

## WaMu's Option-ARM Strategy\*

*“The option-ARM product is the key flagship product for our company.” Kerry Killinger, CEO*

Washington Mutual, Inc. (generally known as “WaMu”) called itself “the bank for everyday people” because it focused on consumers and small-to-medium-sized businesses. With this strategy, WaMu grew by the end of 2007 to be the nation’s largest savings and loan in both assets (\$328 billion) and revenues (\$25.5 billion) – see Exhibit 1.<sup>1</sup> Headquartered in Seattle, the company’s history dated back to 1889.

In simple terms, a savings and loan bank borrows (generally from ‘depositors’ or ‘savers’) and invests the proceeds (generally by lending). The bank pays interest on borrowed money, e.g., demand deposits and certificates of deposit (CDs), and earns interest on loans to individuals and businesses. Bank profits are affected by the “spread” between the borrowing and lending interest rates. Other things equal, banks make more money when borrowing (deposit) rates are low and lending rates are high. Banks earn additional revenue by charging fees for “originating” loans. Banks may also sell their loans or investments to other financial institutions rather than holding them to maturity. If the proceeds from the sale exceed the book value of the loan or investment, the bank recognizes a gain on the sale. Thus, WaMu’s sources of revenue include: (1) interest income generated from loans to customers and investment securities, (2) fees for originating and servicing loans, (3) gains from loan sales, and (4) fees for other financial services provided to customers. WaMu’s costs include: (1) interest paid on customer deposits and other borrowing, (2) losses due to loan defaults, and (3) administrative costs.

### *Home Loans – the Adjustable Rate Mortgage (ARM) Strategy*

Home (mortgage) loans are secured by property and can vary dramatically in their structure (Exhibit 8). The conventional fixed rate mortgage has a constant monthly payment calculated to pay off both the loan balance and interest over the term of the loan, which is typically 30 years. With an adjustable rate mortgage (ARM), the interest rate on the principal balance resets or ‘adjusts’ periodically. ARMs that adjust in less than one year are classified as short-term ARMs in Exhibit 8. Those that adjust after one year are classified as medium-term ARMs. For example, the interest rate may start at 5% for five years and then ‘adjust’ at the five-year anniversary to a new rate based on current market conditions.

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\* This case was prepared from public sources by Jane Jollineau Kennedy, Deloitte & Touche Professor of Accounting and Robert M. Bowen, PricewaterhouseCoopers Professor of Accounting – both at the University of Washington. Revised October 26, 2008.

<sup>1</sup> Savings and loan associations are also called thrift institutions. Thrifts were originally established to promote personal savings through savings accounts and home ownership through mortgage lending, but now provide a range of services similar to many commercial banks.

In 2004 WaMu was under considerable pressure to turn around its lagging mortgage division. A key initiative, beyond cost control, was to emphasize higher margin products (e.g., loans), most notably ARMs. In prepared remarks for the 2004 third-quarter conference call, CEO Kerry Killenger said:

“We are paying closer attention than ever to product mix to assess our profit by product and distribution channels, and exercise stronger controls than ever. The goal is to ensure that we are disciplined about originating higher margin product whenever we can. In this market our emphasis is ARM product origination, principally for our balance sheet. These ARMs helped the balance sheet to grow by \$10.3 billion this past quarter.”

### *The Option-ARM Strategy*

During the same third-quarter 2004 conference call, Killinger said “The option-ARM product is the key flagship product for our company.” The option-ARM is a variation of the ARM that allows the borrower ‘options’ such as paying the ‘interest only,’ or even making payments that are *less* than the interest on the loan. When this latter option is chosen, the principal amount owed by the borrower *increases*, which is referred to as “negative amortization” or “neg-am.”

Option-ARMs proved extraordinarily popular during the housing boom. Between April 2004 and the end of 2007, WaMu underwrote \$184.8 billion in option-ARMs and another \$9.5 billion in ARMs that reset within a year. The company also earned fees for bundling these loans and selling them as mortgage-backed securities.<sup>2</sup>

As the boom faded in 2006 and 2007, nearly one half of all option-ARM borrowers made minimum negative amortization payments. Despite booking \$1.4 billion of negative amortization interest revenue in 2007 (Exhibit 3),<sup>3</sup> WaMu recorded a net loss for 2007 of \$67 million, compared with a net income of \$3.56 billion in 2006. The decline was primarily the result of significant deterioration in the company’s residential mortgage loan portfolio and a sudden and severe contraction in secondary mortgage market liquidity for nonconforming residential loan products such as ARMs.<sup>4</sup>

### *Subprime Lending*

From the bank’s perspective, “subprime” loans are those made to borrowers who cannot get the best (prime) rates due to their poor financial position or credit rating. The bank charges a higher

<sup>2</sup> “Mortgage-backed securities (MBS) are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization” (<http://www.sec.gov/answers/mortgagesecurities.htm>). Mortgage-backed securities were typically purchased as low-risk investments by institutions such as banks, corporations, and pension funds.

<sup>3</sup> For example, the journal entry would look something like:

DR: Cash (A)	\$x billion
DR: Loan receivable (A)	\$1.4 billion
CR: Interest income (OE - revenue)	\$x+1.4 billion

<sup>4</sup> Loans are generally called ‘jumbo’ or ‘non-conforming’ loans when they exceed the loan amounts allowed by Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) — two government-sponsored enterprises that help facilitate the availability of home loans.

rate of interest on these loans to compensate for the higher default risk. Although WaMu appeared to exit the subprime lending business in 2003 when it sold Washington Mutual Finance to Citigroup, it retained a significant presence in the subprime market through its 1999 purchase of Long Beach Mortgage. As of early 2008, Long Beach Mortgage was one of the country's largest lenders to people with damaged credit. While Long Beach operated in all 50 states except Mississippi, its largest market by far was California (Exhibit 10).

In 2005, Long Beach Mortgage made more than one-quarter of all WaMu home-purchase loans. CEO Killinger expressed a desire to see that business grow faster than WaMu's traditional mortgage lending because it was more profitable: "We earn better margins in the subprime business because we're very efficient and have an advantage over some competitors" (Seattle Times, Nov. 13, 2005). In prepared remarks for a conference call discussing WaMu's 2004 results, Senior Vice President and CFO Tom Casey said

"First, we remain comfortable that we can achieve average asset growth in the 10 to 12% range. While we sell a significant portion of our ARM production into the secondary market, we still expect ARM retention to be a driver of asset growth. We also expect growth to come from planned increases in the home equity, multi-family, and nonprime lending."

