Washington Mutual

Washington Mutual, Inc.
Prepared Remarks for Second Quarter 2004 Earnings Conference Call
July 22, 2004

Remarks of Kerry Killinger
Chairman, President and CEO

Good morning.

You've all read the specifics of our earnings results for the second quarter by now. So let me turn directly to the key issues before Washington Mutual – and you, our shareholders. I know many of you are unhappy. I understand your concerns. And as a significant shareholder, I am not happy either.

So I would like to change my standard presentation and instead focus on addressing three questions today. First, why were second quarter earnings down? Second, why did we lower 2004 earnings guidance so much? And third, what are we doing to address the challenges? Let's get into it.

First, why were earnings down in the quarter? The problem lies with our mortgage banking results, which were poor. The mortgage banking segment reported a loss of $63 million compared with income of $489 million a year ago.

The rest of Washington Mutual produced good earnings, especially our retail banking business, which continues to grow and grow quite profitably. The rest of Washington Mutual generated $552 million compared with $528 million a year ago. And our retail banking results rose to $508 million, up 25 percent.

So what happened to the mortgage banking business? Let me get to the heart of the issue up front. Our mortgage banking business has an unacceptably high cost structure. Until recently, we did not fully comprehend the depth and breadth of these issues—and their impact on the profitability of this business in a contracting market. So what does this mean? Our mortgage banking business is undergoing a complete overhaul from costs and processes to products and the geographies we serve. I take responsibility for this. By the time we end today, I hope to fully explain what we are doing to fix this problem.

Now, the second quarter. Results are down because of four specific factors.

First, home loan volumes fell, along with the contraction of the mortgage market. They were up from the first quarter, but down substantially from peak refinancing volumes of a year ago.

Second, as I just said, our mortgage business has an unacceptably high cost structure that affects results across the board. While we have adjusted many of our costs to declining volumes, we will only be able to achieve improvements in the fixed part of the cost structure when systems conversions and process improvements are made. We are making progress, but the completion will take more time.

Third, the increase in ARM lending shifts our mix to more loans for portfolio than for sale. We earn profits over time from spread income here, but it results in less upfront gain on sale.

Finally, our MSR hedging program had a huge negative effect on second quarter earnings. Our hedging has produced excellent results over the past couple of years. We basically have a good program today. However, it produced significant earnings volatility in the second quarter. It reflected factors that included unusual movements in interest rates and changes in the spreads between mortgages and interest-rate swaps. By the way, the change between mortgages and swaps was more than a 2 standard deviation move. This was, frankly, much more volatility than we have seen in the past or than our initial 2004 earnings guidance contemplated. That is why we are undertaking an even closer look at all of our hedging strategy alternatives. Tom will discuss that in detail.

The second question – why did we take our earnings guidance for the year down so sharply?

For many years, we have given annual earnings guidance based on the interest rates and economic conditions at the time we initially gave that earnings guidance. We avoided giving quarterly EPS guidance because we believe that level of precision is not appropriate for our company. The initial 2004 earnings guidance we gave you was based on specific assumptions we made about interest rates. It was also based on an assumption that we could reduce the cost base of the mortgage banking business more quickly than has been the case.

Over the years, actual results have been pretty close to our guidance. But in periods of rapid changes either up or down on interest rates – we have had to revise our guidance, sometimes substantially, to reflect these changes.

For example, in 2001 when interest rates were falling, we had significant and frequent increases in our guidance. Over a nine-month period in 2001, we increased earnings guidance by a total of 21 percent.

This year – unfortunately, developments have caused us to revise our earnings guidance downward. As you know, we recently revised our guidance down to a range of $3.00 to $3.60 per share for the year.

So what key developments caused this revision? The most important was our view that the increase in long term interest rates will be sustained. The impact of rising rates on our mortgage banking unit is exaggerated because of our current high cost structure. Because of this, we anticipate reporting lower than expected gain on sale – especially in the second half of the year. We also had less net interest income because of a sale of securities that Tom will address. As I mentioned before, the MSR hedging strategy has produced more volatile results than we previously expected and higher long term interest rates have increased our overall hedging costs.

