARM portfolio in order to reduce delinquencies from payment shocks. Its recast risk mitigation plan includes contacting borrowers within six months of a rate reset and offering to refinance the loan with discounted fees into a GSE/FHA salable product or modifying the loan into a 5/1 interest-only hybrid ARM at the current market rate or at a discount rate, depending on borrower qualifications.

With respect to timing of losses, the FDIC's stress analysis assumes that all of the estimated $19.0 billion life of loan losses in the SFR loan portfolio (exclusive of foreclosure costs and lost income) will occur in the 2008 -2010 timeframe. The Bank projects that SFR losses during this time period will approximate $15.0 billion. To date, actual losses of $3.5 billion YTD 2008 remain within the Bank's Recession Scenario projections of $8.6 billion for 2008. By assuming that all losses are accelerated to the shorter time period, the FDIC assumes that approximately $4.0 billion of losses projected by the Bank for 2011 and beyond will occur in the approximate 2009 to 2010 time period and must be supported by capital now.

In order to assess what might be a worst case, staff reviewed a further FDIC stress assessment where the Bank's Recession Scenario was stressed by an additional 10% and 20% in addition to the already discounted core operating income assumption and the assumption that all potential life of loan losses occur in the 2008 to 2010 time period, despite the fact that approximately $4.0 billion is projected to occur in 2011 and beyond. Even under this scenario, the results that we have seen shows WMB falling to "undercapitalized" under the PCA standards and such assumptions are debatable.

We further determined that the ALLL was adequate as of June 30, 2008, having been significantly increased in the second quarter in response to our examination and deteriorating trends factored into their reserve analysis.

The net losses stemming from credit costs and related higher expenses associated with discontinuing operations led the holding company to raise $7.2 billion in additional equity and infuse $5 billion into WMB. WMB has started to deleverage to reduce exposure to home loans in order to help maintain its capital ratios. Management plans to reduce assets to $280 billion by year-end 2008, $263 billion by year-end 2009, and $253 billion by 2010 to maintain satisfactory capital ratios until losses subside. Although capital presently exceeds the minimum regulatory standards by a significant margin, we are fully aware it may not be sufficient to support the institution's risk profile if conditions deteriorate beyond estimates in the Bank's Recession Scenario. Second quarter 2008 loan losses were within the expected range. Should housing prices continue declining beyond that assumed in the Recession Scenario credit losses will likely exceed internal estimates and additional capital or other mitigation may be needed. We are monitoring the situation continuously.

Core Operating Income

WMB's losses began in the fourth quarter of 2007 ~~and profitability is not expected to return until~~ the third quarter of 2009, based on management's Recession Scenario forecasts. This scenario assumes the high end of the range for SFR credit losses of $19 billion, not counting foreclosure costs.

Recession Forecast	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	YE 2010
Earnings	(1,350,555)	(1,077,380)	(835,264)	(376,880)	144,352	186,260	2,009,194
Ending GAAP Equity	24,879,191	23,651,811	22,816,547	22,439,666	22,584,018	22,770,278	24,779,473
Tier 1 Leverage Ratio	7.42%	7.45%	7.29%	7.27%	7.46%	7.65%	8.63%
Tier 1 Risk-based Ratio	8.73%	8.37%	8.08%	7.96%	8.10%	8.26%	9.33%
Total Risk-based Ratio	12.82%	12.51%	12.19%	11.92%	11.99%	12.16%	12.80%

In addition, the forecast takes into account planned changes in the balance sheet, such as reductions in lower yielding SFR balances and increased higher yielding credit card balances. Similarly, higher loan losses are included for higher risk credit cards. Restructuring and resizing costs are estimated at $450 million, with $207 million recorded in the second quarter 2008, and the remaining to be recorded in the second half of 2008. The restructuring is expected to result in future annual cost savings of approximately $1 billion, which is factored into the forecast.

Stress Scenario: When we stress forecasted net income in the Recession Scenario to account for potential execution risk, additional AFS impairments, and other operational risks such as increased cost of funds by an additional $500 million after taxes per quarter beginning in the fourth quarter of this year, profitability does not return until 2010. This scenario slightly breaches capital levels required by the MOU (6.75% Tier 1 and 11.25% Total RBC), but they remain significantly above "well-capitalized" PCA thresholds, before returning to profitability.

Recession and $500M per quarter	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	YE 2010
Earnings	(1,350,555)	(1,577,380)	(1,335264)	(876,880)	(355,648)	(313,740)	1,509,194
Ending GAAP Equity	24,879,191	23,151,181	21,816,547	20,939,666	20,584,018	20,270,278	20,279,473
Tier 1 Leverage Ratio	7.42%	7.27%	6.91%				6.81%
Tier 1 Risk-based Ratio	8.73%	8.15%	7.63%	7.29%	7.20%	7.11%	7.23%
Total Risk-based Ratio	12.82%	12.29%	11.75%				

Management's ability to execute a deleveraging strategy, to halt asset quality deterioration, and to resolve problem assets within expected loss scenarios are risks to achieving the forecast. However, our analyses of modeling support for loan losses, the bank's ability to generate core earnings, estimated restructuring cost savings, and planned changes to its asset mix indicate the profit forecast is reasonably well supported, albeit subject to the ongoing risks.

With respect to projected core earnings, the FDIC's stress scenario assumes that core earnings remain at approximately $1.2 billion per quarter over the next 10 quarters through yearend 2010 versus the Bank's estimate of $1.4 billion per quarter in their recession case scenario ($1.9 billion in the base case scenario). OTS reviewed the Bank's core earnings estimates and concluded that core income assumptions are reasonably supported at the $1.4 to $1.5 billion per quarter level. Over 10 quarters, this accounts for approximately $3.0 billion of the potential

additional capital support. We understand the rationale of using the $1.2 billion per quarter assumption since this was derived from the lowest core income of $1.4 billion in the most recent quarter. However, our examination team in looking at the Bank's support for its core income assumptions felt that several facts warranted some consideration (not included in the FDIC's core income assumption) in arriving at a reasonable and supportable core income assumption. These facts included:

- Actual core income has averaged $1.5 billion over the last several quarters.
- WMB has already incurred significant cost to obtain approximately $1.0 billion in cost savings associated with essentially closing its mortgage banking operations that was unprofitable.
- WMB is re-mixing its loan portfolios. The low yielding SFR loan portfolio is dramatically declining due to shutting down the wholesale loan conduit, amortization, refinancing into loans being sold to the GSEs, and losses, among other reasons. Over the next ten quarters, low yielding SFR loans are projected to decline by approximately $58 billion. At the same time the Bank is retaining and bringing back on balance sheet higher yielding credit card receivables. Despite the increased loan loss provisions associated with these credit card balances, the higher yields on the relatively smaller portfolio more than makes up for the loss of the larger portfolio of lower yielding SFR loans and is accretive to core income.
- Fee income improvement from a conservative (approximately half of historical growth and close to interest credited) projected growth in deposits.

Our analysis concluded that the forecast and underlying assumptions are reasonable but subject to ongoing risks, including:

- Economic conditions, housing prices, and employment levels worse than assumed.
- Default probability and/or loss severity for loans greater than estimates.
- Execution risk of ongoing and future changes to the business strategy.
- Operational risks, including legal and reputational risks.
- Rating agency downgrades further than assumed.
- Declining valuation of pledged assets for liquidity purposes.
- Changes in interest rates or the shape of the yield curve.

As a result of these ongoing risks, we stressed management's recession case earnings by $500, pretax, using the FDIC's capital analysis. This analysis essentially resulted in stressed operating earnings approximating $1.1 billion per quarter through YE 2001. Using this stressed income and maintaining losses within the range forecast through 2010 results in capital ratios that are below the MOU requirements, but within well capitalized status.

This analysis is illustrated in the table that follows:

Beginning GAAP Equity	$24,380	$24,380	$24,380
July 2008 Capital Injection	2,000	2,000	2,000
Earnings Before Prov thru YE 2010	12,064	11,148[3]	14,148
Cum. Loss Est. (Home Loans)	(19,000)	(15,000)[4]	(15,100)
Other Loan Losses	(9,100)	(9,100)	(9,100)
Foreclosure Cost	(3,450)	(3,450)	(3,450)
Losses taken in 2Q08	2,200	2,354[5]	2,354
Existing ALLL at 2Q08	8,456	8,456	8,456
Embedded Losses in AFS Sec.	(1,475)	(841)[6]	0
Net Capital Impairment	($10,305)	($6,534)	($2,693)
Regulatory Capital Ratios @ yearend 2010			
Tier 1 Leverage	5.0%	6.8%	8.4%
Tier 1 Risk-based	5.1%	7.2%	9.0%
Total Risk-based	8.6%	10.6%	12.5%

Capital-3:
The overall level and composition of capital is considered less than satisfactory but is currently considered adequate to withstand immediate pressure stemming from significant credit deterioration, insufficient earnings, and other negative market trends. Although the examination concluded that capital was adequate in the short-term, maintaining satisfactory levels in the long-term is, in part, dependent on the severity of the credit losses emanating primarily from the SFR loan portfolios and on management's ability to appropriately react to risks posed by the current market events and economic downturn. Management's actions to improve WMB's capital position include the curtailment of riskier lending products, suspension of dividends, current and future material reduction of assets, accessing the capital markets twice at the holding company and infusing a total of $6.5 billion into the bank since the fourth quarter of 2007.

The holding company (WMI) raised $3 billion in capital in December 2007, and another $7.2 billion in April 2008. Capital infusions to WMB ($6.5 billion between December1, 2007 and September 11, 2008) maintained their capital ratios above well-capitalized levels and internal targets. At June 30, 2008, Tier 1 Leverage ratio was 7.1 percent and a Total RBC ratio was 12.4 percent (per UTPR). Subsequently, WMB's Tier 1 Leverage ratio increased to approximately 7.6 percent and the Total RBC ratio to 13.2 percent as additional capital was contributed. WMI has retained approximately $1.5 to 2 billion from capital raises for debt service, future WMB capital needs and to maintain its credit rating. The April 2008 $7.2 billion capital raise included a "price protection" feature that states if there is a change of control of the company or the company sells more than $500 million of common stock or equity-linked securities within 18

[3] Based on WMB recession scenario operating income that is stressed by $500.0 million, pretax

[4] OTS reflects losses projected for 2008-2010 vs. FDIC projection that all life of loan losses occur by YE 2010

[5] Reflects actual 2Q08 losses

[6] OTS assumes net of tax unrealized loss, FDIC assumes gross unrealized loss

months of closing at a price lower than $8.75 per share, the company would have to pay the difference between the lower price and $8.75 per share to the investors. This feature effectively precludes more than $500 million additional capital from sources other than the TPG investor group while the price protection feature is active and the stock trades below $8.75. The company's stock was recently trading at less than $3 per share.

WMB forecasts its earnings and capital levels under two scenarios, a Base Case and a Recession scenario. The Base Case assumes the most probable level of credit losses, while the Recession scenario assumes the high end of credit losses. The Base Case also uses the forward rate curve, while the Recession scenario assumes a fed rate cut to 1 percent, lower GDP, higher unemployment, and steeper housing price declines. As shown below, all capital levels are above the minimum levels required by the MOU of 6.75 percent Tier1 and 11.25 percent Total RBC.

Base Case	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	YE 2010
Earnings	(1,159,101)	(500,166)	(511,535)	232,423	622,200	1,040,294	3,534,477
Ending GAAP Equity	25,070,646	24,420,480	23,908,945	24,141,368	24,763,568	25,803,862	29,338,339
Tier 1 Leverage Ratio	7.46%	7.68%	7.67%	7.87%	8.26%	8.72%	10.48%
Tier 1 Risk-based Ratio	8.81%	8.70%	8.56%	8.72%	9.09%	9.62%	11.46%
Total Risk-based Ratio	12.89%	12.84%	12.68%	12.67%	12.98%	13.52%	14.93%
Recession Scenario	**Q3 2008**	**Q4 2008**	**Q1 2009**	**Q2 2009**	**Q3 2009**	**Q4 2009**	**YE 2010**
Earnings	(1,350,555)	(1,077,380)	(835,264)	(376,880)	144,352	186,260	2,009,194
Ending GAAP Equity	24,879,191	23,651,811	22,816,547	22,439,666	22,584,018	22,770,278	24,779,473
Tier 1 Leverage Ratio	7.42%	7.45%	7.29%	7.27%	7.46%	7.65%	8.63%
Tier 1 Risk-based Ratio	8.73%	8.37%	8.08%	7.96%	8.10%	8.26%	9.33%
Total Risk-based Ratio	12.82%	12.51%	12.19%	11.92%	11.99%	12.16%	12.80%

As shown in the Earnings analysis, if we further stress the Recession Scenario by lowering net income by $500 million after taxes per quarter (beginning in 4Q08), the resulting capital levels temporarily breach the levels required by the MOU, but remain above the "well-capitalized" PCA threshold. However, at this time, based on a comparison to the S&P performance for similar loans, the credit loss estimates are not out of line and the additional stress of $500 million per quarter provides for a margin of error.

The forecast and underlying assumptions are subject to ongoing risks as stated above.

Management-3:
We concluded that Board oversight and management performance was less than satisfactory, largely due to the significant deterioration in the Bank's financial condition since June 2007. While some of the deterioration was attributable to the downturn in credit and housing markets, other contributing factors should have been more proactively managed. The most significant contributing factors include continued SFR underwriting weaknesses, an Enterprise-wide Risk Management function that was not fully effective and various compliance deficiencies. The failure to address these weaknesses fully in a timely manner is now exacerbating SFR credit losses. Management has commenced positive steps to address the deficiencies noted, and we believe are capable, under the leadership of the new CEO, of correcting them.

With our support, a new CEO was put in place on September 7, 2008. The organization was experiencing a loss of confidence in the abilities of the former CEO. The board was unanimous ~~in moving to find a qualified CEO quickly.~~

Management has regularly revised its financial forecasts to better reflect these unprecedented times of home price declines, secondary market disruptions and event risk among other things. This is not unusual and reflects management's continual effort to updating forecasts and plans as information changes.

Much of the Bank's asset quality and earnings problems stem from the Home Loans Group. Management personnel of the Card Services and Multi-family/Commercial groups are considered capable. While the Retail Banking group is currently without a permanent senior manager, middle management is satisfactorily running this segment of the bank under the direction of the COO. Operations management under the CFO, including treasury and market risk management, are considered strong. We have criticized the Enterprise Risk Management function, but this has been significantly strengthened with the recent addition of a capable Chief Enterprise Risk Officer.

As noted above, the bank's current condition and poor operating performance are primarily the result of insufficient risk management and oversight of the Home Loans Group that made it vulnerable to the current housing and economic downturn. The strategy over the last three years of expanding home lending increased credit risk from relaxed underwriting practices, weak controls, and concentrated delivery of nontraditional mortgage products to higher risk geographic markets. Despite our past examination concerns about underwriting practices, oversight was insufficient to control the escalating risks. The last several examination reports criticized various aspects of SFR underwriting; however, the most notable criticism pertained to underwriting of stated income loans without effective reasonableness testing. Similar criticism has been noted in internal credit review reports. These underwriting practices, resulting in the large credit losses, were not timely addressed and the bank only recently exited higher risk lending, including stated income lending.

The weaknesses in compliance management that we identified in our prior examination, although improved, continue to require management's attention. The primary weaknesses are unclear compliance roles and responsibilities, lack of consistent self-testing methodology and measurement metrics across business units, lack of compliance leadership continuity, mismatched managerial line authority and accountability, and inconsistency in implementing the stated commitment to compliance best practices. In addition, we found a violation of the BSA/AML Cease and Desist Order due to a continuing inadequate compliance program and failure to satisfactorily address the backlog of alerts.

There have been several notable board changes since the prior examination:

- The directors amended the bylaws to increase the board from 13 to 14 members and elected Stephen I. Chazen to the Board. Mr. Chazen is President and CFO of Occidental Petroleum Corporation, an international oil and gas exploration and production company.

- The board elected David Bonderman, Managing Director of the global private investment firm, TPG, pursuant to the April 7, 2008, Investment Agreement between WaMu and TPG Investors.

- Directors Mary E. Pugh and Ann V. Farrell left the board. Mr. Bonderman succeeded Ms. Pugh as Chair of the Finance Committee until June 2008 when Director Orin C. Smith was appointed Chair. Mr. Bonderman serves as Vice Chair.

- Independent director Stephen E. Frank assumed the position of Chairman of the Board formerly filled by CEO/Director Kerry Killinger. The change, initiated by the shareholders, is a measure intended to strengthen corporate governance.

- At TPG's request, Larry Kellner, former EVP and CFO of American Savings Bank and currently COB and CEO of Continental Airlines, is a board observer.

- WaMu has initiated a search for individuals with extensive financial services and strong leadership experience to fortify the board as new independent directors. There is currently one board vacancy.

Senior management changes during the review period:

- Chief Legal Officer Fay L. Chapman retired and Stewart M. Landefeld, a partner of Perkins Coie LLP, served as interim Chief Legal Officer until Michael S. Solender, formerly General Counsel of the Bear Sterns Companies, was named Chief Legal Officer in June 2008. Ms. Chapman will serve as consultant to WaMu for two years.

- John P. McMurray replaced Ronald J. Cathcart as Chief Enterprise Risk Officer. Mr. McMurray, formerly the chief credit officer at Countrywide Financial Corporation, joined WaMu late 2007 as Chief Credit Officer. Mr. Cathcart has resigned.

- President and COO Stephen J. Rotella assumed James B. Corcoran's responsibilities as President, Retail Banking on an interim basis until a permanent successor is selected. Mr. Corcoran has resigned.

Liquidity-3:
The Bank's liquidity position is less than satisfactory because of uncertainty about the adequacy of future funding sources and needs. The examination concluded that absent some significant negative event, current sources will likely be sufficient to fund current and projected operational needs. WMB's liquidity position was impacted negatively by the secondary market disruption and WMB has effectively lost access to the secondary market (other than mortgage loan sales to the GSEs) as a funding source for mortgage and credit card products. Liquidity is also suffering

from headline risk and there are signs that regulatory issues have and will impact FRB potential funding.

WMB is dependent on retail deposits and secured borrowing for funding. The institution lost approximately $9.1 billion in retail and small business deposits in the months following the IndyMac Bank failure and an unexpectedly large second quarter loss announcement. Some illustrative data around these withdrawals include: an estimated 69% of the funds outflow represented uninsured money, a high percentage of customers withdrawing money maintained an account relationship with WMB; the actual number of new accounts was stable or grew during this time period; the average cost of funds leaving was reported as being the relatively higher costing funds. WMB has run several five day CD promotions at a relatively high rate. Management estimated that if all the $9.1 billion was replaced at this high rate, the impact on cost of funds would be approximately $200 million spread over several quarters.

Liquidity needs have lessened due to significant curtailment of lending activity and should be further reduced due to planned asset shrinkage. Liquidity funds management practices were judged satisfactory and management exhibits a strong knowledge of liquidity risk management. The implementation of a well-developed contingency plan has allowed the Bank to maintain excess liquidity in a difficult market environment and to react to rapidly changing credit environment.

The FHLBank of San Francisco applies conservative market valuations on pledged collateral before discounting it to its borrowing capacity. As the housing and financial markets deteriorated since mid-2007, the FHLBank systematically lowered the borrowing capacity for its members and future haircuts are expected.

Liquidity is managed to ensure sufficient liquidity under two stress scenarios and the bank presently has nearly $45 billion of total liquidity, not including its potential $8 billion access to the FRB discount window. Under the most severe stress scenario, WaMu had $13.8 billion in excess liquidity at July 31, 2008. This excess liquidity is after an assumed 2 notch downgrade in ratings, a 10% additional retail deposit run off and a $5 billion commercial deposit run off, FHLB haircuts increasing another 4%, no credit card securitization or conduit rolls. The stressed excess liquidity of $13.8 billion is below the Bank's internal $25 billion policy threshold that was set when the Bank was heavily engaged in mortgage banking operations and larger in size.

Management is continuing to build its liquidity through retail deposits and pledging additional collateral for borrowing lines. Current uninsured retail deposits are estimated at $17 billion but expected to be approximately $3 billon less when an account by account scrub is done and uninsured commercial deposits are estimated at $5 billion. Recent deposit trends are generally stable and back to pre-IndyMac patterns.

***Sensitivity to Market Risk-2*:**
Both the OTS and FDIC concur with the rating in this component. WaMu's exposure to interest rate risk was minimal at December 31, 2007, based on internal NPV modeling estimates and the

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quantitative guidelines contained in Thrift Bulletin 13a. Internal interest rate risk results indicate a modest interest rate risk profile throughout the examination review period, including the most recent June 30, 2008, results. Estimated post-shock NPV ratios have consistently been in excess of minimum NPV limits established by the board.

Asset Quality-4:
Asset quality deteriorated significantly and is considered unsatisfactory. Pronounced deterioration has occurred in SFR portfolios resulting from housing and economic weakness coupled with management's underwriting practices, concentrated use of nontraditional mortgage products, and weak controls within the Home Loans Group. Undue emphasis had been placed on loan production at the expense of loan quality. While problem asset levels increased, the Bank's internal asset review function remains satisfactory, and the Multi-family/Commercial and Credit Card Groups and their credit processes are well managed. Concerns were also cited in the Small Business loan portfolio, which remains relatively small.

WaMu	30-Jun-08		31-Mar-08		31-Dec-07	
	$(000s)	(% TA)	$(000s)	(% TA)	$(000s)	(% TA)
Delinquent Loans (30-89 days)	5,441,790	1.77	5,243,686	2.14	4,741,615	1.89
Nonperforming Loans	10,025,164	3.27	8,133,286	3.33	6,431,861	2.57
Repossessed Assets	1,531,807	0.50	1,381,066	0.43	1,015,127	0.31
Nonperforming Assets	11,556,971	3.76	9,514,352	2.99	7,446,988	2.29
Classified Assets/ Core Capital + Allowances	43.44%		40.74%		32.74%	

Delinquency Rates by Loan Category			
SFR Delinquency Rate	7.47	5.76	4.18
Home Equity Delinquency Rate	4.00	3.48	3.12
Subprime Delinquency Rate	25.19	23.09	21.25
Managed CC Delinquency Rate	7.05	6.89	6.47

The SFR prime, subprime, and home equity lending programs have been the predominant source of WMB's asset quality problems. The examination found the underwriting policies, procedures and practices in need of improvement, particularly with respect to stated income lending which has subsequently been discontinued. The Bank utilized an Automated Underwriting System that proved has limited effectiveness in proactively adjust to an increasing credit risk environment. The Bank lacked an effective reasonableness test process for stated income lending and policies and procedures were not uniform in the Home Loans Group. With our encouragement, stated income lending was discontinued for all channels during the examination.

Nontraditional pay-option ARM products are concentrated in prime and subprime portfolios representing 38 percent of total loans. Home equity loans account for 33 percent of total loans. The loan portfolio is geographically concentrated with 50 percent of loans secured by properties in California and 10 percent secured by properties in Florida, both states suffering from highly

depreciating real estate values. Approximately 48 percent of loans were originated in 2006-2007, a time when underwriting and controls were weak.

Refer to the Earnings section for analysis of estimated loan losses.

Management recently ceased making subprime loans, pay-option ARM loans, and all stated income loans and home equity loan production is nominal. In addition, they resized the Home Loans Group by discontinuing the wholesale lending channel, eliminating thousands of positions, and by focusing on mortgage lending directly to its customers through its retail distribution channels.

Dochow, Darrel W

From: Finn, Michael E
Sent: Tuesday, January 24, 2006 7:25 PM
To: Chow, Edwin L; Dochow, Darrel W
Subject: FDIC participation

The message was crystal clear today. Absolutely no FDIC participation on any OTS 1 and 2 rated exams. We should only be copying FDIC on 3, 4 and 5 ROE transmittals - no cc or bcc on ROEs of 1s and 2s. We should also deny FDIC requests to participate on HC or affiliate exams. I'll fill you in when I return.

Permission for FDIC to join us on WaMu and Downey will stand for now, but they should not be indirect contact with thrift management or be requesting info directly from the thrift. Please remind Regina and Lawrence.

Mike Finn

Permanent Subcommittee on Investigations
EXHIBIT #49

From: Carter, Lawrence D
Sent: Monday, June 19, 2006 1:30 PM
To: Dochow, Darrel W <dochowdw@office of thrift supervision.com>
Subject: RE: wm board meeting

Too late. I was bringing him up to speed this morning, and casually answered as to who I knew was attending the board meeting from our side and time and date. Didn't even cross my mind that we would have an issue with their attendance at the board meeting. He has already emailed his people, but said he will "repair damage" if we need to backtrack. Sorry.

While on the subject, Steve has offered a small number of FDIC people to help with MSR, credit scoring, and Basel (especially op risk), which I would certainly like to take him up on, but know we will have to follow protocol. He will need to know relatively quickly in order to get some of these people on the schedule if possible. Let me know how to proceed here.

-----Original Message-----
From: Dochow, Darrel W
Sent: Monday, June 19, 2006 8:04 AM
To: Carter, Lawrence D
Subject: FW: wm board meeting
Importance: High

FYI, in case Steve asks you, say that you will follow-up with me.
-----Original Message-----
From: Dochow, Darrel W
Sent: Thursday, June 15, 2006 1:11 PM
To: Finn, Michael E
Subject: RE: wm board meeting

Will do.

-----Original Message-----
From: Finn, Michael E
Sent: Thursday, June 15, 2006 11:33 AM
To: Dochow, Darrel W
Subject: RE: wm board meeting

Please hold off contacting Steve until you hear back from me. Given Scott P's firmness on FDIC issues, I have call in to take his pulse.

-----Original Message-----
From: Dochow, Darrel W
Sent: Wednesday, June 14, 2006 4:58 PM
To: Finn, Michael E
Subject: FW: wm board meeting

FYI. I intend to respond to Steve tomorrow if possible and wanted you to know of the request in case any thinking has changed. We typically would have them attend as an observer if they wanted.
-----Original Message-----
From: Funaro, Stephen P. [mailto:SFunaro@FDIC.gov]
Sent: Wednesday, June 14, 2006 4:47 PM
To: Dochow, Darrel W
Cc: Carter, Lawrence D
Subject: wm board meeting

Darrel,

The FDIC (myself and a representative from the RO - likely ARD Doerr, or DRD Villalba, or RD Carter) would like to attend the WM Board meeting when examination findings are presented. Has a date and time been established and do you know who all will be attending from OTS. Thanks,

---

Steve

FDIC

Memo

To:	Bill Baxter, Section Chief, Large Banks
Through:	J. George Doerr, Assistant Regional Director
From:	Ken Kroemer, FDIC Examiner-In-Charge: Washington Mutual Bank
	Trina Dong, FDIC Asset Manager — Washington Mutual Bank
CC:	Stephen Funaro, Dedicated Examiner
Date:	
Re:	Potential Impact of a Possible Housing Bubble on Washington Mutual Bank

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Summary

Washington Mutual Bank's (WMB) single-family residential (SFR) loan portfolio has embedded risk factors that increase exposure to a widespread decline in housing prices. The overall level of risk is moderate, but increasing. Management practices are acceptable.

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Background

A deflating housing bubble could materially affect several aspects of WMB's~~Washington Mutual Bank's~~ business model. A general decline in housing prices would adversely impact:

a) The ~~single-family residential~~ (SFR) loan portfolio,;
b) The home equity loan portfolio,; and
c) Mortgage banking revenue.

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A decline in home prices is one of several factors that could adversely affect WMB's~~Washington Mutual Bank's (WMB)~~ SFR loan portfolio. Other factors include a sustained increase in interest rates and a general economic slowdown. This memorandum is limited to a discussion of the SFR portfolio's vulnerability to a weakening housing market.

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SFR Loans

The SFR portfolio is comprised of held-for-investment (HFI) loans of $112.5 billion and $26.8 billion in held-for-sale (HFS) loans. An additional $20 billion is held in

Permanent Subcommittee on Investigations
EXHIBIT #51a

mortgage-backed securities. The asset quality of the HFI portfolio remains satisfactory as depicted by a low level of adverse classifications and charge-offs.

The SFR HFI portfolio contains several characteristics that elevate its risk profile. These elements include a substantial volume of Option ARM loans, hybrid loans, and low-doc loans, as well as relatively recent product offerings such as interest-only loans. The portfolio is largely unseasoned and has geographic concentrations. Approximately $27 billion or 24% of the portfolio has FICO scores of less than 660 and $5.4 billion or 5% of loans have loan~~Loan~~-to-values (LTV) greater than 80% without mortgage insurance. Included in the portfolio are loans originated for sale to investors but deemed unsaleable due to defects; and loans repurchased from investors, generally due to early default. Many loans have multiple risk factors. In addition, longstanding underwriting deficiencies add yet another layer of risk to the portfolio. A sub segment of the SFR HFI portfolio is the Loans to Higher-Risk Borrowers initiative that is discussed later.

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- *Option ARM, Hybrid, and Interest-Only* – The HFI portfolio consists largely of Option ARM and hybrid products, representing 61% and 32% of the portfolio, respectively. These products expose the institution to enhanced risk primarily through potential payment shock and negative amortization. Option ARM loans can negatively amortize to 125% of the original principal amount. The internal analysis indicates a significant migration of potential negative amortization loans to loans that actually negatively amortize. While the potential negative amortization loans declined to 65% of Option ARM loans at March 31, 2005 from 91% at a year ago, loans that are negatively amortizing rose notably from 5% to 33% over the same period. Internal data revealed that the percentage of loans negatively amortizing has increased more rapidly for lower credit quality (lower FICO score) loans over the past twelve months than it has for loans of higher credit quality. The Interest-Only product is relatively new, with $9 billion outstanding.

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- *Low Documentation* – The verification of source and income level is critical in determining the reliability of debt-to-income and borrower's ability to repay a loan, especially for Option ARM borrower who may be exposed to a substantial payment increase. As such, loans that do not have full income verification may experience higher default risk. The low documentation loans represent 58% of the HFI portfolio.

- *Unseasoned Portfolio* – Payment shock risk embedded in the Option ARM product does not manifest itself until the 61st month of each loan, when the interest rate resets and the outstanding principal is amortized over the remaining term of the loan. As of March 31, 2005, approximately 81% of the Option ARM portfolio was originated within the last two years. These borrowers are predisposed to repricing shock in a rising rate scenario based on their lower start rates and initial minimum payments.

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- *Geographic Concentrations* -

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- Market data suggests that a housing bubble does not exist on a nationwide scale, but that in some regions the rapid rates of housing price increases may be unsustainable. It is widely thought that home prices could stagnate in some markets rather than exhibit general price deflation. On the other hand, in some markets price indicators such as the relationship between home prices and market rents, and the level of non-owner occupied properties portend a price correction. Anecdotal evidence suggests speculative forces may be driving up values in select locales. Markets perceived as higher risk include Southern California, South Florida, and Las Vegas. WMB's SFR portfolio is distributed as follows:

California	42%
New York/New Jersey	11%
Florida/Georgia	9%
Nevada/Arizona/Utah/Colorado	6%
Washington/Oregon/Idaho	5%
Illinois	4%
Texas	2%
Other	21%

Loans to Higher-Risk / Sub Prime Borrowers
In January 2005, management developed a higher-risk lending (HRL) strategy and defined company-wide higher-risk loans as follows:

- Purchased sub prime loans through the Specialty Mortgage Finance (SMF) program,
- Originated SFR loans with FICO scores below 620,
- Originated consumer loans with FICO scores below 660, and
- Long Beach Mortgage Company's (LBMC) HFI portfolio.

Management intends to expand the HRL definition and layer additional risk characteristics in the future. Currently, the strategy limits HRL portfolio to 200% of Total Risk-Based Capital at the Washington Mutual, Inc. (WM) level. This ratio was at 152% as of March 31, 2005. WMB's HRL portfolio, which currently excludes LBMC HFI loans, is $32.9 billion and represents 142% of Total Risk-Based Capital or 194% of Tier 1 Leverage Capital. Using March 31, 2005 capital figures, the ratio for WMB would increase to 275% of Tier 1 Leverage Capital if the bank reaches the 200% of WM Total Risk-based Capital concentration limit.

The individual sectors constituting the loans to higher-risk borrowers' portfolio possess characteristics and risk parameters as detailed below.

SMF Portfolio
The SMF program involves the bulk purchase of sub prime loans from various originators, with servicing generally retained by the seller. This portfolio totaled

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approximately $18.9 billion at March 31, 2005, and continues to be managed satisfactorily. The delinquency ratio and loss rate were manageable at 5.68% and 0.22%, respectively. However, the sub prime nature of the borrowers presents additional credit risks. The portfolio FICO stratification and the sample-weighted average FICOs bear out the borrowers' historically weak financial position. About 69% of this portfolio has a FICO score of 620 or less. Additionally, nearly 60% of the SMF portfolio consists of hybrid products tied to 6-month LIBOR. These borrowers are susceptible to an increasing interest rate environment due to payment shock problems. However, the loss exposure in this portfolio is not excessive given the weighted average LTV of the entire portfolio is about 78%.

Originated SFR Loans to Higher-Risk Borrowers
Management defined higher-risk loans in this portfolio to include all loans with an original FICO score less than 620. Of the $112 billion SFR HFI portfolio, approximately $12 billion or 11% loans are to higher-risk borrowers. The March 2005 internal analysis indicates that loans to higher-risk borrowers are riskier than the rest of the SFR HFI portfolio because of lower FICO scores. These loans have a higher delinquency ratio of 3% compared to 0.37% for non-HRL portfolio. Another credit risk attribute is the levels of Option ARM and hybrid loans due to potential negative amortization and payment shock in a rising rate environment. Additionally, half of the SFR HRL portfolio is comprised of low documentation loans. Although this portfolio is subject to credit and interest rate risks, the loss exposure on these loans is generally mitigated by reasonable LTV positions. Approximately 88% of the HRL portfolio has a LTV less than 80%. However, many of these borrowers also have home equity lines, further encumbering the collateral and impairing the borrower's overall debt service capacity.

Originated Consumer Loans to Higher-Risk Borrowers
A relatively small portion of the consumer portfolio is designated as HRL, which is defined as first lien home equity loan with a FICO score of less than 620 and second lien home equity and other consumer borrowers with FICO score less than 660. Only 4% of the consumer loans met the HRL definition as of March 31, 2005. Management's analysis shows a delinquency rate of 2.39% for HRL, which is eight times higher than the non-HRL portfolio. However, the loss exposure in this portfolio is manageable as less than 8% of the HRL portfolio has combined LTV over 90%. Based on the loan sample reviewed, the average combined debt-to-income ratio was 37% for loans to higher-risk borrowers and 31% for prime borrowers. These averages are well below the bank's policy on maximum debt-to-income ratio of 55%.

Long Beach Mortgage Company (LBMC) – HFI Portfolio
The LBMC HFI portfolio totaled $2.6 billion as of March 31, 2005, and is projected to increase to $5 billion by year-end 2005. LBMC is currently an affiliate of WMB, although management proposes to bring it under WMB as a subsidiary to extend the benefits of federal pre-emption. As with the borrowers in the SMF program, the

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borrowers at LBMC typically have a history of impaired credit. The weighted average FICO for this portfolio is 621 compared to 605 for the SMF portfolio. One added credit risk element present in this portfolio is the level of low documentation (i.e. stated income) loans, representing nearly 48% of the portfolio compared to a modest 6% for SMF. To the extent that borrowers embellish their income levels to qualify for a loan, the LBMC HFI portfolio may experience greater default levels. A sample of loans was reviewed as part of the examination. The March 3/14, /2005 Visitation review disclosed pervasive underwriting weaknesses similar to those found in WMB's SFR loan portfolio.

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A significant portion of LBMC HFI loans are composed of first liens with associated piggyback second liens that have been sold to or are awaiting sale to investors. Although the cumulative LTV ratio for the portfolio is nearly 100%, the presence of the piggyback second deeds may reduce LBMC's loss given default exposure. However, a recent study indicated that default rates on such loans might be as much as 20% higher than non-piggyback loans. Additionally, the borrowers in this portfolio are susceptible to a rising interest rate environment, as 90% of this portfolio consists of 2/28 Hybrid loans tied to 6-month LIBOR. Given that the debt-to-income ratios are high for these borrowers, a payment shock could cause a spike in defaults. However, LBMC will not face this risk for the next two years since the HFI portfolio consists of new originations.

Allowance for Loan and Lease Losses (ALLL)

WMB's management addresses general credit risks through the unallocated portion of the ALLL ~~Allowance for Loan and Lease Losses~~. At March 3/31, /2005, the ALLL was $1.256 billion. Of this, $874 million is allocated for expected losses in the portfolio based upon a multiple of historical experience. The remaining unallocated $382 million is available for unforeseen losses arising from concentrations, new products, market events, etc.

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Stress Testing

Management has not specifically stress-tested the SFR portfolio for the impact of a housing bubble. It does perform risk assessments of major housing markets and tracks the performance of significant credit products by vintage and risk strata. No undue risks have been disclosed.

Management's Perspective

Management acknowledges the risks posed by current market conditions and recognizes that a potential decline in housing prices is a distinct possibility. Management believes, however, that the impact on WMB would be manageable, since the riskiest segments of production are sold to investors, and that these investors will bear the brunt of a bursting housing bubble.

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FDIC
Memo

To:	Bill Baxter, Section Chief, Large Banks
Through:	J. George Doerr, Assistant Regional Director
From:	Ken Kroemer, FDIC Examiner-In-Charge: Washington Mutual Bank Trina Dong, FDIC Asset Manager: Washington Mutual Bank
CC:	Stephen Funaro, Dedicated Examiner
Date:	
Re:	Potential Impact of a Possible Housing Bubble on Washington Mutual Bank

Summary
Washington Mutual Bank's (WMB) single-family residential (SFR) loan portfolio has embedded risk factors that increase exposure to a widespread decline in housing prices. The overall level of risk is moderate, but increasing. Management practices are acceptable.

Background
A deflating housing bubble could materially affect several aspects of WMB's business model. A general decline in housing prices would adversely impact:

a) The SFR loan portfolio,
b) The home equity loan portfolio, and
c) Mortgage banking revenue.

A decline in home prices is one of several factors that could adversely affect WMB's SFR loan portfolio. Other factors include a sustained increase in interest rates and a general economic slowdown. This memorandum is limited to a discussion of the SFR portfolio's vulnerability to a weakening housing market.

SFR Loans
The SFR portfolio is comprised of held-for-investment (HFI) loans of $112.5 billion and $26.8 billion in held-for-sale (HFS) loans. An additional $20 billion is held in mortgage-backed securities. The asset quality of the HFI portfolio remains satisfactory as depicted by a low level of adverse classifications and charge-offs.

The SFR HFI portfolio contains several characteristics that elevate its risk profile. These elements include a substantial volume of Option ARM loans, hybrid loans, and low-doc loans, as well as relatively recent product offerings such as interest-only loans. The portfolio is largely unseasoned and has geographic concentrations. Approximately $27 billion or 24% of the portfolio has FICO scores of less than 660 and $5.4 billion or 5% of loans have loan-to-values (LTV) greater than 80% without mortgage insurance. Included in the portfolio are loans originated for sale to investors but deemed unsaleable due to defects; and loans repurchased from investors, generally due to early default. Many loans have multiple risk factors. In addition, longstanding underwriting deficiencies add yet another layer of risk to the portfolio. A sub segment of the SFR HFI portfolio is the Loans to Higher-Risk Borrowers initiative that is discussed later.

* Option ARM, Hybrid, and Interest-Only - The HFI portfolio consists largely of Option ARM and hybrid products, representing 61% and 32% of the portfolio, respectively. These products expose the institution to enhanced risk primarily through potential payment shock and negative amortization. Option ARM loans can negatively amortize to 125% of the original principal amount. The internal analysis indicates a significant migration of potential negative amortization loans to loans that actually negatively amortize. While the potential negative amortization loans declined to 65% of Option ARM loans at March 31, 2005 from 91% at a year ago, loans that are negatively amortizing rose notably from 5% to 33% over the same period.

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

July 5, 2005

TO: Michael J. Zamorski
Director

THROUGH: John M. Lane
Deputy Director

FROM: John H. Corston
Associate Director

SUBJECT: Insured Institutions' Exposure to a Housing Slowdown

Background:
In recent weeks, the media has reported extensively on the growing possibility of a housing bubble. DIR and other analysts cite residential real estate markets in San Francisco, Southern California, Phoenix, Las Vegas, South Florida, Washington, DC, and New York as being potentially overheated. History has supported and examiners have viewed one-to-four family residential lending as low risk, with the exception of local or regional markets that have experienced periods of significant economic stress. This view is reinforced by favorable risk-based capital treatment for one-to-four family residential loans and even more favorable treatment under Basel II. Despite the favorable history, we believe recent lending practices and buyer behavior have elevated the risk of residential lending. Concerns are compounded by significantly increased investor activity and new loan products that allow less creditworthy borrowers to obtain mortgages. The new loan products of most concern include Option Adjustable Rate Mortgage (ARM) Loans, Interest Only (IO) Loans, and Piggyback Home Equity Loans.

A study by the National Association of Realtors found that 23 percent of all American houses bought in 2004 were for investment, not owner occupied, and an additional 13 percent were purchased as second homes. Much of this investor activity and the new loan products mentioned above are predicated on continued escalation of home prices. Moreover, LTVs are based on appraised values that are potentially inflated. Investor activity and promotional [liberal] lending could precipitate a more rapid decline in property values as investors and homeowners/buyers react to any softening.

Insured Institutions' Exposure to a Housing Slowdown:
Currently, insured institutions have not experienced any deterioration in credit quality from their exposure to residential lending and the home price boom. However, as new residential credit products season and interest rate/economic/home price variables change, some institutions could become highly susceptible to increased delinquency and loss rates.

