From: Doerr, J. George
Sent: Monday, September 08, 2008 5:28 PM
To: Chow, Edwin L
Cc: Ivie, Stan
Subject: FW: Washington Mutual

Attachments: WaMu 09 08 08.pdf

From: Beeson, Sandra L.
Sent: Monday, September 08, 2008 2:23 PM
To: 'darrel.dochow@ots.treas.gov'
Cc: Doerr, J. George
Subject: Washington Mutual

Good afternoon Regional Director Dochow,

Attached is the Washington Mutual document. Please let me know if you encounter any problems with the PDF.

WaMu 09 08 08.pdf (619 KB)

Sandy Beeson
DRD Doerr's Executive Secretary
San Francisco Regional Office
(415) 808-8151 ~ (415) 808-7945 fax

CONFIDENTIAL PROBLEM MEMORANDUM		MEMO DATE: In-Process
HENDERSON, NV		CURRENT RATING: 4 444442
Washington Mutual Bank		FORMER RATING: 3 232432
CLASS: SB	INSURED: 12/27/1988	FUND ID: DIF
CONT OWNER / % OWNED : / 13		
CERT #: 32633	OCC/OTS #: 0/0	BANKS IN BHC/CHAIN: 2 / 0

CERTIFICATE NUMBER	32633	32633	32633
EXAMINATION START DATE / TYPE / SCOPE	01/08/2007 / O / R	03/13/2006 / O / R	03/14/2005 / O / R
EIC: LAST NAME	Franklin	Carter	Carter
EIC: FIRST NAME / MI	Benjamin / D	Lawrence / D	Lawrence / D
UNIFORM RATING: CAMELS / COMPOSITE RATING	222212 / 2	222222 / 2	222222 / 2
TOTAL ASSETS	318,295,206	347,416,019	305,721,973
TOTAL LOANS	245,418,066	265,051,746	247,458,828
TOTAL DEPOSITS	213,336,756	191,296,713	187,066,383
TOTAL EQUITY CAPITAL	27,929,317	30,266,489	23,731,721
DISALLOWED INTANGIBLES	9,297,569	8,637,095	5,825,333
ALLL ADJUSTMENT		0	
TIER 1 CAPITAL	20,651,576	23,146,431	16,981,937
TIER 2 CAPITAL	9,772,664	6,918,489	6,561,087
TOTAL RISK-WEIGHTED ASSETS	240,257,758	237,880,070	199,004,019
LEVERAGE RATIO	6.70	6.84	5.68
TIER 1 RB CAPITAL RATIO	7.88	9.04	8.40
TOTAL RB CAPITAL RATIO	11.94	11.94	11.68
SUBSTANDARD	5,289,083	2,580,717	2,095,216
DOUBTFUL	20,072	6,280	8,133
LOSS	0	0	0
TOTAL CLASSIFICATIONS	5,309,155	2,586,997	2,103,349
SUB&DBF ITMS/TOTCAP + INELI	18.51	8.60	9.05
ALLL	1,540,368	1,657,197	1,268,347
PD + NON-ACC/GROSS LOAN	0.00	1.89	1.13
SPECIAL MENTION ITEMS	1,566,665	1,027,606	794,582
CLASS CONCENTRATION / # ADV. CLASS. CONCEN.			

EARNINGS AND RESERVES	06/30/2008	12/31/2007	12/31/2006	12/31/2005
NET OPERATING INCOME	-4,272,651	274,250	3,500,393	3,513,899
CASH DIVIDENDS	0	4,862,524	5,716,700	2,791,700
SALE OF EQUITY CAPITAL	0	0	0	864,366
NET OTHER CHANGES IN CAPITAL	2,258,911	983,054	1,043,939	5,259,840
NET CHG IN EQU CAP ACCNTS	-2,013,740	-3,605,220	-1,172,368	6,846,405
NET LOAN LOSSES OR RECOVERIES	3,538,570	2,166,066	909,194	408,733
PROVISIONS FOR LOSSES	9,422,769	3,107,233	816,726	212,521

