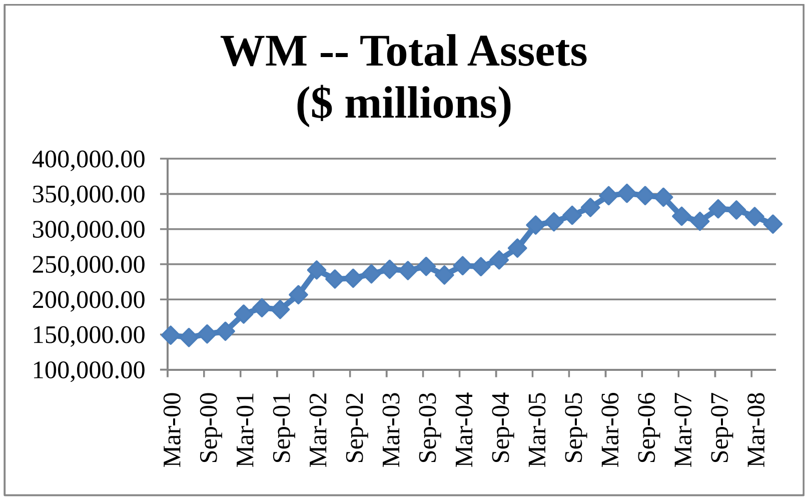
Washington Mutual

Summary

Washington Mutual ("WaMu") was one of the leading consumer and small business banks in the US and an important part of the housing finance boom of the past decade. At December 31, 2007, WaMu and its subsidiaries had assets of $328 billion. The Company has a history dating back to 1889 and, until its seizure by regulators and sale in September 2008, its subsidiary banks operated nearly 2,500 consumer and small business banking stores throughout the nation.

The chart below shows the assets of the bank units of WaMu through June 2008.



Source: FDIC/IRA Bank Monitor

The Early Days

"The Washington National Building Loan and Investment Association filed articles of incorporation on September 25, 1889, to offer its stockholders a safe and profitable vehicle for investing and lending. This allowed the Association to help Seattle residents rebuild after the fire.[1]

The company made the first monthly-installment home loan on the Pacific Coast on February 10, 1890. The borrower, a Norwegian-born seaman, used the $700 loan to build a house in Ballard, a neighborhood in Seattle. This creative amortized home loan proved so popular that the Association made more than 2,000 similar loans to help build 250 blocks of housing in Seattle."

On June 25, 1908, the company changed its name to Washington Savings and Loan Association and again in 1917, when the country's focus was on World War I, the company converted to a mutual savings bank changing its name to WaMu. "Washington Mutual expanded its assets during World War I by 68 percent, thus escaping the impact of the recession that followed. The company emerged from the war years with a reputation as the strongest savings institution in the state of Washington.

In 1962, WaMu installed its first computer, an IBM 1401 the size of a refrigerator with 4k of memory, and in 1974, WaMu pioneered the first shared cash machine network

[1] Official WaMu history used in this section.

In 1983, at a time when many thrifts folded, WaMu acquired Murphey Favre, a full-service securities brokerage firm and thereby became a public company via reverse merger. This acquisition was the first of its kind in the nation. The bank converted from a mutual form of ownership to a capital stock savings bank on March 11, 1983. With the stock sold and the bank publicly owned, WaMu reengineered, diversified and continued expanding. The bank's assets more than doubled within six years of going public."

Growth via Mergers

From the early 1990s, WaMu expanded its retail banking and lending operations organically and through a series of acquisitions of retail banking institutions and mortgage companies. Kerry Killinger became CEO in April 1990 and chairman of the board the next January.

From 1990 to 1996, WaMu acquired 16 smaller banks in Washington, Oregon, Utah and California. Below is a list of some of the transactions completed during this period:

Mergers by Washington Mutual Bank since 1993 (some in more than one stage):

