Money Machine

Special Report: BANKING & FINANCE QUARTERLY
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A little over two years ago, OneWest Bank didn't exist. Since then, it has earned more than $2.4 billion. That's more, far more, than every other local bank. Combined.

And it has done so without much lending, typically the major profit driver for banks and thrifts. So how has the Pasadena savings bank pulled it off?

It got the deal – some might say steal – of the financial crisis when a high-powered team of private equity and hedge fund investors bought the assets of failed IndyMac Bank on the cheap from federal regulators and launched OneWest.

While no one is contending that the owners have done anything untoward or illegal, critics point out that the deal is allowing OneWest's owners to make billions of dollars in profits while costing the Federal Deposit Insurance Corp. – and the banking industry that funds it – more than $10 billion.

In fact, due to a generous loss-share agreement, regulators could be stuck helping the thrift financially for years to come, without sharing in the spoils.

"It's outrageous," said Bert Ely, a bank consultant in Alexandria, Va., who has been a vocal critic of the FDIC's handling of the sale. "The FDIC gave the store away on that one."

So how did one group of investors turn a money-losing institution – which was so bad that rival banks passed on acquiring it – into a cash cow virtually overnight?

A series of interviews and a review of public documents and financial data conducted by the Business Journal show that OneWest owes its eye-popping performance largely to unusually generous terms agreed to by the FDIC.

The FDIC contends that its hands were tied during a period of dramatic upheaval. One of the largest mortgage lenders in the country during the housing boom, IndyMac failed spectacularly in 2008, leaving the FDIC to operate the bank for eight months, with a mountain of bad loans to unload just as the economy was cratering.

But some experts say the FDIC got taken by some of the savviest investors in the world, including financier George Soros, hedge fund titan John Paulson and bank buyout specialist J. Christopher Flowers.

In fact, shortly after the lopsided sale – and reports of OneWest's huge profits – the FDIC cut the discounts on failed-bank assets, eliminated the most generous loss-share provisions and placed restrictions on private-equity buyers that virtually cut them off from future acquisitions.

The window for private-equity buyouts of failed banks shut quickly, in other words, but not before OneWest cashed in.

Former FDIC Chairman William Isaac said the way the deal worked out shows why the agency typically doesn't sell failed banks to financial buyers.

"The FDIC is concerned about people coming in, getting a great bargain at the bottom of the market and flipping the institution in a couple of years and getting great profits that will embarrass the FDIC," said Isaac, now a senior managing director with FTI Consulting Inc., based in West Palm Beach, Fla.

Steven Mnuchin, a Goldman Sachs alum and private equity investor who became OneWest's chairman, bristled at the notion that the investors only want to suck profits out of IndyMac's old assets and flip the thrift.

The only member of the investment group to agree to an interview, Mnuchin maintained that OneWest has a long-term plan to do more business lending and expand other divisions such as wealth management. (See sidebar, page 26)

He also noted that since its establishment, OneWest has bought two additional failed Southern California banks, First Federal Bank of California and La Jolla Bank, which bolstered its local branch network and helped set it up for the long term.

"We've been very busy over the last two years," said Mnuchin during a recent interview at OneWest's Pasadena headquarters. "Now our priority is to expand what was primarily a consumer bank into a commercial bank. We have a very big flow of business in the commercial sector, particularly in the last few months."

Profit center

OneWest has earned $2.48 billion in profit since it launched in March 2009, and any way you look at it, the earnings are amazing.

It earned more in fourth quarter 2009 – $680 million – than all other banks and thrifts headquartered in Los Angeles County combined have earned in the two years since OneWest began operating.

Even in its worst quarter, last year's fourth, it recorded net income of $81 million, which accounted for more than one-third of the combined profits of the 77 banks and thrifts headquartered in the county.

Last year, with a return on assets of 2.9 percent, OneWest was the second most profitable depository institution in the United States with at least $5 billion in assets, according to an analysis done for the Business Journal by Charlottesville, Va., industry research firm SNL Financial. A common banking industry metric, return on assets shows how much profit was generated as a percent of loans and other assets.

"I've never seen a bank earn that kind of money and in a thrift it's even harder," Isaac said. (As a federal savings bank, OneWest falls in the thrift regulatory). "An average bank would earn 1 percent on assets; if it's a phenomenal bank, it would be earning 1.5 percent on assets."

According to SNL's data, OneWest also had a 19.4 percent return on equity, which measures the owners' rate of return. That number was the third highest in the country. Many healthy banks can brag if they earn more than a 10 percent return on equity.

The spectacular numbers stem from OneWest's unusually good deal.