While most insured institutions do not retain significant portions of hybrid ARM and IO exposures, we have identified 18 banks and thrifts headquartered in potentially risky boom markets (San Francisco, Southern California, Phoenix, Las Vegas, South Florida, Washington, DC, and New York) that have significant concentrations of ARMs and/or large originations of IO loans. We have also isolated 24 institutions headquartered in these markets that have high exposure to acquisition, development and construction (ADC) lending which could be negatively affected by any softening in real estate prices.

Supervisory Response Options:

1. **Remind the industry and examiners** that new residential mortgage structures may increase historical PD/LGD rates.

Permanent Subcommittee on Investigations
EXHIBIT #51b

2. **Conduct target reviews** of specific institutions with high ARM and ADC exposure.
3. **Use standard exam procedures** for specific institutions with high ARM & ADC exposure.

Supervisory Concerns:

Potential Housing Bubble/Concentrations of Risk

The ongoing housing boom in the hot markets listed above has been attributed to historically low interest rates, a shift of household assets from equities to real estate, increased investor activity, and new loan products that allow otherwise ineligible borrowers to buy homes. Can real estate prices in these hot markets be sustained?

According to *The Economist*, recent downturns in British and Australian housing markets dispel previous notions about the long-term stability of U.S. home prices:

- Bursting bubbles or home price declines do not require a trigger, such as a significant rise in interest rates or unemployment. British and Australian home prices declined in the past year with only modest interest rate increases and low unemployment.
- Home prices will not necessarily keep rising because there is a limited supply of land and growing number of households. As expectations of rising prices in Great Britain faded, demand declined.
- Average home prices in the U.S. have not decreased for a full year since statistics have been maintained. Some U.S. markets have declined over several years, and outside the U.S. many countries have experienced a drop in average home prices (such as Japan) over the last decade. In fact, rapid appreciation in the U.S. appears similar to the Japanese market just prior to its decade long decline.

Subprime/No equity

Low interest rates and declining revenue sources have caused lenders to create products to attract more customers. As a result, a significant volume of loans with higher risk characteristics are being offered to less creditworthy borrowers. Additionally, banks that originate mortgages to borrowers with lower credit scores or documentation defects are more likely to hold higher volumes of these loans because they can't always be sold to the secondary market.

According to the National Association of Realtors, 42 percent of all first-time buyers and 25 percent of all buyers made no down-payment on their home purchase last year.

Option ARMs (and Borrower Payment Behavior)

Typical option ARM loans allow the borrower to make payments based on an introductory (teaser) rate, payments that only cover interest, or minimum payments that can result in negative amortization. The negative amortization may be allowed up to 125 percent of the original principal amount. These borrowers could eventually be faced with higher interest rates and required principal reductions -- resulting in substantially higher monthly payments. We assert that modeling of PD/LGD rates for these new, untested loans is far more difficult than conventional loans because sufficiently-stressed data is unavailable.

Interest Only Mortgages

In California, over 60 percent of all new mortgages this year are interest only or negative amortization, up from 8 percent in 2002. A decade ago, such loans were not even available to consumers. These loans could also have higher interest rates and will eventually have to be renewed into amortizing loans resulting in higher monthly payments. We assert that modeling of PD/LGD rates for these new, untested loans is far more difficult than conventional loans because sufficiently-stressed data is unavailable.

Piggyback Home Equity Loans

In lieu of Private Mortgage Insurance (PMI), home equity loans are increasingly providing at least part of the down payment to reduce the primary mortgage to 80 percent. In many cases, the home equity loans

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are made by the same institution that originates the first mortgage, resulting in increased risk that may not be evident from average loan-to-value percentages. Piggyback home equity loans could disguise the true nature of the borrowing relationship and are resulting in less credit protection due to the lack of PMI. These loans could also circumvent compliance with regulatory Real Estate Lending Standards. While most institutions report favorable average LTV ratios, the LTVs may not factor in piggyback home equity loans and are based upon appraised values at what could be the peak of the market values.

<u>Letters of Credit and the Florida Condo Market</u>
There is a growing body of evidence that lenders along Florida's Gulf Coast are offering letters of credit (LOC) to high-end home buyers who use LOCs instead of a cash down payment to reserve condos before they are built. This adds further to the ability of investors to contract for condos with even less money down and elevates the risk to the issuing lenders.

<u>Spillover Effect in Construction and Development Lending</u>
A housing bust could have an immediate negative affect on construction and development loan portfolios if the expectation of flat or declining values results in fewer buyers and investors.

Insured Institutions' Exposure to a Housing Slowdown:

Institutions with very high exposure to one-to-four family ARMs and ADC loans in boom markets could be negatively impacted by a real estate slowdown. To isolate institutions that have outsized ARM and ADC exposures as of 3-31-05, we queried and analyzed Call Report/MSA data on banks headquartered in hot markets (San Francisco, Southern California, Phoenix, Las Vegas, South Florida, Washington, DC, and New York) with assistance from DIR. We also requested narrative comments from the SF, ATL, and NY regions on particular institutions. The table and narratives below highlight banks and thrifts with ARM exposures in hot markets exceeding 500% of Tier 1 capital. This analysis is followed by a similar listing and narratives on institutions with ADC lending exposures in hot markets exceeding 400% of Tier 1 capital.

Large institutions, other than specialty mortgage or ADC lenders, were not included in our data query. Large institutions are well diversified, and we believe they would not be as exposed to weaknesses in mortgage lending as smaller institutions which concentrate on their headquarters markets.

Institutions with Significant 1-4 Family ARM Concentrations in Hot Markets

Cert.	Institution Name/Location	CAMELS	PFR	Total Assets $M	Total ARM Loans $M	ARM/ Tier 1 Capital 3-31-05	RE Loan Yield 12-31-04

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Washington Mutual Bank, FSB, Stockton, CA, TA $306B, OTS CAMELS 222223/2
Holds $66B in Option ARMs. 70% of Option ARM customers **only make the minimum payment each month**. Interest rate increases are capped on these loans through 5th year of the mortgage. Nearly 50% of collateral is in California. Examiner indicates that $112B in residential mortgages are held-for-investment, with 24% having FICO scores of less than 660 and 5% having loan-to-values greater than 80% with no PMI. No internal stress test yet on effect of a housing bubble.

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Institutions with Significant ADC Concentrations in Hot Markets

Cert.	Institution Name	PFR	CAMELS	Total Assets $M	ADC Loans Outstanding $M	ADC / Tier 1 Capital % 3-31-05	RE Loan Yield 12-31-04

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Mortgage-Backed Securities and Residuals

Significant holdings of mortgage-backed securities and associated residuals should also be considered at all insured institutions, particularly those in hot markets. While MBS are typically AAA rated and should be less susceptible to credit losses than direct lending activities, residuals may present elevated risk as their subordinated structures absorb losses for senior tranches. Additional screening is needed to identify residual exposures that are not already captured by the Quarterly Lending Alert.

Supervisory Response Options:

Bankers and examiners have generally considered residential credit as a low-risk lending field with perpetually low loss and past due rates. While this is a historically valid notion, the secular changes in home loan products during this decade could alter long-term default and loss behavior. Consideration should be given to reminding examiners and the industry that many home mortgages originated over the past two years contain liberal terms and conditions compared to traditional standards. We suggest that insured institutions establish appropriate concentration limits, conduct stress tests on ARM and ADC portfolios, and increase overall credit risk mitigation efforts.

Deleted: most

Targeted on-site reviews of institutions with significant ARM and ADC exposures as illustrated above could prove helpful in identifying emerging problems, especially if significant growth has taken place while higher-risk mortgage products have dominated the market. Such reviews should concentrate on these institutions' underwriting standards, with particular emphasis on the evaluation of the borrower's ability to repay under a stressed scenario.

A vigorous review of policies and transactions should also be considered at examinations of institutions with significant ARM and ADC exposures. Elevated exposures to new, untested loan products characterized by high loan-to-value ratios (based on boom market appraisals) and lower credit scores should warrant the most scrutiny.

A RAC project is underway to determine the impact of a potential housing bubble on insured banks. The group is in the process of pinpointing the most exposed insured institutions and weighing options for targeted on-site examination work.

FDIC_WAMU_000015119

From: Doerr, J. George
Sent: Thursday, September 07, 2006 11:45 AM
To: Funaro, Stephen P.
Subject: RE: OTS re: WAMU

Good. Stay tuned.
-----Original Message-----
From: Funaro, Stephen P.
Sent: Thursday, September 07, 2006 8:37 AM
To: Doerr, J. George
Subject: RE: OTS re: WAMU
Meeting does not take place until next week - Thurs 9/14
-----Original Message-----
From: Doerr, J. George
Sent: Thursday, September 07, 2006 5:56 AM
To: Carter, John F.
Cc: Owens, Serena L.; Villalba, Vanessa I.; Funaro, Stephen P.
Subject: Re: OTS re: WAMU
I'll be happy to write the letter myselfn later today. I'll run it by you. Steve, what time is your call scheduled with Darrel?

-----Original Message-----
From: Carter, John F.
To: Doerr, J. George
CC: Owens, Serena L.; Villalba, Vanessa I.; Funaro, Stephen P.
Sent: Wed Sep 06 19:46:17 2006
Subject: RE: OTS re: WAMU
The OTS must really be afraid of what we might come across, but bottom line is we need access to the information. George: Although I don't know what input we'll get from DC, you might want to be on standby to have someone start drafting a response back to Finn stating that we don't view his actions consistent with his pledges of cooperation and emphasizing the need for us to have access to information without the OTS filter/spin or something to that effect. We also want to mention this is the second access issue that has come up on WAMU in a relatively short period of time citing their original plans to not provide Stephen any working space in the bank. Let's finesse it and keep it on the high ground but still get our points across.
-----Original Message-----
From: Doerr, J. George
Sent: Wednesday, September 06, 2006 4:37 PM
To: Funaro, Stephen P.
Cc: Carter, John F.; Owens, Serena L.; Villalba, Vanessa I.
Subject: Re: OTS re: WAMU
Well now that's another thing. He absolutely agreed you'd have access to the Examiner Library. And he hasn't arranged that.

-----Original Message-----
From: Funaro, Stephen P.
To: Doerr, J. George
Sent: Wed Sep 06 19:17:45 2006
Subject: RE: OTS re: WAMU
Darrel Dochow contacted me today and we arranged a meeting for September 14th at 9AM. He mentioned the purpose of the meeting was to coordinate "process workout and logistics" so I was assuming we would coordinate for the fall visit (scope of our work, new location, people, and time frame) and he would update me on Wamu since I haven't had access to the Wamu examiner's library since the end of the 2Q. He did not mention that the status quo was changing.

From: Doerr, J. George
Sent: Wednesday, September 06, 2006 4:03 PM
To: Carter, John F.
Cc: Corston, John H.; Funaro, Stephen P.; Villalba, Vanessa I.; Owens, Serena L.
Subject: OTS re: WAMU
John, we received the letter from RD Mike Finn regarding our routine request to join their next on-site exam target (subprime and economic capital) this Fall. As you know, Mr. Finn says NO, totally contrary to what Vanessa and I discussed with Deputy Darrel Dochow on August 17. I thought I'd just quote, in part, some of the letter (not sure if you can pull up a pdf on your blackberry). "OTS transmitted a final examination report to Washington Mutual on August 30, 2006 in which the institution was assigned a composite 2 rating, CAMELS subfactor ratings of 2s, a 2 rating for

Permanent Subcommittee on Investigations
EXHIBIT #51c

Compliance, and a 2 rating for Information Technology. We provided FDIC Senior Examiner Stephen Funaro with all pertinent examination information, conclusions, and findings from these concurrent examinations. [In point of fact, here, we were on the exam with them.] In addition, we invited Assistant Regional Director George Doerr and Mr. Funaro to observe our presentation of examination findings to the Board of Directors of Washington Mutual. We are not aware of any disagreement the FDIC has with our examination findings or any expressed concerns regarding examination activities. [No, there are none, and we told them that.]

"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 exam findings with the FDIC, as we have in the past. [Sharing has always occurred, but we've been on the exam with them.] 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.

"We are committed to continuing to keep your office fully informed regarding all significant information and matters relating to Washington Mutual. In this regard, OTS Regional Deputy Director Darrel Dochow has already spoken with Deputy Regional Director Vanessa Villalba and Mr. Doerr to make arrangements that will ensure the FDIC receives the information it needs. [I have in my notes that when Vanessa and I spoke with Darrel Dochow on August 17, we specifically mentioned the need to coordinate with him on which exam targets we may want to join - he never said anything negative about that.] In addition, we have contacted Mr. Funaro offering to arrange plans for his ongoing communication with our case management team. [Steve - they have?]

"We look forward to continuing an open and constructive relationship with the FDIC and commit to work closely with your staff to address any questions or provide appropriate information relating to Washington Mutual."

Obviously, we have a major problem here. OTS is taking the approach we need to establish a "regulatory need to participate" on an exam, and that the basis would have to be disagreement on exam findings. Mr. Finn is totally missing the point on our need for timely accurate information to properly categorize WAMU for deposit insurance premium purposes, more so now than ever in the past. The downside of OTS's approach here - for WAMU - is that such information in the past has allowed to recognize that WAMU does a pretty good job with option arms, hybrid products, and subprime lending. If we can't observe that on-site, we might have to assume these are the type of products that push WAMU's risk category out the spectrum requiring higher premiums.

Finally, we're only asking to send three examiners - this can't be a burden issue.

Let me know how you want to proceed.

And John Corston, we may need to elevate this if we can't get satisfactory resolution from RD Finn.

DSC-SF:JGDoerr:10/5/2006:S:\Review4\DoerrJ\WAMU\OTS Finn Response Final 10-06-06.doc

~~**Case Name: Washington Mutual Group**~~ 2006 OCT 10 AM 10 55

cc: Day Files
Institution Files–Washington Mutual Bank
FO–Seattle (Attn. S. Funaro)
WO-Large Banks Mr. Corston MB-5076
JGDoerr
MCawthon
RD Carter

October 6, 2006

Mr. Michael E. Finn
Regional Director
Office of Thrift Supervision
P. O. Box 7165
San Francisco, CA 94120-7165

Dear Mr. Finn:

I have received your response to our August 14, 2006 letter in which we request permission to participate in aspects of the upcoming examination of Washington Mutual Bank. Regarding 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 concerns regarding supervisory activities at Washington Mutual. Such criteria are not prerequisite for requesting - or for the OTS granting - FDIC staff participation in target examination activities.

As you are aware, the FDIC and the OTS have a long, cooperative, and productive working relationship with respect to the examination of Washington Mutual Bank, which we hope to continue. Past experience has proven that our participation in targeted reviews is beneficial to our respective Agencies, as well as to the Bank. For example, OTS supervisory staff continues to request assistance from FDIC specialists, with which they have developed a working relationship, for support on targeted reviews. Additionally, Bank personnel have been complimentary of FDIC staff participation. I would be happy to discuss specific examples at your convenience.

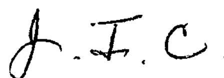
The 2002 Interagency agreement entitled "Coordination of Expanded Supervisory Information Sharing and Special Examinations" and the related Board Resolution that was unanimously approved in January of 2002 both state that the OCC, the FRB, and OTS are committed to providing the FDIC information on and access to insured depository institutions (IDIs) that represent a heightened risk to the deposit insurance funds and selected large IDIs. Large IDIs in this context include "certain identified large thrifts supervised by the OTS;" including Washington

Permanent Subcommittee on Investigations
EXHIBIT #52a

Mutual Bank. The 2002 Agreement clearly allows for FDIC staff participation in examination activities to evaluate the risk of a particular banking activity to the deposit insurance fund.

Washington Mutual Bank 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, a key objective of the 2002 Agreement. I trust this letter provides sufficient clarification with regard to our initial request, as well as expectations going forward. I look forward to your response. If I can provide additional information, please do not hesitate to contact me.

Sincerely,



John F. Carter
Regional Director

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Office of Thrift Supervision
Department of the Treasury
West Region

Pacific Plaza, 2001 Junipero Serra Boulevard, Suite 650, Daly City, CA 94014-1976
P.O. Box 7165, San Francisco, CA 94120-7165 • Telephone: (650) 746-7000 • Fax: (650) 746-7001

November 10, 2006

Mr. John F. Carter
Regional Director
Federal Deposit Insurance Corporation
25 Jessie Street at Ecker Square, Suite 2300
San Francisco, CA 94105

Dear Mr. Carter:

I am writing to follow-up on our discussion last week about your October 6, 2006, letter requesting FDIC participation on our examination of Washington Mutual.

As we discussed, OTS does not seek to have FDIC staff actively participate in our examination activities and conclusions at Washington Mutual. We do understand your need for access to examination information and your need to meet with OTS staff to discuss our supervisory activities at Washington Mutual. To facilitate this information sharing and discussions, we have agreed to allow your Dedicated Examiner, Steve Funaro, 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 also understand that the FDIC may occasionally request OTS permission to have FDIC exam staff assist Mr. Funaro on site at Washington Mutual in his risk assessment activities. We will consider these limited requests to send additional FDIC staff to Washington Mutual on a case-by-case basis. I agreed to your initial request to have one quantitative specialist assist Mr. Funaro on site at our current targeted review of value at risk and economic capital.

Our offices have worked well together over the years and we look to continue that constructive relationship. Our supervisory team will continue our pattern of regular meetings with the FDIC to ensure you have access to all information that you need.

Sincerely,

Michael E. Finn
Regional Director

Permanent Subcommittee on Investigations
EXHIBIT #52b

SF:DSC:SFunaro:01/04/2007:S:\REVIEW4\SFunaro\WMB-OTS Exam Letter Jan 07.doc
Case Name: Washington Mutual Group
cc: Bank File (Washington Mutual Bank, Henderson, Nevada)
FO – SEA (Funaro)
~~JGD~~

Mr. Michael E. Finn
Regional Director
Office of Thrift Supervision, West Region
P.O. Box 7165
San Francisco, California 94120-7165

JAN 10 2007

Dear Mr. Finn:

The FDIC requests permission to have examination staff assist Senior Examiner Funaro in his risk assessment activities at Washington Mutual Bank. The risk assessment activities will be coordinated with the OTS's targeted examinations of asset quality and market risk which will start in the first half of 2007. Specifically, the FDIC requests one examiner to assist in the review of single family residential lending, one examiner to assist in the review of interest rate risk, and one senior examination specialist and one quantitative expert to assist in an ongoing review of the bank's value at risk methodology.

Thank you for your consideration, and we look forward to continuing the constructive relationship our agencies have established at Washington Mutual. If you have any questions, please contact me. Also, you or your staff may direct any questions to Assistant Regional Director J. George Doerr at (415) 808-8019 or Senior Examiner Stephen P. Funaro at (206) 284-1112.

Sincerely,

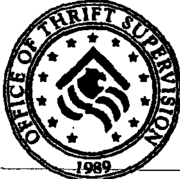
J. F. C.

John F. Carter
Regional Director

Concur: ____________________________

Permanent Subcommittee on Investigations
EXHIBIT #52c

(Beer c
(S. Funaro)



Office of Thrift Supervision
Department of the Treasury
West Region

Pacific Plaza, 2001 Junipero Serra Boulevard, Suite 650, Daly City, CA 94014-1976
P.O. Box 7165, San Francisco, CA 94120-7165 • Telephone: (650) 746-7000 • Fax: (650) 746-7001

2007 JAN 24 AM 10 58

January 22, 2007

Mr. John F. Carter
Regional Director
Federal Deposit Insurance Corporation
25 Jessie Street at Ecker Square, Suite 2300
San Francisco, CA 94105

MC

Dear Mr. Carter:

We received an undated letter from you on January 11, 2007 in which you requested permission to have additional FDIC examiners assist Senior FDIC examiner, Steve Funaro, in conducting his risk assessment activities at Washington Mutual. As noted previously in response to an earlier request, we understand that the FDIC may occasionally seek permission to have FDIC exam staff assist Mr. Funaro.

Consistent with our earlier communications, I authorize your request to have three additional examiners assist Mr. Funaro in his assessment of interest rate risk, value at risk and single family lending. Please have Mr. Funaro coordinate all questions and requests for information through OTS Examiner in Charge, Benjamin Franklin.

We will continue to communicate with your office regularly on our continuous examination activities at Washington Mutual. The next of our ongoing briefings is scheduled for February 1, 2007 in Seattle. As always, these briefings are open to you and your case management team. Please advise me promptly if there is any additional information that your staff needs to conduct its risk assessment activities.

Sincerely,

Michael E. Finn
Regional Director

CASE NAME: Washington Mutual Inc
BNC:
DIST:
FO: Seattle (Funaro)
W/O-RM:
STATE:
OTHER:

Permanent Subcommittee on Investigations
EXHIBIT #52d

Funaro, Stephen P.

From: Villalba, Vanessa I.
Sent: Friday, October 13, 2006 2:56 PM
To: Doerr, J. George; Carter, John F.; Corston, John H.
Cc: Funaro, Stephen P.
Subject: Re: wamu quarterly

none of us were aware of this.
Vanessa I. Villalba
Deputy Regional Director
San Francisco Region

This message was sent using a blackberry.

-----Original Message-----
From: Doerr, J. George
To: Carter, John F.; Villalba, Vanessa I.; Corston, John H.
CC: Funaro, Stephen P.
Sent: Fri Oct 13 17:46:54 2006
Subject: Fw: wamu quarterly

Please read info about OTS denying us space and access to information. The situation has gone from bad to worse. I'm in Chicago awaiting my connecting flight home. (Delays)

-----Original Message-----
From: Doerr, J. George
To: Funaro, Stephen P.
Sent: Fri Oct 13 17:38:12 2006
Subject: Re: wamu quarterly

I didn't know this latest development. Do John and Vanessa know about this? How about John Corston?

-----Original Message-----
From: Funaro, Stephen P.
To: Doerr, J. George
Sent: Fri Oct 13 11:39:30 2006
Subject: RE: wamu quarterly

George,
There is no bank specific issue you need to be there for. Our issue is with OTS management (Finn and Dochow) and how they have apparently mislead RD Carter, DRD Villalba, you, and me. This regards space for the dedicated examiner and access to information - participation in OTS exams is a separate issue. I met with OTS examiners yesterday and they have not made arrangements for permanent space for me at the new location and protocols for information sharing have not been developed (they have been given no direction from their senior management). I speak to misleading us as follows: In July RD Carter talked with Finn and he agreed to space and access. On 8/17 you and DRD Villalba had a telephone conversation with Dochow and he agreed it was not necessary to fix what was not broken and he promised access to space and information. On 9/15 I met with Dochow and he agreed to space and information sharing (although the exact method of information sharing was not fully outlined). In addition to the quarterly at 1PM, on that day I have a meeting with Dochow and the exam leads at 9AM. I would like to iron things out at that meeting, but I am prepared for more of Dochow's stalling tactics and misrepresentations. I did give the exam crew a laundry list of information I need on an ongoing basis, but I am not confident they can provide it: they do not have a resident team, they appear short staffed and are going through a transition from full scope exams to the continuous program, and only one member of the crew is local.

Permanent Subcommittee on Investigations
EXHIBIT #53

-----Original Message-----
From: Doerr, J. George
Sent: Thursday, October 12, 2006 9:56 PM
To: Funaro, Stephen P.
Subject: Re: wamu quarterly

I don't plan to come unless there is an issue I should be there for.

-----Original Message-----
From: Funaro, Stephen P.
To: Doerr, J. George
Sent: Thu Oct 12 12:37:18 2006
Subject: RE: wamu quarterly

Finn, Dochow, and exam leads. It does not appear Albinson will attend, but Dochow left open the possibility.

-----Original Message-----
From: Doerr, J. George
Sent: Wednesday, October 11, 2006 11:20 PM
To: Funaro, Stephen P.
Subject: Re: wamu quarterly

Probably not. I'll be in SLC the day before. But before I decide, let me know who is coming from OTS.

-----Original Message-----
From: Funaro, Stephen P.
To: Doerr, J. George
CC: Villalba, Vanessa I.
Sent: Wed Oct 11 14:33:08 2006
Subject: wamu quarterly

George,
Will you be attending the Wamu quarterly regulator meeting that takes place on Thursday 10/19 in Seattle. The meeting is from 1PM to 3PM.

From: Doerr, J. George
Sent: Friday, January 05, 2007 03:01 PM
To: Funaro, Stephen P.
Subject: RE: wm exam

I'm just not relishing another round of "No." Well, let them make fools of themselves again!
-----Original Message-----
From: Funaro, Stephen P.
Sent: Friday, January 05, 2007 11:37 AM
To: Doerr, J. George
Subject: Re: wm exam
I don't think so on the Vallue at risk side and the field will be supportive of SFR and IRR work. Not sure how Finn and Dochow feel about SFR review - may not want us getting a feel for how they are implementing NTM guidance, but we will keep it low profile.

-----Original Message-----
From: Doerr, J. George
To: Funaro, Stephen P.
Sent: Fri Jan 05 13:50:08 2007
Subject: RE: wm exam
Any resistance expected that you know of?

From: Funaro, Stephen P.
Sent: Friday, January 05, 2007 9:48 AM
To: Doerr, J. George
Subject: wm exam
George,
I had a discussion this morning with Bob Charurat who has been working on Wamu value at risk and market risk. He suggested we also request permission to bring a quantitative expert (Dan Nuxoll) to assist us on the market risk stuff at Wamu. I have updated the request to incorporate his suggestion.
<< File: WMB-OTS Exam Letter Final Jan 07.doc >>

Permanent Subcommittee on Investigations
EXHIBIT #54

Funaro, Stephen P.

From: Doerr, J. George
Sent: Tuesday, February 06, 2007 11:32 AM
To: Carter, John F.
Cc: Corston, John H.; Baxter, Bill R.; Hirsch, Pete D.; Funaro, Stephen P.
Subject: FW: wamu

John, here we go again. This is unnecessary hair splitting by OTS Seattle, and does not comport with the approval we got from RD Finn on participation. OTS wants to draw a distinction between loan file review as an examination activity (that they object to) vs. risk assessment (which they do not object to). I don't fathom the distinction. When it comes to non traditional mortgages, proper risk assessment would involve getting a feel for how the bank ensures compliance with non traditional mortgage guidance, and to do that you do some file review.

We should call Mike Finn and start the process of taking this up the line again.

John, Bill, Pete – fyi for now, we'll keep you advised.

From: Funaro, Stephen P.
Sent: Tuesday, February 06, 2007 11:23 AM
To: Doerr, J. George
Subject: wamu

George,
I met with Darrel Dochow this morning and OTS is restricting FDIC on the current examination in the SFR review segment. OTS will not allow us to review SFR loan files. The FDIC objective was to determine what steps the bank is taking to implement non traditional mortgage guidance – file review is a part of that risk assessment. OTS views FDIC involvement as assisting the dedicated examiner whereby FDIC examiners would be authorized to look at bank reporting, have access to OTS examiners, and view OTS work products. In a letter dated 1/22/07, OTS RD Finn authorized the FDIC request to have three additional examiners assist the dedicated examiner in his assessment of interest rate risk, value at risk, and single family lending – that letter did not contain any restrictions on our involvement.

Darrel Dochow stated that the FDIC has not been given permission to participate in the OTS asset quality review, and it has not demonstrated a need to participate in that review. Apparently, OTS views loan file review as examination work which is distinct from risk assessment activities. In any event, this situation throws resources we have dedicated into limbo.

Permanent Subcommittee on Investigations
EXHIBIT #55

From: Ward, Timothy T
Sent: Wednesday, March 26, 2008 10:09 PM
To: Reich, John M <reichjm@office of thrift supervision.com>; Polakoff, Scott M <polakoffsm@office of thrift supervision.com>; Dochow, Darrel W <dochowdw@office of thrift supervision.com>
Subject: Re: Call from Sheila this evening

Thanks for the kind words John. It was a good meeting.

Timothy T. Ward
Office of Thrift Supervision
202.285.6405 - cell
202.906.5666 - office

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Reich, John M
To: Polakoff, Scott M; Ward, Timothy T; Dochow, Darrel W
Sent: Wed Mar 26 20:52:32 2008
Subject: Call from Sheila this evening

Scott, Tim, and Darrel,

Sheila called this evening on her way home - re WaMu. Basically she was encouraging us to make certain if they receive an acquisition offer, they should accept it, and was attempting to learn if I had any more definitive idea about how receptive or committed they would be to a sale. I told her that the Board had instructed Kerry to consider all options, and that Kerry was keeping his Board informed frequently of his efforts. We should talk about this tomorrow. I had a very similar discussion with Bob Steel a couple of weeks ago and I'm sure he and Sheila are reading off the same page.

Scott and Tim, I was proud of you both today, you both did a great job! OTS clearly outdid OCC in presentation and knowledge.

Sheila was complimentary of OTS's presentation and commented about our being on top of the issues. I would like to think she meant it, but I'm always a bit skeptical of her compliments. I told her I was surprised at how casual OCC's discussion of NatCity was considering what may happen in the near term. Also I expressed again my surprise at how OCC and the FDIC are treating Citi under the circumstances and said I expect the FDIC to treat all institutions similarly whether supervised by OTS or OCC. She agreed, and said she needs to talk with Dugan about both Citi and NatCity. We'll see.

Thanks again for a great job. It is truly a pleasure for me to have people like Scott, Tim, and Darrel providing leadership at OTS.

John

Funaro, Stephen P.

From: Doerr, J. George
Sent: Monday, April 30, 2007 2:18 PM
To: Collins, David A.
Cc: Funaro, Stephen P.
Subject: RE: Meeting with OTS Regional Management

Washington Mutual:

Last February, in a meeting with RD Carter and I, RD Finn pushed back on his previous approval of our participation in the 2007 exam targets, specifically as to our ability to work loan files alongside OTS examiner, and we were particularly interested in WAMUs compliance with nontraditional mortgage guidance. (Mr. Finn had approved our backup participation on the exam on January 22, 2007.) While we have had reasonably good access to his examiners and we have been able to look at other areas, Mr. Finn drew the line at any loan file review, stating it would be duplicative and a burden on the bank.

After the Quarterly Regulators Meeting at WAMU on April 19, I again brought up the issue. Mr. Finn and his examiner, Ben Franklin, stated that OTS did not intend to look at files for purposes of testing nontraditional mortgage guidance until after the bank made a few changes they had agreed to. I asked if we could then join the file review whenever OTS did look at this, and he said, "No."

From: Collins, David A.
Sent: Monday, April 30, 2007 1:43 PM
To: Doerr, J. George; James, Kathleen M.; Parkerson, George W.; Milot, Jacquelyn S.
Cc: Ivie, Stan; Dujenski, Thomas J.; Carlson, Melissa A.; Phillips, P. Bonn
Subject: Meeting with OTS Regional Management

RD Ivie and DRD Dujenski will be meeting with OTS Regional Director Michael Finn and Assistant Director Steve Gregovich this Friday, May 4th (10:00am). If you have any issues or concerns relative to the OTS that you would like presented at this meeting please forward your topics to my attention by the close of business on Thursday so I may compile a list for discussion.

Thank you for your input. If you have any questions please feel free to contact me at ext. 8172.

Permanent Subcommittee on Investigations
EXHIBIT #57

From: Bowman, John E <john.bowman@ots.treas.gov>
Sent: Sunday, March 30, 2008 7:40 PM
To: Polakoff, Scott M <polakoffsm@office of thrift supervision.com>
Subject: Re: WAMU

Already started. If you have a chance would you call me this evening at my home number 703.[redacted] Thanks

John E. Bowman
Deputy Director and
Chief Counsel

[redacted] = Redacted by the Permanent Subcommittee on Investigations

----- Original Message -----
From: Polakoff, Scott M
To: Reich, John M; Bowman, John E; Ward, Timothy T
Cc: Stark, Sharon L
Sent: Sun Mar 30 18:01:08 2008
Subject: RE: WAMU

John B - could you, first thing in the a.m., have someone on your staff put together a position paper on the need for Treasury to stay removed from the supervision of wamu, including any attempt to influence our supervision of wamu's capital raising process. This is a follow up to the brief conversation the Director and I had in your office. I suspect that such a position paper will come in handy soon.

Thanks.

Scott

-----Original Message-----
From: Reich, John M
Sent: Friday, March 28, 2008 6:59 PM
To: Bowman, John E; Polakoff, Scott M; Ward, Timothy T
Subject: Re: WAMU

Most interesting to learn they met with Steel to discuss the transaction. And extremely surprising to me that Steel hasn't returned my call yet (and also an email message this morning). I predict I will be summoned to Treasury on Monday.

John

----- Original Message -----
From: Bowman, John E
To: Reich, John M; Polakoff, Scott M; Ward, Timothy T
Sent: Fri Mar 28 18:50:51 2008
Subject: WAMU

Gentlemen,

I have now received a copy of the material that JPM provided various parties here in D.C. this date. I have made copies and given one to Tim directly. John and Scott I will place a copy on each of your desk chairs.

Permanent Subcommittee on Investigations
EXHIBIT #58

Polakoff_Scott-00045768_001

Mr. Cohen again indicated the willingness of JPM to discuss the material either over the phone or in person at our request should we have any questions. In addition, he did confirm (when I asked him directly) that in fact JPM had met with Steel at Treasury to discuss the proposed transaction.

Have a good weekend.

---

855 1
20.10

Dochow, Darrel W

From:	Polakoff, Scott M
Sent:	Tuesday, July 22, 2008 6:15 AM
To:	Dochow, Darrel W; Chow, Edwin L
Cc:	Ward, Timothy T
Subject:	FW: Updates
Attachments:	FW: Washington Mutual PDF; Wachovia - Summary of Wachovia Corp. Earnings Call

Darrel, Edwin - I have read the attached letter from the FDIC regarding supervision of Wamu and am once again disappointed that the FDIC has confused its role as insurer with the role of the Primary Federal Regulator. Its letter is both inappropriate and disingenuous. I would like to see our response to the FDIC, which I assume will remind it that we, as the PFR, will continue to effectively supervise the entity and will continue to consider the FDIC's views. I would also like our letter to ask for the FDIC to provide us, in writing, with supporting analysis for any areas in which FDIC examiners disagree with OTS examiners' assessment of risk.

Tim - I wonder if you should call Chris Spoth and ask for a copy of any similar letter that the FDIC sent to the OCC regarding Nat City, Wachovia, etc.

Scott

-----Original Message-----
From: Ward, Timothy T
Sent: Tuesday, July 22, 2008 8:30 AM
To: Dochow, Darrel W
Cc: Polakoff, Scott M; Chow, Edwin L
Subject: Fw: Updates

Darrel,

Just to be clear, there is no way OTS can approve a $2.5 million termination payment. This institution is in troubled condition. Please confirm that you will not approve this payment and you will discuss any other proposals with me before acting.

Thanks.
Timothy T. Ward
Office of Thrift Supervision
202.285.6405 - cell
202.906.5666 - office

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Dochow, Darrel W
To: Ward, Timothy T
Sent: Mon Jul 21 21:42:25 2008
Subject: Updates

OFFICIAL FILE COPY
OTS/WEST

Tim:

With so much going on, I thought that I would send a short email update that we can discuss at your convenience:

Redacted by Permanent Subcommittee on Investigations

Permanent Subcommittee on Investigations
EXHIBIT #59

Redacted by Permanent Subcommittee on Investigations

WAMU:

Earnings (loss of $3.3 billion) will be announced after markets close 7/22/08. Bank has been building liquidity (cash) by drawing down FHLB advances in case deposit outflows occur. About $5.9 billion in deposits left company last week with latest day seeing a small $161 million increase. Killinger reportedly contacted Reich, Bair, Benanke and Paulson today asking that they keep up efforts at restoring public confidence in FDIC insurance and depositories. Kerry also reportedly followed up with Reich on the weekend emails regarding check holds on IndyMac official checks. Management held another all manager discussion this morning to reinforce that IndyMac official checks should be

FW:
ıington Mutua

processed as any other bank's official check . I have to assume that the FDIC had a considerable time lag in their information and was seeing the outcome of actions taken early in the week before the FDIC issued their FIL. Jim Hendriksen has been working on the enforcement document and we hope to share latest version with Susan Tuesday.

Wachovia -
nary of Wachc

Managem nt through legal counsel responded to the exam findings saying that they do believe they violated the BSA C&D. I have requested a briefing from Bowman on the appraisal investigation and understand that John is trying to work out a convenient date. Our intention is to get the management team the enforcement document as soon as it is vetted and final, hopefully in a few days. Holding company infused $2 billion to bank today at our request bringing Core Tier 1 ratios to just above 7%. FDIC sent me a letter today that is more typical of times past where they paper the record and try to look good. Copy is attached and we should discuss my response.

<<FW: Washington Mutual PDF>>

Redacted by Permanent Subcommittee on Investigations

Administrative Issues:

A. Need to discuss staffing and positions with you. I want to have another FM in Seattle very soon and need to have an OK before I tell Sherri to submit a request to Matt/Avelino. I will have a same grade Regional Examiner (Supervisory) in Seattle retire sometime between October 2008 and March 2009 and am also worried that FM John Potthast will retire early if the work load does not decline.

FDIC
Federal Deposit Insurance Corporation
25 Jessie Street at Ecker Square, Suite 2300
San Francisco, California 94105

Division of Supervision and Consumer Protection
San Francisco Regional Office
(415) 546-0160

July 21, 2008

Mr. Darrel W. Dochow
Regional Director, West Region
Office of Thrift Supervision
P.O. Box 7165
San Francisco, CA 94120-7165

Dear Mr. Dochow: DARREL

The FDIC is completing its 2008 special insurance examination of Washington Mutual Bank (WMB), which was conducted concurrently with the Office of Thrift Supervision (OTS). At the July 15, 2008, exit meeting, OTS advised the WMB board of directors of its decision to downgrade the institution's Uniform Financial Institutions Rating to "3," which would necessitate consideration of a corrective program.

As we discussed, we believe that WMB's financial condition will continue to deteriorate unless prompt and effective supervisory action is taken. A strong corrective program, including a provision for additional capital, is essential to reducing the risk to the deposit insurance fund and returning the institution to satisfactory condition. Accordingly, the FDIC respectfully requests that any corrective program imposed by OTS include the following specific provisions:

- WMB shall formulate and adopt a capital plan acceptable to the OTS, the key features of which shall be:
    - A prompt capital injection of no less than $2 billion.
    - Maintenance of capital ratios of at least 1% above the minimums for "Well Capitalized" institutions, as that term is defined by Part 325 of the FDIC Rules and Regulations.
    - Maintain an adequate allowance for loan and lease losses (ALLL).
    - Promptly recognize impairment in the AFS investment portfolio due to other than temporary impairment.
    - Promptly assess the ability or inability to recognize the benefits of deferred tax assets and establish appropriate valuation allowances.

- Revise and enhance the institution's ALLL methodologies and the methodologies for recognizing contingent liabilities for unfunded loan commitments per examination findings.
- Maintain adequate accounting and charge off procedures for real estate owned and troubled debt restructures.
- Maintain adequate reporting of loan modifications.

In addition, we believe OTS should direct the institution's parent company to raise a minimum of $5 billion in equity capital as soon as it is practical and to prohibit any future repurchase of holding company debt.

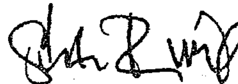
As a part of the FDIC's ongoing monitoring of the bank's capital adequacy, we also ask that management provide, on an updated basis and at least quarterly, detailed information and analysis regarding both WMI and WMB including:

- Financial and capital projections.
- Strategic/long-range forecast and projections.
- Remaining credit loss forecast for all loan portfolios.
- Liquidity projections and forecasts and excess borrowing capacity.
- Insured and uninsured deposit product inflows and outflows.
- Detailed breakout of loan performance by product types with the associated charge-offs and trends.
- Asset valuations and potential impairment analysis for AFS investments.
- Changes in asset values subject to fair value measurements including but not limited to the mortgage servicing rights (MSR).
- Up-to-date analysis on deferred tax assets (DTA).
- Management should also be prepared to provide deposit download information in a timely and accurate manner.

Please contact me if you have any questions. You may also direct questions to Deputy Regional Director George Doerr at (415) 808-8019, Assistant Regional Director David Promani at (415) 808-8056, or Senior Examiner Stephen Funaro at (206) 284-1112.

Thank you for your prompt attention to this matter.

Sincerely,



Stan Ivie
Regional Director

File 08551
90.10

Dochow, Darrel W

From: Dochow, Darrel W
Sent: Tuesday, July 22, 2008 1:50 PM
To: Slvie@FDIC.gov; jdoerr@fdic.gov
Cc: Ward, Timothy T; Polakoff, Scott M; Quigley, Lori G; Chow, Edwin L; Blackburn, Dale R; Franklin, Benjamin D
Subject: Response to July 21 letter RE WAMU

Attachments: Scan001.PDF

Stan:

After receiving your letter, I needed to respond in writing. I hope that we can continue to have a strong working relationship and sharing of views in a less formal manner.

Darrel

Scan001.PDF
(80 KB)

OFFICIAL FILE COPY
OTS/WEST

Permanent Subcommittee on Investigations
EXHIBIT #60

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

Pacific Plaza, 2001 Junipero Serra Boulevard, Suite 650, Daly City, CA 94014-1976
P.O. Box 7165, San Francisco, CA 94120-7165 • Telephone: (650) 746-7000 • Fax: (650) 746-7001

July 22, 2008

Mr. Stan Ivie
Regional Director
Federal Deposit Insurance Corporation
25 Jessie Street at Ecker Square, Suite 2300
San Francisco, CA 94105

Dear ~~Mr. Ivie~~ Stan:

I received the PDF copy of your letter dated July 21, 2008 regarding the completion of your 2008 special insurance examination of Washington Mutual Bank (WMB) which was conducted concurrently with the OTS's comprehensive examination of WMB and its parent holding company, Washington Mutual Inc. (WMI). In your letter you state that the FDIC respectfully requests that any corrective programs imposed by OTS include a number of specific provisions and further that OTS should direct WMI to raise a minimum of $5 billion in equity capital and prohibit any future repurchase of holding company debt.

