Professional Risk Managers' International Association

Washington Mutual

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Summary

The Great Recession of 2007/2008 was fueled by subprime mortgages which led to the collapse of the housing market and threatened to destroy the international financial system.[1]

Founded in 1890, Washington Mutual Bank (also known as WaMu) gained a reputation as a conservative institution. It expanded over its 100 plus year history until in 2007 it boasted $188.3 billion in deposits, 2,200 branch offices in 15 states, and more than 43,000 employees. But by 2006 they had begun to engage in aggressive investment in mortgage-backed securities which included subprime mortgages.

The housing market's sharp downturn in 2007 occurred as housing prices fell and homeowners' mortgages outpaced what their homes were worth. Shares dropped precipitously, and after the bankruptcy of Lehman Bros spurred a 10-day run on WaMu bank branches, they entered bankruptcy on September 25, 2008, with roughly $307 billion in assets.

Main Content

The financial crisis that erupted in 2007 and 2008 had been building for several years. In May 2000, the Fed began lowering the federal funds interest rate from 6.5 percent. The rate bottomed out at 1 percent in June 2003. The lowered rates were designed to boost the economy by providing businesses and consumers bargain rates for money.

Many consumers acquired property because of the low mortgage rates, and home prices began to rise. Among these consumers were subprime borrowers, or those with no credit history or poor credit.
The banks then sold those loans on to Wall Street banks, and packaged them into mortgage-backed securities, a low-risk investment.

By the end of 2007, WaMu had $188.3 billion in deposits, 2,200 branch offices in 15 states, and 43,000 plus employees.[2] However, when mortgage originations slowed in 2006, Washington Mutual (aka WaMu) cut more than 10,000 jobs. This downfall continued through 2007 when in December its dividends were slashed by 73 percent. The following month WaMu reported a loss of $1.87 billion. Second quarter losses in 2008 totaled $3.3 billion. ("Timeline | Washington Mutual: A long history," 2008)

By 2008, Wamu's business came from retail banking (60 percent), credit cards (21 percent), and around 14 percent came from home loans. Though home loans constituted its smallest percentage, its failure was large enough to drive the company out of business. (Amadeo, 2020)

After Lehman Brothers declared bankruptcy in mid-September 2008, depositors panicked and made a run on WaMu banks, plunging shares to a paltry $2.01. On September 28, 2008, federal regulators took over

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[1] Duignan, B. (2019, October 7). *Financial crisis of 2007–08*. Encyclopedia Britannica. https://www.britannica.com/event/financial-crisis-of-2007-2008
[2] Amadeo, K. (2020, December 18). *Washington Mutual and How It Went Bankrupt*. The Balance. https://www.thebalance.com/washington-mutual-how-wamu-went-bankrupt-3305620

WaMu in the biggest bank failure in US history. ("Timeline | Washington Mutual: A long history," 2008) WaMu was sold to J.P. Morgan Chase for $1.9 billion. (Amadeo, 2020)

In October 2008, 89 former WaMu employees filed a lawsuit against the company. Court documents describe that risk managers who were supposed to protect the company from financial disaster, were routinely ignored and even fired by management.[3]
Concurrently, bank lenders and underwriters were pressured to sell risky but lucrative loans to homeowners. In addition to pushing subprime mortgages, they also pushed adjustable-rate loans also known as option arms. Such loans allow borrowers to defer interest payments and low introductory rates. But when the deferment period ended these borrowers were saddled with much higher payments and interest rates, increasing the possibility of default. (Thomas & Pearle, 2008)

WaMu's risk managers warned the company that option arms created substantial risks, but this finding was ignored. In fact, risk managers reported that they felt pressure to sweep any adverse findings under the rug. If they did not, they were reprimanded and sometimes even fired. (Thomas & Pearle, 2008) WaMu's motto at the time, "the Power of Yes," appeared to be vigorously enforced.[4]

Soon following WaMu's collapse, Congress passed the Troubled Asset Relief Program (TARP), which sought to stabilize the financial system with an allocation of $700 billion.[5]

On December 17, 2011, The New York Times complained that federal banking regulators finally reached a settlement with three former WaMu executives. The settlement of $64.7 million seemed paltry after huge losses the company suffered while under the executives' leadership. (Morgenstern, 2011)

On March 19, 2012, WaMu finally exited from Chapter 11 bankruptcy as it entered it, right behind Lehman Bros. The process involved seven reorganization plans and more than 3 years of court battles.[6]

Drivers of Failure

Five reasons lay behind WaMu's failure. The first involves how much business they did in California, where the housing market fell more severely than in other parts of the country. (Amadeo, 2020)

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[3] Thomas, P., & Pearle, L. (2008, October 13). *Exclusive: WaMu insiders claim Execs ignored warnings, encouraged reckless lending*. ABC News. https://abcnews.go.com/TheLaw/story?id=6021608&page=1#abcnews.go.com/TheLaw/story?id=6021608&page=1

