John McMurray/Managing Directors/CF/CCI
09/07/2007 10:45 AM

To Jess Lederman/Managing Directors/CF/CCI
cc
bcc
Subject Fw: Your Speech / Exceptions /SLDs

----- Forwarded by John McMurray/Managing Directors/CF/CCI on 09/07/2007 10:45 AM -----

John McMurray/Managing Directors/CF/CCI
05/25/2005 02:38 PM

To Nick Krsnich/Managing Directors/CF/CCI
cc
Subject Fw: Your Speech / Exceptions /SLDs

FYI, here's the email Dave referenced at the beginning of Monday's meeting. I would like to have a follow up conversation with you about this. Thanks.

----- Forwarded by John McMurray/Managing Directors/CF/CCI on 05/23/2005 07:48 AM -----

John McMurray/Managing Directors/CF/CCI
05/22/2005 08:50 PM

To Dave Sambol/Managing Directors/CF/CCI@COUNTRYWIDE
cc
Subject Your Speech / Exceptions /SLDs

I really enjoyed the excellent speech you gave on Friday morning in Santa Barbara. Moreover, I want to seek your direction and guidance on several topics which relate to issues you talked about in your speech. One of the topics is outlined here in this email to facilitate a discussion.

In your speech, you described how guidelines and credit standards have become increasingly more aggressive across the industry and here at CW. Since exceptions are generally done at terms even more aggressive than our guidelines, I want to make sure all of the various groups (Production Divisions, Bank, Credit, etc.) are aligned on key SLD/exception issues.

CW's approach to exceptions has been lucrative over the past several years. Given the expansion in guidelines and growing likelihood that the real estate market will cool, this seems like an appropriate juncture to revisit our approach to exceptions and reconfirm where we're comfortable and change where we're not. I would like to supplement my opinions/recommendations on these issues with your guidance.

1. Purpose of SLDs. To ensure that exception policies and processes are properly designed, I wanted to reconfirm the purpose of the SLDs. Here's my current understanding: The purpose of the SLDs is to evaluate credit risk and price "off-menu" transactions.

2. Comfort with Credit Risk. A key alignment issue is our comfort with the where and how of credit risk, especially with respect to exceptions.

a. <u>Use of 2nds Liens as Credit Enhancement.</u> Many of the exception transactions we do are structured as a piggy-back transaction where we're providing a second lien. One advantage of this approach is that it makes the 1st easier to sell. A disadvantage is that we're taking much of the credit risk through our second. Are we comfortable with the current approach where CW takes much of the credit risk on exceptions? Or, should we encourage exceptions to be done as a single 1st lien where we can more effectively sell the credit risk away?

b. R&W Exposure. We've sold much of the credit risk associated with high risk transactions away to third parties. Nevertheless, we will see higher rates of default on the riskier transactions and third parties coming back to us seeking a repurchase or indemnification based on an alleged R&W breach as the rationale. While Credit has taken steps to prepare for this situation, I'm not sure various parts of the company are sufficiently aware or aligned.

c. Security Performance. To the extent our securities contain a greater concentration of higher risk transactions than those issued by our competitors, our security performance may be adversely impacted. The issue here is the extent our concern over security performance drives what we will or won't do on an exception.

d. Optics. Irrespective of whether the credit risk was sold away or appropriately priced for the underlying risk, higher default rates will be controversial and may also lead to "Monday morning" criticism of both guidelines and exceptions. Here the main issue to make sure everyone's aware that we will see higher default rates, especially if the economic environment deteriorates. Your Friday speech was the first time I've heard this topic clearly stated to a large audience.

3. **Approval Standard.** Exceptions can generally be approved using one of three approaches: (1) offset exception items with compensating factors, (2) offset exception items with risk-based pricing, or (3) offset exception items with a combination of both compensating factors and risk-based pricing. The answers to the preceding questions will influence the approval standard we want the SLDs to use. The general standard we use for all loans (that we expect the loan to be paid in a timely manner based on our underwriting) should also apply to exceptions.

4. **Policy and Process Uniformity.** Should we have more than one policy and process for exceptions? Or, should we adopt one uniform methodology to be used across Divisions and Companies (e.g., the same methodology would be used for Bank and non-Bank loans)?

5. **Exception Pricing.** Our pricing models have some inherent limitations which are amplified when used to price exceptions.

a. Distribution of Outcomes. Our pricing generally reflects the mean average outcome. Prices will therefore be inadequate for outcomes worse than the mean. There are at least two alignment issues or questions germane here. One, everyone should be aware of the outcome we're priced to. Two, are there any instances where we should be pricing to a different outcome?

b. Data Limitations. There are at least two key limitations in our data: (1) While we have one of the best data sets in the industry, our data do not include high-stress economic environments; and (2) Models are often used to price transactions (e.g., exceptions) beyond the scope of the data used to estimate the models.

Although the topics I have outlined above are relevant to the scheduled SLD summit, the summit may not be the best setting to discuss these issues. I'll stop by to ask see what you think. Thank you.