As the FDIC knows, the OTS has and continues to take appropriate supervisory and enforcement action in its role as the Primary Federal Regulator for WMB and WMI. We have consistently worked closely with your dedicated examiner and regularly held discussions to keep the FDIC informed of the condition of WMB and corrective actions. We downgraded the composite rating of WMB on February 27, 2008 to a "3" based on increasing concerns in earnings, asset quality and liquidity. This downgrade was made prior to completion of the then ongoing examination which concluded June 30, 2008. On an interim basis we required a Board Resolution (adopted March 19, 2008) resolving to improve asset quality, earnings, liquidity and weaknesses and concerns in my February 27, 2008 letter. We understand from direct discussions and comments at the July 15, 2008 meeting we held with the Board of Directors that OTS and FDIC are in agreement with the composite "3" rating for WMB. I further understand that it wasn't until I told management on June 20, 2008 that OTS would pursue a Memorandum of Understanding that the FDIC even incorporated that in their consideration. OTS is preparing enforcement action that I hope to present to the Board soon.

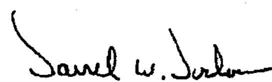
I find it curious that your letter largely reiterates OTS examiner findings and current corrective actions that OTS has already initiated plus a request for OTS to direct WMI to raise a

minimum of $5 billion in additional equity capital. WMI raised approximately $7 billion in equity capital in April 2008 and infused $3 billion into WMB. At my request, an additional $2 billion was infused into WMB this week. This is the first time that anyone from the FDIC has suggested to me that WMI (the holding company) should raise an additional $5 billion in equity capital. In checking with the examination team, I am told that back in May 2008, FDIC examiner Bob Charuat did a very rough capital analysis that did not follow GAAP and was based on inappropriate assumptions. That analysis estimated potential life of loan losses at less than WAMU's own recession forecast but suggested that $5 billion additional holding company capital might be needed at December 31, 2008 to exceed the WMI "elevated capital targets" assuming all losses were taken in 12 months, no core earnings or tax recapture after year one, permanent impairment of the OTTI at March 31, 2008 and a large loss factor for unused HELOC and credit card lines. The examiners reportedly discussed at the time that these assumptions were not GAAP, included artificial constructs and that moving estimated potential life of loan losses into 2008 was not realistic.

I value the constructive working relationship that we have had, and I have and will continue to consider the FDIC's views relating to our examination and supervision of institutions of mutual interest. I would hope that we can continue to have ongoing discussions and not unexpected letter exchanges. The OTS takes its Primary Federal Regulator role seriously and we will continue to do everything we can to effectively supervise entities under our jurisdiction.

I look forward to seeing you on August 1, 2008 at the Interagency meeting that the FDIC is hosting and to our morning meeting at the FRB.

Sincerely,



Darrel W. Dochow
Regional Director

From: Doerr, J. George
Sent: Wednesday, July 30, 2008 06:06 PM
To: Corston, John H.; Funaro, Stephen P.; Promani, David; Burns, Robert L.; Hirsch, Pete D.
CC: Grum, Christine; Lane, John M.
Subject: Re: WAMU Briefing Paper

Steve -- are we possibly out of sync with OTS on composite and several components? I thought we were closer than that.

-----Original Message-----
From: Corston, John H.
To: Funaro, Stephen P.; Promani, David; Doerr, J. George; Burns, Robert L.; Hirsch, Pete D.
CC: Grum, Christine; Lane, John M.
Sent: Wed Jul 30 17:46:35 2008
Subject: WAMU Briefing Paper
Attached it the one page briefing document that I will be providing to Sandra and Sheila for tomorrow's 10am EDT briefing. Please review it and make any changes you think will make the documents more accurate realizing it should remain one page in length. I also pasted it below the phone-in information for those reading this on Blackberries.
<<WAMU 7-31-08 Briefing.doc>>
Below is the conference bridge number for Thursday, July 31 at 10:00 a.m.:
Dial 1+ Toll Free: 866-673-8225 (or Toll: 203-566-3072). You will be prompted for the pass code:
Enter: 3811536 followed by the # sign.
You will hear the confirmation and be connected to the conference.

WASHINGTON MUTUAL BANK
Areas of Focus:
* Capital - Protection limited and declining with an immediate need of approximately $5 billion
* Asset Quality - Risk high and increasing with continued deterioration in all categories with credit models not keeping pace
* Liquidity - Risk moderate/high but stable with near-term borrowing capacity and available cash to handle deposit outflows of up to $25 billion

Capital
* 1Q'08 leverage ratio - 6.94%; Tier 1 RBC - 8.13%; Total RBC - 12.21%
* In April 2008, the holding company raised $7 billion in new capital and down streamed $3 billion to the bank. July '08, an additional $2 billion was down streamed.
* OTS MOU asks for $2 billion (already completed) and Capital Contingency Plan that shows how they will maintain capital 1% above regulatory minimums

Asset Quality
* The bank's credit culture emphasized home price appreciation and the ability to perpetually refinance, including the ability to sell non performing assets. The bank's underwriting standards were therefore lax as management originated loans under a securitization model to transfer risk to the market.
* The bank is mainly a real estate lender with concentrations in certain higher risk product segments (including Option ARM loans, subprime residential loans, HELOC 2nds, and interest only (IO) loans) and geographic concentration with 50% of the residential portfolio secured by California real estate and 10% secured by Florida real estate.
* The bank's asset quality continues to deteriorate as delinquencies, non performing loans, and net charge offs are growing and have not peaked or stabilized.
* The bank also has credit card exposure where performance has deteriorated over the past year with the severity accelerating during the last three months.

Liquidity
* Total deposits have declined approximately $9 billion since the IndyMac failure. The majority of outflows were from time deposits with greater than $100 thousand. Remaining retail accounts over $100 thousand are $18 billion or 13% of total retail deposits.
* Liquidity remains highly dependent upon the FHLB and retail deposits, including brokered deposits, for funding.
* Moody's placed the ratings of the holding company and the bank on review for possible downgrade on 7/22/08. The holding company will become sub-investment quality given a 1-notch downgrade from Moody's. On Friday, S&P reduced the holding company and the bank issuer ratings by 1-notch to BBB- and BBB, respectively, with the outlook stable. It is unknown what action, if any, Fitch will take.

Examination/Memorandum of Understanding (MOU)

* OTS Proposed CAMELS - 3-4-3-4-3-2/3; LIDI rating - D negative
* FDIC review of ratings in process with possible disagreement on Capital, Management, Liquidity and composite
* FDIC in general agreement with OTS MOU; however, we had requested that it be more specific
* The OTS sent the MOU to WAMU on Friday, July 25, 2008

From: Dochow, Darrel W <darrel.dochow@ots.treas.gov>
Sent: Friday, August 1, 2008 12:29 PM
To: Polakoff, Scott M <polakoffsm@office of thrift supervision.com>; Ward, Timothy T <wardtt@office of thrift supervision.com>; Reich, John M <reichjm@office of thrift supervision.com>
Cc: Quigley, Lori G <quigleylg@office of thrift supervision.com>; Chow, Edwin L <chowel@office of thrift supervision.com>; Bisset, John K <bissetjk@office of thrift supervision.com>; Franklin, Benjamin D <franklinbd@office of thrift supervision.com>; Blackburn, Dale R <blackburndr@office of thrift supervision.com>
Subject: Fw: WaMu

See below. I talked with Stan Ivie this morning. It was news to Stan that a ratings difference was decided. He said that the Regional office had not made a final decision and he had not talked with me yet but intended to. Apparently the LIDI group was discussing the rating (and apparently has now decided on a "4"). He also said he was under the impression that his dedicated EIC had said he told OTS and WAMU that he felt the rating was a "4" at the Board meeting and I told him that was incorrect. You can see from the below email that at about 5 pm pacific time yesterday, the FDIC EIC had a conversation with John Bisset, our operations lead on site, about the rating.

Stan was getting a flurry of emails this morning and is going back to his staff on what has been said about the ratings.

Steve Hoffman, top supervisor at the FRB of SF, also got a fairly detailed email from Deborah Bailey about the meeting today with all agencies regarding WAMU. The FRB of SF is currently meeting to decide whether WAMU should have access to the new 84 day TAF program and even if the FRB feels comfortable with them in the 28 day TAF funding program. WAMU had hoped to enter the 84 day program.

I am in an Interagency meeting and will be back to the Daly City office by 1pm pacific time. Maybe we can talk.

Darrel

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Bisset, John K
To: Dochow, Darrel W
Cc: Franklin, Benjamin D
Sent: Fri Aug 01 11:37:46 2008
Subject: RE: WaMu

First I heard was about 5pm yesterday, Steve came in to chat. We discussed the "break the bank" scenario and the fact that this scenario could be triggered by a 4 rating or a "troubled institution" designation. He indicated that they were getting close to that point. At the time I did not interpret this as a rating difference, just a reiteration of their level of concern.

Hopefully I can talk to him later this morning and get some better information.

Permanent Subcommittee on Investigations
EXHIBIT #62

-----Original Message-----
From: Dochow, Darrel W
Sent: Friday, August 01, 2008 6:50 AM
To: Ward, Timothy T
Cc: Polakoff, Scott M; Reich, John M; Franklin, Benjamin D; Blackburn, Dale R; Bisset, John K; Chow, Edwin L
Subject: Re: WaMu

That is news to us as the FDIC dedicated examiner and local FDIC has said they agree with the composite and maybe yesterday's meeting changed that..

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Ward, Timothy T
To: Dochow, Darrel W
Cc: Polakoff, Scott M; Reich, John M
Sent: Fri Aug 01 09:28:13 2008
Subject: WaMu

Sheila Bair just reported on a conference call that there was a rating difference on this exam. Can you fill us in.

Thanks.
Timothy T. Ward
Office of Thrift Supervision
202.285.6405 - cell
202.906.5666 - office

Sent from my BlackBerry Wireless Handheld

From: Bair, Sheila C. <SBair@FDIC.gov>
Sent: Friday, August 1, 2008 7:13 PM
To: Reich, John M <John.Reich@ots.treas.gov>
Subject: Re: WaMu Rating

We will follow the appropriate procedures if the staff cannot agree

You asked me to hear out wamu. I hope that you would also hear out our examination staff if it comes to that

-----Original Message-----
From: Reich, John M <John.Reich@ots.treas.gov>
To: Bair, Sheila C.
Sent: Fri Aug 01 13:07:55 2008
Subject: WaMu Rating

Sheila,

In my view rating WaMu a 4 would be a big error in judging the facts in this situation. It would appear to be a rating resulting from fear and not a rating based on the condition of the institution. WaMu has both the capital and the liquidity to justify a 3 rating. It seems based on email exchanges which have taken place that FDIC supervisory staff in San Francisco is under pressure by the fear in Washington to downgrade this institution. If in fact the FDIC intends to rate this institution as a 4-rated troubled institution, then prior to such action I would request a Board meeting to consider the proper rating on this institution.

John

Permanent Subcommittee on Investigations
EXHIBIT #63

From: Funaro, Stephen P.
Sent: Friday, August 01, 2008 04:54 PM
To: Charurat, Bob
Subject: FW: WAMU

From: Promani, David
Sent: Friday, August 01, 2008 8:04 AM
To: Ivie, Stan
Cc: Doerr, J. George; Funaro, Stephen P.
Subject: WAMU

Major ill will at WAMU meeting yesterday caused by FDIC suggestion in front of WAMU management that they find a strategic partner. Reich reportedly indicated that was totally inappropriate and that type of conversation should have occurred amongst regulatory agencies before it was openly discussed with management.

OTS proposes ratings of 3-4-3-4-3-2/3 which are based on exam results and largely 1Q2008 operating results. 2Q2008 operating results were worse than anticipated and surprised the street. In our opinion the bank needs capital and liquidity outflows cannot be sustained. Embedded losses exist on the B/S and WAMU's sense of when things may stabilize or improve seems to be in a disconnect with securities analysts. FDIC is looking at a rating of 4-4-3/4-4-4-2/4. The biggest disagreements seem to be in the area of liquidity, capital, and potentially management if you accept the notion that management has lost credibility with the street. We can talk more about this later.

David Promani
Assistant Regional Director
PH# 415-808-8056
FAX 415-808-7935

Permanent Subcommittee on Investigations
EXHIBIT #64

From: Reich, John M <John.Reich@ots.treas.gov>
Sent: Wednesday, August 6, 2008 10:22 PM
To: Dochow, Darrel W <dochowdw@office of thrift supervision.com>; Polakoff, Scott M <polakoffsm@office of thrift supervision.com>; Ward, Timothy T <wardtt@office of thrift supervision.com>
Cc: Quigley, Lori G <quigleylg@office of thrift supervision.com>; Blackburn, Dale R <blackburndr@office of thrift supervision.com>
Subject: Re: WAMU Update and FW: FDIC Ratings

Thanks, Darrel, for the update. The headbutting is currently going on in DC between myself and Sheila Bair.

John

----- Original Message -----
From: Dochow, Darrel W
To: Reich, John M; Polakoff, Scott M; Ward, Timothy T
Cc: Quigley, Lori G; Blackburn, Dale R
Sent: Wed Aug 06 22:11:22 2008
Subject: WAMU Update and FW: FDIC Ratings

John, Scott and Tim:

I just talked with WAMU COB Steve Frank. He and David Bonderman met confidentially with Liam McGee, President for Global Consumer and Small Business Banking for Bank America Corporation as the potential new CEO for WAMU. He spent a fair amount of his career in California and is currently in Charlotte. His brief bio in on the BAC website. The meeting with Liam went very well according to Steve Frank and Liam appears sincerely interested. Steve Frank is having a discussion Thursday morning with the other directors and will arrange to have additional directors meet with Liam over the weekend. Steve Frank believes that the other directors will be impressed with Liam and be ready to move forward to begin contract negotiations early next week. They also expect that Liam will want to talk with me. Steve said that he will update me no later than Friday on what has been scheduled with Liam and asked that I pass along the information to you as he wants to stay connected with John Reich and other senior OTS folks in Washington. I encouraged him and the Board to move ahead quickly so that a positive announcement could be made next week. He also briefly discussed a conversation that he had this morning with their attorneys about whether the Board should agree to a Board Resolution instead of the MOU.

Second, the below email from OTS EIC Ben Franklin clearly shows where the FDIC is now heading and that much is being driven by the Washington DC office, with the examiner deferring to them on several ratings. It is interesting to also note the reference to the purported FRB call to the FDIC Chairman about liquidity concerns. I heard some of this theme today from FDIC Regional Director Stan Ivie. Stan said that he got a call from FDIC Wash DC about a FRB call made to the FDIC about WAMU having to disclose the MOU today and did it not make sense to have any disclosure timed to the end of the week. I reminded Stan that we discussed the document language with the company Tuesday, that further discussions were needed, and that there was no final decision by the company on whether they would actually disclose until final language was agreed to and any action became effective. Stan also said that he has asked FDIC Dedicated examiner at WAMU Steve Funaro to finalize his memo on the rating for WAMU by Friday so that Stan could share it with me. He originally wanted to meet on August 12 to get my comments on their analysis and I told him that I was unavailable that entire week.

WAMU management folks (CFO Casey, Treasurer Williams and others) are in fact meeting with the FRB of San Francisco tomorrow morning. I was informed incorrectly that the meeting was today. They flew down this evening but are not meeting until tomorrow. Robert Williams is to give me an update after that meeting.

COO Steve Rotella and I also talked this evening. Tom Casey will give or have someone give me, Ben Franklin and Dale Blackburn a preview of how the quarter is beginning as there reportedly are some encouraging data points through July on charge offs, delinquencies, etc. While the July numbers by themselves do not indicate how the quarter will actually end up, having the most current information is helpful. I also focused Steve on the latest Liquidity Report and discussed deposit and funding strategy.

Darrel

Permanent Subcommittee on Investigations
EXHIBIT #65

Ward_Timothy-00005346

From: Franklin, Benjamin D
Sent: Wednesday, August 06, 2008 4:12 PM
To: Dochow, Darrel W; Blackburn, Dale R
Cc: Bisset, John K
Subject: FDIC Ratings
Importance: High

Darrel, Dale,

We just spoke to Steve Funaro who indicated that we will likely be "butting heads" on the Liquidity rating. He is now thinking a "4" rating based on the recent $8.0 billion deposit outflow, tightening of lending policy by the FHLBSF, and per him, a call from the Fed to the FDIC Chairman expressing concern about WaMu's liquidity. He acknowledged that his position from a few weeks ago of a "3" rating for Liquidity has changed as a result of these factors.

Steve mentioned that he may also get guidance to rate Capital a "4" and Management a "4", however, his indication seemed to be that he is already backing the "4" liquidity rating, but will go along with "4" Capital and Management ratings if that is the decision of FDIC management.

Ben

From: Donald.L.Kohn@frb.gov
Sent: 08/06/2008
To: Bair, Sheila C.
Cc:
Bcc:
Subject: Re: W

I'll say. Bernanke would be glad to talk to him, but John won't like the message. Ben has several times pushed us on contingency planning and volunteered to meet with Reich if we think it would be helpful.

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: ""Bair, Sheila C."" [SBair@FDIC.gov]
Sent: 08/06/2008 05:46 PM AST
To: Donald Kohn
Subject: Fw: W

This is pretty over the top

-----Original Message-----
From: Reich, John M <John.Reich@ots.treas.gov>
To: Bair, Sheila C.
Sent: Wed Aug 06 17:32:48 2008
Subject: Re: W

Dear Sheila,

You really know how to stir up a colleague's vacation.

I do not under any circumstances want to discuss this on Friday's conference call, in which I may or may not be able to participate, depending on cell phone service availability on the cruise ship location.

Instead, I want to have a one on one meeting with Ben Bernanke prior to any such discussion - as early next week as possible following my return to the office. Also, I may or may not choose to have a similar meeting with Secretary Paulson.

I should not have to remind you the FDIC has no role until the PFR (i.e. the OTS) rules on solvency and the PFR utilizes PCA.

You personally, and the FDIC as an agency, would likely create added instability if you pursue what I strongly believe would be a precipitous and unprecedented action. And if it occurs without my consent, I will not sit quietly by and observe - there would be a public reaction. Put yourself in the PFR's shoes in this situation. We have our

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responsibilities, including the right of primary supervisory determination of this institution's condition, and until Congress changes the statutes under which we operate, our responsibilities as the PFR are not to be simply tendered to the FDIC in a down economic cycle. It seems as though the FDIC is behaving as some sort of super-regulator - which you and it are not.

I also believe there could be a high potential for FDIC actions of the type you are contemplating to cause irreparable harm to Wamu if, at any point in the near future, Wamu wishes to actualy seek a buyer. The potential harm could stem from the fact that any such potential buyer may have been allready been contacted by the FDIC.

If in fact any meetings or discussions have already taken place by the FDIC with either JPMC, Wells Fargo, or any other entity, in any capacity in which WaMu was even mentioned, I would like to see a copy of the signed confidentiality agreement signed by the bank - required in any resolution scenario before an institution is told the name of the failing bank.

This is an OTS regulated institution, not an FDIC regulated institution. We make any decision on solvency, not the FDIC, and I have staff equally as competent as staff at the FDIC, whom I know well.

The FDIC can do whatever internal contingency planning it wishes, but should in no way go outside the FDIC. This is a 3-rated institution. Are you also trying to find buyers for Citi, Wachovia, Nat City and others?

Finally, if Wamu were to learn of the FDIC's actions, there may well be a question as to whether these actions may constitute a disclosable event. That, in and of itself, is a reason not to proceed with this approach for a publicly traded institution. The government should not be in the business of arranging mergers - particularly before they are necessary, and we are not at that point in WaMu's situation.

I will attempt to be on the Friday conference call, and I am going to assume this notion is not going to be raised.

John

----- Original Message -----
From: Bair, Sheila C. <SBair@FDIC.gov>
To: Reich, John M
Cc: Murton, Arthur J. <AMurton@FDIC.gov>; Polakoff, Scott M
Sent: Wed Aug 06 11:32:51 2008
Subject: W

Dear John,

I'd like to further discuss contingency planning for W during the call on Friday. Art talked with Scott about making some discrete inquiries to determine whether there are institutions which would be willing to acquire it on a whole bank basis if we had to do an emergency closing, and on what terms. I understand you have strong objections to our doing so, so I'd like to talk this through. My interest is in assuring that IF we have to market it on an emergency basis, there is multiple bidder interest.

In any event, both the FDIC and the FRB agree that there needs to be a contingency plan in place, so let's talk this through on Friday. I'd really like to develop a plan everyone is comfortable with.

Sheila

From: Corston, John H.
Sent: Tuesday, August 26, 2008 05:37 PM
To: Lane, John M.; Spoth, Christopher J.; Owens, Serena L.
Subject: FW: Updated Earnings Assessement / Capital Analysis
Attachments: Untitled Attachment; WMB Forecast Update_OTS_08-14-08updated.ppt

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FYI, it looks like the region will be well armed for Thursday's discussion with the OTS.

From: Charurat, Bob
Sent: Tuesday, August 26, 2008 12:14 PM
To: Corston, John H.; Burns, Robert L.
Cc: Funaro, Stephen P.; Doerr, J. George; Cawthon, Michael S.
Subject: RE: Updated Earnings Assessement / Capital Analysis
Can you forward me the "cleaned up" version? I remember by my original draft has a couple of typos -- no doubt a result of trying to wrap it up while on vacation.
Any just to give you an update -- the OTS will be arguing the main points that the bank can successfully restructure the balance sheet mix resulting in higher yield on assets. That is, by running off lower yield mortgages and increasing MFL, CRE, Cards, and maintaining HE/HELOC exposure. Yes -- this is not a typo -- they want to maintain HE/HELOC exposure balance. Additionally, their forecast assume a $70B reduction in FHLB advances being replaced by deposit growth of $20B (and the increase in fees). Any below is the balance sheet projection. Notice how the future cash balance is only $3B -- this may also be unrealistic as the bank's liquidity problems would likely require them to maintain a higher cash balance of at least $10B -- therefore reducing asset yields.
<<...>>
It is important to note that the update data provided to us is still incomplete as there is no information on yield assmuptions for assets by product type or for rates paid to grow deposits (so we don't know how much increase in yield is due to changing balance sheet mix and how much is due to wishful anticipation). Also, we have no information on charge-offs for non-SFR related loans and new loan volume and how they came up with those numbers.
I find it troubling that the primarily regulator is able to conclude on capital without digging into these numbers. We have been asking for the forecasted balance sheet for months now and this is the first we have them. Our skeptical assessment is essentially forcing them to dig deeper behind the numbers. Which they should have done in the first place before deciding on a capital rating. Also OTS has recently asked bank to run their capital analysis with $500 million less per quarter in assumed earnings accretion and they indicate the result show the bank is still above well capitalized. They have not release the results to us on this but be prepared for it as we should still view these results with a skeptical eye -- since we still don't have complete information on bank assumptions to reconstruct them.
Another thing to consider is to be prepared for the argument regarding tax assumptions. I know for a fact that bank forecast include the reduction of net losses by 35% to reflect the realization of future tax benefits. This is going to one of the biggest factor in the capital impairment numbers.
I am attaching latest WaMu forecast with updates and more information (but still not sufficient) to reconstruct their analysis as well as our additional request on bank forecast and what I see as risk to their assumptions that are not factored in their forecast. It is typical of WaMu to provide partial selected information. As usual we never get the full picture -- "just a bunch layers of onions to peel off" and hoping to find something inside.

<<...>>
Here are some risk to bank forecast to consider in your discussion on Thursday.
Plausible Risks to Assumptions and Needed Sensitivity Analysis
No 1% rate cuts in recession scenario but TED spreads widens (flight to quality as Libor rate increases reflecting increased credit risk among inter-bank borrowings).
Cash balance may be too low - may be more realistic to assume $10B in stress/recession due to headline risk impacting liquidity.
Increasing cost of deposits to maintain and/or grow deposit base given market conditions and increased bank competition (and/or alternatively estimate negative impact on retail franchise value reducing fee income and deposit balances).
Impact of having relatively the same funding proportion mix and determine impact on cost of funds and fee income.
Bank strategy to mitigate losses is not unique and already replicated by competitors - many top competitors go after the same markets - resulting in crowding effects and lessening effectiveness to implement strategy. Bank may have difficulty in restructuring balance sheet mix while going after credit worthy customers (unless they go down the credit spectrum -- which would impact their future losses). Also competition on credit worthy non-SFR assets (MFL, Cards, CRE, etc.) can get fierce driving down yields as competitors (e.g. WB, BofA, Citi, NCC, etc.) will try to rebalance in the same areas.

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Here are additional information we need to dig down into bank numbers and do further analysis.
Request List - We need sufficient information to be able to reconstruct bank forecast on capital adequacy and assumed earnings accretion to absorb losses through YE 2010.
Complete detailed spreadsheets with unlocked formulas of the capital adequacy analysis including forecast balance sheet and income statement for base and recession case and sensitivity analysis around changes in assumptions and stress factors.
Breakdown of the following categories with the following information for 2006, 2007, YTD 2008, and forecast through YE 2010:

- Interest income amounts and yields for all interest bearing assets and loans by product categories (e.g.) see below:

i. SFR mortgage
ii. SFR construction
iii. Home equity lines
iv. Multi-family
v. Other loans secured by RE
vi. Non-residential Mortgages
vii. Other loans (credit cards)

- Interest expense amounts and yields for all interest bearing liabilities and deposits by product categories (e.g.) see below:

i. Checking
ii. Money Market
iii. Savings
iv. Time Deposits
v. Wholesale
vi. Borrowed Funds

- Detailed breakdown of non-interest income amounts by type of income for each asset and liability groups. Primarily want the breakdown associated with depositors and other retail banking fees by deposit product type as well as for credit card fee income and other large sources of income.
- Support for loss estimates outside of the $12B-$19 cumulative loss estimate for existing home loans (e.g. new loan volume, credit cards, MFL, CRE, etc.) with related detailed breakdowns of the losses.
- Support for assumption of voluntary prepayments on SFR mortgages of 14%-16% and comparison to recent months.

From: Corston, John H.
Sent: Tuesday, August 26, 2008 8:11 AM
To: Lane, John M.; Spoth, Christopher J.; Owens, Serena L.
Cc: Ivie, Stan; Doerr, J. George; Funaro, Stephen P.; Charurat, Bob; Cawthon, Michael S.; Burns, Robert L.; Hirsch, Pete D.; Grum, Christine; Stephens, Kirk A.
Subject: RE: Updated Earnings Assessement / Capital Analysis
FYI, I just sent the capital analysis for WAMU to Lori Quigley and stated that the region will likely be discussing this on this Thursday's call. [redacted] I am planning on forwarding this quarter's higher risk LIDIs to her when they are done.

From: Corston, John H.
Sent: Tuesday, August 26, 2008 11:08 AM
To: 'Quigley, Lori G'
Subject: FW: Updated Earnings Assessement / Capital Analysis
Attached is the cleaned up version, please use this one.
<< File: 2Q08 WaMu Capital Analysis.ZIP >>

▬ = Redacted by the Permanent Subcommittee on Investigations

From: Polakoff, Scott M
Sent: Wednesday, September 10, 2008 12:25 PM
To: Reich, John M <reichjm@office of thrift supervision.com>
Subject: RE: Rating Disagreement

John - what a lousy way to start your day. I am making some phone calls on my end. Just spoke with Art Morton and then Darrel.

The FDIC Board meeting is next week (9/16) to discuss the WAMU differences. We will invite Darrel and Ben Franklin to participate in person, probably with Tim and me. The FDIC will have Stave Ivies, Steve (dedicated examiner) and probably Chris Spot.

I'll deal with this stuff from my end - please don't worry about it. Safe travels and have a great speech.

Thanks.

Scott

-----Original Message-----
From: Reich, John M
Sent: Wednesday, September 10, 2008 9:13 AM
To: Polakoff, Scott M
Subject: Fw: Rating Disagreement

I cannot believe the continuing audacity of this woman. I don't know if I can wait much longer to announce my intentions.

----- Original Message -----
From: Reich, John M
To: 'sbair@fdic.gov' <sbair@fdic.gov>
Sent: Wed Sep 10 09:08:52 2008
Subject: Re: Rating Disagreement

As his PFR I would have appreciated advance notice of your intent to do this. We would have preferred to be the first bearer of that news.

----- Original Message -----
From: Bair, Sheila C. <SBair@FDIC.gov>
To: Reich, John M
Sent: Wed Sep 10 09:06:17 2008
Subject: Rating Disagreement

John

I called Allan Fishman yesterday to make sure he was aware of our likely rating disagreement and the time sensitivity of the matter. Stan Ivie will be following up

From: Polakoff, Scott M
Sent: Wednesday, September 10, 2008 2:53 PM
To: Reich, John M <reichjm@office of thrift supervision.com>
Cc: Ward, Timothy T <wardtt@office of thrift supervision.com>; Bowman, John E <bowmanje@office of thrift supervision.com>
Subject: Wamu- need your help

John - based on my discussion with Art Murton this morning, it is clear to me that the FDIC hopes that TPG may be a willing party to inject capital into the bank. I thought it would be helpful if we invited David Bonderman and his folks to join us for a meeting at our office where we could include the FDIC. The purpose of the meeting would be to discuss the various views of the institution's risk profile, current actions under consideration by the FDIC, and possible capital considerations. We would control the meeting and ensure that we have no repeat of the inappropriate behavior displayed by some of the FDIC in our last session with the bank.

This is my idea, not the FDIC's idea. It could be beneficial on a number of fronts. If, however, you are opposed to it then please tell me and I will not move forward.

Thanks.

Scott

▬▬ = Redacted by the Permanent Subcommittee on Investigations

From:
Sent:
To: Dochow, Darrel W <dochowdw@office of thrift supervision.com>
Subject: RE: ▬▬

Ok. Our review of the Option ARM program is a priority in our scope and we can integrate any questions we have into that scope, surfacing any priority ones for immediate answers. I DO NOT think WAMU has increased start rates like Downey in that WAMU is competing with Countrywide (which I keep getting told is regulated too) and others, and I can't imagine they would readily do so. I believe their 10-K says, though, that they have increased the qualifying rate and I would expect to see that they have held firm on that. In terms of disclosures, I remember they were going to make some enhancements in terms of dissemination, but I don't believe we ever took issue with the existing array of disclosures they had.

I am nervous about us putting disproportionate pressure on institutions to increase start rates and decrease the start rate/fully-indexed rate differential. I think we may create lopsided competitive issues. WAMU tried to increase start rates in the past and was not followed by Countrywide, so WAMU ended up reversing. I realize that reducing this differential reduces the risk in this product, but so far this is a presupposed risk of borrowers reaching recast and having huge payment shocks, a risk that may be more imagined than real given prepayments and borrower options to refinance. There are articles out there that argue both ways on this risk. I am also bothered by the fact that World's CEO continues to tell

-----Original Message-----
From: Dochow, Darrel W
Sent: Thursday, March 30, 2006 2:54 PM
To: Carter, Lawrence D
Cc: Finn, Michael E
Subject: Fw: ▬▬
Importance: High

Lawrence:
Let's discuss when we are both back next week. I want to double back and be sure that we know if wamu is being a good citizen in terms of start rates and disclosures (I.e. not backtracking to increase volume given the potential disappointing quarter) and that the potential purchase of the option arm mta product from downey reconciles with rotella's comments about reducing msr and slowing the creation of msr. We should be careful not to mention ▬▬n any conversations. Monday and wednesday are good for me.

Sent from my BlackBerry Wireless Handheld

-----Original Message-----
From: Finn, Michael E
To: Dochow, Darrel W; Carter, Lawrence D
Sent: Thu Mar 30 15:02:00 2006
Subject: RE: ▬▬

FYI. WaMu was meeting with ▬▬ today to discuss taking on ▬▬ MTA Option ARM production, which is currently being sold off to Greenwich.

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= Redacted by the Permanent Subcommittee on Investigations

-----Original Message-----
From: Finn, Michael E
Sent: Thursday, March 30, 2006 11:58 AM
To: Chow, Edwin L; Lane, Timothy J; Buting, Michael W; Williams, Regina L
Cc: Gregovich, Steven M
Subject:
Sensitivity: Private

called today to give me an update on some changes to lending program. He said three week ago raised the start rate on the COFI Option ARM product from 1.375% to 1.95%. The effect of this change is to push the max neg am (110%) recast assuming only minimum payments out from 34 months to about sixty months, which closely matches the stated recast date. has seen a 33% decline in volume since enacting the change, but Dan expects to hold firm the move. He stressed that this could result in significant balance sheet runoff at current loan payoff rates.

did not see a reaction in the market (no other 1% start lenders moved their rates up). Dan said that would continue originating its 1% start MTA product for sale. They had sold that production to Greenwich last year, but are meeting with another party today about a new loan sale arrangement for the MTA product. Dan said he also heard that FF/Cal recently went back to the 1% start.

Dan said that the market has noticed the loan program change and his loan officers and account execs are being heavily recruited. He said that word was out that was "out of the market". He didn't substantiate any of the comments.

Dan also mentioned that also redesigned their loan disclosures in plain English. The disclosure must be provided to all borrowers at first contact and provided again for signature at closure. Dan said he shared the new disclosures with the exam team.

The Board asked Dan to request a copy of the ROE in advance of the OTS Board meeting. I indicated that we were working to schedule an exit discussion and committed that we would transmit the exam to the Board before meeting with the Board. He may contact Tim to reiterate that message. We didn't discuss any examination issues.

08551

90.10

Dochow, Darrel W

From: Gregovich, Steven M
Sent: Thursday, July 27, 2006 8:55 PM
To: Gardineer, Grovetta
Cc: Finn, Michael E; Dochow, Darrel W; Garvin, Mary C; Kirch, Kurt J
Subject: NTM Open Issues

Grovetta - Thanks for the call this afternoon and keeping us involved. Maybe these last minute comments will help with your slide presentation to the Director:

We should consider going on the offensive, rather than defensive to refute the OCC's positions:

- NegAm *potential* is not like a loan commitment;
  - Unlike HELOC's where the borrower can draw the full amount immediately, the full amount of negative amortization cannot be immediately utilized or drawn - unless an unprecedented instantaneous rise in interest rates were to occur. Otherwise, NegAm will only occur to the extent that interest rates rise <u>and</u> the borrower pays less than the fully amortizing payment. The "commitment" is controlled by interest rate movements more than borrower behavior. A HELOC is a 2nd TD, and allows a borrower to draw the line to the full committed amount immediately. A NegAm loan is a 1st TD, and is structured so that the borrower cannot draw to the "committed" amount at will. The possibility of an increased loan amount due to NegAm occurs gradually over time (typically 5 years, in some extreme circumstances 3-4 years).
  - Further, there is no additional "cash" outlay by the institution; simply a shift in the timing/amount of the receivable.
  - Typically, NegAm interest is **not** capitalized. It is recognized as deferred interest (until the re-cast date). For accounting purposes, the principal balance does not increase. The borrower can repay the NegAm interest without penalty.
- They state that loans originated in 2005 have shown a marked increase in negative amortization to approximately 70%. This is an attempt to support that "this time it's different." This number can be misleading. True, minimum payment usage is around 70%, but measures of actual NegAm accumulation are much lower. For example, WaMu has a 68% minimum payment usage in May, but only 56% of the loans have a principal balance above the original principal balance. More importantly, the dollar amount of NegAm (deferred interest) is only 80 basis points (!) of total outstanding loan balances. These measures of accumulated NegAm were higher in 2000-01. I've attached a chart from WaMu to demonstrate this point (slide 1). We've previously demonstrated that NegAm usage is higher when interest rates are rising, but usage is also dependent on seasoning. Typically borrowers use the option early (typically to 70-80%), but less as the loan ages. I've attached another slide from WaMu showing this pattern for numerous vintages (slide 2). I've also attached a slide from UBS showing a similar pattern for WaMu loans sold in the secondary market (slide 3).

WaMu Historical Deferred Inter...

OFFICIAL FILE COPY
OTS/WEST

Borrower qualification standards - potential negative amortization balances *(OTS positions)*

- I don't understand the point of the second bullet - "amortized faster than..."
- No other regulatory loan underwriting criteria requires that "worst case" scenario be utilized. We cannot

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OTSWMS06-008 0001491

lose sight that these are 1-4 family residential mortgages, arguably the lowest risk category of any collateralized loans.

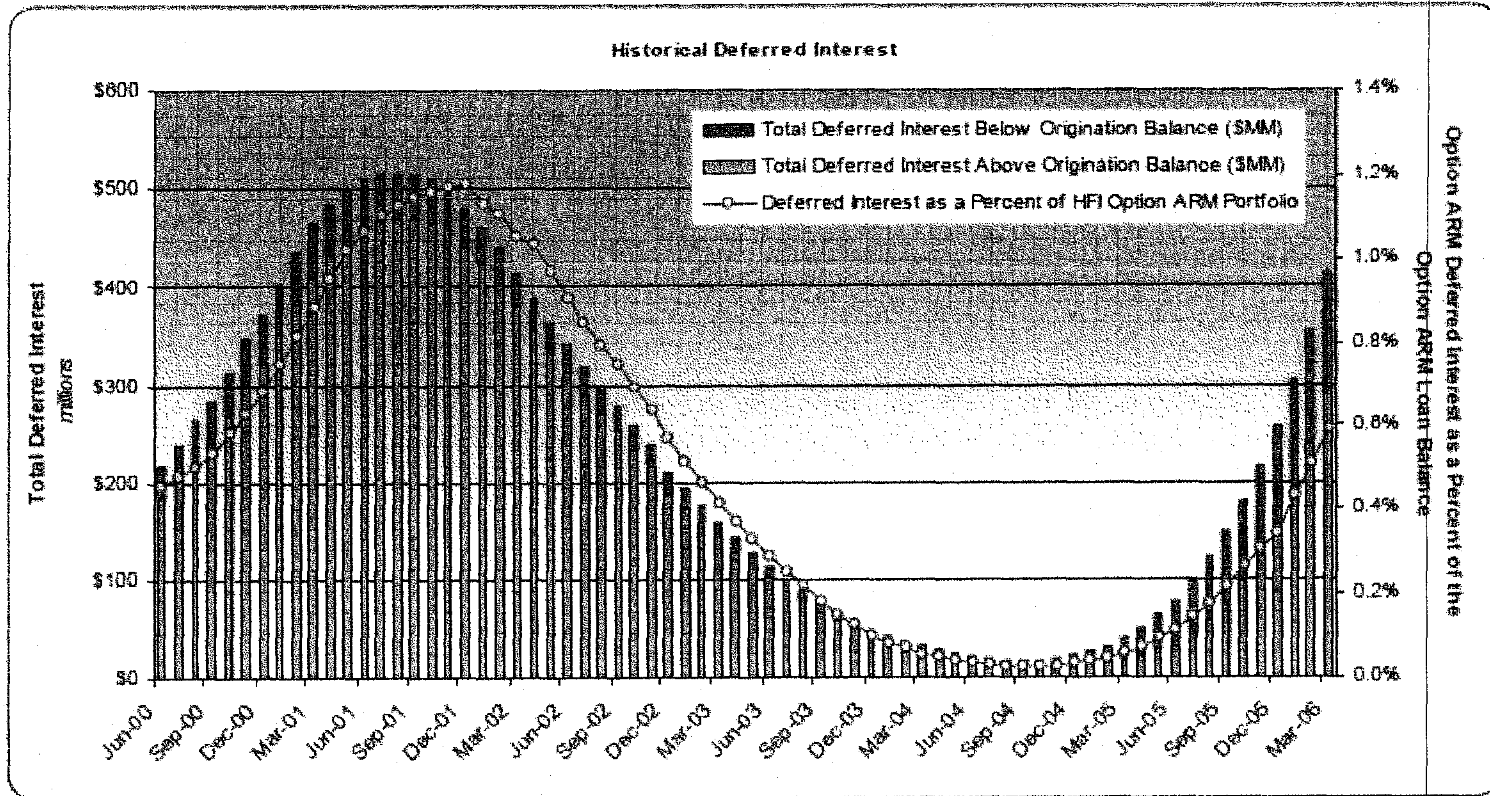
- Product allows the borrower flexibility to use their initial home equity as a future payment shock cushion, without resulting in interim negative payment performance or additional fee charges (i.e. late fees assessed on insufficient payments).
- We have 20+ years of experience with NegAm ARM products. Historical loss rates are not substantially different than on comparable ARM or fixed rate products. World has been a "pure" NegAm lender since 1981 and has never seen annual charge offs exceed 18 basis points on it's SFR portfolio. Again, it's not the product, it's the underwriting.
- The current guidance will create some inequities. All ARM borrowers are subject to some of the same risks (e.g. payment shock), but at varying degrees. The old traditional ARM has severe payment shock potential due to the possible 2% per year interest rate adjustment, but the guidance ignores this product because of the its tenure and familiarity. Hybrid ARMs also have payment shock potential, but are also ignored in the guidance. Requiring lenders to qualify borrowers assuming a fully amortizing repayment schedule would change current underwriting practices for IO loans (it would also change the practices for Hybrid ARMs if they were included in the guidance), but not for Option ARMs as lenders already qualify borrowers assuming a fully amortizing repayment schedule. Hybrid ARM lenders qualify borrowers at the initial fixed payment and would receive inequitable and preferential treatment.

Good luck with your meeting.

