Golden West Financial Corp

Earnings Review **BUY**

Equity | United States | Savings & Loans/Thrifts
26 January 2006

Pay-Options Have Real Value; Reiterate Buy Rating

Merrill Lynch

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Market Too Concerned about Deferred Interest; Buy GDW

We remain confident that GDW manages the complexities of the option-ARM product quite well and that it turns the controversial negative amortization loan feature into positives for investors. Investors remain overly concerned that an acceleration of deferred interest could undermine GDW's earnings quality and lead to credit deterioration in the future. We disagree. Deferred interest at GDW does not illustrate the quality-of-earnings issues typical for financial institutions and the current negative amortization increases the effective LTV of a likely subset of loans that negatively amortizing by only 2.5%, by our estimates. We think this is manageable, given GDW's experience and low-LTV portfolio.

GDW reported a 61% increase in deferred interest income QoQ, totaling $448M at quarter-end Q4'05, generating about 9.5% of total interest income. Option-ARM's introduce factors outside the traditional parameters for mortgage lenders, though GDW is probably the most prudent originator of the product with a history of good performance. We think GDW benefits from a perceived quality differential, though based on our conversations, we think many investors continue to misunderstand the product and it special features. We aim to correct this.

Maintain Buy Rating and EPS estimates

We reiterate our Buy rating on GDW shares and maintain our $80 price objective. We think GDW shares warrant a 1x multiple premium to a universe of large-cap financials given the company's low-risk strategy, efficient operating model and strong earnings growth potential. Our $80 target implies a 13x forward multiple to our $6.15 EPS estimate for 2007, which we think will be discounted into GDW shares by late 2006.

Maintain 2006 EPS estimate of $5.40 and 2007 estimate of $6.15, or about 14% growth YoY. In our view, GDW will generate strong asset growth in a market with little or no growth and its earnings could get a favorable tail-wind if short-term interest rates stabilize or fall, which we think could occur in the 2nd half of 2006.

Estimates (Dec)

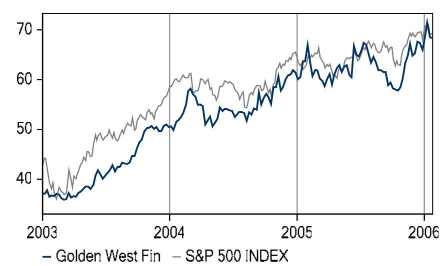
(US$)	2004A	2005A	2006E	2007E	2008
EPS	4.12	4.77	5.40	6.15	– – –
GAAP EPS	4.12	4.77	5.40	6.15	– – –
EPS Change (YoY)	15.7%	15.8%	13.2%	13.9%	– – –
Consensus EPS (First Call: 24-jan-2006)			4.77	5.37	6.08
Dividend Rate	0.21	0.26	0.26	0.34	– – –

Valuation (Dec)

	2004A	2005A	2006E	2007E	2008
P/E	16.6x	14.3x	12.7x	11.1x	– – –
GAAP P/E	16.6x	14.3x	12.7x	11.1x	– – –
Dividend Yield	0.3%	0.4%	0.4%	0.5%	– – –

Stock Data

Price	US$68.32
Price Objective	US$80.00
Date Established	17-Jan-2006
Investment Opinion	A-1-7
Volatility Risk	LOW
52-Week Range	US$55.40-71.46
Mrkt Val / Shares Out (mn)	US$21,328 / 312.2
ML Symbol / Exchange	GDW / NYS
Bloomberg / Reuters	GDW US / GDW.N
ROE (2006E)	– – –
Total Dbt to Cap (Dec-2005A)	41.9%
Est. 5-Yr EPS / DPS Growth	12.0% / 15.0%



Quarterly Earnings Estimates

	2005	2006	2007
Q1	1.12A	1.23E	1.48E
Q2	1.16A	1.31E	1.53E
Q3	1.22A	1.39E	1.56E
Q4	1.27A	1.47E	1.57E

Refer to important disclosures on page 13 to 14. Analyst Certification on page 12. Price Objective Basis/Risk on page 12.