The bulk of its income during the first few quarters of its existence came in the category Gains and Losses on Financial Assets and Liabilities Carried at Fair Value. According to analysts, this was likely a matter of paper gains on the assets it bought from the FDIC at a discount. (The institution is not publicly traded, but all banks and thrifts must submit certain information to its regulators in quarterly call reports.)

OneWest's owners acquired IndyMac's loan portfolio at a 23 percent discount to the already depressed book value. As the market has started to rebound, many of the discounted loans have performed better than expected, allowing OneWest to recover more on the loans.

In a simplified example, a loan originally worth $100 may have been written down and further discounted, and OneWest purchased it for $60. But if the loan proved sound – which was the case for many of the loans – OneWest could sell it for, say, $80, pocketing a 33 percent profit.

But even if a loan sours, OneWest can still make money. That's because the OneWest investors entered into a loss-share agreement on more than $12 billion of IndyMac's loans and an additional $8.6 billion of FirstFed's and La Jolla's assets, meaning the FDIC will reimburse OneWest's loan losses past a certain threshold. Such agreements are not unusual, but analysts said the terms of the IndyMac deal could lead to a further windfall for OneWest.

Under the agreement, OneWest must shoulder the first 20 percent of losses on the portfolio of covered loans. The FDIC will then cover 80 percent of the next 10 percent of losses, and it will reimburse 95 percent of losses past that point – the latter a stipulation the FDIC has since stopped giving to failed-bank buyers.

The terms of the deal can actually be quite lucrative. On bad loans, OneWest, which bought many of the loans at 70 percent of par value, gets the cash from a foreclosure and is also reimbursed up to 95 percent of the difference between the original loan value and the foreclosure sale amount. Analysts said that means OneWest could actually pocket more money than it originally paid the FDIC for the loans – even though the loan was bad.

Certainly not all the bad loans will be profitable for OneWest, but in theory many could be.

It has yet to receive any payments under its IndyMac or FirstFed loss-share agreements. However, OneWest is expected to begin receiving payments soon for legacy IndyMac assets, since it has recognized about 85 percent of the losses necessary to trigger payments, according to regulatory data.

Ely said “mistakes were made” with the loss-share agreement, giving OneWest an overly generous deal.

A OneWest executive, who was not authorized to speak with the media and asked not to be named, agreed with the notion that OneWest has the FDIC to thank for the bulk of its profits.

“You got it,” the executive said.

Since the thrift can profit from bad loans, the agreement has opened OneWest to criticism in online blog posts and viral videos for incentivizing the bank to foreclose on homeowners. The FDIC has said the allegations are false, and that OneWest is required to offer loan modifications before proceeding to foreclosure.

Meanwhile, even as it makes few loans, the savings bank has been generating sizable income simply by servicing the $158 billion mortgage business it inherited from IndyMac. Servicers do not own the loans, but earn fees for collecting payments on them.

The acquisition instantly turned OneWest into one of the largest mortgage servicers in the country. Still, the portfolio has shrunk to $137 billion through normal runoff, analysts noted, and is not being replenished given how few mortgages the bank makes.

“At the current rate they’re going now, they won’t have a lot left in five years,” said Guy Cecala, chief executive and publisher at Bethesda, Md., mortgage research firm Inside Mortgage Finance Publications Inc.

Cecala questioned whether executives are interested in bulking up their business lines or simply continuing to squeeze profits out of legacy assets.

“It wasn’t set up as a bank. It was set up as an investment,” he said. “And it’s been a very profitable investment for them.”

Tough time

In 2008, IndyMac hardly appeared to be an attractive investment.

Shortly before the institution was shuttered by regulators, executives invited a series of private-equity investors to look through its books in the hopes of securing a lifeline. All of the investors passed.

The swiftness of IndyMac’s failure, which was hastened due to a billion-dollar run on the bank, left the FDIC unable to find a buyer prior to the seizure, as normally happens.

Even afterward, though, the government had a difficult time finding interested buyers, in part because the assets included a portfolio full of deteriorating Alt-A mortgages with escalating interest rates, and a relatively tiny network of 33 far-flung branches. IndyMac’s failure also occurred in the midst of the housing bust and on the cusp of the broader financial crisis, which likely scared off potential buyers.

“The thing you have to keep in mind is when IndyMac failed,” said Andrew Gray, a spokesman for the FDIC. “There was no price certainty in the fall of 2008.”

The agency, which operated IndyMac in conservatorship, is not equipped to run banks long term, forcing it to sell even in a down market.

Gray added, “The faster you move assets back to the private sector and let them be rehabilitated, the lower the cost is for the government.”

