Prepared Statement of David Schneider

before the
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
United States Senate

April 13, 2010

Chairman Levin, Ranking Member Coburn, and Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the causes and consequences of the recent financial crisis. My name is David Schneider. I understand the importance of the Subcommittee's investigation and welcome the opportunity to provide the Subcommittee with information related to its work.

From July 2005 until September 2008, I served as President of Home Loans at Washington Mutual. At the time I started, I had responsibility for WaMu's prime mortgage business, which included the origination of mortgages done through loan officers, mortgage brokers or whole loan purchases from third parties. Home Loans also included WaMu's business of servicing prime residential mortgage loans and a variety of functions supporting WaMu's business, including a capital markets group.

Over time, my responsibilities expanded. In 2006, I was given responsibility for real-estate secured consumer lending (home equity loans and lines of credit), which had been part of WaMu's retail banking line of business. Also in 2006 I was given responsibility for Long Beach Mortgage Company, a subprime mortgage lender that WaMu had bought in 1999. Long Beach was WaMu's only subprime channel. As discussed more fully below, Long Beach was eventually incorporated into the Home Loans business line and then shut down in the third quarter of 2007.

WaMu's lending strategy. The Subcommittee has asked that I address "how strategy for the Home Loans Division was established and implemented at WaMu, including with respect to the decision to move to a 'High Risk Lending Strategy.'" I am not in a position to provide first-hand testimony regarding the adoption of WaMu's Higher Risk Lending Strategy, because that strategy was adopted before I joined WaMu, but I am happy to tell the Subcommittee what I do know.

It is my understanding that the strategy was adopted (before I arrived in July 2005) in connection with WaMu's 2005 Strategic Plan, which was reviewed with the WaMu Board of Directors in June 2005. After I arrived at WaMu I was informed of the strategy and the reasons for it. In brief, I was told that WaMu had capital that needed to be put to more productive use for the company's shareholders. In addition, WaMu's management wanted to reduce WaMu's relative exposure to market risk—that is, exposure to interest rate changes. It was my understanding that WaMu's management planned to do so by taking on additional credit risk through a shift in the assets WaMu chose to hold on its balance sheet.

It was also my understanding that management planned its decision to be part of a broader effort to better diversify the risk of the bank across its various lines of business and to reduce its exposure to market risk. For example, management regarded the acquisition of the Providian credit card business as part of this new strategy. Within Home Loans, the bank diversified its risk profile not only by changing its lending product mix and parameters, but also by reducing its concentration in Mortgage Servicing Rights. The rights to service loans owned by others were at the time one of the largest assets on WaMu's balance sheet, and they subjected the bank to substantial interest rate risk. In fact, primarily in an effort to reduce its exposure to this risk, WaMu sold $140 billion of Mortgage Servicing Rights in 2006.

The new strategy therefore focused on assets that presented a particular credit risk/market risk balance, such as credit cards, home equity loans and certain prime, Alt-A, and subprime loan products. For example, credit card and mortgage loans with payment obligations that adjusted based on market interest rates helped shift WaMu's risk profile from market to credit risk, and it was in this area that WaMu decided to put greater focus. To accomplish that goal in Home Loans, WaMu planned to accelerate the development of various Alt-A, subprime, and adjustable rate mortgages.

The Home Loans business. As I indicated above, WaMu's prime mortgage business was conducted through its Home Loans business line, which I was hired to run in July 2005. During periods when WaMu handled Alt-A loans, those loans were within Home Loans' purview as well. Subprime lending, by contrast, was handled through Long Beach Mortgage, which was separate from Home Loans until early 2006.

