STATEMENT OF STEPHEN J. ROTELLA

BEFORE THE
UNITED STATES SENATE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

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Chairman Levin, Ranking Member Coburn, and Distinguished Subcommittee Members:

I want to thank the Subcommittee for inviting me to testify and for the opportunity to submit a written statement in connection with my testimony. While the majority of WaMu's people and functions were unrelated to residential mortgage lending, I understand that the Subcommittee's inquiry is focused on residential mortgage lending, and I will, therefore, address my remarks to that particular subset of WaMu's much larger consumer and business banking operations.

Professional Background

I was the Chief Operating Officer at Washington Mutual (WaMu) from 2005 until September 2008, when the FDIC seized the bank and sold its assets at the height of the global financial crisis. Prior to the FDIC seizure of WaMu, I had worked in the financial services industry for three decades. I began my career at what is now Accenture and subsequently worked at several companies in the mutual fund, brokerage and banking industries until I joined Chemical Bank in 1987. I spent nearly 18 years at Chemical Bank (and its successor companies), now known as JPMorgan Chase. I worked my way up from a staff position at Chemical Bank to become one of a handful of executives who successfully navigated Chase Home Finance (JPMorgan's residential lending business) through some of the largest and most challenging operating integrations in the history of the industry. Together with my colleagues, we grew Chase's home lending business from a modest regional business into the fourth largest and one of the most respected operations in the country. I was promoted to Chief Operating Officer of Chase Home Finance in 1998, and then to Chief Executive Officer in 2000—a position I held until I left Chase in 2005 to join WaMu. I was a member of the JPMorgan Executive Committee, which consisted of the top thirty or so executives at the company.

As COO and CEO of Chase Home Finance, I was committed to community development and affordable lending, and, in that regard, I spearheaded one of the largest commitments to expanding home ownership at that time. I was also active in the lending industry, serving on the board of the Mortgage Bankers Association, as president of the Consumer Mortgage Coalition, and as a member of the Housing Policy Council of the Financial Services Roundtable. I also participated in FM Watch, a group focused on the systemic risk and duopolistic market power of the GSEs, well before the global financial crisis brought these issues to the fore.

Joining WaMu

I joined WaMu in 2005, following the company's search to fill the newly created position of Chief Operating Officer. Because WaMu had been a competitor of Chase for years, I had some familiarity with WaMu and its business practices. I knew that WaMu was the sixth largest retail depository institution and the third largest mortgage lender in the country. I also knew that WaMu had emerged on the national stage as a result of a succession of large bank and mortgage company acquisitions in the 1990s and 2000s, and that it had experienced extraordinary growth in home lending in the early 2000s. By 2003, WaMu had an 11.4% share of the home lending market with new loan volume of approximately $417 billion during that year.

From my vantage point as a longtime competitor, I knew that WaMu had a number of strengths, but that I would also face several significant challenges when I accepted the

COO position in 2005. While the Bank's underwriting practices and lending policies seemed to be roughly in line with its peer institutions (on comparable products in comparable localities), WaMu had certain characteristics that I believe resulted in a heightened level of risk. Three factors in particular (each of which had developed over many years) needed to be addressed proactively:

First, the credit risk associated with WaMu's home lending was highly concentrated. WaMu was significantly invested in mortgage assets relative to its size, and those assets were concentrated in a limited number of states. A key component of this particular risk factor was the fact that WaMu, as a federally-chartered thrift, was generally required to invest at least 65% of its assets in residential real estate and consumer loans. In addition, nearly 60% of WaMu's residential loans were secured by properties in California and Florida, both of which had above-trend home price appreciation for a number of years.

Second, the bank had significant operating weaknesses, particularly in its home lending segment. In my judgment, WaMu had grown too quickly in the late 1990s and early 2000s and did not develop the corresponding depth of management or the requisite infrastructure to sustain that growth. When I arrived at WaMu in 2005, the bank was separately operating three home lending businesses (prime, subprime and home equity), with outdated infrastructure and multiple, inconsistent systems and processes resulting from the succession of acquisitions noted above. Operational weaknesses made it very difficult to properly manage such a complex business—particularly during a high growth, high volume period.

Third, WaMu was experiencing rapid growth in its higher risk home loan products. In particular, even while WaMu's overall lending volume declined in 2004, the bank's Option ARM volume was up 124% and subprime volume was up 52% that same year.

These and other factors resulted in certain operating missteps and financial losses in 2003 and 2004 that led to management changes at the company. It was in this environment that a new executive team began to take shape, which included my recruitment to WaMu in January 2005. Thereafter, I accelerated this process in my areas of responsibility with the hiring of additional experienced managers. The team (which consisted of new executives from well respected companies as well as tenured WaMu veterans) believed that with enough time and effort, WaMu could resolve its deficiencies and take its place among the country's finest financial institutions.