The FDIC prefers to sell failed banks whole, which is typically more cost-effective than liquidating an institution in piecemeal fashion. Case in point: Since the FDIC operated the former IndyMac thrift for months, one former employee noted, it unloaded a number of new Aeron chairs. Famous for their ergonomics and design, the chairs retail for more than $700 apiece, but the FDIC sold them for pennies on the dollar.

The government invited more than 80 parties to bid on IndyMac.

In order to increase the amount of capital in the market, the FDIC loosened the traditionally strict rules governing private-equity investment in banks, giving the OneWest group an unexpected opening. Once limited to minority stakes, private-equity firms were suddenly allowed to bid on whole banks.

Investors were eager.

“At that time, private equity was looking for opportunities to enter the space,” said Christian Otteson, a partner at Denver’s Bieging Shapiro & Barber LLP who represents buyers of failed banks.

Blackrock, Cerberus Capital Management LP and Apollo Management LP were among firms that started sniffing around failed banks.

Still, there were questions about the value of IndyMac.

“There’s always concern about the true franchise value of what you’re getting,” Otteson said.

What’s more, assembling a viable team was challenging.

Mnuchin was quick to spot the opportunity IndyMac offered, and was in many ways the perfect candidate to take it over.

During his 17-year tenure at Goldman Sachs Group Inc., he ran the mortgage-backed securities business, and later co-founded Dune Capital Management LP, a private-equity firm that initially specialized in real estate.

A major player in New York’s financial world – and a fixture of Manhattan’s social scene – Mnuchin ran in exclusive circles and had access to significant amounts of capital.

“I knew five of the six investors for very long periods of time – in many cases 20 years,” he said.

Prior to starting Dune, Mnuchin headed SFM Capital Management, an investment firm backed by George Soros.

So Mnuchin put together an investment plan and assembled a group of financial heavyweights that boasted no fewer than four billionaires. In all, the group included J.C. Flowers & Co., a New York private-equity firm focused on the financial sector; New York hedge fund Paulson & Co.; MSD Capital LP, the New York private investment firm for computer mogul Michael Dell and his family; SSP Offshore LLC, an investment fund managed by Soros Fund Management in New York; Greenwich, Conn.-based private-equity firm Stone Point Capital LLC; and an affiliate of Silar Advisors LP, a New York investment firm specializing in distressed assets.

The team had plenty of experience capitalizing on distress. Paulson famously earned billions through his bets against subprime mortgages prior to the housing bust, while Flowers collected huge sums in 2000 by rescuing the institution later known as Shinsei Bank.

“From day one, the investors have all been 100 percent supportive of the plan for the bank, the growth opportunities for the bank and have been instrumentally supportive to what we’re building,” Mnuchin said.

With such big names circling failed banks, regulators were wary. Still, they had few alternatives.

Despite finding big-bank buyers for a number of failed institutions, including Washington Mutual, which was bought by JPMorgan Chase & Co., the FDIC received no interest from major banks for IndyMac.

Twenty-three groups, primarily from the private-equity world, submitted initial bids, six bid in the final round and just one – the OneWest consortium – bid for the entire institution, which it was awarded at a steep discount.

When IndyMac failed, it had $31 billion in assets. The FDIC immediately wrote down the value of the assets to $23 billion. Under the terms of the sale to OneWest, the FDIC kept a small portion of the least attractive assets and sold at a discount the remaining assets, which had been written down yet again. In the end, OneWest acquired IndyMac's assets for just $13.9 billion.

The actual cash outlay from the ownership group, however, was $1.55 billion, which was injected as new capital. (In bank failures, most of the acquisition cost is typically offset by the deposits assumed by the acquirer.)

Mnuchin declined to comment on the deal, but outsiders didn't mince words.

"It was an idiotic decision on the part of the FDIC to not sell IndyMac to a large banking entity but to keep it independent," said Ely, the bank consultant.

He contrasted the deal with that of Downey Savings and Loan, a midsize Newport Beach thrift that failed in November 2008 and was sold to U.S. Bank. The FDIC expects to lose $1.4 billion on that deal, a fraction of the cost of IndyMac.

Ely said IndyMac should have been sold to a big bank with the capital cushion to absorb more losses.

"My belief is that had someone like Wells (Fargo) or U.S. Bancorp – a big banking company – if someone like that had purchased IndyMac and sold it into its operations, it would have been a much lower loss for the FDIC and therefore the banking industry," he said.

What's more, the deal included no mechanisms by which the FDIC could recover more money if the assets performed better than expected. Now a common feature in failed-bank transactions, "clawback" provisions limit the upside for buyers and allow the agency to recover additional money if the deal turns out to be very good for the buyers.

