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Banking Regulator Played Advocate Over E

Agency Let Lenders Grow

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When Countrywide Financ agencies charged with ove giant mortgage lender sim the spring of 2007.

The benefits were clear: C the Office of Thrift Supervision, promised more flexible oversight of issues related to the bank's mortgage lending. For OTS, which depends on fees paid by banks it regulates and competes with other regulators to land the largest financial firms, Countrywide was a lucrative catch.

But OTS was not an effective regulator. This year, the government has seized three of the largest institutions regulated by OTS, including IndyMac Bancorp, Washington Mutual -- the largest bank in U.S. history to go bust -- and on Friday evening, Downey Savings and Loan Association. The total assets of the OTS thrifts to fail this year: $355.7 billion. Three others were forced to sell to avoid failure, including Countrywide.

In the parade of regulators that missed signals or made decisions they came to regret on the road to the current financial crisis, the Office of Thrift Supervision stands out.

OTS is responsible for regulating thrifts, also known as savings and loans, which focus on mortgage lending. As the banks under OTS supervision expanded high-risk lending, the agency failed to rein in their destructive excesses despite clear evidence of mounting problems, according to banking officials and a review of financial documents.

Instead, OTS adopted an aggressively deregulatory stance toward the mortgage lenders it regulated. It allowed the reserves the banks held as a buffer against losses to dwindle to a historic low. When the housing market turned downward, the thrifts were left vulnerable. As borrowers defaulted on loans, the companies were unable to replace the money they had expected to collect.

The decline and fall of these thrifts further rattled a shaky economy, making it harder and more expensive for people to get mortgages and disrupting businesses that relied on the banks for loans. Although federal insurance covered the deposits, investors lost money, employees lost jobs and the public lost faith in financial institutions.

As Congress and the incoming Obama administration prepare to revamp federal financial oversight, the collapse of the thrift industry offers a lesson in how regulation can fail. It happened over several years, a product of the regulator's overly close identification with its banks, which it referred to as "customers," and of the agency managers' appetite for deregulation, new lending products and expanded homeownership sometimes at the expense of traditional oversight. Tough measures, like tighter lending standards, were not employed until after borrowers began defaulting in large numbers.

The agency championed the thrift industry's growth during the housing boom and called programs that extended mortgages to previously unqualified borrowers as "innovations." In 2004, the year that risky loans called option adjustable-rate mortgages took off, then-OTS director James Gilleran lauded the banks for their role in providing home loans. "Our goal is to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion," he said in a speech.

At the same time, the agency allowed the banks to project minimal losses and, as a result, reduce the share of revenue they were setting aside to cover them. By September 2006, when the housing market began declining, the capital reserves held by OTS-regulated firms had declined to their lowest level in two decades, less than a third of their historical average, according to financial records.

Scott M. Polakoff, the agency's senior deputy director, said OTS had closely monitored allowances for loan losses and considered them sufficient, but added that the actual losses exceeded what reasonably could have been expected.

"Are banks going to fail when events occur well beyond the confines of reasonable expectation or modeling? The answer is yes," he said in an interview.

But critics said the agency had neglected its obligation to police the thrift industry and instead became more of a consultant.

"What you had here is a regulatory motif that was too accommodating to private-sector interests," said Jim Leach, a former Republican lawmaker who led what was then the House Banking Committee and now lectures in public affairs at Princeton University. "In this case, the end result is chaos for the industry, their customers and the national interest."

Warning Signs Ignored

On a hot Friday afternoon in June 2001, federal regulators swept into the suburban Chicago offices of Superior Bank and told stunned employees that it had been closed by OTS.

Superior was the largest thrift to fail since the savings and loans crisis in the early 1990s. Its demise foreshadowed the current upheaval. The company had made billions of dollars in mortgage loans to customers with credit problems but boosted profits instead of setting aside enough revenue to cover the eventual losses.