My Responsibilities at WaMu

Reporting directly to Kerry Killinger, CEO, my initial responsibility was to implement and execute the strategic plan established by the Board of Directors, and to improve the bank's day-to-day operations. The heads of WaMu's four business lines—Retail Banking, Commercial Lending, Home Loans and, later in 2005, Credit Cards—reported to me, as did the heads of other units such as Technology and Marketing. All other segments of the bank, including Risk Management (which encompassed, among other things, the credit risk management function, internal auditing , regulatory relations and compliance), Finance (including the treasury function and strategic planning), Legal and Human Resources, reported to Mr. Killinger.

Prior to the time I joined WaMu in 2005, the Board of Directors had approved a five-year strategic plan. This plan called for additional growth in the mortgage lending business with a particular emphasis on higher margin and higher risk products. The Board's decision to move to a higher margin lending strategy was undoubtedly influenced by the fact that it was very difficult for private sector lenders to make a reasonable return on capital in conventional lending, due to the dominance and advantages of Fannie and Freddie in the conventional lending segment. As a result, lenders like WaMu could obtain higher returns for loans with more credit risk, which led to a market expansion in those products. The bank's strategy, while it had some logic at the time the Board envisioned it, and was similar to strategies adopted at a number of other banks, was, with the benefit of hindsight, ill-advised. As the post-2005 financial crisis conclusively established, credit risk was mis-priced for a declining housing market.

I did not design this strategy-, and due to the state of the company's operations, which were even weaker than I had anticipated before I joined WaMu, and a changing external environment, I and others realized that changes to the strategy needed to be implemented. With a steadily softening real estate market, a small group of executives consisting primarily, but not exclusively, of me, the Chief Financial Officer and the head of Strategy, determined that WaMu needed to move away from its concentration in home mortgages, which was a fundamental change to the company's historical business model. We gained the concurrence of the CEO. Thus, even while other high profile industry players (including Bank of America, Wachovia and Merrill Lynch) were acquiring mortgage companies and growing their residential lending businesses, we worked to change WaMu's risk profile by:

(i) diversifying the bank's mix of businesses;

(ii) reducing new loan volumes and WaMu's corresponding share of the residential lending market; and

(iii) reducing the size of our mortgage loan and servicing portfolios.

We believed that if WaMu carefully built up non-mortgage revenues while at the same time reduced mortgage concentration, we ultimately could enhance WaMu's long-term prospects, with more stable earnings and a lower level of risk. We also knew that effecting fundamental change at a complex institution with over $340 billion in total assets would take careful planning, execution and time.

Diversification

A critical strategy was to broaden and expand revenues in the retail banking segment while also improving the retail bank's operations and efficiency. I led the revamping of WaMu's checking and deposit products and the build out of small business and online banking services that significantly stimulated customer and deposit growth. By 2006, we moved the retail bank into top tier positions in customer acquisition, internet banking, small business growth and overall customer service. At the same time, we made the decision to begin closing hundreds of underperforming retail bank branches throughout the United States in an effort to reduce costs and improve the financials of the retail banking segment. In the third quarter of 2005, WaMu bought and I led the team that seamlessly integrated an $18 billion credit card business from Providian Financial Corporation. We also worked to prudently grow WaMu's commercial lending business. These changes allowed the bank to leverage its fixed costs while simultaneously beginning to diversify its business as a whole.

Reduction of New Loan Volumes

Beginning in 2005, I recruited a number of new executives into the home lending area and we began to reduce the volume of WaMu's higher risk lending and WaMu's overall share of the mortgage market. We were successful in this endeavor. When I joined the company, subprime lending through the bank's Long Beach Mortgage subsidiary was increasing every quarter. I recognized operating issues at Long Beach and made a series of changes to address these issues and to reduce subprime lending growth. In late 2005, I changed the management of Long Beach and consolidated it into our larger home lending unit to gain efficiencies and achieve more transparency into the workings of the business. Subprime lending volume, (as noted earlier, up 52% in 2004), was reduced slightly in 2005, and reduced at an accelerating rate in subsequent years. Specifically, subprime volume was down 31% in 2006 and an additional 69% in 2007. By the middle of 2007, the level of new volume was negligible and in the third quarter of that year, the bank entirely shut down its Long Beach related subprime lending operations.

As the U.S. housing market continued to deteriorate and its impact began to spread to the overall economy, we continued to shift focus toward reducing WaMu's credit exposure. We reduced WaMu's volume of Option ARM loans by nearly 35% from 2005 to 2006, and by an additional 44% year-over-year decline in 2007. At the start of 2008, Option ARM volume was very low and the company stopped originating that product altogether in the second quarter. Management also progressively tightened underwriting standards across all loan products, shifted the bank's product strategy toward originating more conforming mortgage loans that could be sold to Freddie Mac and Fannie Mae, and discontinued lending conducted through the correspondent and later the wholesale channel—thereby migrating WaMu's mortgage volume away from third party producers and toward direct originations from retail customers where the company would have greater control over the entire loan process.