Steve

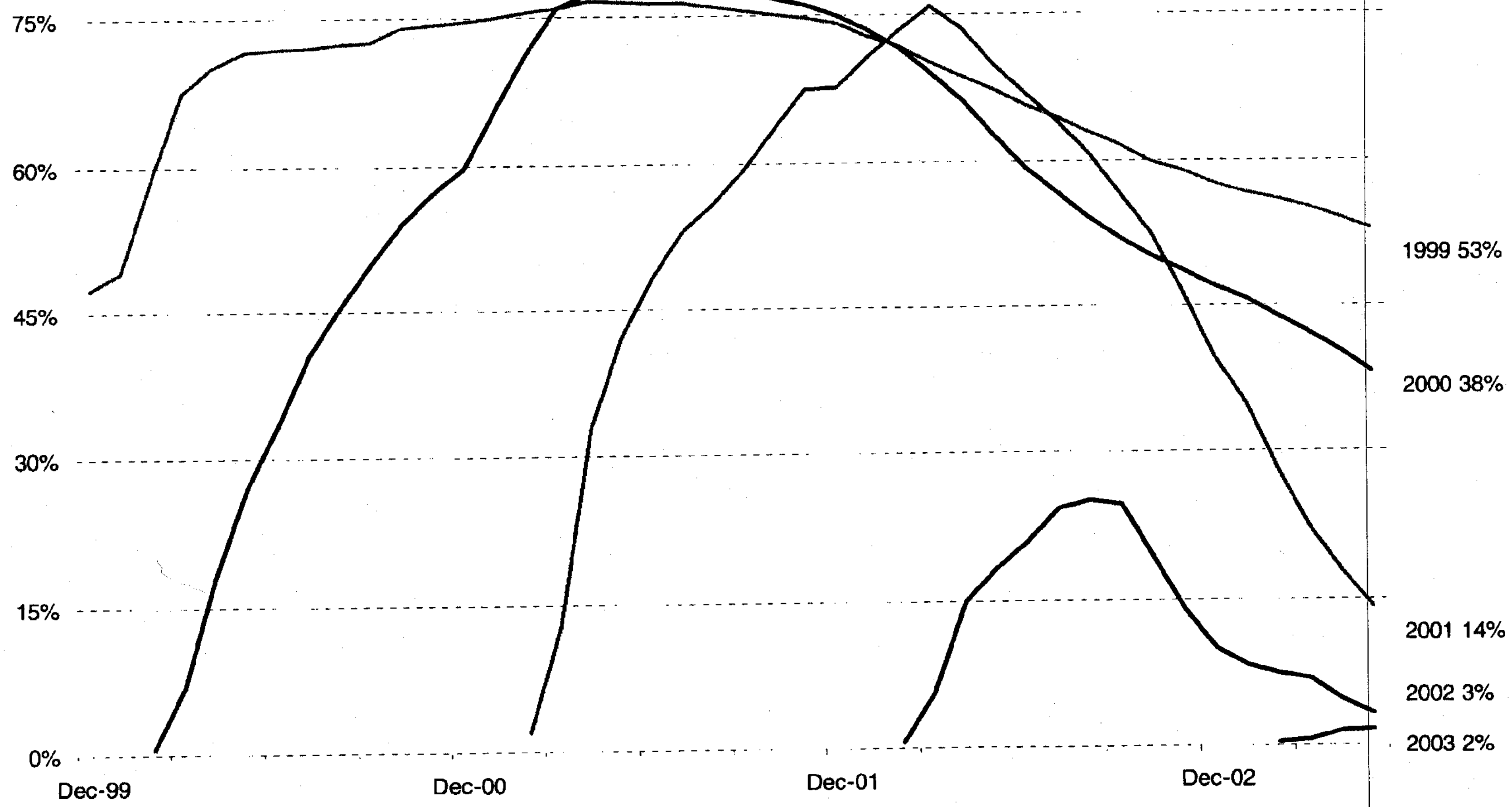
OTSWMS06-008 0001492

WaMu Historical Deferred Interest



OTSWMS06-008 0001493

Percent of Neg Am MTA Loans w/ Deferred Interest (on a dollar basis)



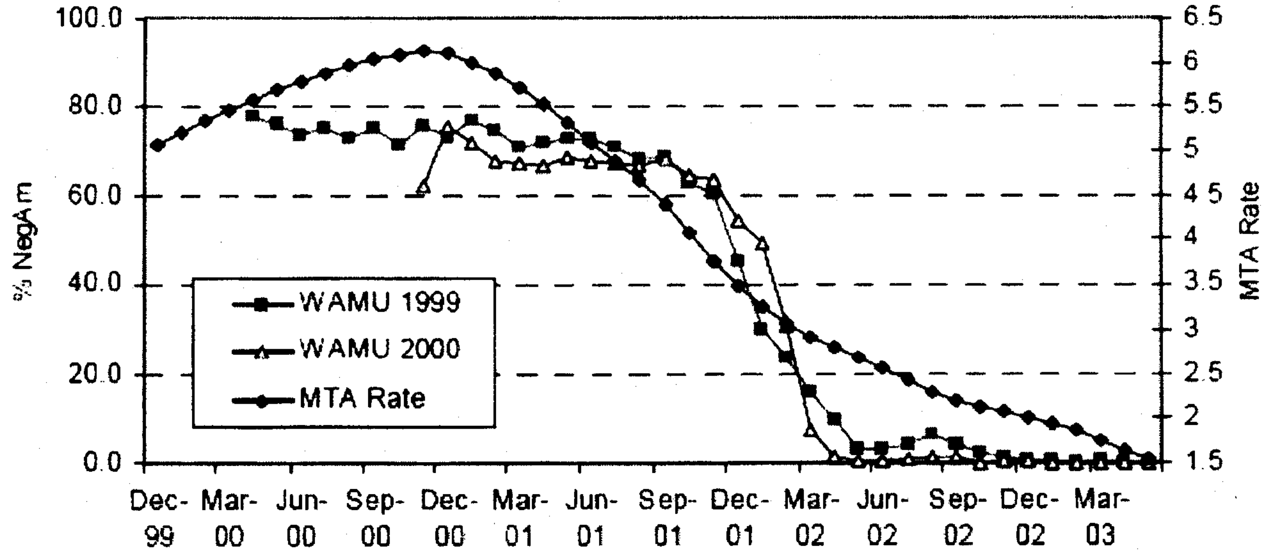
Source: ED

OTSWMS06-008 0001494

Minimum Payment Usage

WaMu sold loans 1999, 2000 vintage

From UBS Mortgage Strategist



OTSWMS06-008 0001495

From: Gregovich, Steven M <steven.gregovich@ots.treas.gov>
Sent: Tuesday, August 15, 2006 12:31 PM
To: Finn, Michael E <finnme@office of thrift supervision.com>
Subject: FW: Latest AMP Guidance
Attach: Option ARM comment summary.doc

Some comments from Kurt and David.

-----Original Message-----
From: Kirch, Kurt J
Sent: Monday, August 14, 2006 3:30 PM
To: Henry, David R; Gregovich, Steven M
Subject: RE: Latest AMP Guidance

I agree that we should not cave on the max neg-am requirement:

* Loans are underwritten at fully-amortizing rate
- there's a big difference between a borrower that chooses to make lower payments and one that must make lower payments. Qualifying at fully-indexed means the borrower exercises their personal judgment. We are double counting. Further, hybrid ARMs are not underwritten in this manner. No consideration is given to what the potential first payment may be once the loan hits the first variable payment (i.e., an adverse future scenario).

* Worst case assumptions-unsupported by historical data. We assume...
- No borrower will EVER make more than the minimum payment
- No borrower will EVER will be in a position to Refi

Prudent risk management practices would dictate using institution specific or industry data based on reasonably estimable measures, NOT dictating a prescriptive unsupported scenario. Hedging here by considering distance of start rate to fully-indexed is still based on the use of these harsh and unsupportable assumptions. The start-rate issue should be dealt with in that section of the proposed guidance.

* Current underwriting already addresses additional risk of Option ARMs
- In general, Option ARMs are underwritten to tougher standards than "traditional" mortgage loans
  >LTVs in 70's
  >FICOs higher
  >DTIs low-to-mid 30's

Concept of risk layering is understood by prudent lenders and offsets to risk are built into underwriting up-front.

Proof: Solid and profitable secondary market executions of Option ARM product. Executions largely determined by perceived risk as determined by S&P and Moody's criteria. NRSOs appear to be well-aware of potential risks of these products and have updated criteria as appropriate to reflect this.

* Market impact - MTA hybrid IO ARMs are a huge product for Wamu (I'm trying to get current stats as we speak). I would imagine there would be a fairly big impact on their lending in this product if they were required to underwrite to full neg-am over the life of the loan, assuming borrower makes minimum payment ALWAYS.

We have dealt with this product longer than any other regulator and have a strong understanding of best practices. I just don't see us taking a back seat on guidance that is so innate to the thrift industry.

I wouldn't feel one bit disappointed if we had to go it alone on this one.

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Attached are a few summary items I pulled from some of the comment letters.

<<...>>

-----Original Message-----
From: Henry, David R
Sent: Monday, August 14, 2006 1:31 PM
To: Gregovich, Steven M
Cc: Kirch, Kurt J
Subject: RE: Latest AMP Guidance

I don't think we should concede on the Max Neg Am qualification fully even if it provides the weight behind our concern over the start rate and accrual rate differential. Just for the argument that in three years time a borrower could also add on other debt in all other forms of borrowed credit - so that whether she pays her fully amortizing or not - her total debt and ability to repay upon recast could also be questioned because the presumption that she doesn't know how to manage her credit. Let alone the argument that she might earn more in three years. If this is the only method of getting muscle behind our start rate accrual rate issue - perhaps the institutions underwriting policy must include both an original loan amount LTV and DTI but a Max NegAm LTV DTI with some probability assessment and include description of the tools used by management to monitor and evaluate the risk over time.

Also not only do we have nonregulated instiutions but institutions that are selling off the credit risk in the secondary market - wouldn't we would look at them differently?? Given the durrent disparity in the regulators perception of the risk and the willingness of the secondary market to gobble this stuff up - have the Rating Agencies weighed in on or been consulted with respect to the Guidance?

Finally, I'm becoming more impressed with the need for good disclosure, must be all that good compliance training. But when Mariana remarks on the various attorney's she encounters chomping at the bit to sue someone - I can just surmise that this will be where the greater amount of the issues with AMP will come from rather than Credit issues.

DRH

-----Original Message-----
From: Gregovich, Steven M
Sent: Monday, August 14, 2006 11:29 AM
To: Henry, David R; Kirch, Kurt J
Cc: Gong, Tracy S
Subject: FW: Latest AMP Guidance

Please look at the latest version. This is moving pretty quickly, so don't focus on edits. Focus primarily on the qualification paragraph and footnote #16. We have suggested changes to both, but no movement yet. I'm most interested in your opinions of the impact of footnote #16.

-----Original Message-----
From: Phillips-Patrick, Fred J
Sent: Monday, August 14, 2006 8:43 AM
To: Finn, Michael E; Gardineer, Grovetta; Gregovich, Steven M
Cc: Polakoff, Scott M; Albinson, Scott M

Subject: RE: Latest AMP Guidance

Mike,

I share your concern about the spread between the start rate and the fully indexed rate -- as that spread is the main driver of potential neg am, early recast, and ultimately the risk of the product.

The current guidance attempts to focus on that issue by having the institution calculate, based on the actual loan terms, the start rate, and today's fully indexed rate, the additional amount a borrower could draw if he/she made the minimum payments until either early recast or contractual recast of the loan. The larger the spread, the more a borrower could draw. The effect of the current guidance language would be to reduce the amount a borrower could qualify for as the spread increases, which, given the heighten risk environment, seems prudential.

Here's the guidance as it stands now. See page 13 for the current qualification language. However, you should read the entire document, as it is now very much risk-focused, emphasizing the need for an institution to market, underwrite, and manage the risks of these products prudently.

<< File: NTM Preamble and Guidance (8-11-06).doc >>
Fred

-----Original Message-----
From: Finn, Michael E
Sent: Sunday, August 13, 2006 6:56 PM
To: Gardineer, Grovetta; Gregovich, Steven M
Cc: Polakoff, Scott M; Albinson, Scott M; Phillips-Patrick, Fred J
Subject: Latest AMP Guidance

Can one of you send me that latest version of the guidance? I want to take a fresh read one more time.

I'm still struggling to reconcile our differences with the OCC. Somehow we should not be that far apart in our stances and perhaps there is still good compromise on the qualification process. This note provides some ideas to consider as we wind down this final steps in releasing the guidance.

I keep thinking that qualification standards should be no more stringent for low risk Option ARMs than they are for IOs or 3/1, 5/1 hybrids. That said, the big difference between some Option ARMS and these other products is early recast because loan structures/terms (deep discount starts and extended amortizations) and borrow behavior (maximum neg am utilization) create much greater potential for an early recast and significant payment shock. You have recast and payment shock risk on IOs and Hybrids, but its much less severe, well understood and fairly clearly disclosed. On Option ARMs, the potential recast/shock can be severe, it's less well understood by the borrower, and disclosures can be strengthened. Our focus should be on the risk that creates early recast with significant payment shocks - i.e. deeply discounted start rates with extended amortization periods.

I want to read the guidance one more time, but I keep coming back to deeply discounted start rates (now with extended amortization) as my biggest concern with this product and its use. Countrywide recently announced that they are reintroducing their

1% start rates. The market will likely follow in lock step. This is not good. With today's fully amortizing rate of 6.75% or higher, the differential between start rates and fully indexed is nearing, if not over, 600 basis points. Historically it was in the 200 bp range. Negative amortization, early recast and payment shock will only get worse given this differential. This is the greatest risk to borrower, lender and regulator on Option ARMs. We have tried informally to encourage large thrifts in the West region to move start rates up to mitigate this risk, but attempts have not been sustained or successful at moving the market. Institutions that don't follow the lowest start rates in the market lose volume almost immediately.

If the debate on Option ARM start rates and qualification standards is still open, we should consider steering the discussion to more stringent qualification for Option ARM loan structures/terms that are most susceptible to early recast and severe payment shock. I would support a more rigorous/diligent underwriting assuming full usage of max negative amortization on a loan that is likely to recast well short of 5yrs with a shock greater than some percent (100, 150, 200?). I still do not support the treatment of all potential neg am on Option ARMs as loan commitments, particularly where the loans are structured so that they would only recast at the contractually set date (i.e 5, 7 or 10 years).

Possible thoughts on a way to describe a tougher, but more limited circumstance, qualification process might be as follows:

One of the greatest risks to borrowers and lenders is the potential for early loan recast with significant payment shock. Historically, start rates were set at levels that did not result in loans recasting prior to the stated recast term (i.e 5 years or longer period). Today's quite common deeply discounted start rates, particularly when combined with extended amortization periods, can produce loan recast well before the typical five year or longer contractual recast date, sometimes resulting in recasts that occur less than two years from origination.

In general, to avoid unsafe risk of early recast with significant payment shock, loan start rates should be set at levels that will not result in early recast of the loan assuming the borrower chooses the maximum utilization of the negative amortization option. If an institution chooses to offer loan start rates that will likely result in early recast given existing market conditions (flat interest rates), then the institution must (i) qualify the borrower assuming the maximum utilization of negative amortization, and (ii) clearly disclose to the borrower the estimated date of recast and expected minimum monthly payment at recast assuming no change in market conditions.

Please accept these thoughts for consideration as you wrap up work on the guidance. If we can address the low start rate issue and influence industry behavior, than I would support a tougher underwriting process to get there. Of course, we should be mindful that we still have the potential problem that this guidance will not reach the full mortgage market and our actions could result in a shifting of low start rate product to unregulated entities. Please let me know if you have any questions.

Mike

Permanent Subcommittee on Investigations

EXHIBIT #73

Washington Mutual

Alternative Mortgage Guidance Implementation Plan

October 2006

JPM_WM02549033

Alternative Mortgage Guidance Implementation Plan

Objective and Alignment

An Executive Steering Committee will govern a a cross-functional Working Group (Legal, ERM, Home Loans stakeholders) responsible for reviewing the new guidance, identifying gaps/impacts, and assigning ownership over the development and execution of required remediation plans as appropriate.

Early analysis of the guidance and its related impacts has identified the following critical areas requiring our attention:

- Loan Terms & Underwriting Standards – Qualifying borrowers, Risk layering, Reduced documentation (stated income)
- Portfolio and Risk Management – Policies (including limits), monitoring, controls/audits, stress testing, etc.
- Third Party Originations – Due diligence, monitoring
- Consumer Protection/Disclosure – Promotional materials, monthly statements, controls
- Communications – Press, investor relations, in-house

Alternative Mortgage Guidance Implementation Plan
Governance Structure

Alternative Mortgage Guidance Governance Structure

Executive Steering Committee

Members: D. Schneider, B. Porter, F. Chapman, A. Magelby, W. Pollock, J. Domer, R. Cathcart, C. Feltgen, J. Robinson

Working Group

Investor Relations/ Communications	Op Risk	Production	Internal Audit	Legal	Credit	Underwriting	Compliance/ Reg Relations	Capital Markets
E. Soter *D. Wisdorf*	*M. Wagner* *J. Fierling*	*R. Perry* *J. Scavone/* *S. Harris* *K. Thorstenson* *S. Field*	*D. Dahl-Ahumndson*	*Stephenson* *M. Albon*	*B. Shaw* *A. Park* *C. Abercombie* *E. Mortensen* *R. McCoppin*	*M. Brown*	*G. Imm* *C. Doperalski*	*D. Potolsky*

Event Timeline

- *9/29 – Interagency Guidance Issued*
- *9/29 – David Schneider Public Statement Issued*
- *10/1 – Preliminary Credit Impact Analysis Completed*
- *10/3 – Weekly Working Group Established*
- *10/12 – OTS Meeting to Discuss Guidance*
- *10/12 – Initial Executive Steering Committee*
- *10/17 – David Schneider Option ARM Presentation to BOD*
- *10/18 – Q3 Earnings Release and Analyst Call*
- *Ongoing – Daily Topical Deep Dives Related to Interagency Guidance*

JPM_WM02549036

Recap of OTS Meeting

Attendees:
OTS – Darryl Dochow, David Henry, Michael Finn, Lawrence Carter, Ben Franklin, Steven Gregovich
WaMu – David Schneider, Benson Porter, Cheryl Feltgen, John Robinson, Dick Stephenson, Jake Domer

Intent:
Gain OTS perspective on the new guidance.

General Questions and OTS response:
Q: From OTS' perspective, what are the key differences between this new guidance and OTS' existing guidance? (i.e. What has changed in their view?)
A: OTS is still gathering FAQ from their constituency and expects they may issue a position paper (at some undetermined future date), however their initial response was that they view the guidance as flexible. They specifically pointed out that the language in the guidance says "should" vs. "must" in most cases and they are looking to WaMu to establish our own position of how the guidance impacts our business processes.

Q: What will examiners expect to see over the next few months in terms of WaMu actions to implement the new guidance?
A: OTS will be checking on progress during the course of their normal exam cycle in early 2007 to ensure we are making progress on addressing any gaps we see between our current processes and the guidance. They would also like to be involved along the way as we are making interpretive decisions regarding the guidance.

Q: How much 'credit' or flexibility in our interpretation of the guidance will we get, given our long and successful history originating the Option ARM?
A: OTS position is that no one is going to get implicit "credit", however they will consider our history and experience as factor in assessing whether or not our practices are in compliance with the new guidance.

Q: One area that concerned us greatly in the proposed guidance was the proposed dramatic changes in third party oversight. Since the final guidance suggests that the agencies didn't intend to change their existing guidance in that area, is it fair to assume that our existing controls, combined with improvements that we would develop in the ordinary course are likely acceptable under the new guidance?
A: Consistent with their other answers the OTS expects us to establish our own position as to how the guidance impacts our business processes. They will be looking to ensure we adequately make training available to our significant brokers as well as continue to actively monitor broker performance. Their words were "do not need to police, but do not be blind to broker behavior".

Summary of Guidance - Operational & Strategic Impact

Loan Terms and Underwriting Standards

Should reflect the effect of a substantial payment increase on borrower's capacity to repay when amortization begins. Institutions are strongly cautioned against ceding underwriting standards to third parties that have different risk tolerances. Includes guidance on qualifying borrowers, risk layering, and documentation.

Portfolio and Risk Management Practices

Should keep pace with the growth and changing risk profile of their NTM loan portfolios and changes in the market. Includes guidance on policies and procedures and third party originations.

Consumer Protection Issues

Agencies are concerned that consumers may enter into these transactions without fully understanding the product terms. WaMu should not only apprise consumers of the benefits of NTMs, but also take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. Includes guidance on customer disclosures and communication.

Strategic Summary

- Based on preliminary analysis of the guidance to date, while there are some operational changes forthcoming, the impact to Home Loans with regards to the origination of the Option ARM product appears limited.
- WaMu Home Loans is well positioned to continue offering the Option ARM product to our customers.
- We do not see any fundamental reason to change our approach on how the Option ARM product is offered to our customers other than the operational changes necessary per the guidance.
- We believe there will be continued healthy demand for this product if positioned appropriately with our customers

Preliminary Analysis of Key Impacts to WaMu

GUIDANCE	WASHINGTON MUTUAL ASSESSMENT
Qualifying Borrowers Repayment capacity should include an evaluation of ability to repay the debt by final maturity at the fully indexed rate assuming a fully amortizing repayment schedule. Repayment analysis should be based upon the initial loan amount plus any balance increase from the negative amortization provision.	Current policy does not include negative amortization when qualifying payments. Adjustments to underwriting guidelines will be necessary to include the potential for negative amortization in DTI calculations. This does not necessarily equate to qualifying at the full neg am cap, but could in fact be lower if the terms are such that the borrower does not have the potential to reach the cap by the end of the initial payment option period. It is also questionable as to the term over which the fully amortized payment is calculated (i.e. at inception of loan over 30 years, or over remaining period when the loan is capped).
Introductory Interest Rates A wide initial spread between introductory and fully-indexed rates means that more borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Institutions should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.	Further analysis and understanding of the OTS view needs to be performed to understand whether our current approach to risk-based pricing is sufficient, if start rate pricing changes are needed, or if additional disclosures will satisfy the guidance. What amount of payment shock is considered "disruptive" and "extraordinary"? In addition, work is in process to move from 110% to 115% neg am cap which would mitigate some of the risk of disruptive early recasting
Policies Policies for nontraditional mortgage lending activity should reflect acceptable levels of risk (including limits on risk layering), include risk management tools for risk mitigation purposes, and set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.	More detailed and formalized tracking of concentration risk is needed to demonstrate the acceptable level of risk in our portfolio and origination volume. Possible solution is to augment the Negative Amortization information currently provided by the Credit Information & Analytics group. Similar detail could be added to the monthly concentration reporting for the Home Loans Risk Management Committee, including stress testing and economic capital allocation.

Preliminary Analysis of Key Impacts to WaMu

GUIDANCE	WASHINGTON MUTUAL ASSESSMENT
Third-Party Originations Institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight should include monitoring of quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations. Monitoring should track the quality by both origination source and key borrower characteristics. Quality issues should result in immediate remedial action (e.g. more thorough application reviews, more frequent re-u/w, termination). Recommended Practices – Control Systems: With respect to nontraditional mortgage loans that an institution makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the institution should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, bank policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, bank policies, or laws. Note: The Final Guidance removes any specific references to monitoring the sales practices of mortgage brokers and correspondents.	HL CR and CCR are independent review functions from operations that assess the quality of loans originated in the HL business lines (including Wholesale [Brokers] for both Prime and Subprime) via transactional & process reviews, focusing on credit & compliance quality, and involving the business on root cause analysis & corrective action. HL is not engaged in traditional Correspondent lending, however does operate actively with Correspondents via our Conduit program. Currently a majority of transactions acquired thru the Conduit are subject to a contracted full due diligence review (Clayton). A sub-working group has been established to review the new guidance, identify gaps/impacts, and develop remediation plans as appropriate.

Preliminary Analysis of Key Impacts to WaMu

GUIDANCE	WASHINGTON MUTUAL ASSESSMENT
Consumer Protection Issues Ensure that advertising of non-traditional products clearly discloses the risk of payment shock and negative amortization.	Current practice includes disclosure of potential payment shock on option ARMs and IOs and for negative amortization on Option ARMs. Assess whether disclosures could be made more conspicuous. Assess need to revise advertising to always include financing examples that attempt to project recasted payment.
Distribute product descriptions early in the shopping process	Need to create IO brochure similar to Option ARM brochure. Train sales staff & brokers to furnish upon inquiry. Post to website. Create PDF versions for email. Consider modifying Option ARM calculator to always show recasted payment.
Train production personnel to properly sell and servicing personnel to properly service non-traditional mortgages	Option ARM training available for LCs. Currently developing broker training. Create similar production training for IOs. Establish special servicing number for Option ARMs/IOs.
Monitor sales practices to ensure that production personnel are properly selling the product	Consider establishing central intake system for all complaints relating to NTM products.
Ensure proper disclosure of payment options, risk of negative amortization, etc on servicing statements	Option ARM statements contain extensive info. Consider enhancing statements to note min pymt may not cover interest. IO statements may need more disclosure.
Disclosure of Prepayment Fees	In process of adding prepayment disclosure to 3-day docs and Rate Lock Policy Agreement.
Disclosure of higher rate for low or no doc loans	No special disclosures in current practice. Need to implement.
Refrain from incentivizing sales staff to originate loans in a manner contrary to Guidance	Given additional disclosure, u/w controls, and monitoring, no changes to incentive plans appear to be needed.

OPTION ARM NEG AM REVIEW
WORKPROGRAM 212A(1)
&
NONTRADITIONAL MORTGAGE GUIDANCE REVIEW

SCOPE

- Review WAMU's monitoring and oversight of the Option Arm (OA) Neg-Am portfolio.
- Review WAMU's compliance with Interagency Guidance for Nontraditional Mortgage Lending; Underwriting: issued October 2006.

OPTION ARM CONCLUSION

Overall, management has done an effect job of monitoring the institution's OA portfolio via the Quarterly and Monthly Neg Am Analysis Reports. During our loan review we reviewed 44 OA loans and disclosed no major underwriting concerns.

Given the increasing interest rate environment of 2005 and 2006 the OA portfolio has experienced increased rates of negative amortization although negatively amortizing loans are not yet nearing the point of recasting. Default risk for the 2005 and 2006 vintages is especially enhanced because of the potential payment shock caused by the negative amortization feature. It's doubtful whether OA loans originated in earlier years that are approaching the recast date (month 60) will experience greater default rates than other loans because payment shock should not be as much of an issue. The loans originated in earlier years are indexed to (12-month Moving Treasury Average and the Constant Maturity Treasury) which were declining from 2001 through the first half of 2004. Hence negative amortization should not adversely affect these Option Arms.

In general, the negative amortization feature erodes the equity cushion available to protect the bank in event of foreclosure. Loans with loan-to-value ratios of 80 percent or more and the ability to negatively amortize to 125 percent of the original loan amount and originated within the last couple of years are especially at risk. In 2006 the Neg-Am limit/cap was reduced from 125 percent to 115 percent. Thought limiting the amount of potential negative amortization, the lower limits may increase recast speeds causing payment shocks to occur earlier for those loans originated in 2006 and beyond.

<u>Management's Monitoring of the OA Portfolio</u>

WAMU prepares a Negative Amortization Analysis report on its residential OA products on a quarterly basis. The analysis includes (1) negative amortization and payment trend over time, (2) negative amortization accrual/non-accrual loan performance trends, (3) deferred interest outstanding, (4) Economic and Portfolio Impact analysis (5) Neg-Am Financial Performance, (6) Payment Shock Impact Analysis. The Payment Shock Impact Analysis covers the potential impact that payment shock might have on the performance of the negative amortization portfolio and the delinquency/charge-off implications.

Permanent Subcommittee on Investigations
EXHIBIT #74

Wamu has incorporated a Payment Shock analysis page into the Quarterly Neg-Am Report in response to recommendations made from the prior exam. The institution also prepares an abbreviated analysis on a monthly basis. Management has improved its monitoring and analysis in this area.

Neg-Am Report Highlights (March 31, 2007)

At the end of 1Q07, total deferred interest was $1.275 Billion or 2.22 % of the outstanding balance for loans that currently have the potential to negatively amortize, with $1,115 MM above the origination balance. The projections for total deferred interest increased from $1.29 billion at 4Q06 to $1.59 billion at 1Q07, a 23% upward revision in estimated amount of total deferred interest. The estimated peak in deferred interest is projected to occur in January 2008. In the 4Q06 Neg-Am Report the *estimated* total deferred interest *forecast* for 1Q07 was set at 1.179 billion; actual deferred interest exceed this forecast amount by $96 MM or 8 % of the forecast amount.

♦ The potential financial impact of payment shock associated with Option ARMs is estimated at $154.3 MM should a stressed economic scenario occur. The estimated timing of the shock losses is from February 2010 to February 20011. The stress scenario assumes 300 bps growth in the 1-year treasury over the next six months, then a flat trend, and 0% house price growth.

♦ Option ARMs contribute the majority of net income after tax (NIAT) to the SFR portfolio (including Subprime). Option ARMs perform better financially than other SFR Prime products because they have a higher margin, the banks recognizing the interest income when a loan is deferring interest, and loans that defer interest actually *accrue* interest on that deferred interest, thereby increasing the interest income associated with these loans.

♦ From 1Q06 to 1Q07, the percent of borrowers making the minimum payment increased from 61.1% to 73.6% up 12.5%.

♦ On a vintage basis, both 2005 (at 80.7 % in March 2007) and 2006 (at 86.9 %) substantially exceed all other vintages' minimum payments. The rate for all other vintages combined was 59.5%.

♦ Deferred interest in nonaccrual status rose 54% ($2.4 MM) in 1Q07. The non-accrual rate for loans with negative amortization is lower than the nonaccrual rate for loans without negative amortization (but having the potential to accrue it). However, the nonaccrual rates have been trending towards each other since early in 2006, with the non-accrual rate for loans with deferred interest briefly surpassing the non-accrual rate for loans without deferred interest in February 2007, but then dropped in March 2007 due to a $98 MM sale of non-accrual Option Arms (NPA22).

♦ Loans with negative amortization have a 6 bps higher foreclosure rate than loans without deferred interest. Neg-Am foreclosure balances increased three-fold from 1Q06

to 1Q07 compared to a two-fold foreclosure balance increase for loans without deferred interest.

♦100% of the potential early recasts are on loans with a 110% or 115% limit, which were only in place for the 2005, 2006 and 2007 vintages. As a result, all potential early recasts are limited to those vintages, with the 2006 vintage making up 94% of the early recast dollars.

♦ The increase in losses associated with payment shock are highest for the 2006 vintage and are driven by a larger increase in the interest rate, a higher decline in the prepayment rate and a lower deferred interest cap, which may result in recasts before these loans have been on the books for five years.

♦ Due to the low increased loss rate for all vintages prior to the 2005 vintage, the loss impact associated with recasts for these vintages is very low.

♦ In September 2009, losses associated with recasts for the 2006 vintage begin, which is prior to the start of the 2005 vintage losses. This is due to the lower negative amortization cap (110%) in place in 2006. From September 2009 to December 2011, 87% of the $169.7MM of potential increased loss would occur (4Q06 Neg-Am Report).

As of January 31, 2007, the bank reported a total of $61.9 billion in outstanding OA loans in the Held for Investment portfolio. Of those, approximately 80 percent of the entire OA portfolio is actively negatively amortizing in some fashion.

» Current Balance > Original Balance - $4.8 billion;
» Current Balance > Prior Balance - $5 billion;
» Current Balance > Original and Prior Balance - $37.7 billion.

OA Portfolio Vintage

Of the $62.9 billion in OA loans as of December 31, 2006, approximately 28 percent were originated in 2006 with the remainder of the portfolio consisting of the following vintages:

» 2005 31.5 %
» 2004 18.7 %;
» 2003 12.0 %
» 2002 2.5 %;
» 2001 less than 1 %
» 2000 1.7 %
» Before 2000 4.4 %

OTSWMEF-0000009890

OA – High Risk Borrowers & Risk Layering

Management defines high-risk borrowers as those with FICO scores less than 620 (for first lien single-family loans). As of March 31, 2007, OA loans with FICOs of less than 620 represented approximately 5 percent of the entire OA portfolio.

OA Portfolio – Documentation Level & Risk Layering

As of December 31, 2006, approximately 73 percent of the OA portfolio consisted of "Low Doc" loans. Although the level of Low Doc loans seems excessive, management mitigates this risk to some extent by requiring lower LTVs and higher FICOs on Low Doc loans.

OA Product types and characteristics

Monthly Option ARM Products (Loan Amount ≤ $3.0M):

- 1-Month Option ARM (12-MTA or COFI index)
- 3-Month Option ARM (12-MTA or COFI index)

  These product lines consist of Option ARMs tied to either the 12-MTA or the 11th District Cost of Funds Index (COFI). The term offered are 15 and 30 years. The initial fixed interest period is 1 month or 3 months, with the interest rate adjusting monthly thereafter. The initial fixed payment period is one year, and after that the payment adjusts annually subject to a 7.5 percent cap. The payment cap is suspended if the loan recasts, when a fully amortizing, fully indexed payment is required. The recast loan limit is 115 percent of the originated loan amount. Four payment options are offered after the initial introductory period: 1) minimum payment, 2) interest only payment, 3) fully amortizing principal and interest payment based on the initial term, 4) fully amortizing payment based on a 15 year term.

  Target Market: Borrowers wanting flexible features, lower payments, or payment options.

Fixed Period 12-MTA ARM Products (Loan Amount ≤ $3.0M):

- Flex 5 Option ARM:

  The Flex 5 products are Intermediate Option ARMs with an Option ARM feature tied to the 12-MTA index after the initial fixed period of 5-years. The initial interest rate and payment remains fixed for 60-months. Payments are fully amortized over the term of the loan during the initial fixed period. The interest rate adjusts monthly after the fixed initial period based on the calculated index plus the margin. Deferred interest (payment option) is available after the fixed period has expired.

Target Market: Borrowers who want Option ARM lending flexibility and expanded parameters and lower payments.

Option Arm Advantage 90:

- The Option ARM Advantage 90™ is designed for borrowers who select a 10.1% down purchase loan or an 89.9% no cash out refinance in lieu of an MI-insured or an 80% or less LTV.

NONTRADITIONAL MORTGAGE GUIDANCE REVIEW

Summary:
Below is a brief outline of the major components of the Interagency Nontraditional Mortgage Guidance October 2006. Only the Underwriting section is evaluated in this document.

Underwriting:

- The borrower should be qualified at fully indexed, fully amortizing payment considering balance increases.
- Over-reliance on the use of credit scores as a substitute for income verification should be avoided.
- No collateral dependent loans. The ability of the borrower to pay an amortizing payment should not be based on the sale or refinancing of the collateral

Portfolio Risk Management

- Policies should establish portfolio limits for risk layering, and loan concentrations.
- Nontraditional mortgage products require enhanced performance monitoring and reporting.
- ALLL levels should reflect portfolio risk, and may need enhancement as the risks associated with nontraditional mortgages changes.
- Mortgage Banking Operations: monitoring of recourse in sold loans, and develop contingency plans if demand for nontraditional mortgage products in secondary market drops.

Consumer Protection

- Marketing should be balanced
- Potential payment shock, interest rate increases, capacity for negative amortization, and prepayment penalties should be explained and disclosed in a consumer friendly manner.
- Pricing premium for reduced documentation should be clearly disclosed.

WAMU GAP ANALYSIS EVALUATION: UNDERWRITING

Underwriting

Conclusions:

1) As of December 31, 2006 WAMU still did not consider potential Negative Amortization in qualifying the borrower for Option ARMs: this practice is not conforming to the October 2006 Interagency Guidance. WAMU considered the potential payment shock between the *qualified amortizing payment* and the amortizing payment at recast, including any negative amortization, to be non-significant. The WAMU analysis shows an approximate 20% difference between the two payments mentioned above.

    - As of May 15th Wamu is moving toward changing the Option Arm qualification parameters to include calculating the qualifying DTI using a fully indexed, fully amortizing payment that includes potential negative amortization balance increases. This would bring the underwriting portion of the Option Arm program into compliance with the Interagency Guidance on Nontraditional Mortgage Lending issued in October 2006.

2) Wamu's general policy and procedures covering Low-Doc or Stated Income loans appears to rely heavily on FICO scores. In The Conventional Underwriting Guidelines section covering Low-Doc, Stated Income loans, it says under, "Reasonableness of Stated Income": Step 2) "is designed to minimize risk by...calculating the payment shock and establish a limit on the amount of increase permitted". These limits are quite liberal.... 100% increase in payment for LTV < 75%, and 50% increase for LTVs > 75%. Even if the new loan payments exceed these liberal limits, step 3 allows for stated income use if the borrower has a high enough FICO score. This seems to indicate a high degree of reliance on FICO in determining who qualifies for stated income loans. Hence FICO scores are being relied upon in place of income documentation/verification. This degree of reliance on FICO score appears inconsistent with the nontraditional guidance.

3) Interest Only loans, (with higher FICO and lower LTV), are not being qualified at an amortizing payment. These are being qualified at the interest only rate and do not consider payment shocks/increases when the loan starts amortizing. This is not inline with the NTM Guidance.

    - As of May 15th, Wamu is moving toward qualifying all IO loans with IO periods less than 5 years at an amortizing payment. This is compliant with the Interagency NTM Guidance. However IO products with IO periods of 5 years or more will continue to be qualified at the interest only payment. This is still not consistent with the guidance.

4) Wamu states that they do not engage in underwriting practices that heighten the need for a borrower to rely on the sale or refinancing of the property to make amortizing payment on the loan; and therefore they are not making collateral based loans. However the liberal use of the Low-Doc/Stated Income loans raises the question of reliability of the declared income as being the primary repayment source. The combination of stated income loans and higher loan to values ratios likely increases the chance that the ultimate collect ability of the loan may rest upon the liquidation of the underlying property, or refinancing the loan.

From: Cathcart, Ron
Sent: Monday, March 19, 2007 8:46 PM
To: Schneider, David C. <david.schneider@wamu.net>
Cc: Chapman, Fay <fay.chapman@wamu.net>; Rotella, Steve <steve.rotella@wamu.net>; Casey, Tom <tom.casey@wamu.net>; Feltgen, Cheryl A. <cheryl.feltgen@wamu.net>
Subject: FW: Follow-up information to last evening's call regarding subprime interagency guidance, etc. . . .
Attach: NTM Impact New 20070315 Revised.xls

Clearly a different set of facts, which argues in favor of holding off on implementation until required to act for public relations (CFC announces unexpectedly) or regulatory reasons.

From: Park, Alex
Sent: Monday, March 19, 2007 5:17 PM
To: Feltgen, Cheryl A.; Cathcart, Ron
Cc: Hyde, Arlene M.; Potolsky, Doug; Weisbrod, Jay A.; Sinn, Susan M.; Smith-McCrainey, Denise; Wilson, John; Coultas, Dave; Champney, Steven D.; Wagner, Maynard; Biglin, Brian J.; Sang, Xiaoyu
Subject: FW: Follow-up information to last evening's call regarding subprime interagency guidance, etc. . . .

First of all, my apologies.

The original information I had sent out had error in the analysis. I did not include the volume of loans with <=90% CLTV in the impact calculation. The information Cheryl had sent previously is correct.

The following is the correct info:

- Based on the info from Xiaoyu Sang, if we implement the Purchase only change for NTM' we'll have around 10% Purchase volume.
  - Most of the drop comes from 95% CLTV change we had already made as this change alone drops Purchase from 24% in Feb 2007 to 12%.
  - The total volume reduction from 95% CLTV change is estimated as 20%.
- Implementing the NTM change for Purchase only drops additional 2.5% of volume.
  - If we implement the NTM changes to all loans, then we'll see additional drop of 33% of volume.
- The 95% CLTV change dropped the most loans from Purchase population, but NTM change will drop most loans from Refinance (better performing) population if we apply it to all loans.

Thank you.

Alex

-----Original Message-----
From: Park, Alex
Sent: Thursday, March 15, 2007 9:45 AM
To: Feltgen, Cheryl A.; Cathcart, Ron
Cc: Hyde, Arlene M.; Potolsky, Doug; Weisbrod, Jay A.; Sinn, Susan M.;

Permanent Subcommittee on Investigations
EXHIBIT #75

Smith-McCrainey, Denise; Wilson, John; Coultas, Dave; Champney, Steven D.; Wagner, Maynard
Subject: Re: Follow-up information to last evening's call regarding subprime interagency guidance, etc. . . .

Cheryl and Ron:

Based on the info from Xiaoyu Sang, if we implement the Purchase only change for NTM' we'll have around 11% Purchase volume.

Most of the drop comes from 95% CLTV change we had already made as this change alone drops Purchase from 24% in Feb 2007 to 12%.

The total volume reduction from 95%
CLTV change is estimated as 20%.

Implementing the NTM change for Purchase only drops additional 0.6% of volume. If we implement the NTM changes to all loans instead of just Purchase, we'll have additional 2.3% drop in volume from the total volume based on Feb 2007. The total NTM changes only add up to 3% due to all the other credit policies we had changed instead of 32%.

Given this info, I recommend that we consider taking the high road of fully accepting the NTM guideline. This should certainly place us in a better position with OTS.

Thank you.

Alex

----- Original Message -----
From: Feltgen, Cheryl A.
To: Park, Alex
Sent: Thu Mar 15 02:53:40 2007
Subject: FW: Follow-up information to last evening's call regarding subprime interagency guidance, etc. . . .

Can you reply with the response to Ron's question? I don't have the backup handy. Thanks.

Cheryl

From: Cathcart, Ron
Sent: Wednesday, March 14, 2007 9:51 AM
To: Feltgen, Cheryl A.
Subject: RE: Follow-up information to last evening's call regarding subprime interagency guidance, etc. . . .

What are the relative projected volumes of purchase/non?