OTS regulators had not questioned the company's assurances about the quality of its loans. They had not required Superior to set aside more money. Even after the problems were identified, several federal investigators concluded that regulators had continued to rely on the company's promises rather than forcing it to take action.

"The whole Superior episode should have served as a warning," Ellen Seidman, then-director of OTS, said in a recent interview. Seidman acknowledged that she should have acted faster and more forcefully to address Superior's problems. Seidman, a Democrat, left her post shortly after the Bush administration began and had little role in revising the agency's approach.

Although the failure and disappearance of Superior triggered minor reforms, OTS did not learn the broader lesson. Thrifts were expanding into high-risk mortgage lending, but OTS was not requiring stronger safeguards.

John Reich, who has been OTS director since 2005, and Polakoff, his deputy, were well positioned to have learned the lesson. At the time of Superior's difficulties, Reich was one of the leaders of the Federal Deposit Insurance Corp. and Polakoff ran FDIC's Chicago office. Indeed, Polakoff's office recognized Superior's problems before OTS and pushed for increased scrutiny of Superior's bookkeeping.

In testimony before Congress in the fall of 2001, Reich listed what he considered the lessons of Superior's failure. Among them, he said, "we must see to it that institutions engaging in risky lending . . . hold sufficient capital to protect against sudden insolvency."

But instead of increasing oversight, OTS shrank dramatically over the next four years.

Reducing Regulation

In the summer of 2003, leaders of the four federal agencies that oversee the banking industry gathered to highlight the Bush administration's commitment to reducing regulation. They posed for photographers behind a stack of papers wrapped in red tape. The others held garden shears. Gilleran, who succeeded Seidman as OTS director in late 2001, hefted a chain saw.

Gilleran was an impassioned advocate of deregulation. He cut a quarter of the agency's 1,200 employees between 2001 and 2004, even though the value of loans and other assets of the firms regulated by OTS increased by half over the same period. The result was a mismatch between a short-handed agency and a burgeoning thrift industry.

He also reduced consumer protections. The other agencies that regulate banks review corporate health and compliance with consumer laws separately, which consumer advocates say helps ensure that each gets proper scrutiny from specialists. Gilleran merged the consumer exam into the financial exam.

Gilleran did not respond to multiple requests to be interviewed for this article. But at the time he headed the agency, he defended the consolidation of the exams, saying thrifts would be required to conduct "self-evaluations of their compliance with consumer laws."

Then-Rep. John J. LaFalce (D-N.Y.), who at the time was the ranking Democrat on the House Financial Services Committee, wrote in a letter to Gilleran that this was "a complete abrogation of the mandate your agency has been given by Congress."

The consumer exam had in part monitored whether thrifts were complying with the law by providing quality loans in lower-income communities. During Gilleran's four-year tenure, OTS cited only one institution for failing to meet that obligation, compared with 12 citations in the previous four years.

John Taylor, chief executive of the National Community Reinvestment Coalition, and other advocates say better enforcement of consumer protections, such as rules against predatory lending, could have kept thrifts healthy because consumer complaints are an early warning of unsustainable business practices.

A Surge in High-Risk Loans

For thrifts regulated by OTS, the option ARM was the rocket fuel of the mortgage boom, the product most responsible for driving profits to record heights and for burning lenders badly on the way back down. Yet even after other bank regulators urged higher lending standards for these mortgages, OTS was reluctant to insist on it.

Simeon Ferguson, an 85-year-old Brooklyn resident with dementia, according to his attorney, signed up in February 2006 for an option ARM. The monthly cost was $2,400, but the terms of the loan from IndyMac Bancorp, a major thrift based in Pasadena, Calif., allowed Ferguson to pay less than that each month, the way people can with a credit card.

Many of the loans made by IndyMac and other thrifts were extended to borrowers without ensuring they could afford their full monthly payments. Ferguson, who lived on a fixed monthly income of $1,100, was one such borrower, according to a pending lawsuit filed on his behalf in federal court. The suit alleges that IndyMac never checked on his income or assets.