[4] Morgenstern, G. (2011, December 17). *Slapped wrists at WaMu* (Published 2011). The New York Times. https://www.nytimes.com/2011/12/18/business/in-a-wamu-settlement-with-the-fdic-slapped-wrists.html

[5] *Global impact of the collapse.* (n.d.). Baker Library | Bloomberg Center | Harvard Business School. https://www.library.hbs.edu/hc/lehman/exhibition/global-impact-of-the-collapse

[6] *WaMu exits bankruptcy, on heels of Lehman*. (2012, March 19). Reuters. https://www.reuters.com/article/us-washingtonmutual/wamu-exits-bankruptcy-on-heels-of-lehman-idUSBRE82I15S20120319

Nationwide, home values started falling in 2006 after stability for decades. By the end of 2007 the nation had a housing inventory of about ten months. Normally, California had about six months of inventory, but that number had ballooned to more than fifteen months. (Amadeo, 2020)

The second reason involved a too-quick expansion of branches. This led to branches being located in many poor locations that brought in poorly qualified buyers, which encouraged the bank to lend out subprime mortgages. (Amadeo, 2020)
The third reason centered around the August 2007 collapse of the market for mortgage-backed securities. The decline in home prices meant that WaMu could not resell mortgages because they were higher than the worth of the homes. This depleted the bank's cash reserves. (Amadeo, 2020)

In March 2008 WaMu accepted new capital in the amount of $8 billion from investor Texas Pacific Group. However, this investment did not save them. (Amadeo, 2020)

Lehman Brothers bankruptcy on September 15, 2008 was the fourth reason. Depositors panicked and over the next 10 days withdrew $16.7 billion from WaMu accounts. This amount, about 11 percent of WaMu's total deposits, left it with too little money to conduct day to day business. The Federal Deposit Insurance Corporation (FDIC) stepped in as bankruptcy loomed. (Amadeo, 2020)

The fifth and final reason for WaMu's failure was its size, which didn't meet the "too big to fail" metric, so the government didn't bail it out like it did American Insurance Group (AIG) or Bear Stearns. (Amadeo, 2020)

The losers in WaMu's bankruptcy were shareholders, bondholders, and bank investors. Everyday depositors did not lose their money. Bondholders were down $30 billion and shareholders losses involved everything but a paltry 5 cents a share. (Amadeo, 2020)

Afterward

In order to address the conditions which led to the 2007/2008 financial collapse, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. The act was designed to protect consumers from the risks of investments like those taken by Wall Street.[7] Dodd-Frank established regulatory groups within the government such as the Financial Stability Oversight Council (FSOC) whose job it was to label certain financial firms as systemically important to the economic wellbeing of the country. These firms and banks with excess of $50 billion in assets were subjected to increased regulation and a special resolution process in order to prevent them from exposing the country to systemic risk.[8]

In 2018, Congress rolled back some provisions of the Dodd-Frank Act with the Economic Growth, Regulatory Relief, and Consumer Protection Act. This act eased regulations on small banks with assets

[7] Amadeo, K. (2020, October 30). *What is the Dodd-Frank Wall Street reform act?* The Balance. https://www.thebalance.com/dodd-frank-wall-street-reform-act-3305688
[8] Webel, B. (2017, April 17). *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Background and Summary*. Congressional Research Service. https://crsreports.congress.gov/product/pdf/R/R41350/10

between $100 billion and $250 billion, which freed them from running stress tests to prove they could withstand a financial catastrophe. It also allowed consumers to freeze their credit for free. (Amadeo, 2020)

Lessons Learned

1. Rapid expansion creates risk. WaMu's large network of branches required substantial cash outlay to maintain. J.P. Morgan Chase, who bought out the bankrupted WaMu, wanted the institution's large branch network and its strong deposit base. (Amadeo, 2020)
2. Listen to risk management. WaMu's risk management team warned the company about its untried dependence on option arms and its reckless acquisition of subprime mortgages. Such warnings were ignored and risk managers were disciplined and sometimes even fired.
3. Do not rely on government help in the event of failure. WaMu's finances did not reach the level of making its failure dangerous to the economic health of the country. Any hope they had of government assistance quickly evaporated.
4. Greed precedes disaster. As with all of the giant financial institutions that failed during 2008, greed was the ultimate cause. Management encouraged greater and riskier home loans. Tying top management's compensation to the financial losses experienced by large companies like WaMu may help keep them accountable for their decision making.

Timeline of events

1890 — Washington Mutual Bank is founded
Early 2000s — WaMu begins issuing credit cards
2006 — Mortgage originations slow and home values start decreasing
March 2008 — Texas Pacific Group provides WaMu with $8 billion investment
September 15, 2008 — Lehman Brothers declares bankruptcy
September 25, 2008 — WaMu goes bankrupt
2010 — Dodd-Frank Wall Street Reform and Consumer Protection Act is signed into law
March 19, 2012 — WaMu exits Chapter 11 bankruptcy protection

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