SELECTED RATIOS AND TRENDS	PEER	06/30/2008	12/31/2007	12/31/2006	12/31/2005
ASSET GROWTH RATE		-1.30	-5.73	4.51	21.17
NET OPER INC/AVG AST		-4.58	0.27	1.55	1.76
OVERHEAD EXP/AVG AST		2.92	3.84	3.23	2.69
NT INT(TE)/AVG ERN AST		3.58	3.26	2.95	2.77
NONINT INC/AVG ASSETS		1.29	2.26	2.44	2.06
LOAN RES TO TOT LOANS		3.49	1.02	0.60	0.63
NT LNS LOSS TO AVG LNS		3.06	0.93	0.36	0.17
EARN COVG NT LOAN LOSS		0.61	1.75	6.46	13.19
AVG EARN AST/AVG AST		86.29	86.39	87.47	88.44
VOL LIAB DEPENDENCE					

CONFIDENTIAL PROBLEM BANK MEMORANDUM
Washington Mutual Bank
Henderson, Nevada, Nevada

Identification and Nature of the Problem
The financial condition and performance of Washington Mutual Bank (WMB or Bank) continues to deteriorate, due to losses associated with an increasing level of problem loans. Past due loans and credit losses have increased steadily over the past five quarters and show no immediate signs of reaching a stabilized level. WMB is expected to be unprofitable in 2008 and 2009, and the earnings power of the retail franchise continues to diminish. The Bank's weakening financial condition has contributed to increased reputation risk, resulting multi-billion dollar deposit runs that have significantly impacted liquidity. Ultimately, the Bank's financial condition and viability remains dependant on WMB's ability to maintain adequate capital and return to profitability. Both of these factors appear threatened in view of the Bank's heightened risk profile and susceptibility to today's weak housing and credit markets. Based on the Bank's risk profile, continued financial deterioration, and overall risk to the deposit insurance fund, a CAMELS and composite rating of 444442/4 is considered appropriate. The OTS has assigned ratings to WMB of 343432/3.

Asset Quality
WMB has accumulated significant high-risk loan concentrations, including non-traditional mortgage loans (Option Adjustable Rate Mortgages) that represent 178% of capital and reserves; subprime residential loans that represent 81% of total capital and reserves; and second-lien home equity loans that represent 150% of capital and reserves. In addition, approximately 49% and 10%, respectively, of the residential loan portfolio is located in the declining real estate markets of California and Florida. Over half of the total real estate portfolio is located in areas where home prices have already declined by more than 15%. Also, the portfolio is largely unseasoned, as approximately 50% of the residential portfolio has been originated since January 1, 2006. WMB's underwriting practices relied heavily on stated-income, reduced documentation, and high loan-to-value credits. The quality of the loan portfolio is reflective of systemic underwriting weaknesses and risk selection practices compounded by both geographic and product concentrations. This layering of risk has created a residential loan portfolio with complex embedded risks. The level of adversely classified assets has almost doubled since 6/30/07, and trends in all portfolios as shown below are unfavorable.

KEY RATIOS	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
Adversely Classified Assets to Tier 1 Capital and Reserves	23.37%	29.37%	32.74%	40.74%	43.41%
SFR Delinquency Rate	2.39%	2.86%	4.18%	5.76%	7.47%
SFR Charge Off Rate	0.09%	0.20%	0.36%	1.22%	2.55%
Subprime Residential Delinquency Rate	13.10%	17.48%	21.25%	23.09%	25.19%
Subprime Residential Charge Off Rate	1.79%	2.85%	5.73%	8.70%	13.83%
Home Equity Delinquency Rate	1.40%	2.16%	3.12%	3.48%	4.00%
Home Equity Charge Off Rate	0.38%	0.74%	1.80%	3.12%	4.66%
Managed Credit Card Delinquency Rate	5.11%	5.73%	6.47%	6.89%	7.05%
Managed Credit Card Charge Off Rate	6.40%	6.38%	6.92%	9.33%	10.78%