In late 2005, WaMu planned to expand subprime lending along the East Coast taking subprime mortgages directly to consumers through its retail branches and home-loan offices. Analysts expressed concern about this strategy, e.g., "I hate the business," said Richard Bove, an analyst with Punk, Ziegel & Co. "Asking people who can't afford to buy something to pay *up* to buy that product is a concept that, for me, doesn't work." (Seattle Times, Nov. 13, 2005).

### *Accounting for Loan Losses*

When banks lend money, they expect the customer will repay the loan with interest according to the agreed-upon payment schedule. Inevitably though, some customers fail to meet this obligation and ultimately default on the loan. Under Generally Accepted Accounting Principles, it is not permissible for banks to wait until customers default on their loans to recognize uncollectible accounts. Instead, management must estimate a periodic expense that anticipates loan defaults by customers. Although management cannot know which customers will not pay, it can make a reasonable estimate using models that predict loan defaults. The expense that results from this estimate reduces current period income and is typically called the "provision for loan losses."<sup>5</sup> To adjust the asset side of the balance sheet for this contingency, banks set up a contra-asset to Loans Receivable called Allowance for Loan Losses.<sup>6</sup> Its purpose is to reduce the balance of the asset, Loans Receivable, to the amount expected to be collected in the future, i.e., its net realizable value. Thus the journal entry for the periodic estimate of loan losses is:

DR: Provision for loan losses (OE)	xxx
CR: Allowance for loan losses (contra A)	xxx

<sup>5</sup> This expense account is similar to "bad debts expense" or "Uncollectible Accounts Expense" or "Provision for Uncollectible Accounts" used by non-financial businesses to recognize estimated bad debts.

<sup>6</sup> This contra-asset account is similar to "allowance for doubtful accounts" used by non-financial businesses to reduce their accounts receivable to the net realizable value.

When an actual customer account is determined to be uncollectible, it is written off against the Allowance account as follows:

DR: Allowance for loan losses (contra A)	yyy
CR: Loans receivable – acct #10101 (A)	yyy

This journal entry removes customer loan #10101 from the books. Note that the expense associated with this bad debt was recorded when the original provision for loan losses was estimated, likely in an earlier period.

WaMu described its allowance for loan losses as follows:

The allowance for loan losses represents management's estimate of incurred credit losses inherent in the Company's loan portfolio as of the balance sheet date. The estimate of the allowance is based on a variety of factors, including past loan loss experience, the current credit profile of borrowers, adverse situations that have occurred that may affect a borrower's ability to meet his financial obligations, the estimated value of underlying collateral, general economic conditions, and the impact that changes in interest rates and unemployment levels have on a borrower's ability to repay adjustable-rate loans. Determining the appropriateness of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. The Company maintains a comprehensive governance structure and a certification and validation process that is designed to support, among other things, the appropriateness of the estimate of the allowance for loan losses. Subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for loan losses in future periods. 2007 10-K, MD&A, p. 63.

### *Evaluating WaMu's mortgage loans*

The case questions below put you in the role of a financial analyst attempting to evaluate the quality of WaMu's mortgage portfolio and the adequacy of its loan loss provisions.

Figures and exhibits in the case include:

- Figure 1: U.S. inflation-adjusted Home Prices: 1890 to 2006
- Figure 2: Percentage change in Los Angeles inflation-adjusted home prices: 1988 – 2008
- Figure 3: Percentage change in Miami, Florida inflation-adjusted home prices: 1988 – 2008
- Exhibit 1: Rankings of U.S. Thrifts by (A) assets and (B) revenues, 2007
- Exhibit 2: Income from continuing operations, 2005-2007
- Exhibit 3: Balance sheets for the years ended December 31, 2006 and 2007
- Exhibit 4: Statement of Cash Flows, Operating and Investing Sections
- Exhibit 5: Statement of Cash Flows, Financing Section
- Exhibit 6: Loans by category
- Exhibit 7: Nonperforming Loans (i.e., loans over 90 days past due) and Foreclosed Assets
- Exhibit 8: Home loans by category (excluding home equity loans and lines of credit)
- Exhibit 9: Option-ARM Home Loans (*excluding* subprime loans)
- Exhibit 10: Geographic Distribution of Option-ARM Home Loans at December 31, 2007
- Exhibit 11: Unpaid principal balances (“UPB”) of Subprime Home Loans held in portfolio at December 31, 2007
- Exhibit 12: for an analysis of WaMu's allowance for loan losses.

## Questions:

1. Describe WaMu's business model. To assist your thinking about this, prepare journal entries to record the following hypothetical events:
  - a) customer deposits \$50,000 in a WaMu savings account on 1/1/2008
  - b) WaMu pays 2% (annual) interest on that deposit at 3/31/08
  - c) WaMu lends the \$50,000 to another customer for a 8% home equity loan on 1/1/08
  - d) WaMu accrues interest on that loan as of 3/31/08

How much did WaMu earn in the first quarter of 2008 on this deposit and the corresponding loan? What affects this spread?

2. Consider the data in Exhibit 8 on home loans and Exhibit 9 on option-ARMs. What is your assessment of the magnitude and risk of option-ARMs relative to conventional fixed-rate loans?
3. Using data in Exhibit 12, prepare journal entries for 2007 that show the aggregate effect of WaMu's: a) estimate of bad debts, b) charge-offs of loans receivable, and c) recovery of previously charged-off accounts.
4. As an analyst (and trying to avoid hindsight bias), evaluate the quality of WaMu's loans and the adequacy of WaMu's loan loss estimates. As a basis for analyzing loan losses over time, calculate the following ratios for as many years as possible with the data given:
  - a. Ratio of non-performing loans to all loans and the ratio of non-performing home loans to total home loans. (See Exhibits 6 and 7)
  - b. Ratio of the balance in the allowance for loan losses to the balance of non-performing loans held in the portfolio.
  - c. Ratio of the annual loan charge-offs to the balance of non-performing loans.
  - d. Ratio of the annual loan charge-offs to the annual provision for loan losses.

What is your overall assessment of WaMu's ability to anticipate loan losses?

5. [Purely Optional] To understand the mechanics of standard fixed-rate mortgages versus ARMs, construct amortization tables for the following loans:
  - a. Fixed rate mortgage: \$200,000 30-year mortgage at 6% that is paid off fully by equal monthly payments over 30 years
  - b. Interest-only mortgage: \$200,000 30-year mortgage at 6% with 'interest only' monthly payment (i.e., no principal paid)
  - c. Option ARM: \$200,000 30-year option-ARM with negative amortization in the first five years. Assume the minimum payment is made for the first 24 months.<sup>7</sup>

[Hints for above: See the template on Blackboard to get you started. You can use the fill command on each spreadsheet once you set it up.]

