Wachovia case study

LBO Supervision Conference
November 12 & 13 2008
Atlanta, GA

Summary

- Second half 2007
  - How prepared was the company for July 2007 events?
  - How did we evaluate their response to the crisis?
- January-August 2008
  - Limited runs on Wachovia after earnings announcements in April and July
  - Supervisory activities
- September 2008
  - Silent run following Lehman failure, accelerating after WaMu resolution by FDIC
  - Under pressure from bondholders, depositors, and FDIC, Wachovia seeks a buyer
- Lessons learned
  - Reputation concerns outweigh apparent access to cash

Overview

- Wachovia was founded in 1879 in Winston-Salem, which is in an area of North Carolina known as the Wachovia Valley
- $812 billion in assets at June 30, fourth among BHCs (pre-Morgan Stanley and Goldman Sachs)
- RFI 222/2 (2) as of January 2007
- RFI downgraded to 332/3(3) on July 22, 2008; CAMELS downgraded to 233322/3 by the OCC on August 4, 2008 (Wachovia Bank NA)
- Both BHC and bank signed MOUs in August; the 4(m) is still pending

Background

2001

- Merger with First Union; HQ moved to Charlotte

2003

- Wachovia Securities merged with Prudential Securities; Prudential retains 38% stake

2004

- Acquisition of SouthTrust for $14 billion

2006

- Acquisition of Westcorp (auto finance)
- Ultimately fatal acquisition of Golden West Financial in October for $25.5 billion

2007

- Acquisition of AG Edwards for $6.8 billion, making Wachovia Securities the #2 retail brokerage in the US

Second half 2007

Second half 2007

- Wachovia's pre-existing conditions
  - Atlas SIV
  - Sagittarius CDO
  - Multiseller conduit, VFCC, still able to roll CP
  - CDO exposures
  - CMBS risk
  - VRDN/TOBs
  - Golden West
- Supervisors step up monitoring
  - Daily liquidity calls July through September

January-August 2008

January-August 2008

- Silent bank runs anticipated by company at times of results.
- Company tries to be more transparent.
- Rating agency downgrades.
- Supervisors increasingly concerned.
- Market indicators increasingly differentiate Wachovia's risk.

Company initiatives

- **Project Alvin:** to prepare for announcement of $9 billion loss in 2Q08, including:
  - Stressing portfolio for increased deposit outflows and increased funding needs
  - Open lines of communication with branches to monitor deposit activity
  - Increase deposits via rate promotions, staff incentives
- Impacts on liquidity
  - Rapid increase in CD/time deposits
  - Gradual increase in brokered deposits
  - Net deposits rose moderately
- **Project Stanley:** Reduce balance sheet by at least $20 billion by year-end to improve liquidity and capital.

Supervisory activities I

- **Liquidity and capital management exam** (6/23/08)
- **Overall liquidity satisfactory:** "We recognize the current staff has adequately managed the risks associated with the market disruption. Also, the actions your department has undertaken to increase parent liquidity and improve balance sheet utilization were appropriate and well timed. Nevertheless, we have identified corporate liquidity processes relating to contingent liability identification and contingency finding planning (CFP) that need strengthening. Further, capital management analysis should be enhanced by more formally incorporating what-if stress scenarios. Also, we have concems regarding the staff levels and MIS especially as liquidity management takes on a inore global role."
- MRIAs:
  - Improve legal entity contingent liability identification. Pre-crisis planning had missed exposures to certain conduit assets, liquidity puts, and other nonbank commitments. The exam identified potential exposures to ARS, Evergreen, and ECM.
  - Ensure liquidity function is staffed appropriately. The MRIA noted key man risk as well as insufficient automation, which increases time required to produce regular MIS and limits ability to conduct additional analyses or stress tests. Also, the same staff covered liquidity and capital planning.
- The May 18, 2005 parent inspection had identified concerns with contingent planning and the lack of parent company analysis and metrics.