Option ARM loans represent about half, or $53 billion, of the $107 billion in prime single family residential loans. Approximately 46% of the Option ARM loans recast at the earlier of 5 years or when the current loan balance exceeds 125% of the original loan amount. About 27% of Option ARM loans have a 115% amortization cap, and 25% of Option ARM loans have a 110% amortization cap. Management estimates that between August of 2008 and December of 2010, $26 billion in Option ARM loans will recast, including $6 billion in early recasts and $20 billion in scheduled recasts. The early recasts, which include loans that hit the negative amortization cap prior to the fifth year, have a weaker credit profile than scheduled recasts. Management estimates that 25% of these recasts, or $6 billion, will have payments increased to at least 1.6 times the pre-recast payment, and 78% of these recasts will be early recasts. As of June 30, 2008, 10.8% of the Option ARM loan portfolio was delinquent by 30 days or more, and the annualized charge off rate for the month of June was 5.64%. For Option ARM loans that are repossessed and disposed of, the Bank experienced net chargeoffs totaling 29 cents on the dollar during the 2Q08. Approximately 50% of the Option ARM portfolio is secured by California collateral, and 13% is secured by Florida collateral. Approximately 77% of the Option ARM loan portfolio is comprised of low documentation loans; 14% of the portfolio has loan to value ratios that equal or exceed 90%; and 19% of the portfolio will have debt-to-income ratios that exceed 46%, once loans are recast.

Subprime residential loans total $16 billion, including $14 billion in loans secured by first liens and $2 billion in second lien home equity loans. The subprime residential delinquency rate currently totals 25.19%, with an annualized charge off rate of 13.83%. Prime home equity loans total $60 billion and include $16 billion in first lien loans and $45 billion in second lien loans. The home equity delinquency rate currently totals 4.00%, with an annualized chargeoff rate of 4.66%. The second lien portfolio reflects an 11.1% delinquent rate for loans past due 30 days or more and a June monthly annualized charge off rate of 5.97%. Furthermore, the portfolio is concentrated in California, with 60% of the loans secured by California real estate. Unfunded HELOC commitments total $41 billion. WMB also reports a $26 billion managed credit card portfolio, which is 42% comprised of subprime credit card receivables. The credit card portfolio has experienced managed net charge offs accelerating to almost 11% as of June 30, 2008. The Bank's $1 billion small business portfolio is weak, with 9% delinquent 30 days or more and a June annualized charge off rate of 15%. Asset Quality has led to negative earnings and capital and threatens the Bank's future viability.

Liquidity
The Bank's liquidity is under considerable pressure from reputation risk associated with reported losses through the second quarter 2008 and adverse market reaction to recent bank failures. Liquidity remains highly dependent upon FHLB borrowings and high-cost retail deposits, including retail brokered deposits. Since the week of July 14, 2008, and through month end July, retail deposit outflow totaled $10 billion. Approximately two-thirds of the outflow was estimated to involve uninsured deposits, and the total outflow represented more than 6% of the retail deposit base. While deposit outflows have stabilized somewhat, the average daily outflow still totaled $330 million during the first 19 days of August, if two dates (August 1 and August 15) are excluded due to increased payroll activities. The impact of certain simultaneous stress events and reputation risk suggests that the Bank's excess liquidity will be significantly diminished and well below the Bank's internal targets in the next three to six months. The lack of market confidence in the Bank's viability will likely continue to increase reputation risk and could result in future deposit runs.

Management is building cash and cash equivalents and pledging additional collateral at the FHLB and the FRB to allow enough borrowing capacity to meet withdrawal demand; however, the Bank can not sustain deposit outflows over an extended period of time. Also, the additional pledged collateral is being consumed by increasing margin requirements. To stem deposit outflows and reduce reliance on borrowings, the Bank's current strategy is to pay deposit rates that are at or above competitive rates.