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<sup>7</sup> To calculate this minimum payment, assume that the loan is designed to be paid out monthly over 30 years *as if* it accrued 1% interest, i.e., the payment is based on a term of 360 months, an interest rate of .01/12, where the PV is \$200,000 and the FV is \$0. Of course, interest is actually accruing at the market rate of 6%.

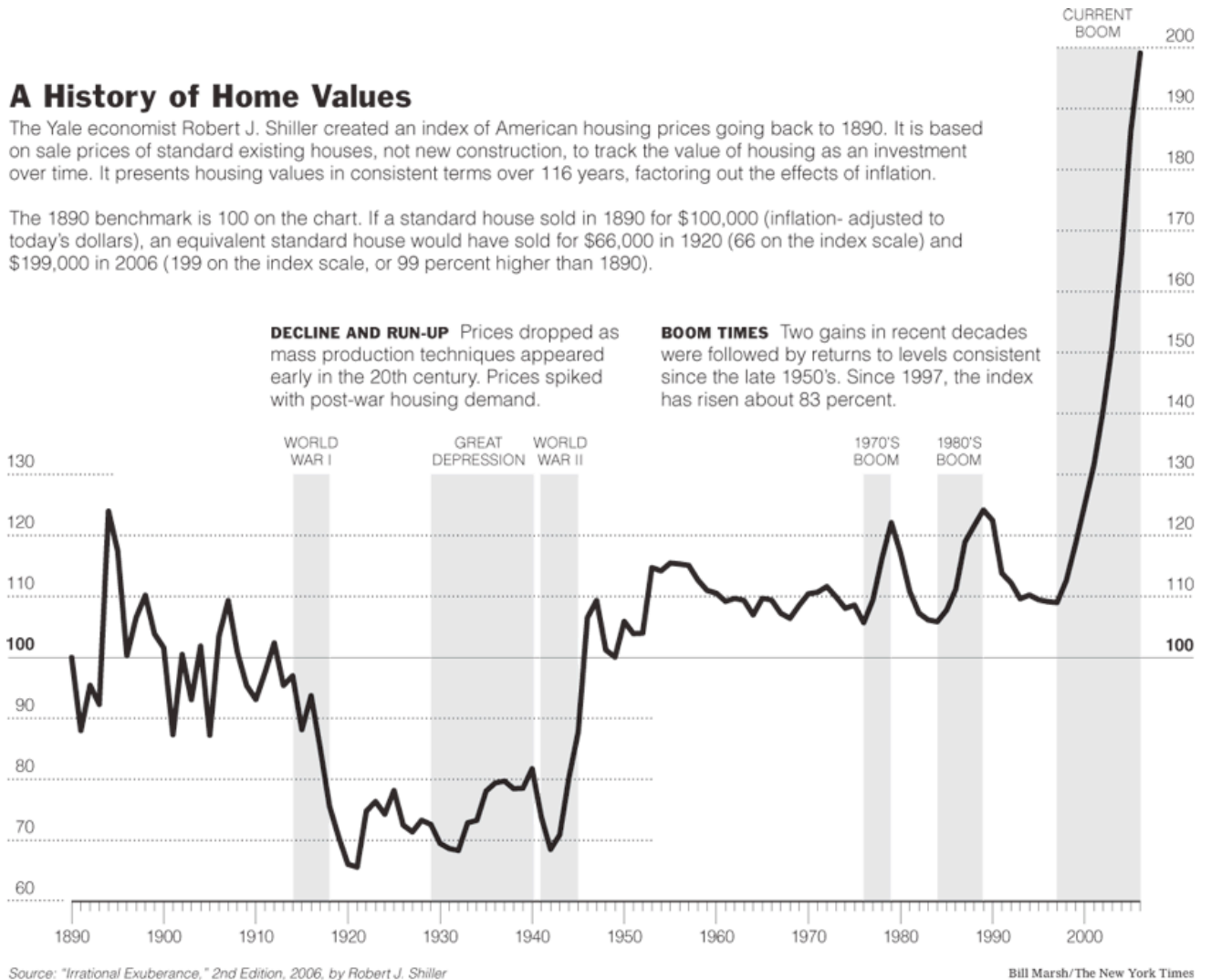
Figure 1

**U.S. inflation-adjusted Home Prices: 1890 to 2006**

**A History of Home Values**

The Yale economist Robert J. Shiller created an index of American housing prices going back to 1890. It is based on sale prices of standard existing houses, not new construction, to track the value of housing as an investment over time. It presents housing values in consistent terms over 116 years, factoring out the effects of inflation.

The 1890 benchmark is 100 on the chart. If a standard house sold in 1890 for \$100,000 (inflation-adjusted to today's dollars), an equivalent standard house would have sold for \$66,000 in 1920 (66 on the index scale) and \$199,000 in 2006 (199 on the index scale, or 99 percent higher than 1890).



