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Senate Investigations Subcommittee Releases Levin-Coburn Report On the Financial Crisis

WASHINGTON – Concluding a two-year bipartisan investigation, Senator Carl Levin, D-Mich., and Senator Tom Coburn M.D., R-Okla., Chairman and Ranking Republican on the Senate Permanent Subcommittee on Investigations, today released **a 635-page final report** (PDF, 6MB) on their inquiry into key causes of the financial crisis. The report catalogs conflicts of interest, heedless risk-taking and failures of federal oversight that helped push the country into the deepest recession since the Great Depression.

Links to the full report and the exhibits are available at the bottom of this page.

"Using emails, memos and other internal documents, this report tells the inside story of an economic assault that cost millions of Americans their jobs and homes, while wiping out investors, good businesses, and markets," said Levin. "High risk lending, regulatory failures, inflated credit ratings, and Wall Street firms engaging in massive conflicts of interest, contaminated the U.S. financial system with toxic mortgages and undermined public trust in U.S. markets. Using their own words in documents subpoenaed by the Subcommittee, the report discloses how financial firms deliberately took advantage of their clients and investors, how credit rating agencies assigned AAA ratings to high risk securities, and how regulators sat on their hands instead of reining in the unsafe and unsound practices all around them. Rampant conflicts of interest are the threads that run through every chapter of this sordid story."

"The free market has helped make America great, but it only functions when people deal with each other honestly and transparently. At the heart of the financial crisis were unresolved, and often undisclosed, conflicts of interest," said Dr. Coburn. "Blame for this mess lies everywhere from federal regulators who cast a blind eye, Wall Street bankers who let greed run wild, and members of Congress who failed to provide oversight."

The Levin-Coburn report expands on evidence gathered at four Subcommittee hearings in April 2010, examining four aspects of the crisis through detailed case studies: high-risk mortgage lending, using the case of Washington Mutual Bank, a $300 billion thrift that became the largest bank failure in U.S. history; regulatory inaction, focusing on the Office of Thrift Supervision's failed oversight of Washington Mutual; inflated credit ratings that misled investors, examining the actions of the nation's two largest credit rating agencies, Moody's and Standard & Poor's; and the role played by investment banks, focusing primarily on Goldman Sachs, creating and selling structured finance products that foisted billions of dollars of losses on investors, while the bank itself profited from betting against the mortgage market.

New Evidence. Today's report presents new facts, new findings and recommendations, with more than 700 new documents totaling over 5,800 pages. It recounts how Washington Mutual aggressively issued and sold high-risk mortgages to Wall Street, Fannie Mae, and Freddie Mac, even as its executives predicted a housing bubble that would burst, and offers new detail about how its regulator deferred to the bank's management. New documents show how Goldman used net short positions to benefit from the downturn in the mortgage market, and designed, marketed, and sold CDOs in ways that created conflicts of interest with the firm's clients and at times led to the bank's profiting from the same products that caused substantial losses for its clients. Other new information provides additional detail about how credit rating agencies rushed to rate new mortgage-backed securities and collect lucrative rating fees before issuing mass ratings downgrades that shocked the financial markets and triggered a collapse in the value of mortgage related securities. Over 120 new documents provide insights into how Deutsche Bank contributed to the mortgage mess.

"Our investigation found a financial snake pit rife with greed, conflicts of interest, and wrongdoing," said Levin. Among the report's highlights are the following.

- **High Risk Lending**. With an eye on short term profits, Washington Mutual launched a strategy of high-risk mortgage lending in early 2005, even as the bank's own top executives stated that the condition of the housing market "signifies a bubble" with risks that "will come back to haunt us." Executives forged ahead despite repeated warnings from inside and outside the bank that the risks were excessive, its lending standards and risk management systems were deficient, and many of its loans were tainted by fraud or prone to early default. WaMu's chief credit officer complained at one point that "[a]ny attempts to enforce [a] more disciplined underwriting approach were continuously thwarted by an aggressive, and often times abusive group of Sales employees within the organization." From 2003 to 2006, WaMu shifted its loan originations from low risk, fixed rate mortgages, which fell from 64% to 25% of its loan originations, to high risk loans, which jumped from 19% to 55% of its originations. WaMu and its subprime lender, Long Beach Mortgage, securitized hundreds of billions of dollars in high risk, poor quality, sometimes fraudulent mortgages, at times without full disclosure to investors, weakening U.S. financial markets. New analysis shows how WaMu sold some of its high risk loans to Fannie Mae and Freddie Mac, and played one off the other to make more money.
- **Regulatory Failures.** The Office of Thrift Supervision (OTS), Washington Mutual's primary regulator, repeatedly failed to correct WaMu's unsafe and unsound lending practices, despite logging nearly 500 serious deficiencies at the bank over five years, from 2003 to 2008. New information details the regulator's deference to bank management and how it used the bank's short term profits to excuse high risk

