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   RESULTS & DISCUSSION

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WASHINGTON MUTUAL, INC.: FORTUNE 500 TO NOWHERE

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PHAGWARA

ABSTRACT

*Washington Mutual bank (WaMu) was United States **largest savings and loan association** managing an asset of value $327.9 billion valued in year 2007 until it filed for bankruptcy (on 25th September 2008) making the occasion as the **largest bank failure in U.S. hist**ory by asset size. Before filing for bankruptcy, it was U.S's sixth largest bank by asset-size. The Case focus on the Risk Management tools, Credit Appraisal process, Credit Concentration and Risk Assessment Measures adopted by WaMu in order to help its holding company (Washington Mutual Inc.) to continue a position in **Fortune 500** list for continuous four years 4and also on the internal as well as external environment which caused its failure.*

KEYWORDS

ARM (Adjustable Rate Mortgage), Negative Amortization, PMI (Private Mortgage Insurance).

INTRODUCTION

Washington Mutual bank (WaMu) was United States largest savings and loan association managing an asset of value $327.9 billion valued in year 2007 until it filed for bankruptcy (on 25th September 2008) making the occasion as the largest bank failure in U.S. history by asset size[5], [17]. Before filing for bankruptcy, it was U.S's sixth largest bank by asset-size [1], [5].

Washington Mutual, Inc. (WMI) was the former owner of WaMu (before filing of bankruptcy) and also filed for bankruptcy a day after WaMu got the benefit of receivership under Federal Deposit Insurance Corporation (FDIC). WaMu was a financial services provider to small and mid-sized business and consumers. WaMu operated in three verticals: The **retail Banking and Financial Services Group**, the **Mortgage Banking Group** and the **Commercial Group**. First two verticals were consumer-oriented while the third vertical was commercial customers' oriented[2]. The company's major products include deposits, home loans, and credit cards in consumer-oriented segment [3], [1].

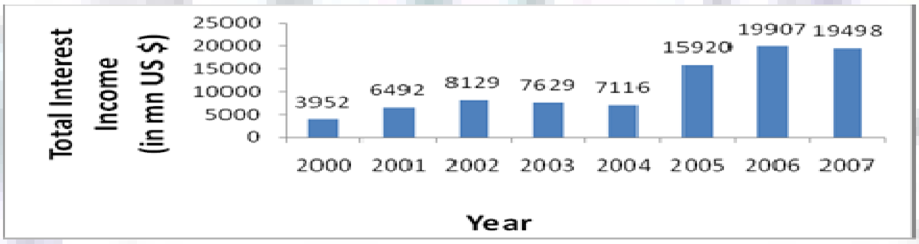
Management of WaMu thought to convert WaMu into "Wal-Mart of Banking", focused to service lower and middle class consumers that other banks deemed too risky. Moreover, it designed terms and conditions of even Complex Mortgages and Credit Cards such that it can be easily accessible for even lower creditworthy borrowers to get it financed, which can be helpful in its strategy to increase "Market-Share" enabling itself to operate on mass-banking[4]. One of the statements of its CEO "We hope to do this industry what Wal-Mart did to theirs, Starbucks did to theirs, Costco did to theirs and Lowe's Home Depot did to their industry" affirms the mass-banking strategy[5],[7].

One of the advertising campaigns introduced by WaMu during 2003 was "The Power of Yes", which emphasized on saying YES to even a less credit-worthy customer. WaMu used to press sales agents to approve loans just on the basis of stated income (Stated Income means just mention your income on the proposal form, no need to give proof of your mentioned income). Revenues at WaMu's home-lending unit increased from $707 million to almost $ 2 billion in 2003, which is attributed to the campaign started [5], [3].

WaMu offered very high commissions for selling more of riskiest loans. More selling of riskiest loan enable WaMu to charge high interest rates and hence, high profits and in turn huge compensation to its executives. Not only this, WaMu motivated appraiser to provide inflated values of the property against which loan was granted, so that loan sanctioned could appear as less risky and hence, could be easily bundled and sold to investors.

GROWTH PHASE OF WaMu

Data Monitor, a leading business information company specialized in industry analysis, published a research in August 2008,which states that " The US commercial banking has been growing continuously since the beginning of the decade and is expected to grow further at least until 2011". It also indicated that the commercial banking segment of US will keep on growing at a CAGR (Compounded Annual Growth Rate) of 4.4% until year 2011. Moreover, the credit card market was expected to grow at a CAGR of 5.7% until 2011. Both of these were the core strength of WaMu and hence, experts were of the opinion that WaMu will show a robust growth in future. Moreover, the risk taking capability of the management also helped the analyst to forecast a double digit growth rate for WaMu. Before 2005, WaMu followed traditional model of originating loans i.e. at fixed rate of interest, but seeing the intense competition in the market, it adopted a riskier non-traditional model to finance loans. The closest competitor of WaMu in 2005 was Countrywide Financial Corporation, when it adopted new strategy to increase a wide gap between the two. The graph shown below indicates the growth in total interest income of WaMu. Increase in total interest income in year 2005 (100% increase) and onward with respect to 2004 can be due to the change in business strategy as far as loan financing model is concerned.



