



**Office of Thrift Supervision**  
Department of the Treasury

*West Region*

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December 12, 2007

Board of Directors  
c/o Carlos Garcia, Chairman  
Countrywide Bank, FSB  
4500 Park Granada  
Calabasas, CA 91302

Members of the Board:

On April 2, we began the 2007-2008 annual cycle of the continuous examination of Countrywide Bank, FSB (CWB), and its holding company Countrywide Financial Corporation (CFC). This first annual exam cycle is expected to terminate on March 31, 2008, after which time we will summarize cycle results in an annual Report of Examination, with ratings, and conduct a meeting with the boards of directors.

The continuous examination process consists of ongoing monitoring and a series of four quarterly target reviews covering multiple areas of focus. Our first quarterly target review ("Q2 2007 review") commenced on April 2, 2007, along with the initiation of the annual exam cycle. Our second quarterly target review ("Q3 2007 review") commenced on July 2, 2007. The Q3 2007 review was extended to October 31 because of the market disruption that occurred during the third quarter. The attached limited Report of Examination is our report for both quarterly target reviews. Note that, while ordinarily we would intend to assign ratings in the annual report at the end of the exam cycle, the market disruption had such a significant impact on the Countrywide organization that we determined certain ratings, including the overall composite rating, needed to be assigned immediately. The attached report communicates those ratings.

Note also that this report covers only CWB. A separate report has been issued to CFC's board of directors and covers both CWB and the holding company complex. Although our streamlined examination process provides us the flexibility to examine holding companies and insured institutions concurrently, we generally must issue separate reports, particularly if the reports are issued to the boards of directors and ratings are assigned.

We already discussed the contents of the attached report with executive management in two exit meetings, one on August 7, 2007, covering the Q2 2007 review, and one on November 29, 2007, covering the Q3 2007 review. We expect to meet directly with you during your meeting on December 19. We issued 11 findings memos as a result of our reviews. Management is in general agreement with our findings and has provided us appropriate responses.

Please note that the attached report is the property of the Office of Thrift Supervision. OTS furnishes this document to the institution for its confidential use. Except as provided in 12 C.F.R. Section 510.5, the institution's directors, officers, or employees may not disclose the report, or any portion of it, to unauthorized

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If the institution receives a subpoena or other legal process calling for production of this document, notify the Regional Director immediately. Advise the attorney and, if necessary, the court of the above prohibition and refer them to 12 C.F.R. Section 510.5.

Please review the attached report in its entirety at your next meeting and note your review in the minutes of that meeting. You need not prepare or send OTS a written response to the report.

If you have any questions, please call me at (818) 223-6523. If I am unavailable, please call Assistant Director Steven M. Gregovich at (650) 746-7020 or Regional Director Darrel W. Dochow at (650) 746-7010.

Sincerely,

Lawrence D. Carter  
Examiner-in-Charge

cc: Stan Ivie, Regional Director, Federal Deposit Insurance Corporation



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**REPORT OF EXAMINATION**

**Countrywide Bank, FSB  
Alexandria, VA 22314**

**Docket Numbers:** 18039

**Type of Examination:** Comprehensive Limited (Quarterly Target Reviews)

**Examination Start Date:** April 2, 2007

**Examiner-in-Charge:** Lawrence D. Carter, FTR, CTE II

**Date:** December 12, 2007

On April 2, 2007, the Office of Thrift Supervision (OTS) began its 2007-2008 annual cycle of the continuous examination of Countrywide Bank, FSB (CWB or bank), and its holding company Countrywide Financial Corporation (CFC). This first annual exam cycle is expected to conclude on March 31, 2008, after which time we will summarize cycle results in an annual Report of Examination, with ratings, and conduct a meeting with the boards of directors.

The continuous examination process will consist of ongoing monitoring and a series of four quarterly target reviews. Each target review will cover multiple areas of focus. Our first quarterly target review ("Q2 2007 review") commenced on April 2, 2007, along with the initiation of the annual exam cycle. Our second quarterly target review ("Q3 2007 review") commenced on July 2, 2007. The Q3 2007 review was extended to October 31 because of the market disruption that occurred during the third quarter. This limited Report of Examination is our report for both quarterly target reviews, although it may also discuss subsequent matters if important. Note that, while ordinarily we would intend to assign ratings in the annual report at the end of the exam cycle, the market disruption had such a significant impact on the Countrywide organization that we determined certain ratings needed to be assigned immediately. This Report therefore will communicate examination ratings.

Note also that this Report covers only CWB. A separate report has been issued to CFC's board of directors and covers both CWB and the holding company complex. Although our streamlined examination process provides us the flexibility to examine holding companies and insured institutions

concurrently, we generally must issue separate reports, particularly if the reports are issued to the boards of directors and ratings are assigned.

In addition to following up on the outstanding findings of the Office of the Comptroller of the Currency (OCC) and Federal Reserve (FRB), we performed the following exam work during Q2 and Q3 2007:

- Capital - Assessment of the impact of the market disruptions on CWB and CFC's capital.
- Asset Quality - We conducted reviews in the following areas: (1) single-family lending, including nontraditional mortgages, home equity lending, reverse mortgages, subprime lending, third party oversight (brokers/correspondents), and quality control; (2) commercial real estate and construction lending; (3) LandSafe appraisal operations; (4) real estate owned (REO); (5) CWB's allowance for loan and lease losses (ALLL), with a focus on follow-up on OCC issues; (6) loans-to-one-borrower reporting; and (7) internal asset review. The review also included an assessment of composition and trends, with a focus on assessing the impact of the market disruptions on CWB's asset quality.
- Management - We conducted reviews in the following areas: (1) transactions with affiliates and insiders; (2) tax-sharing agreement; and (3) governance and risk management during the market disruption.
- Earnings - We reviewed the first filing of the Thrift Financial Report (TFR), as of March 31, 2007. We also performed an assessment of the impact of the market disruptions on CWB and CFC's earnings.
- Liquidity and Sensitivity - We focused significant attention on liquidity levels and liquidity risk management at both CWB and CFC. We also performed reviews in varying levels of depth in the following areas: (1) held-for-sale valuation processes; (2) investment securities; (3) mortgage servicing rights (MSR)/residual valuation; (4) repurchase activity and reserves; (5) overview of mortgage banking production activities at Countrywide Home Loans (CHL); and (6) market risk management, including derivatives, hedging, and interest rate risk management.
- Compliance and Fair Lending - We focused on: (1) overall compliance risk management and fair lending, including following up on FRB findings; (2) compliance with lending-related regulations; (3) Electronic Funds Transfer Act (EFTA) compliance; (4) steering; (5) broker compensation; (6) home equity loan finance charges; and (7) compliance with the interagency nontraditional mortgage guidance pertaining to consumer protection.

- Information Technology - Discovery review with focus on understanding structure. More targeted reviews of project management, information security, and authentication in an internet banking environment.