Currently uninsured retail deposits, which remain most exposed to reputation risk, are estimated at $17 billion or 14% of the retail deposit base. Credit sensitive commercial deposits totaling $5 billion and retail brokered deposits totaling $21 billion are also sensitive to withdrawal. The San Francisco FHLB notified management on August 29, 2008 that additional collateral margin of 3%-5% will be instituted on September 15, 2008. This will reduce borrowing capacity (presently at $29 billion) by up to $9 billion. Borrowing capacity at the FRB Discount Window is estimated at $8 billion; however, the FRB is concerned about the Bank's future prospects and recently discouraged the Bank's bid on a new 84-day Term Auction Facility (TAF) borrowing. WMB no longer has access to unsecured fed funds borrowings, and counterparties are requiring the Bank to post collateral to conduct new trades. Rating agency downgrades to sub-investment grade are possible for Washington Mutual Inc. (WMI), the holding company, and WMB, which could result in borrowing options becoming even more limited.

Liquidity may also be strained by the Bank's securitized credit card receivables. WMB has $18 billion in securitized credit card receivables, with $7 billion in term securitizations and conduit financings maturing in the second half of 2008. Maturing card securitizations and conduits are captured in the Bank's liquidity planning. However, the remaining $11 billion in securitized credit card receivables are at risk if WMB trips early amortization triggers and receivables come on balance sheet before expected maturity dates. This will require the Bank to fund these receivables internally and would pressure liquidity. The primary early amortization trigger is excess spread becoming negative. Excess spread for securitized credit cards has reduced from 8.16% in June of 2007 to 4.55% as of June, 2008. As loss rates in the trust have been increasing, from a net chargeoff rate of 8.65% at June 30, 2007 to 12.96% at June 30, 2008, excess spread has been constricting rapidly.

Bank management has developed short-term liquidity strategies that may not be sustainable over the long term, and a recurrence of the July deposit withdrawals is a concern. WMB projects $14 billion of readily available liquidity sources in its three month stress scenario. This scenario has a reasonable possibility of occurring should another liquidity event occur. For example, one of the stress factors in this scenario is an additional FHLB collateral haircut of 4%. As noted above, the San Francisco FHLB has already notified management that a haircut in this range will be implemented on September 15, 2008. Further, the available liquidity in the stress scenario is well below management's internal target of $25 billion, and liquidity falling to $14 billion is a serious concern. Management presented a remediation plan to directors to address this shortfall and raise liquidity back to the $25 billion internal target. The plan relies largely on raising an additional $5 billion of retail deposits at above-market rates and $4 billion of additional liquidity from expected mortgage runoff through October 31, 2008. Management has generated substantial deposits through its ongoing rate promotions; however, a significant portion of these deposits has been offset by reductions in the Bank's lower yielding accounts. In the first 20 days of August, retail deposits had grown only $75 million. Management is attempting to improve FHLB borrowing capacity by securitizing loans that are not currently eligible FHLB collateral and establishing a new $5 billion borrowing line with the FHLB-Seattle. To date, management's efforts to increase FHLB borrowing capacity have been largely negated by increased margin requirements. The bank remains exposed to future market value declines or advance rate deductions related to the pledged collateral.