In summary, the continued high operating costs in our mortgage banking unit are inhibiting our ability to produce satisfactory results. This unit simply has not performed to our expectations.

The net of all of this is that our mortgage banking unit is expected to produce significantly lower results than we previously thought. I must say one more time, the rest of Washington Mutual is performing pretty much as planned, and we expect it to achieve earnings in a range of $3.15 to $3.25 for the year. But the mortgage banking unit is now expected to report earnings per share in a range of minus 15 cents per share to a gain of 35 cents.

I find this level of profitability totally unacceptable. So it has our full attention. Now as it relates to providing earnings guidance, what have we learned?

First, giving a wide range of earnings guidance is appropriate because interest rates can shift suddenly. We are going to do our best to give you a clear sense of the assumptions behind our 2004 guidance later in this call. And we intend to reevaluate our approach to 2005 guidance so that it is suitable to our company and so that it works for you.

Second, our MSR hedging approach can produce huge quarter-to-quarter swings. We will continue to evaluate how best to address this volatility, but investors need to expect that there will be quarterly variations.

Let me turn to the third and perhaps most important question. So what are we doing to address our current challenges?

Our core strategy is sound and we believe it will create great value for shareholders over time. That strategy is to serve a broad base of middle market consumers and small businesses with well designed and attractively priced products. Our strategy is to become a low cost provider, pass on great prices to customers and grow market share. This is working well for our retail banking and multi-family lending businesses. We are in an excellent position in these businesses and these businesses are profitable and growing nicely. This is where we are going to go with our mortgage business.

But first, here's a top line on the success of our retail banking and multi family lending businesses. Our balances in home equity loans and lines of credit grew to $36.1 billion at the end of the second quarter, up 76 percent from a year ago. We opened 66 new stores in the second quarter and have opened 301 over the past twelve months. Depositor and other retail banking fees increased by 12% in the quarter from a year ago. We added 157,000 net new retail checking accounts in the second quarter, and they are up 792,000 over the past twelve months. Small business checking accounts alone grew by 34,000 from the first quarter.

The largest part of our commercial group, multi-family lending, continues to do well and further establishes WAMU as a national leader in this space. We have a seasoned management team there, we have developed a very attractive cost structure and we are leveraging our position into markets across the country. The multi family portfolio was $21.2 billion at the end of the second quarter, up $1.7 billion from a year ago.

To wrap it up with a bottom line, profits from the retail bank increased to $508 million in the second quarter, up 25 percent from a year ago. And the commercial group reported profits of $187 million in the second quarter, up 6 percent from a year ago. This is net of income from discontinued operations. As I said before, the rest of Washington Mutual is performing as planned.

So our operating challenges are squarely centered in the mortgage banking business and here is what we are doing to address them.

Let me remind everyone that we assembled a large mortgage lending franchise through a series of acquisitions in a relatively brief period. We acquired PNC Mortgage, Fleet Mortgage, HomeSide Lending, and North American Mortgage. The refinancing boom hit and we had the opportunity to derive significant profits from these acquisitions. We did not complete the integration of these operations during the refi boom because we decided, at the time, that the software systems we were developing internally would provide a better road to conversion.

So, we did not execute on a long held practice of fully integrating acquisitions onto a "common-systems-platform" in a short period of time. Those of you following us over a period of years know that we have consistently done a good job of integrating our retail banking operations onto a common platform. We were then able to generate substantial growth through cross sales to the acquired bank's customer base as well as attracting new customers. Our focus on capturing substantial earnings opportunities from the refi boom delayed our doing this in a timely manner in the mortgage area, and quite frankly, when we did undertake this integration effort, we did not execute as well as we should have. We had some technology and systems challenges which became larger than anticipated. In other words, we did not execute our normal game plan. That then delayed building the kind of mortgage business we want to have. One like our retail banking business that is high volume, low cost, scaleable and focused. This integration has simply taken too long.