We issued 11 findings memos as a result of our Q2 and Q3 2007 reviews:

1. Earnings – Thrift Financial Report
2. Management - TWA - Dual Officers/Employees
3. Asset Quality - Appraisals
4. Compliance –Single-Family Home Flood Insurance
5. Compliance - Fair Lending Program Review
6. Asset Quality - Interagency Guidance on Nontraditional Mortgage Product Risks
7. IT - Project Management Methodology
8. Compliance – NTM Review – Consumer Protection Guidance
9. Sensitivity - Market Risk Management & Oversight
10. Liquidity - Liquidity Risk Management Practices
11. Liquidity - Investment Securities Portfolio

We discussed our key findings and overall conclusions in two exit meetings, one on August 7, 2007, and one on November 29, 2007. These meetings included executives of both CWB and CFC. Management was in general agreement with our findings and agreed to take appropriate corrective actions within reasonable timeframes.

Our more detailed conclusions, findings, and required corrective actions for the Q2 2007 and Q3 2007 target reviews follow.

### **CWB CAPITAL – “2”**

**Current capital levels are satisfactory relative to CWB’s risk profile and financial condition.** CWB meets the FDICIA “well capitalized” standards. CWB also meets the 7 percent core and 12 percent risk-based capital standards established by a CWB board resolution dated September 24, 2007. A \$1.0 billion cash infusion from the parent in exchange for perpetual preferred stock was necessary to meet the board resolution standards after accelerated funding of loans through the bank reduced capital to lower levels. The parent made this infusion as of September 30, 2007.

Notwithstanding the satisfactory levels of capital, the Tier 1 leverage (core) capital ratio has declined, as shown below.

Capital Measure	3/31/07		06/30/07		09/30/07	
	(000s)	Ratio	(000s)	Ratio	(000s)	Ratio
Tier 1 Leverage (Core)	\$7,634	8.06%	\$7,990	8.00%	\$8,870	7.31%
Total Risk-Based	\$7,927	13.50%	\$8,454	13.66%	\$9,777	13.47%

Source: September 30, 2007 Uniform Thrift Performance Report (UTPR).

Management and the board will need to continuously monitor and assess capital adequacy given the current negative and uncertain market conditions. Should conditions deteriorate, management and the board will need to reassess the need to either reduce risk or increase capital.

Low investor appetite for various non-agency loan products has severely impacted business strategy, future earnings growth, and capital retention. The curtailed growth for certain mortgage loan products limits income generation and will continue to present multiple challenges to management's efforts in providing for capital formation at the bank. With the CHL/CWB integration project underway, the bank is the funding vehicle for loans, with steady but curtailed loan growth projected for the balance of this year and throughout 2008. The current financial forecast (provided to examiners in early November) projects a pattern of moderate income increases, thereby limiting the amount of income that can be contributed to retained earnings for capital growth. The forecast also projects the core capital ratio falling to 7.2 percent, which does not provide much of a cushion above the board minimum. We believe the cushion should be higher.

The bank experienced a third quarter loss of \$328 million, due primarily to higher loss provisioning. The higher provisioning reflects ongoing deterioration in the bank's loan portfolio, particularly within the home equity loan portfolio. To cover a portion of the additional reserves, CHL agreed to reimburse the bank for losses associated with the transfer and reclassification of loans from the held-for-sale (HFS) portfolio to the held-for-investment (HFI) portfolio. This reimbursement took the form of two dividends from CHL to CFC and two corresponding capital contributions from CFC down to the bank. The dividends and corresponding capital contributions were paid on September 7, 2007 and September 30, 2007, in the amounts of \$85 million and \$120 million, respectively, totaling \$205 million.

In compliance with our August 16, 2007, directive letter, the bank is not currently paying dividends. We are concerned, however, that pressure may mount on CWB to pay common dividends to help defray CFC's debt service and other operating costs. CWB projects beginning to pay dividends during the first quarter of 2008, but this will be for the new perpetual preferred stock.

## CWB ASSET QUALITY – “3”

Our Q2 and Q3 2007 asset quality reviews focused first on understanding Countrywide’s lending activities and the infrastructure supporting those activities. We then focused our review on specific areas, based either on our assessment of risk or on regulatory priority. We looked critically at asset portfolio composition and trends, particularly at CWB. This review became more intense as market conditions deteriorated and after the third quarter 2007 market disruption led to the bank funding more of CHL’s loan production. In this latter regard, we attempted to ascertain that CWB executed proper governance in ensuring that the bank only funded assets that met its underwriting guidelines and investment criteria (see also “CWB Management” section of this Report). Finally, we performed limited transaction testing, selecting targeted samples of loans to review.

We determined that asset quality was less than satisfactory at September 30, 2007, and we have therefore assigned a “3” rating to this CAMELS component. This rating is a downgrade from the “2” rating assigned in our September 28, 2007, letter to the bank’s board of directors, and is reflective of ongoing portfolio deterioration and negative and uncertain market conditions. Credit risk management processes have been satisfactory, although we did note some strain on these processes as a result of the market disruption. Management and board reports provide substantive information from which to determine the bank’s credit risk profile. Management also produces sophisticated reporting that properly addresses the complexity of the bank’s lending operations.

### Portfolio Composition and Performance Trends

CWB has operated predominantly as a portfolio lender, originating and retaining in its HFI portfolio 1-4-family first and second lien mortgage loans and securities sourced through CWB’s affiliate, CHL. CHL produces mortgage loans in three production channels: (1) Consumer Markets Division (CMD), the retail channel; (2) Wholesale Lending Division (WLD); and (3) Correspondent Lending Division (CLD). At September 30, 2007, the residential loan portfolio accounted for about 70 percent of CWB’s total assets, with another 15 percent of assets in predominantly non-agency mortgage-backed securities (MBS).

At September 30, 2007, the bank’s HFI mortgage loan portfolio was concentrated in pay option adjustable-rate mortgages (ARMs) (37 percent); hybrid ARMs (20 percent), primarily with a fixed interest-only period; home equity lines of credit (HELOCs) (16 percent); and fixed rate seconds (FRS) (21 percent). Together, these products comprise around 94 percent of the HFI portfolio. The loan portfolio is also concentrated in California, with about 43 percent of the HFI portfolio secured by property located in California. Finally, the portfolio has a concentration in high loan-to-value (LTV) (“reportable”) loans. Management reported that the ratio of reportable loans to total capital just exceeded the 100 percent guideline set forth in OTS Regulations Section 560.101 and Thrift Bulletin No. 72a. Management expects the ratio to reach 145 percent at December 31, 2007, and has requested our nonobjection to the use of a CHL pledged deposit to reduce the exposure.

