Washington Mutual

Washington Mutual, Inc.
Prepared Remarks for Third Quarter 2004 Earnings Conference Call
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Remarks of Kerry Killinger
Chairman, President and CEO

Thank you, Alan. Good morning everyone. For those of you who haven't had a chance to speak with Alan Magleby yet, he joined us a few weeks ago as the new head of our investor relations team, and we're very glad to have Alan on board.

On last quarter's call, we took a close look at the specific factors we needed to address to improve our performance, especially in our mortgage banking business. Today, I'll report to you on our progress down the path to renewed competitiveness for our mortgage banking group. I'll also discuss some of the other steps we took this past quarter to ensure that every part of our business is as focused as possible on its core strengths.

You should all have seen our third quarter results by now.

Net income for the quarter was $674 million or $0.76 cents per diluted share compared with last year's third-quarter earnings of $1.02 billion or $1.11 per diluted share, and up substantially from the second quarter earnings of $489 million or $0.55 per diluted share. For the year-to-date, net income totals $2.21 billion or $2.50 per diluted share compared with last year's $3.04 billion and $3.27 per diluted share.

I'm also pleased to report that on Tuesday the board declared a dividend of $0.45 per share up from $0.44 previously. As you know, our practice of small but steady increases in the dividend reflects our long-term view of Washington Mutual's future and we continue to be very positive about those long-term prospects.

As we look at the trends in our operations, we see measured progress toward our goals. The performance of our core businesses was consistent with our expectations. Our retail bank led the way with a 27 percent earnings increase over the same quarter a year ago, reflecting strong fee and asset growth. Results from our mortgage banking group were much improved, and we are making progress in our efforts to reduce expenses and improve the efficiency of all of our operations. But we still have more to do before we achieve a level of performance that I'll be satisfied with.

Before I look at the specifics of our performance, let me remind everyone of our core strategy. It is to serve a broad base of middle market consumers and small businesses with well-designed and attractively priced products. It is to be a low-cost provider and pass on great prices to our customer base as we grow the franchise. You can see this strategy at work in our retail banking and multi-family lending businesses. Our most important challenge today is to bring our home mortgage business into line with that strategy.

As to the specifics of our quarterly performance, I will begin with the mortgage bank. In terms of mortgage origination, we remain one of the nation's top 3 mortgage lenders. More importantly, this segment returned to profitability, producing net income of $271 million in the third quarter after a loss of $63 million in the second quarter.

We saw significant improvement in the MSR performance compared with the second quarter. We benefited from lower medium-term rates and a widening of the swap to mortgage basis spread. We also took advantage of these conditions to refine our hedging. The result is that we continue to be appropriately hedged against changes in the overall level of interest rates and we believe we have improved our protection from the type of mortgage basis risk exposure we saw last quarter. Still, the MSR remains a volatile asset quarter to quarter, and we continue to work with BlackRock to refine our hedging program. Tom will discuss the MSR performance in more detail in a minute and we'll have more to say about this subject at our Investor Day meeting in New York in November.

Last quarter, I told you 2004 was a transition year and that we would improve our productivity over the course of the next 6 quarters. I told you we knew what we needed to do to get better and it was time for us to just do it. Well, we are.

During the third quarter we have successfully completed the conversion of our loan servicing systems to a single technology platform which sets the stage for more efficient operations and better customer service. We consolidated 12 mortgage loan fulfillment centers into the remaining 34 and reduced staffing in these locations so we could achieve better capacity management. We transitioned our back office servicing functions to four core sites. We completed the sale or closure of approximately 100 home loan offices in non-core markets—offices that contributed only 2 percent of our new loan volume. We did this so we could significantly expand the franchise in our retail footprint markets where our growth prospects are best. We made progress on the reduction of our multiple loan fulfillment systems; of the four in use today 94 percent of current originations are now processed on two systems, on their way to one by the middle of next year. And, at the end of the quarter, we continued to make substantial reductions in head count and improve the efficiency of our mortgage banking operations.

We are already seeing the impact of these steps. The mortgage bank's noninterest expenses have fallen from $729 million in the third quarter a year ago to this quarter's $602 million. We reduced noninterest expense in the mortgage bank by another $47 million in the third quarter compared to the second quarter.

But our strategy is about more than just taking out cost. It's also about reinventing the way we do business in the mortgage banking area. We want to emerge from this difficult period fully equipped to compete and, ultimately, to lead. This work is unfolding on two key fronts: process improvement and channel focus.