iQprofile℠ Golden West Financial Corp

Key Income Statement Data (Dec)	2004A	2005A	2006E	2007E	2008
(US$ Millions)					
Net Interest Income	2,619	2,935	3,403	3,897	---
Net Fee Income	280	445	413	349	---
Securities Gains / (Losses)	---	---	---	---	---
Other Income	14	11	6	5	---
Total Non-Interest Income	294	456	420	354	---
Total Operating Income	2,913	3,391	3,823	4,251	---
Operating Expenses	(840)	(956)	(1,093)	(1,178)	---
Pre-Provision Profit	2,072	2,435	2,730	3,073	---
Provisions Expense	(3)	(8)	(12)	(14)	---
Operating Profit	2,069	2,427	2,718	3,059	---
Non-Operating Items	---	---	---	---	---
Pre-Tax Income	2,069	2,427	2,718	3,059	---
Net Income to Comm S/Hold.	1,280	1,486	1,679	1,889	---
Adjusted Net Income (Operating)	1,280	1,486	1,679	1,889	---
Key Balance Sheet Data					
Total Assets	106,889	124,615	140,766	148,119	---
Average Interest Earning Assets	92,376	115,467	131,804	142,326	---
Weighted Risk Assets	---	---	---	---	---
Total Gross Customer Loans	102,279	119,050	134,432	141,454	---
Total Customer Deposits	52,965	60,158	68,043	73,168	---
Tier 1 Capital	---	---	---	---	---
Tangible Equity	---	---	---	---	---
Common Shareholders' Equity	7,275	8,671	9,914	11,356	---
Key Metrics					
Net Interest Margin	2.83%	2.54%	2.58%	2.74%	---
Tier 1 Ratio	---	---	---	---	---
Effective Tax Rate	38.1%	38.8%	38.3%	38.3%	---
Loan / Assets Ratio	95.7%	95.5%	95.5%	95.5%	---
Loan / Deposit Ratio	193.1%	197.9%	197.6%	193.3%	---
Oper Leverage (Inc Growth - Cost Growth)	-1.1%	2.6%	-1.5%	3.4%	---
Gearing (Assets / Equity)	14.7%	14.4%	14.2%	13.0%	---
Tangible Common Equity / Assets	0%	0%	0%	0%	---
Tangible Common Equity / WRAs	---	---	---	---	---
Business Performance					
Revenue Growth	15.5%	16.4%	12.7%	11.2%	---
Operating Expense Growth	16.6%	13.8%	14.2%	7.8%	---
Provisions Expense Growth	-71.3%	143.8%	39.9%	20.7%	---
Operating Revenue / Average Assets	3.1%	2.9%	2.9%	2.9%	---
Operating Expenses / Average Assets	0.9%	0.8%	0.8%	0.8%	---
Pre-Provision ROA	2.2%	2.1%	2.1%	2.1%	---
ROA	1.4%	1.3%	1.3%	1.3%	---
Pre-Provision ROE	31.5%	30.7%	29.5%	28.9%	---
ROE	19.5%	18.7%	18.1%	17.8%	---
RoTE	---	---	---	---	---
RoWRAs	---	---	---	---	---
Dividend Payout Ratio	---	---	---	---	---
Efficiency Ratio (Cost / Income Ratio)	28.8%	28.2%	28.6%	27.7%	---
Quality of Earnings					
Total Non-Interest Inc / Operating Inc	10.1%	13.5%	11.0%	8.3%	---
Market-Related Revenue / Total Revenues	0%	0%	0%	0%	---
Provisioning Burden as % of PPP	0.2%	0.3%	0.4%	0.5%	---
NPLs plus Foreclosed Real Estate / Loans	0.3%	0.3%	0.3%	0.3%	---
Loan Loss Reserves / NPLs	0%	0%	0%	0%	---
Loan Loss Reserves / Total Loans	0%	0%	0%	0%	---
Provisions Expense / Average Loans	---	---	---	---	---

Company Description

Golden West Financial (GDW), with over $110 billion in assets, operates World Savings Bank, the third-largest thrift in the US, which is principally involved in retail banking and mortgage lending. The bank's mortgage lending offices are in 35 states and primarily originate adjustable-rate residential mortgages and home-equity loans. Golden West also manages the Atlas family of mutual funds via its subsidiary Atlas Advisers.

Stock Data

Institutional Ownership (Vickers)	76.2%
Average Daily Volume	1,331,656
Brokers Covered (FirstCall)	20

Why We Are Less Concerned over GDW's Options-ARM Product than Others:

Investors remain overly concerned that an acceleration of deferred interest recognition warrants more attention than we do: GDW reported a 61% increase in deferred interest income QoQ, totaling $448M at quarter-end and contributing about 9.5% of total interest income. We think the topic receives more attention than it really should, with respect to GDW, as most of the attention is skewed with a negative bias. Though the option-ARM product does introduce several factors outside the traditional parameters for mortgage lenders, we think GDW is one of the most prudent originators of the product with a long history of good credit performance. We generally think that GDW shares benefit from a perceived quality differential, though based on conversations we have with investors, we continue to think that many investors largely misunderstands the product and how it functions. We aim to correct this.

Deferred interest is caused by rising interest rates and low start rates, both of which auto-correct over a cycle. This cycle appears different than others: Deferred interest, a.k.a. negative amortization, is caused by 2 primary drivers; rising interest rates and teaser start-rates. Interest rate induced deferred in somewhat normal and has a more marginal impact on the magnitude of deferred interest. Teaser-rate induced deferred interest accelerates the deferral at a riskier point in the life of a loan, though is generally balanced with lower original loan-to-values and other mitigating factors. The current lending cycle appears to be emphasizing the latter of the two, which we think has peaked investor, regulatory and the general public's interest in the product and the sales practices behind it.

- **Interest rate induced deferred interest**

First, rising interest rates will generally impact the accrual rate on loans sooner than it will the payment rates on option-ARM loans, causing a timing difference that leads to possible deferred interest. Note rates (accrual rates) generally adjust monthly based on the movement of an underlying index. Payments, on the other hand, adjust on a lag and are capped at 7.5% each year. This difference will cause negative amortization that should reverse, once short-term interest rates stabilize or fall.

Practically speaking, short-term interest rates are cyclical and will generally rise in good economic time or in periods characterized by inflation and will fall when the opposite holds true. To us, this suggests that individual borrowers benefit from this natural cycle, as does GDW. When rates are rising, GDW witnesses increasing asset yields. When interest rates fall, it incurs less credit risk as its customers benefit from payment relief. We think this is a favorable trade-off, in either scenario.