In 2006, at the peak of the boom, lenders made $255 billion in option ARMs, according to Inside Mortgage Finance, a trade publication. Most option ARMs were originated by OTS-regulated banks.

Concerns about the product were first raised in late 2005 by another federal regulator, the Office of the Comptroller of the Currency. The agency pushed other regulators to issue a joint proposal that lenders should make sure borrowers could afford their full monthly payments. "Too many consumers have been attracted to products by the seductive prospect of low minimum payments that delay the day of reckoning," Comptroller of the Currency John C. Dugan said in a speech advocating the proposal.

OTS was hesitant to sign on, though it eventually did. Reich, the new director of OTS, warned against excessive intervention. He cautioned that the government should not interfere with lending by thrifts "who have demonstrated that they have the know-how to manage these products through all kinds of economic cycles." Reich, through a spokesman, declined to be interviewed for this article.

The lending industry seconded Reich's concerns at the time, arguing that the government was needlessly depriving families of a chance at homeownership. IndyMac argued in a letter to regulators that in evaluating loan applications it was not fair to rule out the possibility that a prospective borrower's income might increase. "Lenders risk denying home ownership to qualified borrowers," chief risk officer Ruthann Melbourne wrote.

The proposal languished until September 2006, when it was swiftly finalized after a congressional committee began making inquiries.

The long delay in issuing the guidance allowed companies to keep making billions of dollars in loans without verifying that borrowers could afford them. One of the largest banks, Countrywide Financial, said in an investor presentation after the guidance was released that most of the borrowers who received loans in the previous two years would not have qualified under the new standards. Countrywide said it would have refused 89 percent of its 2006 borrowers and 83 percent of its 2005 borrowers. That represents $138 billion in mortgage loans the company would not have made if regulators had acted sooner.

Risks Ran Rampant

Even after the guidance was issued, some banks interpreted it as permission to maintain old habits because the regulatory agencies had stopped short of issuing a binding rule.

Washington Mutual, for instance, said in a December 2006 securities filing that it was continuing to qualify borrowers based on their ability to afford a teaser interest rate. In August 2007, the bank was still qualifying borrowers at a 2 percent teaser rate instead of the full rate of 5 percent or higher they would eventually face, according to a shareholders' lawsuit filed by Bernstein Litowitz Berger & Grossmann.

As early as 2003, the company set up credit risk teams at more than a dozen offices around the country to assess the growing flood of applications for option ARM loans. The basic job was to "make exceptions" to the bank's standards so loans could be approved, said Dorothea Larkin, a former Washington Mutual credit risk manager and a witness in the Bernstein Litowitz suit.

"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 in an interview.

It was clear to some Washington Mutual employees that the company was making loans that borrowers could not afford and that the bank could suffer as a result. In 2005, a small group of senior risk managers drew up a plan that would have required loan officers to document that borrowers could afford the full monthly payment on option ARM loans.

The plan was shared with OTS examiners, according to a former bank official who spoke on condition of anonymity because the bank's practices are the focus of a federal investigation as well as several lawsuits.

"We laid it out to the regulators. They bought into it. They supported it," the former official said. But when a new executive team at the bank nixed the plan, the former official said, "the OTS never said anything."

In addition to taking more risks, Washington Mutual was setting aside a smaller share of revenue to cover future losses. The reserves had steadily declined relative to new loans since 2002. By June 2005, the bank held $45 to cover losses on every $10,000 in outstanding loans, according to financial records filed with federal regulators. Average reserves at OTS-regulated institutions had declined by about a third since June 2002, but Washington Mutual's reserves had fallen even further. They were 25 percent lower than the average for OTS-regulated thrifts.

OTS did not force the company to address the problem with reserves, though agency examiners worked full-time inside Washington Mutual's Seattle headquarters.

Polakoff said OTS closely monitored the company's allowance for loan losses and considered it sufficient. "They had good models in place calculating expected losses on the loan portfolio," he said.

