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OTS letter to FDIC re WaMu ratings

Darrel W. Dochow

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Office of Thrift Supervision

Department of the Treasury

West Region

SEP 17 AM 10 52

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September 11, 2008

Mr. Stan Ivie
Regional Director
Federal Deposit Insurance Corporation
25 Jessie Street at Ecker Square, Suite 2300
San Francisco, CA 94105

CASE NAME: Washington Mutual, Inc.

BHC: _____

INST: Washington Mutual Bank

NON-BK: _____

PCA/CA: _____

FO: PHO SCANNER

W/O-RM: RAMS - Mr. Hulley

CITY: _____

STATE: _____

OTHER: _____

Dear Mr. Ivie: ^{STAN}

This is in response to your letter regarding our discussions with respect to the Uniform Financial Institution Rating (UFIR) for Washington Mutual Bank (WMB).

Thank you for separately sending a copy of the Confidential Problem Bank Memorandum for WMB that details rationale for why the FDIC believes that WMB should be rated a composite "4". As we have discussed, the OTS assigned a "3" rating at the July 15, 2008 meeting with the Board of Directors. The enclosed document summarizes the OTS examination findings and differences with respect to our respective office's ratings.

Sincerely,

Darrel W. Dochow
Regional Director

Enclosure



Office of Thrift Supervision

Department of the Treasury

101 Stewart Street, Suite 1010, Seattle, WA 98101-2419
Telephone: (206) 829-2600 • Fax: (206) 829-2620

West Region

Seattle Area Office

September 11, 2008

WaMu Ratings of 3/343432

Introduction

The FDIC West Region recently informed us that they are moving forward with CAMELS Ratings of 4/444442 for Washington Mutual Bank (WMB or Bank). The OTS West Region assigned ratings of 3/343432 under the Uniform Financial Institutions Rating Systems (UFIRS) definitions at the July 15, 2008 meeting with the Board of Directors. We have agreement with the FDIC regional office on the Asset Quality, Earnings, and Sensitivity component ratings, but are one notch higher on the Capital, Management, Liquidity and therefore the Composite ratings.

OTS and FDIC regional representatives met on several occasions in August after we learned of a potential ratings difference. We share a common perspective about the company's deteriorated financial condition. The OTS regional representatives believed that the discussions allowed us to clarify some important information, particularly around the assumptions used in the FDIC's stress scenarios that showed potential capital deterioration to "undercapitalized" by 2010.

This memorandum highlights our examination findings, enforcement actions, basis for our assigned ratings, and what we understand are the key drivers for the difference in rating at this point in time with the FDIC.

Examination Approach

Our examination of WMB is conducted on a continuous basis using dedicated examination leads and teams of examiners from throughout the West Region and country. During the period of September 10, 2007 to June 30, 2008, we conducted targeted examinations of retail/consumer lending, mortgage lending, credit administration, servicing, and operations. Much of the financial information available at time of the reviews was dated March 31, 2008. Information was updated to June 30, 2008 in key areas as it became available. In addition, we conducted Information Technology and Compliance examinations and assessed the institution's compliance with the outstanding BSA/AML Order to Cease and Desist.

Midway during our continuous examination review period (2/27/2008), we downgraded the composite rating to "3" based on net losses and negative asset quality trends. We re-confirmed this "3" composite rating at completion of the examination on June 30, 2008 and met with the board of directors on July 15, 2008 to discuss our findings, conclusions and anticipated enforcement action. OTS entered into MOUs with both Washington Mutual Bank and Washington Mutual Inc., which became effective concurrently with a change in CEO on September 7, 2008. We continuously monitor WMB's condition and will adjust composite and component ratings in accordance with the UFIRS definitions. The OTS examination team

worked closely with the FDIC dedicated examiner and his team during the entire examination review period and FDIC participated in the exit meeting with the Board of Directors. Unfortunately, we had not realized until after the meeting with the Board of Directors that the FDIC would have a composite ratings difference.

Enforcement Actions

Cease and Desist Order (C&D). OTS issued a C&D order on October 17, 2007 related to weaknesses in WMB's Bank Secrecy Act/Anti-money Laundering (BSA/AML) programs.

Civil Money Penalty (CMP). OTS issued an order for CMPs totaling \$60,448 related to Bank's violation of flood insurance regulations in its Multifamily Loan group on October 17, 2007.

Board Resolution – Required Board Resolution committing to correct concerns at time of mid-exam ratings downgrade to a composite “3” on February 27, 2008.