Well enough of the past. Where are we today and how quickly are we going to get all this fixed?

As I mentioned before, the fixed cost structure of our mortgage banking operations is simply too high. This is caused by too many manual processes and multiple operating platforms. The high cost structure hurts our efficiency ratios and our gain on sale results. It also impacts our market share because we are unwilling to reach for additional market share until we have sound, efficient platforms.

Last fall, it became apparent to me that the management team leading our mortgage banking group was not making satisfactory progress in addressing these challenges. So, we made some big changes.

We replaced several people and asked our entire executive team to step up and help assess the situation. We discovered the problems in the mortgage banking unit were substantial and needed immediate attention. Here's what we did:

First, we addressed variable costs – taking out the equivalent of 7,700 FTE since last August to reflect volume shifts.

Second, we made and continue to make solid strides on technology. We have had a whole series of technology improvements over the past several quarters and we're getting much closer to having stable and unified platforms. In fact, we converted all of our customers onto a single loan servicing platform over the July 4th weekend, and we are also methodically consolidating down our many legacy loan fulfillment systems. These changes will help the sales and operations to right size and accelerate many improvements in our efficiency. So far, the results from these have been very promising.

Third, as I mentioned earlier, our hedging performance has been consistent with the strategy we chose. But I should also add that the volatility experienced in the second quarter caused us to do an even deeper evaluation of our hedging strategies. In addition to our quality hedging team, we have retained BlackRock as our strategic hedge advisor to give us access to the industry's best capabilities and to work with us on evaluating alternative strategies.

Fourth, we are seeing encouraging improvements in pilot programs for the cross sale of products to our mortgage customers. As I mentioned earlier, home equity lending for the company is extraordinarily strong. Cross sales of home equity lines of credit to our mortgage customers are an important component of this program. So we have made great strides, but there is much more to do.

The top priority for the balance of this year and next year is to reduce the mortgage banking group's fixed cost structure. We are aligning all corporate resources to make this happen. There is no greater priority for us at this time. We need to complete the systems integrations and replace manual processes with automated processes. We can then accelerate other initiatives to streamline and simplify processes, improve cycle times, and refocus our product line, in addition to taking out costs.

The good news is that we have been doing all the base building to get this done.

It is now time to just do it. We see the opportunity to reduce the mortgage banking unit's cost structure substantially over the next 18 months. Naturally, the total cost structure of the mortgage banking unit will depend on the level of mortgage originations. But you can expect to see improved productivity performance over each of the next several quarters.

We will also continue to refine our mortgage distribution channels to fit our strategy and maximize profitability. We will emphasize origination of higher margin products such as our option ARMs. And we will emphasize originations through our retail and wholesale channels. Further, we will focus on those geographic markets where we have the best chance of cross selling additional banking products to those customers.

For example, we are planning to open approximately 150 new home loan centers, and add 750 new loan sales positions over the next two years, primarily targeted to areas where we have a retail banking presence. At the same time, we will close about 100 home loan centers and eliminate 410 loan sales positions in “non-strategic” areas. Production from these closed offices represents only about 2 percent of our total home loan volume. Although this will help us cut costs, the main benefit is that it will allow us to focus resources on the markets where we have the strongest prospects for growth.

So, we expect our mortgage business will be fully competitive at the end of 2005. Then we will work toward industry leadership by creating a mortgage unit that can do what we do best. That means running a high volume, low cost, scaleable operation that delivers value from the right set of products in the right markets.

Let me turn to the subject of management. The team that we deployed last fall to evaluate the mortgage banking unit has taken on a far larger job than we first expected and they have made terrific progress.

Let me say something a few words about the people in our mortgage group. We have one of the most productive sales forces in the business. We have tens of thousands of employees dedicated to serving customers in a profitable manner and I thank all these people for the work they have done to get us through this challenging period and I look forward to a much brighter future.

