FEDERAL RESERVE BANK OF SAN FRANCISCO

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LARGE BANK SUPERVISION
Bank Treasury Bank
Holding Co. [redacted]
Charter # 24141
City, State Thousand Oaks, CA
File # 5 1 DATE 9/19/05

September 8, 2005

Mr. Angelo R. Mozilo
Chairman of the Board of Directors
and Chief Executive Officer
Countrywide Financial Corporation
4500 Park Granada
Calabasas, California 91302

Dear Mr. Mozilo:

During the first half of 2005, we conducted reviews covering certain aspects of Countrywide Financial Corporation's (CFC) market, credit and operations risks. We also reviewed certain areas relative to risk management, inclusive of the following targeted examination areas: corporate-wide risk management, strategic planning, economic capital, and internal audit. Additionally we targeted specific areas of certain operational activities and performed a review of the risk management practices at the Balboa insurance subsidiaries.

At the conclusion of each review, we discussed our findings in detail with the appropriate business line managers and executives including the Senior Managing Director, Enterprise Risk Assessment (ERA) and the General Auditor. This letter provides a summary of our findings and recommendations to date. Consistent with prior years, our supervisory cycle will conclude September 30th, after which we will issue our Annual Report of Inspection to the Board of Directors. This year we will use the new bank holding company rating system.

Risk Management

<u>Corporate-wide Risk Management</u>
During June we conducted a review of the corporate-wide risk management processes at CFC. One purpose was to determine how the company integrates the assessment of its capital adequacy with a comprehensive view of the risks it faces. In this sense, risk management and strategic and capital planning have intertwining goals.

CFC has focused on risk management across the organization in the past year as evidenced by the enhanced staffing within the ERA group, through the creation of executive and operational risk committees, and with an amended compensation program that includes a 20 percent weight for risk management. Also, CFC enhanced its strategic and capital planning programs.

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Management allocated additional resources to Financial Planning/Strategic Planning, converted the strategic planning model to a more risk-based and quantifiable QRM model, and established a group to address economic capital. All the while, management has continued to strengthen the Internal Audit function.

CFC is becoming much more proactive in the area of risk management, but still lags other large banking organizations in some areas, such as economic capital, EVA, and loss database analytics. CFC's growth profile makes having a comprehensive risk management framework essential. And by being the leader in the mortgage industry, it is incumbent on CFC to be a first class corporate-wide risk manager.

Our review noted that Countrywide does not have an independent credit review function. We believe it appropriate to establish an independent credit review function to validate the credit quality and the level of credit risk in line with the board's risk appetite. Risk management processes also could be enhanced with a comprehensive loss history database and robust metrics for economic capital.

Much of our supervisory interest focused on the significant growth and the limit structures. We realize there are a number of initiatives already underway to address growth issues but we are very interested in the company's action plan and timetable to have risk controls well-established ahead of the growth. We also would like to understand how CFC will moderate the growth until this infrastructure is fully functional.

We also are very interested in being apprised of the limits being put into place as the company goes through the development of a comprehensive limit structure. We are particularly interested in the limits for the higher risk assets, including the MSRs, and would like to understand the rationale for the limit levels. President Stanford Kurland is responding to these information requests.

Strategic Planning

As part of the corporate-wide, risk management, multi-exam format we also reviewed strategic planning. Our major objective was to determine how management incorporates risk management and control mitigants into the planning process and to evaluate the reasonableness of the company's five-year plan including growth strategies, accounting for risk, and capital adequacy. The Company has changed its planning organization and methodology since last year, which will enhance the use of scenario analyses and simulation analytics. The company adopted formal written policies for strategic planning as of June 2004. As part of the target inspection, we reviewed the current policy and found it, in general, to be comprehensive.

CFC is projecting rapid growth through 2009. The plan estimates a 5-year CAGR of 22.7 percent. The implication of this is that CFC will be a $400 billion institution by 2009, with a 28 percent share of the U.S. mortgage market. The Company projects a servicing portfolio of $2.1 trillion by 2009.

The Strategic Plan calls for a growth in MSRs and residuals up to $28 billion by 2009. At the same time, equity capital is projected to barely keep pace. The ratio of MSRs plus residuals to capital will continue at nearly 100 percent for the next five years. These factors indicate an increased risk exposure associated with having a nearly one-third market share.

Economic Capital

As part of the Risk Management assessment, we conducted a review of the Economic Capital program at CFC. CFC currently has an adequate capital management program, providing capital for growth, support for risk exposures and margin for uncertainties and complexities of their business. CFC is "well capitalized" under regulatory standards and maintains a capital cushion commensurate with market and management estimates of risk.

For certain business lines, CFC generates an overall economic capital charge that is an amalgamation of all three economic risks. As a result, in certain cases, the economic charge for a specific risk cannot be isolated to a specific risk category. Also, CFC's methodology of allocating capital to certain elements of operational risks cannot be analytically supported.

We suggest management isolate the economic capital charge for each risk and include the results as part of the reporting process to senior management and the board. The economic program that will isolate each risk is in process and the first modeled iterations, although not sufficiently accurate, are a positive step forward. Additionally, as part of the economic capital initiative, management has begun a process to measure operational risk and provide validation for the program consistent with SR 99-18.

CFC meets the general provisions of SR 99-18, regulatory reporting guidelines and their own internal limit parameters. However, as noted in the review, certain elements of 99-18 require enhancement.