With respect to process improvements, we have set in motion a number of broad-based initiatives utilizing our Operational Excellence program. A key goal of this program is to improve our margins by improving the way we execute, day in and day out. Simply put, we are working on ways to speed up how fast we can move a customer from application to closing and how much we can improve the overall consistency of our mortgage fulfillment process. This is called cycle time, and by improving it, we will reduce operating costs and hedge costs, which collectively will improve our gain on sale. We'll have a much more detailed discussion of our work on this front at next month's investor day.

We're also refocusing our mortgage distribution channels so that they are squarely supportive of our core strategy and so we are positioned to maximize profitability. We have intensified our emphasis on production in our retail and wholesale channels. And at least for now, we have consciously de-emphasized certain parts of our correspondent lending, which are frankly less profitable for us at this point in the cycle. Similarly, we are directing resources toward expansion in our retail footprint markets, where we see the prospects for solid, long-term growth because of the combination of retail branch presence, high brand identity, and marketing muscle.

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 wherever 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 formula is quite clear. The right products at the right price in the right channels delivered with substantially lower cost, greater efficiency, and higher consistency. And the people in our mortgage business are equally clear about what they have to do to deliver on it. I am proud of how hard they are working and encouraged by the progress I see under the leadership of Craig Chapman. And, as we told you last quarter, we are very alert to opportunities to strengthen this team where it makes sense. This morning we issued a press release announcing that Taj Bindra has joined us as the new EVP of Finance and Servicing Operations of Mortgage Banking. Taj comes to us from JPMorgan Chase where he served for the past five years as CFO of Chase Home Finance. We're excited about the skill and mortgage banking experience he will bring to the table. I would also like to take a moment to thank Tony Meola, Dyan Beito and Dan Gilbert for their executive leadership of our mortgage team. They led our team to accomplish more than I frankly thought possible over the past quarter. This reinforces what I said last quarter, and that is that we have one of the most productive sales forces in the business and we have tens of thousands of employees dedicated to serving our customers in a profitable manner. I thank all of these people for their terrific work.

As we've told you, this is not an overnight fix that we're talking about but it is a fix we can deliver effectively over the next 15 months and you will see progress each quarter.

That's where the mortgage bank is going.

Let me turn to our retail bank, where we're very happy with our continuing progress. The retail bank reported record earnings of $529 million, an increase of 27 percent from last year's third quarter. Now I should note that this exceptional level of growth benefited from an environment that allowed us to book substantial asset growth. Over time, we would expect to see slower, but solid growth in earnings from the retail bank.

Our retail strategy drives income in three ways: increasing fee income, as well as loan and deposit growth. Our growing customer base is driving solid growth in both fee income and consumer lending. While we are seeing a period of slower deposit growth for the industry, we are pleased with our current rate of deposit growth. Our outlook is positive because of the growth markets in which we're positioned. In short, we continue to build on our already sound position in our retail markets.

Retail deposit fee income increased 9 percent to $514 million from the third quarter of last year. Net new retail checking accounts totaled a healthy 143,000 for the quarter.

We were especially pleased by the growth in small business checking accounts and we see signs that we are making measurable inroads in that market. Fundamentally, this type of small business represents a natural extension of our retail business model. In the third quarter, small business customers opened 32,000 net new checking accounts, a level that essentially repeats the growth we saw in the second quarter, when 34,000 net accounts were opened. We believe this brisk rate of growth validates our view that the small business market is a huge opportunity for us.

All told, we have added 755,000 net new retail checking accounts over the past year, and this helped support our growth in fee income.

Total retail banking deposits at quarter end were up nearly $2.5 billion from the second quarter. Retail banking deposits increased $3.9 billion compared with a year earlier.

Let me now turn now to consumer lending.

In the third quarter we topped $40.5 billion in home equity loans and lines of credit, up 68 percent from only $24.1 billion a year ago. This success story reflects the strong asset generation capability of our retail bank distribution system.

Our retail bank's cross-sell ratio continues to notch upward as we work to provide all of our Washington Mutual's products and services to our retail customer base. At the end of the third quarter the cross-sell ratio was 5.83 compared with 5.79 for the second quarter of 2004 and 5.57 for last year's third quarter.

A significant initiative for our retail bank has been the opening of 57 new stores in the third quarter. These include 14 in Florida and 20 in Chicago, where we continue to work toward critical mass. We are on track to achieve our target of 250 new store openings this year.

Quite understandably, some of you have asked us whether the pace of retail expansion and the growth in our retail profitability is sustainable. We know there are some obstacles that any retail bank will have to overcome, namely, that the marketplace has become more competitive, and at the same time, today's interest rate environment is less conducive to deposit growth for that sector. We remind everyone that our strategy is to attract households and to cross-sell multiple products to those households. Deposits are but one of many products we sell. As I mentioned previously, our cross-sell ratio is 5.83. So, yes, deposits may be growing at a slower pace but households are growing nicely, cross-sell ratios are rising, net checking accounts are growing and consumer loans are growing at exceptional rates. Our retail banking model is working very well, even in the more competitive conditions, and our new store performance continues to meet our expectations.