But it is now time for the next phase in our attack on these issues. Our goal is to assure continued, crisp execution of the cost savings initiative in the mortgage bank, while at the same time; we also ensure the optimum focus on our core retail operations.

So, Craig Chapman will now run the mortgage banking operation. Craig has an outstanding track record as a manager. He did a great job of leading our consumer finance company, has built the nation’s leading multi family lending franchise, oversaw the company’s $1 billion cost reduction initiative, and is uniquely qualified to drive the cost savings and other initiatives required at this time at our mortgage banking unit. To free up his time to do this, Craig’s chief administrative officer responsibilities will be reassigned to another executive.

This move will allow Deanna Oppenheimer to spend full time on growing our crown jewel, the retail banking operations. She has proven over the years her ability to set the standard in innovation and growth. We need her to focus on this – our largest and fastest growing business.

It is important to note that our overall consumer strategy is intact and these management changes do not signal any change in our fundamental strategy. Craig and Deanna will work very closely to maximize cross sales, and as I said before, we are lining up our mortgage banking distribution to more closely mirror our retail banking strategy.

We will also aggressively recruit in new talent as appropriate. For example, we are currently recruiting in a new CFO for our mortgage banking operations. We have terrific talent in the unit today. But we know we need to get stronger and we will not rest until we are convinced we have the strongest team in the business.

Let me conclude with a summary of our outlook for mortgage operations. We have a huge amount of work ahead of us over the next several quarters to get where we want to be. There are some quick fixes, but there are some things that will take time.

As I mentioned before, it appears to us that the mortgage banking segment will report a small loss to a modest gain this year. Actual results will depend on interest rates and the mortgage market, MSR hedge performance and our ability to achieve necessary cost savings. So I view 2004 as a transition year and 2005 as a year when we should see much improved performance out of the mortgage banking unit. In 2006, we expect our mortgage banking operation to perform as an industry leader in productivity and efficiency. This is aggressive, but doable given our commitment we have to making it happen.

So, in short, we have a mortgage banking franchise capable of operating at a higher level of performance. We are determined to make that happen.

Before turning this discussion over to Tom, let me just say I apologize for the performance of our mortgage banking unit over the past few quarters. The problems were greater and they are taking longer to fix than we initially thought. This is totally unacceptable to me and our commitment to you is very simple – we will fix the unit and will clearly communicate that progress to you.

Now, I'd like to turn it over to Tom for more specifics on the second quarter.

Remarks of Tom Casey
Executive Vice President and CFO

Thank you, Kerry.

I'd like to focus on 3 key issues that are driving our financial performance.

First: The MSR hedging program. It drove the loss in the mortgage banking business in the second quarter.

Second: Gain on sale. We expect it to be down in the 2nd half of the year.

And, third – expenses. It's critical that we resize the mortgage banking business to create long-term shareholder value.

For the second quarter, most of our financial performance was right in line with our expectations. The key variance, however, was the MSR performance. The best way to see this is to look at our Mortgage Banking segment, which included the MSR performance. It delivered a net loss in the quarter of $63 million versus net income a year ago of $489 million.

Let me give you some background on our MSR hedging program. This program is designed to protect our single most volatile asset. We seek to hedge the change in value of the MSR asset as economically as possible. However, no hedging program is perfect. While some amount of volatility is inevitable in any program our quarterly earnings reflected a level of hedge-related volatility that we have not experienced in the past and that frankly we are not satisfied with. You can see this volatility by looking at our news release, and at the supplemental schedule that we have inserted this quarter on WM 16.

This table is not intended to offer a comprehensive view into our mortgage banking results. We included it for the sole reason of demonstrating one way of looking at the quarter-to-quarter variability in our MSR performance.

Our net MSR performance in the second quarter was a net cost of $724 million. This compares with a net cost in the first quarter of only $83 million.