2006 - COMMERCIAL CAPITAL BANK FSB	1999 - MIDLAND AMERICAN BANK	1996 - WESTERN BANK
2006 - CALNET BUSINESS BANK NA	1998 - INDUSTRIAL BANK	1995 - WASHINGTON MUTUAL A FSB
2006 - WASHINGTON MUTUAL BANK	1998 - HOME SAVINGS OF AMERICA FSB	1995 - ENTERPRISE BANK
2005 - PROVIDIAN NATIONAL BANK	1998 - COAST FEDERAL BANK FSB	1995 - ANCHOR SAVINGS BANK FSB
2005 - WASHINGTON MUTUAL BANK	1998 - WESTWOOD SAVINGS BANK	1994 - SUMMIT SAVINGS BANK
2004 - HAWTHORNE SAVINGS FSB	1998 - PROVIDIAN NATIONAL BANK	1994 - WESTERN FEDERAL SAVINGS BANK
2003 - PROVIDIAN BANK	1997 - TEXAS CENTRAL BANK NA	1994 - LINCOLN SAVINGS BANK FSB
2002 - FIRST FIDELITY INVESTMENT&LN	1997 - GREAT WESTERN BANK A FSB	1994 - GUARDIAN FSA
2002 - DIME SB OF NEW YORK FSB	1997 - BANKERS FEDERAL SAVINGS FSB	1994 - ENCINO SAVINGS BANK FSB
2001 - BANK UNITED	1997 - UNITED SAVINGS BANK	1994 - PROSPECT PARK FSB
1999 - TEXAS CENTRAL BANK NA	1996 - WESTWOOD SAVINGS BANK	
1999 - LAKEVIEW SAVINGS BANK	1996 - STANTON NATIONAL BANK	

The growth of WaMu's balance sheet was driven both by organic factors and acquisitions, and the general level of inflation visible in many other asset classes. The bank's assets grew with the real estate markets, which by the S&L crisis of the late 1980s had become visibly overheated. Yet WaMu was a relatively small institution in 1991, the peak year for losses among US banks during that period of asset inflation and deflation. The losses to the US banking industry and particularly savings and loans used to finance real estate development measure into the hundreds of billions of dollars and are still being paid off in the form of long-term debt used to finance the S&L cleanup.[2]

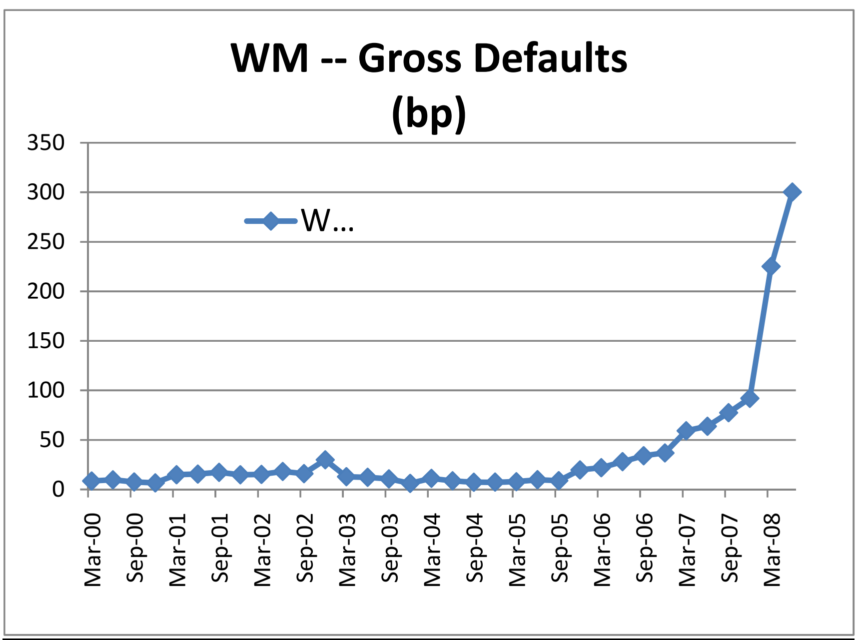
By 1997, more than $60 billion of private label, non-GSE backed subprime mortgage backed securities were sold to investors — six times more than 1991's volume. And yet WaMu would not enter the subprime origination and securitization market until fairly late in the cycle. Indeed, the company's biggest stumble "was a late entry into the subprime market as a way to juice the once fast-growing company's sluggish earnings," *The Wall Street Journal* noted. [3]

[2] See "The Cost of the Savings, and Loan Crisis: Truth and Consequences," FDIC Review, December 2000.
[3] "Cash Infusion Will Let WaMu Chief Keep Job," *The Wall Street Journal*, April 7, 2008.

