



Carl Levin, Chairman

Tom Coburn, Ranking Minority Member

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SENATE SUBCOMMITTEE LAUNCHES SERIES OF HEARINGS ON WALL STREET AND THE FINANCIAL CRISIS

WASHINGTON – On Tuesday, the U.S. Senate Permanent Subcommittee on Investigations, under Chairman Carl Levin, D-Mich., and Ranking Member Tom Coburn, R-Ok., will launch a series of four hearings in April examining some of the causes and consequences of the 2008 financial crisis.

The first hearing will focus on the role of high risk mortgages, and feature Washington Mutual Bank, which was the nation’s largest thrift with more than \$300 billion in assets, \$188 billion in deposits, and 43,000 employees. Washington Mutual specialized in mortgage lending until it was seized by the government and sold to JPMorgan Chase in 2008. It was the largest bank failure in U.S. history. The Subcommittee investigation found that the bank contributed to the financial crisis by making hundreds of billions of dollars in shoddy, high risk mortgage loans, packaging them, and selling them to investors as mortgage backed securities.

“Washington Mutual built a conveyor belt that dumped toxic mortgage assets into the financial system like a polluter dumping poison into a river,” said Levin. “Using a toxic mix of high risk lending, lax controls, and destructive compensation policies, Washington Mutual flooded the market with shoddy loans and securities that went bad. Examining how Washington Mutual operated, and what its insiders were saying to each other, begins to open a window into the troubling mortgage lending and securitization practices that took our economy over a cliff. As the debate on financial reform begins, it is critical to acknowledge that the financial crisis was not a natural disaster, it was a man-made economic assault. Our hearings on the financial crisis will help provide a public record of what went wrong, who should be held accountable, and the ongoing need to protect Main Street from the excesses of Wall Street.”

The Subcommittee began its bipartisan investigation into the financial crisis in November 2008. Since then, Senate investigators have gathered millions of pages of documents, conducted more than 100 interviews and depositions, and consulted with dozens of experts. Future hearings will examine the role of regulators, credit rating agencies, investment banks, and the use of complex financial instruments.

The Washington Mutual case study examines how the bank’s search for profits led to the origination and securitization of shoddy mortgages that infected the entire financial system. The documents show that, in the mid-2000s, the bank made a conscious decision to focus on high risk mortgages, because higher risk loans offered greater profits. Washington Mutual increased its securitization of subprime loans sixfold, primarily through its subprime lender, Long Beach Mortgage Corporation. Over a four year period,

Washington Mutual and Long Beach increased their securitizations of subprime mortgages from about \$4.5 billion in 2003 to \$29 billion in 2006. Altogether, from 2000 to 2007, they securitized at least \$77 billion in subprime loans.

Washington Mutual also increased its origination of other high-risk loans, which it treated as prime loans, including its flagship product known as the Option ARM. Option ARMs allowed borrowers to pay an initial low “teaser rate,” before a higher variable interest rate was triggered. Once the higher rate took effect, borrowers were given the option of paying one of four amounts, with the lowest a “minimum payment” that did not cover the full amount of the interest and principal owed each month. The unpaid amount was then added to the unpaid loan principal, resulting in a negatively amortizing loan in which the total amount owed increased rather than decreased over time until a cap was reached and the loan “recast.” At that point, the required loan payments increased, and many borrowers defaulted. Washington Mutual sold at least \$115 billion in Option ARM loans to investors.

From 2003 to 2008, documents were unearthed showing that these high-risk loans were problem-plagued. Internal reports show that Long Beach and Washington Mutual loans did not comply with the bank’s own credit requirements, contained fraudulent or erroneous borrower information, and suffered from large numbers of early payment defaults on the part of borrowers. One FDIC review of 4,000 Long Beach loans in 2003, found that less than a quarter could be properly sold to investors. A 2005 review of loans from two of Washington Mutual’s top producing retail loan officers found fraud in 58% of the loans coming from one loan officer’s operations and 83% from the other. Yet those two loan officers continued working for the bank for three years, receiving prizes for their loan production. A 2008 review found that staff in another top loan producer’s office had been literally manufacturing borrower information to speed up production.

Documents obtained by the Subcommittee also show that, at a critical time, Washington Mutual selected loans for its securities because they were likely to default, and failed to disclose that fact to investors. It also included loans that had been identified as containing fraudulent borrower information, again without alerting investors when the fraud was discovered. An internal 2008 report found that lax controls had allowed loans that had been identified as fraudulent to be sold to investors.

Washington Mutual pay policies contributed to the problems. Loan officers and processors were paid based on volume, not the quality of their loans, and were paid more for issuing higher risk loans. Loan officers and mortgage brokers were also paid more when they got borrowers to pay higher interest rates, even if the borrower qualified for a lower rate – a practice that enriched WaMu in the short-term, but made defaults more likely down the road. These skewed compensation practices went right to the top. In 2008, when he was asked to leave the failing bank, CEO Kerry Killinger was paid \$25 million.

Based upon the Subcommittee investigation, Senators Levin and Coburn made the following findings relative to the Washington Mutual case history.

- (1) **High Risk Lending Strategy.** Washington Mutual (“WaMu”) executives embarked upon a high risk lending strategy and increased sales of high risk home loans to Wall Street, because they projected that high risk home loans, which generally charged higher rates of interest, would be more profitable for the bank than low risk home loans.
- (2) **Shoddy Lending Practices.** WaMu and its affiliate, Long Beach Mortgage Company (“Long Beach”), used shoddy lending practices riddled with credit, compliance, and operational

deficiencies to make tens of thousands of high risk home loans that too often contained excessive risk, fraudulent information, or errors.

- (3) **Steering Borrowers to High Risk Loans.** WaMu and Long Beach too often steered borrowers into home loans they could not afford, allowing and encouraging them to make low initial payments that would be followed by much higher payments, and presumed that rising home prices would enable those borrowers to refinance their loans or sell their homes before the payments shot up.
- (4) **Polluting the Financial System.** WaMu and Long Beach securitized over \$77 billion in subprime home loans and billions more in other high risk home loans, used Wall Street firms to sell the securities to investors worldwide, and polluted the financial system with mortgage backed securities which later incurred high rates of delinquency and loss.
- (5) **Securitizing Delinquency-Prone and Fraudulent Loans.** At times, WaMu selected and securitized loans that it had identified as likely to go delinquent, without disclosing its analysis to investors who bought the securities, and also securitized loans tainted by fraudulent information, without notifying purchasers of the fraud that was discovered.
- (6) **Destructive Compensation.** WaMu's compensation system rewarded loan officers and loan processors for originating large volumes of high risk loans, paid extra to loan officers who overcharged borrowers or added stiff prepayment penalties, and gave executives millions of dollars even when its high risk lending strategy placed the bank in financial jeopardy.

The April 13 hearing will take testimony from former WaMu executives, including former WaMu Chief Risk Officers James Vanasek and Ronald Cathcart; former General Auditor Randy Melby; former WaMu Home Loans President David Schneider; former head of Capital Markets David Beck; former President and Chief Operating Officer Stephen Rotella; and former Chairman and Chief Executive Officer Kerry Killinger.