- **Teaser rate induced deferred interest**

Secondly, teaser start rates also cause negative amortization, as the initial loan payment is tied to an artificially low rate relative to the accrual rate. Start rates can often be 2%-4% lower than the initial note rate, leading to immediate negative amortization. This appears to be the more immediate issue and the source of most of the deferred interest recognized in the current environment. The primary loan market has embraced the option-ARM product as the product of choice to <u>sell to borrowers</u> in a market that would otherwise be considered over-banked. The best way to think about this is that lenders can sell a low payment in order to entice borrowers to refinance an existing mortgage. This market dynamic has lead to relatively deep teaser rates, when compared to the fully-indexed rate, causing negative amortization immediately upon origination of the loan. In the current ultra-competitive market, deep teaser rates have been a primary sales tool on the part of many lenders.

Let's consider an example; a newly originated loan with a fully-indexed rate of 6% and a 1% teaser start-rate could generate up to roughly 2.14% of deferred interest in its first year, if the borrower chooses to pay the minimum payment. In a rising rate environment this could increase. For the purpose of this example, we think it is helpful to isolate the neg. am. variables. To put the deferred interest in the context of the additional risk, it is useful to consider the negative amortization impact on loan-to-value (LTV), in our example 2.14%. On an 85% LTV, the adjusted LTV becomes 87.15%. Lenders have to balance the increased LTV risk with property appreciation, borrower quality and behavior, as well as a host of other mitigating factors to determine if the risk is appropriate. Within the context of reasonable LTV loans and good borrower performance, this modest increase in the absolute LTV does not seem to pose much additional risk. In a worst case scenario, the loan will build up deferred interest over a long period of time, forcing the loan to be recast (re-amortized) to paydown normally, or the loan will default and the property sold as an REO. If there is no meaningful property appreciation, then the lender could recognize a reversal of deferred interest & a loss.

- **Different this time, increasing uncertainty and market concerns**

The current environment is different from previous cycles in that mortgage-bankers have gravitated toward originating the option-ARM product, with the newly formed secondary market supporting the favorable pricing mortgage-bankers need to support the mortgage banking model. In short, lenders are encouraged to originate large quantities of low teaser rates loans. General loan quality is a concern, sales practices have peaked regulatory interest and the competitive pricing in the primary market is probably putting too much emphasize on the origination of loans that might otherwise go into another product.

As the above list suggests, most of the attention can be characterized as negative, though one positive from all the attention and the expansion of the secondary market is that the option-ARM market is much larger today than it has been historically. In GDW's case, we think this could play into its strengths. It understands how to originate and service the loan better than most, has stable funding, ample liquidity and a strong origination platform, suggesting that it could capture share if the secondary market evacuates the space or applies higher risk premiums prospectively.

Investors should apply a premium to GDW shares and should not be overly alarmed by GDW's deferred interest income because it is an earning asset, with good asst quality and does not require valuation assumptions: The typical critique we hear from investors regarding deferred interest is that it is lower quality earnings and the valuation for GDW shares should be discounted to reflect this lower quality. *We disagree and think that, in GDW's case, the deferred interest income does not deserve a discount and that GDW shares warrant a premium valuation, in large part, due to the same factors that generate deferred interest income in the first place.* We think that a quality of earnings discussion for financials should focus on 3 topics: whether earnings are recurring or not, subject to reversal and/or subject to management discretion. In each case, we think GDW falls on the favorable side of the argument.

- **Recurring versus non-recurring earnings**

Considering how GDW's deferred interest income is generated and earned, we think it qualifies as recurring. At the point deferred interest income is recognized, it becomes an earning asset that will either be pay down over the course of the loan term, at the option of the borrower or the lender, based on varying circumstances. To the degree that investors credit a *normal* loan portfolio as a recurring revenue source, which we think most do, then deferred interest income should be treated equally. The option-ARM is really no different than a monthly adjustable ARM with a restricted HELOC loan embedded within it. GDW gets the benefit of a first position lien and can manage its interest more aggressively, to the degree it needs to. We don't see HELOC lenders receiving the same scrutiny and we don't think GDW should be discounted for a legitimate earning asset that generates good recurring earnings and is positively correlated with interest rates.

- **Risk of reversal seems quite low**

The potential for GDW's deferred interest income to be reversed is low in our opinion because of strong asset quality and a robust surveillance function. Like any other earnings asset, deferred interest income would only be reversed in a loss scenario, which is the normal risk within the financial services universe, again suggesting that a quality of earnings discount is not warranted. The company maintains prudent lending practices, LTVs remain low and additional credit enhancement all suggest that GDW''s loan portfolio should continue to perform quite well, even if credit deteriorates somewhat from the current position. If the markets witness significant property depreciation, then we still think GDW is a better position than most lenders. In this scenario, we would expect interest rates to fall, providing payment relief to borrowers and reducing GDW's credit exposure. The unique payment stability and visibility provided by the option-ARM product could prove to be a valuable relief valve in uncertain times. We believe this should warrant a premium because it increases earnings stability and asset quality relative to other mortgage products.

- **No management discretion over deferred interest income**

Deferred interest income is generally due to borrower behavior and not subject to management application of questionable valuation assumptions. This is relevant because earnings quality for financial companies is questionable if management uses aggressive assumptions value a series of future "uncertain" earnings, which are sometimes reversed if those assumptions prove to be wrong. This is the general critique for gain-on-sale earnings generated by mortgage companies that capitalize servicing or other residual interests. GDW does not present-value a series of future earnings to recognize deferred interest income, so we do not think it warrants a similar comparison.

