

Written Statement to the U.S. Senate Permanent Subcommittee on Investigations

April 13, 2010

My name is Randy Melby. I served as General Auditor for Washington Mutual from December 2004 until September 2008. I have prepared this statement to address the areas of inquiry noted in the Subcommittee's correspondence to me requesting my testimony (attached).

Some of these areas of inquiry relate more closely to my area of responsibility during my tenure at Washington Mutual; others relate to areas of which I had some awareness but which were outside of my responsibility and sometimes outside of my personal knowledge. I begin with the area most directly within my responsibility: the role of the internal audit function at Washington Mutual;

**1. The role of the internal audit function at WaMu and its relationship to other internal review functions, including Corporate Fraud Investigations, Risk Mitigation, and Corporate Credit Review**

**Internal Audit**

My primary role as General Auditor was to provide an independent, objective assessment of WaMu's system of internal control and underlying business processes.

I joined WaMu in June 2004 and became General Auditor in December 2004. As General Auditor, I reported directly to the Chairman of the Audit Committee of the Corporate Board of Director's. I also reported administratively into the Chief Risk Officer, who reported to the CEO. I was not a member of the Executive Committee which was comprised of the CEO's direct reports.

We conducted our work in accordance with the Institute of Internal Auditor's *Standards for the Professional Practice of Internal Auditing and Code of Ethics* and employed the Committee of Sponsoring Organizations of the Treadway Commission – or more commonly referred to as COSO for defining, evaluating, testing and reporting on WaMu's policies, processes and information systems.

My primary objectives were twofold:

1. To assist the Board, management and employees in the effective discharge of their responsibilities by providing analysis, testing, recommendations, advice and information concerning the adequacy and effectiveness of WaMu's internal control structure related to safeguarding of assets, compliance with applicable laws and regulations, and achievement of management's operational objectives; and
2. To promote effective business processes to internal control at a reasonable cost.

The Board, management and employees of WaMu were accountable and responsible for establishing both an adequate and effective internal control environment and for balancing risk and reward in determining and executing business strategies. In other words, Internal Audit does not set or determine business strategies, we audit the processes that have been established to execute against the business strategies determined by the Board and management.

### **Corporate Fraud Investigations**

Corporate Fraud Investigations was accountable for investigating all internal and most external known or suspected fraud. This function also provides expertise and uniform approaches in managing a critical support program to minimize operating losses, maximize recovery efforts, provide recommendations to mitigate future occurrence, and when appropriate, support the prosecution of individuals responsible for losses suffered by WaMu.

### **Risk Mitigation**

It is my understanding that Risk Mitigation at WaMu was a fraud prevention function within the Home Loans Risk Management group. This group was accountable for investigating mortgage fraud that may occur during the loan origination and fulfillment process, by conducting pre-funding and post-funding reviews. In addition to performing investigative work, filing Suspicious Activity Reports and reporting fraud results to management, Risk Mitigation was also the subject matter expert and support function for DataVerify. DataVerify was a fraud detection tool utilized within the loan fulfillment process that was implemented during fourth quarter 2007.

### **Corporate Credit Review**

Corporate Credit Review was accountable and responsible for providing an independent assessment of WaMu's credit risk and credit quality to the Board and Senior Management to ensure that lending and credit risk management practices are consistent with corporate business strategies and risk tolerance objectives. The Corporate Credit Review manager reported directly to the Chief Credit Officer who reported to the Chief Risk Officer, who reported to the CEO. In addition, the Corporate Credit Review manager also had a direct line to the Finance Committee of the Corporate Board of Directors who had Board delegated responsibility for credit risk management and administration matters.

Internal Audit's relationship to each of these functions is as follows:

- Corporate Fraud Investigations was realigned under the Internal Audit department on March 1, 2007. As part of Internal Audit, Corporate Fraud Investigations clarified its role and responsibilities for conducting both internal and external investigations; began identifying

enterprise-wide, systemic fraud trends and improved overall reporting of fraud results and trends to senior management and the Board.

- Internal Audit and Corporate Fraud Investigations were independent functions that collaborated with Risk Mitigation regarding mortgage fraud and the filing of Suspicious Activity Reports.
- Corporate Credit Review was likewise a separate and independent function, accountable and responsible for providing an independent assessment of WaMu's credit risk and credit quality to the Board. Internal Audit performed independent audits of Corporate Credit Review. Internal Audit's objective was to opine on the effectiveness of Corporate Credit Review's assurance work in order to determine the level of reliance we could place on their work. Internal Audit results were reported to Executive management and the Audit Committee.

**2. WaMu's programs and strategies for the origination, purchase, sale, and securitization of higher risk, higher margin loans, including its decision to move to a "High Risk Lending Strategy"**

Strategy and programs regarding the origination, purchase and sale of loans were not within the purview of Internal Audit, as noted above. That said, during my time at WaMu, I became aware of the following understandings:

- Historically, WaMu held adjustable rate mortgage (ARM) loans in its portfolio and substantially increased its Option ARM loan product starting in 2004. A significant portion of WaMu's Option ARM's was sold into the secondary market.