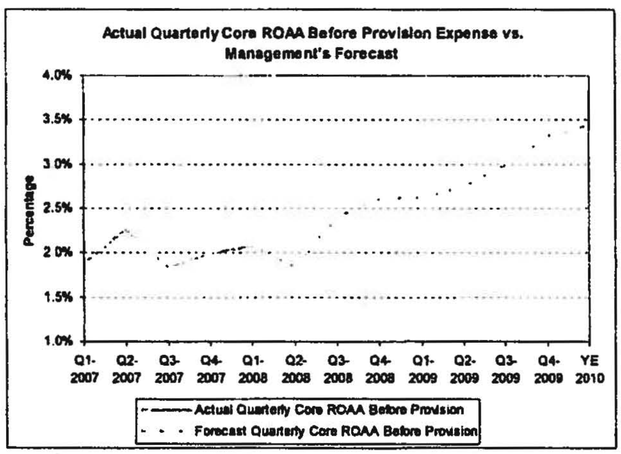
Management

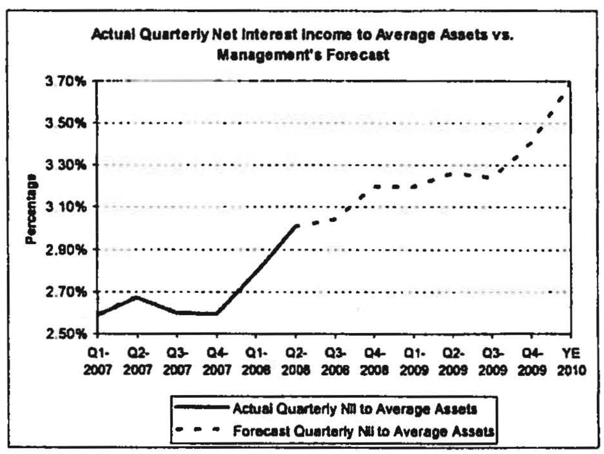
Board and management oversight needs improvement. While unprecedented housing and banking conditions have contributed to the Bank's unsatisfactory financial condition, management and the board are responsible for WMB's liberal loan underwriting and concentrated exposure to declining real estate markets and higher risk loan products. The board has continued to support top leaders, who may not have the capabilities to deal with the problems now facing the Bank. Management continues to experience difficulty in assessing the depth of asset quality problems; forecasts are continually being revised downward in this regard.

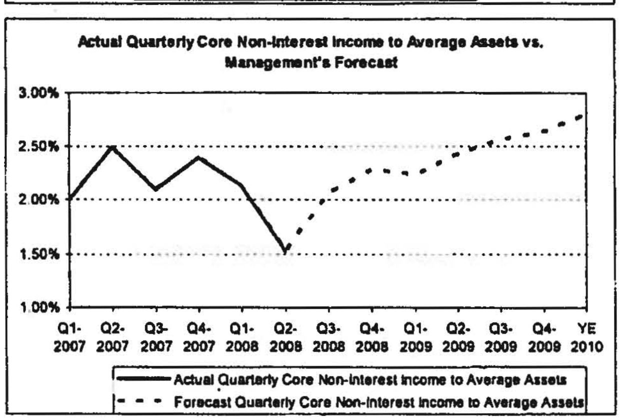
These continual revisions cast doubts as to management's overall expertise and ability to resolve the Bank's problems. WMB is operating without a chief credit officer and a retail bank president. Also, the chief compliance officer position continues to experience turnover. Reputation risk is high and has increased, due to negative press coverage related to current financial, credit, and appraisal concerns, as well as ongoing compliance and legal issues. WMB continues to operate under a BSA/AML Cease and Desist Order, and Compliance remains "3" rated.

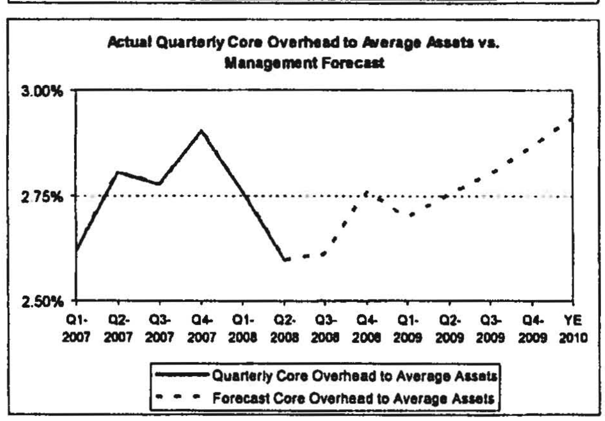
Capital and Earnings
WMB's capital position is deficient and remains vulnerable to a high-risk loan portfolio that exhibits an increasing trend of delinquencies and asset losses. WMB reports Tier 1 Leverage Capital, Tier 1 Risk-Based Capital, and Total Risk-Based Capital ratios totaling 7.07%, 8.40% and 12.44%, respectively, resulting in a PCA Category of "Well-Capitalized". However, problematic Option ARM loans, second lien home equity loans, and residential subprime loans comprise over 400% of Tier 1 Capital and the ALLL. Adversely classified assets have nearly doubled over the past year and now represent 43.4% of core capital and reserves; however, this ratio appears understated, as loans past due 30-89 days, non-performing assets, and troubled debt restructurings equal 68.9% of capital and reserves.

