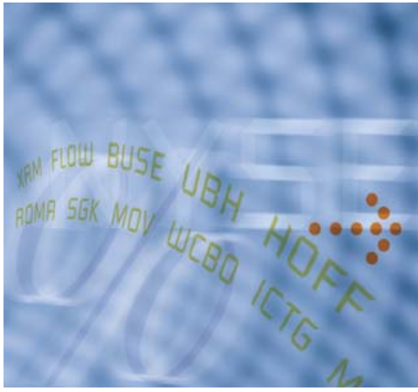

EarningsQuality ANALYTICS™ EQA

Detailed Report WM

01 NOVEMBER 2007

Washington Mutual Inc.
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NYSE	PRIMARY EXCHANGE
12/31	FISCAL YEAR END
09/30/07	RECENT PERIOD END
$27.88	RECENT CLOSING PRICE
24.05 billion	MARKET CAPITALIZATION
8.86	PRICE–EARNINGS RATIO
Savings & Loans	INDUSTRY

Earnings Quality Thesis

At first blush, it appears that Washington Mutual (WM) took a more conservative stance with regard to its loan loss provision in Q3 and in its guidance for Q4. However, we believe that impairment risk continues to be far greater than management has let on, as the firm failed to make any significant adjustments to the carrying value of loans in Q3. Other observations supporting our view include (1) a surge in nonperforming assets, (2) a high level of ARMS to reset within the year, (3) an increasing amount of negative amortization associated with Option ARMs, which produces unsustainable income, (4) loan classification "shifting", (5) a jump in "higher risk" subprime loans, (6) potentially overly optimistic LTVs, and (7) increasing impairments to gain on sale residuals. Given the deterioration in housing market conditions and the credit markets as a whole, we believe the risk of an earnings disappointment is even greater in Q4. As a result, we have assigned the firm an Earnings Quality Grade of F.

EARNINGS QUALITY GRADE	*Scale A – F*	F

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Introduction

Gradient recently reinitiated coverage of Washington Mutual Inc. (WM) in a *Watch List Alert* published on 09/25/07. Our conclusion at that time (following Q2 earnings) was that "signs of impairment are everywhere… except on the income statement and balance sheet." In this context, we expressed caution about the firm's accounting for loans carried in the held to investment category on the balance sheet (under FAS 115). In our opinion, it appears that the company has done very little to shore up its loan loss reserves despite evidence of significant impairments. Following the release of third quarter earnings, it appears that little has changed.

Q3 Results Come up Short; Management Sees Weakness Going Forward

On 10/17/07, WM reported Q3 2007 net income of $0.23 per share, a 71.9% decline from net income of $0.77 per share in the year-ago quarter. Analysts had anticipated Q3 EPS of $0.27, 17.4% higher than actual results.

During Q3, earnings were reduced by a 482.5% YOY increase in the firm's provision for loan losses and negative valuation adjustments across several asset classes. On the Q3 Earnings Call, CFO Thomas Casey acknowledged a "significant and abrupt change in the health of the housing market since our second quarter earnings call." In addition, CEO Kerry Killinger commented that "results for Q3 were significantly impacted by further weakening in the housing market and capital market disruptions."

Remarking on expectations for Q4, Casey said that he believes the trends seen in Q3 will continue through the end of the year:

> Well, we're seeing continuing trends and although the provision for Q3 took into account the results we saw as of the end of September, we are forecasting that there could be continued declines. We're still waiting for the facts to come in. But as I said in my prepared comments, there's probably going to be further declines. We just haven't seen those or been able to measure them yet. But it is a potential that we wanted to make sure that you understood that if that continues, that we would have to see higher provisions in Q4 and that's what we're trying to do with our earnings guidance.

With a much more subdued outlook than in previous quarters, management guided for charge-offs to increase by 20–40% during Q4, and said it would record a provision between $1.127 and $1.327 billion (a 16.5% to 37.2% increase from Q3). As a result, analysts reduced their Q4 EPS estimate to an average of just $0.40 per share, versus an estimate of $0.96 per share just three months ago.[1]

Management's Guidance Only Addresses the Tip of the Iceberg

Given management's guidance, we calculate that charge-offs are expected to be about 0.22%–0.26% of average total loans[2] in Q4, up from 0.19% in Q3 and 0.13% in Q2. The allowance for loan losses should also end the year at approximately

[1] We also find it interesting that the firm's guidance for the increase in charge-offs during Q4 appears to be greater than the implied increase in the provision. In our view, the provision should be growing at least at the pace of charge-offs.
[2] Assuming the same amount of average total loans in Q3 (227,348).