From: Feltgen, Cheryl A.
Sent: Tuesday, March 13, 2007 8:47 PM
To: Schneider, David C.; Cathcart, Ron; Longbrake, Bill A.; Chapman, Fay; Robinson, John
Subject: Follow-up information to last evening's call regarding subprime interagency guidance, etc. . . .

Wanted to send to all of you one of the pieces of information that was requested during last evening's call on the "subprime interagency guidance" and related subjects. The question was what portion of our current production of purchase transactions would not qualify if we underwrote at the fully indexed, fully amortizing rate? We looked at the February production and deducted from it the over 95% CLTV transactions to have a representative look at future production (as you all know, we stopped doing greater than 95% CLTV loans last week). If we qualified only the purchase transactions at the fully indexed, fully amortizing rate, 2.5% of volume would be eliminated. If we qualified all transactions at the fully indexed, fully amortizing rate, 33% of volume would be eliminated.

We are working on the gap analysis comparing our current practice to the items cited in the Fremont Cease and Desist Order. We should have that in the next day or so. The analysis to develop a strategy regarding the rate resets will take a few more days beyond that.

Cheryl

Ms. Cheryl A. Feltgen
Senior Vice President
Chief Risk Officer, Home Loans Division
WaMu
1301 Second Avenue
WMC4001
Seattle, WA 98101
Phone: 206.500.4952
Fax: 206.377.2391
Email: cheryl.feltgen@wamu.net

From: Magrini, William J <william.magrini@ots.treas.gov>
Sent: Tuesday, March 27, 2007 8:26 AM
To: Gardineer, Grovetta <gardineergr@office of thrift supervision.com>; Phillips-Patrick, Fred J <patrickfj@office of thrift supervision.com>
Cc: Luther, Teresa H <lutherth@office of thrift supervision.com>; Quigley, Lori G <quigleylg@office of thrift supervision.com>; Lake, Stephen A <lakesa@office of thrift supervision.com>
Subject: RE: NTM Gap Analysis

I noted that several of our institutions make NINA loans. That, in my humble opinion is collateral dependent lending and deemed unsafe and unsound by all the agencies. The fact that Indy REQUIRES a 660 FICO for such loans is appalling. 660 is below average. That is not a credible risk mitigant.

What ever would possess those institutions to make such loans widely available. I could see it if they required a 760 Fico and lots of equity?

Why would our examiners not question such practices?

It is not at all surprising that delinquencies are up, even among Alt-A. In my opinion credit standards have gone too low.

Bill Magrini

-----Original Message-----
From: Gardineer, Grovetta
Sent: Tuesday, March 20, 2007 1:31 PM
To: Phillips-Patrick, Fred J
Cc: Magrini, William J; Luther, Teresa H
Subject: FW: NTM Gap Analysis

FYI - NTM Gap Analysis compiled by the West Region.

Grovetta

From: Gregovich, Steven M
Sent: Thursday, March 15, 2007 3:01 PM
To: Gardineer, Grovetta
Subject: FW: NTM Gap Analysis

Grovetta - Joanne asked for this, but I figured you'd also want to see it.

Steve

-----Original Message-----
From: Gregovich, Steven M
Sent: Thursday, March 15, 2007 11:59 AM
To: Haakinson, Joanne J

Permanent Subcommittee on Investigations
EXHIBIT #76

Cc: Quigley, Lori G; Messett, Brian C; Henry, David R; Rexroth, Mariana; Finn, Michael E; Dochow, Darrel W; Chow, Edwin L

Subject: NTM Gap Analysis

Joanne - As requested, here is the Nontraditional Mortgage Guidance Gap Analysis summary spreadsheet covering our five largest NTM lenders. We asked each lender to complete a review of current practices vs. the guidance, and we have met with each of them to discuss the analysis. We did not dictate the format or questions, as we wanted to see how each lender interpreted the guidance requirements. All of the participants provided significantly more detail (usually a full binder), so this spreadsheet is a only a compilation summary of their responses, not our judgment of the responses. Also, we are still working with WaMu to gather additional detail.

We would hope that all five of these lenders would be invited to the DC meeting on the 4th, as they have significant influence on the Option ARM market. We would also hope that Countrywide would be invited also.

I will be in Charlotte all of next week, so contact David Henry if you have questions regarding the spreadsheet.

<< File: NTMgapSUMMARY.xls >>

From: Franklin, Benjamin D
Sent: Thursday, April 12, 2007 4:57 PM
To: Henry, David R <henryda@office of thrift supervision.com>
Subject: RE: Wamu NTM Gap Analysis

Ed is just doing the legwork for bob that we talked about earlier, basically putting together "unofficial points" regarding weaknesses we see in WaMu's implementation of NTM guidance. We had stopped working on this based on earlier conversations with Steve that this should not be handled through the exam; however, we renewed it this late last week after Darrel indicated that we should proceed but to run any suggestions by him and mike before we share anything with the Bank. Of course, we will run it by your group first because we plan to incorporate points from the matrix that you shared with us. I doubt that we will have anything to show you until week after next because like I said, we just started to work on this again recently.

-----Original Message-----
From: Henry, David R
Sent: Thursday, April 12, 2007 12:19 PM
To: Franklin, Benjamin D
Subject: RE: Wamu NTM Gap Analysis

Ben,

I'm checking in during vacation on my emails and noted the attached emails. I can certainly work with Ed to get this done for you and Bob but as Mariana points out - we want to coordinate the mesaage with Darrel and Mike.

I will be back to work - at Downey but can better circle up with this and other matters then. If you prefer it not wait - I'd like to see a copy of the memo before it goes out and can circle back up tomorrow evening for any emails.

DRH

-----Original Message-----
From: Rexroth, Mariana
Sent: Thursday, April 12, 2007 10:21 AM
To: Cole, Edward C
Cc: Clark, Mary Suzanne; Henry, David R
Subject: RE: Wamu NTM Gap Analysis

Ed -

Sounds like a plan.

Apropos risk monitoring, there is a piece that I'm waiting on ... there's a lot of overlap, though people don't always recognize it. So I've asked for information about account management/collection/workouts.

Permanent Subcommittee on Investigations
EXHIBIT #77

Then there is the issue of third party originator oversight. Because I had already asked for information about this in connection my fair lending review, I will be receiving materials (actually, they were supposed to be here by 10 am) this week. If I need further information - or a meeting - on this subject, I'll go from there. (Fair lending is actually a pretty good lever on this issue, as the question of whether the broker is an "independent agent" is irrelevant under the ECOA - the lender is accountable (so is the broker, but that's for a different agency or lawsuit to deal with.)

There are various changes on the underwriting side that lenders are sort of holding their collective breaths on - partly to see who goes first, but also because they will involve system changes that will take, from what I gather (and depending on the timing of "change schedules"), about six months to accomplish.

Have you talked with Dave Henry about any of this? There's a certain coordination and sequence to this process that Darrel and Mike have asked us to follow.

Mariana

-----Original Message-----
From: Cole, Edward C
Sent: Thursday, April 12, 2007 10:11 AM
To: Rexroth, Mariana
Subject: RE: Wamu NTM Gap Analysis

Thanks Mariana,
Bob Archibald & Ben Franklin wanted me to write a memo reviewing Wamu's NTM Gap Analysis to see where they are conforming and where they still need work. I'll just leave out any evaluation or comment about the compliance stuff... Consumer Protection and Reg Z , and let you address that. Have you looked at Wamu's NTM gap Analysis from an Underwriting or Risk Assessment/Monitoring perspective at all? I'm working on that at the moment but need more info from Wamu regarding portfolio concentration and risk layering limits. I guess I may need to wait on this info as well. Anyways, it's only been a few months since the guidance came out so they may need more time to make the necessary adjustments. Thanks for the response and matrix. Have a good weekend!

Ed

-----Original Message-----
From: Rexroth, Mariana
Sent: Thursday, April 12, 2007 9:46 AM
To: Cole, Edward C
Cc: Clark, Mary Suzanne; Gregovich, Steven M
Subject: FW: Wamu NTM Gap Analysis

Ed -

First, I will be doing whatever ***exam*** coverage there is of the NTM guidance at WAMU. It was not part of the original scope of the current compliance exam, and as you correctly surmised, any transactions reviewed would be prior to the exam date.

Second, I will be picking this piece up because I am largely there as a result of reviewing the daft guidance, providing comments, meeting with all of the large NTM lenders re their gap analysis, etc. So, this is something I volunteered to do to include something on the subject in the scope of the exam.

While I am certainly glad to do this - that's why I offered in the first place - I do need to devote the bulk of my attention at this moment to the institution's fair lending program and the HMDA outlier review. So, I would characterize any comments I could make at this point as very preliminary.

I have met with them about the NTM guidance gap analysis. There is some information that they didn't cover in that discussion that I am still awaiting. Also, I don't have the current disclosures/documents - I believe that they have been sending them to Steve and even so, those are old and don't reflect any of the changes that they have made or are working on.

The gist of this is - you'll need to wait till the end of the month for more information than the gap analysis matrix that they presented when I met with them (attached).

<< File: Appendix C - Detailed Gap Analysis of NTM Guidance - Consumer Protection (3).doc >>
I hope this helps - if not, you can call me at 510-525-7203.

Mariana

-----Original Message-----
From: Clark, Mary Suzanne
Sent: Thursday, April 12, 2007 7:03 AM
To: Rexroth, Mariana
Subject: FW: Wamu NTM Gap Analysis

Mariana,

If you are in Daly City today, could you update Ed on this issue? Let me know how the discussion goes.

Susie
(206) 490-4744

-----Original Message-----
From: Cole, Edward C
Sent: Wednesday, April 11, 2007 4:07 PM
To: Clark, Mary Suzanne
Subject: Wamu NTM Gap Analysis

Hi Suzanne,
I'm down in Daly City reviewing Wamu's Nontraditional Mortgage Guidance Gap Analysis and I wanted to check-in with you and see if, during the course of the current exam, you have looked at loans from the stand point of whether they have been following the NTM Interagency guidance from October 2006. I'm guessing that any loans sampled during the exam were probably originated before October 2006, and that NTM guidance may not have come into play for this exam. However, if you have seen, heard, or have otherwise been made aware of any major discrepancies regarding the Consumer Protection disclosures regarding NTMs I would be interested in that info. Within the Jan. 2007 Wamu NTM Gap Analysis they outline proposed actions that would help bring them into conformity with the guidance; I'm trying to evaluate whether their proposed actions are sufficient or if they have left anything out. If you have any related information to share, please feel free to e-mail me when you can. Thanks!

Ed Cole

From: Shelley Hymes <shelley@angelenterprisesdc.com>
Sent: Thursday, May 3, 2007 7:56 AM
To: Reich, John M <John.Reich@ots.treas.gov>
Subject: RE: Lunch Friday

Can't ..21?
Not sure about 24/25 – are you around?

Shelley S. Hymes
President
Angel Enterprises
Ph) 202-364-3438
F) 202-364-3319

From: Reich, John M [mailto:John.Reich@ots.treas.gov]
Sent: Wednesday, May 02, 2007 8:07 PM
To: shelley@angelenterprisesdc.com
Subject: Re: Lunch Friday

Could we do Wed., May 23rd?

Sent using BlackBerry

----- Original Message -----
From: shelley@angelenterprisesdc.com <shelley@angelenterprisesdc.com>
To: Reich, John M
Sent: Wed May 02 20:01:16 2007
Subject: Re: Lunch Friday

Hi John. It was so good to see you last night! What a great party! I totally understand re lunch. Could we do following week of 21? I am gone next week and booked the following. Cannot wait for my Jr time!
Sent via BlackBerry from Cingular Wireless

-----Original Message-----
From: "Reich, John M" <John.Reich@ots.treas.gov>
Date: Wed, 2 May 2007 18:42:25
To:<shelley@angelenterprisesdc.com>
Subject: Lunch Friday

Shelley,

Flew to Phoenix today, back home Thursday. Something has come up which causes me to need to reschedule our Friday lunch. Kerry Killinger, the CEO of Washington Mutual (WaMu) will be in town Friday and wants to have a lunch meeting. He's my largest constituent assetwise. Is there any way you could do lunch the following Monday, May 7th? Otherwise my next opportunity would be Friday , May 18th. I'm sorry.......

John

Sent using BlackBerry

From: Dochow, Darrel W <darrel.dochow@ots.treas.gov>
Sent: Wednesday, May 16, 2007 1:01 PM
To: Franklin, Benjamin D <franklinbd@office of thrift supervision.com>
Subject: RE: NINA Loans

Ben:

That is OK, but I am being told that Bill's views may not necessarily represent OTS policy in these matters. I value Bill's input, but we should be careful about relaying his views to others as being OTS policy, absent collaborating written guidance. The views expressed below are somewhat inconsistent with NTM guidance and industry practice. I also understand that Grovetta promised to clarify section 212 of the handbook in several areas as a result of the NTM roundtable discussion in Wash DC last month.

Darrel

-----Original Message-----
From: Franklin, Benjamin D
Sent: Wednesday, May 16, 2007 8:19 AM
To: Dochow, Darrel W
Subject: RE: NINA Loans

Darrel,

I was just thinking of asking him to clarify OTS' position from a policy standpoint (if that is currently his role) in a few areas. We are getting the additional details you indicate below.

Ben

-----Original Message-----
From: Dochow, Darrel W
Sent: Wednesday, May 16, 2007 8:07 AM
To: Franklin, Benjamin D
Subject: RE: NINA Loans

Ben:

Thank Bill for the comments if you feel that you owe Bill a response. I am now updating Lori Quigley and Brian Messett regularly on WAMU and there is no need to duplicate with Bill Magrini as far as I know. I do want to know, however, how WAMU is complying with the handbook and NTM guidance if they are in fact doing nina loans - e.g. how do they do this loan, what are the risk mitigates, how do they demonstrate ability to repay, etc.

Darrel

-----Original Message-----
From: Franklin, Benjamin D
Sent: Tuesday, May 15, 2007 9:19 AM
To: Dochow, Darrel W
Subject: NINA Loans

Darrel,

Permanent Subcommittee on Investigations
EXHIBIT #79

After WaMu's non-traditional survey was reviewed in DC, I got the following note from Magrini:

" I note that WAMU makes a significant amount of No-doc loans. OTS policy states that no-doc loans are unsafe and unsound. I assume they mean no doc regarding NINA or no income-no asset loans.

Without even asking for income or assets/liabilities, the loans are collateral-dependent. This is imprudent, and such loans do not get the advantage of the 50% risk weighting per OTS Examination Handbook Section 212. Moreover, the interagency NTM Guidance states specifically that collateral dependent loans are unsafe and unsound. Following are excerpts from that guidance:

Collateral-Dependent Loans - Institutions should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Institutions that originate collateral-dependent mortgage loans may be subject to criticism, corrective action, and higher capital requirements.

Does WAMU have any plans to amend its policies per no doc loans?"

I have checked for this in the past and found that they didn't do true NINAs (no income or assets collected or verified) and the current team also indicated that they still don't do any. I replied as such to Magrini; however, at a recent meeting, I double checked on this and found out that the Bank begin doing NINA's in 2006 through their conduit program. As such, all these loans are held for sale. They currently have approximately $90.0 million in the HFS portfolio. Originations for 2006 approximated $600.0 million as does YTD 2007 originations.

I just want to clarify with Magrini that we ban HFS NINA's the same as we do for portfolio, but wanted to make sure you were aware of this issue first. I think we do but I seem to remember that in the past we may have allowed these on a HFS basis but placed a strict limit on how long these could remain in the HFS portfolio.

Let me know your thoughts.

Ben

From: Franklin, Benjamin D
Sent: Wednesday, May 16, 2007 12:28 PM
To: Reiley, Mark E <reileyme@office of thrift supervision.com>; Archibald, Robert D <archibaldrd@office of thrift supervision.com>
Subject: RE: NINA Loans

I didn't intend to send a memo until I got a blessing from Darrel or DC on what our official policy is on this. I just spoke to Steve Gregovich about this, and apparently there is more controversy around this issue than I was aware of. Since I addressed this issue at Indymac several years ago (where we allowed them to do NINA's if they limited the time in warehouse to 60 days under the assumption that FICO was an indicator of ability to repay (with Magrini's blessing)), West Region guidance on this has apparently changed. Steve indicated that many of our larger institutions now do NINAs (including Countrywide), and he indicated that the warehouse restriction that we put on Indy was probably a temporary supervisory decision. Apparently Bill Magrini is the lone ranger in his view that NINA's are imprudent. West region position seems to be that FICO, appraisal, and other documentation such as application etc. is sufficient to assess the borrower's ability to repay in all but subprime loans. While I probably fall more into the Magrini camp (until we get empirical data to support NINAs are not imprudent) we will just document our findings in WPs until the "'official" policy on this has been worked out.

Ben

-----Original Message-----
From: Reiley, Mark E
Sent: Wednesday, May 16, 2007 8:31 AM
To: Archibald, Robert D
Cc: Franklin, Benjamin D
Subject: NINA Loans

Bob,
The Handbook guidance Section 212 states that no-doc loans (NINAs) are unsafe and unsound loans (Pg. 212.7). Furthermore, even if the no-doc (NINA) loans are originated and held for sale the guidance indicates (pg. 212.8) the association must use prudent underwriting and documentation standards and we have already concluded they are unsafe and unsound. Even if the institution holds the loans for a short period of time. I checked with Tracy gong and she indicated this is a hot topic in DC and we are getting a significant amount of push back from the industry. Even Bill Magrine and Fred Phillips-Patrick are at odds with how to proceed. I also asked her about how we handled other institutions with NINA loans. She wasn't sure but thought Downey had some. I call Kuzcak and he said Downey doesn't originate NINAs anymore. Tracy indicated what ever we ask them to do should be run by the higher ups. At this point I don't think a memo is the best avenue, I think we need to request in writing that WAMU respond to us on how the NINA's comply with the handbook guidance?

Let me know.
Mark

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Division of Enforcement

June 24, 2008

George Curtis
Deputy Director
(202) 551-4740
(202) 772-9279 (fax)

Susan Chomicz, Esq,
Deputy Chief Counsel
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Re: *In the Matter of Washington Mutual, Inc.* SF-3255

Dear Ms. Chomicz:

As you are aware, the Securities and Exchange Commission is investigating Washington Mutual, Inc. In its offering documents for certain mortgage-backed securities and required periodic filings with the SEC, Washington Mutual claimed that all of its appraisals were conducted in compliance with regulations promulgated by the Office of Thrift Supervision. As the federal agency responsible for investigating violations of the federal securities laws, the SEC is investigating whether these claims by Washington Mutual to the investing public were false and misleading.

The SEC has authority to conduct "investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision" of the Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78a et seq.] and the rules and regulations thereunder. Section 21(a) of the Exchange Act [15 U.S.C. § 78u(a)]. The staff has sought documents from Washington Mutual and other entities as part of its investigation and has sought to speak with relevant witnesses.

Recently, the SEC staff was advised by Washington Mutual's counsel, Josh Levine, that the OTS instructed Washington Mutual not to provide documents to the Commission relating to the OTS's review of Washington Mutual's appraisal processes or any communications between the OTS and Washington Mutual.

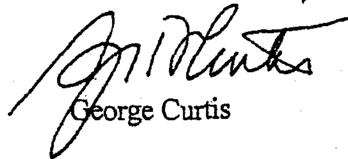
With respect to the OTS's instruction to Washington Mutual to withhold documents responsive to the SEC's document request, we understand that Mr. Levine was instructed by OTS Regional Counsel Jim Hendrickson to refer the SEC to 12 C.F.R. § 510.5, entitled "Release of unpublished OTS information." That regulation, however, explicitly states that it applies to "requests by the public," and does not apply to "[r]equests for information by other government agencies." 12 C.F.R. § 510.5(a)(1), (a)(3)(ii).

Permanent Subcommittee on Investigations
EXHIBIT #80

Since the documents we are seeking could be directly relevant to our potential case, we request your reconsideration of the referenced instructions. In that same regard, I would like to meet with you to discuss this and other issues that have arisen in the course of the SEC's investigation.

Please contact me at 202-551-4740 to discuss a mutually convenient time to meet.

Very truly yours,



George Curtis

From: Burns, Robert L.
Sent: Thursday, April 03, 2008 09:28 AM
To: Eagar, Leo J.; Funaro, Stephen P.
Subject: RE: Findings from Review of WAMU Basel II models (HELOC and credit cards)

John and Steve,
Chris Grum is heading up some work on mortgage loss modeling at large banks and working with Steve Burton in DIR (their research side, not their publication side). Would you mind if I forwarded this to them?
It is a project that Sandra Thompson asked for - we have shared some mtge loss forecasting work from WB, E-Trade and BofA already and I am sure they would love to see some work being done by the banks out west as well.
robert

From: Eagar, Leo J.
Sent: Tuesday, April 01, 2008 4:15 PM
To: Hoyer, Brent D.; Hirsch, Pete D.; Funaro, Stephen P.; Fitzgerald, Tracy E.; Burns, Robert L.
Subject: Findings from Review of WAMU Basel II models (HELOC and credit cards)
I spent the past several weeks participating in a qualification review of Basel II models for credit cards and HELOCs at Washington Mutual. Findings memos are attached for your review, if you are interested. OTS had a team of 5 examiners working on this review and I worked closely with them throughout. These were the first in-depth Basel II reviews conducted at this institution; OTS will be starting a review of SFR models at the end of April and will progress through other IRB models (such as commercial loans, op risk, Pillar 2, etc) over the next several months. The OTS wanted my help for the next review, but I've got other commitments including UBS.
In my opinion, OTS (field personnel plus DC quants) conducted a thorough review of the models and developed appropriate recommendations which management will be required to address. It's too early to know if upper level OTS management might succumb to pressure from the bank and back off on recommendations if management pushes back (although no indication yet that WAMU intends to complain). At the exit meeting last week Darrel Dochow personally attended and did fully support the field examiners. It is clear, however, that OTS at all levels is very aware of the political clout of WAMU within their agency.
I don't think that Washington Mutual has made a final decision with regards to a date for starting the parallel run. Originally they were planning to begin as soon as possible, but they told us that they will postpone (to an undetermined date) due to market conditions and other considerations. Also, we also heard that WAMU does not want to be the first to adopt. Finally, I don't think the OTS will complete their review of the entire Basel II system until 4th quarter 2008, and there will be recommendations from the reviews that management will need to address before the models can be qualified, so it looks like the earliest date to start the parallel run would be the beginning of 2009.
The document titled "WAMU Summary of Findings" is a high level overview of findings. Bottom line: the credit card models need some enhancements but could probably be qualified in a timely manner (book balance of $9.8 billion on 12-31-2007 or about 3% of total assets, with managed receivables of $27.2 billion). In contrast, the HELOC models have significant deficiencies and will require considerable efforts to correct; we are particularly concerned about the lack of downturn in the data for both PD and LGD quantification and it is not clear that parameters fully reflect the risk in this portfolio (book balance $49.4 billion on 12-31-2007, which is about 15% of total assets).
<< File: WAMU Summary of Findings IRB Review March 2008.doc >>
The other documents are detailed findings memos, probably of interest only if you have insomnia or want detail about specific quantification methods, risk drivers, etc. Would be helpful perhaps for someone who is reviewing Basel II retail models at other banks, because these documents might provide perspective on industry practice and provide benchmarking. Feel free to distribute these documents as appropriate.
<< File: WAMU Notes on Credit Card IRB.doc >> << File: WAMU Notes on HELOC IRB.doc >> << File: WAMU Notes on Validation.doc >>
I did enjoy the opportunity to participate in this review. There are probably other exam priorities right now, but I would welcome the opportunity to participate in additional Basel II retail reviews at other institutions if you would like my assistance. Let me know and I'll try to work it into my schedule.
Give me a shout out if you have any questions!

Permanent Subcommittee on Investigations
EXHIBIT #81

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

Permanent Subcommittee on Investigations
EXHIBIT #82

Offices of Inspector General

DATE: April 9, 2010

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

Sheila C. Bair, Chairman
Federal Deposit Insurance Corporation

FROM:

Eric M. Thorson	Jon T. Rymer
Inspector General	Inspector General
Department of the Treasury	Federal Deposit Insurance Corporation

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

cc: Randy Thomas, OTS
Jason Cave, FDIC
Christopher Drown, FDIC DSC
Arlinda Sothoron, FDIC DIR

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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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OIG

Evaluation Report

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.

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

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.

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.

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),

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.

<u>SECTION I</u>

Causes of WaMu's Failure

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.[1] 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."[2]

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.

[1] WaMu defined borrowers with a score of less than 620 on the FICO scale as subprime.
[2] 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.

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

Loan Product Type	Return (in Basis Points)
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[3] and negative amortization.[4] 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

[3] 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.
[4] 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.

percent of interest income) in interest income due to capitalized interest[5] on Option ARMs.[6]

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,[7] 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.

[5] 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.

[6] WaMu included $1.07 billion of capitalized interest in earnings in its December 31, 2006 financial statements.

[7] 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.

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.[8]

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

	Option ARMs	Subprime	Home Equity
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.

[8] 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.

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 Providian 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

that federal regulators were taking enforcement action against the institution.[9]

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.[10]

[9] OTS was considering informal enforcement action against WaMu at that time, but that information was not released to the public.
[10] Certain liabilities were not assumed by JPMorgan Chase & Co.

SECTION II

OTS's Supervision of WaMu

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.[11] 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.[12] 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.

[11] OTS did impose enforcement actions in 2007 related to the Bank Secrecy Act and consumer compliance. See Table 6.
[12] OTS Examination Handbook, Section 070, page 070.6.

Table 4: CAMELS Composite Rating Definitions

1	Sound in every respect
2	Fundamentally sound
3	Exhibits some degree of supervisory concern in one or more of the component areas (*i.e.*, capital adequacy, asset quality, management, earnings, liquidity, sensitivity to market risk)
4	Generally exhibits unsafe and unsound practices or conditions
5	Exhibits extremely unsafe and unsound practices or conditions; exhibits a critically deficient performance; often contains inadequate risk management practices relative to the institution's size, complexity, and risk profile; and is of the greatest supervisory concern

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.[13] OTS assigned significant resources to examine and monitor WaMu, including dedicated staff

[13] 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.

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

Examination Start Date	WaMu Examination Hours*
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.[14] 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.

[14] 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	-
Totals	**193**	**545**	**67**	**380**	**96**	**2**

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.[15]

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

[15] OTS Examination Handbook, Section 070, page 070A.8.

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

1	Strong asset quality and credit administration practices
2	Satisfactory asset quality and credit administration practices
3	Less than satisfactory asset quality and credit administration practices
4	Deficient asset quality or credit administration practices
5	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.

<u>OTS Reported Persistent Single Family Residential Underwriting Deficiencies</u>

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

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."[16] 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."

[16] OTS Examination Handbook, Section 201, page 201.8.

- **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.

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.[17] Wholesale loan channels represented 48 to 70 percent of WaMu's total single family residential loan production during the years 2003 to 2007.[18] 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.[19] 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

[17] 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.
[18] WaMu exited wholesale lending channels in 2008 as losses mounted.
[19] OTS Examination Handbook Section 750, page 750.12.

WaMu's Residential Quality Assurance (RQA) office[20] 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,[21]
  - 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.

[20] 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.
[21] A loan that becomes delinquent or goes into default within its first year is a strong indicator of possible mortgage fraud.

- **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.[22] 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.

[22] OTS Examination Handbook, Section 330, page 330.1.

Table 10: Management Rating Definitions

1	Strong performance by management and the Board of Directors and strong risk management practices
2	Satisfactory performance by management and the Board of Directors and satisfactory risk management practices
3	Improvement needed in management and Board of Directors performance or less than satisfactory risk management practices
4	Deficient management and Board of Directors performance or inadequate risk management practices
5	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.[23] Risk management was especially important in the case of WaMu because of its size, high-risk lending strategy, continuous restructuring, and changes in management.

[23] OTS Examination Handbook, Sections 310, pages 310.2 and 310.3.

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);[24]
- 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.[25] 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,[26] and risk assessments also showed that WaMu displayed weaknesses in ERM and general management oversight. For example,

[24] WaMu acquired Providian National Bank on October 1, 2005. Providian had a large subprime credit card operation.
[25] 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.
[26] 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.

- **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.[27]

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

[27] OTS Examination Handbook, Section 310, page 310.1.

(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.

<u>OTS Largely Relied on WaMu to Track the Status of Findings Memoranda</u>

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.[28] 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.

[28]OTS also relied on WaMu to track the status of information technology and compliance issues.

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.[29]

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

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

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.

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

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.

SECTION III

FDIC Monitoring of WaMu and Insurance Assessments

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[30] – 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

[30] 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[31] 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.[32]

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)
1. Well-Capitalized	1A (0 bps)	1B (3 bps)	1C (17 bps)
2. Adequately Capitalized	2A (3 bps)	2B (10 bps)	2C (24 bps)
3. Undercapitalized	3A (10 bps)	3B (24 bps)	3C (27 bps)

Source: 12 CFR Part 327, Final Rule Supplemental Information

FDIC has a number of tools it uses to monitor risk.[33] 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

[31] 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.

[32] FDIC premiums are calculated by multiplying the assessment rate basis points (bps) by the institution's deposit base.

[33] See Appendix 3 for a more detailed explanation of FDIC monitoring tools.

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

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

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

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

Insurance Assessment Period	LIDI Risk	CAMELS Composite Rating	Regulatory Capital Level	Insurance Risk Category
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.

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.[34] 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."[35] 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.

[34] The ratio is known as the Designated Reserve Ratio.
[35] 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

<table>
<tr><th rowspan="2">Capital Group</th><th colspan="3">CAMELS Rating</th></tr>
<tr><th>A
CAMELS 1 & 2</th><th>B
CAMELS 3</th><th>C
CAMELS 4 & 5</th></tr>
<tr><td>1. Well-Capitalized</td><td>R-I
5 to 7 bps</td><td rowspan="2">R-II
10 bps</td><td rowspan="2">R-III
28 bps</td></tr>
<tr><td>2. Adequately Capitalized</td><td></td></tr>
<tr><td>3. Undercapitalized</td><td colspan="2">R-III 28 bps</td><td>R-IV 43 bps</td></tr>
</table>

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
TOTAL			$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.

<u>FDIC Invoked Back-up Examination Authority in Each Year from 2005 to 2008, But Those Requests Met Resistance from OTS</u>

Prior to 2005, FDIC was the primary regulator for a smaller financial institution held by WaMu's parent company. Examiners told us FDIC and OTS had a very good working relationship during this period and

the OTS routinely used FDIC examiners to assist OTS examiners with their examination. In 2005, the FDIC-supervised institution was merged into WaMu, and FDIC no 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)[36] (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

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

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

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

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.[37] 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

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

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.[38] 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

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

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.[39] 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."[40]

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.

[39] 12 U.S.C. §1818(t).
[40] FDIC Case Manager Manual, Enforcement Actions, page 8-2.

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.[41] 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.

[41] 12 C.F.R. 327.

SECTION IV
Conclusions and Recommendations

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.[42] 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.

[42] OTS Examination Handbook, Section 060.

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.[43] 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

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

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)

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

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.

* * * * *

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.

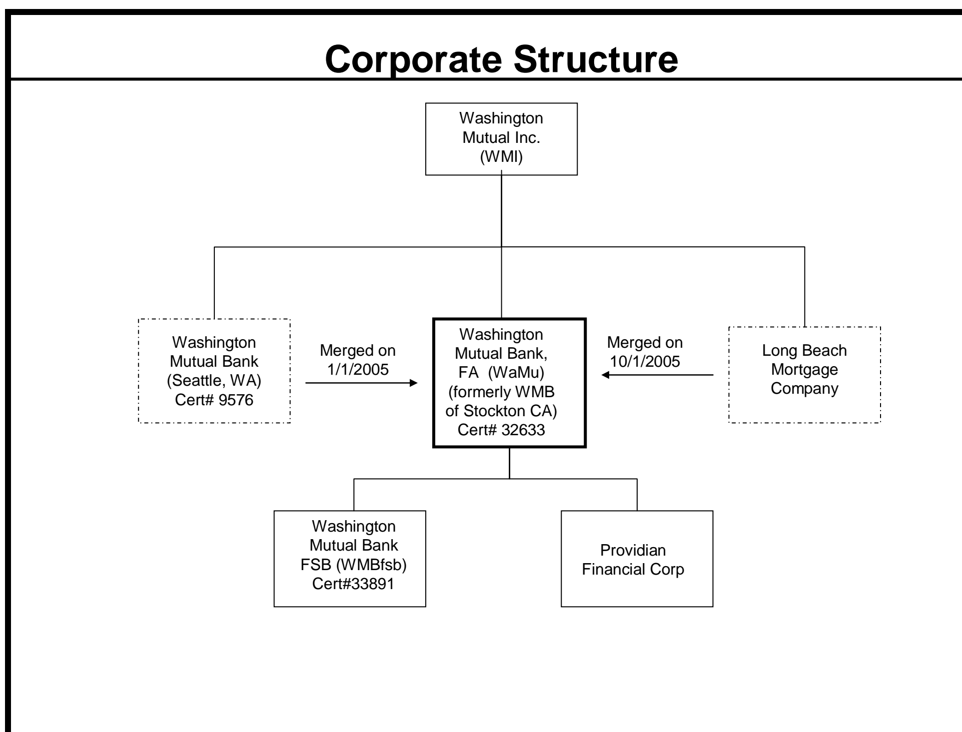
- We reviewed and analyzed deposit insurance rules and regulations and interviewed DIR personnel responsible for insurance assessments.

- 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 Providian Financial Corp. The acquisition was consummated during the third quarter of 2005, and valued at $6.2 billion. The acquisition of Providian 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 shrunk 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.

<u>FDIC Risk Monitoring Activities from an Individual Institution Perspective</u>

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,[44] 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.[45] 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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[44] 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.

[45] 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.[46] 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.[47] 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.[48] 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

[46] The Reconciliation List was a semiannual review until June 6, 2007, at which time it became a quarterly review.
[47] January 29, 2002 Interagency Agreement, "*Coordination of Expanded Supervisory Information Sharing and Special Examinations"*.
[48] 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.[49] 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.

[49] 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

<table>
<tr><th rowspan="2">Capital Group</th><th colspan="3">Supervisory Group</th></tr>
<tr><th>A</th><th>B</th><th>C</th></tr>
<tr><td>1. Well-Capitalized</td><td>I</td><td rowspan="2">II</td><td rowspan="2">III</td></tr>
<tr><td>2. Adequately Capitalized</td><td>II</td></tr>
<tr><td>3. Undercapitalized</td><td colspan="2">III</td><td>IV</td></tr>
</table>

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:

Capital Category	Total Risk-Based		Tier 1/ Risk-Based		Tier 1/ Leverage
Well-capitalized[a]	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).				

[a] 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**	**Matters requiring board attention** **Sensitivity to Market Risk**: 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. **Corrective actions** **Capital Adequacy**: Implement appropriate corrective action, as agreed to by management, in the responses to the various findings memos issued during the examination. **Asset Quality**: Implement appropriate corrective action, as agreed to by management, in the responses to the various findings memos issued during the examination. **Management**: Monitor implementation of corrective actions initiated in response to the various findings memos issued during the examination. **Earnings**: Implement appropriate corrective action, as agreed to by management, in the responses to the various findings memos issued during the examination. **Liquidity**: Implement recommendations in Joint Memo 16, as agreed. **Sensitivity to Market Risk**: Implement appropriate corrective action, as agreed to by management, in the responses to the various findings memos issued during the examination.	**None**

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**	<u>**Matters requiring board attention**</u> **Asset Quality – Single Family Residential Underwriting**: 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. **Asset Quality – Subprime Borrowers**: 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. **Asset Quality – Single Family Loan Channel Profitability**: 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. **Asset Quality – ERM**: 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. **Asset Quality/Sensitivity – Data Management**: Monitor management's progress in improving the management and accuracy of pipeline and warehouse data, including plans to reduce the manual control process. **Sensitivity – Mortgage Servicing**	None

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
			Rights (MSR): 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. **Sensitivity – Net Income Scenario Analysis**: 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. **Management – ERM**: Monitor and obtain reports from management on status of ERM function in terms of effectiveness and resource adequacy. **Management – Cost-Cutting Measures**: Ensure cost-cutting measures are not impacting critical risk management areas. **Management – Organizational Changes**: Closely monitor impact of organizational changes, particularly in terms of making sure adequate, committed resources support an experienced management team. **<u>Corrective actions</u>** **Capital Adequacy**: None. **Asset Quality**: Implement appropriate corrective actions as agreed to in management's responses to the various findings memos issued during the examination. **Management**: Implement the required actions set forth in the MRBAs section of the report and monitor implementation of corrective actions initiated in response to	

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
			the various findings memos issued during the examination. **Earnings**: None. **Liquidity**: Implement recommendations in Joint Memo #1, as agreed. **Sensitivity to Market Risk**: Implement appropriate corrective actions as agreed to by management in the responses to the various findings memos issued during the examination.	
3-14-05	2/222222	**$306**	**Matters requiring board attention** **Asset Quality – SFR Underwriting**: 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. **Asset Quality – Credit Risk Oversight (CRO)**: 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. **Management – ERM**: 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. **Corrective actions** **Capital Adequacy**: Implement the required Basel II/economic capital allocation model development monitoring	None

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
			actions set forth in the MRBA section of the report. **Asset Quality**: 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. **Management**: 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. **Earnings**: None. **Liquidity**: 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. **Sensitivity to Market Risk**: 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.	
3-13-06	2/222222	**$347**	**Matters requiring board attention** **Asset Quality – Subprime SFR Underwriting**: 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. **Management – ERM**: 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.	None

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
			Corrective actions **Capital Adequacy**: None. **Asset Quality**: 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. **Management**: Implement appropriate corrective action as agreed by management in their various written responses to findings memos issued during the examination. **Earnings**: None. **Liquidity**: None. **Sensitivity to Market Risk**: Management should implement the corrective actions set forth in the bank's response to S&S Finding Memo #17.	
1-08-07	2/222212	**$318**	**Matters requiring board attention** **Asset Quality – Subprime SFR Underwriting**: Ensure that management reduces underwriting deficiencies to the tolerance levels agreed upon in response to Asset Quality Findings Memo 3. **Management – Enterprise Risk Management**: 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. **Corrective actions** **Capital Adequacy**: None **Asset Quality**: (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. **Management**: (1) Implement required	Cease & desist order related to deficiencies in BSA/AML on 10/17/07.

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
			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. **Earnings**: None. **Liquidity**: None. **Sensitivity to Market Risk**: None.	
9-10-07	3/343432 Changed to 4/343442 on 9-18-08	$318	**Matters requiring board attention** **Asset Quality – SFR Lending**: 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. **Asset Quality – ALLL**: Continue to refine and develop an effective ALLL methodology and maintain an adequate ALLL at all times. **Management – Board Information**: 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. **Management – Board Committee Structure**: Assess the current Board committee structure to determine whether the risk factors are appropriately delineated among current committees. **Management – ERM**: 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. **Management – Strategic Plan**: Continue to develop and finalize the new	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. 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.

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
			strategic plan that is currently a work in progress. **<u>Corrective actions</u>** **Capital Adequacy**: 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. **Asset Quality**: • Ensure that corrective actions indicated in the responses to the various Asset Quality related findings memoranda are implemented in a timely manner. • 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. • Continue to refine and develop an effective ALLL methodology. • Ensure that ALLL is maintained at an adequate level at all times. • Cease "stated income" lending for all mortgage loans and all other loans over $50,000. • Ensure that the bank adequately documents the borrower's ability to pay on all non-mortgage loans over $50,000. **Management**: • Implement the actions set forth in the MRBA section of this report. • Ensure full compliance with the requirements of all outstanding enforcement actions. • Implement the corrective actions agreed to by management in the written responses to findings memos issued during the examination. • Submit the Strategic Business Plan as requested. • Strengthen the Compliance Manager position.	

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
			Earnings: Monitor actual versus projected operating results and keep OTS informed of material differences. **Liquidity**: • Cure violations of the WaMu Liquidity Management Standard as soon as possible, but no later than October 30, 2008. Maintain sufficient liquidity thereafter. • 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. **Sensitivity to Market Risk**: • Enhance the net portfolio value (NPV) modeling process particularly relating to Option adjustable rate mortgages (ARM) loan and subprime loan valuations. • Introduce non-parallel stress scenarios to complement the existing parallel shift stress scenarios within the Downside Net Interest Margin measure.	

Office of Thrift Supervision
Department of the Treasury

John E. Bowman
Acting Director

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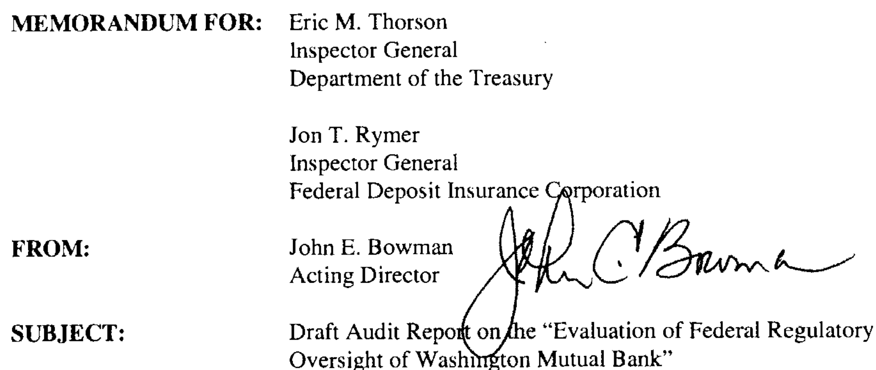
March 30, 2010



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

Jon T. Rymer
Inspector General
Federal Deposit Insurance Corporation

FROM: John E. Bowman
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 16th, 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.

Page 2
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

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 SB
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.

