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JPMorgan's WaMu Windfall Turns Bad Loans Into Income (Update2)

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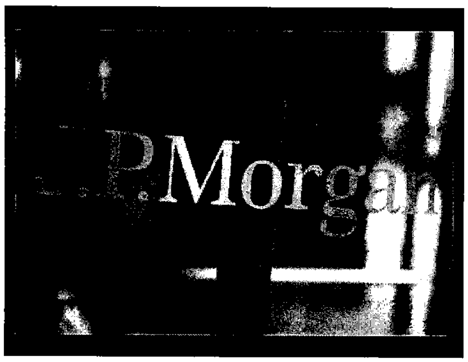
By Ari Levy and Elizabeth Hester



May 26 (Bloomberg) -- **JPMorgan Chase & Co.** stands to reap a $29 billion windfall thanks to an accounting rule that lets the second-biggest U.S. bank transform bad loans it purchased from Washington Mutual Inc. into income.

Wells Fargo & Co., **Bank of America Corp.** and **PNC Financial Services Group Inc.** are also poised to benefit from taking over home lenders Wachovia Corp., Countrywide Financial Corp. and National City Corp., regulatory filings show. The deals provide a combined $56 billion in so-called accretable yield, the difference between the value of the loans on the banks' balance sheets and the cash flow they're expected to produce.

Faced with the highest **U.S. unemployment** in 25 years and a surging **foreclosure rate**, the lenders are seizing on a four- year-old rule aimed at standardizing how they book acquired loans that have deteriorated in credit quality. By applying the measure to mortgages and commercial loans that lost value during the worst financial crisis since the Great Depression, the banks will wring revenue from the wreckage, said **Robert Willens**, a former Lehman Brothers Holdings Inc. executive who runs a tax and accounting consulting firm in New York.

"It will benefit these guys dramatically," Willens said. "There's a great chance they'll be able to record very substantial gains going forward."

JPMorgan rose $2.13, or 6.2 percent, to $36.54 at 4 p.m. in New York Stock Exchange composite trading. Wells Fargo gained 1.3 percent to $25.65 and PNC Financial climbed 5 percent to $43.25. Bank of America fell 9 cents to $10.98.

Purchase Accounting

When **JPMorgan** bought WaMu out of receivership last September for $1.9 billion, the New York-based bank used purchase accounting, which allows it to record impaired loans at fair value, marking down $118.2 billion of assets by 25 percent. Now, as borrowers pay their debts, the bank says it may gain $29.1 billion over the life of the loans in income before taxes and expenses.

The purchase-accounting rule, known as Statement of Position 03-3, provides banks with an incentive to mark down loans they acquire as aggressively as possible, said **Gerard Cassidy**, an analyst at RBC Capital Markets in Portland, Maine.

"One of the beauties of purchase accounting is after you mark down your assets, you accrete them back in," Cassidy said. "Those transactions should be favorable over the long run."

JPMorgan bought WaMu's deposits and loans after regulators seized the Seattle-based thrift in the biggest bank failure in U.S. history. JPMorgan took a $29.4 billion writedown on WaMu's holdings, mostly for option adjustable-rate mortgages and home- equity loans.

'Price Judgment'

"We marked the portfolio based on a number of factors, including housing-price judgment at the time," said JPMorgan spokesman **Thomas Kelly**. "The accretion is driven by prevailing interest rates."

JPMorgan said first-quarter gains from the WaMu loans resulted in $1.26 billion in interest income and left the bank with an accretable-yield balance that could result in additional income of $29.1 billion.

The difference in accretable yield from bank to bank is due to the amount of impaired loans, the credit quality of the acquired assets and the state of the economy when the deals were completed. Rising and falling interest rates also affect accretable yield for portfolios with adjustable-rate loans.

It's difficult to gauge how much the yield will add to total revenue because banks don't disclose the expenses that chisel away at the figure. The income is also booked over the life of the loans, rather than in a lump sum, and banks don't spell out how long that is, Willens said.