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$2.7–$2.8 billion.[3] At first glance, these figures suggest that the firm is taking a more conservative stance going forward. However, we believe that impairment risk continues to be much higher than reflected in management's guidance. Our observations include:

(1) a surge in nonperforming assets (*pg 3*)
(2) a high level of ARMS to reset within the year (*pg 4*)
(3) increasing negative amortization associated with Option ARMs, which produces unsustainable income (*pg 5*)
(4) loan classification "shifting" (*pg 6*)
(5) a jump in "higher risk" subprime loans (*pg 6*)
(6) potentially overly optimistic LTVs (*pg 7*)
(7) increasing impairments to gain on sale residuals (*pg 9*)

We begin with the gap between the growing amount of nonperforming assets and the firm's allowance for loan losses.

Has The Firm Properly Valued its Loans Held to Investment?

ALLOWANCE FOR LOAN AND LEASE LOSSES DECLINING AS A PERCENT OF NONPERFORMING ASSETS

Looking at the increase in the provision for loan and lease losses, it appears on the surface that WM management took a more conservative stance in Q3. However, the devil is in the details. While the provision nearly tripled to $967 million (from $166 million a year ago), the increase appears to be too little too late as the allowance for loan losses has failed to keep pace with the increase in nonperforming loans.

According to the company's Q3 earnings release, nonperforming loans are up 126.3% year-over-year to $5.45 billion from $2.40 billion. On a relative basis, nonperforming loans are up even more, jumping to 1.65% of total assets from just 0.69% a year ago.

In light of the surge in nonperforming assets and the current credit environment, we would have expected the allowance to increase at least in proportion to the increase in nonperforming assets. That has not been the case, however, as the allowance for loan losses is up only 21.9% in dollar terms ($1.89 billion versus $1.55 billion a year ago).

The potential inadequacy of this figure can be seen by comparing the dollar amount of the allowance to the dollar amount of nonperforming loans. As shown in the table on the next page, in the year-ago quarter end 09/30/06, the allowance represented 64.8% of nonperforming loans. However, at 09/30/07, the allowance accounted for just 34.7% of nonperforming loans.

(Table: Analysis of Growth in Allowance for Loan and Lease Losses vs. Nonperforming Assets, *next page*.)

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[3] Calculated using the high and low guidance for the provision in Q4, the high and low guidance for charge-offs, and holding the amount of recoveries constant from Q3.

Analysis of Growth in Allowance for Loan and Lease Losses vs. Nonperforming Assets
($ in millions)

	Qtr Ended 09/30/07	Qtr Ended 06/30/07	Qtr Ended 03/31/07	Qtr Ended 12/31/06	Qtr Ended 09/30/06
Nonperforming assets	$5,451	$4,025	$3,259	$2,775	$2,392
Allowance for loan and lease losses	$1,889	$1,560	$1,540	$1,630	$1,550
Allowance as a % of nonperforming assets	34.7%	38.8%	47.3%	58.7%	64.8%

Had the allowance for loan and lease losses remained constant as a percentage of nonperforming assets, trailing 12M income before tax would have been reduced by $1.6 billion.

Benefit to EBT from a Lower Relative Allowance
($ in millions)

	09/30/07
Hypothetical dollar allowance if held constant at 64.8% of nonperforming assets	$3,532.21
Less: actual allowance	($1,889.0)
Benefit to 12M income before tax	$1,643.21

ARMS TO RESET INCREASES THE LIKELIHOOD FOR HIGHER NONPERFORMING ASSETS

Adjustable rate mortgages (ARMs) appear to be the single largest contributor to the decline in WM's balance sheet quality. At 09/30/07, WM carried $111.3 billion (90.4% of the home loan portfolio) in ARMs in its investment portfolio. The problem with these loans is that, when they reset at higher, fixed rates, the borrower's payments will increase substantially. Further, the ability to refinance at favorable terms is all but impossible in the current market—demonstrated by the 34% sequential reduction in WM's own refinancing volume during Q3. Consequently, we believe that the dollar amount of nonperforming ARMs is likely to increase substantially over the next 12 months. As of 06/30/06, $60.3 billion of those loans were due to reset within the next year while another $25.4 billion reset in more than one year (although the average time frame for the latter basket of loans to reset is unknown).