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, Office of Enterprise Risk Management

Office of Thrift Supervision

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Liaison Officer

Office of Management and Budget

OIG Budget Examiner

United States Senate

Chairman and Ranking Members
Committee on Banking, Housing, and Urban Affairs
Committee on Finance
Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs

U.S. House of Representatives

Chairman and Ranking Member
Committee on Financial Services

Comptroller General of the United States

Acting Comptroller General

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Securities, Insurance, and Investments, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

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FINANCIAL REGULATION

Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions

Statement of Orice M. Williams, Director
Financial Markets and Community Investment

GAO

Accountability * Integrity * Reliability

GAO-09-499T

Permanent Subcommittee on Investigations
EXHIBIT #83

March 2009

Highlights of GAO-09-499T, a testimony to the Subcommittee on Securities, Insurance and Investments, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

FINANCIAL REGULATION

Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions

Why GAO Did This Study

Financial regulators have an important role in assessing risk management systems at financial institutions. Analyses have identified inadequate risk management at large, complex financial institutions as one of the causes of the current financial crisis. The failure of the institutions to appropriately identify, measure, and manage their risks has raised questions not only about corporate governance but also about the adequacy of regulatory oversight of risk management systems.

GAO's objectives were to review (1) how regulators oversee risk management at these institutions, (2) the extent to which regulators identified shortcomings in risk management at certain institutions prior to the summer of 2007, and (3) how some aspects of the regulatory system may have contributed to or hindered the oversight of risk management. GAO built upon its existing body of work, evaluated the examination guidance used by examiners at U.S. banking and securities regulators, and reviewed examination reports and work papers from 2006-2008 for a selected sample of large institutions, and horizontal exams that included additional institutions.

In January 2009, GAO designated the need to modernize the financial regulatory system as a high risk area needing congressional attention. Regulatory oversight of risk management at large, financial institutions, particularly at the holding company level, should be considered part of that effort.

View GAO-09-499T or key components.
For more information, contact Orice Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

The banking and securities regulators use a variety of tools to identify areas of risk and assess how large, complex financial institutions manage their risks. The banking regulators--Federal Reserve, Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS)—and securities regulators—Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA)—use somewhat different approaches to oversee risk management practices. Banking examiners are assigned to continuously monitor a single institution, where they engage in targeted and horizontal examinations and assess risks and the quality of institutions' risk management systems. SEC and FINRA identify areas of high risk by aggregating information from examiners and officials on areas of concern across broker-dealers and by monitoring institutions. SEC and FINRA conduct discrete targeted and horizontal examinations. The banking regulators focused on safety and soundness, while SEC and FINRA tended to focus on compliance with securities rules and laws. All regulators have specific tools for effecting change when they identify weaknesses in risk management at institutions they oversee.

In the examination materials GAO reviewed for a limited number of institutions, GAO found that regulators had identified numerous weaknesses in the institutions' risk management systems before the financial crisis began. For example, regulators identified inadequate oversight of institutions' risks by senior management. However, the regulators said that they did not take forceful actions to address these weaknesses, such as changing their assessments, until the crisis occurred because the institutions had strong financial positions and senior management had presented the regulators with plans for change. Regulators also identified weaknesses in models used to measure and manage risk but may not have taken action to resolve these weaknesses. Finally, regulators identified numerous stress testing weaknesses at several large institutions, but GAO's limited review did not identify any instances in which weaknesses prompted regulators to take aggressive steps to push institutions to better understand and manage risks.

Some aspects of the regulatory system may have hindered regulators' oversight of risk management. First, no regulator systematically looks across institutions to identify factors that could affect the overall financial system. While regulators periodically conducted horizontal examinations on stress testing, credit risk practices, and risk management for securitized mortgage products, they did not consistently use the results to identify potential systemic risks. Second, primary bank and functional regulators' oversee risk management at the level of the legal entity within a holding company while large entities manage risk on an enterprisewide basis or by business lines that cut across legal entities. As a result, these regulators may have only a limited view of institutions' risk management or their responsibilities and activities may overlap with those of holding company regulators.

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to participate in today's hearing on regulators' oversight of risk management at large, complex, financial institutions. As you know, financial regulators have a role in assessing the risk management systems at the financial institutions they supervise. This oversight is a responsibility of both federal regulatory agencies, including the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Securities and Exchange Commission (SEC), and of self - regulatory organizations, such as the Financial Industry Regulatory Authority (FINRA). Several significant analyses of the current financial crisis, which has threatened the stability of the financial system and led to the insolvency of some large U.S. financial institutions, have identified inadequate risk management at large financial institutions as one of the causes of the crisis.[1] Major institutions across the financial sector—Lehman Brothers, Washington Mutual, and Wachovia—have failed or been rescued at the last moment by mergers and acquisitions, and the factors that led to these failures such as poor underwriting standards for mortgages and a lack of understanding of the risks posed by some structured products, as well as the failures themselves, have led to instability of the financial system in the United States. The failures of these institutions to appropriately identify, measure, and manage their risks have raised serious questions about the adequacy of the regulators' oversight of risk management. Moreover, these failures raise a number of questions about what lessons can be learned from the current crisis that should be considered as Congress and the Administration begin to rethink the current financial regulatory system.

My statement today focuses on our review of regulators' oversight of risk management systems at a limited number of large, complex financial institutions (initiated at the request of Chairman Reed) as well as our past work on the federal regulatory system. Specifically, I will discuss (1) how

[1]Senior Supervisors Group, *Observation on Risk Management Practices during the Recent Market Turbulence*, March 6, 2008; The President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments*, March 13, 2008; Financial Stability Forum *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, April 7, 2008; and Basel Committee on Banking Supervision: The Joint Forum, *Cross-sectoral review of group-wide identification and management of risk concentrations*, April 2008. Institute of International Finance, *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations—Industry Response to the Market Turmoil of 2007-2008*, July 2008.

regulators oversee risk management at large financial institutions, (2) the extent to which regulators identified shortcomings in risk management at selected institutions prior to the beginning of the financial crisis in the summer of 2007, and (3) how some aspects of the regulatory system may have contributed to or hindered the oversight of risk management.

To prepare for this testimony, we built upon our existing body of work on regulatory oversight of risk management.[2] We evaluated the examination guidance used by examiners at the Federal Reserve, OCC, OTS, and SEC. We also conducted a literature review to identify good risk management practices. We identified and used as criteria The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Enterprisewide Risk Management—Integrated Framework* and several analyses of risk management as they relate to the current financial crisis including the Institute of International Finance's (IIF) *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations* and the Senior Supervisor Group's *Observations on Risk Management Practices During Recent Turbulent Times*. Finally, for the the period 2006-2008, we reviewed the authorities under which the regulators exercise oversight of risk management, examination reports, and workpapers supporting these reports for a small number of large financial institutions that we selected. The results cannot be projected to the universe of large complex institutions but rather provide examples of risk management oversight at the selected institutions. In this regard, I note that the statutory authority providing for GAO audits of the federal bank regulators generally prohibits GAO from disclosing regulatory nonpublic information identifying an open bank. Therefore, we will not disclose the banking institutions included in our study or detailed information obtained from the examinations or interviews with the examination staff.

We conducted this work from December 2008 to March 2009 in accordance with generally accepted government auditing standards. Those

[2]GAO, *Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration*, GAO-07-154 (Washington, D.C.: Mar. 15, 2007); *Risk-focused Bank Examinations: Regulators of Large Banking Organizations Face Challenges*, GAO/GGD-00-48 (Washington, D.C.: Jan. 24, 2000); *Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk*, GAO/GGD-98-153 (Washington, D.C.: July 20, 1998); *Financial Derivatives: Actions Taken or Proposed Since May 1994*, GAO/GGD/AIMD-97-8 (Washington, D.C.: Nov. 01, 1998) GAO/GGD/AIMD-97-8; and *Financial Derivatives: Actions Needed to Protect the Financial System*, GAO/GGD-94-133, (Washington, D.C.: May 18, 1994).

standards require that we plan and perform the audit to obtain sufficient evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In Summary

The Federal Reserve, OCC, OTS, and SEC maintain continuous contact with large, complex institutions, using a risk-based examination approach that aims to identify areas of risk and assess these institutions' risk management systems but the approaches of banking and securities regulators varies somewhat across regulators. The banking regulators (Federal Reserve, OCC, and OTS) use a combination of supervisory activities, including informal tools and examination-related activities to assess the quality of risk management. For example, bank examiners review the activities, products, and services that an institution engages in to identify risks and then through continuous monitoring and targeted examinations assess how the institution manages those risks. Banking examiners use the information they gather to assign a rating that, among other things, includes an assessment of the quality of the institutions' risk management systems including its governance and policies. The Federal Reserve and OCC have detailed risk assessment frameworks or processes. Both OCC and the Federal Reserve conduct a number of targeted examinations. SEC's and FINRA's risk management assessment of broker-dealers primarily relies on discrete targeted examinations to determine whether institutions are in compliance with regulatory rules and securities laws. Generally, all the regulators look at risk management at the institutional level, but they also perform horizontal examinations—coordinated supervisory reviews of a specific activity, business line, or risk management practice across a group of peer institutions. When bank regulators identify weaknesses in risk management at an institution, they have a number of informal and formal supervisory tools they can use for enforcement and to effect change.[3] Similarly, SEC and FINRA have specific tools for effecting risk management improvements that are used when institutions are not in compliance with specific rules or regulations.

[3]Informal enforcement actions include commitment letters, memoranda of understanding, and for bank regulators safety and soundness plan. Formal actions are authorized by statute, are generally more severe, and are disclosed to the public. Formal actions include consent orders, cease and desist orders and formal written agreements, among others.

In the examination materials we reviewed, we found that regulators had identified numerous weaknesses in the institutions' risk management systems prior to the beginning of the financial crisis; however, regulators did not effectively address the weaknesses or in some cases fully appreciate their magnitude until the institutions were stressed. For example,

- Some regulators found that institutions' senior management oversight of risk management systems had significant shortcomings, such as a lack of a comprehensive means to review enterprisewide risks, yet some regulators gave the institutions satisfactory assessments until the financial crisis occurred.

- Regulators identified other risk management weaknesses, such as the testing and validation of models used to assess and monitor risk exposures and price complex instruments. For example, some regulators found that institutions had not tested the assumptions in models used to evaluate risks—such as the likelihood of a borrower to default—but, for at least one institution, examiners did not prohibit the institutions from using untested models nor did they change their overall assessment of the institutions' risk management program based on these findings.

- In a 2006 review, the Federal Reserve found that none of the large, complex banking institutions it reviewed had an integrated stress testing program that incorporated all major financial risks enterprisewide, nor did they test for scenarios that would render them insolvent.

In these instances, regulators told us that they did not fully appreciate the risks to the institutions under review or the implications of the identified weaknesses for the stability of the overall financial system. One regulator told us it was difficult to identify all risk management weaknesses until these systems became stressed by the financial crisis.

Some aspects of the regulatory system may have hindered regulators' oversight of risk management. One is that no regulator systematically and effectively looks across all large, complex financial institutions to identify factors that could have a destabilizing affect on the overall financial system. As a result, both banking and securities regulators continue to assess risk management primarily on an individual institutional level. Even when regulators perform horizontal examinations across institutions in areas such as stress testing, credit risk practices, and the risks of structured mortgage products, they do not consistently use the results to identify potential systemic risks. In addition, in 2005, when the Federal

Reserve implemented an internal process to evaluate financial stability issues related to certain large financial institutions, it did not consider risks on an integrated basis and, with hindsight, we note that it did not identify in a timely manner the severity of the risks that ultimately led to the failure or near failure of some of these institutions and created severe instability in the overall financial system. Another aspect of the regulatory system that hinders regulators' oversight of risk management, by creating areas of overlap or limiting their view of risk management, comes from primary bank and functional regulators— such as the regulator of a broker-dealer—overseeing risk management at the level of a legal entity within a holding company that owns a number of subsidiary entities. While these regulators focus on depositories or broker-dealers, large financial institutions manage risks on an enterprisewide basis or by business lines that cut across legal entities. To the extent that a primary bank or functional regulator concentrates on the risks of a legal entity within an enterprise, the regulator will have a limited view of how the enterprise as a whole manages risk. On the other hand, if the regulator reviews risks outside the legal entity, it may be duplicating the oversight activities of other regulators including the holding company regulator. Finally, when a financial institution manages risks such as market risk across the depository and broker dealer, the primary bank and broker-dealer regulators may be performing duplicative oversight of certain functions as well.

Background

Financial institutions need systems to identify, assess, and manage risks to their operations from internal and external sources. These risk management systems are critical to responding to rapid and unanticipated changes in financial markets. Risk management depends, in part, on an effective corporate governance system that addresses risk across the institution and also within specific areas of risk, including credit, market, liquidity, operational, and legal risk.[4] The board of directors, senior

[4]Credit risk is the potential for financial losses resulting from the failure of a borrower or counterparty to perform on an obligation. Market risk is the potential for financial losses due to the increase or decrease in the value or price of an asset or liability resulting from broad movements in prices, such as interest rates, commodity prices, stock prices, or the relative value of currencies (foreign exchange). Liquidity risk is the potential for financial losses due to an institution's failing to meet its obligations because of an inability to liquidate assets or obtain adequate funding. Operational risk is the potential for unexpected financial losses due to inadequate information systems, operational problems, and breaches in internal controls, or fraud. Legal risk is the potential for financial losses due to breaches of law or regulation that may result in heavy penalties or other costs.

management (and its designated risk-monitoring unit), the audit committee, internal auditors, and external auditors, and others have important roles to play in an effectively operating risk-management system. The different roles that each of these groups play represent critical checks and balances in the overall risk-management system.

Since 1991, the Congress has passed several laws that emphasize the importance of internal controls including risk management at financial institutions and the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has issued guidance that management of financial institutions could use to assess and evaluate its internal controls and enterprisewide risk management.

- Following the savings and loan crisis in the 1980s, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) strengthened corporate governance in large U.S. banks and thrifts. FDICIA required management to annually assess its system of internal control over financial reporting and the external auditors to attest to management's assertions. The corporate governance model established under FDICIA emphasized strong internal control systems, proactive boards of directors, and independent, knowledgeable audit committees.

- During 1992, and with a subsequent revision in 1994 COSO issued its Internal Control – Integrated Framework. The COSO Framework set out criteria for establishing key elements of corporate governance, especially the "tone at the top." The framework also set forth the five components of an effective system of internal control: control environment, risk assessment, control activities, information and communication, and monitoring.

- With the failures of Enron and WorldCom, Congress passed the Sarbanes-Oxley Act of 2002 (SOX) which required managements of public companies to assess their systems of internal control with external auditor attestations, though the implementation for smaller public companies has been gradual and is not yet complete. Under section 404 of SOX, the SEC required that management identify what framework it used to assess the system of internal control over financial reporting. Though it did not mandate any particular framework, the SEC recognized that the COSO Framework satisfied the SEC's own criteria and allowed its use as an evaluation framework.

- In 2004, COSO issued Enterprise Risk Management – Integrated Framework (ERM Framework), though it is not a binding framework for any particular entity or industry. The ERM Framework, which

encompasses the previous internal control framework, establishes best practices and expands the criteria and tools that management can use to assess whether it has an effective risk management system. The framework encourages the board of directors and senior management, in their corporate governance roles, to set the risk appetite of the entity, which is the amount of risk the entity is willing to accept in its overall strategy. Management further sets risk objectives to achieve the entity's goals and sets risk tolerances to ensure that the risk appetite is not exceeded.

Regulators also have a role in assessing risk management at financial institutions. In particular, oversight of risk management at large financial institutions is divided among a number of regulatory agencies. The Federal Reserve oversees risk management at bank holding companies and state member banks that are members of the Federal Reserve System; OTS oversees thrift holding companies and thrifts; SEC and FINRA oversee risk management at SEC-registered U.S. broker-dealers; and OCC oversees risk management at national banks.

The Federal Reserve and OTS have long had authority to supervise holding companies. The Federal Reserve's authority is set forth primarily in the Bank Holding Company Act of 1956, which contains the supervisory framework for holding companies that control commercial banks. OTS's supervisory authority over thrift holding companies is set forth in the Home Owners Loan Act. In the Gramm-Leach-Bliley Act of 1999 (GLBA), Congress expanded the range of permissible holding company activities and affiliations and also set forth restrictions and guidance on how those companies should be supervised. However, Congress did not clearly express the aims of holding company supervision. GLBA authorizes the Federal Reserve and OTS to examine the holding company and each subsidiary in order to: (a) inform the regulator of "the nature of the operations and financial condition" of the holding company and its subsidiaries; and (b) inform the regulator of the financial and operational risks within the holding company system that may threaten the safety and soundness of the holding company's bank subsidiaries and the systems for monitoring and controlling such risks; and (c) monitor compliance with applicable federal laws. On the other hand, GLBA specifies that the focus and scope of examinations of holding companies and any of their subsidiaries shall "to the fullest extent possible" be limited to the holding company and "any subsidiary that could have a materially adverse effect on the safety and soundness of a depository institution subsidiary" due to the size, condition or activities of the nonbank subsidiary or the nature or size of transactions between that subsidiary and the banking subsidiary. In

our work over the years, we have encountered a range of perspectives on the focus of holding company examinations, some of which emphasize the health of the depository institution as the primary examination focus and some of which look more expansively to the holding company enterprise under certain conditions.

In addition to the provisions generally applicable to holding company supervision, GLBA also limits the circumstances under which both holding company regulators and depository institution regulators may examine functionally regulated subsidiaries of bank holding companies, such as broker-dealers. Gramm-Leach-Bliley permits holding company regulators to examine functionally regulated subsidiaries only under certain conditions, such as where the regulator has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated bank or that an examination is necessary to obtain information on financial and operational risks within the holding company system that may threaten an affiliated bank's safety and soundness. The examination authority of depository institution regulators permits the examination of bank affiliates to disclose fully an affiliate's relations with the bank and the effect of those relations on the bank. However, with respect to functionally regulated affiliates of depository institutions, Gramm-Leach-Bliley imposes the same restraint on the use of examination authority that applies to OTS and the Federal Reserve with respect to holding companies. That is, Gramm-Leach-Bliley instructs that bank and holding company supervisors generally are to limit the focus of their examinations of functionally regulated affiliates and, to the extent possible, are to reply on the work of primary bank and functional regulators that supervise holding company subsidiaries. An example of this situation would be where a holding company has a national bank or thrift subsidiary and a broker-dealer subsidiary. Under GLBA, the holding company regulator is to rely "to the fullest extent possible" on the work of primary bank and functional regulators for information on the respective entities. Also under GLBA, bank supervisors are similarly limited with respect to affiliates of the institutions they supervise.

SEC's authority to examine U.S. broker-dealers is set forth in the Securities and Exchange Act of 1934. Under the 1934 act, SEC's examination authority over broker-dealers does not permit SEC to require examination reports on affiliated depository institutions, and if SEC seeks non-routine information about a broker-dealer affiliate that is subject to examination by a bank regulator, SEC must notify and generally must consult with the regulator regarding the information sought. Oversight of U.S. broker-dealers is performed by SEC's Division of Trading and Markets

(Trading and Markets) and Office of Compliance, Inspections, and Examinations (OCIE). In addition, SEC delegates some of its authority to oversee U.S. broker-dealers to FINRA, a self-regulatory organization that was established in 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange.

Under the alternative net capital rule for broker-dealers, from 2005-2008, SEC conducted a voluntary consolidated-supervised entity program under which five investment bank holding companies voluntarily consented to having SEC oversee them on a consolidated basis.[5] Today, no institutions are subject to SEC oversight at the consolidated level, but several broker-dealers within bank holding companies are still subject to the alternative net capital rule on a voluntary basis.[6]

Regulators Identify Areas of Risk and Examine Risk Management Systems, but Their Specific Approaches Vary

The Federal Reserve, FINRA, OCC, OTS, and SEC each identify areas of risk relating to the large, complex financial institutions they oversee and examine risk management systems at regulated institutions. However, the banking and securities regulators take different approaches. The banking regulators (Federal Reserve, OCC, and OTS) use a combination of supervisory activities, including informal tools and examination-related activities to assess the quality of institutional risk management systems and assign each institution an annual rating. SEC and FINRA aggregate information from officials and staff of the supervised institutions throughout the year to identify areas of concern across all broker-dealers. For those broker-dealers covered by the alternative net capital rule, SEC and FINRA emphasize compliance with that rule during target examinations. Under the CSE program, SEC continuously supervised and monitored the institutions in the program.

[5] 17 C.F.R. § 240.15c3-1.

[6] Bear Stearns was acquired by JPMorgan Chase, Lehman Brothers failed, Merrill Lynch was acquired by Bank of America, and Goldman Sachs and Morgan Stanley have become bank holding companies.

Banking Regulators Use a Number of Supervisory Activities for Assessing Risk Management at Large, Complex Institutions

Banking regulators carry out a number of supervisory activities in overseeing risk management of large, complex financial institutions. To conduct on-site continuous supervision, banking regulators often station examiners at specific institutions. This practice allows examiners to continuously analyze information provided by the financial institution, such as board meeting minutes, institution risk reports/management information system reports, and for holding company supervisors supervisory reports provided to other regulators, among other things. This type of supervision allows for timely adjustments to the supervisory strategy of the examiners as conditions change within the institution. Bank examiners do not conduct a single annual full-scope examination of the institution. Rather, they conduct ongoing examinations that target specific areas at the institutions (target examinations) and annually issue an overall rating on the quality of risk management.[7]

Each regulator had a process to assess risk management systems. While each included certain core components, such as developing a supervisory plan and monitoring, the approach used and level of detail varied.

- The Federal Reserve's guidance consisted of a detailed risk assessment program that included an analytic framework for developing a risk management rating for holding companies. Unlike most bank regulatory examination guidance, this guidance is not yet publicly available. According to Federal Reserve officials, the primary purpose of the framework is to help ensure a consistent regulatory approach for assessing inherent risk and risk management practices of large financial institutions (the holding company) and make informed supervisory assessments. The Federal Reserve program for large complex banking organizations is based on a "continuous supervision" model that assigns a dedicated team to each institution. Those teams are responsible for completing risk assessments, supervisory plans, and annual assessments. The risk assessment includes an evaluation of inherent risk (credit, market, operational, liquidity, and legal and compliance) and related risk

[7]Depository institutions receive what is known as a CAMELS rating. The CAMELS rating is defined as Capital Adequacy-C, Asset Quality-A, Management-M, Earnings-E, Liquidity-L, and S-Sensitivity to Market Risk. The Federal Reserve issues what is known as a RFI/ C(D) rating. It is defined as Risk Management-R, Financial Condition-F, Potential impact of the parent company and nondepository subsidiaries on the subsidiary depository institutions-I, Composite Rating-C and Depository Institution-D. The D rating subcomponent is the primary banking rating. In late 2007, OTS changed its guidance related to the CORE competencies—Capital, Organization, Relationship, and Earnings. In a rule finalized on January 1, 2008, OTS changed the "R" to Risk Management.

management and internal controls. The risk assessment is often the starting point for the supervisory plan as well as a supporting document for the annual assessment.

The annual assessment requires the dedicated team to evaluate and rate the firm's risk management, its financial condition, and the potential impact of its non-depository operations on the depository institution. To apply the risk or "R" rating, the examiner must consider (1) board of director and senior management oversight; (2) policies, procedures, and limits; (3) risk monitoring and management information system; and (4) internal controls for each of the risk areas.[8] The examiners then provide an overall "R" rating for the institution.

- OCC's onsite examiners assess the risks and risk management functions at large national banks using a detailed approach that is similar to that used by the Federal Reserve's examiners. The core assessment is OCC's primary assessment tool at the institutional level. According to OCC's guidance, its examiners are required to assess the quality, quantity, and overall direction of risks in nine categories (strategic, reputation, credit, interest rate, liquidity, price, foreign currency translation, transaction, and compliance). To determine the quality of risk management, OCC examiners assess policies, processes, personnel, and control systems in each category. This risk assessment is included in the examination report that is sent to the bank's board of directors. OCC also provides a rating based on the bank's capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (the CAMELS rating), all of which can be impacted by the quality of a risk management system. OCC's supervisory

[8]According to Federal Reserve documentation, Board of Director and Senior Management Oversight evaluates the adequacy and effectiveness of its understanding and management of risk inherent in the BHC's activities, as well as the general capabilities of management. It also includes considerations of management's ability to identify, understand, and control the risk undertaken by the institution, to hire competent staff, and to respond to change in the institution's risk profile or innovations in the banking sector. Policies, Procedures, and Limits evaluates the adequacy of policies, procedures, and limits given the risk inherent in the activities of the consolidated organization and the organization's stated goals and objectives. The analysis may include a consideration of the adequacy of the institution's accounting and risk-disclosure policies and procedures. Risk monitoring and management information system reviews the assumption, data, and procedures used to measure risk and the consistency of these tools with the level of complexity of the organization's activities. Internal controls and audits are evaluated relating to the accuracy of financial reporting and disclosure and the strength and influence, within the organization, of the internal audit team. The analysis will include a review of the independence of control areas from management and the consistency of the scope coverage of the internal audit team with the complexity of the organization.

strategy or plan for targeted examinations is developed from this Risk Assessment System.[9] Examiners can change a bank's ratings at any time if the bank's conditions warrant that change. Targeted examinations are a key component of OCC's oversight. Based on the materials we reviewed covering the last 2 years, OCC conducted 23 targeted examinations in 2007 and 45 in 2008 at a large national bank. These examinations focused on specific areas of risk management, such as governance, credit, and compliance.

- Recently revised OTS guidance requires its examiners to review large and complex holding companies to determine whether they have a comprehensive system to measure, monitor, and manage risk concentrations, determine the major risk-taking entities within the overall institution, and evaluate the control mechanisms in place to establish and monitor risk limits. OTS's recently revised guidance on assessing risk management includes a risk management rating framework that is similar to the Federal Reserve's. It includes the same risk management rating subcomponents—governance/board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems, and internal controls—and criteria that the Federal Reserve applies to bank holding companies. However, OTS considers additional risk areas, such as concentration or systemic risk. Starting in 2007, OTS used a risk matrix to document the level of 13 inherent risks by business unit. The matrix also includes an assessment of each unit's risk mitigation or risk management activities, including internal controls, risk monitoring systems, policies/procedures/limits, and governance. OTS began using the risk matrix to develop its supervisory plan. Based on our review of examination materials, OTS conducted targeted examinations on risk management in such areas as consumer lending and mortgage-backed securities.

In the last few years, the banking regulators have also conducted examinations that covered several large complex financial institutions on specific issues such as risk management (horizontal examinations). According to the Federal Reserve, horizontal examinations focus on a single area or issue and are designed to (1) identify the range of practices in use in the industry, (2) evaluate the safety and soundness of specific activities across business lines or across systemically important institutions, (3) provide better insight into the Federal Reserve's

[9]The Risk Assessment System is the assessment framework of the nine categories of risk and the risk management systems.

understanding of how a firm's operations compare with a range of industry practices, and (4) consider revisions to the formulation of supervisory policy. During the period of our review, the Federal Reserve completed several horizontal examinations on large, complex banking organizations, including stress testing and collateral management. According to Federal Reserve officials, examiners generally provide institutions with feedback that tells them generally how they are doing relative to their peers, and if any serious weaknesses were identified, these would be conveyed as well. With the Federal Reserve, OCC conducted a horizontal examination on advanced credit risk practices and OTS conducted a review across institutions for nontraditional mortgages and used the findings to issue supplemental guidance. According to an OCC official, the regulator uses the findings in horizontal reviews as a supervisory tool and to require corrective actions, as well as a means to discover information on bank practices to issue supplemental guidance.

Securities Regulators' Approaches to Assessing Risk Management Revolve around Regularly Scheduled Targeted Examinations

SEC and FINRA generally assess risk management systems of large broker-dealers using discrete, but risk-focused examinations. The focus of SEC and FINRA oversight is on compliance with their rules and the Securities and Exchange Act of 1934. Although SEC and FINRA are in continuous contact with large, complex institutions, neither SEC nor FINRA staff conduct continuous onsite monitoring of broker-dealers that involves an assessment of risks. FINRA's coordinator program is continuous supervision, albeit not on site. According to SEC and FINRA, however, they receive financial and risk area information on a regular basis from the largest firms and those of financial concern through the OCIE compliance monitoring program, the FINRA capital alert program, and regular meetings with the firms. To identify risks, they aggregate information from their officials and staff throughout the year to identify areas that may require special attention across all broker-dealers. SEC and FINRA conduct regularly scheduled target examinations that focus on the risk areas identified in their risk assessment and on compliance with relevant capital rules and customer protection rules. SEC's internal controls risk management examinations, which started in 1995, cover the top 15 wholesale and top 15 retail broker-dealers as well as a number of mid-sized broker-dealers with a large number of customer accounts. At the largest institutions, SEC conducts examinations every three years, while FINRA conducts annual examinations of all broker-dealers. According to Trading and Markets, the CSE program was modeled on the Federal Reserve's holding company supervision program, but continuous supervision was usually conducted off site by a small number of examiners, SEC did not rate risk management systems, nor use a detailed

risk assessment processes to determine areas of highest risk. During the CSE program, Trading and Markets staff concentrated their efforts on market and liquidity risks because the alternative net capital rule focused on these risks and on operational risk because of the need to protect investors. According to OCIE, their examiners focused on market, credit, operational, legal and compliance risks, as well as senior management, internal audit and new products. Because only five investment banks were subject to consolidated supervision by SEC, SEC staff believed it did not need to develop an overall supervisory strategy or written plans for individual institutions it supervised; however, OCIE drafted detailed scope memorandums for their target examinations. While no institutions are subject to consolidated supervision by SEC at this time, a number of broker-dealers are subject to the alternative net capital rule.

SEC and FINRA conduct horizontal or "sweep" examinations and, for example, have completed one for subprime mortgages. OCIE officials said that it had increased the number of these types of examinations since the current financial crisis began. Under the consolidated supervised entity program, Trading and Markets conducted several horizontal examinations aimed at discovering the range of industry practice in areas such as leveraged lending.

Banking Regulators Have a Variety of Tools to Address Risk Management Weaknesses

The banking regulators have developed guidance on how they should communicate their examination findings to help ensure that financial institutions take corrective actions. Bank regulators generally issue findings or cite weaknesses in supervisory letters or an annual examination report addressed to senior management of the financial institution. However, regulators also meet with institution management to address identified risk management weaknesses. Examples include:

- After a target examination, the Federal Reserve, OCC, OTS each prepare supervisory letters or reports of examination identifying weaknesses that financial institutions are expected to address in a timely manner. In addition to issues or findings, the Federal Reserve and OCC supervisory letters provided a specific timeframe for the institution to send a written response to the bank regulator articulating how the institution planned to address the findings. In these instances, for the files we reviewed, the institutions complied with the timeframes noted in the supervisory letter. These letters may be addressed to the board of directors or the CEO or as we found, the senior managers responsible for the program. For example, a Federal Reserve Bank addressed a recent targeted examination on a holding company's internal audit function to the chief auditor of the

holding company. Similarly, OCC addressed an examination of advanced risk management processes to a bank's chief credit officer. OTS also addressed some reports of target examinations to senior managers responsible for specific programs.

- In their supervisory letters, OCC sometimes identifies "Matters Requiring Attention," which instruct the bank to explain how it will address the matter in a timely manner. In its supervisory guidance, matters requiring attention include practices that deviate from sound governance, internal control and risk management principles that may adversely impact the bank's earning or capital, risk profile, or reputation if not addressed.[10] According to its guidance, OCC tracks matters requiring attention until they are resolved and maintains a record when these matters are resolved and closed out. OCC also includes recommendations to national banks in their supervisory letters. In addition, OCC will insert recommendations in their letters which are suggestions relating to how a bank can operate a specific program or business line more effectively.

- After the beginning of the financial crisis, the Federal Reserve issued revised examination guidance in July 2008 that established three types of findings: matters requiring immediate attention, matters requiring attention, and observations. Previously, each of the individual Federal Reserve Banks had its own approach to defining findings. Matters requiring attention and observations are similar to related practices followed by OCC. For matters requiring immediate attention, the matter is considered more urgent. According to their guidance, matters requiring immediate attention encompass the highest priority concerns and include matters that have the potential to pose significant risk to the organization's safety and soundness or that represent significant instances of noncompliance with laws and regulations.

- OTS examiners may list recommendations in the report, findings, and conclusions, but in the materials we reviewed examiners did not report these in a standard way. While members of the Board of Directors are required to sign the report of annual examination indicating that they have read the report, they are not required to submit a written response. The OTS Handbook Section 060 Examination Administration provides guidance on the use of "matters requiring board attention" or other lesser supervisory corrective actions that should be addressed in the

[10]OCC Memorandum, Matters Requiring Attention, August 8, 2005.

examination correspondence. According to OTS, matters requiring board attention and corrective actions are also tracked in its regulatory action system for follow up.

- For 2008, we reviewed one regulator's tracking report of matters requiring attention at one institution and found that only a small number of the 64 matters requiring attention relating to risk management and internal controls had been closed out or considered addressed by the end of January 2009. The examiners explained that some matters, such as institutions making adjustments to their technology framework can be time consuming. Another regulator told us that it does not track when institutions have implemented remedial actions.

- Because the banking regulators are generally on site and continuously monitoring large, complex institutions, examiners told us that a significant part of their efforts to improve risk management systems were undertaken through regularly scheduled meetings with senior management. According to Federal Reserve and OCC officials, these meetings allow opportunities for examiners to followup with management concerning actions that they expect the financial institutions to implement. A Federal Reserve examiner explained that several meetings were held with officials at a holding company concerning an internal control matter in order to help ensure that the institution was addressing the issue. For its complex and international organizations program, OTS directs its examiners to use regular meetings with senior management and periodic meetings with boards of directors and any relevant committees to effect change. OTS guidance indicates that examiners' regular meetings with senior management are designed to communicate and address any changes in risk profile and corrective actions. OTS also views annual meetings with the Board of Directors as a forum for discussing significant findings and management's approach for addressing them.

In addition to these tools, bank regulators' approval authorities related to mergers and acquisitions could be used to persuade institutions to address risk management weaknesses. For example, the Federal Reserve, OCC, and OTS are required to consider risk management when they approve bank or thrift acquisitions or mergers and could use identified weaknesses in this area to deny approvals. In addition, bank regulators have to approve the acquisition of bank charters and must assess management's ability to manage the bank or thrift charter being acquired.

SEC's Oversight Tools Are Aimed at Addressing Violations

If SEC's OCIE or FINRA examiners discover a violation of SEC or FINRA rules, the institution is required to resolve the deficiency in a timely manner. OCIE developed guidance on deficiency letters for examinations. According to SEC and FINRA staff, because SEC or FINRA rules do not contain specific requirements for internal controls, problems with internal controls generally are not cited as deficiencies. However, weaknesses in internal controls can rise to such a level as to violate other FINRA rules, such as supervision rules. Deficiencies and weaknesses are followed up on in subsequent examinations. OCIE's compliance audits require institutions to correct deficiencies and address weaknesses. OCIE staff told us that if the institutions do not address deficiencies in a timely manner, they may be forwarded to the enforcement division. For example, OCIE staff was able to discuss limit violations with one firm and required the firm to change their risk limit system to significantly reduce their limit violations—indicating senior management was taking steps to better oversee and manage their risks. Under the consolidated supervised entity program, SEC's Trading and Markets relied on discussions with management to effect change. For example, Trading and Market staff told us that they had discussions with senior management that led to changes in personnel.

Regulators Identified Weaknesses in Risk Management Systems before the Crisis but Did Not Fully Recognize the Threats They Posed

In the years leading up the financial crisis, some regulators identified weaknesses in the risk management systems of large, complex financial institutions. Regulators told us that despite these identified weaknesses, they did not take forceful action—such as changing their assessments—until the crisis occurred because the institutions reported a strong financial position and senior management had presented the regulators with plans for change. Moreover, regulators acknowledged that in some cases they had not fully appreciated the extent of these weaknesses until the financial crisis occurred and risk management systems were tested by events. Regulators also acknowledged they had relied heavily on management representations of risks.

Some Regulators Identified Weaknesses in Risk Management Systems in a Limited Number of Institutions but Did Not Take Forceful Actions to Address Them until the Crisis Began

In several instances, regulators identified shortcomings in institutions' oversight of risk management at the limited number of large, complex institutions we reviewed but did not change their overall assessments of the institutions until the crisis began in the summer of 2007.[11] For example, before the crisis one regulator found significant weaknesses in an institution's enterprisewide risk management system stemming from a lack of oversight by senior management. In 2006, the regulator notified the institution's board of directors that the 2005 examination had concluded that the board and senior management had failed to adequately oversee financial reporting, risk appetite, and internal audit functions. The regulator made several recommendations to the board to address these weaknesses. We found that the regulator continued to find some of the same weaknesses in subsequent examination reports, yet examiners did not take forceful action to require the institution to address these shortcomings until the liquidity crisis occurred and the severity of the risk management weaknesses became apparent. When asked about the regulator's assessment of the holding company in general and risk management in particular given the identified weaknesses, examiners told us that they had concluded that the institution's conditions were adequate, in part, because it was deemed to have sufficient capital and the ability to raise more. Moreover, the examiners said that senior management had presented them with plans to address the risk management weaknesses.

In another example, other regulators found weaknesses related to an institution's oversight of risk management before the crisis. One regulator issued a letter to the institution's senior management in 2005 requiring that the institution respond, within a specified time period, to weaknesses uncovered in an examination. The weaknesses included the following:

- The lack of an enterprisewide framework for overseeing risk, as specified in the COSO framework. The institution assessed risks (such as market or credit risks) on an individual operating unit basis, and was not able to effectively assess risks institutionwide.

- A lack of common definitions of risk types and of corporate policy for approving new products, which could ensure that management had reviewed and understood any potential risks.

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[11] OTS does not have specific risk-based or leverage capital requirements for thrift holding companies but does require them to hold adequate capital pursuant to capital maintenance agreements.

- An institutional tendency to give earnings and profitability growth precedence over risk management.

In addition, the regulator recommended that senior management restructure the institution's risk management system to develop corporate standards for assessing risk. However, the regulator's assessment of the institution's risk management remained satisfactory during this period because senior management reported that they planned to address these weaknesses and, according to examiners, appeared to be doing so. Moreover, the examiners believed that senior management could address these weaknesses in the prevailing business environment of strong earnings and adequate liquidity. After earnings and liquidity declined during the financial crisis that began in 2007, the examiners changed their assessment, citing many of the same shortcomings in risk management that they had identified in 2005.

At one institution, a regulator noted in a 2005 examination report that management had addressed previously identified issues for one type of risk and that the institution had taken steps to improve various processes, such as clarifying the roles and responsibilities of risk assessment staff, and shortening internal audit cycles of high-risk entities in this area. Later in 2007, the regulator identified additional weaknesses related to credit and market risk management. Regulatory officials told us that weaknesses in oversight of credit and market risk management were not of the same magnitude prior to the crisis as they were in late 2007 and 2008. Moreover, examiners told us that it was difficult to identify all of the potential weaknesses in risk management oversight until the system was stressed by the financial crisis.

Some regulators told us that they had relied on management representation of risk, especially in emerging areas. For example, one regulator's targeted review risk relied heavily on management's representations about the risk related to subprime mortgages—representations that had been based on the lack of historical losses and the geographic diversification of the complex product issuers. However, once the credit markets started tightening in late 2007, the examiners reported that they were less comfortable with management's representations about the level of risk related to certain complex investments. Examiners said that, in hindsight, the risks posed by parts of an institution do not necessarily correspond with their size on the balance sheet and that relatively small parts of the institution had taken on risks that the regulator had not fully understood. Another regulator conducted a horizontal examination of securitized mortgage products in 2006 but relied

on information provided by the institutions. While the report noted that these products were experiencing rapid growth and that underwriting standards were important, it focused on the major risks identified by the firms and their actions to manage those risks as well as on how institutions were calculating their capital requirements.

Regulators Identified Weaknesses in Models Used to Calculate Risk but May Not Have Acted on These Findings

Regulators also identified weaknesses in the oversight and testing of risk models that financial institutions used, including those used to calculate the amount of capital needed to protect against their risk exposures and determine the valuation of complex products. Regulators require institutions to test their models so that the institutions have a better sense of where their weaknesses lie, and OCC developed guidance in 2000 related to model validation that other regulators consider to be the standard. OCC's guidance states that institutions should validate their models to increase reliability and improve their understanding of the models' strengths and weaknesses. The guidance calls for independent reviews by staff who have not helped to develop the models, instituting controls to ensure that the models are validated before they are used, ongoing testing, and audit oversight. The process of model validation should look not only at the accuracy of the data being entered into the model, but also at the model's assumptions, such as loan default rates.

Institutions use capital models as tools to inform their management activities, including measuring risk-adjusted performance, setting prices and limits on loans and other products, and allocating capital among various business lines and risks.[12] Certain large banking organizations have used models since the mid-1990s to calculate regulatory capital for market risk, and the rules issued by U.S. regulators for Basel II require that banks use models to estimate capital for credit and operational risks. The SEC's consolidated supervised entity program allowed broker-dealers that were part of consolidated supervised entities to compute capital requirements using models to estimate market and credit risk. In addition, institutions

[12]Economic capital models measure risks by estimating the probability of potential losses over a specified period and up to a defined confidence level using historical loss data. See GAO-07-253 *Risk-Based Capital: Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework* (Washington, D.C.: February 15, 2007).

use models to estimate the value of complex instruments such as collateralized debt obligations (CDOs).[13]

Regulators identified several weaknesses related to financial institutions' oversight and use of risk models:

- One regulator found several weaknesses involving the use of models that had not been properly tested to measure credit risks, an important input into institutions' determinations of capital needed, but did not aggressively take steps to ensure that the firm corrected these weaknesses. In a 2006 letter addressed to the head of the institution's risk management division, the examiners reported deficiencies in models used to estimate credit risk, including lack of testing, a lack of review of the assumptions used in the models, and concerns about the independence of staff testing the models. The regulator issued a letter requiring management to address these weaknesses, but continued to allow the institution to use the models and did not change its overall assessment. Although the institution showed improvement in its processes, over time, in late 2007, examiners found that some of the weaknesses persisted. In late 2008, examiners closed the matter in a letter to management but continued to note concerns about internal controls associated with risk management.