The results of the first and the second quarters are the high and low ends of our MSR performance since we implemented our hedging program in 2002. Not being satisfied with the quarter-to-quarter variation we conducted a thorough review of our MSR risk management performance and methods.

As Kerry indicated, we also asked Black Rock to scrutinize our methods and performance. As many of you know, Black Rock is a leading expert in this area. They had working with us for some time, providing risk management analytics enterprise wide, we asked them to begin a strategic review of our MSR hedging program. As part of this work, they have reported that our people, processes and policies have been working as we intended.

We will continue to work with them to look at different hedging strategies that might help us to reduce the volatility of our MSR hedging results going forward. If we make material changes in our hedging program, I will let you know what those changes are and what we are doing to implement them.

The MSR is a complex asset to hedge with many inherent risks and many factors that affect performance. We believe it would be cost prohibitive to eliminate all of the risks inherent in the asset. The review has helped us identify areas where we can commit additional resources to help make our MSR program even more effective.

Looking at the second quarter, two specific factors contributed the most to our hedging results.

Like our peers, we use interest rate swaps as part of our hedging program. They can be very effective. However, when rates move quickly, the spread between swap pricing and mortgage prices can move well outside their historical mean. During the quarter, we saw a significant tightening by 23 basis points of the basis spread between the FNMA 30-year coupon rate and the 10-year swap rate. At its lowest point, the absolute spread between these indices was 48 basis points which is lower than we've seen in quite some time.

Because our swaps are valued on a different bases from the MSR which is valued on mortgage interest rates our losses from the hedging instruments were greater than the appreciation of our MSR asset.

Mortgage and swap rates tend to be highly correlated over time. There is a lot of historical information showing that he spread between the two varies consistently around a historical mean. But, at any quarter end when these assets are valued the absolute level of basis spreads will affect our reported hedge performance. While the variance between the 1st and 2nd quarters were significant. We believe the six-month total gives you a better indication of our performance of the MSR.

Second, due to the rise in interest rates, the overall cost of hedging rose sharply in the second quarter. To be more specific, in a higher interest-rate environment as opposed to the very low-rate environment of most of the first quarter and all of 2003 the MSR value has the potential for greater losses. This occurs because rates can decline more in the high-rate environment, thereby increasing the risk of prepayments.

In short, our hedge costs rise with interest rates because, in essence, we are buying protection for a higher absolute risk. This risk is generally referred to as negative convexity.

Now, turning to the second half of the year and to our future outlook we expect the same. Higher interest rates, negative convexity resulting in higher hedging costs and lower gain on sale.

Let me be more specific to give you an idea of how we're looking at the MSR for the rest of the year. The mid-point of our range assumes the MSR performance will be comparable to the performance in first six months of the year.

The 50-cent range in our mortgage banking segment guidance takes into account the variance in the MSR hedge performance that we could reasonably expect in 2004, under the interest rate scenarios we've laid out.

And, now, let's turn to gain on sale for the second quarter. The second quarter gain on sale inclusive of hedging activities related to loans held for sale was $255 million, compared to $600 million last year. The decline reflects the significant reduction in lending volume as well as narrowing gain on sale margins and our strategic decision to portfolio more loans.

In the first quarter of this year, net gain on sale was $105 million. As we indicated during our first quarter conference call, this amount was low because of an accounting change related to the timing of when gain on sale is recognized. This quarter, loan sales were relatively strong because of the mini-refi wave in March and April.

However, as Kerry noted, we are not optimistic that this level of gain on sale will continue during the second half of the year. Mortgage volume is declining. Loans held for sale were down $6.7 billion from the end of the first quarter.

Our single-family loan pipeline also declined to $27 billion, from $38 billion on a linked quarter basis and, of course, we are focusing our origination teams on ARM production principally for our portfolio instead of lower-margin loans that we originate for sale. There's a lag between origination and sale, so we have visibility into our gains from sales for the third quarter.

