THIRTY YEARS OF BANK FAILURES, BAILOUTS, AND REGULATORY BATTLES

INSIDE THE FDIC

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WILEY

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Cover image: Lock © iStock.com/tomasdipagi
Cover design: C. Wallace

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:
ISBN 9781118994085 (Paperback)
ISBN 9781118994122 (ePDF)
ISBN 9781118994108 (ePub)

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

For Erica—the love of my life

Acknowledgments

First and foremost I'd like to thank my wife, Erica, who reviewed every word many times over. Without her insights and support, this book would not have been possible.

I'd also like to give particular thanks to my former colleagues and friends, Art Murton, Maureen Sweeney, and Jim Wigand, each of whom reviewed the entire manuscript and provided me with critically important comments and suggestions.

Others important contributors include April Breslaw, Diane Ellis, and Gary Hindes. A great many other former colleagues and friends spent their personal time reviewing specific chapters, helping me remember events, and ensuring that I got my facts straight.

Thanks to Annie Moffett and Matt Rees for great editorial assistance, to Oliver Wyman, and in particular Steve Szaraz, for supporting my efforts, and to Tula Batanchiev and her staff at Wiley for their support in publishing this book.

I'd like to thank my cousin, Adrian Nicole LeBlanc, an exceptionally talented and accomplished writer, who helped guide me through the book publishing process.

I'd also like to thank my three sons, Adam, Eric, and Greg, who lent moral support throughout the process.

Any mistakes that remain are my own.

Introduction

We have heard little from the behind-the-scenes people who were on the front lines as the events of 2008 unfolded. Their actions can calm the storm and bring fair treatment to inherently unfair situations, or they can compound the problems. These often-maligned bureaucrats can either display courage, integrity, and fair play or contribute to an environment of fear, anger, and chaos.

This book doesn't focus on the arcane and mind-numbing details of capital, liquidity, and the other technical parts of a bank regulator's job. Instead, it puts human faces on the causes and effects of financial crises. These are personal stories of real people grappling with complicated issues while under enormous pressure, of individuals trying to ensure that they and others are treated fairly by our government, and of individuals misusing the system to serve their personal interests.

I spent 28 years as a bank regulator at the Federal Deposit Insurance Corporation (FDIC). During my career, I worked directly with ten FDIC chairmen and with many other senior government officials.

I was the highest-level FDIC career executive during the two biggest financial crises in the United States since the Great Depression. During the banking and S&L crisis of the 1980s and early 1990s, I assisted with the creation of the Resolution Trust Corporation (RTC) and personally had to explain to President George H. W. Bush that the FDIC's deposit insurance fund was running out of money. During the 2008 financial crisis, I helped develop the agency's policy and operational initiatives and served as chief executive officer at IndyMac Federal Savings Bank, the first large bank in over 20 years to be shut down and then reopened under government ownership.

Thus, I come to the topic with a perspective that's often absent from the financial-sector debates that play out on the airwaves and in the opinion pages. This book provides a different view of the FDIC and other bank regulators. Readers will see:

- How an agency that had become almost invisible would emerge as a major and highly independent force impacting U.S. financial markets.
- How 10 FDIC chairmen helped shape the FDIC and the U.S. financial regulatory system.
- How conflicts between the FDIC and other financial regulatory agencies unfolded amid the pressures and challenges associated with bank failures and financial crises.

I hope this book engages a different kind of discussion about the longer-term strategies needed to prevent repeating cycles of booms, busts, and bailouts. I also hope to encourage others to write about their experiences, so the historical perspective of long-term government employees can be added to policy debates in other regulatory arenas as well.

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Chapter 1

IndyMac

I flew into Burbank, California, Thursday evening, July 10, 2008; drove a rental car the short distance to Pasadena; and checked into the Hilton Pasadena on South Los Robles Avenue. Dozens of my colleagues from the Federal Deposit Insurance Corporation (FDIC) were also checking into hotels throughout the city. We used our personal credit cards rather than our government cards. Why? Because if anyone learned that the FDIC had descended on Pasadena, they might conclude (correctly) that a bank was about to be closed.

Bank closings are carefully planned events, and they are usually handled quietly, smoothly, and uneventfully. The bank's depositors hardly know that anything has happened. For the vast majority, their money is safely protected by the FDIC's deposit insurance system. A bank is typically closed on a Friday afternoon and reopened under new ownership the following Saturday or Monday morning. Customers generally see the same bank employees at the same branch offices; only the name of the bank has changed. This well-rehearsed pattern is designed to maintain public confidence in the U.S. financial system and to prevent banks' depositors from trying to withdraw all of their funds at the same time.

