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## How Wachovia came crashing down

Federal regulators forced ailing Wachovia Corp. into the arms of Citigroup on Monday in a deal to sell its banking operations. Friday, Wachovia spurned that shotgun wedding as Wells Fargo & Co. rode in with a richer offer.

Citigroup is putting up a fight, and any sale of Wachovia must be approved by federal regulators, but it's clear which deal shareholders will prefer for now. Regardless of who ends up buying Wachovia, the bank crumbled under the weight of bad mortgage loans it inherited as a result of its daring, expansive culture.

Wachovia's acquisition two years ago of Golden West Financial in Oakland, Calif., achieved a long-held goal of building a coast-to-coast bank with a foothold in the lucrative California market.

It also picked up a hefty portfolio of Golden West home loans, including option adjustable-rate mortgages that allowed borrowers to choose their monthly payment and defer the principal.

Some people were startled that Charlotte, N.C.-based Wachovia didn't unload these risky mortgages from its books, said Tony Plath, an associate banking professor at the University of North Carolina-Charlotte.

"They had plenty of time to sell them," Plath said, "but rather than get rid of the product, they promoted it."

By offering borrowers the opportunity to make minimal monthly payments, the "Pick-A-Pay" mortgages appeared to make buying a home more affordable, especially in heated housing markets. The interest rates on the loans, however, would reset at much higher rates after a few years, and some option ARM customers had difficulty refinancing as housing markets weakened. The loans began to sour.

In April, Wachovia slashed its dividend and said it would cut 500 jobs and raise \$7 billion in fresh capital. It stopped offering "Pick-A-Pay" mortgages in June, but the damage had been done. As defaults mounted and the mortgages lost value, Wachovia's earnings evaporated. The company's board ousted longtime chief executive officer Ken Thompson.

In July, the company reported a loss of almost \$10 billion for the first half of the year as its non-performing assets – mostly those mortgages – ballooned to \$12 billion at the end of June, more than double the amount six months earlier.

Concerned about these losses and unsure about the quality of Wachovia's assets, other banks became skittish about making crucial short-term loans to the big bank. Wachovia hired Robert Steel, a former undersecretary at the Treasury Department and Goldman Sachs executive, to replace Thompson as CEO and stabilize the company.

But worries about Wachovia's mortgage portfolio surged 10 days ago in the wake of a "silent run" on deposits at the Seattle-based savings bank Washington Mutual before it was taken over by the Federal Deposit Insurance Corp. on Sept. 25, said David Danielson, president of bank-consulting firm Danielson Associates Inc. in Vienna. At Washington Mutual, "people pulled \$16 billion out, and there was never a line at the bank," he said.

Immediately after taking over Washington Mutual, the FDIC sold it to JPMorgan Chase. The major New

York-based bank, however, slashed the value of Washington Mutual's mortgage portfolio, which prompted concerns that the value of Wachovia's mortgages might be much lower than had been stated.

A similar silent run appears to have hit Wachovia. Steel ran out of time.

By Sept. 27, the FDIC was negotiating a hurried sale of Wachovia's bank subsidiary. Over the next two days, the FDIC and Wachovia arranged to sell the bank to New York-based Citigroup for nearly \$2.2 billion, or just \$1 a share. The FDIC insisted Wachovia did not fail, but it was so worried the bank might, it agreed to pick up any loan losses above \$42 billion from Citigroup.

Wachovia's share price plummeted from a close of \$10 on Sept. 26 to \$1.84 on Monday.

Wachovia's prospects took an abrupt turn Friday when it announced that Wells Fargo had agreed to buy the entire company, not just the bank, for \$14.8 billion in stock, or about \$7 share. And San Francisco-based Wells Fargo won't rely on FDIC assistance. Wachovia shares leapt \$2.30, or 58 percent, to \$6.21 each on Friday.

In the Citigroup deal, Wachovia would have remained an independent company with its brokerage subsidiary Wachovia Securities and Evergreen Asset Management.

Plath, the UNC-Charlotte professor, attributed the difficulties that crippled Wachovia partly to changes in its strategy in recent years and a more aggressive pursuit of short-term results.