In short, I am very excited about the prospects for our retail bank. Deanna Oppenheimer and I look forward to sharing with you in November the concrete steps we are taking to sustain and extend our competitive advantage.

Well, a few words about our commercial group are in order.

While earnings were down due to some large transactions last year, we see very good growth prospects for the primary businesses in this group which are multi-family, nonprime residential and commercial real estate. Importantly, during the quarter we announced a series of steps to sharpen the focus of our Commercial Group's business lines. By exiting some secondary businesses, we will be able to concentrate our teams on major markets, products and services where we can best serve our commercial customers. Year over year the increase in the average loan balances was 10 percent and average deposit balances were up 27 percent. We are pleased with the group's progress and it remains an important part of our overall business strategy.

Now, Tom will provide you a more in depth look at the quarter's results.

Remarks of Tom Casey
Executive Vice President and CFO

Thank you, Kerry.

To echo Kerry's summary, we had a good quarter, though we recognize we have a way to go before we achieve a level of performance that satisfies us.

In my remarks, I will walk you through our income statement, offering some commentary on the fundamental issues that have shaped this quarter. Along the way, I will touch on the trends in our net interest margin, the performance of our MSR hedging program, our gain on sale and our progress on expense control. Then, I'll briefly touch on our balance sheet, and the highlights of our business segments.

Net interest income for the quarter was $1.74 billion, down $54 million from the second quarter. Net interest margin declined from 2.86 percent in the second quarter to 2.77 percent in the quarter just ended. As we pointed out in last quarter's conference call, the net interest margin has been under pressure from rising short-term interest rates during the last few months as well as escrow and custodial balances.

Although total assets increased by $10.3 billion from second to third quarter, average assets were essentially unchanged during the quarter. The average balance of loans held in portfolio increased $9.3 billion but was offset by a decline in available for sale securities and loans held for sale.

You can see on the face of the Income Statement, we terminated $1.75 billion of repurchase agreements that had embedded pay-fixed swaps. This termination of debt along with a smaller termination resulted in a loss of $147 but it allowed us to replace higher-cost borrowings at a lower net borrowing rate, and we expect this to help future periods by reducing the effect of increases in short-term interest rates.

Despite this step, we expect our net interest margin to decline further in the fourth quarter primarily because the repricing of our ARM portfolio, which includes loans, is indexed to a moving Treasury-based average, lags the repricing of certain LIBOR-based borrowings which tend to reprice more frequently. Further Fed tightening or an even flatter yield curve could put additional pressure on the net interest margin.

Looking at our noninterest income, one of the largest variables in recent quarters has been the performance of our MSR program.

As shown on WM 16 of our press release, our net MSR valuation less hedging expense during the third quarter was much improved to a net cost of $123 million from a net cost in the second quarter of $724 million and similar to a net cost of only $83 million in the first quarter.

Our loans serviced for others portfolio ended the period at $551.2 billion, down slightly from the end of the second quarter and our MSR was capitalized at 111 basis points down from 134 basis points at June 30th.

Two market movements contributed to the third quarter results: lower medium-term interest rates and a widening of the rate on interest rate swaps to mortgage rates. Both of these indicators moved in the opposite direction from what we experienced in the second quarter, and this translated into a more favorable net MSR outcome this quarter compared to last quarter.

First, in regard to the absolute level of interest rates. As we noted in the second quarter, our hedging costs tend to be less in an environment of stable, lower rates because the risk inherent in the MSR is simply less expensive to hedge.

Secondly, during the third quarter the spread between 10-year swaps and 30 year current coupon mortgage rates widened by 14 basis points from the level at the end of the second quarter, returning to levels similar to those in the first quarter. This widening of basis spreads contributed to the quarter's favorable MSR results. And as we've discussed, it is this movement in the spread between interest rate swaps and mortgage rates that has been responsible for a large portion of the quarter-to-quarter change in performance we've seen this year.

Looking ahead, we would not expect to generate this degree of favorable performance on an ongoing basis. While we were pleased with this quarter's performance, we are not satisfied with the level of volatility we have been seen on a quarter to quarter basis. So, as we saw the basis spread widen during the quarter, we adjusted our MSR hedge to lower our exposure to basis risk in the future. We achieved this by changing the mix of instruments in our hedging portfolio to include more mortgage-based instruments and less interest rate swaps.