But IndyMac was no ordinary bank, and this would be no ordinary closing.

IndyMac was a poster child for how home mortgage lending had spiraled out of control during the preceding boom years. The bank had been launched in 1985 as a division of Countrywide, a California mortgage lender that encountered its own troubles in 2007. IndyMac became independent of Countrywide in 1997, and it gradually came to specialize in something called Alt-A mortgages, which were typically offered to borrowers whose credit profiles were better than subprime but not strong enough to qualify for prime loans. In the case of IndyMac, borrowers could obtain home mortgage loans without going through a formal credit review process—they simply stated to loan officers their income, asset, and debt levels. After the crash, these arrangements became known as "liar loans" or "ninja loans" (no income, no job, and no assets).

IndyMac did not keep most of the mortgages it originated. They were packaged together, sold, and used as collateral for mortgage-backed securities. This originate-to-sell model also was not unique to IndyMac. Many banks found that they could increase their profits by selling mortgage loans soon after they made them. The sales proceeds could then be used to make new loans, which could create a steady stream of income. As long as there was an appetite in the market for mortgage-backed securities, there would be a need to create new home mortgages. This would create additional pressure to further weaken lending standards in order to find new customers.

With housing prices rising throughout the United States, IndyMac found many willing borrowers. The bank's profits tripled from 2001 to 2006, according to the *New York Times*. During 2006 alone, IndyMac originated $90 billion in new mortgages, and racked up $342.9 million in profits. The bank had established 182 loan production offices around the country to help it find new customers, and at its peak it was the nation's 10th-largest mortgage lender.

To help finance its mortgage lending, IndyMac had raised $20 billion in deposits through the Internet, deposits placed at its 33 branches in Southern California, and from the brokered-deposit market. The bank offered higher interest rates than anyone else so it was easily able to attract rate-chasing deposits. The bank had also borrowed $10 billion in high-cost money from the Federal Home Loan Bank of San Francisco (FHLB-SF).

This toxic cocktail of high-cost funding, weak lending standards, and a constant churning of new loan originations left IndyMac highly vulnerable in the event of a downturn in the housing market. Predictably, problems for IndyMac started once housing prices began to fall in 2006 and 2007. Borrowers who never had the income or assets to support their mortgages began to understand how overextended they were and started defaulting on their monthly payments. As home values dropped below the amount owed on the mortgages, there were even some strategic defaulters who stopped making their mortgage payments even though they still could afford them. They simply didn't want to own a house that was worth less than their outstanding mortgage balance, known as "upside down" in the mortgage business.

IndyMac had not focused its lending activities on the subprime market. Most of its mortgage loans were made to middle- to high-income families, who were interested in the convenience, leverage, and favorable rates they could obtain from the bank. IndyMac's difficulties were a clear indication that the problems in the mortgage market had extended well beyond subprime loans.

IndyMac had also ramped up its lending to home builders, who were squeezed by the downturn in the housing market. At the end of the first quarter of 2008, IndyMac had $1.06 billion in loans outstanding to home builders—more than half of which had been categorized as "nonperforming." By the spring of 2008, IndyMac officials knew the bank was in serious trouble. It had lost nearly $615 million the year before, and the company's share price had fallen to $6. Conditions worsened in the first quarter, with IndyMac reporting $184 million in losses. The bank's chief executive, Michael Perry, acknowledged that it would not return to profitability "until the current decline in homes prices decelerates." Around this time, IndyMac was talking to private equity firms about acquiring the institution. When no buyers could be found, the bank started planning to shutter its mortgage lending business.

At the FDIC we had long been aware that IndyMac was dangerously exposed to the downturn in the real estate market. By the late spring, our concern was growing, so we set up a meeting with senior officials at the

Office of Thrift Supervision (OTS), the federal regulator responsible for supervising IndyMac. FDIC Chairman Sheila Bair and I, and two senior officials from the Federal Reserve, met with John Reich, who was the Director of OTS, and Scott Polakoff, a former FDIC regional director who was now serving as the OTS deputy. Polakoff suggested that the OTS could supervise a gradual reduction in the size of the bank until its problems were more manageable. My colleagues and I from the FDIC didn't think it was a good idea to leave the people who had created the problems at the bank in charge of a gradual wind-down of its operations. I told the group that IndyMac was going to be the most expensive bank failure since the FDIC was created in 1934.