Supervisory activities II

- **Report of inspection** (7/22/08)
- **RFI downgraded to 332/3:** Based on weaknesses in risk management (board and senior management oversight, MIS, risk monitoring) and weakened financial condition (poor earnings, deteriorating asset quality, and reduced capital cushion).
- **Liquidity rated "2":** "Consolidated liquidity is currently **adequate** to meet the funding needs of the corporation. Throughout the market disruption, management has opportunistically raised funds, maintained excess funds at the parent, and appropriately worked to minimize exposure to overnight funding markets. The liquidity position also continues to benefit from the corporation's large core deposit base. However, management is appropriately concerned with prolonged volatile markets and the potentially higher cost of issuing term debt. We recognize and are pleased by management's efforts to identify funding vulnerabilities and to assess available sources for meeting potential shortfalls."
- **MIS rated "3":** "With liquidity MIS, reports did not capture several funding needs that arose during the stressed environment and these needs were not addressed in the contingency funding plan (CFP)."
  - "[The] production of consolidated liquidity MIS is not sufficiently automated, limiting management's ability to develop consolidated funding analysis promptly or to readily create nonstandard reporting during stressed periods."

Supervisory activities III

- **RAP/Supervisory Plan vetting** (8/20/08)
  - **Inherent liquidity risk "Considerable":** "The inherent risk profile has increased to considerable despite Wachovia's ability to meet 2008 funding needs, maintain liquid assets above short term funding needs, and maintain a stable deposit base. Significant deterioration in Wachovia's financial condition is the driving force in downgrading Market Access to considerable. Management is appropriately concerned that a prolonged volatile market and poor performance by the company may impair the company's ability to issue term debt or raise capital."
- **MOU** (8/19/08)
  - Liquidity risk/funding plan among documents required within 30 days.

September 2008

September 2008

- Holding company liquidity appeared very strong,; risk of deterioration over 2009 if term markets never opened; maturities had been laddered well.

		2Q08 Actual	3Q08 Projected	4Q08 Projected	1Q09 Projected	2Q09 Projected	3Q09 Projected	4Q09 Projected
1	**Beginning Cash Position**	13,593	22,255	19,356	12,999	10,044	8,409	5,331
2								
3	**Sources:**							
4	Subsidiary Dividends	-	-	-	-	-	-	-
5	Long-Term Debt Issued	3,700	-	-	-	-	-	-
6	Inflows from Subsidiaries (debt repayment)	-	2,315	-	-	-	-	-
7	Other (LoTS / Common & Pfd stock)	8,050	-	-	-	-	-	-
8	Total Sources:	11,750	2,315	-	-	-	-	-
9	**Uses:**							
10	Intercompany Loans, net	404	(250)	(250)	(250)	(250)	(250)	(250)
11	Investments in Subsidiaries (incl UHRL purchases)	(2,300)	(1,560)	(600)	(80)	(65)	(50)	(35)
12	Long-Term Debt Matured	(698)	(1,164)	(2,082)	(2,159)	(96)	(2,314)	(2,646)
13	Corporate Dividends (common & pfd)	(896)	(397)	(228)	(368)	(229)	(368)	(229)
14	Open-Market Purchases	-	-	-	-	-	-	-
14	ARS Purchase	-	(803)	(3,100)	-	(900)	-	-
15	Net Other Common Stock Activity	0	3	3	3	5	5	5
16	Change in Com'l Paper	339	-	-	-	-	-	-
17	Other	62	(250)	(100)	(100)	(100)	(100)	(100)
18	Total Uses:	(3,088)	(4,420)	(6,358)	(2,954)	(1,635)	(3,078)	(3,254)
19	**Ending Cash Position**	**22,255**	**20,150**	**12,999**	**10,044**	**8,409**	**5,331**	**2,077**

Supervisory activities

- **Thursday, September 11**
  - Steel and top WB executives visited BOG, pushing for 23A and capital relief.
  - Board and Charlotte staff agreed that holding company liquidity is strong and the 23A relief is a "want rather than a need."