Since the change in mix resulted in the use of more mortgage-based instruments, we expect them to change in value in ways that correlate more closely with the change in value of the MSR. In contrast, second quarter's portfolio contained more swap-based derivatives, which while correlated with the mortgage rates over time can vary significantly quarter to quarter.

By taking this action, we significantly lowered our exposure to basis risk in the future. But, keep in mind that while we have reduced one type of volatility, we have not eliminated all volatility. We are simply better positioned to mange volatility in the underlying markets. The trade off, of course, is that lower volatility comes at a higher hedging cost and we will continue to monitor that.

Also remember what I said at the end of the second quarter: We manage the MSR over a period of time longer than just one quarter. In other words, we seek to hedge the economic value of the asset over time, despite the variability of the quarterly financial results required under GAAP accounting.

I want to close this quarter's comments on MSR performance by stating that we continue to evaluate our MSR risk management policies and practices. As we entered the fourth quarter, we have introduced a modest reduction in our hedge position from its historic levels, a step that should allow a portion of the MSR recovery to exceed the loss on corresponding hedges if there is a rise in medium- to long-term rates. As we drive efficiencies within our mortgage business, we will continue to evaluate opportunities to align our hedge profile with the performance of the overall mortgage business. Overall, our goal is to ensure a balanced approach to the performance of the mortgage banking operations and the various forms of risk associated with the MSR asset. We continue to work closely with our advisor BlackRock and I expect to have more to say at November's Investor Day.

The next element in the operations of our mortgage businesses I'll cover is the gain on sale for the quarter.

Our gain on sale, inclusive of hedging activities related to loans held for sale, was $187 million in the third quarter, down 27 percent from the second quarter level of $255 million.

Loans sold in the third quarter of $29.1 billion declined 45 percent from $52 billion in the second quarter. The second quarter included volume driven by the mini-refinancing wave in late March. And in the third quarter, we saw our gain on sale margin increase as markets conditions improved and the changes we're making in our mortgage operations start to take hold.

At the end of the third quarter, we had $29.2 billion of loans that are held for sale, a little above the $27.8 billion at the end of the second quarter and we would expect sale levels to be similar in the fourth quarter to those in the third quarter.

Also included in our third quarter noninterest income was $514 million of depositor fees generated by our growing retail banking business. This was a modest gain from the previous quarter but up 9 percent compared with last year's third quarter and up 10 percent on a comparable year-to-date basis. The increased fee income is due in large part to the 755,000 net new retail checking accounts that we added over the past year.

Now, let me turn to another area that continued to be the focus of intense attention for the company during the past quarter: the reduction of noninterest expense.

Taken as a whole, our expenses were up slightly in the third quarter as compared with the second quarter. However, this masks the progress we are making.

The third quarter expenses include restructuring charges of $71 million, up from the second quarter's charges of $26 million. Many of these charges stem from severance tied to headcount reductions in the quarter and other cost saving steps driven by our actions to improve the efficiency of our mortgage bank.

When you net out restructuring charges, expenses fell from the second quarter by $24 million. We continue to see cost reductions despite the opening of 181 financial centers on the way to 250 for the year. These new stores are central to our plans to grow the retail bank's customer base and to grow income from fees, deposits, and loans.

Company wide, we reduced headcount by 1,800 during the third quarter. At quarter end 3,300 of our current employees had planned termination notifications. Of the pending terminations 1,500 were completed on October 1st with the remainder scheduled for the fourth quarter. Since the beginning of the year we have reduced head count by 5,900, which is net of the staff growth to support our retail bank expansion. In addition, we have also made sizeable reductions in the level of temporary and contract employees. The majority of the headcount reductions have come from our mortgage banking segment.

In the fourth quarter, we expect the run rate for our expenses, net of restructuring charges, to be lower than during the third quarter even as we continue to invest in new retail branches.

We still expect to close the year with noninterest expenses around $7.5 billion, which is in line with the targets we have set for this year.

Now let's look at the strong growth we had in the balance sheet during the quarter.

For the quarter, assets were up $10.3 billion to $288.8 billion.

This reflects an $11.6 billion increase in our loans held in portfolio. The loan portfolio has grown 18 percent, or $31 billion, since the beginning of the year.

Our company has exceptional asset generation capabilities with a diversity of loan products including residential and home equity loans as well as multifamily.

Total loan volume for the quarter was $61.8 billion. Of the $47.8 billion in home loan volume, adjustable-rate production comprised 67 percent. And third quarter originations of just short-term adjustable-rate loans of $19.1 billion set an internal record and reflected our strong market position in this loan product.