- WaMu began accelerating purchase of subprime loans in 2003 and had plans to continue growing this portfolio.
- In addition to selling loans to secondary market participants, WaMu acquired home loans from a variety of sources, pooled and securitized those loans and sold them to investors.
- WaMu recorded a net loss for 2007 due to significant credit deterioration in the single-family residential mortgage loan portfolio. In addition, credit quality concerns created uncertainty in the market for subprime mortgage products. Those concerns resulted in a contraction in secondary mortgage market liquidity for nonconforming residential loan products.
- During the fourth quarter of 2007, WaMu discontinued all remaining lending through the subprime mortgage channel.
- During the second quarter of 2008, WaMu eliminated the production of negatively amortizing products, including Option ARMs.

While I became aware of the above matters during my work as General Auditor, I was not aware of nor had I seen the “Higher Risk Lending Strategy” document dated and presented to the Finance Committee of the Board of Directors in January 2005 during my tenure as General Auditor. I was made aware of the “Higher Risk Lending Strategy” terminology after my departure from WaMu.

### **3. The demand from Wall Street for high risk home loans**

I was aware of the demand from Wall Street for high risk home loans in conjunction with WaMu's strategy for selling loans into the secondary market and securitizing loans and my general knowledge of the banking industry.

**4. Home loan underwriting and control policies, practices, and problems at Long Beach Mortgage Company ("LBMC"), including key audits and other reviews of Long Beach and management's response**

While not all inclusive, listed below is my recollection and understandings regarding underwriting, control policies and practices at Long Beach Mortgage Company (LBMC):

- During the fourth quarter of 2005, WaMu announced its plans to reorganize its single family residential mortgage lending operations. This reorganization combined LBMC within the Home Loans Group.
- LBMC practice was to re-underwrite all purchased subprime loans and satisfy WaMu's credit guidelines.
- Practices existed for monitoring broker relationships to mitigate credit risk and potential fraud stemming from broker practices.

Internal audits of LBMC operations were conducted in 2005, 2006 and 2007. LBMC operations were discontinued in fourth quarter 2007. Internal audit results reflected a less than satisfactory control environment in each year audited due primarily to a lack of sustainable and repeatable processes and ineffective management oversight. Key audits and other reviews included:

#### 4/16/06 LBMC – Repurchase Reserve Root Cause Analysis

- LBMC originated subprime loans and held the loans in portfolio or sold them through securitizations or whole loans sales. In mid-2005, LBMC shifted from a securitization to a whole loan sales program. Unlike securitizations, the whole loan sales program included an early payment default provision that required LBMC to repurchase loans if the first payment due to the investor was not remitted by the borrower and not cured within 60 days of payment due date.
- During the third quarter of 2005, LBMC experienced a dramatic increase in the volume of loans repurchased under recourse provisions.
- Internal Audit executed a post mortem review of control and process breakdowns that included ineffective corporate governance, risk management practices and management oversight.

#### 12/31/06 LBMC Mortgage Repurchase Reserves Audit Report

- The overall system of internal control requires improvement and is less than satisfactory.
- Data integrity and governance issues were identified as needing improvement

#### 8/20/07 LBMC Loan Origination and Underwriting

- The overall system of internal control requires improvement and is less than satisfactory.
- Issues identified pertained to the lack of sustainable and repeatable processes due primarily to deficiencies related to underwriting quality, data integrity, the manually intensive processing environment and repeat issues from prior audits and other independent reviews.

Management's responses initially addressed the control deficiencies identified in the audit reports; however, action plans weren't effectively executed in all cases.

**5. Home Loan underwriting and control policies, practices, and problems at WaMu, including key audits and reviews, and management's response**

While not all inclusive, listed below were my understandings regarding underwriting, control policies and practices at the Home Loans (HL) Group:

- In 2003 and 2004 a cost containment initiative was launched and was primarily directed at reducing the fixed cost structure of the mortgage banking business, through FTE reductions and facilities closures. By the end of 2004, this initiative resulted in reductions of approximately 10,000 employees.
- WaMu continued to increase its emphasis on home equity lending in 2005 through 2007.
- During the fourth quarter of 2005, WaMu announced additional plans to reorganize its single family residential mortgage lending operations. This reorganization consolidated WaMu's subprime mortgage origination business, LBMC, within the Home Loans Group.
- In 2007 and 2008, WaMu implemented a series of actions and initiatives to further consolidate the Home Loans business including:
  - Discontinuing all remaining lending through the subprime mortgage and wholesale channels;
  - Eliminating negatively amortizing products including the Option ARM from the product line.
  - Eliminating additional FTEs in the Home Loans business; and



- Closing various home loan centers, sales offices and home loan processing and call centers.
- WaMu also took certain actions designed to reduce its potential future exposure to credit risk, including the reduction or suspension of certain undrawn home equity lines of credit.