Going…

- **Monday, September 15:** Lehman allowed to fail; market turns attention to AIG. WB started daily liquidity conference calls with regulators. Steel appeared on Cramer's Mad Money on CNBC.
- **Tuesday, September 16:** Fed announced $85 billion loan to AIG after market close
- **Friday, September 19:** Board staff decided to support 23A request in light of heightened market volatility, but the issue was soon overwhelmed by events.
- **Liquidity calls**
  - Increasing reliance on FHLBs, TAF
  - Increasing deposit outflows
  - Concern about VFCC and VRDNs, though not yet realized

... going...

Week of September 22-26

- For most of the week, the company remained confident in liquidity position, and there was optimism about Paulson rescue plan.
- Deposit outflows continued but other sources remained intact.
- WB remained in a net FF sold position, successfully testing market appetite for WB exposure by purchasing nominal amount of FF.

Gone

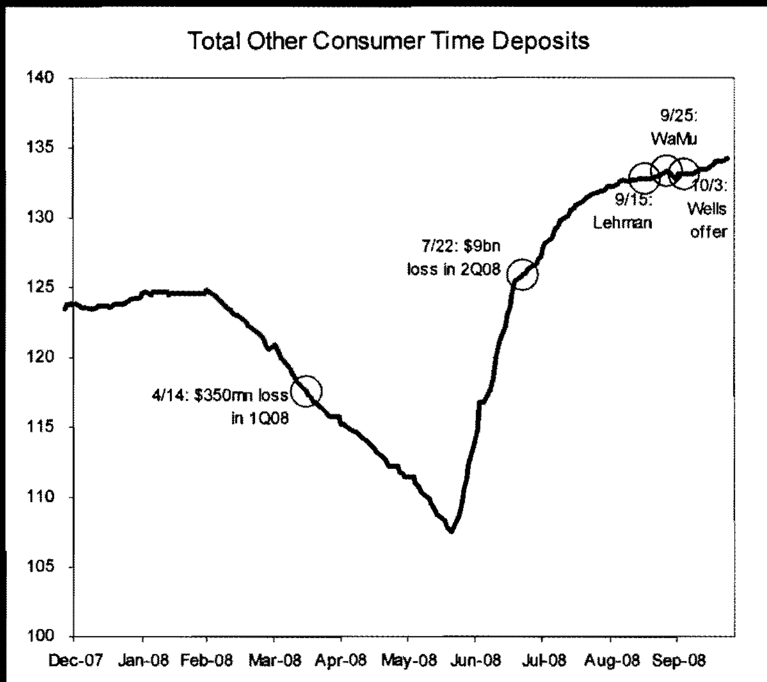
Thursday, September 25

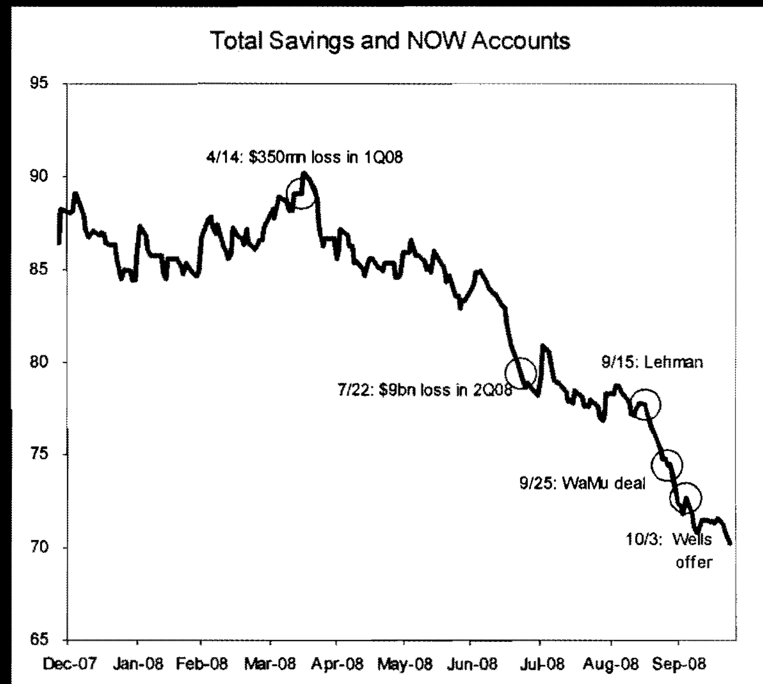
- In the wake of Washington Mutual, investors and depositors became increasingly concerned about Wachovia's prospects and dramatically curtailed counterparty lines.
- The tiered resolution of the Washington Mutual was particularly problematic for Wachovia because Wachovia has a significant exposure in senior bank notes. These concerns caused Wachovia's debt spreads to increase to over 1400 on Friday September 26, prompting the company to seek capital or an acquirer.