In 1999, WaMu company bought subprime lender Long Beach Financial, which writes mortgages for people with less-than-stellar credit. At the time CEO Killinger calls it "an important extension of WaMu's core strategy to be one of the nation's leading consumer-oriented financial-services institutions."[4] But in fact Long Beach was considered one of the more dubious lenders in the CA market. An example of poor lending criteria employed by Long Beach was a mortgage of $720,000, with no down payment, made to a Mexican strawberry picker who earned $14,000 a year. Since the bank assumed it could sell the mortgage to an investor, credit diligence went out the window.

But Long Beach was not WaMu's only foray into subprime lending. In October 2005, WaMu purchased the formerly "subprime" credit card issuer Providian for approximately $6.5 billion. Providian's new management team's strategy of targeting Prime credit card consumers had been underway since 2001; therefore WaMu claimed that the credit card unit's non-performing loan portfolio had improved significantly prior to the company's sale to WaMu.

Ironically, following the close, the performance of the WaMu's loan portfolio began to deteriorate further. As the first chart illustrates, WaMu was beginning to shrink in terms of total assets by the end of 2005, suggesting that the bank already was beginning to feel increased stress from its credit book. The chart below shows the aggregate default experience of WM's bank units from 2000 through the bank's seizure in Q3 2009.



Source: FDIC/IRA Bank Monitor

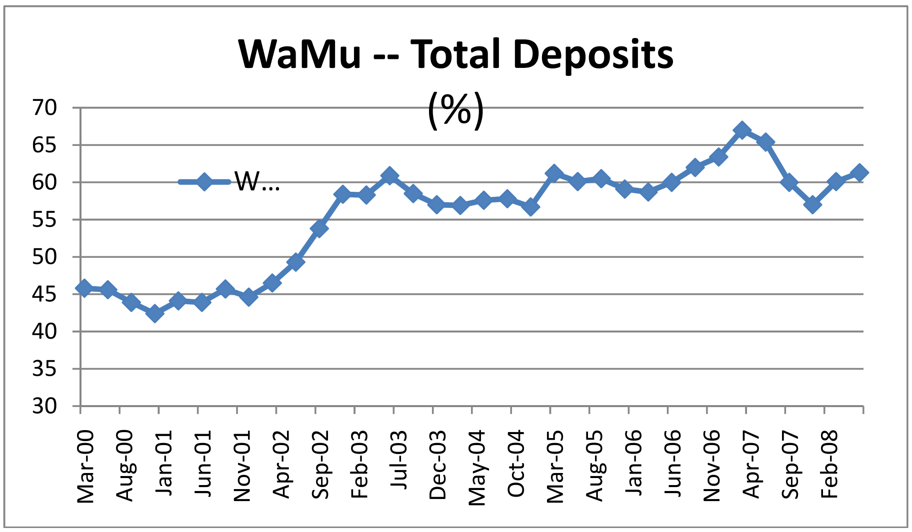
Even as the bank was starting to shrink going into 2006, WaMu began the move into its new headquarters, WaMu Center, located in downtown Seattle. All of the company's statements and disclosures to investors spoke of growth and bright prospects ahead, and yet it is clear to this writer,

[4] See "Washington Mutual: A long history," *The Seattle Times*, September 21, 2008

at least, that the end of WaMu was starting. By August 2006, WaMu began using the official abbreviation of "WaMu" in its branding and all but legal situations.

Up to this point, the company's earnings were primarily driven by; lending to consumers and small businesses, by deposit taking activities which generate net interest income, by activities that generate noninterest income, including the sale and servicing of loans, and the provision of fee-based services to its customers.

But on average, during the last decade of its existence, only some 60% of its assets were funded with deposits, with the remainder funded in the markets and from the Federal Home Loan Banks. In fact, by June 2008 just prior to the resolution, 20% of total assets were funded with FHLB advances. Regulators set 15% advances to assets as the threshold for safety & soundness concerns. The chart below shows WaMu's deposits as a percentage of assets.



Source: FDIC/IRA Bank Monitor

Boom & Bust

By 2007, WaMu had four operating segments for management reporting purposes: the Retail Banking Group, which operated a retail bank network of 2,257 stores; the Card Services Group, which operated a nationwide credit card lending business; the Commercial Group, which conducted a multi-family and commercial real estate lending business in selected markets; and the Home Loans Group, which engaged in nationwide single-family residential real estate lending, servicing and capital markets activities. But beneath this image of seeming solidity was a profoundly troubled institution.