"It's no secret that Ken Thompson was frustrated that the stock market wasn't putting a higher value on Wachovia," he said.

Wachovia is the product of a 2001 merger between two North Carolina banks with distinctly different cultures. Wachovia, based in Winston-Salem, was highly regarded for its attention to credit quality and customer service. First Union, based in Charlotte, was known more for its willingness to innovate and pursuit of growth, especially through acquisitions.

"First Union had a reputation for taking risks that other banks wouldn't, which isn't all bad," said George Morgan, a finance professor at Virginia Tech's Pamplin College of Business in Blacksburg.

As the legal barriers to interstate banking eased in the late 1980s, First Union expanded rapidly by buying scores of other institutions, first in the Southeast and then in mid-Atlantic states such as Pennsylvania and New Jersey. That expansion also was stoked by the rivalry with Bank of America predecessor NationsBank, also headquartered in Charlotte.

The roster of Virginia banks that became part of First Union includes Dominion Bankshares, Signet, First American and Ameribanc Investors Group.

In a 1995 interview, then-chairman and CEO Ed Crutchfield said his goals were to make First Union one of 15 or so banks that would have assets of \$200 billion to \$300 billion by 2005 and operate nationwide.

"I'm an unapologetic believer that banks and certain other industries are going to have to get big or be very small. The middle-sized guy is in trouble," said Crutchfield, nicknamed "Fast Eddie" for the breakneck pace of First Union's expansion.

First Union, too, was quicker than most banks at moving into investment services. Beginning in the early 1990s, it acquired a string of mutual-fund management companies and brokerage firms, including Richmond-based Wheat First Butcher Singer in 1997.

Crutchfield's acquisition drive ran into costly hurdles, in part because he sought to merge banks quickly and slash their costs. The rushed consolidation of Philadelphia-based Core States Financial in 1998 and lapses in its service alienated customers, who flocked to rival institutions.

At the same time it was buying Core States, First Union paid more than \$2 billion in stock for the Money Store, a consumer-finance company that lent to individuals and small businesses with tarnished credit. The Money Store turned out to have serious accounting problems and lacked adequate internal controls. Two years after the acquisition, First Union shut it down and reported a second-quarter loss of \$2.2 billion.

As part of its merger with Wachovia, First Union adopted the Wachovia name because its own identity had been so badly bruised. However, consolidation of the two banks was done more methodically, and the culture that the old Wachovia brought to the combination paid off with awards for delivering quality customer service.

In Hampton Roads, the First Union-Wachovia combination ended up with the biggest share of the region's bank deposits: almost 22 percent at midyear 2007, according to the FDIC's latest report of deposits by market share.

The attention to customer service appeared to wane, and the company's strategy began to change in about 2005, said UNC-Charlotte's Plath. Wachovia, he said, began taking greater risks and pursued practices that later reflected badly on the bank.

The most glaring risk that Wachovia took involved paying a hefty \$25 million for Golden West at the height of the housing boom and continuing to promote the savings bank's "Pick-A-Pay" option ARMs.

But there were other things that chipped away at Wachovia's stature, Plath said .

One involved Wachovia's ties to telemarketers who maintained accounts at the bank. In a settlement with the Office of the Comptroller of the Currency in April, Wachovia agreed to pay as much as \$125 million to victims of telemarketers' questionable products and services, including vouchers for discount travel and groceries. Wachovia, which didn't admit or deny any wrongdoing in the settlement, also agreed to pay a \$10 million civil penalty and contribute \$8.9 million to consumer-education programs.

In August, Wachovia Securities and Wachovia Capital Markets reached a settlement with the Securities and Exchange Commission that allows thousands of investors, small businesses and charities to recover as much as \$8.8 billion from auction-rate securities bought from the two Wachovia units. Wachovia, according to the SEC's allegations, marketed these securities as an alternative to cash but failed to make good on its promise to support the securities with bids at auction.

One question still to be asked at Wachovia, said Plath, is "Where was the board?"

"A lot of these decisions were strategic," he said, and would have required the board's approval.

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