The use of Option-ARM products and recognition of deferred interest does not appear to increase inordinately the relevant risks to GDW: Another typical critique we hear with respect to GDW is that the combination of an ARM loan and the negative amortization feature increases credit risk to GDW. Though we can appreciate the origin of this critique, we think that GDW manages its business in a way that the product feature disperses credit risk. This is in part because we think the standard of care use to originate loans at GDW is quite good and because we think its surveillance function mitigates the risk.

Asset Quality Strong: GDW underwrites each loan with the anticipation of retaining the loan on its balance sheet. It uses it own underwriters and its own appraisers to validate borrower capacity and collateral values. GDW further restricts the types of properties and the maximum loan terms to reduce the risk that negative amortization will present a high risk of loss. We think this improves the credit quality of GDW's portfolio over most other lenders.

Surveillance function important: Though $440M of deferred interest seems like a large number, it is likely dispersed over a large pool of loans suggesting less risk concentration than the aggregate number implies. To the degree that individual loans are at risk, on a deferred interest basis, GDW's servicing function monitors the activity, borrower payment behavior and current collateral value and acts accordingly. If loan intervention is requires, GDW is in a strong position to minimize losses, given its 1st lien position.

Regulatory risk seems manageable for GDW: The real outlier, in our view, is how the regulators approach the pending modifications to alternative lending guidelines and how it implements the revised guidance. We think GDW's long history with its regulator and the specific product of regulatory focus will lead to a relatively status quo environment for GDW. This may not hold true for every lender. We anticipate that GDW will provide additional information to the regulatory authorities prospectively and will likely focus its internal efforts on more comprehensive portfolio reviews, but we think a major modification to its business is unlikely.

Roughing Up Some Numbers

Deferred interest generates about 9.5% of interest income: In order to put the issue in context, we think it is helpful to consider some figures to relate the deferred interest issue to GDW's earnings and its balance sheet. As of Q4'05, GDW had $448M of deferred interest income, up from $280M from Q3'05. The net difference of $168M is the net amount recognized in earnings for Q4'05, representing about 9.5% of total interest income.

Chart 1: Deferred interest-to-Loans

	Total Loan & MBS	Loan & MBS Past 18 Mos. w/ Prepays
Total Deferred Interest	$448,816	$448,816
Loan Balance (M)	$119,366	$17,869
% of Loan Balance	0.38%	2.51%

Source: Company filings and Merrill Lynch estimates

Some investors prefer to compare the deferred interest income recognized in the quarter to the net interest income, which is about 22%. We don't think this is the appropriate comparison because considering only the revenue recognition, without the interest expense associated with the earning asset will distort the comparison. We think unfairly. The deferred interest make the loan balance go up and it is financed through normal channels, like any other loan, and it has capital against it. We think a top-line to top-line comparison is fair and accurately captures the impact.

Total negative amortization only 0.38% of total loans & MBS, suggesting it might be immaterial: Given our earlier discussion on what loans are generating abnormally high deferred interest, we think investors should also focus of the aggregate amount of deferred interest relative to the loan portfolio. Against loans, total deferred interest is about 0.38% of total loans and MBS, suggesting a very small amount relative to GDW's $120B loan and MBS portfolio.

Total deferred interest adds only about 2.5% to the overall loan-to-value, an amount that suggests very little in the way of increased risk: After making adjustments to the loan and MBS portfolio to reflect only the subset of loans that we think generates a majority of the deferred interest, we find that the aggregate LTV would go up by a modest 2.5%, as measured by loan-to-value. Considering that GDW's average LTV is less than 70%, increasing the exposure by 2.5% does not appear to increase the credit risk in a meaningful way. This figure will likely rise, based on the dynamic we explained earlier, but we do not think it poses a real challenge to GDW, in the current market.

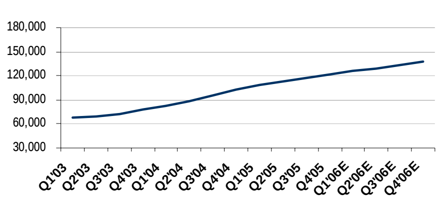
In our view, the more useful comparison is to consider the deferred interest in the context of the loans that actually have negative amortization. Arguably, this metric loses some of its quality because it requires a few estimates to calculate, but it is a useful exercise none the less. We approach the analysis by looking at total volume originated since June of 2004, which is about $84B in loans. Discussions with GDW suggest that this period corresponds to the use of deep-teaser loans to stimulate loan volume. Though the teaser issue may not hold true for GDW, we assume it is competitive on payment rate, or volume would not be as strong as it was. We then apply the prepayment speeds the company recognized over the period to estimate the remaining loan balance that we think could be generating deferred interest, which totals about $18B. Against $450M in deferred interest, this totals an insignificant 2.5% of the *original loan balance*. Given recent appreciation of 14% per year, this still overstates the risk, in our view.

We remind investors that even though the metric suggests little risk at the aggregate, there are likely some loans that GDW is monitoring closely for risk management purposes. This brings us back to the strong surveillance/servicing function that we think GDW maintains, which should limit losses. GDW maximum loss per annum is about 0.18% and it is currently running at roughly 0% net charge-offs.