The failure in 2007 of a mortgage originator called New Century Financial provided incontrovertible evidence of an earthquake in the mortgage securities market. A meeting of all of the major investment houses occurred at the Federal Reserve in New York several weeks later. One of the great thinkers of Wall Street laid out a scenario of how New Century had grave consequences for the markets and especially the market for securitization of mortgages. But nothing was done by the Fed to address the deteriorating credit conditions inside mortgage lenders for more than a year.[5]

In July 2007, a WaMu peer, Countrywide Financial, reported that defaults and delinquencies were rising across all classes of mortgages, not just the subprime ones that started the ripple effect that caused the collapse of New Century. In August, WaMu announced it was increasing its mortgage standards and cautioned that conditions were deteriorating in the secondary mortgage market, where mortgages are packaged and resold, sometimes several times. Ultimately WaMu increased loss reserves by about $500 million in September -- about 30% higher than it had indicated it would in July.[6]

Jim Mueller wrote in the *The Motley Fool* that at first, the thrift was a red flag that earnings would be less, mostly due to the increased loss reserves. The actual earnings pointed to some real problems, like:

- Total provisions for loan and lease losses expense up 480% year over year and 160% sequentially, to $967 million
- Net charge-offs up 170% year over year and 55% sequentially, to $421 million
- Nonperforming asset ratio up 96 basis points year over year and 36 basis points sequentially, to 1.65% of total assets
- Total customer deposits below $200 billion for the first time in more than a year and a half, down 7.9% year over year and 3.5% sequentially."

Following September 2007, WaMu:

- Announced layoffs of more than 3,000 workers
- Became embroiled in an SEC probe related to a New York state lawsuit of First American (NYSE: FAF) over an alleged role in fixing home appraisals
- Cut its dividend by 73%
- Said it would dilute its shares with a preferred stock offering.

Mueller concluded that "the second half of 2007 was terrible for the company." His views were pretty widely shared by most – but not all -- of the investment community.

By the start of 2008, WaMu was already doomed. As the chart on Page 4 illustrates, WaMu reported charge-offs of $1.6 billion in 2007, three times 2006 levels and roughly four times the loss rate experienced by peers. WaMu's realized losses were roughly twice the $800 million in losses reported by Countrywide, for example. Countrywide's lead bank unit reported all of $460 million in loan charge-offs in 2007, albeit a 14-fold increase from 2006. And, again, regarding funding, both WaMu and Countrywide were only partially core funded with deposits and heavily dependent upon the money markets and Federal Home Loan Banks for liquidity.

The loan default experience disparity between WaMu and the mortgage peer group comes in part because of the Q4 2005 acquisition of Providian, the sub-prime credit card operation which WaMu

[5] See "Fed Chairmen and Presidents: Roundtable with Roger Kubarych and Richard Whalen," *The Institutional Risk Analyst*, October 30, 2009.
[6] See Mueller, Jim, "Worst Stock for 2008: Washington Mutual," *The Motley Fool*, January 14, 2008

bought after a partial regulatory clean-up at the target. It may be no coincidence that, from the close of that transaction, the Loss Given Default or "LGD" of WaMu's lead bank unit has been > 90% and charge-offs climbed dramatically, closing over 70bp (annualized) at the end of Q3 2007. Remember that the loss rate generally for mortgage lenders tracked by the FDIC was less than a third of the 70bp loss rate for WaMu, illustrating the degree to which acquisitions like Long Beach and Providian had changed the business model and thereby increased the "normal" credit loss profile of WaMu.

Indeed, using data from the FDIC in the chart on the previous page and calculations from The IRA Bank Monitor, the default rate for WaMu's lead bank is seen as a rising ski slope, trending upward since *Q3 2005* when the bank reported just 8bp of charge offs. Could that huge loss rate be attributable to WaMu's credit card business, which represented just 4% of total loans? The WaMu credit card book was throwing off 1,000bp of defaults in Q3 2007 and this loss rate would increase before the bank's failure. Indeed, even WaMu's commercial and industrial portfolio or "C&I" loans reported 315bp of default vs. just 34bp for real estate loans in the same period.

