February 8, 2008

William G. Reed, Jr.
Board of Directors
Member, Finance Committee
Washington Mutual Corporation
1301 Second Avenue
Seattle, Washington 98101

Dear Mr. Reed:

Washington Mutual's failure to manage mortgage-related risk cost its shareholders $28 billion in 2007, a 71% decline that wiped out all of the shareholder value created since 2000. Given Washington Mutual's longstanding specialization in mortgage and housing-related lending, as well as management's past assertions that it would control exposure to mortgage-related risk, these losses are particularly disconcerting. Indeed, it appears that Washington Mutual's loan portfolio was especially vulnerable to the collapse of the housing bubble, leading to $6.5 billion in write downs and credit losses to date.

With Washington Mutual's 2008 director election less than three months away, we call on you, as a member of the Finance Committee of the Board of Directors in 2005 and 2006, to describe the actions you took during that period to understand and assess Washington Mutual's underlying exposure to mortgage risk across its businesses and satisfy yourself that management was taking appropriate steps to control such exposure. Absent a compelling explanation from you, we intend to recommend that shareholders vote against you at the 2008 annual meeting.

The crux of our concern is as follows:

1. By mid-2005 it was apparent that mortgage lenders were loosening lending standards and that an overheated U.S housing market was at risk of collapse. Washington Mutual executives recognized that they faced a challenging environment, but misinterpreted the challenge they faced. Instead of seeking to protect shareholders from increasing delinquencies driven by falling house prices, they believed that rising interest rates were compressing margins, and sought to reallocate Washington Mutual's portfolio away from conforming, fixed-rate mortgages toward riskier loans that provided higher margins to the originator. By failing to properly recognize the risks of this reallocation, Washington Mutual's corporate leadership exposed shareholders to considerably increased risk of write-offs and credit losses once the housing bubble burst.

2. Finance Committee members should have recognized that the risks of such a collapse had risen dramatically by late 2005 and thus taken particular care to satisfy yourselves that management was taking steps to monitor and control Washington Mutual's exposure. As Mark Adelson, Head of Structured Finance Research at Nomura Securities, warned in September 2005: "Even the possibility of a [housing] bubble burst should lead [investors] to a defensive position." (*Asset Securitization Report,* September 20, 2005)

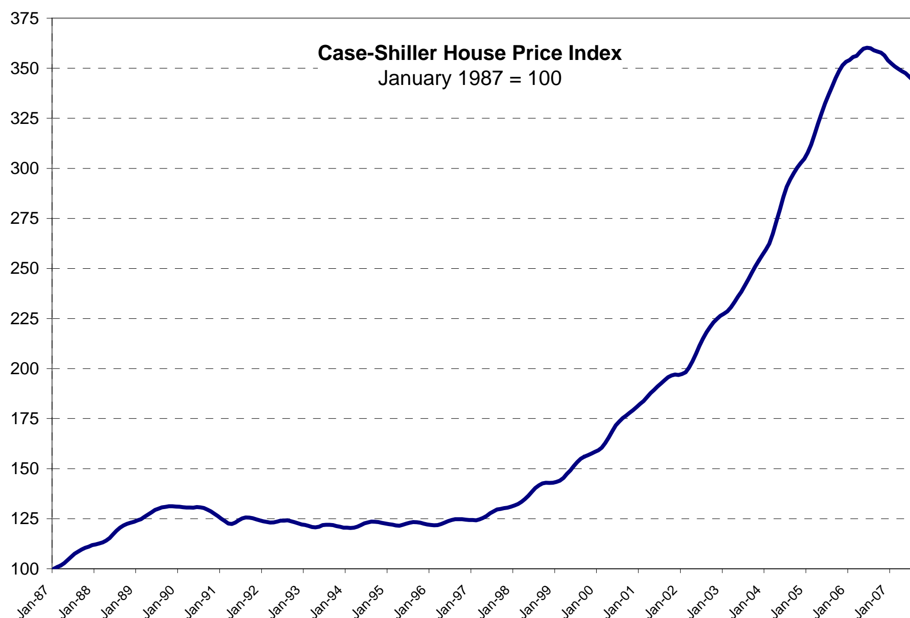
3. In 2004 and 2005, there were signs that Washington Mutual's subprime practices might not be sustainable. As early as 2004, for example, the *Financial Times* singled out Washington Mutual' exposure to a potential fallout in the U.S. mortgage market: "But after a period of powerful growth, mortgages may soon become WaMu's Achilles heel. Last December the bank provided the first evidence that its profits might not be sustainable."

