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# Analysis of the Causes and Implications of Washington Mutual Bank's Failure

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## Abstract

**Washington Mutual, once one of the largest savings and loan banks in the United States with a distinctive business model, became the protagonist of the largest bank failure in U.S. history on the day of its 119th anniversary. This article introduces the main history of Washington Mutual's development, analyzes the causes of Washington Mutual's bankruptcy, and considers the implications of Washington Mutual's bankruptcy.**

## Keywords

**Washington Mutual; Bank Failure; Insights from Experience.**

## 1. History of Washington Mutual Bank

Founded in 1889 and headquartered in Seattle, Washington Mutual is the fourth largest provider of residential mortgage services in the United States and a regional financial services company that offers a diverse range of products and services to consumers and small and medium-sized businesses, primarily in the areas of insurance, home mortgage, and financial services.

Washington Mutual's success would not have been possible without its CEO, Killinger. After Killinger became CEO, Washington Mutual continued to make acquisitions. Before each acquisition, CEO Kerry Killinger investigated whether the acquired business was consistent with Washington Mutual's business philosophy, whether it would generate positive earnings within two years, and whether it would be compatible with Washington Mutual's business structure. By his leadership, Washington Mutual became stronger and stronger.

Washington Mutual's success has been based on a departure from the traditional business model, with large acquisitions being only one of the factors in its success, as well as a frugal, low-key approach to maintaining low operating expenses. In addition, Washington Mutual is customer-focused and committed to improving the quality of service. "To improve service, we need to think outside the banker's box and think like a retailer," says Deanna Oppenheimer, president of Washington Mutual's Financial Services Group. The business philosophy gives customers a family-like touch that has made it so popular. Finally, Washington Mutual is unique in that it targets a middle-class clientele, and CEO Killinger has said, "We don't want just high-end customers; we want a broad range of middle-class customers." To attract this segment of customers, Washington Mutual was the first in the country to offer free checking accounts, bilingual (English and Spanish) voice ATMs, and other user-friendly initiatives. The most important ports of contact for the average American family with their bank are their mortgage and checking accounts.

However, Washington Mutual's operating model was not perfect. In the wake of the financial crisis, the FDIC announced on the evening of September 25, 2008. that Washington Mutual, the largest bank in U.S. history, was insolvent and JPMorgan Chase acquired the 119-year-old bank for $1.9 billion. JPMorgan Chase acquired part of the business and branches of the 119-year-old bank, which once had $300 billion in assets and $188 billion in deposits, for a super low price of $1.9 billion.

ISSN: 2688-9323

## 2. Causes of Washington Mutual's Bankruptcy

The failure of Washington Mutual is not an accident. We need to think carefully about the causes of its bankruptcy and learn lessons in time to avoid the recurrence of the tragedy as much as possible.

### 2.1. High Percentage of Subprime Loans

Subprime mortgages are loans provided by some lending institutions to borrowers with poor creditworthiness and low income. After the recession occurred in 2001, the U.S. housing market was highly prosperous stimulated by ultra-low interest rates, and the subprime mortgage market developed rapidly. However, as the U.S. housing market cooled significantly, coupled with rising interest rates, many borrowers in the subprime mortgage market were unable to repay their loans on time, causing some lenders to suffer severe losses or even go bankrupt. Washington Mutual, the largest savings and loan financial institution in the United States, has a middle-class clientele and its deposits are mostly used for home loans, so the risk of non-repayment is high. This had a huge impact on the bank's profitability and capital adequacy. Washington Mutual eventually broke down and went bankrupt.

### 2.2. Lack of Liquidity

Liquidity is considered the lifeline of a commercial bank. It not only directly determines the survival of individual commercial banks, but is also critical to the stability of the entire economic system. Once short-term liquidity is insufficient, loans cannot be collected, and companies cannot fulfill their short-term debts in time, they will be forced to sell their assets or even go bankrupt and liquidate. The subprime mortgage crisis created a huge funding gap for Washington Mutual, making it unable to meet payments on the company's debts and extremely illiquid, eventually leading to a run on customers and the bankruptcy of Washington Mutual.