In April 8, 2008, WaMu got $7 billion from a group of investors led by David Bonderman's TPG Inc. after losses on subprime loans ate up capital and erased 74 percent of its market value. WaMu sold 176 million shares at $8.75 a piece, 33 percent below the closing price on the New York Stock Exchange, and $5.5 billion in convertible preferred shares, the company said in a statement. TPG bought $2 billion of the shares and the rest were purchased by other investors. The lender also slashed its dividend and announced 3,000 job cuts.[7]

But by September 7, 2008, CEO Killinger was forced out, replaced by Alan Fishman, former chief executive of Independence Community Bank of New York, which was sold two years earlier to Sovereign Bancorp. The same day the U.S. government took control of mortgage giants Fannie Mae and Freddie Mac. Countrywide had been sold to Bank of America earlier in the summer and it was pretty clear to analysts who follow the bank regulatory channel that WaMu was next in line for resolution. Unfortunately this perspective was not shared by David Bonderman and TPG, one of the largest and most experienced private equity funds in the US. Bonderman had been a long-time director of WaMu and apparently had a close relationship with Killinger that may have prevented him from understanding the true nature of the financial problems as WaMu.

On September 25, 2008, regulators seized WaMu while the bank's management team was on a commercial air flight. "The move came as lawmakers reached a stalemate over the passage of a $700 billion bailout fund designed to help ailing banks, and removed one of America's most troubled banks from the financial landscape," as Eric Dash of the *New York Times* reported. "Customers of WaMu, based in Seattle, are unlikely to be affected, although shareholders and some bondholders will be wiped out."

By the end of 2008, however, WaMu as it was known had been resolved by the Office of Thrift Supervision, restructured by the FDIC and sold to JPMorgan Chase Bank (NYSE:JPM) at just pennies on the dollar of book value. On September 25, 2008, the banking operations of Washington Mutual, Inc - Washington Mutual Bank, Henderson, NV and Washington Mutual Bank, FSB, Park City, UT were sold in a transaction facilitated by the Office of Thrift Supervision (OTS) and the Federal

[7] See "Washington Mutual Gets $7 Billion From TPG-Led Group," *Bloomberg News*, April 8, 2009.

Deposit Insurance Corporation (FDIC).[8] Washington Mutual, Inc. then filed bankruptcy in Wilmington, Delaware, taking with it all liquidated and unliquidated claims pending against the parent.

Upon the closure, JPMorgan Chase (NYSE:JPM) acquired the assets and most of the liabilities of Washington Mutual Bank from the FDIC as Receiver for Washington Mutual Bank. Included in the liabilities acquired by JPMorgan Chase were Washington Mutual Bank's covered bonds, other secured debt and securities issued by the Washington Mutual Master Trust and Washington Mutual Master Note Trust.[9]

J.P. Morgan agreed to pay $1.9 billion to the government for WaMu's banking operations and assumed the loan portfolio of the thrift, which has $307 billion in assets. The full cost to J.P. Morgan was higher, because it wrote down about $31 billion of the bad loans and raised $8 billion in new capital to fund the transaction. All WaMu depositors had full access to their cash, but holders of more than $30 billion in debt and preferred stock took near complete losses in the bankruptcy.[10]

When a bank fails in the US, the primary regulator declares the institution insolvent and the FDIC becomes the receiver of the failed bank unit. This has the effect of rendering the parent holding company immediately insolvent, as in the case of Washington Mutual, Inc. The assets and deposits of WaMu's two bank subsidiaries were put into a new corporation, which was then purchased by JPM creating a new cash basis. The WaMu loss reserve also conveyed with the assets and liabilities of the subsidiary banks, helping to offset the cost to JPM of the purchase.

Conclusion

The failure of WaMu is a watershed event in the US banking industry. WaMu had been one of the most aggressive lenders in the mortgage industry, using a combination of subprime mortgage loans and credit cards to fuel asset growth. Although WaMu growth was based on an unstable liabilities combination of core deposits, purchase funds and FHLB advances, it failed due to the poor quality of its assets. The strategy to grow rapidly through low lending standards and bad quality acquisitions, led to predictable results.

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[8] See the FDIC Press Release dated September 25, 2009

[9] Of note, by operation of law, parties to agreements by Washington Mutual Bank could not exercise any contractual or other rights to trigger termination, acceleration, default, or other actions based upon the insolvency, the appointment of the FDIC as receiver, or the transfer of such agreements to JPMorgan Chase. The Federal Deposit Insurance Act, 12 U.S.C. §§ 1821(d) and (e) (13), prohibits the exercise of such contractual or other rights in order to promote an orderly resolution of insured depository institutions.

[10] See "WaMu Is Seized, Sold Off to J.P. Morgan, In Largest Failure in U.S. Banking History," *Wall Street Journal*, September 26, 2008.