Internal audits of the Home Loans Group were conducted in 2005 - 2008. Audits were conducted of loan originations and underwriting, loan servicing, capital markets activities, compliance with laws and regulations and technology processes. The annual audit plan provided for between 35,000 – 40,000 hours each year or approximately 25% - 30% of the total annual plan hours.

Internal audit results reflected a less than satisfactory control environment due primarily to a lack of sustainable and repeatable processes caused by a manually intensive processing environment, non-compliance with policies and standards and an inordinate amount of change over this time period. Issues identified related to non-compliance with specific laws and regulations, Long Beach Mortgage issues discussed above, ineffective fraud monitoring processes, underwriting and appraisal processes, charge-off processes and technology related control weaknesses.

**6. WaMu and Long Beach policies, practices, and problems related to selling whole loans and securitizing mortgages.**

While not all inclusive, listed below were my understandings regarding policies and practices related to the sale and securitization of loans:

- In 2004 and 2005, Long Beach Mortgage Company (LBMC) engaged in whole loan sale transactions of originated subprime loans in which it agreed to repurchase from the investor

each “early payment default” loan at a price equal to the loan’s face value plus the amount of any premium paid by the investor. In the fourth quarter of 2005, LBMC experienced increased incidents of repurchase of early payment default loans sold by LBMC and this trend continued into 2006. (See above)

- WaMu began experiencing increased incidents of repurchase requests no later than the fourth quarter of 2006.
- In 2008, the provision for loan repurchases rose significantly, primarily reflecting an increase in the volume of investor requests to repurchase loans WaMu had previously sold.

Internal Audits of processes related to securitizations were performed in 2005 – 2007 with a focus on controls surrounding sale and securitization transactions, deal structuring, transaction management and settlement, accounting, regulation compliance and supervisory oversight. Issues identified included processes for validating the accuracy of data and reporting.

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## United States Senate

COMMITTEE ON  
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS  
WASHINGTON, DC 20510-8250

MICHAEL L. ALEXANDER, STAFF DIRECTOR  
BRANDON L. MILHORN, MINORITY STAFF DIRECTOR AND CHIEF COUNSEL

March 11, 2010

VIA U.S. MAIL & EMAIL (jsavitt@jetcitylaw.com)

Mr. Randy Melby  
c/o James P. Savitt, Esq.  
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Dear Mr. Melby:

On March 25, 2010, the U.S. Senate Permanent Subcommittee on Investigations will hold the first in a series of hearings examining some of the causes and consequences of the recent financial crisis. The first hearing will focus on the role of high risk home loans in the financial crisis, using as a case history high risk home loans originated and sold by Washington Mutual Bank ("WaMu"). The hearing will begin at 9:30 a.m. in Room 216 of the Hart Senate Office Building in Washington, D.C.

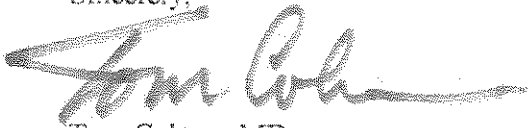
The Subcommittee requests that you testify on a panel at the hearing regarding your role at WaMu. To assist the Subcommittee's understanding of the issues, we ask that you be prepared to address and answer questions about the following matters:

- 1) WaMu's programs and strategies for the origination, purchase, sale, and securitization of higher risk, higher margin loans, including its decision to move to a "High Risk Lending Strategy";
- 2) The demand from Wall Street for high risk home loans;
- 3) The role of the internal audit function at WaMu and its relationship to other internal review functions, including Corporate Fraud Investigations, Risk Mitigation, and Corporate Credit Review;
- 4) Home loan underwriting and control policies, practices, and problems at Long Beach Mortgage Company ("Long Beach"), including key audits and other reviews of Long Beach and management's response;
- 5) Home loan underwriting and control policies, practices, and problems at WaMu, including key audits and reviews, and management's response; and
- 6) WaMu and Long Beach policies, practices, and problems related to selling whole loans and securitizing mortgages.

Please submit a written statement addressing the above matters. This statement will be included in its entirety in the printed hearing record. Subcommittee rules require that the written statement be received by 9:30 a.m. on March 23, 2010. Please deliver the written statement to the Subcommittee's Chief Clerk, Mary Robertson, through electronic mail at [Mary\\_Robertson@hsgac.senate.gov](mailto:Mary_Robertson@hsgac.senate.gov). In addition, you should be prepared to provide an oral statement of up to five minutes in length, to be followed by questions from Subcommittee Members.

Thank you for your assistance in this matter. If you have any questions or would like additional information, please contact Zachary Schram (Senator Levin) at (202) 224-9505 or Anthony Cotto (Senator Coburn) at (202) 224-3721.

Sincerely,



Tom Coburn, MD  
Ranking Minority Member  
Permanent Subcommittee on Investigations



Carl Levin  
Chairman  
Permanent Subcommittee on Investigations