Source: New York Times, August 26, 2006

Figure 2

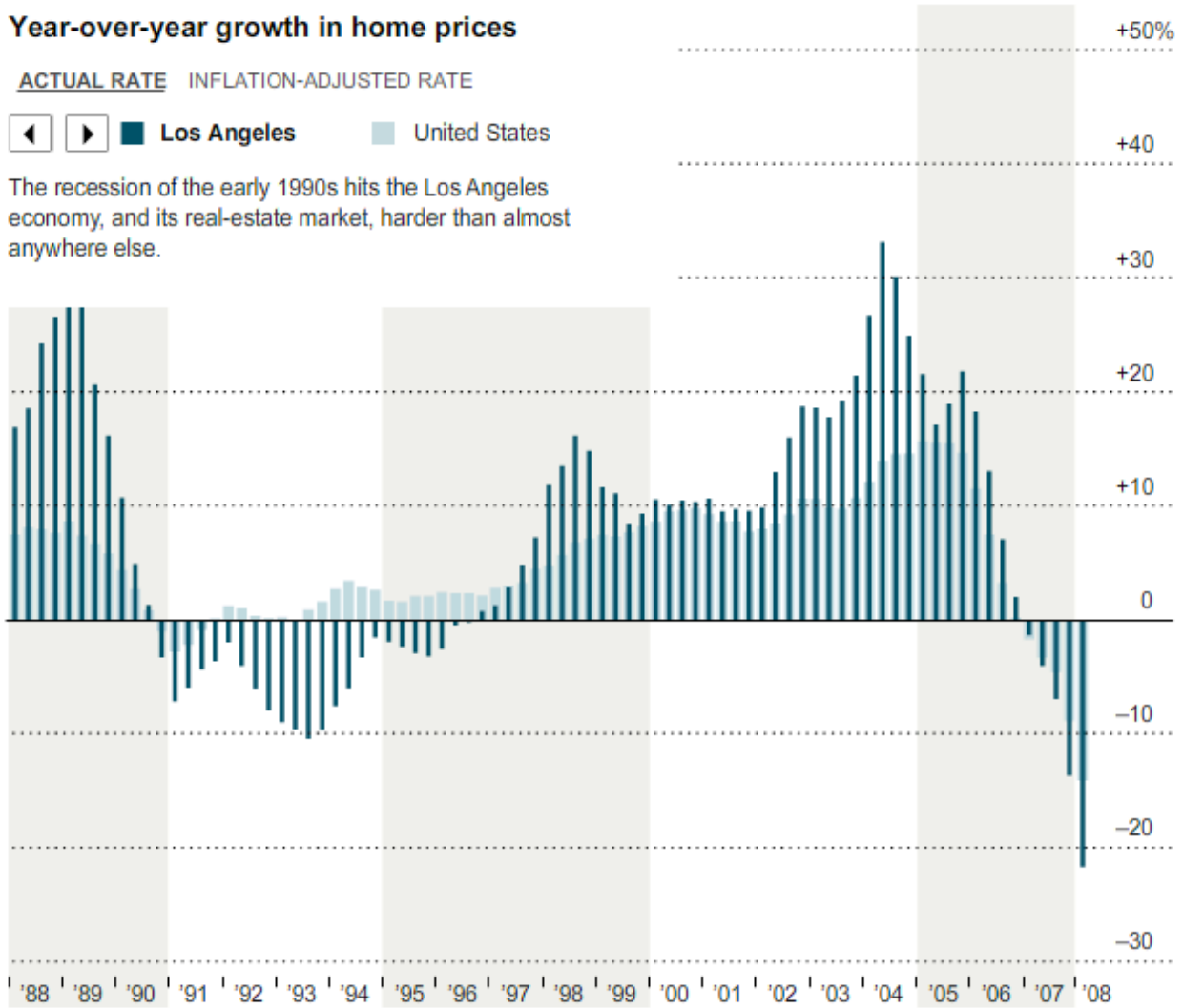
**Percentage change in Los Angeles inflation-adjusted home prices: 1988 – 2008**

**Year-over-year growth in home prices**

ACTUAL RATE INFLATION-ADJUSTED RATE

◀ ▶ ■ **Los Angeles** ■ United States

The recession of the early 1990s hits the Los Angeles economy, and its real-estate market, harder than almost anywhere else.