Q4'05 Earnings Wrap-up

Golden West Financial (GDW) reported Q4'05 EPS of $1.27, $0.03 above our forecast and the consensus estimate: Fundamentals remain strong, though some of the quarterly surprise was 1x in nature, suggesting that the quarter was more "in line" than a "beat". Importantly, asset growth remains strong and seems to have good momentum going into the typically slow 1st quarter. The spurious income statement items that were above or below our estimates appear to be largely explainable and some simple geography, suggesting a cleaner quarter than we first thought, based on the numbers.

Chart 2: GDW Average Earning Assets



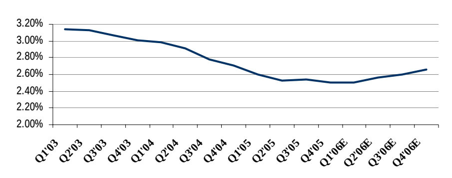
Source: Company filings and Merrill Lynch estimates

Asset growth continues despite the flat yield curve. Loan volumes persist at a healthy pace and could benefit from an expanded market and potential for option-ARM secondary market to contract: Average earning assets grew at an annualized rate of 13.7% to $122B in Q4'05, driven by a continuation of robust lending volumes, which we think reflects GDW's increased investment in its lending platform and a general expansion of the option-ARM mortgage market. As of Q3'05, GDW had grown its full-time FTE's by about 12% annualized, which we think is heavily weighted toward mortgage operations. Lending volume generally trails hiring by around 6 months, so we think that much of the productive capacity is still coming on line and could lead to stronger volumes than investors anticipate, even as lending activity slows in the aggregate. Also, though the flat yield curve suggests that option-ARM activity should face stiff headwinds, which it has in some respects, increased focus by the primary market appears to have grown the total saleable market meaningfully. Though precise figures for the size or growth in the option-ARM market remain elusive, it appears that activity continues to be quite robust, based on our conversation with market participants.

We think this could lead to generally stronger lending volumes for GDW in 2006 and 2007, though there remains a high degree of uncertainty in how the next few years could play out, given the uncertainty in real-estate appreciation, the impact of rising interest rates and possible regulatory changes, all of which could impact long-term results. That said, we think GDW's business model will remain quite viable and could prove stronger than expected, especially if the mortgage secondary markets do not cooperate, which could be a reasonable scenario for a variety of reasons. First, if the securitized option-ARM product that has recently flooded the market proves to be of lower quality than "as expected", the secondary market could evaporate. Second, if short-term interest rate trend lower, then the secondary market appetite for the product would presumably weaken. Third, if credit spreads widen, generally or for specific reasons, the economics to originate option-ARMs for the secondary market may dissipate. In each scenario, we think GDW would be a clear benefactor. It originates for portfolio, so is insensitive to capital market dislocations. It funds via deposits, FHLB advances and Bank Notes, suggesting little in the way of liquidity pressure. It has historically produced the highest credit-qualify assets, suggesting relatively better loan performance if economic factors worsen.

Downside risk if option-ARM market continues to be over-banked and destine for efficient secondary market execution: In our view, the toughest market for GDW is one characterized by markedly lower option-ARM activity, robust secondary market demand for the product in securitized form and aggressive mortgage-banking driven pricing. If this sounds familiar, it's because it's the current environment GDW is contending with today, minus the weak primary-market product demand. GDW has somewhat solved this problem by increasing its production platform. As we mentioned above, GDW's investment activity has been robust, though given the market expansion we think occurred over the past 1-2 years, it's likely that GDW maintains a lower share of the overall market today than it did just 3 years ago. Depending how the market evolves, this could prove to be a positive, or GDW will have to downsize quickly and concentrate on portfolio retention to stem prepays. In this stagnant environment, we think GDW would benefit from higher net interest margins to offset some of the slower asset growth headwinds, which is part of the "secret-sauce" at GDW. It has a particularly stable earnings model under many different scenarios and why we think it deserves a high multiple.

Chart 3: GDW Net Interest Margin



Source: Company filings and Merrill Lynch estimates

Net Interest Margin pressure persists more than anticipated, due to timing impact of borrowing re-pricing and deferred loan cost amortization: GDW reported a 0.04% decline in NIM to 2.50% from 2.54% in Q3'05, versus our forecast of flat NIM QoQ. The variance appears to be due to certain timing issues on the re-pricing of borrowings and higher deferred loan cost amortization than we anticipated. The re-pricing issue stems from a temporary reduction in LIBOR that distorted the re-pricing of certain borrowings, and which we carried forward. Deferred loan cost amortization was driven by the higher prepays witnessed in the quarter, which accelerate the amortization and retards asset yields. Neither subtlety was properly factored into our model.

We think GDW's borrowings will generally benefit from what has been a relatively stable 3-month LIBOR, suggesting that rising asset yields could provide modest NIM support in Q1'06, which we are forecasting to be in line Q4'05, before expanding in Q2'06. However, if the Fed continues to raise rates beyond the 4.5% we anticipate, then margin expansion would likely be postponed to later in 2006 or 2007, depending on the path of interest rates. Also, if prepays remain stubbornly high, it is possible that GDW could witness more amortization-induced margin pressure that is not factored into our forecast.

Robust fee income driven by high prepays and strong origination volume: Interestingly, GDW's lending volume remains largely refinance oriented, though increasingly, lending volumes reflect new loans coming into GDW versus loans refinanced from its existing portfolio. This portfolio dynamic increases prepay and origination fee income and impairs net interest income, due to slower asset growth.