Based on the pipeline, we estimate third-quarter gains to be less than half that of the second quarter. Furthermore, with lending volumes falling faster than we are able to take out costs at least in the short term the pressure on earnings margins rise resulting in lower gain on sale.

And this brings me to our third area of focus – expenses and rationalizing our business model for mortgage banking. We continue to make progress. But, a lot more work needs to be done. Kerry laid out the basic road map.

We've already attacked a significant portion of our variable costs taking out the equivalent as 7,700 FTEs since last August. We're well on our way to integrating our new systems and platforms. Now, we need to further improve our processes, our cycle times, back office efficiencies, and product design and introduction.

And, as Kerry also mentioned, we are taking steps that will allow us to deliver additional expense reductions this year and next as we bring down fixed costs in the Mortgage Banking business and as we reduce unnecessary overhead. During the second quarter we terminated 700 employees, bringing the total reduction since January to 3,600. As of the end of the second quarter we gave termination notices to an additional 2,400 employees. They will depart in the third quarter. And today we announced approximately 2,500 additional reductions relating to the change in focus in our retail mortgage network, as Kerry noted.

Another important milestone during the quarter was the conversion of 1 million customer home loans from our Intelliview mortgage servicing system to the Fidelity Servicing Package. With all the home loans on one servicing system, we can now take the next steps in driving efficiency in this area.

For example, we can now close our San Antonio loan servicing site. Those operations, as well as the activities of several support areas, are in the process of being rationalized and consolidated. In the third and fourth quarter, we expect to complete additional loan production system conversions. These consolidations are enabling the sales and operations teams to right size and go after efficiencies more aggressively.

Now, let me shift to the rest of Washington Mutual.

As Kerry noted, it continues to demonstrate solid performance. Loan growth continues to be strong with loans held in portfolio rising by $20.3 billion, or 12 percent since the beginning of the year and $8.5 billion or five percent during the quarter.

The success of our ARM loan production contributed to our $6.3 billion increase in our single-family portfolio since the beginning of the year and our home equity loans and lines of credit balances increased $8.4 billion year to date. We expect to continue strong loan portfolio growth in the second half of the year.

Credit quality continues to be excellent. Our net charge offs this quarter were only $24 million, compared with $46 million last quarter and $81 million a year ago. For the quarter, we provisioned $60 million in loan and lease losses, or $36 million in excess of charge-offs as a result of the growth in the loan portfolio. The ratio of NPAs to assets at quarter end was 60 basis points. This is well below our targeted level of 1.00 percent.

Between the first and second quarters we reduced the level of investment securities by $16.7 billion making room for further loan growth.

Net interest income rose modestly in the quarter, as loan growth was offset by the reduction in our investment and securities. This action has reduced the sensitivity of our net interest margin to rising interest rates. It has also avoided a large unrealized loss. It is the correct long-term strategy for us although it results in lower net interest income for the year.

The net interest margin for the quarter remained virtually unchanged. It was at 2.86 percent compared with 2.89 percent in the first quarter.

Looking forward while we still believe that our margin for the year will come in at the lower end of our long-term range of 2.80 to 3.10 percent we may see some pressure on the margin later this year as short-term rates rise. Depending on how quickly short-term interest rates rise our margin could drop below 2.80 percent before the assets fully reprice.

Let me make some general points about expenses. We are making progress but we need to accelerate our efforts to reduce our expenses further. Restructuring and technology-related charges of $26 million this quarter and $68 million for the first quarter were included in noninterest expense. The second quarter restructurings were primarily severance and facility-closure expenses.

Expenses for the quarter before these charges were only up $10 million, in spite of $49 million of expense growth in our retail banking and financial services segment. Expenses in our mortgage banking segment were down $22 million, even though expense savings in this segment were somewhat offset by costs that we incurred in the early second quarter up-tick in refinancing volume. Looking ahead, we remain on track to achieve our total expense goal for 2004 of around $7.5 billion.