### 2.3. Credit Rating Downgrade

The objective of a credit rating is to evaluate the ability of an economic entity to meet its contractual obligations on time, and its fundamental purpose is to reveal the degree of risk of default of the evaluated entity. Credit rating is extremely important for banks: first of all, credit rating can be used as a basis for capital market management to review and make decisions. Through credit rating, government departments can restrict securities issuing subjects to enterprises with strong solvency and high creditworthiness to maintain the order and stability of the capital market; enterprises with higher credit rating can raise funds at lower cost, under which they will be motivated to improve theirs. In addition, companies with higher credit ratings are likely to be able to raise capital at lower costs and will be incentivized to improve their operations to facilitate public financing. Washington Mutual's investment in subprime mortgages was heavily weighed down by bad debt from credit losses, and its enterprise value fell significantly. Fitch downgraded Washington Mutual's long-term credit rating from BBB to BBB-, and Moody's downgraded Washington Mutual's long-term deposit rating from Ba2 to Ba3 and its senior unsecured debt rating from Ba2 to Ba3, while Washington Mutual's bond credit rating was downgraded to junk in S&P's latest rating. The credit rating downgrade directly triggered the run on Washington Mutual.

### 2.4. Inadequate Supervision

Although the U.S. has always been considered to have a sound financial system and advanced regulatory tools, in 1999 the U.S. Congress introduced the Financial Services Modernization Act, which strongly promoted financial liberalization and relaxed financial regulation, and OTC financial innovations were active, making the overall financial environment risky at that time, coupled with the fact that Washington Mutual's main target customers were the low- and

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middle-income classes, with low loan thresholds and insufficient regulation, the subprime mortgage crisis eventually helped Washington Mutual go bankrupt.

## 3. Insights from the Washington Mutual Bank Bankruptcy

### 3.1. Ensure Adequate Capital Adequacy Ratio

The capital adequacy ratio is the capital ratio necessary to ensure the normal operation and development of banks and other financial institutions. Financial authorities in various countries generally regulate the capital adequacy of commercial banks to monitor their ability to withstand risks, and a higher capital adequacy ratio indicates that the bank is more resilient to risks. One of the reasons for Washington Mutual's bankruptcy was poor capital liquidity, and other commercial banks should learn a lesson and replenish their capital in time to ensure adequate financing sources.

### 3.2. Focus on the Credit of Commercial Banks

The functions of commercial banks include credit intermediation and credit creation, which shows that credit is very important for commercial banks. A higher credit rating increases customers' trust in commercial banks, which is conducive to commercial banks absorbing more deposits and lowering their funding costs; while Washington Mutual Bank directly triggered a run crisis due to credit rating downgrades. To obtain a higher credit rating, commercial banks must have a matching scale of operation, business status, and profitability, and continuously improve their management level.

### 3.3. Strengthen Risk Management and Timely Monitoring and Inspection of All Risky Assets

The positioning of Washington Mutual's mid-range customer base brought high risks, and the outbreak of the subprime mortgage crisis accelerated Washington Mutual's bankruptcy. Therefore, commercial banks and the government should strengthen risk forecasting, supervise and inspect all risky assets, and identify risks promptly. In addition, the business goal of commercial banks is to obtain high profits, and corresponding to its business goal is high risk. To obtain high profits, commercial banks keep launching financial derivatives, which are exposed to credit risk, market risk, liquidity risk, and other risks; therefore, financial derivatives must be launched promptly within the scope of regulatory capacity.

### 3.4. Strengthen the Management of Commercial Banks' Assets and Liabilities

The business of commercial banks is mainly divided into asset business, liability business, and intermediate business. Asset business mainly refers to loan business, including commercial loans, bill discounting, securities investment, financial leasing, etc. Liability business is the business activity of commercial banks to organize the source of funds, and it is the starting point and foundation for the operation of asset business and other businesses of commercial banks. The poor quality of commercial banks' asset and liability business is not conducive to their development, and Washington Mutual's subprime loans accounted for too large a proportion, which led to insolvency when the subprime mortgage crisis broke out. Therefore, commercial banks should manage their assets and liabilities well, strengthen the audit of their assets and liabilities business, and arrange the ratio of assets and liabilities reasonably.

## 4. Conclusion

Although Washington Mutual was one of the largest savings and loan banks in the U.S. with strong asset reserves, it still went bankrupt due to a high proportion of subprime loans, lack of liquidity, credit rating downgrades, and insufficient supervision. Nowadays, China's

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commercial banks are in the transition period, facing many unknown risks and serious challenges. They should improve their development, focus on capital adequacy, focus on their credit, strengthen risk management, and enhance asset and liability management based on learning from the failure of their predecessors.

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