But the agency did not fix a basic problem with how Washington Mutual predicted future losses. According to a confidential internal review in September 2005, the company had not adjusted its prediction of future losses to reflect the larger risks associated with option ARM loans. The review described those loans as "a major and growing risk factor in our portfolio." As a result, the company was not setting aside enough money to cover future losses.

Management responded in November to the internal review with a memo promising to update its risk assessment by June 30, 2006. During the nine months before the risk model was revised, Washington Mutual issued about $32 billion in new option ARM loans. OTS officials said in an interview that they were unfamiliar with the company's internal correspondence but would consider nine months an unacceptable delay.

"Nine months to get that model into compliance?" said Dale George, a former WaMu risk manager and a witness in a lawsuit. "I found that astounding."

Known for Being 'Lenient'

Countrywide Financial's decision to reconstitute itself as a thrift and come under the OTS umbrella was a victory for Darryl W. Dochow, the OTS official in charge of new charters in the Western region, home to Washington Mutual, IndyMac and other large thrifts.

In the late 1980s, Dochow had been the chief career supervisor of the savings-and-loan industry, and federal investigators later concluded he played a key role in the collapse of Charles Keating's Lincoln Savings and Loan by delaying and impeding proper oversight of that thrift's operations.

Dochow was shunted aside in the aftermath and sent to the agency's Seattle office. Several of his former colleagues and superiors say he eventually reestablished himself as a credible regulator and again rose in the organization. Dochow did not return a phone call requesting an interview, and OTS said he declined to give one.

As early as 2005, Angelo R. Mozilo, then the chief executive of Countrywide, approached OTS about moving out from under the supervision of the Office of the Comptroller of the Currency, which regulates national commercial banks. In 2006, Dochow and his OTS colleagues met with Countrywide at its headquarters in Calabasas, Calif., in a room decorated with color photos of the company's float entries in the annual Tournament of Roses parade. One depicted a big bad wolf, with arms outstretched, huffing and puffing on a brick house.

Senior executives at Countrywide who participated in the meetings said OTS pitched itself as a more natural, less antagonistic regulator than OCC and that Mozilo preferred that. Government officials outside OTS who were familiar with the negotiations provided a similar description.

"The general attitude was they were going to be more lenient," one Countrywide executive said. For example, he said other regulators, specifically OCC and the Federal Reserve, were very demanding that large banks not allow loan officers to participate in the selection of property appraisers. "But the OTS sold themselves on having a more liberal interpretation of it," the executive said.

Winning Countrywide was important for OTS, which is funded by assessments on the roughly 750 banks it regulates, with the largest firms paying much of the freight. Washington Mutual paid 13 percent of the agency's budget in the fiscal year ended Sept. 30, according to OTS figures. Countrywide provided 5 percent. Individual firms tend to make a larger difference to OTS finances than other bank regulators because the agency oversees fewer companies with fewer assets.

Polakoff said in an interview that the main reason Countrywide sought a new charter was that OTS was a better fit because it regulated banks that focus on mortgage lending. He said he challenged Mozilo: "If you're looking for a weak regulator, and if you're calling us because you think we're a weak regulator, stop now. We will walk away."

Polakoff said Mozilo told him, "That is absolutely not the reason we're even talking to you about a charter." Mozilo declined to be interviewed for this article.

But critics in government and industry said Countrywide's shift from OCC oversight to that of OTS was evidence of a "competition in laxity" among regulators eager to attract business. "Institutions should not be able to find a safe haven in one regulator from the reasonable concerns of another regulator," said Karen Shaw Petrou of Federal Financial Analytics, referring to the Countrywide episode.

In September 2007, six months after helping orchestrate the arrival of Countrywide under OTS, Dochow was promoted to head the agency's Western region.

He had arrived just in time for the second savings-and-loan crisis.

Staff researcher Robert Thomason contributed to this report.

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