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High-risk option ARMs doomed BankUnited, audit says

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The federal Office of Thrift Supervision failed to impose sufficient limits or restrict BankUnited FSB's concentration and growth in the high-risk option ARMs leading up to its failure, a U.S. Treasury Department audit has found.

In a 76-page post-mortem released Thursday, Treasury's Office of the Inspector General also said deficient underwriting and credit administration, combined with the rapid decline in the real estate market, resulted in the deterioration of the thrift's asset quality, including a huge volume of problem loans and significant loan losses.

Deficiencies with the bank have been long known. What's unusual is the audit's pointed targeting of BankUnited's principal regulator.

"OTS did not adequately assess BankUnited's underwriting practices, partly due to using inappropriate risk indicators to measure the performance of the loan portfolio and relying on the thrift's mitigating controls that proved inadequate," the report said.

OTS also did not identify or address the thrift's inaccurate risk-weighting of its loan assets, the report said, noting that inaccurate risk-weighting can have the effect of misstating capital ratios as it did in BankUnited's case.

The report also pointed out that OTS improperly directed the thrift to backdate a capital infusion from its holding company and that as BankUnited reported falling capital levels, the OTS used its authority in a timely manner "but those actions did not prevent BankUnited's failure or a material loss to the insurance fund."

The failed BankUnited FSB's board and management embarked on a high-risk growth strategy with "excessive concentration" in option adjustable rate mortgages, without putting adequate controls in place to manage the high-risk instruments, a U.S. Treasury Department audit found.

In turn, these loan losses greatly diminished earnings and resulted in negative capital, and ultimately, the failure of BankUnited on May 21, 2009, the report said.

A private equity group fronted by veteran banker John Kanas acquired and rechartered the bank from Federal Deposit Insurance Corp. receivership that same evening.

The failure, one of the largest to date in the financial crisis, cost the FDIC's Deposit Insurance Fund an estimated \$5.7 billion.

Experts Agree

Area banking experts who reviewed the Treasury report on Thursday generally agreed with its conclusions.

"When bank management, consumers, and regulators [allow] habitual high-risk activity, such as option ARM's in this case, the results that follow are clearly what happened in the case of the former BankUnited," said Carlos Arboleda, executive director of the banking and financial services group at Stephen James Associates. Arboleda said the report "clearly shows a pattern of opportunities for the ship to be righted, but evidently too little too late was done by all parties."

Both the bank and its borrowers were counting on the continued appreciation of South Florida real estate, which had been "pretty steady" in prior years, said Lewis Cohen, a banking attorney and partner at Cohen & Bobotas in Miami. "When the market began to decline, not only did the value of people's residences decline, but borrowers' incomes declined with the economy as well."

Growth in ARMs

BankUnited historically focused on single-family residential loans, which made up the thrift's largest loan category throughout its existence. Beginning in 2004, BankUnited started to substantially grow its loan portfolio by principally originating and holding single-family residential option ARMs, which totaled \$348.5 million in 2003 and by 2004 had increased to \$2.1 billion.

These loans are riskier because they give borrowers the option of making a minimum monthly payment that does not even cover the interest charges accrued, let alone the principal amount. For borrowers who pay the optional minimum payment, the result is negative amortization.

BankUnited's negatively amortizing loans generated large amounts of capitalized interest, which was recorded on the thrifts' books as (uncollected) interest income. This accrued interest ultimately totaled over 30 percent of BankUnited's capital. The percentage of option ARM loans with negative amortization increased from 53 percent as of December 31, 2005, to 92 percent as of June 30, 2008. By the end of 2007, option ARM loans increased to \$7.5 billion, making up 52 percent of BankUnited's total assets.

When BankUnited began to rapidly increase its option ARM portfolio, its board had not established underwriting policies, monitoring practices, limits, or risk controls commensurate with the risks posed by such growth. "There was no evidence in the board minutes of any strategic discussions among the thrift's board regarding risk tolerances, portfolio diversification, economic risk, growth risk, or limits of any kind," the report said.

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At the time BankUnited began offering reduced documentation loan products, those products had not been tested in stressful economic conditions. Compounding the risk, in 2006 BankUnited further lowered its underwriting standards to compete with other lenders and to increase its option ARM portfolio. As the market descended into free-fall, BankUnited began to tighten underwriting.

"By then, however, it was too late for BankUnited to reduce or mitigate the risk already present in its option ARM portfolio, and due to a frozen secondary market it was unable to sell option ARM loans," the report said. BankUnited's concentration in option ARM loans was primarily in Florida, constituting about 55 percent of its loan portfolio, with other concentrations in California, Illinois, and Arizona, which also were hard-hit. By June 30, 2008, 51 percent of BankUnited's nonperforming option ARMs were located in Florida.

BankUnited submitted a capital restoration plan on Feb. 25, 2009, based on an injection of \$1 billion in new capital by March 31, 2009, but was made contingent upon a loss sharing arrangement with FDIC or another government agency.

OTS determined the bank's plan was not based on realistic assumptions and would not succeed in restoring the thrift's capital.

Oversight fell short

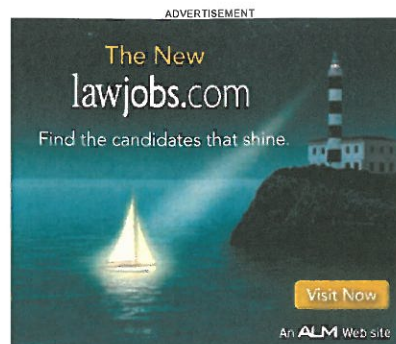
The review found that OTS provided regular oversight of BankUnited, but also said supervision could have been tougher. OTS examiners did find evidence of option ARM risk in the 2006 examination: 70 percent of option ARMs were negatively amortizing; deferred interest represented a growing percentage of income, 87 percent of option ARMs were underwritten with less than full documentation, BankUnited's option ARM monitoring procedures "needed improvement," and BankUnited was not fully complying with 2006 regulatory guidance.

The 2006 examination was also identified as "an appropriate time" to bring the growing option ARM credit risks, weaknesses in option ARM monitoring procedures, and BankUnited's noncompliance to the board's attention for "corrective action."

Although the report found OTS did not identify the problems in time, it said the agency did act appropriately once conditions at the bank deteriorated.

BankUnited did a few things right, the report found, noting that the bank limited lending to the high-rise condominium market in Miami, required mortgage insurance on loans with a loan-to-value ratio over 80 percent, did not make loans to borrowers with a credit score less than 620 and did not make second mortgages. "Too many eggs in one basket is a risky policy, no matter how good that basket looks at the time," said Miami banking consultant Dennis Nason. "This is why guidelines are put into place."

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