Portfolio performance has deteriorated rapidly in recent quarters due to both negative market trends and the bank's concentration in products and geographies that have been impacted the most by these negative trends. Although the bank has purchased mortgage pool insurance to mitigate exposure in the highest risk concentrations, the bank does not yet have much history on collecting on the insurance for the pay option pool, the pool with the highest level of delinquency. Furthermore, pool insurers are experiencing their own challenges given current market conditions, thus heightening the risk that these insurers might not perform when the bank needs them most. Delinquencies, foreclosures, and charge-offs, have all increased. The following table shows the significantly increasing delinquency trends in the bank's HFI portfolio from yearend 2006 to September 30, 2007:

<b>Total Delinquency (%)*</b>	<b>12/31/2006</b>	<b>3/31/2007</b>	<b>6/30/2007</b>	<b>9/30/2007</b>
Pay Option	3.49	3.70	5.48	8.03
HELOC Seconds	2.32	2.25	2.97	3.76
Fixed Rate Seconds	1.61	1.42	1.51	2.18
Other First Liens	2.65	2.38	2.74	3.34
<b>Total Mortgage Loans</b>	<b>2.87</b>	<b>2.84</b>	<b>3.69</b>	<b>4.91</b>

\*MBA method

Similarly, the following table shows the increasing loan loss (charge-off) trends in almost all loan portfolios and year-to-date (YTD) dollar losses recorded by the bank:

<b>Annualized Loss Rates (%)</b>	<b>12/31/2006</b>	<b>3/31/2007</b>	<b>6/30/2007</b>	<b>9/30/2007</b>	<b>2007 YTD Losses (\$Millions)</b>
Pay Option	0.01	0.09	0.20	0.33	32
HELOC Seconds	0.34	0.80	1.89	2.86	131
Fixed Rate Seconds	0.14	0.18	0.31	0.50	24
Other First Liens	0.05	0.10	0.10	0.06	10
<b>Total Mortgage Loans</b>	<b>0.11</b>	<b>0.25</b>	<b>0.47</b>	<b>0.71</b>	<b>197</b>

Internal forecasts project further worsening of loan quality within all key loan portfolios through the first quarter of 2008. In particular, September 30, 2007, management reports show total 90+ day delinquencies forecasted to increase from their current level of \$1.3 billion to \$2.4 billion by yearend 2007 and to \$3.4 billion at March 31, 2008.

CWB's product and geographic concentrations have exacerbated the negative performance trends. Much uncertainty remains as to the extent of losses still to be incurred on the various nontraditional mortgage and higher risk loans in the HFI portfolio that were originated prior to the recent period of underwriting guidelines tightening. Specifically, pay option 90+ day delinquencies are forecast to double, from \$0.8 billion at September 30, 2007, to \$1.6 billion by yearend 2007, and to increase further to \$2.3 billion by the end of the first quarter of 2008. Additionally, we have ongoing concerns about the pay option loans originated during 2006 and 2007, which represent over 52 percent of the bank's outstanding pay option portfolio. Due to the generally lower underwriting quality of these vintages, delinquency and loss rates are expected to accelerate as these loans continue to season.



Finally, there is uncertainty regarding the bank's ability to sell loans remaining in the HFS portfolio (\$7.8 billion as of September 30, 2007) due to current market conditions. Already, approximately \$8.4 billion was transferred from HFS to HFI during the third quarter, of which \$3.8 billion met neither the recently tightened underwriting guidelines nor the bank's new HFI investment criteria and were therefore subject to a "make-whole" agreement with the holding company. These loans did, however, meet the bank's HFS guidelines at origination, and a portion (\$0.9 billion) met the bank's HFI criteria at origination. Of the \$7.8 billion in HFS loans at September 30, 2007, approximately \$2.0 billion were non-agency and could prove illiquid. A portion of these were subprime loans originated prior to an August 2007 underwriting guideline change to agency-only subprime origination. If unable to sell, the increased credit exposure of these loans could impact capital, earnings, and liquidity of the bank.

### ALLL

We reviewed CWB's ALLL in both our Q2 and Q3 2007 reviews. We determined that the ALLL was maintained at acceptable levels, but the methodology used to support those levels remained a work-in-process. We also determined that management had taken, or had planned to take, appropriate corrective action to address weaknesses disclosed in the OCC's targeted first quarter 2007 ALLL examination. Corrective actions will ultimately lead to a new model, which is expected to be in place in the first quarter of 2008.

Our Q2 2007 review was primarily a follow-up review of the OCC's first quarter 2007 targeted examination findings of the bank's ALLL process. The OCC review findings included the following Matters Requiring Attention: (1) Model Development and Validation - management needs to further improve the development, documentation, and validation of credit scorecards and default models; and (2) ALLL Methodology - there is no comprehensive ALLL validation process in place. The OCC's criticisms of model development and validation were a continuation of criticisms originated in its June 2005 HELOC examination and its July 2006 Credit Modeling examination.

In its response, management agreed with the findings of the OCC and provided reasonable detail as to completed and planned corrective action. To address the weaknesses in model development and management, management developed and adopted a comprehensive Quantitative Modeling and Model Validation Policy. The newly adopted modeling policy, increased technical resources, and the monthly oversight of the model validation subcommittee will enable more effective management of modeling risk. To address the observation that there is no comprehensive ALLL validation process, management had planned an independent review of processes and controls surrounding the new ALLL model, once it has been developed and installed. This portion of the review is expected to be completed during the first quarter of 2008.

We also assessed the adequacy of the ALLL at March 31, 2007. We reviewed the ALLL Summary Memo for the bank (dated April 10, 2007) from CFO Steve Thompson and EVP Don White, and

supporting analysis addressing the first quarter 2007 ALLL analysis and found it to be supportive of management's decision-making.

Our Q3 2007 review of the ALLL focused on understanding the dramatic increase in provisions for the quarter and again assessing the adequacy of the ALLL. The bank increased reserves by \$738 million for the third quarter of 2007, which resulted in an allowance balance of \$1.082 billion as of September 30, 2007. The significant provision expense resulted from the following factors: (1) rapid asset quality deterioration with continuing negative trends in delinquency and loss rates; (2) management's anticipation of continuing adverse conditions in the real estate market (i.e., further declines in home price values); and (3) management's determination that the existing ALLL calculation methodology was under-predicting actual losses.

Management utilized several new approaches in its ALLL analysis for Q3 2007 because the current model did not adequately forecast expected losses in such a rapidly deteriorating environment. Internal back-testing covering the previous nine-month period demonstrated that actual defaults and foreclosures were increasingly higher than those predicted by the bank's probability-of-default (PD) models. Consequently, results from several new approaches were also considered in the analysis. The approaches used were based on peer averages, industry benchmarks, regulatory classifications, and estimates for five quarters of charge-offs (using three competing models). Anticipated benefits from mortgage insurance were incorporated into the estimates (management believed that the allowance would need to be approximately \$386 million higher without the insurance). Management settled on the results from a revised loan-level model, which incorporated adjusted PD, roll rates and severities using updated delinquency data.

Management established the September 30, 2007, reserve at the top end of the estimated range from its various modeling approaches. Based upon available information and recent portfolio performance (losses of \$172 million were recognized during the six months ended September 30, 2007), the updated reserve balance was deemed reasonable. Although further deterioration in the bank's asset quality is expected going forward, it appears unlikely that losses will escalate beyond the indicated amount within the upcoming year.

#### **1-4-Family Mortgage Lending**

During our Q2 2007 review, we reviewed limited samples of first- and second-trust-deed mortgages originated by CWB during the fourth quarter of 2006 and the first quarter of 2007 in order to get a sense of the quality of file documentation and underwriting practices, and to assess compliance with internal policies and procedures. Most of the loans selected were home equity loans.

Our review resulted in findings similar to those communicated by the OCC in its supervisory letter dated November 14, 2006. One of the OCC's most significant findings was that the borrower repayment capacity was not adequately assessed by the bank during the underwriting process for

home equity loans. More specifically, debt-to-income (DTI) ratios did not consider the impact of principal amortization or an increase in interest.