WaMu's Home Loans business included four different loan origination channels:

- Retail, which was the origination of mortgage loans through loan officers employed by WaMu, often located in WaMu's bank branches and home loan centers;
- Wholesale, in which independent mortgage brokers would work with potential borrowers, prepare loan files for them, and submit them to one or more lenders for consideration, underwriting and closing;
- Correspondent or conduit, through which WaMu would buy, either in bulk or on a loan-by-loan basis, closed loans that third parties had originated; and
- Consumer direct, essentially an inbound call center-based version of the retail channel that primarily handled refinancings of existing WaMu loans.

The balance among these channels changed over time. In the second quarter of 2006, we terminated WaMu's correspondent channel, which primarily provided fixed-rate loans that were sold in the secondary market (primarily to Fannie Mae and Freddie Mac) and resulted in the creation of Mortgage Servicing Rights. WaMu's efforts in the third-party purchase business shifted to its conduit, which allowed WaMu to buy loans in bulk for securitization. During the third quarter of 2007, in turn, WaMu ceased buying loans in bulk through the conduit channel.

WaMu's Home Loans business originated many different types of loans, including 15- and 30-year fixed rate conforming and non-conforming loans; various types of adjustable rate mortgages ("ARMs"); and Option Adjustable Rate Mortgages—so-called Option ARMs. Lenders had long offered Option ARMs to home buyers and owners, especially in California, where WaMu's business and banking branches were heavily concentrated. The interest rates on Option ARMs changed on a monthly basis, but the terms of the loans provided four monthly payment options to allow borrowers to tailor each month's payment to their current financial situation. Many borrowers valued this flexibility, particularly in California where home prices were high.

Although WaMu intended to expand its credit guidelines consistent with the 2005 Strategic Plan's goal of shifting from market to credit risk, we never did implement the Plan as written. As housing prices peaked and began declining and the economy began softening in 2006, and as credit markets tightened in 2007 and 2008, WaMu took a series of steps to adopt more conservative credit policies and to move away from loan products with greater credit risk. We focused on narrowing WaMu's product set, tightening credit parameters, and resizing our business to reflect lower industry origination volumes. We tightened credit standards by changing documentation requirements; raising required minimum FICO scores and lowering loan-to-value ratios; dramatically curtailing the availability of underwriting exceptions (which allowed certain underwriters to approve loans that did not meet certain underwriting guidelines based on the existence of compensating factors); and increasing the requirements for getting home equity loans. We also instituted a number of business changes designed to make WaMu's loan origination business more effective and efficient in determining which loans should be approved. Among other things, we put in place an automated underwriting tool; we began to employ automated fraud detection programs; and we consolidated WaMu's origination systems, giving us a single system for the origination of home loans. We also reduced the number of loan products we offered. We eliminated Alt-A lending in late 2007 and discontinued Option ARM lending in January 2008.

WaMu's Option ARM lending decreased (in dollar terms) by more than 50% from 2005 to 2006 and by 35% from 2006 to 2007, the last year in which we made any Option ARM loans. Even in fixed-rate prime loans, volume declined substantially: prime, fixed-rate loan volume was down 59% from 2005 to 2006, 12.5% from 2006 to 2007 and 19% from 2007 to 2008.

Long Beach Mortgage. Long Beach was placed under my supervision in the first quarter of 2006. I understand that, at that time, it was a wholly owned WaMu subsidiary (and I believe that it ceased to exist as a separate legal entity not long thereafter). The decision to make Long Beach a WaMu subsidiary and then unwind its corporate structure was made before my arrival at WaMu. Long Beach historically had originated loans through mortgage brokers and only for sale to third parties.

At the time I was given responsibility for Long Beach, I was asked to address the challenges it was experiencing. During 2006 we made management changes at Long Beach. Then, in the third and fourth quarters of 2006, repurchase requests spiked at Long Beach. These requests came from loan buyers who demanded that Long Beach buy back

certain loans. The buyers asserted that the underwriting or performance of these loans was allegedly inconsistent with representations and warranties Long Beach had made in connection with their sales. Buyers sometimes demand repurchase when it is not appropriate, and repurchase demands are typically evaluated in consultation with the buyer and do not always and necessarily lead to repurchase. We nevertheless responded to the spike at Long Beach by establishing a taskforce to review and respond to these demands and implemented a seven-step process for proactively identifying loans that might present repurchase obligations. Through this process, we sought to identify loans that might be subject to repurchase and reached out to buyers when we identified such loans rather than waiting for buyers to come to us.