Friday, September 26

- Wachovia had calls from bond and noteholders asking them to redeem their debt. Calls amounted to **$65 billion** – nearly 50% of outstanding notes and bonds of the banks and holding company.

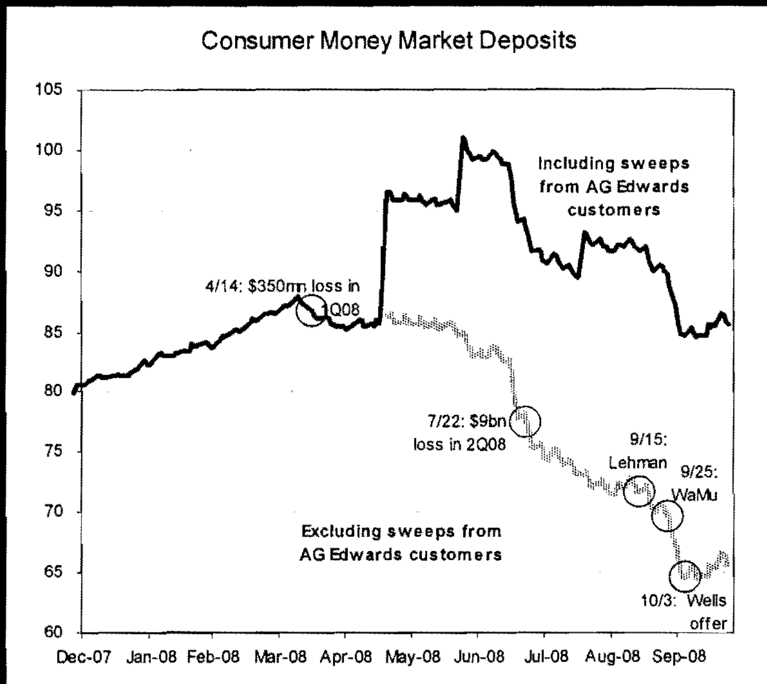
Deposit outflows I

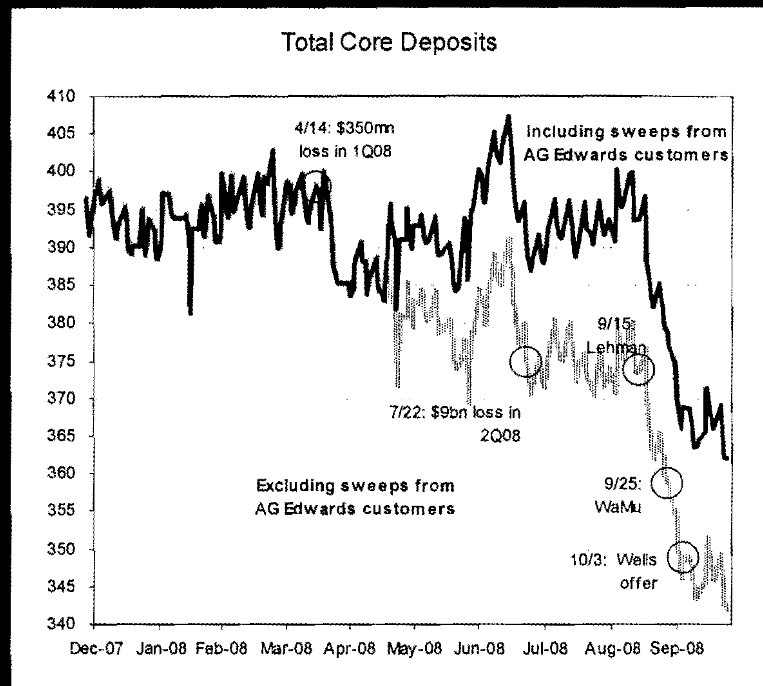




- CD promotion in June brought in more than $15 billion prior to 2Q08 results, more than making up for decline in savings and MMDA