Countrywide has recently completed systems and process changes to comply with the DTI calculation guidance set forth in both "Credit Risk Guidance for Home Equity Lending" (refer to OTS CEO Letter 222 dated May 17, 2005) and "Interagency Guidance on Nontraditional Mortgage Product Risks" ("NTM Guidance") (refer to OTS CEO Letter 244 dated October 10, 2006).

As a result of the third quarter 2007 market disruption and liquidity issues, CHL significantly tightened its underwriting guidelines and shifted funding of loans in the pipeline to the bank. At the same time, production shifted from non-agency to agency-eligible loans. In order to assess the impact of this decision on the bank's asset quality, we performed a special 1-4-family loan review as part of our Q3 2007 review. This review focused on ascertaining that the loans funded by the bank met the bank's underwriting guidelines and investment criteria and were of sound quality.

Separate underwriting criteria are established by product, origination channel, occupancy status, documentation required, and collateral type. Primary factors for the underwriting decision include FICO score, loan amount, LTV and cumulative LTV (CLTV). Loans must also meet DTI requirements (generally, maximum of 45 percent for FICO score under 660, maximum of 50 percent for score over 660). For most categories, Countrywide has increased the minimum FICO score, lowered the allowable CLTV, and/or decreased the loan amounts. We noted that in many cases Countrywide's underwriting guidelines allow a somewhat lower FICO score if the CLTV is lower, or allow a higher CLTV with a stronger FICO score. Larger loans generally require a lower CLTV and/or a higher FICO score.

Our special Q3 2007 review included transaction testing of a sample of first liens, HELOCs and FRS loans funded by the bank for a three-week period ended September 28, 2007. Loans underwritten and funded after the implementation of the new guidelines complied with the new guidelines. While approval and application of the new criteria is viewed favorably, it is unknown whether new originations will perform better over the long term. Furthermore, with reduced origination volumes, it appears unlikely that these changes will significantly improve overall portfolio performance in the near term.

### **Compliance with NTM Guidance**

During our Q2 2007 review, we performed our initial review of CFC and CWB's compliance with the October 2006 NTM Guidance. We focused on Countrywide's own internal assessment, which identified three gaps related to: (1) qualifying borrowers (DTI ratios), (2) consumer protection, and (3) portfolio and risk management - ALLL and capital allocation. The internal assessment provided did not contain clear action plans, with timeframes, for closing the gaps, and did not clearly address each point in the guidance. We asked for an improved assessment format and supporting documentation in Examiner Findings Memo #6, dated June 26, 2007.

Management agreed with our findings and, in its response to our memo, prepared a more detailed assessment that satisfactorily addressed each point in the NTM Guidance. Additionally, management provided documentation of the key action steps and milestones to address all noted gaps.

We performed additional work in assessing compliance with the guidance during our Q3 2007 review. We noted additional issues related to the consumer disclosures portion of the guidance, and we issued a findings memo (see "CWB Compliance" section of this Report).

We have required management to close all gaps to complying with the guidance by yearend 2007. We will continue to assess compliance with the guidance during this exam cycle and will issue findings memos as we identify issues.

### **Appraisal Operations**

During our Q2 2007 target exam, we conducted a review of LandSafe Appraisal (LSA); a wholly owned subsidiary of CFC that provides collateral valuation services to the bank and external customers through the use of either contracted or staff appraisers and automated valuation models (AVMs). Our review focused on compliance with internal policy and applicable OTS regulations. We also followed up on issues raised by the FRB and OCC, as appropriate. Since Internal Audit had recently completed an enterprise-wide appraisal audit of LSA (report dated May 24, 2007), we also considered the findings of the audit report in our review. Sixty appraisal reports were reviewed in detail, encompassing loans from CMD, WLD, and CLD.

We determined that LSA's operations were generally effective, and that appraisal policies and procedures were substantially adequate. However, we identified two appraiser independence findings that were presented to management in Examiner Findings Memo #3, dated June 26, 2007. These criticisms related to: (1) the owner's estimate of value (OEV) being provided to the appraiser on the appraisal request order form in the CMD channel; and (2) numerous WLD appraisals whereby the appraiser was paid directly by the borrower and not the mortgage broker. These matters were discussed in detail with LSA management. Management disagreed with our finding that the OEV should not be provided to the appraiser, indicating that the overall LSA control structure mitigated any bias risk associated with providing the OEV. Notwithstanding this disagreement, our guidance has consistently required that the OEV not be provided, so we required that the OEV no longer be provided to appraisers. Management has agreed to take action to adjust internal systems to eliminate the provision of OEV to appraisers. Management also agreed to take action to require that borrowers not pay appraisers directly for appraisals.

With respect to prior FRB and OCC examination issues, we determined that: (1) management had developed appropriate controls for the appraisal ordering process; and (2) management oversight of the AVM validation program was adequate. In addition, recommendations from the FRB and OCC reviews either have been implemented or are on schedule to meet established deadlines.

### **Third Party Oversight**

The risk management process to control and monitor the quality of third-party originators is conducted by CHL on behalf of the bank. The bank's Production Vendor Management Program provides oversight in conjunction with this process. We reviewed the approval and monitoring of third-party originators providing loans to CWB, WLD, and CLD.

The approval and ongoing monitoring programs for both WLD and CLD are outlined in their respective policy and procedures manuals, which the bank has adopted. The contents of these policies and procedures provide the foundation for a comprehensive risk management program for approving and monitoring third-party originators. In addition, the documents also outline remediation protocol for those third-party originators with performance and/or financial issues.

CFC's overall risk management and governance practices relating to approving and monitoring third-party originators used by CWB, WLD, and CLD is well-established, with appropriate controls and oversight. The originator approval process is comprehensive and appropriate for the level of exposures contemplated for each of the proposed originators. Monitoring focuses on the financial strength of the originator and includes a continuing review of the performance of the loans. Management is proactive in addressing weaknesses disclosed during the ordinary course of business or through the audit and oversight process. CLD has recently devoted additional resources to a special group charged with mitigating losses from correspondent lenders who are winding down their operations. Some of these correspondent lenders have recently run into serious financial difficulties, and others are closing down operations for other reasons, including the current difficult market conditions.

### **REO Operations**

We reviewed REO operations as part of our Q2 2007 review. We determined that CFC and the bank's accounting for REO properties was in compliance with regulatory requirements. Additionally, CFC had adopted an efficient acquisition, management and disposal process for REO.

CFC's REO/Real Estate Management (REM) department administers REO properties for investors, CFC, and the bank, and is responsible for securing, processing, administering, marketing and liquidating REO assets acquired through foreclosures, bankruptcies and repurchases. The bank's Servicing Vendor Management (SVM) group oversees the servicing activities performed by CHL, including all aspects of the servicing process, with emphasis on collections and default-related activities affecting the bank's portfolio.

Internal Audit reviewed CFC's REO/REM department and issued a report dated April 30, 2007. The report noted that CFC's Corporate Accounting Department had self-identified the need to modify existing systems and procedures related to the recognition of expenses for administering and

marketing REO properties. In addition, Internal Audit noted that CFC's REO/REM policies and procedures for administering and monitoring REO properties were outdated, incomplete or non-existent. Corrective actions listed in the report were to be fully implemented by the end of the third quarter of 2007.