Wachovia ARMs

Wells Fargo arranged the $12.7 billion purchase of Wachovia in October, as the Charlotte, North Carolina-based bank was sinking from $122 billion in option ARMs. As of March 31, San Francisco-based Wells Fargo had marked down $93 billion of impaired Wachovia loans by 37 percent. The expected cash flow was $70.3 billion.

The Wachovia loans added $561 million to the bank's **first- quarter interest income**, leaving Wells Fargo with a remaining accretable yield of almost $10 billion.

Government efforts to reduce **mortgage rates** and stabilize the **housing market** may make it easier for borrowers to repay loans and for banks to realize the accretable yield on their books. With mortgage rates below 5 percent, originations surged 71 percent in the first quarter from the fourth, a pace that may accelerate during 2009, said **Guy Cecala**, publisher of Inside Mortgage Finance in Bethesda, Maryland.

Recapturing Writedowns

Wells Fargo, the biggest U.S. mortgage originator, doubled home loans in the first quarter from the previous three months, in part through refinancing Wachovia loans.

"To the extent that the customers' experience is better or we can modify the loans, and the loans become more current, that could help recapture some of the writedown," Wells Fargo Chief Financial Officer **Howard Atkins** said in an April 22 interview.

Banks still face the risk that defaults may exceed expectations and lead to further writedowns on their purchased loans. **Foreclosure filings** in the U.S. rose to a record for the second straight month in April, climbing 32 percent from a year earlier to more than 342,000, data compiled by Irvine, California-based RealtyTrac Inc. show.

The companies bought by Wells Fargo, JPMorgan, **PNC** and **Bank of America** were among the biggest lenders in states with the highest foreclosure rates, including California, Florida and Ohio. Housing prices tumbled the most on record in the first quarter, leaving an increasing number of borrowers owing more in mortgage payments than their homes are worth, according to Zillow.com, an online property data company.

Accretable Yield

"We've still got a lot of downside to work through this year and probably through at least part of next," said **William Schwartz**, a credit analyst at DBRS Inc. in New York. "If I were them, I wouldn't be claiming any victory yet."

PNC closed its $3.9 billion acquisition of National City on Dec. 31, after the Cleveland-based bank racked up more than $4 billion in losses tied to subprime loans. **PNC**, based in Pittsburgh, marked down $19.3 billion of impaired loans by 38 percent, or $7.4 billion, and said it expected to recoup half of the writedown. After gaining $213 million in interest income in the first quarter and making some adjustments, the company has an accretable-yield balance of $2.9 billion.

"We're just being prudent," PNC Chief Financial Officer **Richard Johnson** said in a May 19 interview.

'Huge Cushion'

Johnson said he expects the entire accretable yield to result in earnings. The company has taken into "consideration everything that can go wrong with the economy," he said.

Bank of America, the biggest U.S. bank by assets, has potential purchase-accounting income of $14.1 billion, including $627 million of gains from Merrill Lynch & Co. and the rest from Countrywide. Bank of America bought subprime lender Countrywide in July, two months before the financial crisis forced Lehman Brothers into bankruptcy and WaMu into receivership.

As market losses deepened, Bank of America had to reduce the returns it expected the impaired loans to produce from an original estimate of $19.6 billion.

"The Countrywide marks in hindsight weren't nearly as aggressive," said **Jason Goldberg**, an analyst at Barclays Capital in New York, who has "equal weight" investment ratings on Bank of America and PNC and "overweight" recommendations for Wells Fargo and JPMorgan.

Bank of America spokesman **Jerry Dubrowski** declined to comment.

The discounted assets purchased by **JPMorgan** and **Wells Fargo** make the stocks more attractive because they will spur an acceleration in profit growth, said **Chris Armbruster**, an analyst at Al Frank Asset Management Inc. in Laguna Beach, California.

"There's definitely going to be some marks that were taken that were too extreme," said Armbruster, whose firm oversees about $375 million. "It gives them a huge cushion or buffer to smooth out earnings."

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