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# PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

## Wamu: Anatomy of a Murder

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*President*

"Hi! I'm from the government and I'm here to help."

This is the story of how the media, government and rating agencies recklessly destroyed Washington Mutual Bank (Wamu).

Wamu was the largest savings and loan in the country, with over $300 billion in assets. It had a long and distinguished operating history, until the company started making a lot of bad loans during the housing bubble. It is now well chronicled how financial institutions of all stripes raced to make imprudent loans, predicated on the assumption that housing prices would continue rising. Wamu was one of the worst offenders in this regard.

No story, however, is one-sided. Despite these risky loans, Wamu had an enviable and valuable branch system, a huge, coveted deposit base, and a lucrative mortgage servicing operation that benefited from economies of scale. Though far from pristine, Wamu was not the basket case that was constantly and relentlessly portrayed in the media.

To understand the background that led to Wamu's ultimate demise, we have to take a detour to explain how banks account for the performance of their loan portfolios. When a bank makes a loan, it reports the loan (which is basically a receivable) as an asset. The money that funds the loan has to come from somewhere. It might be from customer deposits at the bank, or financing that the bank obtained from the capital markets or elsewhere. Deposits are considered the best form of financing, because the deposit base is stable and low cost (since banks often pay much less on deposits) than they do on other types of funding.

To protect depositors, the government regulates banks like Wamu. Regulators make sure that banks have enough equity or capital to support their risk-taking activities. When a bank's capital gets too low, the government can assert increasing control over the bank's operations, ultimately seizing the bank, if necessary. Banks' financial strength is rated in one of five categories, with "well capitalized" being the highest rating.

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To determine what rating to give, the government looks at the ratio of bank capital to assets. Banks are supposed to have a certain level of capital to support the assets they own, because a certain portion of those assets will go bad. For example, a bank might borrow $90 to finance and own $100 of assets (loans), meaning the bank's equity in the assets is $10 or 10%. Contrary to what has been reported in the media, deposits are a form of liability because depositors can ask for their money back, while mortgages, even if impaired, are assets. If some of the assets go bad, then the equity will be hit. For instance, if 10% of the assets become worthless, then the $10 loss will wipe out the bank's equity. Leveraged firms like banks are therefore supposed to own very conservative assets.

Continuing with this example, banks are required to charge off loans that go bad, as well as build reserves against which these charge-offs are taken. It is the building of these reserves that reduces a bank's capital (not the charge-offs). Regulators always want to see that banks are projecting what additional losses might be coming down the road, and have the bank take the reserves in advance to take care of projected losses.

This is an important distinction because reserves are taken right away to deal with problems that are projected, but have yet to occur. It is the lack of understanding of this critical distinction by the media, among other things, which caused the unnecessary failure of Wamu. It was the biggest bank failure in the history of the US.

When a few months ago Wamu estimated $19 billion of losses on their loans, the losses were projected to occur over the next 2.5 years, not all at once. Despite the media constantly criticizing the projection as inadequate, what they missed is that if 10% of the loans go bad, it does not equate to a 10% loss, since there is housing collateral behind each loan. The ultimate loss would be much smaller than 10%. For example, even if the house has dropped to 50% of the loan balance, the loss would be cut to 5% or in half. A $19 billion loss translated into various combinations of a high percentage of loans going bad and drastic depreciation of the housing collateral. Suffice it to say that not all the assets on Wamu's books were of the questionable mortgage-related variety, and the projected $19 billion loss was already assuming some doomsday scenarios.

In fact, the media was doing the dirty deed of "speculators" who were short Wamu's stock and spreading nasty rumors, without thinking critically about what was being fed to reporters. In contrast, the government initially did not fall for the pessimism. Despite the fact that the FDIC and OTS were scrutinizing Wamu for months, it considered Wamu's capital to be "well capitalized," the highest rating given, right up to when it was seized! This is because the projected future charge-offs were already largely covered by the reserves the bank had already prudently taken. Wamu would still be with us had the media (and rating agencies) not foolishly fostered panic, causing a bank run, and leaving the government no choice but to seize the bank.

While the FDIC was left with no choice but to seize Wamu because of the bank run, it compounded the problem by panicking and giving Wamu away to JP Morgan for grossly inadequate consideration. The government also set a horrendous precedent by discouraging continued financing of the corporate bond market, just when they should be encouraging such financing. The government greatly contributed to the country's financing mechanism coming to a grinding halt. To understand why, it is important to recall what the government did when it seized Wamu and sold the thrift to JP Morgan.