Internal Audit

We performed a high level review of the department's organizational structure, roles and responsibilities, staffing, policy and practices, and MIS. We reviewed the activities of the Audit and Ethics Committee (A&E), and met with the A&E Chairman and the General Auditor.

Our review of this function again found that Internal Audit maintains the necessary functional independence; senior Internal Audit management and the A&E Committee actively oversee audit activities; Internal Audit administration is satisfactory; audit policies and procedures provide appropriate structure and guidance; the audit methodology and processes are sound; and Internal Audit MIS is satisfactory for the needs of the unit and the A&E Committee.

The review did not disclose any supervisory issues or concerns and, as a result, there were no formal recommendations or calls for corrective action.

Market Risk

Market risk remains high based on our continuing assessment of market risk factors. In March we conducted a review of compliance with the Market Risk Amendment (MRA) as a follow-up to the February 2004 MRA target examination. As a result of the February 2004 examination, CFC agreed to a plan to comply with MRA VaR measurement requirements. The plan has been met by CFC management.

The BlackRock Solutions (BRS) VaR analytic model meets the minimum qualitative and quantitative requirements of the MRA. Qualitatively, risk management, testing and review programs are adequate for the risk exposure at Countrywide. Quantitatively the BRS VaR model adequately measures risk factors that cover the risks in Countrywide Securities Corporation's (CSC) portfolio. Although more information on the capture of non-linear interest rate risks and model validation is needed, CSC management has established an ongoing dialogue to provide the Federal Reserve more information regarding the technical aspects of the model. Although compliant, management continues to upgrade the VaR, and intends to upgrade the VaR for "specific" risk, compliant with the MRA, which could reduce the level of capital allocation due to lower "specific" risk for CSC.

Operational Risk

Operational risk remains high based on the multiple and interdependent business lines, the large geographic reach, and the strategy of high growth. A number of operational risk target examinations were conducted during the first half of the year. Each is briefly noted as appropriate.

<u>Incident Response - LandSafe</u>
On March 5, 2005, Countrywide Home Loans was notified by the San Bernardino County Sheriff's Department that they had arrested an individual for credit card theft and found in her possession numerous LandSafe credit reports. Examiners performed a review of the "LandSafe" incident. The objectives of the review were to assess the adequacy of CFC's corporate incident response and managerial escalation processes, and to report on CFC's management's initial remedial measures to secure customer information in light of the LandSafe incident that surfaced.

The root cause of the LandSafe incident was the lack of proper information security consideration when the landsafecredit.com portal was developed and the subsequent breakdown in information security monitoring. Both of these are the direct result of Countrywide's decentralized Information Technology management model.

Management should develop a formal, well-defined mechanism by which incidents are classified as to stakeholders and that define the conditions under which those stakeholders will interact to address the issues at hand.

Vendor Management
Examiners performed a review of the vendor management function. The primary objective was to assess Countrywide's vendor risk management practices. In addition to assessing the overall vendor risk management practices, the review had a special emphasis placed on foreign-based technical service providers in the Philippines, Pakistan, and India.

CFC vendor management processes are adequate given the size and complexity of the company. Due diligence requirements for source selection encompass all material aspects of the vendor relationship, such as the provider's creditworthiness, reputation (e.g., reference checks), controls, disaster recovery plans and tests, insurance, communications capabilities, and use of subcontractors. The most recent internal audit of corporate contracts appears to be adequate in scope. Management has been responsive to the findings identified regarding policy enhancements and the vendor site visit program.

Under the Operational Risk framework, we also performed reviews of business continuity, disaster recovery, and the CFC India Services Limited (CFCI) project. There were no material recommendations.

Credit Risk

Credit risk remains moderate based on our ongoing assessment of overall credit risk factors. During the subject period we conducted a review of CFC's subprime lending activities. The primary objective was to assess the level and trend of credit risk to CFC from subprime lending. This assessment included a review of a sample of recently closed subprime loans through various production channels. No grading or underwriting issues were identified that would affect the salability of these loans. From a credit risk standpoint, credit risk is minimal, as most of the credit risk is passed on as loans are sold on the secondary market through securitization or whole loan sales. Internal controls were found to be adequate, with only minimal exceptions.

Insurance

We performed a review of the insurance risk management activities under the Balboa subsidiary operations. The credit risk at Balboa Reinsurance is adequately managed and appropriately monitored. The Balboa Life and Casualty Group (BLCG) is well managed and the risk management policies, practices and procedures are adequate. BLCG is well capitalized and profitable. The group is rated A (excellent) by A.M. Best. Management is strong and has developed a viable strategic plan.

Legal Risk

CFC Legal risk is moderate. The Countrywide organization is attentive to legal risk concerns and applies devices to mitigate and report legal risks that are adequate or better. Tools designed to monitor legal developments, prepare the organization for those developments and ensure that preparations are completed appear to be very effective.

Dialogue between the Legal Division, ERA, Internal Audit, the business units and the Board of Directors and its Committees, all appear to be satisfactory. Formal and informal dialogue appears to be taking place frequently and continually, though this dialogue and the underlying business practices and objectives are not always robustly documented.

As always, should you have questions or comments about these reviews or our supervisory process in general, please contact me at the number below or Robert Speaks at (415) 977-3826.

Sincerely,

Robert C. Johnson
Director

cc: Audit and Ethics Committee
Walter Smiechewicz, Countrywide Financial Corporation
Sherry Whitley, Countrywide Financial Corporation
Jon D. Greenlee, Assistant Director, Board of Governors
James A. Sheerin, Jr., Board of Governors
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