Memorandum of Understanding (MOU) effective September 7, 2008. Action items include: (1) submission of a 3-year business plan – both base case and stressed scenarios - (within 30 days) for OTS review and non-objection followed by quarterly variance reports, (2) a contingency capital plan (within 90 days), (3) a classified asset reduction plan (incorporated into the business plan), (4) engage an outside consultant to review risk management practices (45 days), and submit a report to OTS (75 days), (5) engage an outside consultant to review the underwriting process for the Home Loans Group (45 days), and submit a report to OTS (75 days), (6) submit a report to OTS to address the consultants' recommendations within 30 days of receipt of the consultants' reports, (7) review alerts for the period April 1, 2006 through June 30, 2008, and file SARs where required (no later than October 31, 2008), and (8) ensure that management corrects all OTS findings specified in the Report of Examination and the Findings Memoranda. Within 55 days of the end of each quarter, the Board shall certify compliance with the MOU and submit a certified copy to the OTS.

Holding Company MOU effective September 7, 2008. Action items include: (1) submission of a consolidated 3-year business plan (within 30 days) for OTS review and non-objection followed by quarterly variance reports, (2) a contingency capital plan (within 90 days).

Ratings Discussion

Composite Rating-3:

In accordance with the UFIRS definitions, the OTS assigned a composite rating to Washington Mutual Bank of “3”. The definition of an institution rated in this category is:

Financial Institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of

withstanding business fluctuations and are more vulnerable to outside influences than those institutions rates a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

By contrast, the UFIRS definition for a "4" says:

Financial institutions in this group generally exhibit unsafe and unsound practices and conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

With regards to component ratings, the OTS and FDIC concur on the "4" rating for Asset Quality and Earnings and the "2" rating for Sensitivity. The OTS believes that "3" ratings are appropriate for Capital, Management and Liquidity while the FDIC believes that these components should be rated "4".

The composite rating difference between OTS and FDIC regions stems primarily from one's conclusions about the credit cost projections and the timing of such losses, level of prospective core operating income, and adequacy of liquidity during this uncertain time and unprecedented market reaction. In addition, there is an element of potential timing difference as the OTS rating was assigned at completion of the examination on June 30, 2008 and we continue to watch closely the unfolding events and implications of the public disclosure of the enforcement action and the "4" FDIC rating on key funding partners and public confidence. All the above conclusions drive the amount of capital currently needed to support the risk in the institution.

Both OTS and FDIC analyzed and further stressed the Bank's Recession Scenario projections. Under the FDIC's stress analysis, we understand the Bank's capital designation could fall to "undercapitalized" by late 2010. Under the OTS further stress analysis, capital ratios remain above the "well capitalized" thresholds, but dip below the higher Tier 1 Leverage and Total Risk Based Capital thresholds imposed by the MOU of 6.75% and 11.25% respectively by late 2010.

This potential outcomes contained in our further stress scenarios is one reason why OTS included, and FDIC supported, a requirement in the MOUs that the Bank and holding company submit a contingency capital plan within 90 days. This is intended to ensure that the Bank has in place a clear plan for shoring up capital should their Recession Scenario projections become unattainable. It also allows the new CEO time to assess the situation and submit a business and capital plan intended to ensure the financial turn around of the company. As part of the continuous examination process, we are actively monitoring actual performance against plan projections and the unfolding market events.

Credit Cost Projections

In the first quarter of 2008, management revised its expectations for future life-of-loan SFR losses to \$19 billion. In addition to SFR losses, management separately forecasts losses for credit cards and multi-family/commercial loans, plus factors in foreclosure and lost interest expenses. The sum of these credit costs through 2010 total \$35 billion in the Recession Scenario. Estimated SFR loan losses take into account changes in home prices, a variable outside of management's control, and one that is difficult to predict accurately. The following chart shows the default frequency and loss severity assumptions that were made in the first quarter 2008 and the implied losses:

	100% Balance	Case 1	Case 2	Case 3	Case 4	Case 5	Case 6
Option ARM	\$52.5	\$5.6	27%	40%	\$0.5	\$5.1	
Other Prime	58.7	1.4	6%	40%	0.15	1.3	
Home Equity 1st	15.9	0.6	9%	40%	0.06	0.5	
Home Equity 2nd	44.8	7.4	17%	100%	0.64	6.8	
Subprime 1st	15.1	2.8	46%	40%	0.40	2.4	
Subprime 2nd	2.3	1.1	47%	100%	0.15	1.0	
Total	\$189.4	\$18.9	18%	55%	\$1.90	\$17.0	

In order to determine the reasonableness of these assumptions, we looked at the performance of similar loan types in securitizations. In all but the 2007 vintage of home equity loans (9 percent of the portfolio as of June 30), the bank's portfolio performance, in terms of the 90+ day delinquencies, was better than similar loans in securitizations.