The FDIC had dodged a bullet earlier, in January 2008, when Bank of America purchased Countrywide, a troubled bank like IndyMac, except that it was much larger. If Countrywide had failed, the public disruption could have been tremendous and the losses to the FDIC's deposit insurance fund enormous. Bank of America was less fortunate, incurring over $40 billion in losses associated with its purchase of Countrywide and its subprime mortgage loans.

After our meeting at OTS, we anticipated an August closing, which would have given us time to quietly market the bank to prospective buyers. But our already-tight timeline was altered by an unexpected development.

On June 26, Senator Charles Schumer (D-NY) sent a letter to banking regulators highlighting the weakened condition of the bank. The letter stated: "There are clear indications that IndyMac ... could face a failure if prescriptive measures are not taken quickly." While the letter didn't say anything we didn't already know, Senator Schumer took the unorthodox step of publicly disclosing his concerns to the *Wall Street Journal,* which published an article about the IndyMac letter the following day. One day after that, on June 28, the *Pasadena Star-News,* which served many of the communities in which IndyMac operated, published an article with the headline "IndyMac Appears Close to Collapse."

Panic quickly set in. Customer withdrawals quickly reached $100 million per day, and there were extremely long lines of bank customers waiting to get their money—a scenario rarely seen since the bank failures of the Great Depression.

IndyMac's customers withdrew $1.3 billion in the 11 days following release of the Schumer letter, according to OTS. John Reich, the OTS head, said that Schumer's letter gave the bank a "heart attack" and "undermined the public confidence essential for a financial institution." Indeed, an OTS press release said that "the immediate cause of the closing was a deposit run that began and continued after the public release of a June 26 letter to OTS and the FDIC from Senator Charles Schumer of New York."[1]

Because of the accelerated timeline, there was no time to carefully prepare for the bank's closing. Within days of Senator Schumer's letter being released, IndyMac was on the verge of running out of money. The week after the Schumer letter, the bank announced plans to reduce its workforce from 7,200 to 3,400, and to close its wholesale and retail new loan divisions. But that didn't stop the hemorrhaging. The bank's stock price, which had been $50 in 2006, fell to just 28 cents on July 11.

We knew IndyMac had to be closed immediately. Without a ready buyer there were only two choices: we could shut the bank down completely or we could take it over and run it ourselves. Both options were (in the polite terminology of economists) suboptimal.

IndyMac was the seventh-largest savings and loan in the country, with over $32 billion in assets. More importantly, it also managed a $184 billion mortgage-servicing operation. Closing the bank could mean disrupting service on all of the bank's mortgages. Customers might not be able to make their monthly payments or pay off their mortgages. Payments wouldn't be sent to the investors who had purchased securities backed by those mortgages. There would be great uncertainty and disruption in the market. The value of those loans would quickly dissipate, and the losses to the FDIC's deposit insurance fund would grow significantly.

There was only one real choice. IndyMac would have to be placed into a conservatorship, which meant closing the bank, then reopening it as a new bank under the ownership and control of the FDIC, until

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[1] The Treasury Department's inspector general later reviewed the circumstances surrounding the closing of IndyMac. It confirmed that while the deposit run was a contributing factor in the timing of the closing, the underlying cause of the failure was the unsafe and unsound manner in which the bank operated. Indeed, the public disclosure of the letter did not cause IndyMac's problems. The bank was deeply insolvent and was going to be closed.

it could be sold back into the private sector. IndyMac would, in other words, have to be nationalized.

I reflected on these developments the evening I arrived in Pasadena. IndyMac would be closed the following afternoon, on Friday, July 11, 2008. It would be the largest single bank the FDIC had ever closed. The following Monday morning it would be reopened as a new bank under FDIC ownership. I would be responsible for managing the newly constituted "bridge" bank.

Sheila Bair and I had discussed the possibility of my running the bank a few days earlier. While bankers with private-sector experience are typically recruited by the FDIC to manage failed banks, we didn't have enough time to find anyone. Moreover, we thought it would be beneficial to have someone running the bank who possessed an understanding of issues related to deposit insurance. There were thousands of uninsured depositors who would be angry when they found out that they were going to lose some of their money as a result of the closing; that anger could spill over into broader public concern about the safety of deposits at other banks; and there were important policy issues surrounding the creation and management of a government-owned bank.

