Statement of James G. Vanasek

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Washington Mutual Bank
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Mr. Chairman, Senator Coburn, and other distinguished Members of the Committee, thank you for the opportunity to discuss the mortgage and financial crisis from the perspective of a credit officer in the sixth largest bank in this country prior to 2006. I was the Chief Credit Officer and later Chief Risk Officer of Washington Mutual during the period of Sept 1999 to Dec 2005 when I retired. Prior to serving in this capacity, I had worked for several large banking companies in senior credit oriented roles including PNC, First Interstate Bank and Norwest/Wells Fargo. Altogether I have 38 years of experience in credit oriented positions and have been fortunate to have a well established history and constructive relationship with all of the major banking regulators.

Washington Mutual Bank in the Context of the Mortgage Industry

The failure of Washington Mutual occurred in Sept 2008, nearly three years after my retirement so much of what I will tell you today is historical information about the company's strengths and weaknesses during the years of my direct involvement.

Washington Mutual was a reflection of the mortgage industry characterized by very fast growth, rapidly expanding product lines and deteriorating credit underwriting. This was a hypercompetitive environment in which many mistakes were made by loan originators, lending institutions, regulatory agencies, rating agencies, investment banks that packaged and sold Mortgage Backed Securities (MBS) and the institutions that purchased these excessively complex instruments. It was both the result of individual failures and systemic failures fueled by self interest, failure to adhere to lending policies, very low interest rates, untested product innovation, weak regulatory oversight, astonishing rating agencies lapses, weak oversight by boards of directors, a cavalier environment on Wall Street and very poorly structured incentive compensation systems that paid for growth rather than quality. One must also seriously question the wisdom of the elimination of Glass Steagall, and its impact on the securitization market.

Washington Mutual was a company that had grown with exceptional speed due to acquisitions primarily in California following the thrift industry crisis of the early '90s. By 2000 it was a company in search of an identity. At one point the CEO wanted the company to expand into the commercial lending arena in an effort to earn a higher price/ earnings ratio on the stock, only to abandon the effort some three years later. The focus then shifted to rapidly expanding the branch network by opening as many as 250 new locations within 12 months in cities where the company had no previous retail banking franchise. Ultimately this proved to be an unsuccessful

strategy due in part to the effort to grow too quickly. The focus then shifted away from diversification to becoming the so-called "low cost producer" in the mortgage industry. This effort was unsuccessful in large measure due to an expensive undertaking to write a completely new mortgage loan origination and accounting software system that ultimately failed and had to be written off. By mid 2005 the focus had shifted yet again to becoming more of a higher risk, sub-prime lender at exactly the wrong time in the housing market cycle. This effort was characterized by statements advocating that the company become either via acquisition or internal growth a dominant sub-prime lender.

In addition to sub-prime, the company was a large lender of adjustable rate mortgages (ARM's), having had some 20 years of experience with the product. As in the case of sub-prime the product that had only been available to a narrow segment of customers, adjustable rate mortgages, were sold to an ever wider group of borrowers. Product features were also expanded.

Historically plain vanilla mortgage lending had been a relatively safe business. During the period of 1999-2003 Washington Mutual mortgage loan losses were substantially less than 1/10 of 1%, far less than losses of commercial banks. But rapidly increasing housing prices masked the risks of a changing product mix and deteriorating underwriting in part because borrowers who found themselves in trouble could almost always sell their homes for more than the mortgage amount, at least until 2007.

Factors Contributing to the Failure of Washington Mutual Bank

There is no one factor that contributed to the debacle. Each change in product features and underwriting was incremental and defended as necessary to meet competition. But these changes were taking place within the context of a rapidly increasing housing price environment and were therefore untested in a less favorable economic climate. It was the layering of risk brought about by these incremental changes that so altered the underlying credit quality of mortgage lending which became painfully evident once housing prices peaked and began to decline. Some may characterize the events that took place as a "perfect storm," but I would describe it as an inevitable consequence of consistently adding risk to the portfolio in a period of inflated housing price appreciation.

The appetite of Wall Street and investors world-wide created huge demand for high yielding, sub-prime mortgages that resulted in a major expansion of what had historically been a relatively small segment of the business lead by Household Finance. The Community Reinvestment Act also contributed by demanding that banks make loans to low-income families further expanding sub-prime lending.