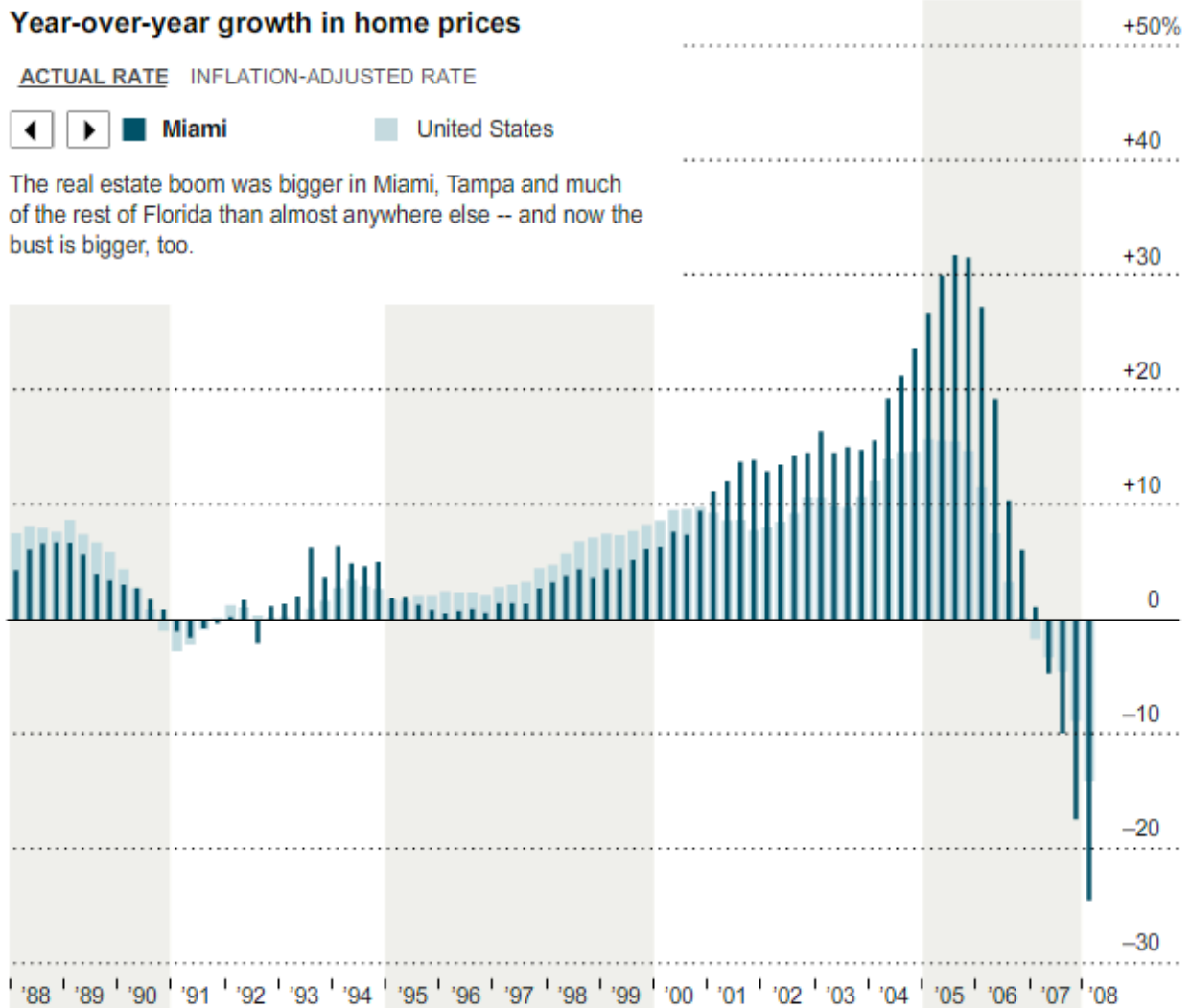


Vu Nguyen, Seth Feaster / The New York Times

Source: New York Times, May 28, 2008

Figure 3

**Percentage change in Miami, Florida inflation-adjusted home prices: 1988 – 2008**



Vu Nguyen, Seth Feaster / The New York Times

Source: New York Times, May 28, 2008



## Exhibit 1

**Rankings of U.S. Thrifts by (A) assets and (B) revenues, 2007**

## A. Top Ten U.S. Thrifts by Assets (in \$ millions)

<u>Rank</u>	<u>Company</u>	<u>Assets</u>
1	Washington Mutual, Inc.	\$327,913.0
2	Countrywide Financial Corp. (1)	208,366.9
3	Sovereign Bancorp, Inc.	84,746.4
4	ING Bank, FSB	79,986.1
5	E*TRADE Bank	51,623.3
6	Hudson City Bancorp, Inc.	44,424.0
7	Merrill Lynch Bank & Trust Co., FSB	37,832.4
8	IndyMac Bancorp Inc. (2)	32,734.5
9	New York Community Bancorp, Inc.	30,579.8
10	USAA Federal Savings Bank	30,219.5

Source: SNL Financial LC.

B. Top Five U.S. Thrifts by Revenues (in \$ millions)<sup>1</sup>

<u>Rank</u>	<u>Company</u>	<u>Revenues</u>
1	Washington Mutual, Inc.	\$25,531
2	Sovereign Bancorp	5,011
3	Hudson City Bancorp	2,135
4	IndyMac Bancorp	2,020
5	New York Community Bancorp	1,678

<sup>1</sup> Based on an analysis of companies in the Fortune 500.

Source: Fortune.

## Exhibit 2

## Income from continuing operations, 2005-2007

	Year Ended December 31,		
	2007	2006	2005
	(in millions, except per share amounts)		
<b>Interest Income</b>			
Loans held for sale	\$ 1,391	\$ 1,807	\$ 2,394
Loans held in portfolio	15,835	15,533	11,827
Available-for-sale securities	1,455	1,460	998
Trading assets	430	606	469
Other interest and dividend income	378	501	232
<b>Total interest income</b>	<b>19,489</b>	<b>19,907</b>	<b>15,920</b>
<b>Interest Expense</b>			
Deposits	6,610	6,263	3,728
Borrowings	4,702	5,523	3,974
<b>Total interest expense</b>	<b>11,312</b>	<b>11,786</b>	<b>7,702</b>
<b>Net interest income</b>	<b>8,177</b>	<b>8,121</b>	<b>8,218</b>
<b>Provision for loan losses</b>	<b>3,107</b>	<b>816</b>	<b>316</b>
<b>Net interest income after provision for loan losses</b>	<b>5,070</b>	<b>7,305</b>	<b>7,902</b>
<b>Noninterest Income</b>			
Revenue from sales and servicing of home mortgage loans	944	768	2,017
Revenue from sales and servicing of consumer loans	1,639	1,527	413
Depositor and other retail banking fees	2,893	2,567	2,193
Credit card fees	778	637	139
Securities fees and commissions	260	215	189
Insurance income	116	127	172
Loss on trading assets	(673)	(154)	(257)
Loss on other available-for-sale securities	(319)	(9)	(84)
Other income	404	699	315
<b>Total noninterest income</b>	<b>6,042</b>	<b>6,377</b>	<b>5,097</b>
<b>Noninterest Expense</b>			
Compensation and benefits	3,766	3,937	3,701
Occupancy and equipment	1,589	1,711	1,520
Telecommunications and outsourced information services	530	554	449
Depositor and other retail banking losses	262	229	226
Advertising and promotion	445	443	315
Professional fees	233	227	181
Foreclosed asset expense	309	117	75
Goodwill impairment charge	1,775	-	-
Other expense	1,691	1,589	1,153
<b>Total noninterest expense</b>	<b>10,600</b>	<b>8,807</b>	<b>7,620</b>
<b>Minority interest expense</b>	<b>203</b>	<b>105</b>	<b>-</b>
<b>Income from continuing operations before income taxes</b>	<b>309</b>	<b>4,770</b>	<b>5,379</b>
<b>Income taxes</b>	<b>376</b>	<b>1,656</b>	<b>1,985</b>
<b>Income (loss) from continuing operations</b>	<b>(67)</b>	<b>3,114</b>	<b>3,394</b>

## Exhibit 3

**Balance Sheets for the years ended December 31, 2006 and 2007**

	December 31,	
	2007	2006
	(dollars in millions)	
<b>Assets</b>		
Cash and cash equivalents	\$ 9,560	\$ 6,948
Federal funds sold and securities purchased under agreements to resell	1,877	3,743
Trading assets (including securities pledged of \$388 and \$1,868)	2,768	4,434
Available-for-sale securities, total amortized cost of \$27,789 and \$25,073:		
Mortgage-backed securities (including securities pledged of \$1,221 and \$3,864)	19,249	18,601
Investment securities (including securities pledged of \$3,078 and \$3,481)	8,291	6,377
Total available-for-sale securities	27,540	24,978
Loans held for sale	5,403	44,970
Loans held in portfolio	244,386	224,960
Allowance for loan losses	(2,571)	(1,630)
Loans held in portfolio, net	241,815	223,330
Investment in Federal Home Loan Banks	3,351	2,705
Mortgage servicing rights	6,278	6,193
Goodwill	7,287	9,050
Other assets	22,034	19,937
Total assets	\$ 327,913	\$ 346,288
<b>Liabilities</b>		
Deposits:		
Noninterest-bearing deposits	\$ 30,389	\$ 33,386
Interest-bearing deposits	151,537	180,570
Total deposits	181,926	213,956
Federal funds purchased and commercial paper	2,003	4,778
Securities sold under agreements to repurchase	4,148	11,953
Advances from Federal Home Loan Banks	63,852	44,297
Other borrowings	38,958	32,852
Other liabilities	8,523	9,035
Minority interests	3,919	2,448
Total liabilities	303,329	319,319
<b>Stockholders' Equity</b>		
Preferred stock	3,392	492
Common stock, no par value: 1,600,000,000 shares authorized, 869,036,088 and 944,478,961 shares issued and outstanding	-	-
Capital surplus – common stock	2,630	5,825
Accumulated other comprehensive loss	(359)	(287)
Retained earnings	18,921	20,939
Total stockholders' equity	24,584	26,969
Total liabilities and stockholders' equity	\$ 327,913	\$ 346,288