As I became more familiar with Long Beach, I concluded that its lending parameters should be tightened, and we did that in many and varied ways. Across a variety of products, we raised minimum FICO scores, lowered maximum loan-to-value ratios, established product-specific maximum loan values, raised minimum credit history requirements, raised documentation requirements, and implemented mechanisms to detect and root out fraud. We did away with stated-income lending and began requiring tax and insurance escrow accounts. As a result, the percentage of Long Beach loans approved based on full documentation increased every year from 2005 to 2008, and the percentage of subprime loans with combined loan-to-value ratios greater than 90% decreased every year over the same period. The broader strategic decisions we made were of a piece with these credit-tightening changes. We eliminated many Long Beach products, and in mid-2007 we stopped originating subprime loans entirely. As a result, subprime lending declined by 33% from 2005 to 2006 and by 80% from 2006 to 2007.

Whole loan sales and loan securitizations. WaMu had the capability to originate far more loans than its capital would allow it to place on its balance sheet. WaMu therefore sold to third parties the majority of the loans it originated, through either securitizations or whole loan sales, keeping only what it could afford to carry in its portfolio. Loans were originated so that they could be either kept or sold, however, and the personnel who handled loan production generally did not know whether any given loan would be held for sale or held for investment—that is, there were no separate procedures for loans intended for sale versus loans intended for WaMu's portfolio.

Decisions on which loans to hold for investment and which to sell were made by bank executives and senior managers through the Asset and Liability Committee ("ALCO"), of which I was a member. Decisions were based on ALCO's evaluation of the risk/return profile for a set of loans, including whether they were of a type that would subject WaMu to interest rate volatility and would suit the needs of the whole enterprise's balance sheet. Because risk/return profiles varied among different types of loans, some loans were more likely to be held for investment than others. WaMu sold almost all of the 30-year fixed rate mortgages it originated, for example, as substantial interest rate volatility was inherent in those loans, while it kept essentially all the home equity loans it originated. ALCO also considered other issues that could affect WaMu's balance sheet, including the product spread and geographic makeup and concentration of the loans it already held on its books.

Securitizations of non-agency loans that came through Home Loans were conducted by Home Loans' capital markets group and involved three other, separate entities: WaMu Capital Corp., WaMu Asset Acceptance Corp., and Washington Mutual Mortgage Securities Corp. Long Beach Mortgage initially had a separate capital markets group that securitized Long Beach loans. Later, as Long Beach was incorporated into Home Loans, its loans were securitized through WaMu Capital Corp. WaMu's mortgage-backed securities were sold to institutional investors such as hedge funds, mutual funds, and other financial institutions. When WaMu securitized loans, it often retained a residual interest in the securities and thus kept the first-loss position on loans that failed to perform. Similarly, WaMu's whole loan sales were generally negotiated transactions with institutions having significant expertise in this area, including those in the financial services, mortgage servicing, and real estate lending industries. Purchasers of both whole loan and mortgage securities had access to extensive information regarding the loans, including the performance of similar loans, and conditions in the housing market. With regard to whole loans sales, buyers were provided actual loan files for their review. Both securitizations and whole loan sales were made possible—as are essentially all financial transactions—by the reality that sophisticated participants in the financial industry value assets differently based on different predictions as to future events, different appetites for different risk/return profiles, and different balance sheet needs.

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Mr. Chairman, Ranking Member Coburn, and Members of the Subcommittee, thank you for the opportunity to address the issues the Subcommittee is considering. To the extent I can provide further insight, I welcome the opportunity to do so. Thank you.