WMI, the holding company, raised $7 billion in capital in April 2008 and injected $5 billion in WMB. However, the ability of WMI to attract new capital is materially hampered by a price protection feature that is embedded in the terms of the $7 billion capital offering, which requires reimbursement for price depreciation to be paid to the investors from the proceeds of future capital offerings if additional shares are issued at a price below $8.75 per share. WMI stock has been trading at around $2.75 per share in recent weeks. Unless additional external capital can be raised, WMI will not be able to downstream capital support to WMB.









Although management continues to forecast adequate capital, the Bank's capital projections and strategic forecasts ultimately rest on the unsupported assumptions that core earnings relative to assets will increase by more than 50%, losses on the existing home loan portfolio are accurately capped at $19 billion, and credit costs will improve starting in 2009 and return to normal levels in 2010. Historic data in housing market declines indicate a long cycle that lasts many years and the current downturn may likely continue through 2010. There is considerable uncertainty in WMB forecasts that stems not only from the unsupported assumptions used to estimate future credit costs, but also from management's ability to execute a business plan to control costs, greatly improve profit margins, and successfully de-leverage the balance sheet while minimizing losses in a stressed environment.

WMB forecasts the ability to generate, on average, core earnings before provision expense of $2 billion per quarter going forward to year-end 2010, for a total of $20 billion in core earnings accretion to absorb credit losses. The Bank's estimated losses in its existing home loan portfolio at $19 billion are largely based on management's judgment, which has been inaccurate in the past. Management acknowledged that there are considerable uncertainties in both the timing of loss recognition and the magnitude of the losses that could exceed the $19 billion estimate. Capital planning should include additional stresses to the losses, as well as to the earnings assumptions.

The forecast is also optimistic when you consider the impact of decreasing subprime credit card and nontraditional mortgage originations and securitizations and increasing non-interest expenses needed to attract and retain deposits. WMB plans to replace lower yielding mortgages with multi-family loans, credit cards, and home equity lines of credit. Reportedly, management intends to modify recasting Option ARMs, which may mitigate increasing losses in this rapidly deteriorating portfolio. However, even if such modifications successfully improved credit costs, they would have a negative impact on interest income. Management has already found that Option ARM modifications through the first half of 2008 reduced the weighted average coupon on these loans by over 100 basis points (although only 7% of recasts have thus far resulted in modifications). Furthermore, current interest income has been over-stated by the capitalization of interest on Option ARM loans. Deferred interest added to the balance of Option ARM loans totals $2 billion, and the ability to collect this capitalized interest is questionable given the poor quality of the portfolio and declining property values. Year-to-date deferred interest totals $600 million and represents 7% of total interest income. The Bank's net interest margin benefited from interest rate cuts in the first half of 2008; however, these cuts have ceased and the Bank's recent loss of $10 billion in retail deposits will negatively impact the net interest margin as substitute funding costs are higher.

Additional concerns with management's forecast include the likelihood that provisions for loan losses will increase due to future mortgage repurchases, and potential asset valuation write-downs and impairments. Valuation assumptions may not be reasonable, due to continuing market risks and the potential volatility of the MSR, which total $6 billion and equal 29% of Tier 1 Capital. The Bank's projected cumulative loss does not include Other Than Temporary Impairment (OTTI) in the AFS portfolio and other mark-to-market positions of roughly $1.5 billion. So far, AFS impairment loss recognized in earnings during the first half of 2008 totaled $474 million and may continue to negatively impact future earnings and capital. Lastly, non-interest income for 2008, excluding OTTI recognition, was down 38% from the prior quarter; however, the forecast depicts that depositor fee income, a significant source of non-interest income, will decline due to reduced deposit accounts. This is a significant inconsistency due to numerical projections that reflect continued growth in these accounts. Non-interest expenses are also expected to increase due to pending litigation, foreclosed assets, modified loans, and reserves for loan repurchases. Also, non-performing loans will also continue to weigh heavily on operating results.