Let me add a touch of detail to what Kerry told you about our segments.

Retail Banking continues to be a real success story. This segment's net income totaled $508 million. This is up 25 percent from a year ago and 8 percent from last quarter. The following key profit drivers are performing in line with expectations.

Retail banking fee income grew 12 percent from last year's second quarter to $507 million. As I told you, we're seeing strong performance in our volume of home equity loans and lines of credit. They are up 62 percent from the 2nd quarter of last year and up 38 percent from the 1st quarter of this year.

On a same-store sale basis for the financial center stores open for more than a year the number of checking accounts per store increased 8 percent year over year.

In addition fee income was up 10 percent, deposit balances were up 3 percent, and home equity lending was up 57 percent.

Our Commercial business continues to steadily improve its profitability. It produced net income of $187 million in the second quarter compared with $169 million in the previous quarter. Last year's second quarter net income was $176 million after excluding $22 million of earnings from WM Finance which was sold during the first quarter of this year.

Multifamily originations were up 16 percent over last year's second quarter. This contributed to a 12 percent increase in average loans outstanding in the Commercial Group.

Finally, capital management. We continued to be well capitalized under all applicable regulatory standards. And our tangible capital came in at 5.32 percent so we will have plenty of room for additional growth.

Now, let me turn the discussion back to Kerry who will add some comments on guidance and closing thoughts.

Kerry Killinger
Chairman, President and CEO (continued)

Thanks, Tom.

In my opening comments, I explained the factors that drove our reduced 2004 earnings guidance. This is frustrating for all of us. So let me give you, in broad terms, the factors underlying our revised guidance for 2004. We want to be as clear as we reasonably can about the assumptions that form the basis for our guidance.

First, we are assuming a ten-year Treasury note between 4.5 and 5.00 percent at year end.

Second, we evaluated a series of factors that can affect our results. So our guidance assumes: the 2004 national mortgage market totals slightly above $2.3 trillion compared with $3.7 trillion last year; loan portfolio growth for the remainder of the year ranges between 10 percent and 15 percent; the net interest margin narrows to around or slightly below 2.8 percent; continued stable credit performance in the second half of the year, consistent with first half of the year; substantial decline in the mortgage gain on sale in the second half of the year; continued strong growth of depositor and other retail banking fees; we do deliver on an expense base of $7.5 billion for the year; the MSR and its hedging performs in line with the first half of the year; and that the range of our earnings guidance considers the potential volatility of the MSR performance.

Once again this $3.00 to $3.60 2004 range covers what we think could be the variability of our mortgage banking business results - in the interest rate and market scenario I just laid out. But we should emphasize that this is not a simple, straight line relationship. For example, if ten year rates stay at 4.50 percent for the rest of the year, that doesn't automatically mean we'll earn $3.60 nor does a 5.00 percent rate mean we'll earn $3.00.

Now hat about 2005? In the past, we've given you an early view about the upcoming year right around this time of year. But in light of recent events, we have decided it makes sense to reevaluate our approach to annual earnings guidance, and we'll be prepared to discuss our approach at our November investor conference.

Now, let me turn to our cash dividend. This quarter the board felt comfortable continuing our history of frequent and modest dividend increases. We believe current earnings are more than sufficient to support the increase in the dividend as well as our asset growth targets. Our payout ratio of course is higher this quarter because of lower earnings, but the board makes dividend decisions based on long term earnings prospects. The dividend level reflects our view of our capital generation opportunities, and we expect the dividend payout ratio to decline in coming quarters.

So this was a challenging quarter. Yet, most of Washington Mutual is strong and growing and growing profitably. The part that isn't - the mortgage bank - is being fixed.

We have a great franchise. We have the right strategy. The path may not be perfectly smooth through the coming months, but we are going to execute on that strategy. Long-term, I believe Washington Mutual will deliver outstanding shareholder value.

With that, let's open it up to your questions.