Source: Income Statements of WaMu

Secondly, the shift in strategy was in anticipation of a higher interest margin. The table shows a list of sale margin by product types of loans of WaMu:

S.No.	Loan Product Type	Return (%)
1	Subprime	1.5
2	Home Equity	1.13
3	Option ARM	1.09
4	Alt-A	0.4
5	Hybrid/ ARM	0.25
6	Fixed Rate	0.19
7	G-Backed	0.13

Source: April 2006, WaMu Board of Directors' Presentation

The lower rate of interest in "**Fixed Rate and G-Backedproducts**" justifies the change in management's strategy to focus more on high margin products. Moreover, the financial market created a demand for high risky products to provide a better return to its investors (which was almost zero in case of G-securities). Hence, risky and complex products like subprime mortgages, CDS (Credit Default Swap), CDOs (Collateralized Debt Obligations) were developed and designed to meet the market demand.
During 2000 and 2003, WaMu's retail branches grew 70 percent. The total number of retail branches was 2200. This period coincides with the period when WaMu launched the advertising campaign **"The Power of Yes".** Not only this, it showcased its employees as casually dressed in different television advertisements to give an indication of "friendly loan sanctioning process".[14]
The success of WaMu's new strategies can be identified by the fact that by 30th June 2008, it had a total asset size of US $ 307 billion. A break-up of assets in different portfolios is given below:

S.No.	Loan Product Type	Asset Size ($ bn)
1	Subprime Mortgage Loans	16
2	Home Equity	53.4
3	Option ARM	52.9
4	Credit Card Receivables	10.6

Source: Financial Statement of WaMu as on 30th June 2008

WHAT WENT WRONG
The five basic characteristics of a borrower to obtain credits are: **Character** (Integrity), **Capacity** (sufficient cash flow to sufficiently match obligation both in terms of duration and volume), **Capital** (Net -worth), **Collateral** and **Conditions** (of borrower as well as entire economy).Since, WaMu had a very liberal process of credit evaluation and hence, was not evaluating borrowers on all the said five elements. Borrowers' were providing "Stated Incomes" on application form and hence, true **capacity** of borrowers' can't be identified. About 90% of all WaMu's home equity loans, 73 % of **Option ARM** (Adjustable Rate Mortgage) and 50% of sub-prime loans were "**Stated Income**". Moreover, there was no meaning of collateral since the values of collaterals were inflated on the direction of WaMu by appraisers [14], [17], [18].
"**High loan-to-Value**" ratio was also one of the prime factors in wiping-out the value of loan portfolio when the prices of homes started falling in 2008. WaMu's 2007 financial statement mentioned that 44 % of subprime loans, 7% of Option ARMs and 35 % of home equity loans were having more than 80% "Loan to Value" ratio. Not only this, WaMu didn't suggest/ asked its borrowers to buy **PMI (Private Mortgage Insurance)** which protects lenders against the default [5].
"Loan Concentration" was another dimension where WaMu missed the basics of banking practices. WaMu had a policy of loan concentration of upto 25% in one metropolitan area.

Region	Option ARM	Subprime Loan	Home Equity
California	49%	25%	53%
Florida	13%	10%	9%

These two were the states which suffered the above average home value depreciation at the time of subprime crisis, which impacted the business of WaMu significantly [2].
WaMu had a high percentage of risky products in its portfolio. Option ARMs had a contribution of 47% of all home loans originated from 2003 -07. WaMu had designed innovative ARMs to suit the need of customers. The payment options in Option ARMs (Adjustable Rate Mortgage) were: [2], [14]
1. Interest Only
2. A minimum monthly payment
3. Pay their monthly mortgages in amounts equal to (monthly principal + interest).

As per 2005 Financial Statement of WaMu, approximately 56% of the total Option ARM loan holders selected option 2 (i.e. A minimum monthly payment only). The minimum monthly payment followed the concept of "teaser rate"- significantly low rate of interest for 1 month and thereafter high/ normal rate of interest. The minimum monthly payment option calculated was not sufficient to even pay the interest cost and hence, the unpaid interest was added back to the principal; making the loan outstanding bulkier month by month. This process is known as **"Negative Amortization".** Financial statement of 2007 says that the quantum of negative amortization had become 84% of the total value of Option ARMs [2].
The rising interest rate also contributed equally to the downfall of WaMu. Since, WaMu had a high loan percentage of mortgages in its loan portfolio (80% of all loans sanctioned were mortgage loans as on 31-12- 2004) and hence, the percentage of NPA (non-performing assets) as well as loan defaulters started increasing as soon as interest rates followed an upward trend. Till 3rd quarter of 2007, WaMu's bottom line had not turned red, but during 4th Quarter of 2007 & 1st Quarter of 2008, it suffered consecutive $ 1 billion quarterly losses because of loss write-off and higher loan loss provisions [15].
On 15 September 2008, credit rating agencies downgraded WaMu as well as WMI which caused a serious concern in investors' mind and they started withdrawing money from the bank. By 24th September 2008, customers' withdrew $16.7 billion in deposits, which made bank illiquid and ultimately forced Office of Thrift Supervision to close the bank on 25th September 2008[6], [16]. The FDIC (Federal Deposit Insurance Corporation) sold it to JPMorgan Chase for $1.9 billion [8].
A day after the bankruptcy of WaMu, WMI (Washington Mutual, Inc.) also filed for bankruptcy; which ended the story of a big giant who always scored a position in **Fortune 500** list from 2005 to 2008 (131 in 2005, 99 in 2006, 81 in year 2007 and 97 in 2008)[3].
When a recently MBA (Finance) passed out student, AVNI joined in "Risk Management" department of an emerging bank ABC Bank Ltd., he was given this case study to analyze and present a report highlighting the "Risk Dimensions", "Credit Evaluation Process", "Exposure Criterion" and "Risk Management Techniques" that a company working in same line of business as WaMu should follow in order to avoid such failure.

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