Accounting for deferred comp program resolves 2 issues for Q4'05: GDW's other non-interest income was inflated in Q4'05, relative to previous quarters and our forecast, due mostly to a $6M deferred compensation program that increased non-interest income with a offsetting expense in G&A. Adjusting for the deferred comp. program, non-interest income was in line with our forecast for a $0.06 pre-tax contribution to earnings. Also, the adjustment to compensation expense also explains at least some of the higher cost structure in the quarter than we thought likely, which we think should revert back to more normal levels in 2006.

G&A expenses abnormally high, though 1x charges and investments in platform expansion account for difference: GDW posted higher than forecast G&A, which is uncharacteristic for the normally frugal GDW, though it appears the $6M in deferred comp, discussed above, and higher expansion costs could have inflated the expense base from its normal earnings burden of around 80-82 basis points of assets. Reversing the $6M in deferred comp brings the G&A drag down to about 83 bps from the reported 85 bps, with much of the difference likely attributable to the platform expansion, though we do not have precise figures currently. This should support lending volume in the future.

GDW repurchase program remains active - $32M in Buybacks for quarter: GDW repurchased 560k shares at an average price of $58.44 during the quarter. About 18M shares remain authorized under the current plan. Decelerating asset growth could be the necessary catalyst to accelerate share repurchases, which we have factored into our forecast for 2006, leading to about $400M in capital to be returned to shareholders and contributing about an additional $0.06 to EPS.

Tax provision lower on quarter, likely temporary: The Q4'05 tax provision provided a positive $0.05 EPS surprise to us, based on our 38.5% effective tax rate, though it appears the temporary tax reduction was attributable to year-end tax adjustment, which are unlikely to persist in 2006 and 2007. We think our current estimate for GDW's effective tax rate is a reasonable base moving forward, though GDW does appear to be benefiting from a rotation away from high-tax states. This could be a modest positive, relative to our model, if it continues.