	Pre-2005	2005	2006	2007	2008	Totals	
Option ARM	\$14.8	\$11.6	\$11.6	\$14.2	\$0.2	\$52.4	29.2%
Other Prime	18.0	7.4	4.5	18.6	3.2	51.7	28.9%
Home Equity 1st	6.7	2.6	1.4		0.4	15.5	8.7%
Home Equity 2nd	10.3	9.6	11.5		0.6	43.6	24.3%
Subprime	4.0	3.8	6.3	1.9	0.0	16.0	8.9%
Totals	\$53.8	\$35.0	\$35.3	\$50.7	\$4.4	\$179.2	100.0%
Percent	30.0%	19.5%	19.7%	28.3%	2.5%	100.0%	

We compared the projected cumulative loss percentages estimated by S&P¹ for 2006-2007 Option ARM and Subprime securitizations and for 2005-2007 Prime Jumbo securitizations to the implied cumulative loss percentages estimated by the bank for those loan types. Although the

¹ July 29, 2008, Ratings Direct, *Standard & Poors Revises U.S. Subprime, Prime, and Alternative-A RMBS Loss Assumptions*

Other Prime category contains Prime Jumbo loans, it also contains other non-jumbo loans with prime characteristics.

	2005		2006		2007		Adjustment to Losses using S&P estimates
	S&P	Bank	S&P	Bank	S&P	Bank	
Option ARM	NA	10.8%	11.0%	10.8%	14.8%	10.8%	570 million
Prime Jumbo	0.32%	2.4%	0.81%	2.4%	1.17%	2.4%	(455 million)
Subprime	NA	22.4%	23.0%	22.4%	27.0%	22.4%	125 million
Net Total							240 million

As the chart above shows, we found in the recent vintages of Option ARMs, that the bank uses lower cumulative losses than S&P. However, since the bank applied a flat loss rate to all vintages, it is also likely that the bank overestimated cumulative losses for pre-2006 vintages. The same holds true for subprime loans. It appears that the bank has overestimated the cumulative losses on its Prime Jumbo loans in all vintages. Moreover, S&P's loss severity component of the cumulative loss calculation includes the costs to foreclose and liquidate, as well as any decline in property value². The bank estimates foreclosure costs separately. Thus, given the better overall performance of 91 percent of the bank's owned portfolio compared to securitizations of similar types and vintages, and that there is no evidence to show that the bank's cumulative losses are understated when compared to S&P's estimated losses for similar types and vintages, we believe that the banks estimated range of SFR life-of-loan losses is reasonable.

FDIC states option ARM loss severity experienced during 2Q08 was 29 cents on the dollar. This is less than the bank projects in their life-of-loan losses. The bank projects a 40% loss severity, not including foreclosure and liquidation expenses that are separately quantified. In addition, the Bank accounts for deferred interest on its Option Arm loan balances in its Recession Scenario forecast.

The bank's overall unsatisfactory condition is primarily the result of the poor asset quality and operating performance in the bank's major Home Loans Group line of business. Multi-family, credit card and retail operations are well run, are not experiencing similar problems to the Home Loans Group, and collectively generate significant core operating income. The deteriorating asset quality in the Home Loans Group is accompanied by inadequacies in risk management, internal controls, and oversight that made the bank more vulnerable to the current housing and economic downturn. The examination criticized past liberal home loan underwriting practices and the concentrated delivery of nontraditional mortgage products to higher risk geographic markets.

Management has ceased making higher risk pay-option ARM loans, stated income loans, and subprime loans. Home equity originations are nominal. In addition, they discontinued the wholesale lending channel, eliminated thousands of positions, and refocused on lower risk GSE-eligible mortgage lending directly to its customers through its retail distribution channels.

² May 7, 2008, Ratings Direct, *The Anatomy of Loss Severity Assumptions in U.S. Subprime RMBS*

Nonetheless, there remains a large volume of higher risk, predominantly single family assets on the balance sheet with deteriorating credit quality that need to be resolved.

The bank is actively addressing the recast risk in its Option ARM portfolio in order to reduce delinquencies from payment shocks. Its recast risk mitigation plan includes contacting borrowers within six months of a rate reset and offering to refinance the loan with discounted fees into a GSE/FHA salable product or modifying the loan into a 5/1 interest-only hybrid ARM at the current market rate or at a discount rate, depending on borrower qualifications.

With respect to timing of losses, the FDIC's stress analysis assumes that all of the estimated \$19.0 billion life of loan losses in the SFR loan portfolio (exclusive of foreclosure costs and lost income) will occur in the 2008 -2010 timeframe. The Bank projects that SFR losses during this time period will approximate \$15.0 billion. To date, actual losses of \$3.5 billion YTD 2008 remain within the Bank's Recession Scenario projections of \$8.6 billion for 2008. By assuming that all losses are accelerated to the shorter time period, the FDIC assumes that approximately \$4.0 billion of losses projected by the Bank for 2011 and beyond will occur in the approximate 2009 to 2010 time period and must be supported by capital now.