One obvious question is whether or not these risks were apparent to anyone in this industry or among the various regulatory or rating agencies? There is ample evidence in the record to substantiate the fact that it was clear that the higher risk profile of the entire industry to include Washington Mutual was recognized by some but ignored by many. Suffice it to say, meeting growth objectives to satisfy the quarterly expectations of Wall Street and investors lead to mistakes in judgment by the banks and mortgage lending company executives. A more

difficult question is why Boards of Directors, regulatory agencies and rating agencies were seemingly complacent.

Another question may be my personal role and whether I made a significant effort to alter the course of lending at Washington Mutual? In many ways and on many occasions I attempted to limit what was happening. Just a few examples may suffice. I stood in front of thousands of senior Washington Mutual managers and executives at an annual management retreat in 2004 and countered the senior executive speaker ahead of me on the program who was rallying the troops with the company's advertising tag line "The Power of Yes." The implication of this statement was that Washington Mutual would find some way to make a loan. The tag line symbolized the management attitude about mortgage lending more clearly than anything that I can tell you. Because I believed this sent the wrong message to the loan originators, I felt compelled to counter the prior speaker by saying to the thousands present that the "Power of Yes" absolutely needed to be balanced with "The Wisdom of No." This was a highly unusual thing for a member of the management team to do, especially in such a forum. In fact it was so far out of the norm for meetings of this type that many considered my statement exceedingly risky from a career perspective.

I made repeated efforts to cap the percentage of high risk and sub-prime loans in the portfolio. Similarly, I put a moratorium on non-owner occupied loans when the percentage of these assets grew excessively due to speculation in the housing market. I attempted to limit the number of stated income loans, loans made without the verification of income. But without solid executive management support, it was questionable how effective any of these efforts proved to be.

There have been questions about policy and adherence to policy. This was a continual problem at Washington Mutual where line managers particularly in the mortgage area not only authorized but encouraged policy exceptions. There had likewise been issues regarding fraud. Because of the compensation systems rewarding volume vs quality and the independent structure of the loan originators, I am confident that at times borrowers were coached to fill out applications with overstated incomes or net worth adjusted to meet the minimum underwriting policy requirements. Catching this kind of fraud was difficult at best and required the support of line management. Not surprisingly, Loan originators constantly threatened to quit and go to Countrywide or elsewhere if their loan applications were not approved.

As the market deteriorated in 2004 I went to the Chairman and CEO with a proposal and very strong personal appeal to publish a full page ad in the Wall Street Journal disavowing many of the then current industry underwriting practices such as 100% loan-to-value sub-prime mortgages and thereby adopt what I termed "Responsible Lending Practices." I acknowledged that in so doing the company would give up a degree of market share and lose some loan originators to the competition, but I believed that Washington Mutual needed to take an industry leading position against deteriorating underwriting standards and products that were not in the best interests of the industry, the bank or the consumer. There was never any further discussion or response to this recommendation.

Another way that I attempted to counteract the increasing risk was to increase the Allowance for Loan and Lease Loss Reserves to cover potential losses. Regrettably there has been a long standing unresolved conflict between the SEC and accounting industry vs. the banks and bank regulators regarding reserving methodology. The SEC and accounting profession believe that more transparency in bank earnings is essential to investors and that the way to achieve transparency is to keep reserves at levels reflecting only very recent loss experience. But banking is a cyclical business which the banks and the bank regulators recognize. It is their belief, and certainly my personal belief, that building reserves in good times and using those reserves in bad times is the entire purpose of a loan loss reserve. What is more, the investors, FDIC and the industry are far better protected with reserves that are intended to be sufficient to sustain the institution through-the-cycle rather than draining reserves at the point where losses are at their lowest. At one point I was forced by our external auditor to reduce the loan loss reserve of $1.8 billion by $500 million dollars or risk losing our audit certification. As the credit cycle unfolded those reserves were sorely needed by the institution.

In my opinion the Basel Accord on bank capital repeats the same mistake of using short term history rather than through-the-cycle information to establish required capital levels and, as such, has been a complete and utter failure to date.

The conventional wisdom repeated endlessly in the mortgage industry and at Washington Mutual was that while there had been regional recessions and price declines, there had never been a true national housing price decline. I believe that is debatable, but it was widely believed and partially on this premise the industry and Washington Mutual marched forward with more and more sub-prime, high loan-to-value and option payment products, each one adding incrementally to the risk profile.

Thank you for your time and attention, I will be happy to address your questions.

James G. Vanasek

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