Chart 4: Golden West Financial (GDW) Earnings Model

	2004 A	Q1'05 A	Q2'05 A	Q3'05 A	Q4'05 A	2005 A	Q1'06 E	Q2'06 E	Q3'06 E	Q4'06 E	2006 E	2007 E
Earnings Model												
Net Interest Income	2,618,605	704,564	719,565	747,828	763,114	2,935,071	787,619	830,717	869,008	915,734	3,403,079	3,896,532
Provision for Loan Losses	3,401	884	1,807	2,810	2,789	8,290	2,100	3,000	3,000	3,500	11,600	14,000
Net Interest Income after provision	2,615,204	703,680	717,758	745,018	760,325	2,926,781	785,519	827,717	866,008	912,234	3,391,479	3,882,532
Non-interest Income												
Fees	210,576	63,922	90,195	106,748	109,002	369,867	73,556	78,413	84,899	87,446	324,313	252,318
Gains on Loans & MBS	13,216	1,758	1,847	3,089	3,820	10,514	1,531	1,486	1,609	1,658	6,285	5,253
Non-recurring Gains/Losses	1,141	219	-	-	-	219	-	-	-	-	-	-
Other	68,990	16,714	20,043	19,597	19,182	75,536	21,225	21,901	22,558	23,235	88,920	96,863
Total non-interest income	293,923	82,613	112,085	129,434	132,004	456,136	96,312	101,800	109,066	112,338	419,517	354,434
Total Revenue	2,909,127	786,293	829,843	874,452	892,329	3,382,917	881,831	929,518	975,075	1,024,573	3,810,996	4,236,966
Non-interest Expense												
Personnel	547,432	151,831	159,791	163,189	174,614	649,425	173,869	182,586	187,979	193,535	737,969	791,884
Occupancy	86,117	22,225	22,568	23,730	24,354	92,877	25,660	26,478	27,272	28,090	107,500	117,103
Deposit Insurance	7,068	1,855	1,869	1,857	1,975	7,556	1,985	2,044	2,106	2,169	8,304	8,967
Other G&A	199,509	48,328	54,346	48,606	55,277	206,557	57,023	58,839	60,604	62,422	238,888	260,228
Total non-interest expense	840,126	224,239	238,574	237,382	256,220	956,415	258,538	269,947	277,961	286,216	1,092,661	1,178,181
Net Income before taxes	2,069,001	562,054	591,269	637,070	636,109	2,426,502	623,294	659,571	697,114	738,357	2,718,335	3,058,785
Income tax provision	789,280	213,804	230,840	254,830	240,864	940,338	238,410	252,286	266,646	282,421	1,039,763	1,169,985
Net income before Extra / Acct. change	1,279,721	348,250	360,429	382,240	395,245	1,486,164	384,884	407,285	430,468	455,935	1,678,572	1,888,800
Extra item. / Acct. change	-	-	-	-	-	-	-	-	-	-	-	-
Net Income to Common	$1,279,721	$348,250	$360,429	$382,240	$395,245	$1,486,164	$384,884	$407,285	$430,468	$455,935	$1,678,572	$1,888,800
Earnings per share	$4.12	$1.12	$1.16	$1.22	$1.27	$4.77	$1.23	$1.31	$1.39	$1.47	$5.40	$6.15
Book Value per share (F.D.)	$23.36	$24.33	$25.36	$26.44	$27.68	$27.68	$28.66	$29.73	$30.88	$32.09	$32.09	$37.16
Dividends per share	$0.2100	$0.0600	$0.0600	$0.0600	$0.0800	$0.2600	$0.0800	$0.0800	$0.0800	$0.100	$0.3400	$0.4200
Payout Ratio	5.1%	5.4%	5.2%	4.9%	6.3%	5.5%	6.5%	6.1%	5.8%	6.8%	6.3%	6.8%
Wtd. Avg. shares outstanding (F.D.)	310,565	311,466	311,771	312,174	311,323	311,683	312,724	311,588	310,477	309,466	311,064	307,257
Ratios												
Operational												
Average Earning Assets	92,375,739	108,489,822	113,599,941	117,875,145	121,904,742	115,467,413	126,019,027	129,799,598	133,693,586	137,704,393	131,804,151	142,325,825
Net Interest Margin (E.A.)	11.34%	2.60%	2.53%	2.54%	2.50%	2.54%	2.50%	2.56%	2.60%	2.66%	2.58%	2.74%
Avg. Earning Assets / Avg.Total Assets		98.8%	98.8%	98.9%	98.8%		98.8%	98.8%	98.8%	98.8%		
Loans & Recourse MBS / Total Assets	95.7%	95.1%	95.7%	95.8%	95.5%	95.5%	96.0%	95.5%	95.5%	95.5%	95.5%	95.5%
Profitability												
ROAA	1.37%	1.27%	1.25%	1.28%	1.28%	1.27%	1.21%	1.25%	1.28%	1.31%	1.26%	1.31%
ROAE	19.46%	18.78%	18.59%	18.85%	18.69%	18.73%	17.48%	17.91%	18.30%	18.72%	18.12%	17.77%
Efficiency Ratio	28.8%	28.5%	28.7%	27.1%	28.6%	28.2%	29.2%	28.9%	28.4%	27.8%	28.6%	27.7%
Adjusted Efficiency Ratio	29.0%	28.6%	28.8%	27.2%	28.7%	28.3%	29.3%	29.0%	28.5%	27.9%	28.6%	27.7%
G&A / Avg. Assets	0.90%	0.82%	0.83%	0.80%	0.83%	0.82%	0.82%	0.83%	0.83%	0.83%	0.82%	0.81%
Capital												
Liabilities / Total Assets	93.2%	93.3%	93.2%	93.2%	93.0%	93.0%	93.1%	93.0%	93.0%	93.0%	93.0%	92.3%
Total Equity / Total Assets	6.8%	6.7%	6.8%	6.8%	7.0%	7.0%	6.9%	7.0%	7.0%	7.0%	7.0%	7.7%
Asset Quality												
Non-performing Assets (NPA)	343,790	353,234	330,942	344,204	382,353	382,353	371,004	392,816	417,652	443,624	443,624	466,798
NPA / Loans	0.34%	0.33%	0.29%	0.30%	0.32%	0.32%	0.30%	0.31%	0.32%	0.33%	0.33%	0.33%
NPA / Assets	0.32%	0.31%	0.28%	0.28%	0.31%	0.31%	0.29%	0.30%	0.31%	0.32%	0.32%	0.32%
Allowance Loan Loss (ALL)	290,110	290,192	291,687	293,375	295,859	295,859	296,959	298,959	300,459	302,459	302,459	308,459
ALL / Total Loans	0.284%	0.271%	0.260%	0.253%	0.249%	0.249%	0.240%	0.236%	0.230%	0.225%	0.225%	0.218%
ALL / NPA	84.4%	82.2%	88.1%	85.2%	77.4%	77.4%	80.0%	76.1%	71.9%	68.2%	68.2%	66.1%
Net Charge-offs	(3,734)	(802)	(312)	(1,122)	(305)	(2,541)	(1,000)	(1,000)	(1,500)	(1,500)	(5,000)	(8,000)
NCO / Total Loans (Annualized)	0.00%	0.003%	0.001%	0.004%	0.001%	0.002%	0.003%	0.003%	0.005%	0.004%	0.004%	0.006%