In order to assess what might be a worst case, staff reviewed a further FDIC stress assessment where the Bank's Recession Scenario was stressed by an additional 10% and 20% in addition to the already discounted core operating income assumption and the assumption that all potential life of loan losses occur in the 2008 to 2010 time period, despite the fact that approximately \$4.0 billion is projected to occur in 2011 and beyond. Even under this scenario, the results that we have seen shows WMB falling to "undercapitalized" under the PCA standards and such assumptions are debatable.

We further determined that the ALLL was adequate as of June 30, 2008, having been significantly increased in the second quarter in response to our examination and deteriorating trends factored into their reserve analysis.

The net losses stemming from credit costs and related higher expenses associated with discontinuing operations led the holding company to raise \$7.2 billion in additional equity and infuse \$5 billion into WMB. WMB has started to deleverage to reduce exposure to home loans in order to help maintain its capital ratios. Management plans to reduce assets to \$280 billion by year-end 2008, \$263 billion by year-end 2009, and \$253 billion by 2010 to maintain satisfactory capital ratios until losses subside. Although capital presently exceeds the minimum regulatory standards by a significant margin, we are fully aware it may not be sufficient to support the institution's risk profile if conditions deteriorate beyond estimates in the Bank's Recession Scenario. Second quarter 2008 loan losses were within the expected range. Should housing prices continue declining beyond that assumed in the Recession Scenario credit losses will likely exceed internal estimates and additional capital or other mitigation may be needed. We are monitoring the situation continuously.

Core Operating Income

WMB's losses began in the fourth quarter of 2007 and profitability is not expected to return until the third quarter of 2009, based on management's Recession Scenario forecasts. This scenario assumes the high end of the range for SFR credit losses of \$19 billion, not counting foreclosure costs.

	Q-2007	Q-2008	Q-2009	Q-2010	Q-2011	Q-2012	TD 2010
Earnings	(1,350,555)	(1,077,380)	(835,264)	(376,880)	144,352	186,260	2,009,194
Ending GAAP Equity	24,879,191	23,651,811	22,816,547	22,439,666	22,584,018	22,770,278	24,779,473
Tier 1 Leverage Ratio	7.42%	7.45%	7.29%	7.27%	7.46%	7.65%	8.63%
Tier 1 Risk-based Ratio	8.73%	8.37%	8.08%	7.96%	8.10%	8.26%	9.33%
Total Risk-based Ratio	12.82%	12.51%	12.19%	11.92%	11.99%	12.16%	12.80%

In addition, the forecast takes into account planned changes in the balance sheet, such as reductions in lower yielding SFR balances and increased higher yielding credit card balances. Similarly, higher loan losses are included for higher risk credit cards. Restructuring and resizing costs are estimated at \$450 million, with \$207 million recorded in the second quarter 2008, and the remaining to be recorded in the second half of 2008. The restructuring is expected to result in future annual cost savings of approximately \$1 billion, which is factored into the forecast.

Stress Scenario: When we stress forecasted net income in the Recession Scenario to account for potential execution risk, additional AFS impairments, and other operational risks such as increased cost of funds by an additional \$500 million after taxes per quarter beginning in the fourth quarter of this year, profitability does not return until 2010. This scenario slightly breaches capital levels required by the MOU (6.75% Tier 1 and 11.25% Total RBC), but they remain significantly above "well-capitalized" PCA thresholds, before returning to profitability.

	Q-2007	Q-2008	Q-2009	Q-2010	Q-2011	Q-2012	TD 2010
Earnings	(1,350,555)	(1,577,380)	(1,335,264)	(876,880)	(355,648)	(313,740)	1,509,194
Ending GAAP Equity	24,879,191	23,151,181	21,816,547	20,939,666	20,584,018	20,270,278	20,279,473
Tier 1 Leverage Ratio	7.42%	7.27%	6.91%				6.81%
Tier 1 Risk-based Ratio	8.73%	8.15%	7.63%	7.29%	7.20%	7.11%	7.23%
Total Risk-based Ratio	12.82%	12.29%	11.75%				

Management's ability to execute a deleveraging strategy, to halt asset quality deterioration, and to resolve problem assets within expected loss scenarios are risks to achieving the forecast. However, our analyses of modeling support for loan losses, the bank's ability to generate core earnings, estimated restructuring cost savings, and planned changes to its asset mix indicate the profit forecast is reasonably well supported, albeit subject to the ongoing risks.