Exhibit 4

Statement of Cash Flows, Operating and Investing Sections

	Year Ended December 31,		
	2007	2006	2005
	(in millions)		
<b>Cash Flows from Operating Activities</b>			
Net income (loss)	\$ (67)	\$ 3,558	\$ 3,432
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Provision for loan losses	3,107	816	316
Gain from home mortgage loans	(52)	(622)	(807)
Gain from credit card loans	(533)	(279)	(103)
Loss on available-for-sale securities	319	5	41
Gain on disposition of discontinued operations, net of tax	–	(415)	–
Depreciation and amortization	504	827	2,656
Goodwill impairment charge	1,775	–	–
Change in fair value of MSR	1,536	1,364	–
Provision for mortgage servicing rights reversal	–	–	(943)
Stock dividends from Federal Home Loan Banks	(89)	(164)	(146)
Capitalized interest income from option adjustable-rate mortgages	(1,418)	(1,068)	(292)
Origination and purchases of loans held for sale, net of principal payments	(77,381)	(125,204)	(165,424)
Proceeds from sales of loans originated and held for sale	78,930	122,977	166,997
Net decrease (increase) in trading assets	2,761	7,226	(3,227)
Increase in other assets	(1,281)	(2,821)	(4,160)
(Decrease) increase in other liabilities	(414)	1,069	3,449
Net cash provided by operating activities	7,697	7,269	1,789
<b>Cash Flows from Investing Activities</b>			
Purchases of available-for-sale securities	(13,494)	(15,578)	(22,501)
Proceeds from sales of available-for-sale securities	8,586	14,002	16,148
Principal payments and maturities on available-for-sale securities	2,341	2,964	3,678
Purchases of Federal Home Loan Bank stock	(1,789)	–	(163)
Redemption of Federal Home Loan Bank stock	1,232	1,803	111
Proceeds from sale of mortgage servicing rights	–	2,526	–
Origination and purchases of loans held in portfolio, net of principal payments	(9,485)	(12,265)	(10,407)
Proceeds from sales of loans	22,548	8,501	940
Proceeds from sales of foreclosed assets	744	489	413
Net decrease (increase) in federal funds sold and securities purchased under agreements to resell	1,866	(1,602)	(1,718)
Net cash used for acquisitions	–	(943)	(536)
Purchases of premises and equipment, net	(321)	(441)	(607)
Proceeds from sale of discontinued operations, net of tax	–	712	–
Net cash provided (used) by investing activities	12,228	168	(14,642)

(The Consolidated Statements of Cash Flows are continued on the next page.)

## Exhibit 5

## Statement of Cash Flows, Financing Section

	Year Ended December 31,		
	2007	2006	2005
	(in millions)		
<b>Cash Flows from Financing Activities</b>			
(Decrease) increase in deposits	\$ (32,030)	\$ 18,005	\$ 10,911
Decrease in short-term borrowings	(1,442)	(3,924)	(1,156)
Proceeds from long-term borrowings	14,831	31,298	18,782
Repayments of long-term borrowings	(17,388)	(24,052)	(10,397)
Proceeds from advances from Federal Home Loan Banks	82,285	41,174	71,701
Repayments of advances from Federal Home Loan Banks	(62,735)	(67,538)	(73,000)
Proceeds from issuance of preferred securities by subsidiary	1,471	2,449	–
Proceeds from issuance of preferred stock	2,900	492	–
Cash dividends paid on preferred and common stock	(1,960)	(1,986)	(1,709)
Cash dividends returned	15	–	–
Repurchase of common stock	(3,497)	(3,039)	(921)
Other	237	418	401
Net cash (used) provided by financing activities	(17,313)	(6,703)	14,612
Increase in cash and cash equivalents	2,612	734	1,759
Cash and cash equivalents, beginning of year	6,948	6,214	4,455
Cash and cash equivalents, end of year	\$ 9,560	\$ 6,948	\$ 6,214
<b>Noncash Activities</b>			
Loans exchanged for mortgage-backed securities	\$ 821	\$ 2,839	\$ 1,366
Real estate acquired through foreclosure	1,259	696	429
Loans transferred from held for sale to held in portfolio	20,203	4,418	8,690
Loans transferred from held in portfolio to held for sale	5,524	22,516	3,023
Mortgage-backed securities transferred from available-for-sale to trading	–	858	–
Common stock issued for acquisition	–	–	5,030
<b>Cash Paid During the Year For</b>			
Interest on deposits	\$ 6,962	\$ 5,780	\$ 3,555
Interest on borrowings	4,612	5,567	3,668
Income taxes	1,485	2,189	1,586

Exhibit 6

Loans by category

	December 31,				
	2007	2006	2005	2004	2003
	(in millions)				
Loans held for sale	\$ 5,403	\$ 44,970	\$ 33,582	\$ 42,743	\$ 20,837
Loans held in portfolio:					
Loans secured by real estate:					
Home loans <sup>(1)</sup>	\$ 110,387	\$ 99,479	\$ 114,144	\$ 109,950	\$ 100,043
Home equity loans and lines of credit <sup>(1)</sup>	60,963	52,882	50,840	43,648	27,644
Subprime mortgage channel <sup>(2)</sup> :					
Home loans	16,092	18,725	21,146	19,184	12,973
Home equity loans and lines of credit	2,525	2,042	11	2	3
Home construction <sup>(3)</sup>	2,226	2,082	2,037	2,344	2,220
Multi-family <sup>(4)</sup>	31,754	30,161	25,601	22,282	20,324
Other real estate <sup>(5)</sup>	9,524	6,745	5,035	5,664	6,649
Total loans secured by real estate	233,471	212,116	218,814	203,074	169,856
Consumer:					
Credit card	8,831	10,861	8,043	-	-
Other	205	276	638	792	1,028
Commercial	1,879	1,707	2,137	3,205	4,266
Total loans held in portfolio <sup>(6)</sup>	\$ 244,386	\$ 224,960	\$ 229,632	\$ 207,071	\$ 175,150

(1) Excludes home loans and home equity loans and lines of credit in the subprime mortgage channel.

(2) Represents mortgage loans purchased from recognized subprime lenders and mortgage loans originated under the Long Beach Mortgage name and held in the investment portfolio.