WMB's internal projections show capital ratios remaining above Well-Capitalized thresholds, even in a recession scenario; however, management's past forecasts have proven to be unreliable, and current forecasts are not credible in light of current conditions and past performance. In the past ten months, the 2008 earnings projections for WMB have been repeatedly and significantly revised downward, from the initial net income projection of $2 billion in October 2007, to the current net loss expectation of at least $6 billion. In the current earnings forecast, management projects a return to profitability for WMB in the second quarter of 2009 and positive net income of $4 billion in 2010, on a rapidly declining asset base. Projected 2010 net income would match the Bank's record earnings performance, a ROA of 1.37%, which was achieved with a much higher asset base. WMB previously achieved similar returns in 2002 and 2003; however, this was a completely different market environment than today, when WMB enjoyed record mortgage origination volumes and very benign credit quality conditions. In summary, it is highly unlikely that WMB can realize core earnings improvement that exceeds historic averages to offset credit costs and bolster capital. Therefore, the Bank's forecast of capital adequacy is inadequate.

Corrective Action
The OTS is in the process of determining an appropriate course of action, with respect to a corrective program. A preliminary draft MOU is being circulated for review that calls for an updated 3-year business plan, maintenance of minimum Tier 1 Leverage Capital at 6.75% and Total Risk Based Capital at 11.75%, capital contingency planning, no dividends, adequate ALLL, a plan to reduce classified assets, correction of examination deficiencies, and for consultants to study risk management, management, and residential underwriting. The FDIC supports the provisions of the MOU; however, the FDIC is also proposing a provision that requires WMB to implement contingency capital planning that recognizes potential deterioration and sufficient capital for a stressed economic environment. OTS has indicated that it believes management will sign the MOU on 9/8/08.

FDIC and OTS representatives met on 8/28/08 to discuss potential WMB ratings differences. The discussion focused primarily on the bank's earnings projections and assumptions through 2010, and the resulting impact on the adequacy of capital ratios. The OTS staff had previously been provided with an earnings and capital analysis prepared by the FDIC. At the meeting, OTS provided the FDIC with additional bank documents. One document showed projected capital ratios through 12/31/10, after applying various stresses to earnings projections. The worst case scenario in this presentation showed the Tier 1 Leverage Capital Ratio declining to a minimum of 6.66% at 12/31/09 and the Total Risk-Based Capital Ratio declining to 10.70% at 12/31/10. The FDIC staff expressed concerns with the bank's projections, and questioned the ability of management to execute its business plan in the current difficult environment, particularly given management's track record. FDIC and OTS staff debated several specific assumptions in management's projections, and also debated the differences between management's projections and those contained in the FDIC analysis. This analysis illustrated the risks to the bank's earnings and capital if management was not able to successfully implement its current business plan based upon information known at the current time. The assumptions questioned by the FDIC staff included management's cost of funds projections, the adequacy of cumulative credit loss estimates, the ability of management to successfully remix earning assets, and the ability of management to grow retail deposits while eliminating most borrowed funds. Representatives from both agencies agreed to review the projections and assumptions in more detail and discuss the forecasts at a later time.

General

WMB is owned by WMI, which is a non-diversified, multiple savings and loan holding company that is regulated as a unitary holding company because the charters of both of its Bank subsidiaries were supervisory acquisitions. The Bank is the largest savings and loan association in the country and the predominant legal entity in WMI, which has no significant subsidiaries outside of Bank's corporate structure. WMI' s earnings are derived almost entirely from the Bank and, therefore, earnings outside of the bank within the holding company will neither materially harm nor provide substantial benefit to WMB. The bank operates over 2,200 branches in fifteen states and has no foreign operations. WMI is rated "Satisfactory" by OTS based on its 1/8/07 examination; however, the 2008 examination proposes a 3, or less than satisfactory rating. The risk profile of WMB is increasing and the institution poses high risk to the deposit insurance fund.

Stan Ivie
Regional Director
San Francisco Region