With respect to projected core earnings, the FDIC's stress scenario assumes that core earnings remain at approximately \$1.2 billion per quarter over the next 10 quarters through yearend 2010 versus the Bank's estimate of \$1.4 billion per quarter in their recession case scenario (\$1.9 billion in the base case scenario). OTS reviewed the Bank's core earnings estimates and concluded that core income assumptions are reasonably supported at the \$1.4 to \$1.5 billion per quarter level. Over 10 quarters, this accounts for approximately \$3.0 billion of the potential additional capital support. We understand the rationale of using the \$1.2 billion per quarter

assumption since this was derived from the lowest core income of \$1.4 billion in the most recent quarter. However, our examination team in looking at the Bank's support for its core income assumptions felt that several facts warranted some consideration (not included in the FDIC's core income assumption) in arriving at a reasonable and supportable core income assumption. These facts included:

- Actual core income has averaged \$1.5 billion over the last several quarters.
- WMB has already incurred significant cost to obtain approximately \$1.0 billion in cost savings associated with essentially closing its mortgage banking operations that was unprofitable.
- WMB is re-mixing its loan portfolios. The low yielding SFR loan portfolio is dramatically declining due to shutting down the wholesale loan conduit, amortization, refinancing into loans being sold to the GSEs, and losses, among other reasons. Over the next ten quarters, low yielding SFR loans are projected to decline by approximately \$58 billion. At the same time the Bank is retaining and bringing back on balance sheet higher yielding credit card receivables. Despite the increased loan loss provisions associated with these credit card balances, the higher yields on the relatively smaller portfolio more than makes up for the loss of the larger portfolio of lower yielding SFR loans and is accretive to core income.
- Fee income improvement from a conservative (approximately half of historical growth and close to interest credited) projected growth in deposits.

Our analysis concluded that the forecast and underlying assumptions are reasonable but subject to ongoing risks, including:

- Economic conditions, housing prices, and employment levels worse than assumed.
- Default probability and/or loss severity for loans greater than estimates.
- Execution risk of ongoing and future changes to the business strategy.
- Operational risks, including legal and reputational risks.
- Rating agency downgrades further than assumed.
- Declining valuation of pledged assets for liquidity purposes.
- Changes in interest rates or the shape of the yield curve.

As a result of these ongoing risks, we stressed management's recession case earnings by \$500, pretax, using the FDIC's capital analysis. This analysis essentially resulted in stressed operating earnings approximating \$1.1 billion per quarter through YE 2001. Using this stressed income and maintaining losses within the range forecast through 2010 results in capital ratios that are below the MOU requirements, but within well capitalized status.

This analysis is illustrated in the table that follows:

Beginning GAAP Equity	\$24,380	\$24,380	\$24,380
July 2008 Capital Injection	2,000	2,000	2,000
Earnings Before Prov thru YE 2010	12,064	11,148 ³	14,148
Cum. Loss Est. (Home Loans)	(19,000)	(15,000) ⁴	(15,100)
Other Loan Losses	(9,100)	(9,100)	(9,100)
Foreclosure Cost	(3,450)	(3,450)	(3,450)
Losses taken in 2Q08	2,200	2,354 ⁵	2,354
Existing ALLL at 2Q08	8,456	8,456	8,456
Embedded Losses in AFS Sec.	(1,475)	(841) ⁶	0
Net Capital Impairment	(\$10,305)	(\$6,534)	(\$2,693)
Regulatory Capital Ratios @ yearend 2010			
Tier 1 Leverage	5.0%	6.8%	8.4%
Tier 1 Risk-based	5.1%	7.2%	9.0%
Total Risk-based	8.6%	10.6%	12.5%

Capital-3:

The overall level and composition of capital is considered less than satisfactory but is currently considered adequate to withstand immediate pressure stemming from significant credit deterioration, insufficient earnings, and other negative market trends. Although the examination concluded that capital was adequate in the short-term, maintaining satisfactory levels in the long-term is, in part, dependent on the severity of the credit losses emanating primarily from the SFR loan portfolios and on management's ability to appropriately react to risks posed by the current market events and economic downturn. Management's actions to improve WMB's capital position include the curtailment of riskier lending products, suspension of dividends, current and future material reduction of assets, accessing the capital markets twice at the holding company and infusing a total of \$6.5 billion into the bank since the fourth quarter of 2007.