Our review of the bank's March 31, 2007, TFR disclosed that REO was not classified "Substandard". This deficiency was presented in a findings memo (see "CWB Earnings" section of this Report). Management has agreed to begin classifying REO as Substandard.

### **Commercial Lending**

We reviewed the activities of the Commercial Real Estate Group (entirely multifamily lending) and the Builders Finance Group (construction and land loans) as part of our Q3 2007 target review. Activities of both groups were launched during 2007, and the outstanding portfolios were relatively insignificant in size (unpaid principal balances at June 30, 2007, totaled \$47.6 million and \$166.0 million for multifamily and construction/land loans portfolios, respectively).

We reviewed the adequacy of policies, procedures, and controls. We also performed transaction testing (included nine Commercial Real Estate Group loans and seven Builder Finance Group loans) to determine compliance with policies and procedures. No critical deficiencies were noted. Underwriting practices were determined to be satisfactory.

Additionally, our sampling (encompassing multifamily, construction, and land development loans) included a review of appraisal reports for compliance with OTS appraisal regulations, Uniform Standards of Professional Appraisal Practices (USPAP), compliance with bank policies, and for reasonableness of value. Overall, the commercial and builder appraisal operations are satisfactory. Policies, procedures, and internal controls are adequate. Appraisal quality is satisfactory, and value conclusions are reasonable and adequately supported.

### **Miscellaneous**

- **Reverse Mortgages Program**

The bank began funding reverse mortgage loans in October 2006. During 2006, the bank originated approximately \$27 million of these mortgages, but this business is expected to expand substantially. The two reverse mortgage products offered by the bank are the FHA/HUD Home Equity Conversion Mortgage (HECM) and the proprietary Simple Equity (SE) Reverse Mortgage.

Our Q2 2007 review of this program determined that adequate policies for underwriting the reverse mortgage loan had been adopted. In addition, no serious deviations from policy,

regulation, or procedures were detected in both our limited sampling review and internal quality control audits.

- Internal Asset Review (IAR)

Our Q3 2007 review of CWB's IAR function determined that the IAR process was mostly delinquency-driven, due to a concentration in 1-4-family loans. Management is in the process of implementing written IAR policies and procedures for the review of the bank's nonhomogeneous loans (multifamily, construction, land and commercial loans). The IAR policy (namely, the "Commercial Credit Review Policy") was in draft form as of the date of our review.

We provided management a list of recommendations for improvement of the draft Commercial Credit Review Policy and discussed those recommendations with management during our review. Management agreed to implement our recommendations. We were advised that the revised Commercial Credit Review Policy would be presented to the Credit Review Committee and the board of directors for final approval by October 30, 2007.

- Quality Control (QC)

During the Q3 2007 review, we reviewed the bank's QC structure, QC's policies, procedures and audit programs, and Internal Audit's latest review of the QC process (dated July 31, 2007). We determined that the QC organization framework was appropriately independent from those areas it audited. In addition, we determined that QC policies, procedures, and audit programs were adequate to monitor loan origination underwriting, compliance matters, and servicing activities. Finally, we noted that review results were generated and presented in regular reports to management, and that those reports were appropriate in terms of focus and content.

- Loans to One Borrower (LTOB)

We reviewed internal LTOB reporting as of June 30, 2007. Our review determined that the bank had implemented adequate policies and procedures to monitor LTOB exposure. No violations were noted.

- Full Spectrum Lending (FSL)

Disruptions in the marketplace and bank management's subsequent decision to curtail the already minimal subprime lending activities and reduce FSL staff led us to curtail our review of FSL. Just the same, our limited review of FSL's subprime lending operations, processes, and controls disclosed no material concerns.

### **Corrective Action Required:**

Implement the corrective actions agreed to by management in its written responses to Examiner Findings Memos #3 and #6. Copies of all the examination findings memos, and management's responses, can be obtained from Enterprise Risk Assessment (ERA).

### **CWB MANAGEMENT – “2”**

CWB management and board performance has generally been satisfactory. Bank policies, procedures, controls, and risk management practices for the areas we reviewed were generally adequate, although we noted that liquidity risk management practices needed improvement. The recent disruptions in the mortgage market posed serious strategic and operational challenges to the bank's board and executive management, and they are now working to reposition the bank on a sound footing. The bank's leadership has worked closely with holding company leadership to ensure the long-term viability of the company as a whole.

### **Governance**

During our Q3 2007 review, we focused our attention on assessing governance during a time of market turmoil. Decisions to accelerate integration plans and fund higher risk loans out of CHL's pipeline tested bank board governance and fiduciary responsibilities during the recent market disruption. We found that risk management practices and decision-making during this period were generally satisfactory. We did, however, note weaknesses in liquidity risk management practices, which were communicated to management in a findings memo (see "CWB Liquidity" section of this Report). We also noted that the bank ended up with some loans in its HFI portfolio for which it did not have an investment appetite prior to the disruption. These loans accumulated in the bank's HFS portfolio until such time as a decision was made to transfer them from the HFS to the HFI portfolio. Although the bank performed an analysis prior to the transfer decision, and the parent will "make the bank whole" for the economic losses associated with these loans, the risk inherent in the bank's portfolio still increased as a result (see "CWB Asset Quality" section of this Report).

As the bank undergoes the planned integration of CHL into the bank, as well as changes in business strategy, there will be increased reliance on various governance committees to ensure that the existing framework keeps pace with all of the strategic and operational changes. Alignment of the bank and CFC boards and committees are proposed as part of this process. Phase I of the integration project is to occur in January 2008. The planned integration will require careful attention and implementation to ensure the safety and soundness of the bank. All existing and proposed transactions with affiliates must be thoroughly analyzed to make sure that the interests of the bank are protected. Careful attention will need to be paid to ensuring separation of boards and committees and reducing the potential conflicts of interest that invariably arise when executives must wear "two hats."



We are concerned with the potential for Countrywide to compromise its controls, systems, and processes as it “right-sizes” and integrates CHL into CWB in the current difficult environment. Layoffs and cost-cutting measures in risk management areas could lead to material weaknesses in the operational and oversight areas of the bank. The expedited integration of CHL operations into the bank has already stressed the bank’s financial condition, and further stress is possible as integration is completed in coming quarters.

### **Transactions with Affiliates (TWA)**

Our Q2 2007 review included an assessment of the management of TWA between the bank and its various holding company affiliates. The objective of our review was to evaluate the effectiveness of policies, procedures, monitoring systems and controls in identifying and accurately reporting TWA and insider transactions (12 C.F.R 563.41 and 563.43), and to ensure compliance with Regulation W and Sections 23A and 23B of the Federal Reserve Act and Regulation O (12 C.F.R. Part 215). Our assessment also encompassed a review of the dual officer/employee relationships and cost allocation processes established as part of the CWB/CFC/CHL integration to determine if appropriate policies, procedures, agreements and controls had been established to govern this activity. We also reviewed the tax-sharing agreement and inter-company tax allocation process for compliance with the “Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure” (November 23, 1998).