activities. Although WaMu recorded increasing problems from its high risk loans, including delinquencies that doubled year after year in its risky Option Adjustable Rate Mortgage (ARM) portfolio, OTS examiners failed to clamp down on WaMu's high risk lending. OTS did not even consider bringing an enforcement action against the bank until it began losing substantial sums in 2008. OTS also failed until 2008, to lower the bank's overall high rating or the rating awarded to WaMu's management, despite the bank's ongoing failure to correct serious deficiencies. When the Federal Deposit Insurance Corporation (FDIC) advocated taking tougher action, OTS officials not only refused, but impeded FDIC oversight of the bank. When the New York State Attorney General sued two appraisal firms for colluding with WaMu to inflate property values, OTS took nearly a year to conduct its own investigation and finally recommended taking action -- a week after the bank had failed. The OTS Director treated WaMu, which was its largest thrift and supplied 15% of the agency's budget, as a "constituent" and struck an apologetic tone when informing WaMu's CEO of its decision to take an enforcement action. When diligent oversight conflicted with OTS officials' desire to protect their "constituent" and the agency's own turf, they ignored their oversight responsibilities.

- **Inflated Credit Ratings.** The Report concludes that the most immediate cause of the financial crisis was the July 2007 mass ratings downgrades by Moody's and Standard & Poor's that exposed the risky nature of mortgage-related investments that, just months before, the same firms had deemed to be as safe as Treasury bills. The result was a collapse in the value of mortgage related securities that devastated investors. Internal emails show that credit rating agency personnel knew their ratings would not "hold" and delayed imposing tougher ratings criteria to "massage the ... numbers to preserve market share." Even after they finally adjusted their risk models to reflect the higher risk mortgages being issued, the firms often failed to apply the revised models to existing securities, and helped investment banks rush risky investments to market before tougher rating criteria took effect. They also continued to pull in lucrative fees of up to $135,000 to rate a mortgage backed security and up to $750,000 to rate a collateralized debt obligation (CDO) – fees that might have been lost if they angered issuers by providing lower ratings. The mass rating downgrades they finally initiated were not an effort to come clean, but were necessitated by skyrocketing mortgage delinquencies and securities plummeting in value. In the end, over 90% of the AAA ratings given to mortgage-backed securities in 2006 and 2007 were downgraded to junk status, including 75 out of 75 AAA-rated Long Beach securities issued in 2006. When sound credit ratings conflicted with collecting profitable fees, credit rating agencies chose the fees.
- **Investment Banks and Structured Finance.** Investment banks reviewed by the Subcommittee assembled and sold billions of dollars in mortgage-related investments that flooded financial markets with high-risk assets. They charged $1 to $8 million in fees to construct, underwrite, and market a mortgage-backed security, and $5 to $10 million per CDO. New documents detail how Deutsche Bank helped assembled a $1.1 billion CDO known as Gemstone 7, stood by as it was filled it with low-quality assets that its top CDO trader referred to as "crap" and "pigs,"

and rushed to sell it "before the market falls off a cliff." Deutsche Bank lost $4.5 billion when the mortgage market collapsed, but would have lost even more if it had not cut its losses by selling CDOs like Gemstone. When Goldman Sachs realized the mortgage market was in decline, it took actions to profit from that decline at the expense of its clients. New documents detail how, in 2007, Goldman's Structured Products Group twice amassed and profited from large net short positions in mortgage related securities. At the same time the firm was betting against the mortgage market as a whole, Goldman assembled and aggressively marketed to its clients poor quality CDOs that it actively bet against by taking large short positions in those transactions. New documents and information detail how Goldman recommended four CDOs, Hudson, Anderson, Timberwolf, and Abacus, to its clients without fully disclosing key information about those products, Goldman's own market views, or its adverse economic interests. For example, in Hudson, Goldman told investors that its interests were "aligned" with theirs when, in fact, Goldman held 100% of the short side of the CDO and had adverse interests to the investors, and described Hudson's assets were "sourced from the Street," when in fact, Goldman had selected and priced the assets without any third party involvement. New documents also reveal that, at one point in May 2007, Goldman Sachs unsuccessfully tried to execute a "short squeeze" in the mortgage market so that Goldman could scoop up short positions at artificially depressed prices and profit as the mortgage market declined.

Recommendations. The Report offers 19 recommendations to address the conflicts of interest and abuses exposed in the Report. The recommendations advocate, for example, strong implementation of the new restrictions on proprietary trading and conflicts of interest; and action by the SEC to rank credit rating agencies according to the accuracy of their ratings. Other recommendations seek to advance low risk mortgages, greater transparency in the marketplace, and more protective capital, liquidity, and loss reserves.

For the full report and relevant exhibits, use the links below:

- **REPORT - Wall Street & the Financial Crisis - Anatomy of a Financial Collapse**
- **FOOTNOTE EXHIBIT LOCATOR (by FN and Bates)**
- **FN 107 - 1342 (pgs 1-1037)**
- **FN 1343 - 1459 (pgs 1038-2164)**
- **FN 1462 - 1576 (pgs 2165-3003)**
- **FN 1584 - 1622 (pgs 3004-3448)**
- **FN 1623 - 2406 (pgs 3449-4484)**
- **FN 2409 - 2706 (pgs 4485-5459)**
- **FN 2724 - 2831 (pgs 5460-5901)**