4. Washington Mutual's aggressive subprime lending not only calls into question the effectiveness of the company's internal risk controls but has also damaged the company's brand and exposed shareholder value to potentially costly litigation. In November 2007, New York State Attorney General Andrew Cuomo filed a lawsuit against First American Corp. and its appraisal subsidiary eAppraiseIT for allegedly colluding with Washington Mutual to artificially inflate real estate appraisals. In addition, the SEC launched an investigation in December 2007 which may involve how WaMu disclosed loans to investors of mortgage-backed securities and how it accounted for loans in financial disclosures.

The CtW Investment Group works with pension funds sponsored by unions affiliated with Change to Win, a coalition of unions representing nearly 6 million members, to enhance long-term shareholder value through active ownership. These funds, together with public pension funds in which CtW union members participate, have about $1.4 trillion in assets and are substantial long-term Washington Mutual shareholders. We detail our concerns further below.

The Warning Signs Were There

By mid-2005, it was apparent that a housing bubble had developed and that the risks of a severe mortgage downturn had increased dramatically. Fueled by historically low interest rates, the creation of mortgage products targeting less credit-worthy borrowers and abundant liquidity from a booming secondary market for securitized mortgages, home prices had virtually doubled over the previous five years (see below graph).



Housing starts, which had increased every year since 2000, peaked in second quarter 2005. Mortgage interest rates began rising, with the average rate on a conventional 30-year fixed rate loan jumping from 5.6% to 6.7% between June 2005 and June 2006. Mortgage lenders were loosening their lending standards and increasingly using novel loan products.

One need not have been an economist or the director of a financial services firm with access to these data, however, to know that a national housing bubble had developed and could burst. One need only have read the news to see that a growing number of economists, investment professionals and public policy experts were sounding the alarm:

- On May 27, 2005, economist Paul Krugman of the *New York Times* said he saw "signs that America's housing market, like the stock market at the end of the last decade, is approaching the final, feverish stages of a speculative bubble."
- On June 9, 2005, Federal Reserve Chairman Alan Greenspan, while downplaying risk of a national housing bubble, acknowledged in testimony to the Joint Economic Committee that he saw "signs of froth in some local markets where home prices seem to have risen to unsustainable levels."
- On July 26 2005, *The Wall Street Journal* reported that "Mortgage lenders are continuing to loosen their standards, despite growing fears that relaxed lending practices could increase risks for borrowers and lenders in overheated housing markets." The article cited increases in novel loan products, including interest-only mortgages, option adjustable-rate mortgages and no documentation loans.
- By December 2005, even some CDO traders warned the bubble could burst. Jason Schechter, then head of CDO trading at Lehman Brothers, echoed other participants at the Opal Financial Group CDO Summit when he said: "What concerns me though is: is this liquidity here to stay, or are we at risk for a sizable downturn?" (*Asset Securitization Report*, December 12, 2005)

While Washington Mutual and many of its peers failed to heed these warnings, a number of firms did take action to reduce their mortgage risk exposure. Goldman Sachs, for example, began aggressively reducing its mortgage-backed securities exposure in late 2006, both by reducing inventory and hedging. Morningstar recently named PIMCO's Bill Gross the best fixed-income fund manager in 2007, lauding him for avoiding exposure to subprime securities and for anticipating the effect that the decline in home prices would have on the broader economy and corporate bonds.

Despite these Red Flags, Washington Mutual Failed to Control Its Mortgage-Related Risk

Given Washington Mutual's long experience in the home loan business, shareholders should have been able to rely on management and the board to recognize the dangers ahead and take appropriate steps to protect shareholder value. But instead of curtailing relevant exposure after 2005, Washington Mutual allowed these risks to grow: the Company's portfolio of Mortgage Backed Securities (MBS) grew over 48% over the year to June 30, 2006, and its residential mortgage loans grew 12% over the same period. While the Company pared back both portfolios in late 2006 and early 2007, it reversed course between March and December of 2007, with MBS investments growing 21% and mortgage loans growing over 12%. The failure of the Company to

maintain a disciplined commitment to reducing mortgage risk exposure, at least as manifested in the overall size of these portfolios, is very difficult for outside observers to understand, especially as management had asserted in early 2006 that foresaw difficult times for its home loan business and was taking steps to adapt.