Another asset category where we are seeing strong growth is our home equity loans and lines of credit generated by our retail bank. In the third quarter, home equity lending volume totaled $10.5 billion, continuing our very strong performance after reaching a record level in the second quarter of $11.6 billion. Our portfolio of these loans now totals $40.5 billion, an increase of 47 percent year to date, and 12 percent from the second quarter. Approximately 51 percent of these loans in this portfolio are in first lien positions and the average loan to value ratio at origination is around 68 percent. We continue to believe these loans offer an opportunity for very high growth with sound risk characteristics for the company.

We expect loan production to remain strong through the fourth quarter and to contribute to solid asset growth.

On the liability side of the balance sheet deposits increased $6.2 billion or 4 percent in the quarter. This increase was a combination of $5.2 billion in wholesale deposits and $2.5 billion in our retail bank, partially offset by a $1.7 billion decrease in custodial and escrow deposits.

As Kerry indicated the deposit market continues to be very competitive. As always we will closely monitor the balance between deposit growth and disciplined pricing to effectively manage our net interest margin.

Finally, let me recap the income performance of our key business operations.

The retail bank produced segment net income of $529 million. This represents an improvement of 4 percent over the second quarter and a year-over-year improvement of 27 percent. Driving the year-over-year earnings growth was higher net interest income from a 38 percent increase in average assets, along with a 9 percent increase in depositor fee income, and a 5 percent increase in average deposits.

The mortgage bank produced segment net income of $271 million, compared with a loss in the second quarter of $63 million. As I noted earlier on this call, the improved results were heavily influenced by the favorable MSR performance. The operating expense of this group continues to decline and during the quarter we experienced strong gain on sale with improved margins.

Turning to our Commercial Group:

Commercial banking profits were $145 million for the third quarter. This compares with $187 million last quarter and $232 million from continuing operations a year ago.

Last year's third quarter earnings in the commercial group included securities gains of $70 million, $55 million in fees from a swap of multifamily loans with Freddie Mac, and a substantially higher gain on sale of specialty mortgage finance loans, which reflected the higher margins of a year ago.

After adjusting for the transactions in the third quarter of last year, net income for this segment was comparable. We continue to be pleased with the performance of this group.

Now I'd like to focus very briefly on credit quality. Our indicators continue to be stable and within our expected ranges. Nonperforming assets as a percentage of total assets of 61 basis points was nearly equal to the 60 basis points at the end of the prior quarter. Reflecting the continued strong credit level, the provision for loan and lease losses of $56 million exceeded net charge offs of $27 million to support the growth of the loan portfolio.

Finally, let me close with a comment on capital. Our tangible capital came in at 5.26 % so we will have room for additional growth. And, we continue to be well capitalized under all applicable regulatory standards.

Now, let me turn the discussion back to Kerry, who will offer some closing thoughts.

Kerry Killinger
Chairman, President and CEO (continued)

Thanks, Tom.

As you know, it's been our policy to give annual rather than quarterly earnings guidance.

With one quarter left we continue to be comfortable with our current guidance of year-end 2004 earnings per share in a range of $3.00 to $3.60 per share. As 2004 began, we told you this would be a transitional year with a lot of moving parts. We're feeling reasonably good about the performance of our business segments for the remainder of this year. We see a marked improvement in the performance of our mortgage bank, which should deliver positive earnings this year as opposed to the possible loss for the year we discussed last quarter. On the other hand, three factors will have a tempering effect on results for the rest of WaMu: the impact of a flattening in the yield curve on our net interest margin, the third quarter one time cost of prepaying more costly borrowings, and higher restructuring costs as a result of acceleration in our cost saving efforts.

All in all, we feel comfortable that we will come in within the 2004 EPS range. However, the year is not over and we've all seen that the MSR is a volatile asset that can have a significant impact on our reported results. So I will not narrow this range of estimates for 2004 at this point.

As we said last quarter, we have been reevaluating our approach to annual earnings guidance and, at our November investor conference; we'll be prepared to discuss our approach to guidance in 2005.

So where are we as we enter the final stretch of 2004?

Our retail bank continues to produce excellent results and continues to grow successfully as it moves into the third year of its large-scale, new store expansion. Our mortgage bank is in the middle of a transformation to become efficient and fully competitive for all economic seasons. Our commercial group is a great compliment to our other real estate based assets and is getting the job done. Credit quality is very good. We are making good progress on expenses and we continue to refine our MSR hedging to reduce volatility. We have a ways to go, but we like where we're going. We know we have a great franchise, and we are confident our efforts will deliver outstanding long-term shareholder value.

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