Purchase and Assumption
Washington Mutual Bank (2008)

Background and context

Washington Mutual Bank (WaMu) was founded in Seattle in 1889 and grew to become one of the largest savings and loans institutions in the US. It began operations as Washington National Building Loan and Investment Association and was renamed to Washington Mutual Savings Bank in 1917. Through the years, WaMu had made several acquisitions and had gone public in 1983. The bank's aggressive expansion strategy saw further acquisitions (including Long Beach Financial), propelling WaMu to be a key player in the lucrative market of subprime mortgages. By 2007, it was selling 10 times more mortgage debt to the secondary market than it did in 2001.

WaMu's foray into aggressive lending did not end with its mortgage related acquisitions. The bank also purchased Providian for $6.45 billion in 2005 and was heavily involved in the business of providing high-risk uncollateralised credit card debt to subprime borrowers.

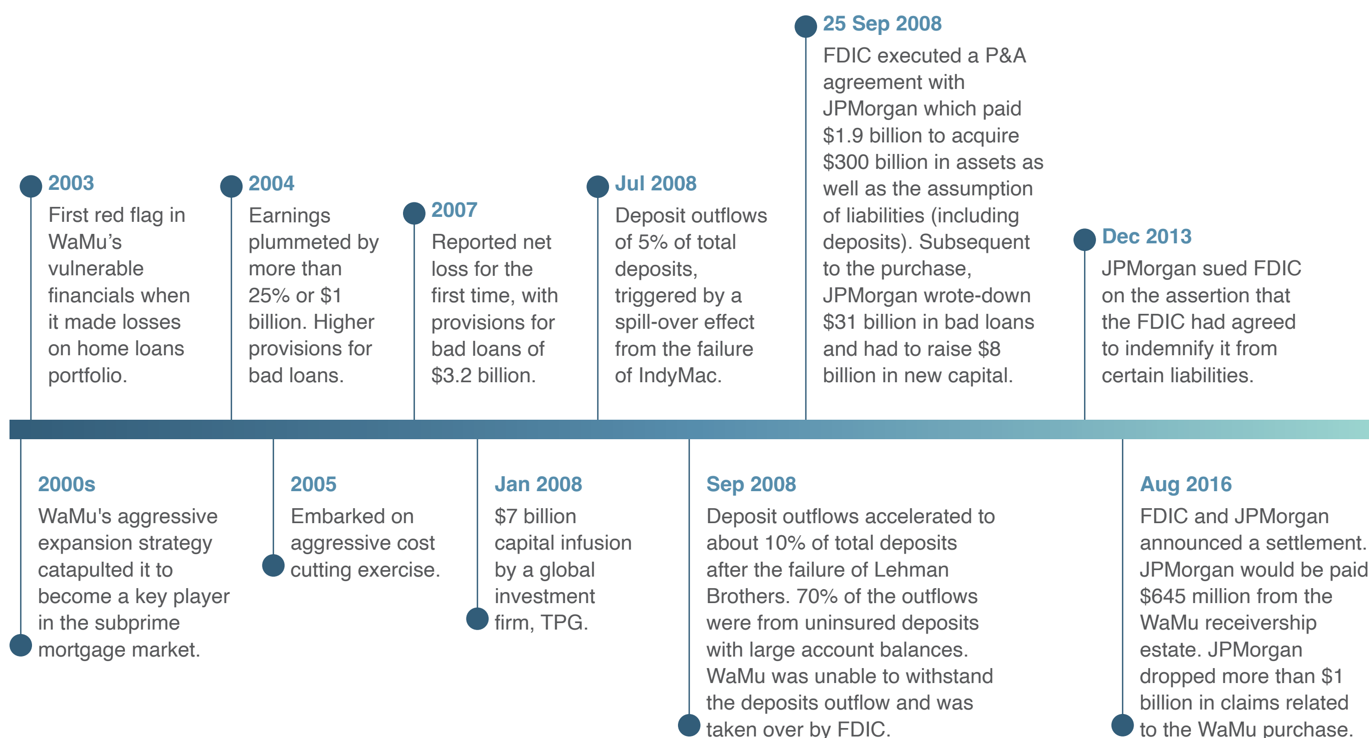
The bankruptcy of Washington Mutual, Inc (WaMu's holding company) was the second largest ever in the US, after Lehman Brothers, and the failure was the largest bank failure in the history of the US. At the time of its failure, WaMu had $188 billion in deposits, an asset size of $307 billion, and over 2,300 branches in 15 states (at the end of 2007, WaMu had more than 43,000 employees). Its largest customers were individuals and small businesses.