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(Table: Total ARMs Relative to Total Home Loans, *next page*.)

Total ARMs Relative to Total Home Loans
($ in millions)

	Qtr Ended 09/30/07	Qtr Ended 06/30/07	Qtr Ended 03/31/07	Qtr Ended 12/31/06	Qtr Ended 09/30/06
Total ARMs (short and medium term)	$111,332	$96,640	$101,555	$108,422	$131,257
Total home loans	$123,145	$106,145	$111,061	$118,204	$141,185
Total ARMs as a % of total home loans	90.41%	91.05%	91.44%	91.72%	92.97%

There is already some evidence that a subset of the ARMs held in portfolio is at risk for significant impairments. Of the $111.3 billion in ARMs, approximately 52.0%, or $57.9 billion, are Option ARMs. According to management (Q2 2007 10-Q), the Option ARMs category has accounted for the largest dollar amount of nonaccrual loans since 12/31/06.

Further, even those loans that are still accruing interest are showing signs of a higher likelihood of impairment. According to the firm's 10/17/07 Q3 Press Release, $1.5 billion, or 2.59%, of the total Option ARMs on the books represented unpaid principle as of 09/30/07. In contrast, at 12/31/06 the amount of unpaid principle was just $0.9 billion, or just 1.40% of the total Option ARMs.

To date, WM has not recognized any material decline in the market value of its Option ARMs. For that matter, WM has not recorded any significant decline in the market value of any of its loans held to investment. And it appears that the firm may be shifting more questionable loans into the held to investment category. This issue is discussed next.

Analysis of Option ARMs
($ in millions)

	Qtr Ended 09/30/07	Qtr Ended 06/30/07	Qtr Ended 03/31/07	Qtr Ended 12/31/06	Qtr Ended 09/30/06
Option ARMs	$57,858	$53,455	$58,130	$63,557	$67,142
Option ARMs as a % of total ARMS	51.97%	55.31%	57.24%	58.62%	51.15%
Unpaid principle (Option ARMs)	$1,500	$1,300	$1,120	$888	$681
Unpaid principle as a % of Option ARMs	2.59%	2.43%	1.93%	1.40%	1.01%

Income from Negative Amortization Loans May be Unsustainable

NEGAMS GROWING, BUT WILL THE BORROWERS REALLY PAY?

As noted above, negative amortization amounted to $1.5 billion of the Option ARM portfolio at 09/30/07. This balance continues to surge because borrowers are choosing to pay just the minimum payment, or are making no payment at all. The problem is that, as the balance grows, the related interest flows through the income statement as income. Year-to-date, WM has recognized $1.05 billion in interest income from negative amortization. This represents 7.2% of the $14.61 billion of total interest income year-to-date. Last year, negative amortization accounted for 5.4% of interest income; the year

before, negative amortization was just 1.8% of interest income.

We believe that the income from negative amortization is unsustainable and, therefore, of lower quality. Further, income from negative amortization is more prone to write-offs in the future, as increases in negative amortization may eventually result in increased delinquencies and defaults. Thus, we would expect that WM management would factor the increase in negative amortization into its loan loss provision (which we believe to be inadequate, as discussed elsewhere in this report).

Shifting Loans From Held-for-Sale to Held to Investment Category

LOAN SHIFTING MAY HAVE AVOIDED SUBSTANTIALLY LARGER IMPAIRMENT

Another concern worthy of watching is the recent shift of "$17 billion in home, multi-family and other commercial real estate loans" from the held-for-sale category to the held to investment category. At nearly 7.5% of the 09/30/07 average loan portfolio balance, the amount shifted between categories is highly material. Our concern, in this regard, is the possibility that it represents an effort to engage in creative loss avoidance. Presumably these loans have been shifted to the held to investment category because WM does not want to sell the loans at this time due to adverse market conditions. In fact, the company marked these loans down by $147 million in the aggregate upon the date of transfer. However, in relative terms, the write-down represents less than 1% of the total loans transferred. Thus, we believe that there may be a substantially larger impairment that has been avoided by changing the classification of these loans under FAS 115.

Signs of Rapidly Increasing Impairment of Subprime Loans

Another factor that may increase the risk of WM's loan portfolio is the relatively large dollar amount of subprime mortgages held in portfolio. According to the Q3 earnings release, WM had $17.3 billion in subprime mortgages (plus another $2.7 billion in subprime home equity loans) as of 09/30/07. Subprime loans have declined from the $20.1 billion carried at 09/30/06, but continue to represent 14.0% of the firm's home loan portfolio.