Overall, we found a comprehensive risk management framework had been implemented to ensure compliance with laws and regulations pertaining to TWA. Policies and procedures provide for effective monitoring and reporting. Affiliate transaction reporting provided to senior management and the board is accurate, and supervision over affiliate transactions is considered effective. Those affiliate transactions tested during the Q2 2007 review were priced appropriately, adequately documented in agreements, and supported by current cost or market information. The tax-sharing agreement conformed to the interagency guidance.

Our review disclosed, however, that only limited written documentation had been implemented to support the dual officer/employee relationship between the bank and applicable affiliates. Examiner Findings Memo #2, dated June 25, 2007, noted that continued efforts were warranted to ensure that procedures, legal agreements and controls are in place that supports the dual officer/employee relationship. This includes implementation of dual officer/employee procedures, execution of applicable employee services agreements between the bank and applicable affiliates, execution of relevant dual officer employee agreements, and documentation of an approved cost allocation methodology. Management agreed with the examination finding and will continue to fully complete the required documentation.

During Q3 2007, we performed an additional targeted review of TWA as a result of the market disruption. The bank entered into two separate covered transactions with extensions of credit to CHL and CFC. Structured as a reverse repurchase facility, the bank extended credit in the form of a repo

line totaling \$800 million to each entity within the allowable limits of Section 23A. Both lines are collateralized by one-time-close loans and HELOCs under the terms of the respective Master Repurchase Agreement, and the interest rate charged on the transferred funds is based on monthly LIBOR plus 25 basis points in compliance with Section 23B. In both respective Agreements, CHL and CFC have agreed to an over-collateralization amount equal to 130 percent of the credit line to comply with Regulation W. We determined that the documentation records and reports prepared to monitor these transactions were acceptable.

**Corrective Action Required:**

Implement the corrective actions agreed to by management in its written response to Examiner Findings Memo #2. Copies of all the examination findings memos, and management’s responses, can be obtained from ERA.

**CWB EARNINGS – “3”**

Earnings need improvement. Severe disruptions in the capital markets, negative asset quality results, and loan portfolio valuation adjustments significantly hampered bank earnings for the third quarter 2007. The bank reported net losses of \$328 million for the quarter. YTD September 30, 2007, earnings of \$176.7 million generated a return on assets of just 0.22 percent. Third quarter losses were due to higher reserve provisioning that reflected deterioration in the bank’s loan portfolio. Key earnings component trends are shown below:

	YTD 9/30/07	Q9/30/07	Q6/30/07	Q3/31/07
IEA Yield	6.95%	6.95%	6.99%	6.89%
Cost of Funds	5.13%	5.04%	5.25%	5.12%
Net Interest Spread	1.81%	1.92%	1.74%	1.78%
Net Interest Margin	2.16%	2.04%	2.15%	2.33%
Noninterest Income	0.79%	0.42%	0.86%	1.19%
G&A Expense	1.26%	1.51%	1.17%	1.05%
Noninterest Expense	1.28%	1.53%	1.19%	1.06%
ROAA	0.22%	-1.09%	0.73%	1.32%
ROE	3.00%	-15.83%	9.64%	16.78%

Source: CWB September 30, 2007 Uniform Thrift Performance Report (3-year and 5-quarter)

There is significant uncertainty at this point in time as to the potential for further asset quality deterioration, which could result in additional unexpected levels of provisioning. Recent liquidity issues impacting Countrywide led to increased borrowings at CWB through the FHLB, and an increased nationwide deposit-gathering campaign through the creation of new financial centers and the offering of premium deposit rates. These activities, along with the issuance of preferred stock, are expected to result in increased expenses for the thrift. The integration of CHL into the bank will cause general and administrative expenses to increase as the bank will be required to take on additional personnel, operations, and processes. The impact of these costs will further strain earnings.

As part of our Q2 2007 review, we assessed the accuracy of CWB's completion of its first TFR as of March 31, 2007. Our scope focused on the process (degree of automation), systems and controls (oversight), accuracy of information, and quality of supporting documentation for the preparation of all TFR schedules except the Consolidated Maturity and Rate (CMR) schedule, which was not to be prepared until September 30, 2007.

We found the process, systems, and controls established for the preparation of the bank's TFR to be satisfactory. Countrywide has implemented an automated process that greatly facilitates the filing of these various schedules. Our review disclosed inaccurate entries for certain line items in various schedules. Our review also disclosed that REO was not reported as "Substandard." These items were communicated to management in Examiner Findings Memo #1, dated June 25, 2007. Management agreed with the findings, and procedures were to be updated in June 2007 to reflect the correct mapping of all items noted. Additionally, management agreed to update the Accounting and Credit procedures to ensure all nonperforming assets were classified Substandard in the June 30, 2007, and subsequent TFRs.

**Corrective Action Required:**

Implement the corrective actions agreed to by management in its written response to Examiner Findings Memo #1. Copies of all the examination findings memos and management responses can be obtained from ERA.

**CWB LIQUIDITY – "3"**

Liquidity and funds management practices need improvement. CWB's level of liquidity underwent significant stress during the third quarter as the secondary mortgage market disruption prompted the necessity to move virtually all mortgage production from the holding company into the bank. Initially, the bank had insufficient levels of committed contingent funding. Management was able to confirm certain existing lines and acquire a new line for the bank, and is in the process of ensuring unfettered access to portions of two lines negotiated at the holding company level. As such, the contingent funding should be sufficient. However, the bank remains heavily reliant on FHLB advances and needs to better diversify funding sources. We also found that contingent funding sources were obtained at a relatively high cost, due to the continuing market disruption. We determined that funds management practices needed improvement. Our recommendations in this area included improvements in the bank's contingent funding plan and analysis, and augmentation of policy limits.

As part of our Q3 2007 review, we conducted a review of CWB's liquidity position and liquidity risk management practices. In particular, the stability and nature of the thrift's deposit base and other funding sources were reviewed, as well as the thrift's contingent funding capacity. The impact of CFC on the thrift's liquidity position was also reviewed. The liquidity risk management review also

included a review of the thrift's contingent funding plan, liquidity policies, and liquidity risk limits. We also performed a review of investment securities policies, procedures, and practices.

CWB's stressed liquidity position was primarily the result of the recent severe disruptions in the mortgage market and the corresponding adverse impact on bank affiliates, CFC and CHL. To relieve some of the liquidity pressure on CHL, the bank agreed to accelerate its plans to fund and portfolio a greater percentage of CHL's loans, including those loans in the pipeline that could no longer be sold or financed on reasonable terms. CHL production running through CWB increased from approximately 50 percent, to nearly 100 percent beginning in early September 2007. CWB also encountered its own ratings downgrades, a loss in fed funds borrowing capacity, and negative press and analyst attention, the latter of which was allegedly responsible for a brief deposit run in mid-August.

At the same time a decision was made to fund more through the bank, CHL underwriting guidelines were tightened to constrict total loan production volumes and shift production mix towards readily salable, agency-eligible product. Currently, approximately 80 percent of production is agency-eligible product.