- A horizontal review of credit risk models by the Federal Reserve and OCC in 2008 found a similar lack of controls surrounding model validation practices for assessing credit risks, leading to questions about the ability of large, complex institutions to understand and manage these risks and provide adequate capital to cushion against potential losses. For example, the review found that some institutions lacked requirements for model testing, clearly defined roles and responsibilities for testing, adequate detail for the scope or frequency of validation, and a specific process for correcting problems identified during validation.

- Before the crisis, another regulator found that an institution's model control group did not keep a complete inventory of its models and did not have an audit trail for models prior to 2000. The examiners said that they did not find these issues to be significant concerns. However, they were

[13]In a basic CDO, a group of loans or debt securities are pooled and securities are then issued in different tranches that vary in risk and return depending on how the underlying cash flows produced by the pooled assets are allocated. If some of the underlying assets defaulted, the more junior tranches—and thus riskier ones—would absorb these losses first before the more senior, less-risky tranches. Many CDOs in recent years largely consisted of mortgage-backed securities, including subprime mortgage-backed securities.

subsequently criticized for not aggressively requiring another institution to take action on weaknesses they had identified that were related to risk models, including lack of timely review, understaffing, lack of independence of risk managers, and an inability or unwillingness to update models to reflect the changing environment.

- Other regulators noted concerns about pricing models for illiquid instruments, but made these findings only as the crisis was unfolding. For example, in a 2007 horizontal review of 10 broker-dealers' exposure to subprime mortgage-related products, SEC and FINRA examiners found weaknesses in pricing assumptions in valuation models for complex financial products. They found that several of these firms relied on outdated pricing information or traders' valuations for complex financial transactions, such as CDOs. In some cases, firms could not demonstrate that they had assessed the reasonableness of prices for CDOs. Another regulator noted in a 2007 targeted examination that although management had stated that the risk of loss exposure from highly rated CDOs was remote, the downturn in the subprime mortgage market could mean that they would not perform as well as similarly rated instruments performed historically.

The Regulators Found That None of the Institutions We Reviewed Had Tested for the Effects of a Severe Economic Downturn Scenario

Because of the inherent limitations of modeling, such as the accuracy of model assumptions, financial institutions also use stress tests to determine how much capital and liquidity might be needed to absorb losses in the event of a large shock to the system or a significant underestimation of the probability of large losses. According to the Basel Committee on Banking Supervision, institutions should test not only for events that could lower their profitability, but also for rare but extreme scenarios that could threaten their solvency. In its January 2009 report, the Basel Committee emphasized the importance of stress testing, noting that it could (1) alert senior management to adverse unexpected losses, (2) provide forward-looking assessments of risk, (3) support enterprisewide communication about the firm's risk tolerance, (4) support capital and liquidity planning procedures, and (5) facilitate the development of risk mitigation or contingency plans across a range of stressed conditions.[14] Moreover, the report noted that stress testing was particularly important after long periods of relative economic and financial calm when companies might become complacent and begin underpricing risk.

[14]Basel Committee on Banking Supervision, Consultative Document: *Principles for Sound Stress Testing Practices and Supervision.* (Basel, Switzerland: January 2009).

We found that regulators had identified numerous weaknesses in stress testing at large institutions before the financial crisis. However, our limited review did not identify any instances in which an institution's lack of worst-case scenario testing prompted regulators to push forcefully for institutional actions to better understand and manage risks. A 2006 Federal Reserve horizontal review of stress testing practices at several large, complex banking institutions revealed that none of the institutions had an integrated stress testing program that incorporated all major financial risks enterprisewide, nor did they test for scenarios that would render them insolvent.. The review found that institutions were stress testing the impact of adverse events on individual products and business lines rather than on the institution as a whole. By testing the response of only part of the institution's portfolio to a stress such as declining home prices, the institution could not see the effect of such a risk on other parts of its portfolio that could also be affected. The review was particularly critical of institutions' inability to quantify the extent to which credit exposure to counterparties might increase in the event of a stressed market risk movement. It stated that institutions relied on "intuition" to determine their vulnerability to this type of risk. It also found that institutions' senior managers were confident in their current practices and questioned the need for additional stress testing, particularly for worst-case scenarios that they thought were implausible..

The 2006 review included some recommendations for examiners to address with individual institutions, and Federal Reserve officials told us that they met with institutions' chief risk officers to discuss the seriousness of the findings just before the crisis began. However, officials told us that the purpose of the review was primarily to facilitate the regulator's understanding of the full range of stress testing practices, as there was neither a well-developed set of best practices nor supervisory guidance in this area at the time. The regulatory officials also told us that these findings were used to inform guidance issued by the President's Working Group on assessing exposure from private pools of capital, including hedge funds.[15] However, this guidance focuses on testing the exposure to counterparty risks, such as from hedge funds, and not on testing the impact of solvency-threatening, worst-case scenarios. In

[15]See President's Working Group, *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, February 22, 2007. The information from this horizontal review was later used in 2008 to analyze risk management practices after the crisis began in the *Senior Supervisors Group Observations on Risk Management Practices During the Recent Market Turbulence*.

hindsight, officials told us that the current crisis had gone beyond what they had contemplated for a worst-case scenario, and they said that they would probably have faced significant resistance had they tried to require the institutions to do stress tests for scenarios such as downgrades in counterparties' credit ratings because such scenarios appeared unlikely.

Other regulators raised concerns about stress testing at individual institutions, but we did not find evidence that they had effectively changed the firms' stress testing practices. In the materials we reviewed, one regulator recommended that the institution include worst-case scenarios in its testing. In a 2005 examination report, examiners noted a concern about the level of senior management oversight of risk tolerances. This concern primarily stemmed from lack of documentation, stress testing, and communication of firm risk tolerances and the extent to which these were reflected in stress tests. While the firm later took steps to document formal risk tolerances and communicate this throughout the firm, the recommendation related to stress testing remained open through 2008.

Another regulator required institutions to show that they conducted stress tests of the institution's ability to have enough funding and liquidity in response to certain events, including a credit downgrade or the inability to obtain unsecured, short-term financing. In addition, institutions were required to document that they had contingency plans to respond to these events. The regulator said that it specifically required institutions to conduct stress tests such as those based on historical events including the collapse of Long-Term Capital Management or the stock market decline of 1987. However, regulatory staff told us that the liquidity crisis of 2008 was greater than they had expected.

Regulators' Oversight of Institutions' Risk Management Systems Illustrates Some Limitations of the Current Regulatory System

In this and other work, we identified two specific shortcomings of the current regulatory system that impact the oversight of risk management at large, complex financial institutions. First, no regulator has a clear responsibility to look across institutions to identify risks to overall financial stability. As a result, both banking and securities regulators continue to assess risk management primarily at an individual institutional level. Even when regulators perform horizontal examinations across institutions, they generally do not use the results to identify potential systemic risks. Although for some period, the Federal Reserve analyzed financial stability issues for systemically important institutions it supervises, it did not assess the risks on an integrated basis or identify many of the issues that just a few months later led to the near failure of some of these institutions and to severe instability in the overall financial

system. Second, although financial institutions manage risks on an enterprisewide basis or by business lines that cut across legal entities, primary bank and functional regulators may oversee risk management at the level of a legal entity within a holding company. As a result, their view of risk management is limited or their activities overlap or duplicate those of other regulators including the holding company regulator.

Regulators Were Not Looking Across Groups of Institutions to Effectively Identify Risks to Overall Financial Stability

In previous work, we have noted that no single regulator or group of regulators systematically assesses risks to the financial stability of the United States by assessing activities across institutions and industry sectors.[16] In our current analysis of risk management oversight of large, complex institutions, we found that, for the period of the review (2006-2008), the regulators had not used effectively a systematic process that assessed threats that large financial institutions posed to the financial system or that market events posed to those institutions.

While the regulators periodically conducted horizontal examinations in areas such as stress testing, credit risk practices, and risk management for securitized mortgage products, these efforts did not focus on the stability of the financial system, nor were they used as a way to assess future threats to that system. The reports summarizing the results of these horizontal examinations show that the purpose of these reviews was primarily to understand the range of industry practices or to compare institutions rather than to determine whether several institutions were engaged in similar practices that might have a destabilizing effect on certain markets and leave the institutions vulnerable to those and other market changes, and that these conditions ultimately could affect the stability of the financial system.

Beginning in 2005 until the summer of 2007, the Federal Reserve made efforts to implement a systematic review of financial stability issues for certain large financial institutions it oversees and issued internal reports called *Large Financial Institutions' Perspectives on Risk*. With the advent of the financial crisis in the summer of 2007, the report was

[16]GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009); *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Strategy*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004) and *Long-Term Capital Management, Regulators Need to Focus More Attention on Systemic Risk*, GAO/GGD-00-3 (Washington, D.C.: Oct. 29, 1999).

suspended; however, at a later time the Federal Reserve began to issue risk committee reports that addressed risks across more institutions. While we commend the Federal Reserve for making an effort to look systematically across a group of institutions to evaluate risks to the broader financial system, the *Perspectives of Risk* report for the second half of 2006 issued in April 2007 illustrates some of the shortcomings in the process. The report reviewed risk areas including credit, market, operational, and legal and compliance risk but did not provide an integrated risk analysis that looked across these risk areas—a shortcoming of risk management systems identified in reviews of the current crisis. In addition, with hindsight, we can see that the report did not identify effectively the severity and importance of a number of factors. For example, it stated that:

- There are no substantial issues of supervisory concern for these large financial institutions.

- Asset quality across the systemically important institutions remains strong.

- In spite of predictions of a market crash, the housing market correction has been relatively mild, and while price appreciation and home sales have slowed and inventories remain high, most analysts expect the housing market to bottom out in mid-2007. The overall impact on a national level will likely be moderate; however, in certain areas housing prices have dropped significantly.

- The volume of mortgages being held by institutions—warehouse pipelines—has grown rapidly to support collateralized mortgage-backed securities and CDOs.

- Surging investor demand for high-yield bonds and leveraged loans, largely through structured products such as CDOs, provided continuing strong liquidity that resulted in continued access to funding for lower-rated firms at relatively modest borrowing costs.

- Counterparty exposures, particularly to hedge funds, continue to expand rapidly.

With regard to the last point, a Federal Reserve examiner stated that the Federal Reserve had taken action to limit bank holding company exposures to hedge funds. The examiner noted that although in hindsight it was possible to see some risks that the regulators had not addressed, it was difficult to see the impact of issues they had worked to resolve.

When asked for examples of how the Federal Reserve had used supervisory information in conjunction with its role to maintain financial stability, a Federal Reserve official provided two examples that he believed illustrated how the Federal Reserve's supervisory role had influenced financial stability before the current financial crisis. First, the official said that the Federal Reserve had used supervisory information to improve the resilience of the private sector clearing and settlement infrastructure after the attacks on the World Trade Center on September 11, 2001. Second, it had worked through the supervisory system to strengthen the infrastructure for processing certain over-the-counter derivative transactions. Federal Reserve officials noted that financial stability is not the sole focus of safety and soundness supervision and that several mechanisms exist in which regulation plays a significant role with other areas of the Federal Reserve in assessing and monitoring financial stability. Federal Reserve regulators indicated that other Federal Reserve functions often consulted with them and that they provided information to these functions and contributed to financial stability discussions, working groups, and decisions both prior to and during the current crisis.

In October 2008, the Federal Reserve issued new guidance for consolidated supervision suggesting that in the future the agency would be more mindful of the impact of market developments on the safety and soundness of bank holding companies. The new guidance says, for instance, that the enhanced approach to consolidated supervision emphasizes several elements that should further the objectives of fostering financial stability and deterring or managing financial crises and help make the financial system more resilient. The guidance says that two areas of primary focus would be:

- activities in which the financial institutions play a significant role in critical or key financial markets that have the potential to transmit a collective adverse impact across multiple firms and financial markets, including the related risk management and internal controls for these activities, and

- areas of emerging interest that could have consequences for financial markets, including, for example, the operational infrastructure that underpins the credit derivatives market and counterparty credit risk management practices.

Primary Bank and Functional Regulators May Limit Their Oversight of Risk Management to Specific Legal Entities Such As Depository Institutions or Broker-Dealers

Some regulators have noted that the current practice of assessing risk management at the level of a depository institution or broker-dealer did not reflect the way most large, complex institutions manage their risks. Regulators noted that financial institutions manage some risks enterprisewide or by business lines that cross legal entity boundaries. The scope of regulators' supervisory authorities does not clearly reflect this reality, however. As set forth in the Gramm-Leach-Bliley Act, various regulators can have separate responsibilities for individual components of a large, complex financial institution. In addition, GLBA generally restricts the focus of holding company examinations to the holding company and any subsidiary that could have a materially adverse effect on the safety and soundness of an affiliated bank. OCC examiners told us that it was difficult for them to assess a bank's market risk management because OCC focused on the national bank's activities, while the financial institution was managing risk across the bank and the broker-dealer. The examiners said that in some cases the same traders booked wholesale trades in the bank and in the broker-dealer and that the same risk governance process applied to both. Thus, both the primary bank regulator and the functional regulator were duplicating each other's supervisory activities. In addition, if initial transactions were booked in one entity, and transactions designed to mitigate the risks in that transaction were booked in another legal entity, neither regulator could fully understand the risks involved. While effective communication among the functional and primary bank regulators could address this limitation, securities regulators told us that they shared information with the Federal Reserve but generally did not share information with OCC.

OCC examination materials show that examiners sometimes assessed risks and risk management by looking at the entire enterprise. In addition, OCC examiners often met with holding company executives. In previous work, we noted the likelihood that OCC's responsibilities and activities as the national bank regulator overlap with the responsibilities and activities of the Federal Reserve in its role as the holding company regulator. We found in this review that this overlap continued to exist; however, we also continued to observe that OCC and the Federal Reserve share information and coordinate activities to minimize the burden to the institution.

Securities regulators face similar challenges in assessing risk management at broker-dealers. In a number of past reports, we have highlighted the challenges associated with SEC's lack of authority over certain broker-

dealer affiliates and holding companies.[17] FINRA officials also cited two examples of limitations on their efforts to oversee risk management within broker-dealers. First, they noted that FINRA's regulatory authority extended only to U.S. broker-dealers and that related transactions generally are booked in other legal entities. FINRA noted that the riskiest transactions were usually booked in legal entities located offshore. FINRA also noted that often inventory positions booked in the U.S. broker-dealer might hedge the risk in another affiliated legal entities. From time to time, FINRA has requested that the U.S. broker-dealer move the hedge into the broker-dealer to reduce the amount of the losses and protect the capital base of the broker-dealer. An SEC official noted that to take advantage of certain capital treatment the transaction and the hedge would both need to be booked in the broker-dealer. Second, FINRA officials noted that their view was limited because market risk policy is set at the holding company level.

In closing, I would like to reiterate a number of central themes that have appeared often in our recent work. While an institution's management, directors, and auditors all have key roles to play in effective corporate governance, regulators—as outside assessors of the overall adequacy of the system of risk management—also have an important role in assessing risk management. The current financial crisis has revealed that many institutions had not adequately identified, measured, and managed all core components of sound risk management. We also found that for the limited number of large, complex institutions we reviewed, the regulators failed to identify the magnitude of these weaknesses and that when weaknesses were identified, they generally did not take forceful action to prompt these institutions to address them. As we have witnessed, the failure of a risk management system at a single large financial institution can have implications for the entire financial system.

Second, while our recent work is based on a limited number of institutions, examples from the oversight of these institutions highlight the significant challenges regulators face in assessing risk management systems at large, complex institutions. While the painful lessons learned during the past year should bolster market discipline and regulatory authority in the short term, history has shown that as the memories of this crisis begin to fade, the hard lessons we have learned are destined to be repeated unless regulators are vigilant in good times as well as bad.

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[17] GAO-09-216 and GAO/GGD-00-3.

Responsible regulation requires that regulators critically assess their regulatory approaches, especially during good times, to ensure that they are aware of potential regulatory blind spots. This means constantly reevaluating regulatory and supervisory approaches and understanding inherent biases and regulatory assumptions. For example, the regulators have begun to issue new and revised guidance that reflects the lessons learned from the current crisis. However, the guidance we have seen tends to focus on the issues specific to this crisis rather than on broader lessons learned about the need for more forward-looking assessments and on the reasons that regulation failed.

Finally, I would like to briefly discuss how our current regulatory framework has potentially contributed to some of the regulatory failures associated with risk management oversight. The current institution-centric approach has resulted in regulators all too often focusing on the risks of individual institutions. This has resulted and in regulators looking at how institutions were managing individual risks, but missing the implications of the collective strategy that was premised on the institution's having little liquidity risk and adequate capital. Whether the failures of some institutions ultimately came about because of a failure to manage a particular risk, such as liquidity or credit risks, these institutions often lacked some of the basic components of good risk management—for example, having the board of directors and senior management set the tone for proper risk management practices across the enterprise. The regulators were not able to connect the dots, in some cases because of the fragmented regulatory structure. While regulators promoted the benefits of enterprisewide risk management, we found that they failed to ensure that all of the large, complex financial institutions in our review had risk management systems commensurate with their size and complexity so that these institutions and their regulators could better understand and address related risk exposures.

This concludes my prepared statement. I would be pleased to answer any questions that you may have at the appropriate time.

Staff Contributions and Acknowledgments

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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.

Permanent Subcommittee on Investigations
EXHIBIT #84

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:

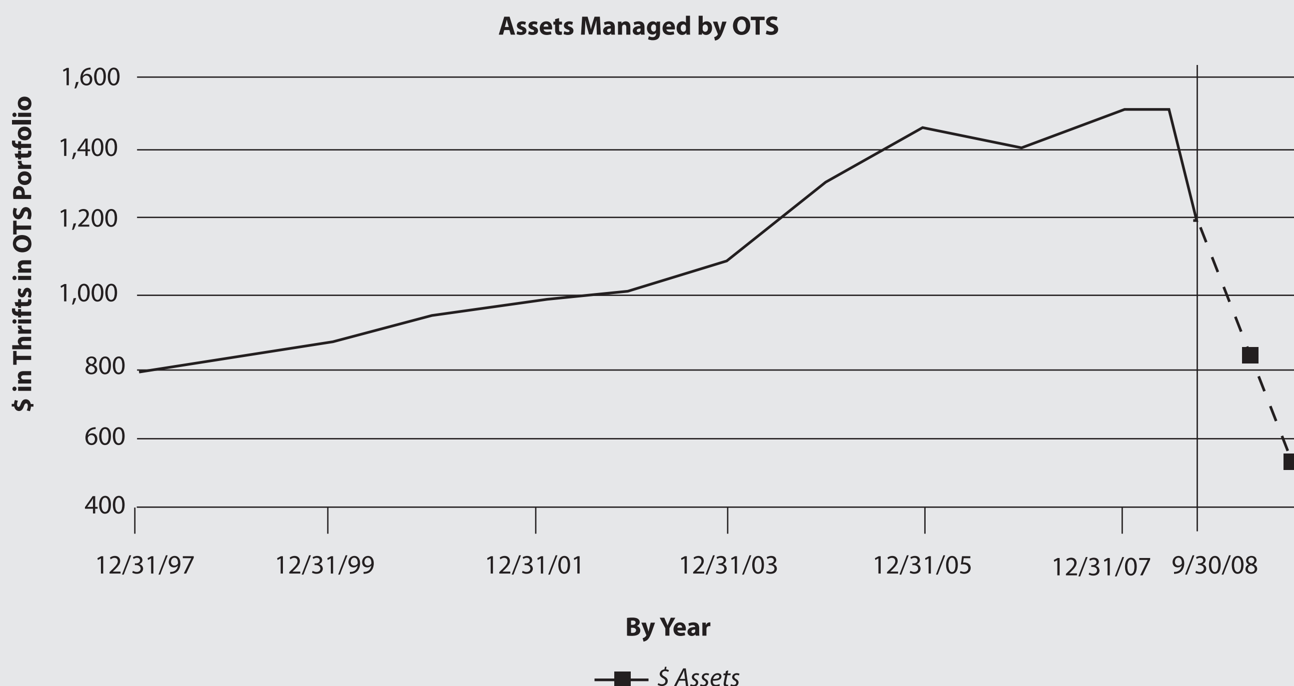
- Almost all of them are tiny subsidiaries of much larger holding companies. In contrast, most thrifts are the primary asset in their holding company. For instance, ING Bank represents less than 5% of the 1.37 trillion pounds in assets controlled by insurance company ING Groep, N.V., and American Express 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.

3 Timothy Curry and Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences,* FDIC Banking Review (December 2000), available at www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf .

4 The asset totals for 1989's failures were equal to just over $230 billion in 2008 dollars.

5 Curry and Shibut at note 3.

6 U.S. Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (March 2008).

7 CRL also recommends that the FDIC be designated as the federal agency that provides regulatory assistance to state regulators involved in the oversight of state-chartered thrifts.

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.

10 John M. Reich, *Aim is Judicious Regulation: Hard times—More Than a Lack of Regulation—Cause Bank Failures,* USA Today (January 5, 2009).

11 Reich at note 10.

12 Cheyenne Hopkins, *For Nonbank Mortgage Role, OTS Sees an Edge Over HUD*, American Banker (November 5, 2007). At a Congressional hearing in October 2007, OTS chief John Reich said: "The OTS has extensive expertise in overseeing and supervising mortgage banking operations that I believe would benefit the current mortgage banking market."

13 Binyamin Appelbaum and Ellen Nakashima, *Banking Regulator Played Advocate Over Enforce*r, Washington Post (November 23, 2008).

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19 Office of Inspector General, Federal Deposit Insurance Corporation, "Issues Related to the Failure of Superior Bank, FSB, Hinsdale, Illinois," Audit Report No. 02-005 (February 6, 2002).

20 Audit report at note 19.

21 Audit report at note 19.

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26 Material Loss Review of NetBank.

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

34 IndyMac Bancorp Inc., 8K filing with Securities and Exchange Commission (May 12, 2008).

35 IndyMac Bancorp, Inc., 10Q filing with Securities and Exchange Commission (July 31, 2007).

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40 Pender, *FDIC Problem List*.

41 Pender, *FDIC Problem List*.

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43 Letter, Eric M. Thorson, Inspector General of the U.S. Treasury, to U.S. Senator Charles E. Grassley (December 22, 2008).

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59 Bob Mims, Bountiful, Utah, *Man Alleges Age Discrimination by Washington Mutual Finance,* Salt Lake Tribune, (August 19, 2003). Washington Mutual denied the former manager's allegations. The case was later settled on undisclosed terms.

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68 Mark Gimein, *Inside the Liar's Loan,* Slate (April 24, 2008); *Bring on the Alt-A Downgrades,* Mish's Global Economic Trend Analysis (May 29,

2008); *Evidence of Walking Away in WaMu Mortgage Pool,* Mish's Global Economic Trend Analysis (February 23, 2008); *WaMu Alt-A Pool Deteriorates Further,* Mish's Global Economic Trend Analysis (April 1, 2008); *WaMu Pool WMALT 2007-OC1 August Update*, Mish's Global Economic Trend Analysis (August 1, 2008); *WaMu's Suspect Mortgage Pool-Fallout from Liar Loans Continues*, Market Oracle (May 7. 2008).

69 Rabon v. Washington Mutual et al, Jackson County (Mo.) Circuit Court (December 14, 2007).

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73 "NY Attorney General Sues First American and its Subsidiary for Conspiring with Washington Mutual to Inflate Real Estate Values," media release, New York State Attorney General's Office (November 1, 2007). In a private lawsuit filed a few months later, a California appraiser claimed WaMu had blacklisted her because she refused to falsify appraisal documents. She alleged that WaMu officials took her off their preferred appraiser list in 2007 because she accurately reported that home values were falling in areas where she was doing appraisals. See Amir Efrati, *WaMu accused of Blacklisting Appraiser Over Homes Prices*, Dow Jones News Service (January 17, 2008).

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100 Matthias Rieker, "Why Popular Reversed Course on a National Charter," *American Banker,* Nov. 17, 2006.

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102 Countrywide Financial Corporation, Q3 2007 Earnings Call, Oct. 26, 2007. See also Gretchen Morgenson, I*nside the Countrywide Spending Spree*, New York Times (August 26, 2008), and Gretchen Morgenson and Geraldine Fabrikant, *Countrywide's Chief Salesman and Defender,* New York Times (Nov. 11, 2007).

103 *Interagency Guidance on Nontraditional Mortgage Product Risks (Sept. 25, 2006). See also Martin Crutsinger, Banks Get Nontraditional Mortgage Advice,* Associated Press (September 29, 2006).

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109 Oral Testimony of Julie Williams, p. 30-31 *Hearing on Congressional Review of OCC Preemption* before the Subcommittee on Oversight and Investigations, House Committee on Financial Oversight, available at http://commdocs.house.gov/committees/bank/hba93717.000/hba93717_0f.htm.

110 See, for example, letter from Alan Greenspan to Rep. John J. LaFalce (May 30, 2002), available at http://www.federalreserve.gov/boarddocs/press/bcreg/2002/20020530/attachment.pdf ("[T]he Board believes it is effective for the banking agencies to approach compliance issues on a case-by-case basis.").

111 Remarks by Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on "The Future of Mortgage Finance," 2008 Annual Meeting National Association for Business Economics; Washington, D.C. (October 6, 2008), available at http://www.fdic.gov/news/news/speeches/chairman/spoct0608.html.

112 Beginning with North Carolina in 1999, at least two dozen states passed predatory mortgage laws significantly stronger than HOEPA.

113 Ohio passed the first of the state laws aimed at the poor underwriting and pushing of unsuitable loans in 2006.

114 For example, several studies of state laws have shown that Gresham's Law is at play in the absence of regulation, with bad lending driving out good lending. With appropriate regulation in place, there is neither reduced access to good lending nor increased pricing for good lending. *See,* for example, Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms,* Center for Responsible Lending (February 23, 2006).

115 The one all-purpose federal law available, the FTC law prohibiting unfair and deceptive acts and practices, has rarely been used, especially against larger banks.

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119 Federal Reserve Board, Final Rule: Truth in Lending, 12 CFR 226, 73 Federal Register 147 (July 30, 2008), p. 44526.

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From:	Killinger, Kerry K.
Sent:	Wednesday, February 23, 2005 10:48 PM
To:	Beck, David <u172571@wamu.com>
Subject:	RE: Moving to Closure on Alliance Ageeement

Good work David. It appears we got a good economic outcome and haven't burnt any bridges for the future.
Kerry
-----Original Message-----
From: Beck, David
Sent: Wed 02/23/2005 3:36 PM
To: W hopeKillinger, Kerry K.; Rotella, Steve; Chapman, Craig J.; Chapman, Fay; Vanasek, James G.; Casey, Tom; Longbrake, Bill A.; Johnson, Keith; Meola, Tony T.; Bindra, Taj; Hillis, Mark R.; Pollack, Wayne A.; Vasquez, Conrad; Fisher, Richard; 'lloacker@hewm.com'; Olsen, Geoffrey G.; Struck, Peter; Pihl, Tim; Horvath, Debora
Subject: Moving to Closure on Alliance Ageeement
I reviewed the most recent proposals from Freddie and Fannie today with Steve. We agreed that the Freddie 65% minimum share (100% of option arms) proposal offers us between 26MM and 37MM of benefit depending on volume. Further, bringing Freddie into partnership with WaMu after 5 years of 85%+ share with Fannie will foster competition and improve our negotiating position for 2006.
39% of our 2005 home loans gain on sale comes from conforming option arm sales. FH stepped up with 21B of committed balance sheet and aggressive forward pricing for OA that result in the financial benefit over FN. FH was also very aggressive in 2004 buying 6B of option arm without a share agreement in place. FH has provided us with new opportunities to further our affordable lending goals and I believe will work hard to deliver an excellent level of service for WaMu.
Fannie negotiated hard for our business especially in the 11th hour. Steve has had an active dialogue with Dan Mudd and he will give Dan a call tomorrow to discuss our decision. After he speaks with Dan, I can arrange calls with the FN team and inform FH of our decision.
As we draft final contracts with FH and FN, I'll be getting the team back together once more to review the final documents.
Thanks for your support.

Permanent Subcommittee on Investigations

EXHIBIT #85

Permanent Subcommittee on Investigations
EXHIBIT #86

Washington Mutual

Pre-Meeting for Fannie Mae

March 12, 2004

Consumer Group – Home Loans
Portfolio Management

JPM_WM02405457

Washington Mutual

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Unattractiveness of holding fixed-rate on our Balance Sheet	Page 9
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JPM_WM02405458

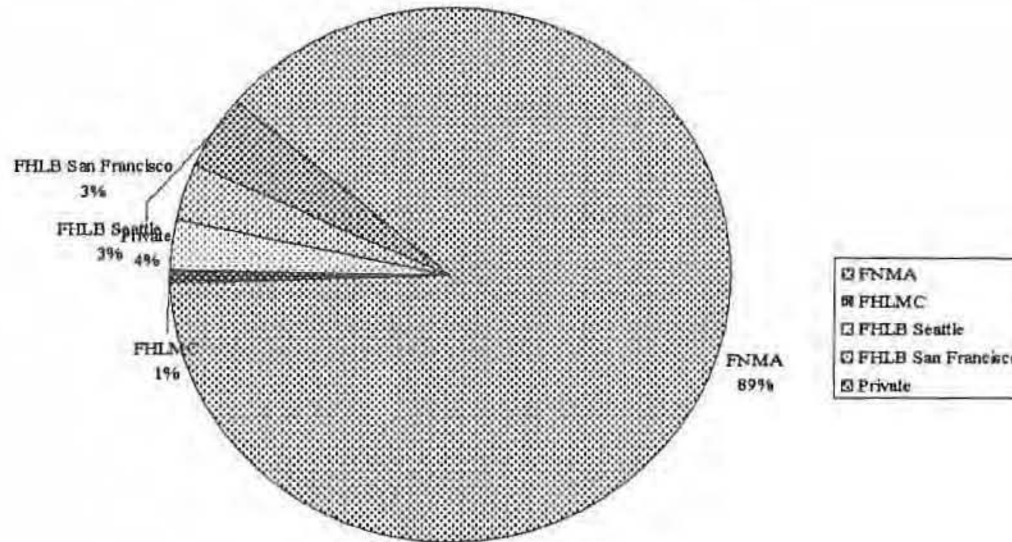
GSE's Impact in the Market

- Total Single Family originations were $3.76 trillion in 2003.
- Combined new business activity of Fannie Mae and Freddie Mac combined (including MBS securitizations and purchases) were $2.25 trillion in 2003 – or 59.8% of market originations.
- Fannie Mae was responsible for 60% of the GSE's new business activity in 2003.
- WaMu contributed 15% of Fannie Mae's 2003 mortgage purchases.
- GSEs dominate the automated underwriting decisioning technology through LP and DU.
- Credit guidelines for the market, in general, follow the GSE's lead.

JPM_WM02405459

Washington Mutual

GSE's Impact in the Market



JPM_WM02405460

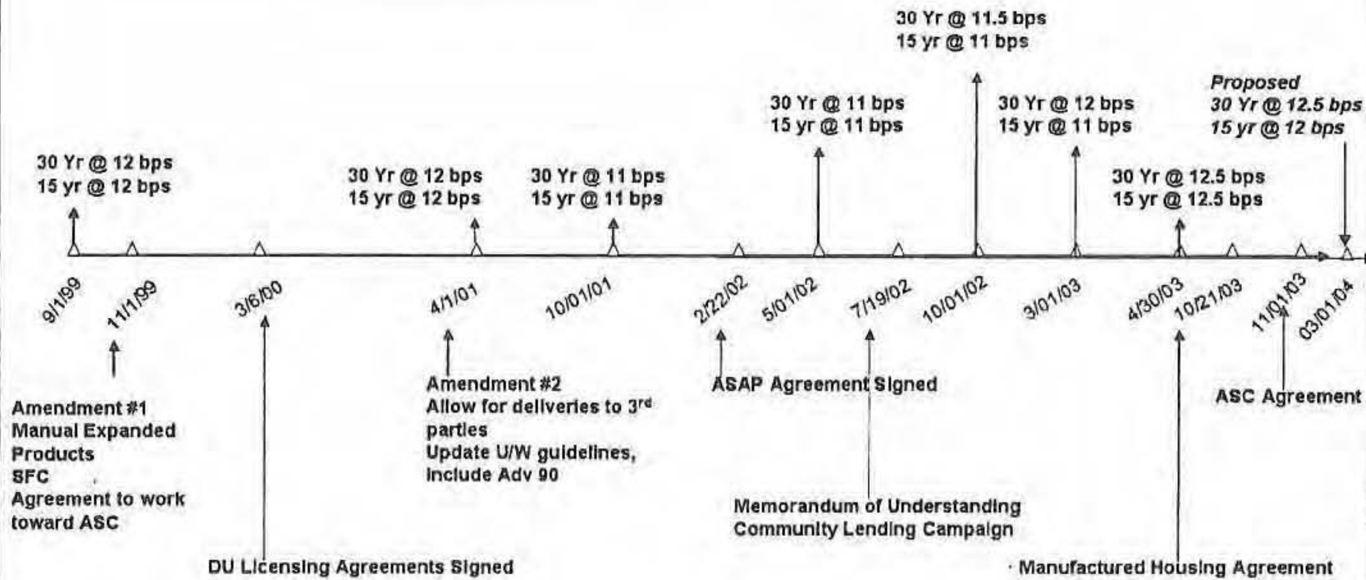
Washington Mutual

Overview of the Alliance

Under this Alliance Agreement with Fannie Mae, WaMu has agreed to deliver no less than 75% of eligible, conforming loans to Fannie Mae.

Alliance Topic	Scope
Eligibility	Establishes eligible mortgage products and basic underwriting guidelines for standard and low-documentation loans, and provides a credit matrices for more aggressive, non-DU loans.
Pricing	Establishes Flow Pricing, Loan-Level Price Adjustments, and Pricing for Portfolio Swap Transactions. Gfee Adjustment for Flow Production and Gfee caps and floor are also defined.
CRA Opportunities and Other Products	Outlines ways in which Fannie Mae will support WaMu's CRA initiatives, Community Access Products, Streamlined Purchase Initiative, Saleable Streamline Process, Advantage 90, etc.
Multifamily Preferred Portfolio Lender Options	Outlines the recourse conditions that Fannie Mae will purchase both structured and flow multifamily deals.
Technology	DU, Customized DU, Pro-Span, Appraisal Database, Streamlined Appraisal Process
Risk Management	Outlines information to be shared, including DU response information, loan performance reporting, and macro and micro economic data for geographical regions. Provides a sample list of customized historical reports that may be developed by Fannie Mae and WaMu jointly.
Balance Sheet Mgmt	BTWNR, Evergreen, ASC, ASAP, etc.

JPM_WM02405461


Washington Mutual
Timeline of the Alliance Agreement
30 Yr @ 11.5 bps
15 yr @ 11 bps
30 Yr @ 11 bps
15 yr @ 11 bps
30 Yr @ 12 bps
15 yr @ 11 bps
Proposed
30 Yr @ 12.5 bps
15 yr @ 12 bps
30 Yr @ 12 bps
15 yr @ 12 bps
30 Yr @ 12 bps
15 yr @ 12 bps
30 Yr @ 11 bps
15 yr @ 11 bps
30 Yr @ 12.5 bps
15 yr @ 12.5 bps
9/1/99
11/1/99
3/6/00
4/1/01
10/01/01
2/22/02
5/01/02
7/19/02
10/01/02
3/01/03
4/30/03
10/21/03
11/01/03
03/01/04
Amendment #1
Manual Expanded
Products
SFC
Agreement to work
toward ASC
DU Licensing Agreements Signed
Amendment #2
Allow for deliveries to 3rd
parties
Update U/W guidelines,
Include Adv 90
ASAP Agreement Signed
Memorandum of Understanding
Community Lending Campaign
ASC Agreement
Manufactured Housing Agreement
6

Current Competitiveness of WaMu Gfee

- At current levels, alternative executions, e.g., Freddie Mac, FHLB, and private investors, do not win a significant level of business.
- We have confirmed, independently, that other large lenders have similar, but not better, Gfees.
- Our acquired entities, PNC, NAMCO, Homeside and Fleet had slightly higher Gfees at the time of acquisition.
- Non-GSE execution of conforming collateral, at times, can be better, but the market is rare and inconsistent.

JPM_WM02405463

Washington Mutual

Current Competitiveness of WaMu Gfee

Best Execution Comparison (as of March 10, 2004)

	Fannie Mae	Freddie Mac *	FHLB - Seattle
Note Rate	5.00	5.00	5.00
Servicing	0.25	0.25	0.25
Base Servicing Multiple	5.7565	5.7565	5.7344
Gfee	0.1250	0.1600	
Buy Up/Down	0.1250	0.0900	-
Buy Up/Down Factor	4.60	4.60	
Coupon	4.50	4.50	4.75
Price w/ Servicing	100.2474	100.0736	100.1391

*Anchor Gfee set at 16 bps for all Freddie Mac customers.

JPM_WM02405464

Washington Mutual

Current Competitiveness of WaMu Gfee

Delivery Profile - February 2004

30Yr	WALTV	WA FICO
WaMu	71.25	706
Nat'l	73.92	710

15Yr	WALTV	WA FICO
WaMu	57.44	722
Nat'l	59.64	724

*non-affordable lending business initiative (e.g. EA/TPR
*WaMu vs. national average

Credit Index Measurement - WaMu vs. Top

	2003	2004 (Jan)
30Yr		
Index	100.14	99.85
15Yr		
Index	100.13	99.6

*Index above 100 indicates riskier profile than top 20 ler
and index below 100 indicates less risky profile than to|
**Lenders are generally within the range of 97 to 103, s

JPM_WM02405465

Washington Mutual

Unattractiveness of holding fixed-rate on our Balance Sheet

	ROTE (Beta Version FTP Grid)		ROTE (Old/Current FTP Methodology)	
	ROTE %	Option Costs (bps)	ROTE %	Option Costs (bps)
30 Yr Fixed	4	49	3.6	95
15 Yr Fixed	2	32	4.2	95
5/1 CMT	7	38	7.9	95
3/1 CMT	7	32	8.0	95
MTA 8.95 Cap	16	48	21	2
MTA 9.95 Cap	17	34	21	2
30 Yr Jumbo	3	70	6.8	95
15 Yr Jumbo	3	42	6.8	95

JPM_WM02405466

Washington Mutual

Value of the Relationship

- WaMu provides about 15% of Fannie Mae's Business
- WaMu is Fannie Mae's 2nd largest provider of business (behind Countrywide)
- WaMu was responsible for 34.7% of Fannie Mae's Multifamily business.
- WaMu is a large user of DU – providing transaction fee business to Fannie Mae
- WaMu is a launch customer of Pro-Span, Fannie Mae's e-business dedicated channel
- WaMu has been a vital partner for Fannie Mae in Affordable Lending
  - Separate Meeting on 03/26/04
- Fannie Mae has assisted WaMu's balance sheet management through quarter-end ASAP transactions and ongoing support of Project Evergreen

JPM_WM02405467

Washington Mutual

Washington Mutual & Fannie Mae Alliance Review

March 18, 2004
Cedarbrook, Seattle
8:00-10:00 a.m.

1. Introductions & Perspectives on the Alliance	Mike Kula and Gail Vernon
2. Guaranty-fee & Alliance Pricing	Tom Lund

- Component and build-up
- National perspective

3. Product & Pricing Collaboration	Account Team

- Salable solutions for portfolio products
- Adoption of WaMu's guidelines
- Special structures & execution initiatives
- Training & technology implementation support

4. Multi-family Alliance	Grace Huebscher

- Scope and priorities
- ARM distribution and Funding/Repo agreements

5. Executive Interaction	Bill Longbrake, Gail Vernon

- Recent developments and interaction
- Priorities for 2004

6. Q&A, review and next steps	Group

JPM_WM02405468

Freddie Mac – WaMu Meeting
July 28, 3:00 – 4:00pm
Steve's Office – 16th fl, Tower

WaMu Attendees
Steve Rotella, *President*
TBD

Freddie Mac Attendees
Gene McQuade, *President* (bio attached)
Paul Mullings, *head of single-family sourcing (marketing/sales)*

WaMu's Current Relationship w/ Freddie Mac

- WM executed a majority share arrangement w/ FRE, effective 4/1/05 thru 3/31/06; included in that arrangement was a market-leading opportunity to sell up to $21 billion of option ARMs to the FRE portfolio.
- FRE's share of WM flow conforming business went from 20% in Q1 to 81% in Q2.
- WM is now FRE's #2 seller (behind Wells); w/ WM's swing in volume from FNM to FRE in Q2, FRE now holds a GSE market share lead for the first two months of Q2.
- Forty percent of FRE's portfolio growth in '05 can be attributed to WM's $8 billion sale of option ARMs;
- There are several initiatives underway w/ FRE staff :
  - Servicing – obtain Tier I status default servicing;
  - Affordable – e-bus initiative, JDC support, Home Possible product adaptation;
  - Excess Servicing – provide daily excess prices as a percent of the IO market.