Analysis of Subprime Loans
($ in millions)

	Qtr Ended 09/30/07	Qtr Ended 06/30/07	Qtr Ended 03/31/07	Qtr Ended 12/31/06	Qtr Ended 09/30/06
Subprime home loans	$17,285	$17,602	$17,610	$18,725	$20,083
Total home loans	$123,145	$106,145	$111,061	$118,204	$141,185
Subprime loans as a pct of total home loans	14.0%	16.6%	15.9%	15.8%	14.2%

Even more troubling, over half (51.5%) of nonaccrual loans are subprime loans; these loans accounted for 32.8% of the total loans written off during the third quarter.

(Table: Analysis of Subprime Nonaccrual Loans, *next page*.)

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Analysis of Subprime Nonaccrual Loans
($ in millions)

	Qtr Ended 09/30/07	Qtr Ended 06/30/07	Qtr Ended 03/31/07	Qtr Ended 12/31/06	Qtr Ended 09/30/06
Nonaccrual loans – subprime	$2,356	$1,707	$1,503	$1,283	$1,121
Nonaccrual loans – subprime as a % of total subprime loans	13.6%	9.7%	8.5%	6.9%	5.6%
Total nonaccrual loans	$4,577	$3,275	$2,672	$2,295	$1,987
Nonaccrual – subprime loans as a % of total nonaccrual loans	51.5%	52.1%	56.3%	55.9%	56.4%
Subprime loans written off	$146	$103	$40	$52	$47
Total loans written off	$445	$304	$212	$166	$179
Subprime loans written off as a % of total loans written off	32.8%	33.9%	18.9%	31.3%	26.3%

LTV data also suggests that the market value of subprime loans has declined materially.

- Management estimates that loans with an LTV of >90% at 09/30/07 was 4% ($0.69 billion) of total subprime loans, compared with 3% ($0.053 billion) at 06/30/07.
- Management also estimates that loans with an LTV of >80% at 09/30/07 was 22% ($3.81 billion) of total subprime loans, compared with 18% ($3.17 billion) at 06/30/07.
- Together, loans with an LTV of >90% and >80% increased 21.7% to $4.5 billion at the end of Q3, up from $3.7 billion in Q2.

Although the amount of subprime loans at risk is significantly higher than just three months ago, it does not appear that the company has made any significant adjustments to the carrying value of these loans either. In this context, although the trailing provision for all loan losses has increased by $1.1 billion year-to-date, total nonaccrual loans have increased over 143% faster by $2.7 billion.

Dollar Change in Provision vs. Dollar Change in Nonaccrual Loans
($ in millions)

	12M Ended 09/30/07	12M Ended 06/30/07	12M Ended 03/31/07	12M Ended 12/31/06
Provision for all loan losses	$1,917	$1,116	$968	$816
Change since beginning of year	***$1,101***	$300	$152	
Subprime nonaccrual loans	$2,356	$1,707	$1,503	$1,283
Change since beginning of year	***$1,073***	$424	$220	
Total nonaccrual loans	$5,451	$4,025	$3,259	$2,775
Change since beginning of year	***$2,676***	$1,250	$484	

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LTV Estimates for the Option ARM Portfolio May be Overly Optimistic

We also believe that WM management may be much too optimistic regarding its estimated LTVs—particularly for the Option ARM portfolio. According to the Q1 10-Q, at origination, 0.4% of the Option ARM portfolio had LTVs >90%, while 22.5% had LTVs between 80–90%. In the Q1 press release, management said that current estimated LTVs >90% were 1% of the loan portfolio balance, while current estimated LTVs between 80–90% were 6% of the balance.[4] In other words, while Option ARMs with LTVs >90% had been estimated to have increased slightly, management had estimated that the level of Option ARMs with LTVs between 80–90% had *decreased* materially from origination as of 03/31/07. We find this difficult to believe given the substantial decline in residential real estate values in several of the major markets served by the company (such as California, Arizona, and Nevada).

Consistent with our concerns, the trend began to reverse in Q2. Despite the increased level of charge-offs during the quarter, management estimated that current LTVs between 80–90% had increased from 6.0% to 11.0% for the Option ARM portfolio. And the estimate continued to move up in Q3, rising to 14.0%. Interestingly, management's estimates of current LTVs >90% has stayed at about 1% of the loan balance for the past nine months. This could be due to larger charge-offs in the >90% category.