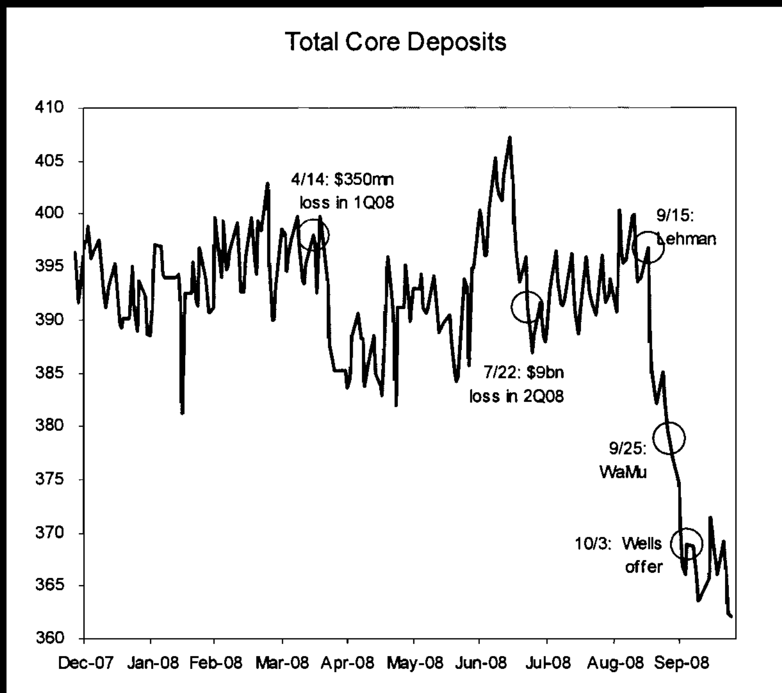
Deposit outflows II

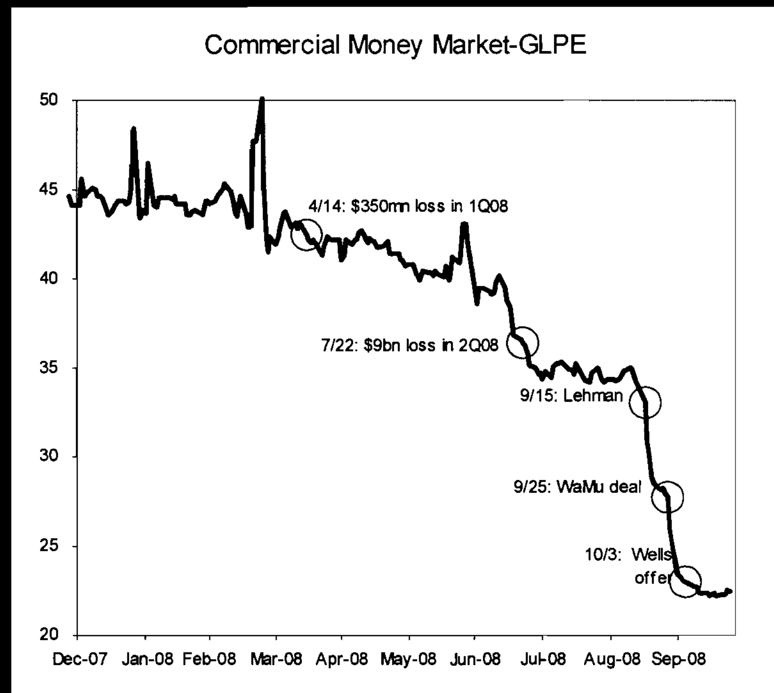




- AG Edwards deposit sweeps masked the declining trend in consumer MMDAs and total core deposits between April and July