The holding company (WMI) raised \$3 billion in capital in December 2007, and another \$7.2 billion in April 2008. Capital infusions to WMB (\$6.5 billion between December 1, 2007 and September 11, 2008) maintained their capital ratios above well-capitalized levels and internal targets. At June 30, 2008, Tier 1 Leverage ratio was 7.1 percent and a Total RBC ratio was 12.4 percent (per UTPR). Subsequently, WMB's Tier 1 Leverage ratio increased to approximately 7.6 percent and the Total RBC ratio to 13.2 percent as additional capital was contributed. WMI has retained approximately \$1.5 to 2 billion from capital raises for debt service, future WMB capital needs and to maintain its credit rating. The April 2008 \$7.2 billion capital raise included a "price protection" feature that states if there is a change of control of the company or the company sells more than \$500 million of common stock or equity-linked securities within 18 months of closing at a price lower than \$8.75 per share, the company would have to pay the

³ Based on WMB recession scenario operating income that is stressed by \$500.0 million, pretax

⁴ OTS reflects losses projected for 2008-2010 vs. FDIC projection that all life of loan losses occur by YE 2010

⁵ Reflects actual 2Q08 losses

⁶ OTS assumes net of tax unrealized loss, FDIC assumes gross unrealized loss

difference between the lower price and \$8.75 per share to the investors. This feature effectively precludes more than \$500 million additional capital from sources other than the TPG investor group while the price protection feature is active and the stock trades below \$8.75. The company's stock was recently trading at less than \$3 per share.

WMB forecasts its earnings and capital levels under two scenarios, a Base Case and a Recession scenario. The Base Case assumes the most probable level of credit losses, while the Recession scenario assumes the high end of credit losses. The Base Case also uses the forward rate curve, while the Recession scenario assumes a fed rate cut to 1 percent, lower GDP, higher unemployment, and steeper housing price declines. As shown below, all capital levels are above the minimum levels required by the MOU of 6.75 percent Tier1 and 11.25 percent Total RBC.

	Q3-2008	Q2-2008	Q1-2008	Q4-2007	Q3-2007	Q2-2007	Q1-2007	YE 2007
Earnings	(1,159,101)	(500,166)	(511,535)	232,423	622,200	1,040,294	3,534,477	
Ending GAAP Equity	25,070,646	24,420,480	23,908,945	24,141,368	24,763,568	25,803,862	29,338,339	
Tier 1 Leverage Ratio	7.46%	7.68%	7.67%	7.87%	8.26%	8.72%	10.48%	
Tier 1 Risk-based Ratio	8.81%	8.70%	8.56%	8.72%	9.09%	9.62%	11.46%	
Total Risk-based Ratio	12.89%	12.84%	12.68%	12.67%	12.98%	13.52%	14.93%	
	Q3-2008	Q2-2008	Q1-2008	Q4-2007	Q3-2007	Q2-2007	Q1-2007	YE 2007
Earnings	(1,350,555)	(1,077,380)	(835,264)	(376,880)	144,352	186,260	2,009,194	
Ending GAAP Equity	24,879,191	23,651,811	22,816,547	22,439,666	22,584,018	22,770,278	24,779,473	
Tier 1 Leverage Ratio	7.42%	7.45%	7.29%	7.27%	7.46%	7.65%	8.63%	
Tier 1 Risk-based Ratio	8.73%	8.37%	8.08%	7.96%	8.10%	8.26%	9.33%	
Total Risk-based Ratio	12.82%	12.51%	12.19%	11.92%	11.99%	12.16%	12.80%	

As shown in the Earnings analysis, if we further stress the Recession Scenario by lowering net income by \$500 million after taxes per quarter (beginning in 4Q08), the resulting capital levels temporarily breach the levels required by the MOU, but remain above the "well-capitalized" PCA threshold. However, at this time, based on a comparison to the S&P performance for similar loans, the credit loss estimates are not out of line and the additional stress of \$500 million per quarter provides for a margin of error.

The forecast and underlying assumptions are subject to ongoing risks as stated above.

Management-3:

We concluded that Board oversight and management performance was less than satisfactory, largely due to the significant deterioration in the Bank's financial condition since June 2007. While some of the deterioration was attributable to the downturn in credit and housing markets, other contributing factors should have been more proactively managed. The most significant contributing factors include continued SFR underwriting weaknesses, an Enterprise-wide Risk Management function that was not fully effective and various compliance deficiencies. The failure to address these weaknesses fully in a timely manner is now exacerbating SFR credit losses. Management has commenced positive steps to address the deficiencies noted, and we believe are capable, under the leadership of the new CEO, of correcting them.

With our support, a new CEO was put in place on September 7, 2008. The organization was experiencing a loss of confidence in the abilities of the former CEO. The board was unanimous in moving to find a qualified CEO quickly.

Management has regularly revised its financial forecasts to better reflect these unprecedented times of home price declines, secondary market disruptions and event risk among other things. This is not unusual and reflects management's continual effort to updating forecasts and plans as information changes.