The market disruption led to an increased reliance on FHLB advances, which are now in excess of 40 percent of assets, relative to previous operating levels of approximately 30 percent. Our understanding is that terms of CWB's advance line agreement with FHLB-Atlanta require a composite rating of "2" or better to maintain the current 50 percent-of-assets limit. Failure to maintain a "2" composite could result in the advance line being reduced. As a result, the bank is already attempting to reduce its reliance on FHLB borrowings back down to more palatable levels.

We understand the company as a whole, and CWB independently, has been working diligently to strengthen liquidity and reassess practices and governance. Although progress is being made, we believe that management needs to continue to focus on a combination of the following: (1) looking for opportunities to diversify funding sources; (2) working further towards reducing the current reliance on FHLB borrowings; and (3) improving the bank's liquidity contingent funding plan, including augmentation of measures and limits.

We note that our component rating is an upgrade from the "4" rating assigned in our letter dated September 28, 2007. This upgrade is premised on CWB and CFC completing the documentation and structural changes necessary to make sure CWB has unfettered access to its portions of the Lehman and Greenwich contingent liquidity lines currently in the name of affiliates.

### **Quantitative Considerations**

CWB ALM policy specifies the use of the following metrics, targets, and limits to monitor liquidity risk:

- Cash Flow Coverage Ratio<sup>a</sup> – Target of  $\geq 1.0x$  with a minimum of 0.50x
- Liquid Asset Ratio<sup>b</sup> – Target of  $\geq 2x$  with a minimum of 1x

Trends in these measures over time show the impact of the liquidity event, particularly in August. Further, utilization of FHLB advances has increased significantly. Changes in measures and FHLB utilization are shown below:

2007	Jan	Mar	Jun	Jul	Aug	Sep	Oct
Cash Flow Coverage Ratio	1.52	1.70	1.39	1.43	1.34	1.55	1.76
Liquid Asset Ratio	8.84	8.77	11.28	8.10	4.78	10.37	9.86
FHLB Utilization (50% of assets maximum)	31.0%	27.7%	28.5%	33.4%	44.9%	43.6%	41.4%

Although the bank uses the two liquidity ratios above as its key liquidity measures, it also performs a number of pre-defined stress scenarios to assess contingent funding capacity under these stress scenarios. The examiners reviewed an ad hoc stress analysis dated September 24, 2007, showing the impact on bank contingent funding of a specified liquidity stress scenario. The analysis showed that CWB required approximately \$18 billion in liquidity and funding capacity in order to cover potential cash demands in a stress scenario. This stress scenario assumed run-off of uninsured deposits, exit of principal and interest (P&I) escrow deposits and a loss of 50 percent of large commercial deposits.

While management's analysis showed that more than sufficient liquidity was available to meet the \$18 billion in cash and funding needs as a result of the stress scenario, management's analysis included certain contingent funding sources as available to the bank, but did not fully consider correlations of funding needs between the holding company, its affiliates, and the bank. As a result, we concluded that a material amount of additional contingent liquidity was required. This conclusion contributed to our decision to assign a Liquidity rating of "4" on September 28, 2007, and to assign a bank composite rating of "3." We communicated our conclusions and discussed the analytical deficiencies with management during the examination and summarized them in our September 28, 2007, letter and Examiner Findings Memo #10, dated November 7, 2007.

We did note that management was in the process of renegotiating certain lines (Park Monaco) and seeking additional funding directly for the bank (Bank of America line), among other efforts. Management successfully finalized both Park Monaco and the Bank of America line, which helped to mitigate our initial concerns regarding contingent funding sources. Bank management continues to work on an arrangement with Lehman and Greenwich whereby the bank would have unfettered access to at least a portion of these holding company contingent funding sources. Bank management has also worked aggressively to grow retail deposits through competitive pricing, enhanced

<sup>a</sup> Cash Flow Coverage Ratio = (Excess collateral + 2 mos. Paydowns + 25% wet loans + 2 mos. Agency loan sales + cash & short-term investments)/(2 mos. Maturing deposits + 2 mos. Unsecured maturities + 1.5 mos. Production) Note: This formula reflects the October revision.

<sup>b</sup> Liquid Asset Ratio = (Excess Collateral + Cash + Rev Repo + Fed Funds Sold)/(Fed Funds Purchased + 30 days Retail & Broker Deposit maturities)

marketing efforts and expansion of its financial centers. Management has also been moving forward with efforts to establish a covered bond facility.

### **Qualitative Factors**

Overall, our review of funds management practices disclosed the following areas in need of improvement:

- Contingent Funding Capacity Analysis (discussed above)
- Contingent Funding Plan
- Liquidity Risk Management Policy Limits

The focus of the findings included enhancing the present contingent funding plan to establish:

- levels or staging of the liquidity event
- triggers for each level or stage
- measures
- management responses
- reporting
- limits on stressed cash flow

Details of findings and required corrective actions were provided to management in Examiner Findings Memo #10. Management agreed to implement appropriate corrective actions.

### **Investment Securities Review**

Our review of investment securities resulted in two findings, the most salient being the need to acquire three or more independent third-party marks for the available-for-sale securities portfolio. These findings were communicated to management in Examiner Findings Memo #11, dated October 29, 2007. Management agreed to implement appropriate corrective actions.

### **Corrective Action Required:**

Provide evidence to the OTS that CWB has unfettered access to the Lehman and Greenwich lines at the holding company. CWB should be a named party to the agreements, and the bank's board should have the ability to prevent affiliates from using CWB's portions of the lines. Controls should also be in place to ensure that CWB collateral is not used to support affiliate borrowing under the lines. Implement the corrective actions agreed to by management in its written responses to Examiner Findings Memos #10 and #11. Copies of all the examination findings memos, and management's responses, can be obtained from ERA.

## **CWB SENSITIVITY – “2”**

CWB's market risk sensitivity is adequately controlled. CWB's measured interest rate risk (IRR) exposure is minimal, and market risk management practices are satisfactory for the size, complexity, and market risk accepted by the institution.

During our Q3 2007 review, we assessed CWB's policies, procedures and practices in the area of asset/liability management to determine:

- Compliance with Thrift Bulletin 13a (TB 13a)
- Prudence of IRR risk limits
- Compliance with IRR risk limits
- The level and trends in IRR

We also performed a broader-based review encompassing market risk management practices at both CFC (and its affiliates) and CWB. Our scope included a review of CFC and CWB's Asset Liability Management (ALM) Policy, risks and controls, and the analytical models/systems used to measure, monitor, control, and report risk exposure. As a result of this review, we issued Examiner Findings Memo #9, dated November 1, 2007, to CFC communicating actions CFC should take to improve its practices.

Results from CWB's internal IRR model and the OTS Net Portfolio Value (NPV) model at September 30, 2007, both indicate minimal exposure to IRR. Management closely monitors the asset/liability mix of CWB's balance sheet and match-funds assets and liabilities to minimize potential maturity mismatches. Although CWB's affiliate, CHL, has a large and volatile MSR asset, the market risk associated with this asset is borne and managed by the affiliate. Similarly, market risk associated with the bank's mortgage pipeline and inventory is managed at CHL, with IRR borne by CHL. Management's current plans call for allowing the servicing portfolio to run off over time at CHL and to begin retention of servicing at CWB. This process will likely evolve over some time; current levels of MSR at the bank are de minimus.