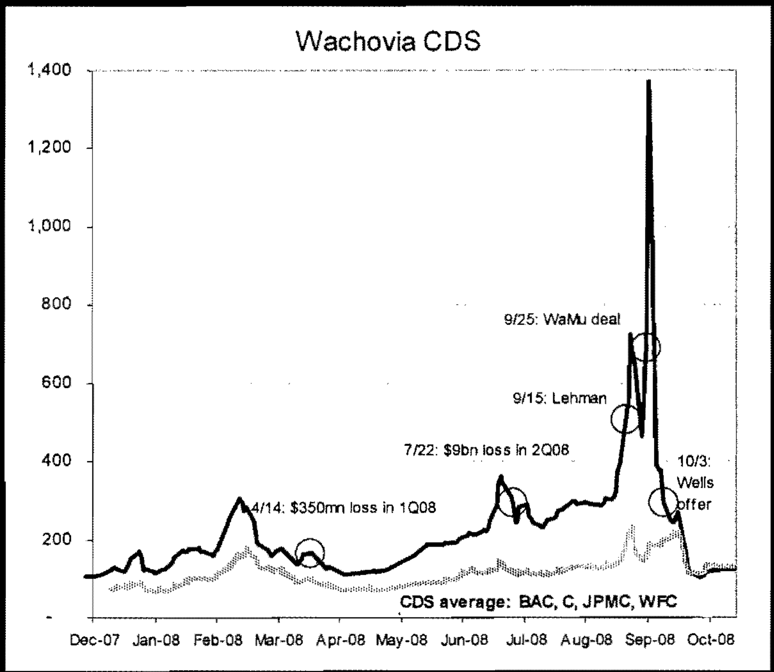
Deposit outflows III

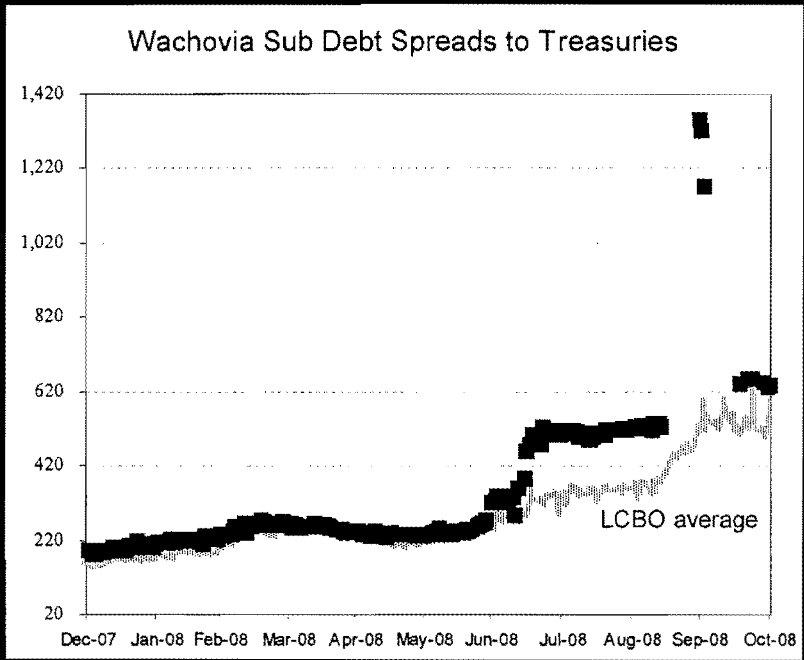




- Deposits began to plummet after the Lehman deal, led by MMDAs; data delay made this fact not well accepted for more than a week