Much of the Bank's asset quality and earnings problems stem from the Home Loans Group. Management personnel of the Card Services and Multi-family/Commercial groups are considered capable. While the Retail Banking group is currently without a permanent senior manager, middle management is satisfactorily running this segment of the bank under the direction of the COO. Operations management under the CFO, including treasury and market risk management, are considered strong. We have criticized the Enterprise Risk Management function, but this has been significantly strengthened with the recent addition of a capable Chief Enterprise Risk Officer.

As noted above, the bank's current condition and poor operating performance are primarily the result of insufficient risk management and oversight of the Home Loans Group that made it vulnerable to the current housing and economic downturn. The strategy over the last three years of expanding home lending increased credit risk from relaxed underwriting practices, weak controls, and concentrated delivery of nontraditional mortgage products to higher risk geographic markets. Despite our past examination concerns about underwriting practices, oversight was insufficient to control the escalating risks. The last several examination reports criticized various aspects of SFR underwriting; however, the most notable criticism pertained to underwriting of stated income loans without effective reasonableness testing. Similar criticism has been noted in internal credit review reports. These underwriting practices, resulting in the large credit losses, were not timely addressed and the bank only recently exited higher risk lending, including stated income lending.

The weaknesses in compliance management that we identified in our prior examination, although improved, continue to require management's attention. The primary weaknesses are unclear compliance roles and responsibilities, lack of consistent self-testing methodology and measurement metrics across business units, lack of compliance leadership continuity, mismatched managerial line authority and accountability, and inconsistency in implementing the stated commitment to compliance best practices. In addition, we found a violation of the BSA/AML Cease and Desist Order due to a continuing inadequate compliance program and failure to satisfactorily address the backlog of alerts.

There have been several notable board changes since the prior examination:

- The directors amended the bylaws to increase the board from 13 to 14 members and elected Stephen I. Chazen to the Board. Mr. Chazen is President and CFO of Occidental Petroleum Corporation, an international oil and gas exploration and production company.

- The board elected David Bonderman, Managing Director of the global private investment firm, TPG, pursuant to the April 7, 2008, Investment Agreement between WaMu and TPG Investors.
- Directors Mary E. Pugh and Ann V. Farrell left the board. Mr. Bonderman succeeded Ms. Pugh as Chair of the Finance Committee until June 2008 when Director Orin C. Smith was appointed Chair. Mr. Bonderman serves as Vice Chair.
- Independent director Stephen E. Frank assumed the position of Chairman of the Board formerly filled by CEO/Director Kerry Killinger. The change, initiated by the shareholders, is a measure intended to strengthen corporate governance.
- At TPG's request, Larry Kellner, former EVP and CFO of American Savings Bank and currently COB and CEO of Continental Airlines, is a board observer.
- WaMu has initiated a search for individuals with extensive financial services and strong leadership experience to fortify the board as new independent directors. There is currently one board vacancy.

Senior management changes during the review period:

- Chief Legal Officer Fay L. Chapman retired and Stewart M. Landefeld, a partner of Perkins Coie LLP, served as interim Chief Legal Officer until Michael S. Solender, formerly General Counsel of the Bear Stearns Companies, was named Chief Legal Officer in June 2008. Ms. Chapman will serve as consultant to WaMu for two years.
- John P. McMurray replaced Ronald J. Cathcart as Chief Enterprise Risk Officer. Mr. McMurray, formerly the chief credit officer at Countrywide Financial Corporation, joined WaMu late 2007 as Chief Credit Officer. Mr. Cathcart has resigned.
- President and COO Stephen J. Rotella assumed James B. Corcoran's responsibilities as President, Retail Banking on an interim basis until a permanent successor is selected. Mr. Corcoran has resigned.

Liquidity-3:

The Bank's liquidity position is less than satisfactory because of uncertainty about the adequacy of future funding sources and needs. The examination concluded that absent some significant negative event, current sources will likely be sufficient to fund current and projected operational needs. WMB's liquidity position was impacted negatively by the secondary market disruption and WMB has effectively lost access to the secondary market (other than mortgage loan sales to the GSEs) as a funding source for mortgage and credit card products. Liquidity is also suffering

from headline risk and there are signs that regulatory issues have and will impact FRB potential funding.

WMB is dependent on retail deposits and secured borrowing for funding. The institution lost approximately \$9.1 billion in retail and small business deposits in the months following the IndyMac Bank failure and an unexpectedly large second quarter loss announcement. Some illustrative data around these withdrawals include: an estimated 69% of the funds outflow represented uninsured money, a high percentage of customers withdrawing money maintained an account relationship with WMB; the actual number of new accounts was stable or grew during this time period; the average cost of funds leaving was reported as being the relatively higher costing funds. WMB has run several five day CD promotions at a relatively high rate. Management estimated that if all the \$9.1 billion was replaced at this high rate, the impact on cost of funds would be approximately \$200 million spread over several quarters.