Normally, when a company sells itself, it gets the buyer to assume and honor the debts of the company being sold. In this case, the FDIC was not acting as a true fiduciary for the thrift that it seized, and was concerned with only one thing -- to make sure it and taxpayers were not on the hook to Wamu depositors. Sheila Bair, head of FDIC, congratulated herself for not costing taxpayers a dime when Wamu was sold to JP Morgan. However, what really happened was that the FDIC panicked and gave Wamu away to JP Morgan without adequate consideration, and in the process discouraged investors from buying corporate bonds.

If Wamu was really that busted a franchise, how come it did not cost taxpayers a cent to take it over? For instance, the seizure of the much smaller IndyMac will cost taxpayers over $8 billion at last estimation. Was JP Morgan in the business of doing taxpayers a giant favor by taking on the depositors if the thrift was so impaired? How come if JP Morgan took such a big risk taking over Wamu's bad loans, it was able to announce that the acquisition would boost its earnings next year? It is my view that JP Morgan wrote $30 billion off Wamu's loans because that was the best time to take a big-bath accounting write-off to clean the slate; in fact it is quite likely that JP Morgan will be able to write-up the assets at some future date, boosting its reported earnings. This is especially so, in light of the $700 billion program set up to buy such assets.

The FDIC foolishly left the creditors of Wamu and its parent in the cold, by not requiring JP Morgan to assume such debt, an arrangement that would have been commercially reasonable and expected in 99 out of 100 buy/sell transactions of this type. The truth of the matter is JP Morgan only paid $1.9 billion to get around $200 billion of loans (after deducting the $30 billion projected loss), not to mention other valuable unimpaired assets. JP Morgan was required to assume liabilities that were made up mostly of deposits that are "sticky;" a lot of these deposits will stay with the bank. When the Wamu creditors got left out unexpectedly and unreasonably in the cold, it sent a chill through the credit markets. The FDIC stiffing Wamu creditors, together with the government's mistake of not propping up Lehman Brothers with a "few" billion dollars, have greatly reduced the ability of companies to raise money by issuing debt in the public markets. Lest you think it is of no consequence if the government failed to bail out some big Wall Street firm like Lehman and "fat cats" who work there, don't forget that all global financial companies are intricately linked at this point. When Lehman's creditors are unfairly stiffed, pension plans that hold its debt are harmed, thereby harming ordinary Americans. The State of California may hold Lehman bonds, and become more unable to pay teachers. And money market funds that hold such debt break the buck and countless investors are hurt.

The government's ad hoc and capricious approach is killing the credit markets. They bailed out Bear Stearns, but refused to help Lehman, even though Lehman was much bigger than Bear Stearns and posed more systemic risk. As it turned out, Lehman was too big to let fail; but the government let it fail all the same. Again, this is not an issue of bailing out the fat cats, but preventing the systemic consequences that have now hurt many ordinary, innocent people. Lehman's demise has now caused a domino effect that the government is spending billions of dollars more trying to address (almost a trillion dollars as I write this). They did not save Wamu's bondholders, but jumped in to save Wachovia's bondholders with a giant back-end guarantee. This turned out to be embarrassingly unnecessary, as Wells Fargo's vastly superior bid showed once again the government panicked and tried to give Wachovia away to Citigroup for a song, while potentially sticking taxpayers with the bill. Wells Fargo is buying Wachovia without any such government guarantee. How are investors supposed to buy bonds brought to market by corporations to raise needed capital when they have no predictability as to whether the government will destroy their credit position without justification?

This credit crisis started with fundamental deterioration in the housing market, but could have been at least somewhat contained had the government acted swiftly and made wise choices to come up with systemic solutions. Instead, it came up with one ad hoc decision after another, dealing with situations differently and capriciously, even though there was no fundamental or economic justification for doing so. Yes, we understand that AIG is not the same as Lehman, but why bail out the much smaller Bear Stearns, but not Lehman? It stiffed the creditors of Wamu, but fully protected the creditors of Wachovia. It is this sort of unpredictable, non-rigorous approach to problems that have contributed largely to the current lack of trust and confidence in our financial markets. Let's all hope the government does a lot better going forward.

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