Market signals





- The market began to discriminate early against Wachovia, and increasingly in 3Q08

Aftermath of Citi offer

- C bid uncertain, WFC surprise
- Deposit outflows accelerate: core deposits declined $10 billion between 9/25 and 10/3
- TOB/VRDNs and multiseller ABCP fail to roll
- By the end of the week, $23 billion in repos raised on Monday had been entirely accounted for

Aftermath of Wells offer

- Dueling lawsuits over the weekend left WB fate uncertain.
- Counterparties unwilling.
- Deposits started to recover after 10/3 Wells Fargo press release.
- WB went to the Discount Window for the first time, raising $29 billion on Monday, 10/6.
- Increased TAF borrowing from $12.5 to $25 billion.

Lessons learned

What Wachovia did right

- Aggressive moves to raise liquidity in July were successful.
- Consistent net sold position, strong HC cash, and plenty of collateral all the way up to September 26.
- 1Q08 and 2Q08 earnings releases were *significantly* more transparent about credit problems than previous WB or peer releases.

WB lessons learned

- Reputation risk=market discipline
  - CDS, equity, and bond prices strongly reflected market skepticism.
  - Market pricing signaled that WB was most likely to be next on the radar – after, say, NCC and WaMu – when systemic concerns surfaced.
- Understand your funding risk, particularly deposits
  - It's not clear WB was prepared for, understood, or tried to prevent the exodus of uninsured commercial deposits that accelerated in September.
  - Sweeps were not as secure as the company thought.
- Where was the $150 billion in available liquidity?
  - WB never went to Discount Window before 9/26. Finally received DW funds on 10/6.
  - Other assets took longer.
- Contingency funding plan
  - Focused on company-specific ratings downgrade, not systemic risks.
- Out of their control
  - Non-support for WaMu bondholders was catalyst that brought down WB.

WB lessons learned: MIS

- Changing metrics
  - Monthly liquidity reports prior to September put the company in a net O/N *purchased* position, taking into account heavy reliance on O/N sweeps. But in the crisis, the company focused on other numbers:
    - "Gross O/N", which excluded all sweeps, put the company in a strong net *sold* position in mid-September, $10-$20bn.
    - "Turn-on-the-lights" money, which netted out *some* sweeps considered hot money, put WB in a fairly strong net sold position, $2-$10bn.
  - Flawed assumption that some sweep accounts are not really O/N money.
- Conflicting data
  - It was often difficult to reconcile company reports from different sources; key metrics such as O/N position were not reflected in MIS.
- Late data
  - Information about deposits was not available for two days, which made it difficult to track most important liquidity drains.
- Understaffed team, insufficient analysis
  - It took too long for WB to admit that the decline in deposits (particularly corporate deposits) was secular or "name-specific." Declines were blamed on weekly fluctuations; on monthly tax day; on a never-quantified large withdrawal by the World Bank.

Our lessons learned

- Reputation risk is real
  - Information from CDS and other markets should be taken seriously
- Systemic risk is real
  - Lehman bankruptcy and the structure of the JPMC-WaMu deal had real repercussions for Wachovia.
- Be skeptical in the face of over-confidence
  - Were we tough enough in supervisory ratings?
- Understand linkages between credit, liquidity risk
- Question top-of-the-market acquisitions

Final questions

- How effective were Fed's central banking activities in helping Wachovia?
- What more could Fed or other supervisors have done, before and during the liquidity squeeze?
- What were weaknesses in Wachovia's MIS and its approach to liquidity risk management?
- Did we have the right information?
- Under what grounds could regulators have blocked the Golden West purchase?