As a result of these actions, we reversed the growth trajectory in WaMu's home lending business overall, shrinking new loan volumes by about 50% from 2004 levels, and faster than the market as a whole. Specifically, the company's share of the mortgage market, which was 11.4% in 2003, dropped to 5.7% by 2007 and 4.0% by the time the bank was seized.

Reduction of Mortgage and Servicing Portfolios

In 2005, we began to slow the rate at which the mortgage assets on WaMu's balance sheet had been growing. The significant volume reductions (noted above) helped and were further aided by other actions. As part of the plan to reduce WaMu's mortgage risk, the bank sold nearly all 2004 and 2005 subprime residuals and began to sell the majority of Option ARM loans that it originated. In 2006, WaMu also sold $18 billion in mortgage loans from its portfolio. Consequently, WaMu's mortgage portfolio was up only 7% from 2004 to 2005—compared to a 23% increase from 2003 to 2004 and a 29% increase from 2002 to 2003. Beginning in 2006, the overall portfolio actually decreased in size, including decreases in the subprime segment (which had increased by 48% from 2003 to 2004) and the Option ARM segment (which had been up 35% from 2003 to 2004) until the secondary markets collapsed in the second half of 2007.

To frame this another way, from 2002 through 2004, the overall residential loan portfolio at WaMu grew 58%. Then, from its peak in 2005, until the middle of 2007, when the collapse of the secondary markets prevented the sale of non-GSE loans, the same portfolio declined by 12%.

I also initiatiated a project to sell approximately $140 billion of mortgage servicing and associated rights corresponding to 1.3 million servicing customers, which was successful. This volatile asset had long plagued the bank, causing significant swings in the bank's financial results. WaMu's home loans team sold these assets to Wells Fargo (which had a much larger balance sheet and more diverse business model than WaMu) in July 2006. The sale of these assets was consistent with our strategy to deploy capital for improved returns and to reduce the size of the bank's home loans business, while at the same time creating a more stable earnings profile by reducing servicing rights as a percentage of capital. The sale also helped appropriately balance WaMu's servicing portfolio with the bank's origination franchise.

Conclusion

Few experts predicted what occurred in the housing market, the mortgage industry, the broader financial markets, or to the nation's economy as a whole. In 2006, Chairman Bernanke predicted that because the "housing market [had] been very strong for the past few years" it would "cool but not change very sharply." Chairman Bernanke also said that even "[i]f the housing market does cool, more or less as expected, that would still be consistent with a strong economy." And in 2009, Chairman Bernanke said that he "did not anticipate a crisis of this magnitude, this severity." Secretary Paulson, likewise, said that he did not anticipate a crisis of this magnitude.

As the former COO of WaMu, I would like to be able to say that after my arrival at the bank in 2005, every decision that was made was correct. But, I was neither more prescient about the future than the Chairman of the Federal Reserve Bank or the Secretary of the Treasury nor did I have complete decision-making authority at the company. All of the bank's businesses, involving over 40,000 employees who worked in the segments of the bank for which I was responsible, needed my full attention—not just the home lending business. Looking back on the decisions that WaMu made after I joined the bank in 2005, I can say that WaMu was moving in the right direction, making sensible decisions and making progress in our objective to move away from WaMu's mortgage-centric legacy and towards a more diversified business mix. In hindsight, I would have tried to move even faster than we did in all the areas over which I had control. Unfortunately, after the capital markets seized up in the third quarter of 2007, our ability to execute on major aspects of our strategy ceased; selling new production as a normal course of business, other than to the GSEs, or reducing the level of portfolio assets was eliminated. Subsequently, the decline in the housing market accelerated and it was not long before the financial crisis, marked by the Bear Stearns and other failures, was in full swing. WaMu's management team continued its efforts to improve the company and the bank raised approximately $10 billion in fresh capital over a few short quarters to bolster the company's financial strength. Indeed, even the Office of Thrift Supervision (WaMu's primary regulator and the entity that ultimately authorized the FDIC to seize the bank) said that the bank met the well-capitalized standards on the same date it was seized by the FDIC.

The Subcommittee's focus understandably is on WaMu's home mortgage business. And there can be no doubt that, when the nation's housing market collapsed, thrifts like WaMu were especially hard hit because of their historical mandate to focus on home mortgage lending. But, lost in the commentary about WaMu and its home lending business is the fact that the broader company had tens of thousands of great employees working hard every day to serve tens of millions of customers and to deliver the highest level of customer care in retail banking and other businesses. The bank engendered some of the highest employee and customer loyalty scores in the industry.

This is the first public statement I have made since the seizure. I want to be clear that I believe that what happened at WaMu was principally the result of the particular risks (e.g., concentration, operating weaknesses and rapid growth) that had developed over many years at the company being magnified and exacerbated by the extreme conditions in the economy. The executive team and all of our people worked very hard to mitigate those risks right up until the seizure and sale of the bank. We desperately wanted more time than the two-plus years we had to transform the company and the opportunity to finish what we had started in 2005.