Exhibit 7

**Nonperforming Loans (i.e., loans over 90 days past due) and Foreclosed Assets**

	December 31,				
	2007	2006	2005	2004	2003
(dollars in millions)					
<b>Nonperforming assets:</b>					
Nonaccrual loans <sup>(1)(2)(3)</sup> :					
Loans secured by real estate:					
Home loans <sup>(4)</sup>	\$ 2,302	\$ 640	\$ 565	\$ 534	\$ 736
Home equity loans and lines of credit <sup>(4)</sup>	835	231	87	66	47
Subprime mortgage channel <sup>(5)</sup>	2,721	1,283	873	682	597
Home construction <sup>(6)</sup>	56	27	10	28	35
Multi-family	131	46	25	12	19
Other real estate	53	51	70	162	153
<b>Total nonaccrual loans secured by real estate</b>	<b>6,098</b>	<b>2,278</b>	<b>1,630</b>	<b>1,484</b>	<b>1,587</b>
Consumer	1	1	8	9	8
Commercial	24	16	48	41	31
<b>Total nonaccrual loans held in portfolio</b>	<b>6,123</b>	<b>2,295</b>	<b>1,686</b>	<b>1,534</b>	<b>1,626</b>
Foreclosed assets <sup>(7)</sup>	979	480	276	261	311
<b>Total nonperforming assets<sup>(8)</sup></b>	<b>\$ 7,102</b>	<b>\$ 2,775</b>	<b>\$ 1,962</b>	<b>\$ 1,795</b>	<b>\$ 1,937</b>
<b>Total nonperforming assets as a percentage of total assets</b>	<b>2.17%</b>	<b>0.80%</b>	<b>0.57%</b>	<b>0.58%</b>	<b>0.70%</b>

- (1) If interest on nonaccrual loans under the original terms had been recognized, such income is estimated to have been \$246 million in 2007, \$118 million in 2006, \$79 million in 2005, \$64 million in 2004 and \$86 million in 2003.
- (2) Nonaccrual loans held for sale, which are excluded from the nonaccrual balances presented above, were \$4 million, \$185 million, \$245 million, \$76 million and \$66 million at December 31, 2007, 2006, 2005, 2004 and 2003. Loans held for sale are accounted for at the lower of cost or fair value, with valuation changes included as adjustments to noninterest income.
- (3) Credit card loans are exempt under regulatory rules from being classified as nonaccrual because they are charged off when they are determined to be uncollectible, or by the end of the month in which the account becomes 180 days past due.
- (4) Excludes home loans and home equity loans and lines of credit in the subprime mortgage channel.
- (5) Represents mortgage loans purchased from recognized subprime lenders and mortgage loans originated under the Long Beach Mortgage name and held in the investment portfolio.
- (6) Represents loans to builders for the purpose of financing the acquisition, development and construction of single-family residences for sale and construction loans made directly to the intended occupant of a single-family residence.
- (7) Foreclosed real estate securing Government National Mortgage Association ("GNMA") loans of \$37 million, \$99 million, \$79 million, \$79 million and \$82 million at December 31, 2007, 2006, 2005, 2004 and 2003 have been excluded. These assets are fully collectible as the corresponding GNMA loans are insured by the Federal Housing Administration ("FHA") or guaranteed by the Department of Veterans Affairs ("VA").
- (8) Excludes accruing restructured loans of \$251 million, \$314 million, \$296 million, \$293 million and \$249 million at December 31, 2007, 2006, 2005, 2004 and 2003.

Exhibit 8

Home loans by category (excluding home equity loans and lines of credit)

	December 31,	
	2007	2006
(in millions)		
<b>Home loans:</b>		
Short-term adjustable-rate loans <sup>(1)</sup> :		
Option ARMs <sup>(2)</sup>	\$ 58,870	\$ 63,557
Other ARMs	9,551	6,791
<b>Total short-term adjustable-rate loans</b>	<b>68,421</b>	<b>70,348</b>
Medium-term adjustable-rate loans <sup>(3)</sup>	36,507	26,232
Fixed-rate loans	5,459	2,899
<b>Home loans held in portfolio<sup>(4)</sup></b>		
Subprime mortgage channel	16,092	18,725
<b>Total home loans held in portfolio</b>	<b>\$ 126,479</b>	<b>\$ 118,204</b>

(1) Short-term adjustable-rate loans reprice within one year.

(2) The total amount by which the unpaid principal balance of Option ARM loans exceeded their original principal amount was \$1.73 billion and \$888 million at December 31, 2007 and 2006.

(3) Medium-term adjustable-rate loans reprice after one year.

(4) Excludes home loans in the subprime mortgage channel.



Exhibit 9

**Option-ARM Home Loans (excluding subprime loans)**

Loan Performance

The table below analyzes the composition of the unpaid principal balance ("UPB") of Option ARM home loans held in portfolio at December 31, 2007:

Loan-to-Value Ratio at Origination	Year of Origination				Total UPB	% of Total
	Pre-2005	2005	2006	2007		
(UPB in millions)						
Home loan Option ARMs						
£50%	\$ 1,202	\$ 719	\$ 458	\$ 753	\$ 3,132	5%
>50-60%	1,439	1,076	883	1,344	4,742	8
>60-70%	4,327	3,525	2,835	3,333	14,020	24
>70-80%	8,521	7,429	8,421	8,519	32,890	57
>80-90%	1,017	495	504	939	2,955	5
>90%	288	92	152	125	657	1
Total home loan Option ARMs held in portfolio	\$ 16,794	\$ 13,336	\$ 13,253	\$ 15,013	\$ 58,396	100%
As a percentage of total UPB	29%	23%	23%	25%	100%	
Average loan-to-value ratio at origination	71	71	73	73	72	
Average estimated current loan-to-value ratio <sup>(1)</sup>	48	69	77	74	66	

<sup>(1)</sup> The average estimated current loan-to-value ratio reflects the UPB outstanding at the balance sheet date, divided by the estimated current property value. Current property values are estimated using data from the September 30, 2007 OFHEO home price index.