Liquidity needs have lessened due to significant curtailment of lending activity and should be further reduced due to planned asset shrinkage. Liquidity funds management practices were judged satisfactory and management exhibits a strong knowledge of liquidity risk management. The implementation of a well-developed contingency plan has allowed the Bank to maintain excess liquidity in a difficult market environment and to react to rapidly changing credit environment.

The FHLBank of San Francisco applies conservative market valuations on pledged collateral before discounting it to its borrowing capacity. As the housing and financial markets deteriorated since mid-2007, the FHLBank systematically lowered the borrowing capacity for its members and future haircuts are expected.

Liquidity is managed to ensure sufficient liquidity under two stress scenarios and the bank presently has nearly \$45 billion of total liquidity, not including its potential \$8 billion access to the FRB discount window. Under the most severe stress scenario, WaMu had \$13.8 billion in excess liquidity at July 31, 2008. This excess liquidity is after an assumed 2 notch downgrade in ratings, a 10% additional retail deposit run off and a \$5 billion commercial deposit run off, FHLB haircuts increasing another 4%, no credit card securitization or conduit rolls. The stressed excess liquidity of \$13.8 billion is below the Bank's internal \$25 billion policy threshold that was set when the Bank was heavily engaged in mortgage banking operations and larger in size.

Management is continuing to build its liquidity through retail deposits and pledging additional collateral for borrowing lines. Current uninsured retail deposits are estimated at \$17 billion but expected to be approximately \$3 billion less when an account by account scrub is done and uninsured commercial deposits are estimated at \$5 billion. Recent deposit trends are generally stable and back to pre-IndyMac patterns.

Sensitivity to Market Risk-2:

Both the OTS and FDIC concur with the rating in this component. WaMu's exposure to interest rate risk was minimal at December 31, 2007, based on internal NPV modeling estimates and the

quantitative guidelines contained in Thrift Bulletin 13a. Internal interest rate risk results indicate a modest interest rate risk profile throughout the examination review period, including the most recent June 30, 2008, results. Estimated post-shock NPV ratios have consistently been in excess of minimum NPV limits established by the board.

Asset Quality-4:

Asset quality deteriorated significantly and is considered unsatisfactory. Pronounced deterioration has occurred in SFR portfolios resulting from housing and economic weakness coupled with management’s underwriting practices, concentrated use of nontraditional mortgage products, and weak controls within the Home Loans Group. Undue emphasis had been placed on loan production at the expense of loan quality. While problem asset levels increased, the Bank’s internal asset review function remains satisfactory, and the Multi-family/Commercial and Credit Card Groups and their credit processes are well managed. Concerns were also cited in the Small Business loan portfolio, which remains relatively small.

Delinquent Loans (30-89 days)	5,441,790	1.77	5,243,686	2.14	4,741,615	1.89
Nonperforming Loans	10,025,164	3.27	8,133,286	3.33	6,431,861	2.57
Repossessed Assets	1,531,807	0.50	1,381,066	0.43	1,015,127	0.31
Nonperforming Assets	11,556,971	3.76	9,514,352	2.99	7,446,988	2.29
Classified Assets/ Core Capital + Allowances		43.44%		40.74%		32.74%

Delinquency Rates by Loan Category						
SFR Delinquency Rate		7.47		5.76		4.18
Home Equity Delinquency Rate		4.00		3.48		3.12
Subprime Delinquency Rate		25.19		23.09		21.25
Managed CC Delinquency Rate		7.05		6.89		6.47

The SFR prime, subprime, and home equity lending programs have been the predominant source of WMB’s asset quality problems. The examination found the underwriting policies, procedures and practices in need of improvement, particularly with respect to stated income lending which has subsequently been discontinued. The Bank utilized an Automated Underwriting System that proved has limited effectiveness in proactively adjust to an increasing credit risk environment. The Bank lacked an effective reasonableness test process for stated income lending and policies and procedures were not uniform in the Home Loans Group. With our encouragement, stated income lending was discontinued for all channels during the examination.

Nontraditional pay-option ARM products are concentrated in prime and subprime portfolios representing 38 percent of total loans. Home equity loans account for 33 percent of total loans. The loan portfolio is geographically concentrated with 50 percent of loans secured by properties in California and 10 percent secured by properties in Florida, both states suffering from highly

depreciating real estate values. Approximately 48 percent of loans were originated in 2006-2007, a time when underwriting and controls were weak.

Refer to the Earnings section for analysis of estimated loan losses.

Management recently ceased making subprime loans, pay-option ARM loans, and all stated income loans and home equity loan production is nominal. In addition, they resized the Home Loans Group by discontinuing the wholesale lending channel, eliminating thousands of positions, and by focusing on mortgage lending directly to its customers through its retail distribution channels.