The bottom line is that, despite increased charge-offs, LTVs continue to rise for the Option ARM portfolio. Further, we believe that LTVs may in fact be much worse than currently estimated given the rapid decline in housing prices in certain major markets served by WM. Regardless, the implications are two-fold. First, the likelihood of default increases as LTV increases since there is less incentive for the homeowner to attempt to resolve troubled loans. This problem will only be exacerbated by the effects of resets. Second, it is likely that the value of property that could be received upon a future default is declining with each passing day. Thus, the amount of losses that may ultimately be incurred on properties acquired (and later auctioned off) upon default is only going to get worse.

Write-Downs Associated with Prior Securitizations Likely to Continue

Another concern brewing at WM is the impact of prior gain on sale transactions on current period earnings. In this regard, we continue to believe that WM's past securitization practices will negatively affect the firm's earnings potential over the next few quarters. Although securitization income has declined since 2004, among large capitalization firms, WM still ranks second only to Countrywide Financial Corp. (CFC) in terms of its heavy reliance on gain-on-sale income. Over the past three full years (2004–2006), securitization gains have accounted for 11.8% of operating income.

Despite the relatively high level of income from the lower quality securitization gains, WM management appears to have been reluctant to write down the value of residual assets retained upon securitization. Through the first six months of

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[4] In the Q2 10-Q, management said that, at origination, 0.4% of its Option ARM portfolio had LTVs >90%, while LTVs between 80–90% dropped to just 3.1% (most likely a result of the charge-offs during the period).

the year, the company had written down its trading assets (where it appears that most of its retained interests are held) by just $253.0 million, or 5.1% of the average balance during this period. Further, there appears to have been little or no write-downs to the balance of mortgage securities available for sale.

The charges appear to have picked up in Q3 with impairments to trading securities and available for sale securities of $153.0 million and $104.0 million, respectively. However, we expect this trend to continue in Q4 and early 2008 as the company's valuations continue to revert to a level that is more in line with economic reality.

Corporate Governance May be Part of the Problem

COULD MANAGEMENT'S COMPENSATION AND BONUS STRUCTURE BE A MOTIVE TO MANAGE EARNINGS THROUGH THE END OF 2007?

Under FASB 115, if management says that it intends to hold a security to investment and that the impairment to the security is temporary in nature, then the firm is not required to record the impairment. In our opinion, however, there is mounting evidence that WM is stretching FASB 115 up to and possibly beyond its limits. At the mid-point of management's provision guidance for all loan losses in Q4 ($1.295 billion), the increase in the trailing provision over the entire year will come in at just $2.05 billion. In contrast, nonaccrual loans are up $2.7 billion year-to-date and they will almost certainly increase further in Q4.

Given the deterioration in both the housing and credit markets, a logical question arises: Wouldn't it be far simpler for WM management to take its lumps now and clean up the balance sheet? Maybe. But, then, maybe not.

According to WM's proxy statement, 40% of management's bonus is dependent on current period earnings. Unfortunately, the proxy does not provide sufficient detail to determine whether or not management still stands a chance of meeting the related target. Nevertheless, we would be remiss if we did not point out this possible motive to postpone recognizing the full economic impact of recent losses.

We also question whether the level of past gain on sale income may have been motivated by other performance bonus goals. In this context, according to the proxy, 25% of management's bonus is dependent on meeting goals pertaining to non interest income and non interest expense.

And, finally, there is the stock price. Clearly the company may be motivated to preserve the stock price, given the substantial stock and option holdings of the management team.

In future work we will analyze the firm's corporate governance structure in more detail.

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How Long Can Management Stretch FAS 115 to its Limits?

The significant (and increasing) gap between the firm's provision and nonaccrual loans leads us to believe that the risk of an earnings miss—and share price underperformance—has increased since we last evaluated the firm. Although the stock is down approximately 19% since we initiated coverage, we are assigning the firm an Earnings Quality Grade of F.

Risks to Thesis

If the firm were to increase its provision to its allowance for loan and lease losses so that the allowance is in line with the level of nonaccrual loans, our concerns may be mitigated. Our concerns would also be moderated if the firm were able to minimize the number of nonperforming ARMs resulting from reset over the next 12 months (although we believe this is unlikely given the current market conditions).

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