### **Corrective Action Required:**

To the extent CFC market risk functions impact or will be integrated into the bank, bank management and the board should stay abreast of the holding company's responsiveness to Examiner Findings Memo #9. Copies of all the examination findings memos, and management's responses, can be obtained from ERA.

## CWB COMPLIANCE – “2”

We performed sufficient work during our Q2 and Q3 2007 reviews to determine that CWB is in an adequate compliance management position.

CWB has its own compliance program and staff; however, most of the compliance resources are maintained within CFC Central Compliance. Although the bank funds the majority of the loans for CFC, it relies on the Central Compliance fair lending and quality control departments to perform testing of the lending-related regulatory requirements.

The scope of our Q2 2007 review consisted of a risk-focused assessment of the compliance program at the enterprise level. This program impacts the bank as described above. It will have additional impact on the bank as the organization becomes more “bank-centric.” Therefore, bank management should be aware of the results of this review. Our review focused on:

- An assessment of management’s responsiveness to the FRB’s recommendations made in their March 1, 2007, exit memo to CEO Mozilo
- A limited validation of the holding company’s mortgage quality control process to determine the reliability of the work performed in the area of lending compliance
- An assessment of the holding company’s fair lending program to determine the reliability of the work performed.

We determined that Countrywide had already addressed, or was making satisfactory progress on addressing, four of the five compliance program recommendations contained in the FRB exit memo. Our office is presently evaluating the adequacy of Countrywide’s response to one outstanding recommendation related to HELOC finance charges.

Our assessment of the quality control process from a compliance standpoint consisted of a loan documentation review for 37 mortgage files and an evaluation of the scope/depth of the quality control testing methodology. Although we made some minor recommendations to strengthen the breadth of the testing, we found the quality control process to be generally satisfactory and commensurate with the size, complexity, and loan volume of Countrywide.

Concurrent with our quality control review, we noted the company’s flood insurance coverage policy/practice was not in compliance with regulatory requirements. As noted in Examiner Findings Memo #4, dated June 25, 2007, we requested that the company no longer grant exceptions allowing less than the 100 percent replacement cost value as a basis for determining flood insurance coverage. Management agreed to amend the policy/practice in response to our finding.



Also, during our Q2 2007 review, we reviewed the enterprise-level fair lending risk assessment, monitoring, testing, and corrective action processes. While Countrywide had extensive fair lending analysis and monitoring processes in the areas reviewed, there were some clear weaknesses that, unless addressed, would preclude our being able to rely on the work done by the company, as provided for in the streamlined option of the Interagency Fair Lending Examination Procedures. Key weaknesses related to the failure to take corrective action at a loan level for underwriting and pricing disparities identified through the analysis and review processes, lack of transaction reviews for pricing disparities, and inadequate procedures and controls around spousal signature requirements. These observations were reflected in Examiner Findings Memo #5, dated June 25, 2007.

The scope of the Q3 2007 compliance review consisted of the following:

- A special compliance review targeting the following areas:
  - FRB Regulations Z (Truth in Lending Act) X (Real Estate Settlement Procedures Act), and B (Equal Credit Opportunity Act) (origination requirements only)
  - Broker monitoring compensation
  - Fair Lending (steering review)
- A review of the bank's compliance with FRB Regulation E (Electronic Funds Transfer Act)
- A limited subprime loan file review (20 transactions)
- An assessment of CWB and CFC compliance with the consumer disclosure portions of the NTM Guidance.

In response to media criticisms and legal complaints targeted at Countrywide as a whole, we performed a special compliance review which tested a substantial number of loan transactions and unfunded application files, without regard for whether the loans were destined for CWB or not. Our lending review concluded the institution's compliance with lending regulations was satisfactory and the few violations noted did not constitute a pattern/practice of regulatory violations and/or cause financial harm to borrowers. Our data analysis/file reviews performed in conjunction with the fair lending review did not result in evidence of steering minorities towards subprime loan products. We also determined that broker relationships were adequately monitored and compensation controls were in place.

Countrywide's performance relative to the consumer compliance portions of the NTM Guidance was determined to be less than satisfactory. Our review included relevant documents such as disclosures, brochures, customer correspondence, advertisements, and selected legal documents from various loan programs. We noted the procedures relating to the early distribution of loan product information to prospective NTM borrowers were unclear. The information that is sent is limited, and does not make clear the key risks associated with the products. Also, although Countrywide does provide their

brokers with some product disclosure information for distribution to consumers, no procedural or content standards have been formally established for the broker to use in the disclosure process. Other findings relating to our review in this area can be found in Examiner Findings Memo #8, dated October 29, 2007.

No significant findings or material observations were noted in our review of the subprime loan files or in our review of CWB's compliance with FRB Regulation E.

**Corrective Action Required:**

To the extent CFC compliance functions impact or will be integrated into the bank, bank management and the board should stay abreast of Countrywide's responsiveness to the findings enumerated in Examiner Findings Memos #4, #5, and #8. Copies of all the examination findings memos, and management's responses, can be obtained from ERA.

**CWB INFORMATION TECHNOLOGY (IT) – NO RATING ASSIGNED**

The scope and objectives of the IT portion of our Q3 2007 review was to gain an understanding of the organization structure and IT operating environment between CFC and CWB, including the IT governance framework, information security program, and project management and systems development methodologies (FASTER PM and FASTER SE). We also determined if the institution was in compliance with CEO Memorandum #228, "Interagency Guidance on Authentication in an Internet Banking Environment" (October 12, 2005).

Based on our limited review, IT management oversight, controls, and procedures were found to be generally satisfactory. CWB has completed implementation of an authentication solution for their entire internet banking applications. CFC has implemented an enterprise-wide IT governance framework, information security program, and project management. CWB has adopted the enterprise-wide standards and has augmented the procedures and standards, as necessary. Our review noted that bank personnel were adhering to corporate standards. During the examination, we issued Examination Findings Memo #7, dated August 30, 2007, requiring that project management standards be enhanced to include migration and systems conversion procedures. Management agreed to implement corrective action.

**Corrective Action Required:**

CWB must ensure project management standards are enhanced as required by Examiner Findings Memo #7. Copies of all the examination findings memos, and management's responses, can be obtained from ERA.

## **MISCELLANEOUS**

### **Outstanding OCC and Federal Reserve Issues**

As part of our Q2 and Q3 2007 reviews, we reviewed Countrywide's responses to the following OCC and FRB letters:

- OCC letter dated March 1, 2007 (CFC 2007-02), regarding CWB's ALLL. We followed up on the OCC's ALLL review as part of our Q2 2007 review scope. We were satisfied with management's response to this letter.
- FRB letter dated March 1, 2007, regarding compliance risk management. We were satisfied with management's response except for an issue regarding home equity loan financing fees, which we expect to resolve soon.
- FRB letter dated March 5, 2007, regarding economic capital. The response to this letter will be evaluated as part of our economic capital review, which was initiated during the fourth quarter of 2007. We note the response contains some disagreement with the FRB's findings.

We also began to reconcile OCC- and FRB-reported findings with those being tracked by CFC. We have initiated tracking of Countrywide's progress in closing those outstanding findings.