> ***Washington Mutual ... was the largest failure of an insured depository institution in the history of the FDIC***
>
> Federal Deposit Insurance Corporation

Significant deterioration in WaMu's performance leading to bank runs

The red flags to WaMu's downfall had been apparent when it began to experience substantial losses on home loans. In 2004, WaMu's earnings plummeted by more than $1 billion or 25% and provisions for bad loans increased by five times. The bank embarked on an aggressive cost cutting exercise, culling 13,450 jobs as well as closing 100 mortgage offices and 53 commercial banking operations. By 2007, the bank's earnings swung to a loss of $67 million from a profit of $3.6 billion in 2006, and provisions for bad loans ballooned to nearly $3.2 billion. In early 2008, WaMu attempted to shore up confidence with a $7 billion capital infusion led by a global investment firm, TPG. However, this proved futile as the bank reported losses of $7.9 billion in 2008.

This series of events preceded WaMu's plummeting deposits over two key periods of significant outflows. The first was triggered by the failure of IndyMac Bank on 11 July 2008. The second episode began on 8 September 2008 and accelerated after the failure of Lehman Brothers. WaMu lost about 5% and 10% of deposits, respectively. On a monthly basis, the bank lost 19% of deposits in September 2008. About 70% of the outflows were from uninsured deposits with large withdrawals from accounts with more than $500 million (these were far above WaMu's average account size of $8,700).



Resolution actions

Sale of WaMu to JPMorgan

Since early 2008, JPMorgan had eyed WaMu as a key acquisition target with interest in WaMu's network of over 2,000 branches and strong deposit base in regional markets. With such an acquisition, JPMorgan would be able to expand its presence across the west coast of US with a bigger share in key markets (New York, Chicago, Dallas, Houston and Phoenix). A broader regional banking presence would also strengthen its retail business including its commercial and business banking, credit card, and asset management units. However, at the time, WaMu had rejected a potential take-over bid by JPMorgan and chose to accept the $7 billion investment from TPG.

Prior to WaMu entering into receivership, the FDIC had received (on a confidential basis, contingent upon WaMu's failure) competing bids from Citibank[32] and JPMorgan for the assets and liabilities of WaMu. Citibank had proposed for 80% of losses to be absorbed by the US government and to limit its financial exposure for the remaining 20% losses to $10 billion. It did not suggest any cash upfront and was unwilling to take on WaMu's uninsured deposits. JPMorgan, on the other hand, was prepared to assume all of WaMu's deposits without any loss sharing arrangement and offered $1.88 billion for the transaction.

This deal makes excellent strategic sense for our company and our shareholders

Jamie Dimon, CEO of JPMorgan Chase

The resolution of WaMu took place at the height of the GFC (only two weeks after the failure of Lehman Brothers). The prevailing environment was one of low public confidence in the financial system, exacerbated by media leaks of WaMu's resolution. As a result, the FDIC acted urgently to instill public confidence following the closure of WaMu on the night of Thursday (25 September 2008). The FDIC Chairman provided assurances to all depositors and for WaMu customers to expect business as usual with no service interruptions on Friday morning. This decision to intervene on Thursday departed from the typical approach of FDIC (as well as other resolution authorities) to close failed banks on Friday night, and work to prepare for smooth transfer of the bank's deposit accounts to an assuming institution over the closing weekend.

On 25 September 2008, FDIC executed a whole bank P&A agreement[33] with JPMorgan for the sale of WaMu. The next day, WaMu's holding company declared bankruptcy. On paper, it appears that JPMorgan had secured a good deal by paying about $1.9 billion for about $300 billion in assets and $40 billion of shareholders' equity. JPMorgan also assumed WaMu's liabilities, including deposits. WaMu's bondholders, shareholders, and bank investors also shouldered the heaviest cumulative losses of about $30 billion of collective investments in WaMu. In fact, JPMorgan had to write down $31 billion in bad loans and raise $8 billion in new capital to support WaMu.