Unfortunately, it appears that Washington Mutual understood these risks to be primarily interest rate rather than credit quality related. As a result, in mid-2006 Washington Mutual embarked on a significant strategic reorientation of its mortgage lending and servicing operations: the company sold servicing rights to $140 billion in fixed rate, conforming mortgage loans to Wells Fargo. In later discussions with analysts, the company explained that due to the "severe overcapacity" in the fixed, conforming market, it was willing to "shed market share in more commoditized areas" in order to focus on higher-margin products including subprime, option ARM, and Alt-A loans. While such a focus could yield higher fees from mortgage origination, it also presented a substantial risk that if home prices began to fall, delinquencies and credit losses would quickly rise.

Our analysis of the volume of risky housing related lending and the share of such loans in Washington Mutual's portfolio reinforces the view that the Company chose to increase exposure to highly price sensitive assets at the peak of the housing bubble. During the first three quarters of 2006, subprime lending increased from $6.4 billion to almost $7.8 billion, or from 14.5% of home loans to nearly 21%. While this is a lower dollar level of subprime lending than took place in 2005, it represents a much higher share of home loan lending, which suggests that the Company was seeking to increase subprime exposure (in order to realize higher margins), and that the dollar level decline should be attributed to the industrywide slowdown in activity. Data on option ARM volume is more limited, but in the second quarter of 2006, it accounted for 26.27% of home loans, up from 16.1% in the previous quarter, down from the peak of 37% in the second quarter of 2005, and essentially unchanged from 26.29% in the first quarter of 2005. Considering the held-for-investment portfolio, the dollar value of subprime loans has fallen steadily since the end of 2005, but the share of such loans in the portfolio grew from 15.2% of home loans at December 31, 2005 to 16.6% at June 30, 2007. Between these dates the dollar value of option ARM loans also fell but the allocation held steady at around 50% of the home loan portfolio from December 31, 2005 through September 30, 2007. The dollar value of option ARM loans actually increased by more than 8% during the third quarter of 2007. Indeed, Washington Mutual didn't halt its subprime mortgage operations until December 2007.

Washington Mutual's failure to substantially reduce exposure to the consequences of home price deflation is particularly troubling in light of new allegations that company employees conspired with appraisers to inflate that value of properties subject to loans. If these allegations prove true, not only would the company face legal penalties, it suggests that the held-for-investment portfolio contains even more risk of credit losses, as homeowners discover that they are in negative equity position and decide to walk away from their houses. Already non-performing loans have increased from 0.82% of total loans as of September 30, 2006 to 2.49% as of December 31, 2007. The Company's balance sheet is showing signs of stress as a result of write downs and credit losses, with the company's Tier 1 ratio dropping to 5.9% as of September 20, 2007, compared to 6.3% as of September 30, 2006. This has led to Fitch Ratings recent downgrade of the Company to A- from A, citing "worsening asset quality" and "extremely challenging conditions in the US residential mortgage market." And Moody's has stated that it does not expect WaMu to return to profitability until 2010. Another large writedown would

further weaken the balance sheet and increase the likelihood of further credit rating downgrades. Most recently on January 18, the company announced its first quarterly loss in a decade.

Where was the Finance Committee?

While it is the CEO's job to manage overall exposure to risk, the NYSE listing requirements mandate that it is the responsibility of the Audit Committee or other designated committee to review the firm's major financial risk and assess the steps management has taken to control such exposure. At Washington Mutual, the board has designated the Finance Committee to be responsible for overseeing financial risk, including allocation of capital and the management of market and credit risk, while the Audit Committee retains oversight responsibility for enterprise risk. While directors cannot be expected to understand every technical aspect of an underlying business, they still must acquire and maintain sufficient knowledge and understanding of the company's business to properly discharge their duty of care.

We believe that Washington Mutual's Finance Committee failed in these duties as they relate to the company's exposure to mortgage-related risk in general and any investments in complex, mortgage-backed derivatives in particular. As *The New York Times* reported on December 21, 2007: "This year the leaders of some of the world's most respected financial institutions — leaders who are paid first and foremost to manage risk — have been caught either unaware or uninformed about giant risks their companies took. Their financial engineers concocted securities so complex that even the brainiacs cannot figure out what those investments are worth."