Source: Company filings and Merrill Lynch estimates

Chart 5: GDW Balance Sheet

Balance Sheet	2004	1st Q - E	2nd Q - A	3rd Q - E	4th Q - E	2005	1st Q - E	2nd Q - E	3rd Q - E	4th Q - E	2006	2007
Cash & Securities	1,666,806	2,365,603	1,983,819	1,903,503	2,222,286	2,222,286	1,610,262	1,658,569	1,708,326	1,759,576	1,759,576	1,851,490
Investments	390,070	371,391	352,324	330,891	315,484	315,484	901,746	928,799	956,663	985,363	985,363	1,036,835
Total Loans & Recourse MBS	**102,279,161**	**107,122,433**	**112,393,906**	**116,182,556**	**119,050,445**	**119,050,445**	**123,668,088**	**126,714,703**	**130,516,144**	**134,431,628**	**134,431,628**	**141,453,850**
Other Assets	2,552,504	2,728,422	2,436,365	2,502,861	2,634,645	2,634,645	3,864,628	3,980,567	4,099,984	4,222,983	4,222,983	4,443,576
Total Assets	106,888,541	112,587,849	117,485,678	121,281,406	124,615,163	124,615,163	128,820,925	132,685,552	136,666,119	140,766,103	140,766,103	148,119,215
Deposits	52,965,311	55,593,265	59,226,140	58,429,315	60,158,319	60,158,319	62,333,891	64,187,988	66,089,726	68,042,889	68,042,889	73,168,198
Borrowings	45,683,630	48,003,682	49,175,804	53,240,980	54,549,382	54,549,382	55,740,884	57,398,874	59,099,467	60,846,045	60,846,045	61,543,344
Other Liabilities	964,724	1,411,404	1,147,291	1,340,642	1,236,497	1,236,497	1,798,093	1,851,577	1,906,434	1,962,776	1,962,776	2,051,445
Total Liabilities	99,613,665	105,008,351	109,549,235	113,010,937	115,944,198	115,944,198	119,872,868	123,438,439	127,095,628	130,851,710	130,851,710	136,762,987
Total Stockholder's Equity	7,274,876	7,579,498	7,936,443	8,270,469	8,670,965	8,670,965	8,948,057	9,247,113	9,570,491	9,914,393	9,914,393	11,356,228
Total Liabilities & Equity	106,888,541	112,587,849	117,485,678	121,281,406	124,615,163	124,615,163	128,820,925	132,685,552	136,666,119	140,766,103	140,766,103	148,119,215
Average Balances												
Average Total Assets	93,633,514	109,807,456	114,951,805	119,237,057	123,443,755	116,860,018	126,718,044	130,753,239	134,675,836	138,716,111	132,715,807	144,571,147
Average Total Liabilities	87,057,389	102,388,216	107,195,250	111,127,913	113,488,818	108,923,497	117,908,533	121,655,654	125,267,033	128,973,669	123,451,222	133,944,629
Average Stockholder's Equity	6,576,125	7,419,240	7,756,555	8,109,144	8,461,148	7,936,522	8,809,511	9,097,585	9,408,802	9,742,442	9,264,585	10,626,519

Source: Company filings and Merrill Lynch estimates

Price Objective Basis & Risk

Our $80 Price Objective is based on a 13x forward multiple on our 2007 EPS estimate of $6.15, which we think is reasonable if GDW realizes our estimate for 14% earnings growth. Also, we think GDW shares could continue to receive a nominal 1x multiple premium to the average commercial bank multiple, due to GDW's strong asset generation capabilities and the perceived lower interest rate and credit risk. Large cap. banks long-term forward PE averages about 12.5x, suggesting our 13x target multiple is somewhat conservative. That said, the recent expansion in valuations on the financial stock universe suggests some conservatism may be warranted.

However, financial stocks could continue to fight credit-risk headwinds, limiting the valuation expansion in an environment that might be characterized by falling interest rates, in our view. More specifically, if the Fed lowers rates, due to a perceived weakening in the economy, then we think valuations for financials will generally improve, though concerns over credit may persist, limiting the upside.

Risk to GDW shares and our price objective are rising and/or volatile interest rates, deterioration in consumer credit, material slowdown in housing or residential real estate and disruption in the capital markets.

Analyst Certification

I, Kenneth Bruce, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

iQmethod SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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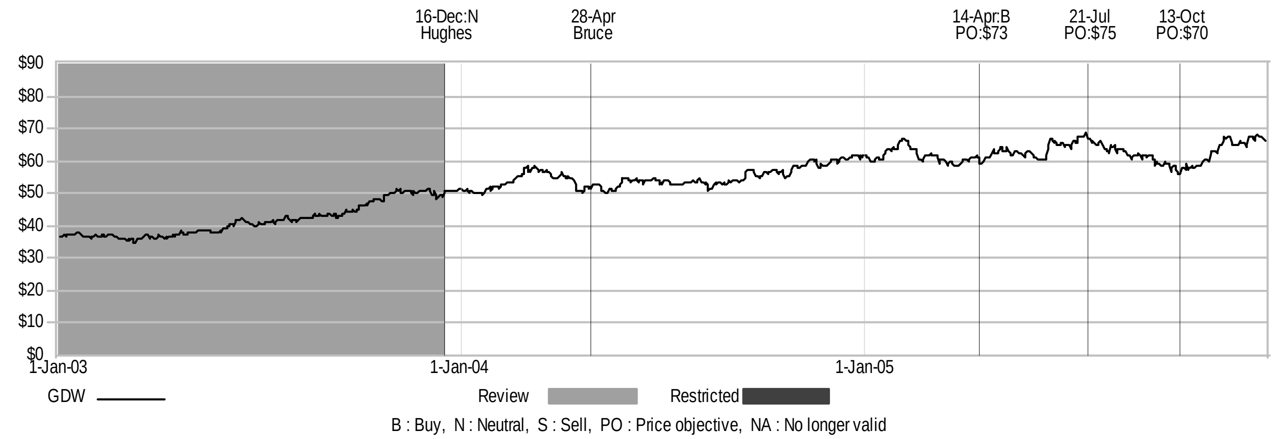
Important Disclosures

GDW Price Chart



The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of December 31, 2005.

Investment Rating Distribution: Financial Services Group(as of 31 Dec 2005)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	81	36.99%	Buy	44	54.32%
Neutral	128	58.45%	Neutral	60	46.88%
Sell	10	4.57%	Sell	2	20.00%

Investment Rating Distribution: Global Group(as of 31 Dec 2005)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1119	40.44%	Buy	376	33.60%
Neutral	1429	51.64%	Neutral	401	28.06%
Sell	219	7.91%	Sell	44	20.09%

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