Key statistics for Option ARM loans held in the Company's home loan portfolio are set forth in the following table:

	December 31,		
	2007	2006	2005
(dollars in millions)			
Loan balance	\$ 58,870	\$ 63,557	\$ 71,201
Capitalized interest recognized in earnings that resulted from negative amortization	1,418	1,068	292
Total amount by which the unpaid principal balance exceeded the original principal amount	1,731	888	160
Balance of loans that experienced a net increase in negative amortization during the year	48,162	48,832	44,796
Percentage of borrowers whose final loan payment of the year resulted in negative amortization:			
By number of loans	50%	51%	42%
By value of loans	69	68	56

Exhibit 10

**Geographic Distribution of Option-ARM Home Loans (*excluding* subprime loans) at December 31, 2007**

	Portfolio		Weighted Average Estimated Current Loan-to-Value Ratio
	(dollars in millions)		
California	\$ 28,956	49%	66%
Florida	7,605	13	66
New York/New Jersey	5,333	9	62
Washington/Oregon	2,186	3	62
Illinois	1,506	3	67
Texas	528	1	65
Other	12,756	22	69
<b>Total home loan Option ARMs held in portfolio</b>	<b>\$ 58,870</b>	<b>100%</b>	<b>66%</b>

Exhibit 11

**Unpaid principal balances (“UPB”) of Subprime Home Loans held in portfolio at December 31, 2007**

Loan-to-Value Ratio at Origination	Year of Origination				Total UPB	% of Total
	Pre-2005	2005	2006	2007		
(UPB in millions)						
<b>Subprime mortgage channel:</b>						
≤50%	\$ 213	\$ 111	\$ 252	\$ 61	\$ 637	3%
>50-60%	259	150	229	87	725	4
>60-70%	533	341	504	209	1,587	9
>70-80%	1,704	2,527	2,382	838	7,451	40
>80-90%	1,827	1,246	2,054	660	5,787	31
>90%	34	134	1,912	247	2,327	13
<b>Total subprime mortgage channel loans held in portfolio</b>	<b>\$ 4,570</b>	<b>\$ 4,509</b>	<b>\$ 7,333</b>	<b>\$ 2,102</b>	<b>\$ 18,514</b>	<b>100%</b>
<b>As a percentage of total UPB</b>	<b>25%</b>	<b>24%</b>	<b>40%</b>	<b>11%</b>	<b>100%</b>	
<b>Average loan-to-value ratio at origination<sup>(1)</sup></b>	<b>77</b>	<b>79</b>	<b>83</b>	<b>80</b>	<b>80</b>	
<b>Average estimated current loan-to-value ratio<sup>(2)</sup></b>	<b>57</b>	<b>71</b>	<b>82</b>	<b>81</b>	<b>73</b>	

<sup>(1)</sup> Origination loan-to-value used for first liens and combined loan-to-value used for second liens.

<sup>(2)</sup> The estimated current loan-to-value ratio reflects the UPB outstanding at the balance sheet date, divided by the estimated current property value. Current property values are estimated using data from the September 30, 2007 OFHEO home price index.

Exhibit 12

Changes in the Allowance for Loan Losses Account, 2003-2007

Changes in the allowance for loan losses were as follows:

	Year Ended December 31,				
	2007	2006	2005	2004	2003
	(dollars in millions)				
Balance, beginning of year . . . . .	\$ 1,630	\$1,695	\$1,301	\$1,250	\$1,503
Allowance transferred to loans held for sale . . . . .	(550)	(401)	(270)	(23)	(3)
Allowance acquired through business combinations . . . . .	-	30	592	-	-
Other . . . . .	7	-	-	-	17
Provision for loan losses <sup>(1)</sup> . . . . .	3,107	816	316	209	42
	<u>4,194</u>	<u>2,140</u>	<u>1,939</u>	<u>1,436</u>	<u>1,559</u>
Loans charged off:					
Loans secured by real estate:					
Home loans <sup>(2)</sup> . . . . .	(214)	(50)	(38)	(39)	(65)
Home equity loans and lines of credit <sup>(2)</sup> . . . . .	(437)	(31)	(30)	(22)	(14)
Subprime mortgage channel <sup>(3)</sup> . . . . .	(566)	(140)	(50)	(39)	(39)
Home construction <sup>(4)</sup> . . . . .	-	(8)	(1)	(1)	(2)
Multi-family . . . . .	(5)	-	(1)	(2)	(5)
Other real estate . . . . .	(2)	(5)	(8)	(11)	(97)
Total loans secured by real estate . . . . .	<u>(1,224)</u>	<u>(234)</u>	<u>(128)</u>	<u>(114)</u>	<u>(222)</u>
Consumer:					
Credit card . . . . .	(448)	(322)	(138)	-	-
Other . . . . .	(8)	(19)	(38)	(53)	(69)
Commercial . . . . .	(76)	(28)	(34)	(21)	(79)
Total loans charged off . . . . .	<u>(1,756)</u>	<u>(603)</u>	<u>(338)</u>	<u>(188)</u>	<u>(370)</u>
Recoveries of loans previously charged off:					
Loans secured by real estate:					
Home loans <sup>(2)</sup> . . . . .	6	1	-	-	10
Home equity loans and lines of credit <sup>(2)</sup> . . . . .	13	8	9	4	1
Subprime mortgage channel <sup>(3)</sup> . . . . .	16	6	3	3	3
Home construction <sup>(4)</sup> . . . . .	1	-	-	-	-
Multi-family . . . . .	-	1	3	3	1
Other real estate . . . . .	5	2	13	10	17
Total loans secured by real estate . . . . .	<u>41</u>	<u>18</u>	<u>28</u>	<u>20</u>	<u>32</u>
Consumer:					
Credit card . . . . .	75	53	40	-	-
Other . . . . .	7	14	19	19	15
Commercial . . . . .	10	8	7	14	14
Total recoveries of loans previously charged off . . . . .	<u>133</u>	<u>93</u>	<u>94</u>	<u>53</u>	<u>61</u>
Net charge-offs . . . . .	<u>(1,623)</u>	<u>(510)</u>	<u>(244)</u>	<u>(135)</u>	<u>(309)</u>
Balance, end of year . . . . .	\$ 2,571	\$1,630	\$1,695	\$1,301	\$1,250
Net charge-offs as a percentage of average loans held in portfolio . . . . .	0.72%	0.21%	0.11%	0.07%	0.20%
Allowance as a percentage of loans held in portfolio . . . . .	1.05	0.72	0.74	0.63	0.71

<sup>(1)</sup> Includes a \$202 million reversal of provision for loan losses recorded in the fourth quarter of 2003.

<sup>(2)</sup> Excludes home loans and home equity loans and lines of credit in the subprime mortgage channel.

<sup>(3)</sup> Represents mortgage loans purchased from recognized subprime lenders and mortgage loans originated under the Long Beach Mortgage name and held in the investment portfolio.

<sup>(4)</sup> Represents loans to builders for the purpose of financing the acquisition, development and construction of single-family residences for sale and construction loans made directly to the intended occupant of a single-family residence.