The resolution via P&A resulted in no cost to the FDIC's deposit insurance fund and was made possible due to two key elements. First was the availability of an acquirer (JPMorgan) with the capacity and ability to execute the P&A swiftly, having undertaken prior due diligence on WaMu. Second was WaMu's unsecured debt of $13.8 billion (4.5% of total assets) to absorb losses in resolution. Without these factors, the bridge bank tool would have been a likely option for the FDIC, which would have adversely impacted the deposit insurance fund as well as uninsured depositors.

Following the acquisition, JPMorgan entered into a protracted legal dispute with the FDIC. The row centred around JPMorgan's assertion that the FDIC had agreed to indemnify it from liabilities not assumed as part of the deal, including claims from decisions that WaMu had made before FDIC struck the deal with JPMorgan. Hence, JPMorgan sought a portion of the remaining $2.7 billion in the WaMu receivership. It was reported that terms of the final agreement between both parties lacked details on included and excluded liabilities, and this was uncommon when compared with resolution arrangements for other large institutions during the GFC.[34] In December 2013, JPMorgan sued the FDIC. On 19 August 2016, FDIC, JPMorgan and Deutsche Bank (which had a separate claim against the WaMu estate) announced a settlement whereby JPMorgan would be paid $645 million from the WaMu receivership estate. In consideration of the settlement, JPMorgan dropped more than $1 billion in claims related to the WaMu purchase.

[32] Citibank submitted a contingent bid for the assets and liabilities of WaMu on 24 September 2008, one day prior to WaMu's failure

[33] As part of its resolution toolkit, the FDIC undertakes P&A transactions according to several variations including Basic P&As, Whole Bank P&As (acquirers of failed institutions purchase maximum amount of the failed FI's assets), P&As with Optional Shared Loss, and Bridge Bank P&As

[34] For instance, JPMorgan agreed "to pay, perform and discharge all the Liabilities of the Failed Bank which are reflected on the Books and Records of the Failed Bank as of Bank Closing". However, the term "Books and Records" was not defined

Key takeaways

The resolution process is significantly aided by the availability of potential bidders, especially for troubled banks with a strong franchise value and synergies with acquirers. The suitor(s) – JPMorgan in WaMu's case – would likely have sized up the bank or attempted to make bid(s) for the distressed institution prior to its non-viability declaration or commencement of formal resolution action. These elements work in favour of a swift resolution process via P&A, which achieves three aims. First, avoiding disruption and protecting insured depositors. Second, zero exposure for the government. Third, preserving the resources of the resolution authority or deposit insurer so that those can be deployed for other failing FIs in times of crisis.

> ***For all depositors and other customers of WaMu, this is simply a combination of two banks ... for bank customers, it will be a seamless transition***
>
> Sheila Bair, former Chairman of the Federal Deposit Insurance Corporation

Agreements that are promptly brokered during times of crisis need to unambiguously reflect the negotiated positions of the buyer (acquiring institution) and seller (resolution authority). This case highlights several areas of uncertainty, such as specific liabilities to be transferred to and assumed by JPMorgan, as well as indemnities provided by FDIC (potentially covering lawsuits by institutional investors against WaMu relating to subprime mortgages). In turn, these led to lengthy post-resolution legal disputes that had dragged on for eight years.

During periods of financial crisis, systemic risk and contagion can spread quickly from failed institutions to other problem ones. The failure on IndyMac on 11 July 2008, for example, triggered a loss of confidence and significant deposit outflows from WaMu. In addition, the bankruptcy of Lehman Brothers on 15 September 2008 occurred slightly a week before WaMu's failure.

In the midst of unfolding crises and stress on the financial system, the case of WaMu highlights the criticality of rapid and expedited responses by resolution authorities pressured by compressed time-to-act and unrelenting public scrutiny. Under such circumstances, resolution authorities need to have heightened levels of planning and preparedness to execute interventions at any time. Typical assumptions of time buffers from 'over-the-weekend' resolution procedures may no longer hold true, particularly in times of fragile public sentiment in banks and when adverse news leaks are rapidly propagated by social media.

A similar source of failure for many FIs is the combination of rapid acquisitions and aggressive lending practices. Such strategies may at first generate rapid growth, but it may be just a matter of time before this apparent success transforms into significantly deteriorating asset portfolios. During the GFC, in spite of the many red flags that had been raised, WaMu continued to bet on recovery of the housing market.