One factor which may have contributed to this failure is the composition and leadership of the Finance Committee. First, we question the decision to place Mary Pugh, the only non-independent outside director, as Chair of the Finance Committee. Not only is Ms. Pugh a former Washington Mutual employee, but the longstanding business relationship between the Company and her firm, Pugh Capital Management, a relationship which yielded payments from Washington Mutual of $175,694 in 2006, and over $200,000 each year from 2002 to 2005, may have dissuaded her from posing tough questions to management concerning the Company's vulnerabilities. The fact that shareholders in 2006 withheld support from Ms. Pugh at by far the highest rate (7.81%) of any Washington Mutual director reinforces our belief that your role on this committee should at the very least be reexamined.

Secondly, we are concerned about your independence: You have been on Washington Mutual's board for 37 years, the longest tenure of any member of the current Board. The Corporate Library has cited the long tenure of some Washington Mutual directors as a concern with the Company's governance. Moreover, you are a director of Safeco Inc. and Green Diamond Resources, on whose board's Chairman and CEO Kerry Killinger also sits. It seems likely to us that the combination of long tenure and interlocking directorships indicates a relationship between yourself and Mr. Killinger sufficiently friendly to deter challenging questions about Washington Mutual's investment decisions.

Finally, we note that Stephen E. Frank not only serves on the Finance Committee but also on the Corporate Development, Human Resources, and Audit Committees; he is the Chairman and lone designated financial expert on the Audit Committee, and as of December 2006 served as Washington Mutual's independent Presiding Director. Mr. Frank also Chairs the Audit

Committee at Northrup Grumman, and serves on the Audit Committee at Puget Energy, where he Chairs the Compensation Committee. This list does not even exhaust Mr. Frank's current list of board memberships, which additionally includes Aegis Insurance Services, Inc. We fear that Mr. Frank may have become overcommitted, and was therefore unable to devote the necessary time to the duties of risk oversight vested in the Finance Committee.

Washington Mutual Shareholders Require a Detailed Explanation

In preparation for Washington Mutual's 2008 director election, we believe shareholders are entitled to a detailed explanation as to what steps Finance Committee members took, individually and collectively, to: (1) understand Washington Mutual's exposure to mortgage risk through both its lending and structuring business and its investments in CDOs, SIVs and other exotic debt instruments; and (2) satisfy themselves that management was taking appropriate steps to control such exposure. Among the issues we would like directors to address:

- *Internal flow of information*. What information was routinely provided to you by management? How frequently was the information provided? Did you request additional information from management in response to mounting concerns with mortgage-related risk? What additional information did you request and when was it requested?

- *Consultation with Senior Executives*. Ronald Cathcart, Washington Mutual's current Chief Enterprise Risk Officer, appears to have management responsibility for overseeing the company's credit, market and operational risk functions. What interaction did Mr. Cathcart have with the Board's Finance Committee in 2005 and 2006? What interaction did James Vanasek, the company's previous Chief Enterprise Risk Officer and Mr. Cathcart's predecessor, have with the Board's Finance Committee in 2005? Did the Finance Committee meet regularly with the senior executives at the company with direct responsibility for measuring, analyzing and managing risk? How often did these meetings task place? Who was present at these meetings?

- *Independent assessment of information*. What independent steps did you take to evaluate the information provided by management? Third-party advisors can serve as an important tool for directors to assess the quality of information they are receiving in the boardroom. Which, if any, outside firms were used by the Committee? When were they hired and what role did they play?

- *Committee deliberations and actions*. What additional actions, if any, did the Committee require management to take to control Washington Mutual's significant mortgage-related exposure? We are particularly interested in deliberations and actions with respect to risk assessment, internal valuation models and hedging strategies. When did these actions occur?

We are not seeking an exhaustive set of documentation, but rather a cogent description of specific steps that you, as an incumbent director on the committee responsible for financial risk oversight and management, took to independently and pro-actively protect the interests of Washington Mutual shareholders from excessive exposure to mortgage risk. We have made similar requests to Mr. Frank, and Ms. Pugh.

We look forward to a timely response so that shareholders can properly assess your performance as a director on the company's Finance committee.

Sincerely,

William Patterson
Executive Director

CC: Kerry Killinger