So how did one side lose out so badly while the other made out so well? Some industry leaders believe the regulators were simply unprepared for the sophistication of the investment capital that started swarming failed banks at the time.

"The FDIC felt a bit overmatched by all of the private equity-sponsored applications it was receiving in late 2008 and early 2009," said Kendall Raine, executive managing director of the financial institutions group at Marshall & Stevens Inc. in downtown Los Angeles.

More fundamentally, Raine said, there was a "mismatch of expectations" when the FDIC began dealing with private equity because investors are looking to maximize profits, while the government wants to minimize losses.

"If the private equity guys made a lot of money doing this, it made the FDIC look bad. And if the private-equity guys blew it and the banks ended up back in trouble, it made the FDIC look bad," Raine said. "Only if the banks … did average but unimpressively well did the FDIC look like it did a good job, which of course wasn't interesting to the private-equity guys."

Clamp down

OneWest did better – much better – than average.

According to an FDIC employee who worked on failed-bank resolutions at the time, "senior people" within the agency, recognizing that OneWest "had gotten a good deal," began grumbling about the thrift's unusually large profits.

Regulators learned their lesson quickly. After another private-equity group bought a large failed bank – Florida's BankUnited, which was acquired by a group that included Blackstone Group LP – the government clamped down on private-equity investors.

Among the changes, the FDIC eliminated the loss-share bracket in which the agency reimburses 95 percent of losses, according to a recent JPMorgan Chase report.

"The terms of (OneWest's) deal would be hard to get today," Raine said.

The FDIC also introduced rules to make failed-bank acquisitions more difficult for nonbank buyers.

But OneWest's owners, who had secured a charter with the IndyMac deal, were free to continue acquiring failed banks. In December 2009, it bought FirstFed. The acquisition is expected to cost the FDIC just $146 million.

Two months later, OneWest bought La Jolla Bank. The back-to-back acquisitions added nearly $10 billion in assets, while the addition of a portfolio of real estate loans purchased in November from Citigroup Inc. added $1.4 billion. In the end, OneWest's assets skyrocketed to $27 billion, the most of any bank or thrift headquartered in Southern California.

Since the deals, OneWest has done a fair amount of scaling back. As the new owners took over IndyMac, they put the "kibosh on new products," one former employee said.

More recently, management shuttered the reverse-mortgage unit known as Financial Freedom, which had been the nation's largest reverse-mortgage lender under IndyMac, resulting in 65 layoffs.

OneWest's loan volume is down significantly in absolute terms and relative to its competitors. According to data compiled by Inside Mortgage Finance, the cutoff for the 50 largest mortgage lenders last year was $2.3 billion.

Cecala noted that OneWest is on pace to do about one-quarter of that for the year.

"Your Aunt Sue does more volume," he said. "Certainly it's one of the smallest amounts of origination for servicers that large."

That apparently is not standard.

In the purchase and assumption agreement, the FDIC states OneWest "agrees to provide full service banking in the trade area" of IndyMac. In granting approval for the OneWest group to organize as a thrift holding company, the OTS said the deal would "ensure that the customers of (IndyMac) continue to receive the services that (IndyMac) had provided."

William Ruberry, a spokesman for the Office of Thrift Supervision, said the agency does not comment on specific institutions, but he acknowledged that mortgage lending is "the traditional bread and butter of the thrift industry."

Strategic plan

Mnuchin, however, defends the strategy being pursued by OneWest, which he said is trying to become a more conventional regional bank.

He said the ownership group submitted a full business plan to regulators that detailed its intentions to move away from mortgage lending.

"That business plan is, in all material aspects, exactly the same today," he said. "You have to understand, it's not our strategic goal to necessarily be in the top 100 mortgage lenders for agency conforming loans."

However, Dennis Santiago, chief executive of Institutional Risk Analytics, a banking industry research firm in Torrance, said in a market dominated by national banks and with substantial regional challengers such as City National Corp., it won't be so easy to become a major lender.

"Can they … become a viable competitor? That's an interesting question," he said. "The bank has not yet seriously begun to prove itself. That's a tough business to get into."

Indeed, the chief executives of lenders such as Community Bank in Pasadena, Farmers & Merchants Bank in Long Beach, Malaga Bank in Palos Verdes Estates and others all said that OneWest, for all its advertising, isn't much of a loan rival.

"We don't see much of them in the lending market," said Randy Bowers, Malaga's chief executive.

Still, one rival said that Soros, Paulson and the other investors showed some nerve to make a major acquisition at a time when other potential buyers passed on the deal.

"This wasn't free money," said the investor, who submitted a preliminary bid for IndyMac's assets in late 2008 and asked not to be named. "It was a calculated risk that turned up heads for them."