Accomplishments

- Execution of a comprehensive credit arrangement that preserves our existing FNM variances w/ FRE, and expands in other areas;
- Execution of $11 billion of forward option ARM trades w/ the FRE portfolio prior to a material spread widening in that product;
- Full testing of the new FRE selling and delivery system that will cut our turn time by up to three days;

WaMu Agenda Topics (WaMu asks)

- The following asks should be used as a means to cement our relationship as FRE does not want to be a "one-year wonder":
  - **Credit**
    - WM wants w/ FRE to get our Enterprise Decision Engine (EDE) model to be fully accepted by them (includes rep and warrant relief); we also plan to embed FRE's LP decision tool within EDE in '06.
    - WM wants FRE to expand the eligibility of lower quality loans to ensure WM is "market competitive".
  - **Production** – WM wants FRE to allow WM to customize Loan Prospector (LP) to gain greater market penetration & efficiency in the wholesale/correspondent markets; FNM has allowed us to do this w/ Desktop Underwriter (DU).

H:\finshare\peter\McQuade meeting (July-05).doc
{ DATE \@ "M/d/yyyy" }; { TIME \@ "h:mm am/pm" }

Permanent Subcommittee on Investigations
EXHIBIT #87

- **Multifamily** – WM wants FRE to provide relief on loan size limitations, seismic reviews, and confirm the integrity of WM's delegated underwriting/servicing model for a flow, delegated program.
- **Non-prime**
  - Potential securitization of SMF assets ($1.5 - $10 bil) that will create liquidity for WM and create a positive affordability profile for FRE;
  - Expansion of credit profile into subprime; *(Keith Johnson wants to keep this point very general);*
- **Affordable** – Increase funding of JDC support to $2mm (from current $1mm)
- **Liquidity** – we want to understand how we can best help the FRE portfolio w/ product.
  - Longer term portfolio commitment on option ARMs;
  - Broader deliverability guidelines w/ respect to option ARMs.
- **MSR Mgmt**
  - Press FRE on the adoption of a reduced minimum servicing fee fixed rate security that is TBA-eligible; (w/ the BMA's recent decision to not support reduced servicing, push the FRE portfolio to step up);
  - Excess Servicing – WM wants FRE to provide daily pricing on excess servicing as a percent IO market; goal is to reduce or eliminate excess servicing at attractive prices. (Syron recently wrote in an article to the Hill agreeing that the GSEs are best positioned to manage interest rate risk.)

Anticipated Freddie Agenda Topics

- Putting their financials in order (timeline, etc.) – we'll want to know what that means for a customer like us, e.g., more attention, better pricing, or what?
- GSE legislation – where headed, sticking points – what does WM want to emphasize
- Mission (Affordable) - both GSEs have switched their tune from being strictly a secondary market liquidity provider to being a champion of home ownership/affordable housing
- Customer centric culture:
  - accepting new products (no better example that MTA Option ARMs);
  - accepting customer processes that have trended to lower documentation standards
- Buying/securitizing what the market originates – we are concerned about FRE's desire to opportunitistically sell large amounts of credit risk into the market thus increasing volatility and supply concerns.

Negotiating Strategy (for the '06 period)

- FRE is not likely to outbid FNM by such a wide margin on option ARMs like in the current contract;
- Thus, value needs to be extracted from other sources such as MSR management, use of own AUS technology, expansion of credit parameters, and increased funding of affordable goals.

EUGENE M. MCQUADE

PRESIDENT AND CHIEF OPERATING OFFICER

Eugene M. McQuade was named Freddie Mac's president and chief operating officer on September 1, 2004. McQuade reports to Chairman and CEO Richard F. Syron. Reporting to McQuade are Freddie Mac's Finance, Corporate Strategy & Administration, Information Systems and Services, Mortgage Sourcing, Operations & Funding, and Mission divisions.

Prior to joining Freddie Mac, McQuade served as president of Bank of America Corporation. He had been president and chief operating officer at FleetBoston Financial Corp. before helping to bring about the April 1, 2004 merger between that company and Bank of America. McQuade joined Fleet in 1992 and became chief financial officer in 1993. He was elevated to vice chairman in 1997 and became president and chief operating officer in 2002.

Before working at Fleet, McQuade served as the executive vice president and controller at Manufacturers Hanover Corp., a predecessor of J.P. Morgan Chase. McQuade began his career at KPMG Peat Marwick in New York.

Originally from New York City, McQuade is a certified public accountant. He earned a degree in Accounting from St. Bonaventure University, of which he is a trustee. McQuade is also a director of XL Capital.

Freddie Mac is a stockholder-owned company established by Congress in 1970 to support homeownership and rental housing. Freddie Mac fulfills its mission by purchasing residential mortgages and mortgage-related securities, which it finances primarily by issuing mortgage-related securities and debt instruments in the capital markets. Over the years, Freddie Mac has made home possible for one in six homebuyers and two million renters in America.

###

09/04

H:\finshare\peter\McQuade meeting (July-05).doc
{ DATE \@ "M/d/yyyy" }; { TIME \@ "h:mm am/pm" }

From: Struck, Peter
Sent: Friday, December 17, 2004 5:36:07 PM
To: Johnson, Keith; Beck, David; Parker, Michael; Pihl, Tim
CC: Lash, Michael; Flynn, Ron; Cooper, Ted
Subject: RE: Risks/Costs to Moving GSE Share to FH

Attachments: Picture (Metafile)

The most recent $3 bil option ARM tape we sent had about 59% of the UPB at the 35bps profile and the rest had an implied g-fee of 98bps. A total wtg avg g-fee of 61bps was quoted.

The suggestion below would have an all-in explicit g-fee of 28bps plus we would need to hold capital on the recourse piece plus the servicing is worth less in the marketplace because of the recourse provision. (Loans sold w/ full recourse are brought back on balance sheet for risk-based capital assessment).

We know that the 35bps non-recourse g-fee is market leading for the profile, the full-recourse g-fee of 15bps is close to full-priced. We need that level down to the high single-digits. FN's risk-based capital charges vary by product type and a neg am product will have a much higher charge.

-----Original Message-----
From: Johnson, Keith
Sent: Friday, December 17, 2004 1:28 PM
To: Struck, Peter; Beck, David; Parker, Michael; Pihl, Tim
Cc: Lash, Michael; Flynn, Ron; Cooper, Ted
Subject: RE: Risks/Costs to Moving GSE Share to FH

Fannie came back this afternoon and said the following:

- They believe that 2/3rds of the Option ARM production will meet their "Profile" to remain qualified at 35 basis points.
- That the 1/3rd "Out of Profile" could be put in a risk sharing deal with a 15 bpt G-Fee
- That they would keep the remaining G-fees on other products the same

They owe us a document that defines "Profile" for Option ARM.

D. Keith Johnson

Executive Vice President and Chief Operating Officer
Washington Mutual Commercial Group
Tel: 206.377.3965 | Fax: 206.490.5656

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-----Original Message-----
From: Struck, Peter
Sent: Friday, December 17, 2004 12:44 PM
To: Beck, David; Parker, Michael; Pihl, Tim
Cc: Lash, Michael; Flynn, Ron; Cooper, Ted; Johnson, Keith

Permanent Subcommittee on Investigations
EXHIBIT #88

Subject: Risks/Costs to Moving GSE Share to FH

David:

Here are some add'l risks to consider:

MSR Management
FN may not have as strong a desire to move forward w/ the min s-fee initiative if WaMu is no longer considered a major alliance partner. FN's business model is relationship, not transaction-oriented and their desire to employ resources and political capital to move this forward may be diminished. **(Risk - mod)**

Multifamily
FN has a fully delegated small apt risk-share program; we are asking FH to duplicate. The risk is FN would either tighten up or limit the program prior to getting FH up to speed **(Risk - low)**

Trading
Traditionally, hedging of the pipeline has been done w/ Fannies and then swapped to Freddies at some cost. If the FH share is increased the pipeline hedging cost may increase (Tim P and Todd L can provide greater color on this issue)

DU
We currently have DU as our principal GSE decision engine. We have negotiated a click charge of $9 vs. a rack rate of $35. If FN is receiving substantially less volume, we can envision that charge increasing. Our monthly volume is 25k, but has been as high as 100k in heavy refi periods (potential cost $8mm in the current environment) **(Risk - mod)**

Technology
We have scoped out w/ FN projects on custom DU and Pro Span. Similar to above, Fannie may reduce/eliminate the resources on their side knowing that business produced from these initiatives may not come their way. **(Risk - mod)**

G-Fee Increase
FN is under earnings pressure from lack of portfolio growth; thus, the insuring business is being asked to take up the slack. At a minimum, we expect the "discounts" on our fixed flow business to go away on 3/31/05. Also the effective g-fee for option ARMs is expected to increase substantially. **(Risk - high)**
A possible offset to this risk is the recent accounting troubles and I would expect FN has a strong desire to not let the perception of accounting issues slip into their business activities by losing a large alliance customer. (Think of the impact to their stock valuation if Wall St believes they will begin to lose customers.)

Affordable Lending
FN has been a valuable partner, and FH will need to step up in this arena. We should expect scaled back efforts in this area. **(Risk - low)**

General Resources Decked Against the Account
FN has many more resources - in all aspects of the relationship from servicing to credit to affordable lending - involved w/ WaMu. Bringing FH up to speed will take more time and effort on our part; Risk is Fannie starts cutting back **(Risk - mod)**

Credit
Historically, FN has been more willing to take risk and think outside the box than FH; however, FH did approve "Fast Track" w/ a few more stips than FN fairly quickly. Also, FN has been very willing to accept waivers on implementation of new requirements due to our system challenges. If FH is our lead partner they will need to step up on this front both from an ability to share in all risks and to provide a speedy response. Risk is FN loses their appetite to take on new credit issues w/ the same outlook as an alliance partner**(Risk - mod)**

Data Integrity
FN is well aware of our data integrity issues (miscoding which results in misdeliveries, expensive and time consuming data reconciliations), and has been exceedingly patient. FH has got a taste of these challenges, but we're not sure how they will react. The risk is FN's unwillingness to accept business and/or charge penalties **(Risk - mod)**

Recourse

FN has been willing to use recourse for either "mistake accommodation" or for deals where we want liquidity, but don't want to pay the credit charge; FH is untested these areas. Risk is their unwillingness to do **(Risk - low)**

Repurchases
FN has been patient as we have improved our internal process to review and respond to repurchase requests. FH has had a similar experience, but not at the same volume. Risk is FN's developing a more stringent timeline requirement. **(Risk - low)**

Servicing
WaMu as 2nd largest FN servicer will continue to have numerous interactions w/ FN and we would expect FN to continue the strong relationship; they may tighten up on timelines, etc. **(Risk - low)**

ASAP Transactions
FN may be less supportative of using their balance sheet to support our quarter-end liquidity needs. **(Risk - mod)**

No Adverse Selection Requirement
In our Alliance agreement w/ FN, we rep no adverse selection w/ respect to credit and HUD goals. FN has expressed a concern in '04 regarding their deliveries; to date they have been very passive in their pursuit of this issue; the risk is they push that issue w/ conssequences, if any, to be determined. **(Risk - low)**

From: Rotella, Steve
Sent: Friday, April 28, 2006 7:57:18 PM
To: Struck, Peter; Killinger, Kerry K.; Casey, Tom; Schneider, David C.
CC: Beck, David; Pihl, Tim; Feltgen, Cheryl A.; Drastal, John; 'LLoacker@HEWM.com'; Olsen, Geoffrey G.; Flynn, Ron
Subject: RE: Business Arrangement w/ Freddie Mac

Congratulations to the team for getting this done and with terrific results for the company. This will have a very positive impact to WaMu.

From: Struck, Peter
Sent: Friday, April 28, 2006 12:38 PM
To: Killinger, Kerry K.; Rotella, Steve; Casey, Tom; Schneider, David C.
Cc: Beck, David; Pihl, Tim; Feltgen, Cheryl A.; Drastal, John; 'LLoacker@HEWM.com'; Olsen, Geoffrey G.; Flynn, Ron
Subject: Business Arrangement w/ Freddie Mac

All:

David Beck asked that I share w/ you the highlights of WM's proposed business arrangement w/ Freddie Mac that David Schneider signed today. First, let me say that this was a great team effort w/ many of David Beck's Cap Mkts group involved, Cheryl Feltgen's credit group, and a legal team lead by Geoff Olsen and outside counsel support from Lynn Loacker (Heller Ehrmin). Over the next two-three weeks, we will look to put these tems into final contract language.

We are all very pleased w/ how the negotiations were conducted, as noted below, WM achieved all of their principal objectives. Peter

HIGHLIGHTS OF 2006 FREDDIE MAC BUSINESS PROPOSAL

Two-yr Agreement, 6/1/06 - 5/31/08

Add'l value of $65mm/yr vs. current contract for an expected total of $131mm for 2 yrs

WM to deliver 75% majority share

Pricing & Credit Triggers in place to ensure WM's competitiveness

Provides for enhanced MSR mgmt execution strategies including:
- Purchase of $13 bil/yr of fixed-rate reduced servicing pools
- Purchase of $10 bil/yr of option ARM reduced servicing pools
- Much improved buy-up/buy-down grid to eliminate excess servicing

Goal-aligned to support increased affordable lending including financial aid of $1.5mm

Opportunities for increased incentive pay-outs as a Tier I servicer

Strategic Perspective

Provides WM with improved execution in all of its product lines for two years as the credit markets face some uncertainty with rising interest rates and weakness in housing prices;

Aligns WM with the stronger GSE over the next 12-18 months; we fully expect once FNM gets its financial house in order to become a very aggressive competitor - just when this contract is coming up for renewal;

The reduced servicing initiatives will allow WM to show the marketplace that such pools are more more valuable than current TBA-pools and will force the market to allow for a lower minimum s-fee for TBA;

Permanent Subcommittee on Investigations
EXHIBIT #89

Fannie Mae Alliance and Freddie Mac Business Relationship Proposal

1/ Executive Summary

The Freddie Mac Business Relationship dated 12/21/2004 establishes another execution opportunity that diversifies WaMu's execution risk and confers material financial benefits for the Option ARM product.

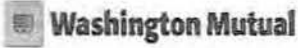
The key to the Freddie proposal is that it provides significant liquidity for our Option ARM originations, with more advantageous credit parameters, competitive g-fees and preferred access to their balance sheet relative to our current agreement with Fannie. Fannie has made it very clear to us that we should not expect to retain the same pricing and credit parameters for Option ARMs in our 2005 pricing agreement that we have enjoyed during 2004. For fixed rate loans and hybrids, g-fess adjusted for MAP Pricing and credit parameters are roughly equivalent to the Fannie Agreement. Outlined below are comparisons of significant terms of Freddie's draft of the LOI and similar terms of our current agreement with Fannie. We are currently negotiating the final terms of the LOI and expect to construct a final agreement that retains the significant non-g-fee related advantages of the Fannie agreement.

Confidential Treatment Requested by JPMC

JPM_WM03201289

Permanent Subcommittee on Investigations

EXHIBIT #90



2/ **Business Relationship Proposal Issues**

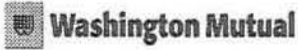
	Freddie Mac	Fannie Mae	Comment
Credit Proposal			
• Agency-to-Agency Streamlined refi; co-ops; relo program	To be resolved – unknown outcome	Accepts in standard flow agreement (10-15% of FR production)	Advantage **FN**
• PMv2 calibration for Option ARM's	1or2Q2005: outcome unknown	Not under discussion; flow parameters accepted on 50-60% of Option ARMs	Advantage **FH**
Pricing Proposal			
• Minimum market share calculation	Market share: Option ARMs: 40% measured quarterly All others (incl.Portfolio sales): 40-60% measured quarterly with a minimum of 30% in any month	75% measured quarterly; excludes Portfolio sales	Advantage **FN**
• Exclusion of NOO	Excludes NOO from flow	FN pricing based on inclusion of NOO with associated delivery fees; may impact overall flow g-fee if excluded	Advantage **FH**
• Representative mix	Requires representative mix compared with all other conforming deliveries to other investors; sole discretion to adjust price with 30 days notice	Requires no adverse selection of FN due to increased risk profile; to be discussed if profile appears to be changing	Advantage **FN**
• Mix: HUD Goals	Same	Same	
• Required reporting Less than minimum delivery	Yes Charge a pair-off fee	No No such fee	Advantage **FN**

Confidential Treatment Requested by JPMC

JPM_WM03201290

• Delivery fee pricing	High on: 80-15-5 LTV>90 Manufactured housing	High on: saleable Low Doc	Advantage **FH** (higher volume Low Doc)
• Guaranty Fee pricing: MTA Option ARM's FR-30 FR-20 FR-15 Amortizing hybrid I/O hybrid	 40-42 16 – (13.3 MAP) 15 – (12.6 MAP) 13 – (10.6 MAP) 8.5 with ARC 12.5 with ARC	 35-91, Avg 53 13 11.5 11.5 17.5 18.5	 After current FN pricing period ends 3-31-05, FN could remove pricing discounts, moving to a higher G-fee for flow deliveries.
MAP Pricing			
• Available	Yes	No... FN has available, but WaMu chose a fixed G-fee (that in the wake of the MBS/PC spread narrowing dramatically saved us $88mm in lower G-fees)	Re-engage FN on a MAP structure
• Buy-Up/Buy-Down grids	Yes	Yes	
• "Preferred Status"	Unknown outcome; unknown meaning	silent	This is key to nail down
Structured Transactions			
• T-Deals & Other Asset Bids	Strong asset & credit bids in 2004		Advantage **FH**
• Reduced Servicing Offer non-TBA Securities Portfolio Bid Min Average Servicing	 Yes FH portfolio has been stronger 20 bps to 10% of FH deliveries	 Yes 20 bps under ASC – no limit	Advantage **FN** Note: FH pulls stripped deals out of the denominator which makes the likelihood of reaching the 20 bps much higher

Confidential Treatment Requested by JPMC JPM_WM03201291



Affordable			
• Community Access	Pricing slightly higher (29-36 bps), but no risk share arrangement	30 bps g-fee, but has risk share arrangement.	Advantage **FH**
• Affordable Partnership	$200k for joint initiatives	0 g-fee for 10% of all Community Access deliveries (open-ended); value of $1.2mm ($200k compares to $67mm in FN deliveries); waiver of 50 bps MH delivery fee;	Advantage **FN**
• CRA initiatives Home Possible e-Bus events in NW	Outcome unknown Outcome unknown Outcome unknown	additional local partnership efforts (JDC, etc.) My Community Mortgage similar to CA Numerous local events	Advantage **FN**
• MSR Management reduced Servicing Fee – hybrids explore synthetic I/O	10 bps Yes	12 bps Yes	Advantage **FH**
Operational Alignment			
• Contract	One Master Agreement, separate Master Commitments for Community Access & reduced servicing	Three Master Agreements: Flow, Option ARM Flow, Transaction Separate delivery contracts	
• Funding cycles	Flow: with Selling System, 5 days or less		
Additional Opportunities			
• Multifamily			
• Loan Prospector (LP)		The cost of DU may increase - $7.8mm annually	
• Repurchases			

Confidential Treatment Requested by JPMC

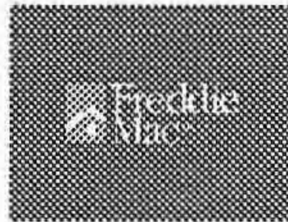
JPM_WM03201292

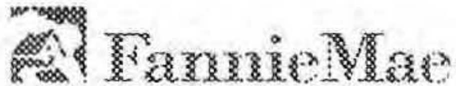
Permanent Subcommittee on Investigations
EXHIBIT #91

Washington Mutual, Inc.®

GSE Forum

September 29, 2005





Dial-in: 866.624-0353; 7304065

WaMu Capital Markets

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Objectives Of The Forum

- *Ensure WaMu receives full value from the negotiated contracts*
- *Monitor the overall health of the GSEs from the perspective of how changes may impact WaMu's ability to execute its Home Loans strategy*
- *Highlight risks and opportunities as they arise or are perceived*
- *The entities covered by this Forum include the mortgage activities of Freddie Mac, Fannie Mae, Ginnie Mae, the Federal Home Loan Bank of San Francisco (MPF program) and the Federal Home Loan Bank of Seattle (MPP)*

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JPM_WM02575608

Objectives Of The Freddie/Fannie Business Agreement

- *Diversify the liquidity risk for the conventional, conforming lending business;*
- *Obtain the most favorable market pricing and competitive advantage for the conforming, Option ARM business;*
- *Harmonize the adverse selection requirements of various purchasers to place Washington Mutual in a flexible position;*
- *Reduce the minimum servicing fee on TBA-eligible mortgage securities;*
- *Capitalize on efforts to increase the value of Washington Mutual's affordable loan products sold; and*
- *Seek opportunities to increase productivity and lower costs of the fulfillment and servicing operations.*

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JPM_WM02575609

WaMu's Deliveries – Q3, 2005

Investor	Volume	%
Freddie	$13,268	59%
Fannie	$ 5,156	23
Private	$ 2,309	10
FHLB-SF	$ 0	
Ginnie	$ 1,896	8

Credit Profile	FH	FN
LTV (wtd avg)	67%	68%
% 75.01–80% LTV	31%	33%
FICO (wtd avg)	729	727
% < 620	3.5%	4.4%
CA Share	22%	22%
Cash-Out Refi	41%	37%
Low-Doc Loans	8%	11%

Affordable Profile – Q3

Goal Met (65/25)

	FH	FN
Flow	No	Yes
Community Access	N/A	Yes
JDC	N/A	Yes
CRA	Yes	N/A

Affordable Profile – Agreement to Date

Goal Met (65/25)

	FH	FN
Flow	Yes	Yes
Community Access	N/A	Yes
JDC	N/A	Yes
CRA	Yes	N/A

Washington Mutual, Inc.

JPM_WM02575610

WaMu's Deliveries – Contract to Date 2005

Deliveries by Product Type	Loan Count	Amount (000)	FNMA Count	FNMA Amount (000)	FHLMC Count	FHLMC Amount (000)	Other Count	Other Amount (000)
Jumbo	43,761	26,890,836	1	175	2	888	43,758	26,889,773
GNMA	35,291	4,598,406	-	-	-	-	35,291	4,598,400
Clean/Perm or MISC Loan Type	3,084	554,021	1	149	-	-	3,083	553,871
WMMSC (inter-company transfer)	2,056	292,740	-	-	-	-	2,056	292,740
Alt-A	2,276	368,872	-	-	-	-	2,276	368,872
A00	541	107,884	532	106,002	-	-	9	982
Option ARM	42,436	9,445,169	-	-	35,421	7,942,708	7,015	1,502,461
Non Owner Occupied	6,496	872,769	4,738	621,616	646	97,481	1,112	153,672
Interest Only ARM's	8,388	2,008,016	5,360	1,281,049	3,010	723,590	22	3,970
Hybrid ARM's	6,558	1,382,294	3,250	694,146	3,303	687,489	5	659
15 yr FRM	23,578	2,961,012	6,501	776,887	16,401	2,114,228	676	69,896
20-30 Yr FRM	120,454	22,050,083	24,959	4,439,845	91,845	17,008,925	3,650	601,312
Total Delivery	294,919	71,532,700	45,332	7,920,771	150,634	28,575,308	98,953	35,036,621

*The filter is applied from top to bottom. Loans appear only once, even if they have more than 1 characteristic - e.g. Non Owner Occupied 15 yr FRM loans will be in Non Owner Occupied but not in 15 yr FRM.

FNMA Delivery Goals	Total Eligible Count	Total Eligible Amount (000)	FNMA Goals 25% Count	FNMA Goals 25% Amount (000)	Actual to FNMA Count	Actual to FNMA Amount (000)	Goal Met?
FNMA Designated Mortgages (1)	38,524	6,351,921	9,631	1,587,980	15,101	2,752,083	Yes
Community Access (2)	1,548	272,189	387	68,047	932	164,663	Yes
FNMA Emerging Market Originations (3)	1,145	233,824	286	58,456	341	70,481	Yes
CRA Deliveries part of Designated Mortgages	24,084	3,519,480	N/A	N/A	7,945	1,210,811	N/A

(1) FNMA Designated:Limited to Interest Only Hybrid ARM's, Amortizing Hybrid ARM's, and 15 Year Fixed Rate
(2) Community Access loans do not include loans originated by Emerging Markets. All Community Access loans are 30 year fixed rate and are not
(3) FNMA Net Emerging Market Originations are all loans originated by EM branches including Community Access loans and other 30 year fixed, i.e. the Actual to FNMA numbers may include loans not in FNMA Designated population.

FHLMC Delivery Goals	Total Eligible Count	Total Eligible Amount (000)	FHLMC Goals 65% Count	FHLMC Goals 65% Amount (000)	Actual to FHLMC Count	Actual to FHLMC Amount (000)	Goal Met?
FHLMC Flow Mortgages (4)	157,687	28,215,229	102,497	18,339,899	114,565	20,534,232	Yes
Community Access (5)	1,548	272,189	N/A	N/A	604	105,836	N/A
FHLMC Emerging Market Originations (6)	1,141	233,044	N/A	N/A	698	144,219	N/A
CRA Deliveries part of Flow Mortgages	94,896	15,361,362	61,682	9,984,885	65,629	10,575,378	Yes

(4) FHLMC Flow: All GSE eligible loans except Fannie Mae EAII and EAIII program
(5) Community Access loans are part of the FHLMC Flow population.
(6) FHLMC Net Emerging Market Originations are all loans originated by EM branches including Community Access loans less EA II & III. This population is part of the FHLMC Flow population.

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JPM_WM02575611

WaMu's Deliveries – Q3, '05

Deliveries by Product Type	Loan Count	Amount (000)	FNMA		FHLMC		Other	
			Count	Amount (000)	Count	Amount (000)	Count	Amount (000)
Jumbo	30,176	18,538,385	-	-	2	888	30,174	18,537,498
GNMA	14,676	1,895,860	-	-	-	-	14,676	1,895,860
Clean/Perm or MISC Loan Type	1,248	259,184	-	-	-	-	1,248	259,184
WMMSC (inter-company transfer)	-	-	-	-	-	-	-	-
Alt-A	1,349	216,561	-	-	-	-	1,349	216,561
A00	204	42,669	203	42,563	-	-	1	105
Option ARM	23,271	5,242,794	-	-	17,430	3,996,522	5,841	1,246,273
Non Owner Occupied	3,561	507,368	2,098	296,629	388	61,347	1,075	149,392
Interest Only ARM's	4,848	1,168,059	2,343	565,470	2,485	599,078	20	3,506
Hybrid ARM's	3,318	707,453	1,055	228,143	2,261	479,025	2	286
15 yr FRM	11,455	1,464,864	2,814	377,229	8,182	1,042,078	459	45,557
20-30 Yr FRM	60,371	11,010,483	20,232	3,646,193	38,357	7,089,351	1,782	274,939
Total Delivery	154,477	41,053,681	26,745	5,156,232	69,105	13,268,288	56,627	22,629,161

*The filter is applied from top to bottom. Loans appear only once, even if they have more than 1 characteristic - e.g. Non Owner Occupied 15 yr FRM loans will be in Non Owner Occupied but not in 15 yr FRM.

FNMA Delivery Goals	Total Eligible		FNMA Goals 26%		Actual to FNMA		Goal Met?
	Count	Amount (000)	Count	Amount (000)	Count	Amount (000)	
FNMA Designated Mortgages (1)	19,621	3,340,376	4,905	835,094	6,212	1,170,847	Yes
Community Access (2)	743	131,140	186	32,785	418	76,166	Yes
FNMA Emerging Market Originations (3)	631	128,907	158	32,227	252	52,311	Yes
CRA Deliveries part of Designated Mortgages	15,694	2,550,807	N/A	N/A	4,283	744,845	N/A

(1) FNMA Designated:Limited to Interest Only Hybrid ARM's, Amortizing Hybrid ARM's, and 15 Year Fixed Rate
(2) Community Access loans do not include loans originated by Emerging Markets. All Community Access loans are 30 year fixed rate and are
(3) FNMA Net Emerging Market Originations are all loans originated by EM branches including Community Access loans and other 30 year fixed, i.e. the Actual to FNMA numbers may include loans not in FNMA Designated population.

FHLMC Delivery Goals	Total Eligible		FHLMC Goals 66%		Actual to FHLMC		Goal Met?	Variance
	Count	Amount (000)	Count	Amount (000)	Count	Amount (000)		
FHLMC Flow Mortgages (4)	79,282	14,248,833	51,533	9,261,741	51,285	9,209,532	No	(52,210)
Community Access (5)	743	131,140	N/A	N/A	321	54,349	N/A	
FHLMC Emerging Market Originations (6)	627	128,127	N/A	N/A	335	69,290	N/A	
CRA Deliveries part of Flow Mortgages	64,216	11,250,807	41,740	7,313,025	42,090	7,422,025	Yes	

(4) FHLMC Flow: All GSE eligible loans except Fannie Mae EAII and EAIII program
(5) Community Access loans are part of the FHLMC Flow population.
(6) FHLMC Net Emerging Market Originations are all loans originated by EM branches including Community Access loans less EA II & III. This population is part of the FHLMC Flow population.

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Ensure Full Value – Contract Provisions

•Freddie Mac/Fannie Mae Strategic Relationships – Follow-up

•ITEM	•COUNTERPARTY	•BUSINESS OWNER	•LEGAL DEPT. •REPRESENTATIVE	•
•Origination/Underwriting				
•Transition to use of Freddie Mac's web-based •system for selling mortgages to Freddie Mac	•Freddie Mae	•Amy Saxe, Cap Mkts	•Michaela Albon and or designee	• ◯
•Freddie Mac to consider waivers to Guide to •accommodate WaMu's corporate relocation •programs	•Freddie Mae	•Ron Flynn, Cap Mkts •Kelly Dommel, Credit •Policy	•Michaela Albon and or designee	• ◯
•ork on implem•entation of EDB•HL•	•Freddie Mac/Fannie •Mae	•Bob Shaw, Credit •Analytics	•Michaela Albon and or designee •	• ◯
•Review of WaMu's appraiser-assisted •automated valuation methods and •consideration of waivers to Guide to •accommodate	•Freddie Mae	•Michelle White •Appraisal •Ron Flynn, Cap Mkts	•Michaela Albon and or designee	• ◯
•Develop best practices support for Loan •Prospector	•Freddie Mae	•Wayne Pollack, Mtg •Ops •	•Michaela Albon and or designee	• ◯
•Develop system to provide credit scores on •streamline refinance mortgages by October 1, •2005	•Freddie Mae	•Ron Flynn, Cap •Markets	•Michaela Albon and or designee •	• ◯
•Finalize waiver re cooperative apartments	•Freddie Mae	•Ron Flynn, Cap •Markets	•Michaela Albon and or designee •	• ◯
•Servicing				
•Agree on milestones and timeframe for WaMu •to achieve waiver • of up to $1.5MM servicing •penalties•	•Freddie Mae	•Marc Helm, Servicing	•Don Cook and or designee	• ◯
•WaMu to attain Tier I/Tier 1 status as servicer	•Freddie Mae	•Marc Helm, Servicing	•Don Cook and or designee •	• ◯
•Review of WaMu's default management •protocols to ali•gn with Guide	•Freddie Mae	•Marc Helm, •Servicing	•Don Cook and or designee	•
•Develop more flexible approach to •assumptions and modifications	•Freddie Mae	•Marc Helm,• •Servicing •	•Don Cook and or designee	•
•Facilitate use of "Early Indicator" on •mortgages underwrit •ten on systems other than •Loan Prospector •	•Freddie Mae	•Marc Helm, •Servicing	•Don Cook and or designee	•

Ensure Full Value - Contract Provisions – cont.

ITEM	COUNTERPARTY	BUSINESS OWNER	LEGAL DEPT. REPRESENTATIVE	
Affordable Housing Initiatives				
Agree on time frame for payment of $1MM to support Johnson Development Corporation Initiatives	Freddie Mac	Susan Jackson, Mtg Production Peter Struck, Cap Mkts	Michaela Albon and or designee	
Develop initiatives in signature markets to improve WaMu's CRA compliance	Freddie Mac	Susan James, Comm Performance	Michaela Albon and or designee	
Determine timing of disbursement of and uses for $500,000 in discretionary funding for purposes of improving homeownership opportunities for new immigrants, minorities and other underserved segments	Freddie Mac	Susan James, Comm Performance	Michaela Albon and or designee	
Implement training on the features and benefits of Home Possible Mortgage suite of mortgage products	Freddie Mac	Krysti Kovarik, Product Dev	Michaela Albon and or designee	
Implement E-Bus pilot program	Freddie Mac	Susan James, Comm Performance	Michaela Albon and or designee	
Implement Hispanic Outreach and Education Initiative Pilot	Freddie Mac	Susan James, Comm Performance	Michaela Albon and or designee	
Freddie Mac to waivers to Guide necessary to accommodate Solid Start program	Freddie Mac	Susan James, Comm Performance	Michaela Albon and or designee	
Explore additional support from Fannie Mae for WaMu's affordable lending initiatives (may include Home Counselor Online and Expanded Approval rollout support)	Fannie Mae	Susan James, Comm Performance	Michaela Albon and or designee	
Custodial				
Align more closely Freddie Mac's custodial requirements with WaMu's custodial procedures	Freddie Mac	Ron Amador, Servicing	Don Cook and or designee	
Other				
Work to reduce WaMu's costs of loan origination and servicing	Fannie Mae	Wayne Pollack, Mtg Operations John Berens, Servicing	Don Cook and or designee	

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Monitor the Overall Health - Credit Performance

- ***The objective will be to ensure WaMu's credit quality exhibits characteristics and performance in line with expectations***
  - As of July '05, the FN servicing portfolio's gross delinquency ratio (2.70%) is below the national average (2.79%)
  - The EATPR portfolio delinquency of 21% (1.5% of total) well exceeds the national average (15.5%) – the majority of this portfolio reflects NAMC/Dime and Homeside, and the seasoning effect
  - FH Servicer Performance (Q2) Performing and Non-Performing Loans: Tier I; "Full Tier I status" requires two consecutive quarters

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Monitor the Overall Health – Prepayment Performance

- ***The objective will be to ensure the securities that WaMu issues do not exhibit characteristics and performance that may harm the value of those securities***

- As of August '05, 1-mo CPRs – WaMu vs. Market

		CF June '05
➢ FN 4.5% '03	12.8 vs. 14.0	
➢ FN 5.0% '03	16.9 vs. 19.1	14.9 vs. 17.3
➢ FN 5.0% '04	13.5 vs. 15.0	
➢ FN 5.5% '05	12.0 vs. 12.5	
➢ GN 5.0% '05	10.0 vs. 8.2	
➢ GN 5.5% '05	13.4 vs. 11.8	
➢ GN 5.5% '04	26.5 vs. 27.8	
➢ FH 4.5% '03	13.2 vs. 12.3	
➢ FH 5.0% '05	5.5 vs. 5.8	4.2 vs. 4.9
➢ FH 5.5% '05	13.0 vs. 12.4	8.6 vs. 10.5

- One pool highlighted for further investigation:

	1 mo CPR	"Z-Score"	UPB	Coupon	Issue Date
FH#A30464	72%	4.21	$10.3 mm	5.50%	12/04

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Highlight Risks & Opportunities

Opportunities

- Both FN and FH have specific HUD goals and need these types of loans
  - Potential portfolio transactions with FN
- Freddie Mac will begin loan level information disclosure for securities beginning Q4; market will discriminate value based on better information
- Fannie Mae Option ARM Custom DU project: use to date – 450 submissions, 72% approved; <20% of Correspondent Sellers have submitted. Original volume lift was anticipated to be $2.5 B
- New initiative to use Custom DU for Alt-A to meet volume goals - $2.6 B in 2006
- Can leverage FH/FN standard affordable products to minimize Community Access recourse
- $5 B portfolio deal with FH in Nov with wider credit profile

Risks

- Hurricanes Katrina and Rita: GSE servicing forebearance as well as loan purchase relief
  - However, if cannot rep/warrant property value, condition, three year recourse applies and cash sale only
- Freddie Mac will begin loan level information disclosure for securities beginning Q4; street will quickly identify inaccurate information (DTI, FICO, etc.)
- Increasing use of Custom DU solidifies technology reliance on Fannie Mae. Freddie Mac is slower to customize LP.

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Other Highlights

- Received Multi-family insurance servicing waiver from Freddie Mac
- Implemented FN/FH market share management reporting
- Ability to provide more accurate delivery data by year end
  - Very important given FH new loan level disclosure requirements in Q4
- FNMA excess servicing securitization transaction
- Long Beach looking at SMF securitization with FH to assist in housing goals
- Freddie Mac preparing for Option ARM on-site Servicing audit

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Upcoming Events and Issues

2006 Contract Negotiations	WaMu has engaged FH and FN to prepare initial term sheets. Key deal points include Option ARM's, excess servicing and base G-fees
GSE Regulatory Reform	Both House $ Senate Committees have voted it out of committee. Floor votes are awaiting resolutions of portfolio limits and affordable housing funding vehicles
October 6 Affordable Meeting (Chicago)	Tony, Taj & Reza to discuss affordable & emerging markets strategies with FH officials
Multi-family	On track to securitize $800mm with FN in October. Also negotiating ability to originate 2nd liens behind the first mortgages. Anticipate additional $400mm in Q4, likely FN but also discussing with FH for flow program. FH securitization may occur in early 2006

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Excess Liquidity Forecast – 'Break the Bank'

Permanent Subcommittee on Investigations
EXHIBIT #92

- Total excess liquidity was $47BN at the end of June 2008 which is consumed by the end of October as a result of significant deposit runoff and loss of wholesale funding sources

WaMu Consolidated Sources and Uses of Cash	Quarterly Change in Balances Q3 2008	Q4 2008	Q1 2009	Q2 2009	Sum of Changes	Ending Balances Actual June 08	Estimated Q3 2008	Estimated Q4 2008	Estimated Q1 2009	Estimated Q2 2009
Scenario: Break the Bank										
Ending Cash	$ (4,935)	$ (1,360)	$ (686)	$ 1,125	$ (5,856)	$ 5,781	$ 846	$ (514)	$ (1,200)	$ (75)
Balance Sheet Changes										
Net Assets Change	$ (7,910)	$ (4,138)	$ (4,343)	$ (5,435)	$ (21,826)	$ 309,731	$ 301,821	$ 297,683	$ 293,340	$ 287,905
Net Retail Deposits Change	$ (23,425)	$ 940	$ 947	$ 954	$ (20,584)	$ 148,425	$ 125,000	$ 125,940	$ 126,887	$ 127,841
Net Other Deposits Change	$ (5,278)	$ (252)	$ 1,788	$ 824	$ (2,918)	$ 10,624	$ 5,346	$ 5,094	$ 6,882	$ 7,706
Wholesale Funding Change	$ 18,408	$ (5,319)	$ (7,120)	$ (6,191)	$ (222)	$ 111,982	$ 130,390	$ 125,072	$ 117,952	$ 111,761
Planned Wholesale Funding	$ 14,008	$ (8,019)	$ (8,220)	$ (6,191)	$ (8,422)					
FHLB Advance	$ 27,081	$ (1,287)	$ (3,751)	$ (3,262)	$ 18,781	$ 58,363	$ 85,444	$ 84,157	$ 80,406	$ 77,144
Repo	$ (102)	$ -	$ -	$ -	$ (102)	$ 102	$ -	$ -	$ -	$ -
Covered Bonds	$ -	$ -	$ -	$ -	$ -	$ 7,739	$ 7,739	$ 7,739	$ 7,739	$ 7,739
Card Securitization	$ (4,400)	$ (2,700)	$ (1,100)	$ -	$ (8,200)	$ 15,385	$ 10,985	$ 8,285	$ 7,185	$ 7,185
Fed Funds	$ (75)	$ -	$ -	$ -	$ (75)	$ 75	$ -	$ -	$ -	$ -
Eurodollars	$ (100)	$ -	$ -	$ -	$ (100)	$ 100	$ -	$ -	$ -	$ -
Institutional CDs	$ -	$ -	$ -	$ -	$ -	0	$ -	$ -	$ -	$ -
Brokered Retail CDs	$ (6,257)	$ (4,032)	$ (2,413)	$ (1,979)	$ (14,681)	$ 19,248	$ 12,991	$ 8,959	$ 6,546	$ 4,567
Term Debt	$ (1,139)	$ -	$ (955)	$ (951)	$ (3,045)	$ 21,830	$ 20,691	$ 20,691	$ 19,736	$ 18,785
Other Funding*	$ (1,000)	$ -	$ -	$ -	$ (1,000)	$ 8,439	$ 7,439	$ 7,439	$ 7,439	$ 7,439
Excess Borrowing Capacity	$ (33,561)	$ 0	$ (0)	$ (0)	$ (33,561)	$ 34,561	$ 1,000	$ 1,000	$ 1,000	$ 1,000
FHLB Advance	$ (26,511)	$ 0	$ (0)	$ (0)	$ (26,511)	$ 27,511	$ 1,000	$ 1,000	$ 1,000	$ 1,000
Repo	$ (4,050)	$ -	$ -	$ -	$ (4,050)	$ 4,050	$ -	$ -	$ -	$ -
Fed Funds	$ (3,000)	$ -	$ -	$ -	$ (3,000)	$ 3,000	$ -	$ -	$ -	$ -
Derivative/Margin Collateral	$ (1,500)	$ -	$ -	$ -	$ (1,500)	$ -	$ (1,500)	$ (1,500)	$ (1,500)	$ (1,500)
Total Excess Liquidity	$ (39,996)	$ (1,360)	$ (686)	$ 1,125	$ (40,917)	$ 40,342	$ 346	$ (1,014)	$ (1,700)	$ (575)
Discount Window	$ (7,000)	$ -	$ -	$ -	$ (7,000)	$ 7,000	$ -	$ -	$ -	$ -
Total Excess Liquidity with Disc. Window	$ (46,996)	$ (1,360)	$ (686)	$ 1,125	$ (47,91[illegible])	$ 47,342	$ 346	$ (1,014)	$ (1,700)	$ (575)

November

* Other Funding includes public funds, Term Auction Facility borrowing, structured finance borrowings, REIT preferred and other preferred stock