GAO report examines Wachovia's near-failure

U.S. officials, worried about damage to economy, were set to aid sale to Citigroup.

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Government officials agreed to aid Wachovia Corp.'s sale to Citigroup Inc. in fall 2008 because they were worried about losses to foreign depositors, runs on mutual funds and damage to other banks and the economy, according to a report by a congressional watchdog.

At the peak of the financial crisis in September 2008, officials agreed to provide loss protection on troubled loans to facilitate the Charlotte bank's sale to Citigroup. The aid was never needed because San Francisco-based Wells Fargo & Co. trumped the Citi deal days later.

The Government Accountability Office report released last week looks at the Wachovia agreement, as well as four other instances involving so-called "systemic risk" exceptions needed to provide emergency assistance when a bank's failure could unhinge the financial system.

In one of the cases, the Federal Reserve Board and the Federal Deposit Insurance Corp. recommended a systemic risk exception in January 2009 to permit a loss-protection agreement for a pool of Bank of America Corp. assets, the GAO said. But the Treasury secretary didn't need to make a final determination because that agreement, part of the publicly announced aid package tied to the bank's Merrill Lynch & Co. deal, later wasn't used.

Use of systemic risk exceptions may have helped contain the nation's financial crisis but also could have encouraged banks "to expect similar emergency actions in future crises, thereby weakening their incentives to properly manage risks and also creating the perception that some firms are too big to fail," the GAO concluded. Congress should ensure greater regulation of important financial institutions as it considers financial regulatory reform, the agency advised.

The report sheds more insight on government decision-making as Wachovia verged on collapse in fall 2008. It comes amid a number of ongoing investigations of the causes of the banking industry's meltdown.

Under a 1991 law, the FDIC, which insures bank and thrift deposits, is required to pursue the least costly approach to the agency's deposit insurance fund when resolving a troubled financial institution. Typically, this means the institution is closed, and insured depositors are given a payout or the bank is acquired by another institution. However, the agency can ignore this rule in an instance that would have "serious adverse effects on economic conditions and financial stability."

To trigger this exception, at least two-thirds of the members of the FDIC and Federal Reserve boards must recommend such a move to the Treasury secretary. The Treasury secretary then must make the final determination in consultation with the president. Congress must be informed of the decision, and the GAO must later review the determination.

The period covered by the report spanned the tenures of former Treasury Secretary Henry Paulson and successor Tim Geithner.

The first exception made under this law involved Wachovia. In describing their reasoning for the determination, Treasury, FDIC and Fed officials told the GAO that mounting problems at the bank could have led to its failure and caused more disruption for financial markets, according to the report.

The FDIC said Wachovia's rapidly deteriorating condition was due "largely to its portfolio of payment-option adjustable-rate mortgage (ARM) products, commercial real-estate portfolio, and weakened liquidity position," the report states, referring to ARMs largely inherited from the bank's 2006 Golden West Financial Corp. acquisition.

The FDIC and the Fed determined Wachovia could be closed with no loss to its deposit fund, but that would cause "significant losses" to subordinated debt holders and possibly senior note holders, according to the report.

Officials were also worried about losses to foreign depositors, a major funding source for some large U.S. banks. Their concerns were amplified by the failure of Seattle-based Washington Mutual Inc. days earlier, which the Treasury determined caused "large losses" for senior and subordinated debt holders, but no losses for the deposit insurance fund.

In addition, officials worried a Wachovia failure could raise concerns about similar U.S. financial institutions, spur losses for mutual funds that held Wachovia's short-term commercial paper debt and disrupt payment and settlement systems.

The FDIC took bids fromCiti and Wells Fargo for government-assisted transactions and named Citi the winner on Monday, Sept. 29. Days later, Wells made an unassisted offer for Wachovia and officially bought the bank Dec. 31, 2008.

Treasury and FDIC officials told the GAO that one measure of the agreement's success was that Wachovia was able to remain open and meet its obligations on Sept. 29. "As Wachovia did not fail, the extent to which a Wachovia failure would have had adverse effects on financial stability is not known," the report said.

Systemic risk determinations were also made for a program that guaranteed financial institutions' debt and to later aid Citigroup itself. In addition to the Bank of America case, the FDIC and Fed recommended a risk exception for a proposed program to help banks with troubled loans, but the program is still in the works.

In comments to the GAO, the Fed said it agreed that systemic risk exceptions were an important part of the government's response but that they could make firms believe they were too big to fail. The Fed and Treasury supported stronger regulatory oversight of large institutions. The FDIC did not provide any comments.