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At 9 A.M. on Friday, July 11, about 60 FDIC employees and contractors gathered in a conference room at the Sheraton Pasadena on East Cordova Street, using a fictitious company name, to review our final preparations for the bank closing. As the financial crisis unfolded in the months ahead, most of the people in that room would move from one bank closing to another, staying in one place just long enough to ensure a successful transition of a closed bank to its new owners. In this case, some of the people in the room would remain behind to help me run the bank.

Rick Hoffman was a bank-closing veteran. He had closed hundreds of banks over the course of his career. He reminded the assembled group that this would be a traumatic event for the people who lived and worked in the local community. We had a job to do, but we had to be sensitive to what the bank's employees and their customers would be experiencing.

I told the group that we were at a critical point in time. The public had grown accustomed to a world where banks did not fail, particularly larger banks. This would be a wake-up call that the problems in the financial sector were getting worse. The world would be watching how we handled this situation. We knew the events of that day would be historic, but none of us could have predicted the extent of the financial crisis that would follow.

As I looked around the room, I saw many people whom I had worked with over the years. Most of them had been through the banking and savings-and-loan (S&L) crisis of the 1980s and early 1990s. I could see the confidence in their eyes. Closing banks is an unusual profession, with unique challenges, but they knew what they needed to do.

After the one-hour meeting, several of us drove over to the bank's headquarters on Walnut Street. From the outside it didn't seem as if there were anything special about the bank's six-story building. Everything seemed pretty quiet. We went down to the basement of the building next door, which the bank also leased. Bank examiners from the OTS were already combing through IndyMac records, and doing so in the least desirable space in the building, something examiners are accustomed to when they go on bank examinations. In a couple of hours, we would begin a weekend of nonstop activity, but for now we just grabbed a few chairs, sat, and waited.

Just before 2 P.M., we walked over to the main building and took the elevator to the sixth floor boardroom. IndyMac's senior managers had gathered there to meet with us. The bank's chief executive officer, Michael Perry, was seated at the head of the long board table that filled much of the room. His senior managers were on each side of him. The OTS examiners sat opposite us. Without much explanation they quickly told the assembled group that IndyMac was being closed and the FDIC was taking control. The bank's senior officials knew that this day was coming, but we still could see their stunned looks. It's one thing to know that something traumatic is going to happen; it's quite another when it actually does.

The OTS examiners turned the meeting over to us. We took a little more time and told the group that a new bank, IndyMac Federal Bank, would be established under the FDIC's ownership to continue the bank's operations until it could be sold. We explained how this would impact the bank's operations, what our immediate needs were, and what our plans were going forward. We let them know that most of them still had jobs and that we would need their help in contacting the bank's employees.

Following the one-hour meeting, Rick Hoffman and I walked down the hall with Michael Perry to his corner office. Wall-to-wall windows provided a spectacular view of the San Gabriel Mountains. The desk at one end of the room overlooked a large black conference table with six chairs around it at the other end. A large flat-screen TV covered most of the wall behind that table. Looking around, it was clear to see that Perry already had removed his belongings from the office.

We sat down at the conference table and confirmed to Perry that he would not have a job with the new bank. This was standard practice. We never retained the CEO of a failed bank. Perry understood and offered to provide us help and answer any questions. He asked if he could send one final e-mail to the bank's employees. He read the seven sentences to us. "I gave everything I had to keep IndyMac Bank safe and sound, and preserve as many jobs as possible." He asked that the employees "work as hard, smart, and courageously for the regulators as you did for me." It was a very emotional moment for the youthful-looking Perry (described as "baby faced" by the *Washington Post*), and he had difficultly reading his message to us.

We let Perry send his e-mail to the bank's employees and told him that he would need to speak with the FDIC's investigative staff before he left the building. Having the bank's senior officials speak with the FDIC's investigators also is a standard part of the bank-closing process. The investigation at IndyMac later would determine that there were more than adequate grounds to sue Perry and some of the other senior managers at IndyMac for damages due to their mismanagement. Perry eventually settled with the FDIC by paying $1 million from his own funds, agreeing to be banned from ever working again in the banking industry, and allowing the FDIC to pursue collections of up to $11 million from his liability insurance coverage.

IndyMac was officially closed at 5 P.M. Central Time. The closing set off a series of prearranged notifications and activity. The branch offices were contacted, as were other employees. A press release announcing the closing was sent out from the FDIC's Washington, D.C., office. That press release was sent to key senators and congressmen as well as every member of California's congressional delegation. The mayor of Pasadena