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Countrywide McMurry Email re Credit Risk

John McMurray

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John McMurray/Managing Directors/CF/CCI
09/07/2007 10:43 AM

To Jess Lederman/Managing Directors/CF/CCI
cc
bcc
Subject Fw: Credit Risk

----- Forwarded by John McMurray/Managing Directors/CF/CCI on 09/07/2007 10:43 AM -----

John McMurray/Managing Directors/CF/CCI
07/26/2005 10:59 AM

To Nick Krsnich/Managing Directors/CF/CCI
cc Stan Kurland/Managing Directors/CF/CCI@COUNTRYWIDE
Subject Fw: Credit Risk

As a follow up to this morning's discussion, I wanted to forward a copy of an email I put together late last year for Keith.

Keith told me that Angelo had asked him whether our credit risk was increasing or decreasing. I told Keith that I thought our credit risk was increasing and prepared this email to provide further explanation. This email was also shared with Bank management (Carlos, Jim, etc.) at the same time I provided it to Keith since the Bank is one of the key areas where we're growing credit risk. I don't know whether Keith shared my email directly with Angelo or just had a discussion. Some of the more relevant passages are highlighted below.

----- Forwarded by John McMurray/Managing Directors/CF/CCI on 07/26/2005 10:37 AM -----

John McMurray/Managing Directors/CF/CCI
09/09/2004 02:49 PM

To Keith McLaughlin/Managing Directors/CF/CCI
cc
Subject Credit Risk

As a follow up to our recent conversation, where I briefly explained why I think our credit risk is increasing, I wanted to send this email to provide additional information. This email contains two summaries outlining why I think credit risk is increasing; the first is very basic and the second has additional details. Please let me know if you want to discuss further. Thank you.

BASIC SUMMARY

Our credit risk is increasing for the reasons outlined below.

I. While I do think credit risk is increasing both here at Countrywide and in the industry in general, please consider my opinion in the following context:

A. We generally earn an expected return for retaining credit risk.

B. We realize diversification benefits since this return is not well correlated with other risks we face (primarily interest rate risk).

C. Many of the factors driving the increase in credit risk are the result of economic forces. In addition,

the trends we're seeing are evident throughout the market -- they're not unique to Countrywide.

D. Increasing our credit risk position may be the most attractive opportunity in the current market to sustain and grow earnings.

II. The **economic environment** for credit risk is deteriorating because:

A. The house price appreciation we've seen in recent years is unlikely to continue.

B. The long term decline in interest rates is unlikely to continue.

C. The market's compensation (i.e. credit spreads) for credit risk has declined.

III. **Loan quality** throughout the primary market is deteriorating due to competitive factors and an excellent housing market coupled with very favorable credit performance over the past several years. Areas where loan quality is deteriorating include:

A. Underwriting standards for collateral and borrowers have become more aggressive.

B. More loans are being originated under riskier loan programs (e.g., ARMs), with riskier features (e.g., low/no doc, IO) and at higher CLTV/LTVs.

IV. Our **loan and execution mix** is deteriorating along with the rest of the market.

A. Our production of HELOC and subprime loans is increasing in both dollar and percentage terms.

B. We're doing more executions where we retain most (e.g., HELOCs) or a substantive (e.g., subprime) credit risk position.

V. With respect to the increasing credit risk I see, here are my **conclusions** and **recommendations**:

A. While we still sell much of our credit risk away, this picture is changing with increased production of HELOC and subprime loans as well as growth in the Bank's WL portfolio.

B. While the credit risk we retain is priced to provide an expected return, there are additional measures we should consider in light of the changing credit environment and our retention of more credit risk.

C. We should confirm that the relevant parties understand where we are in the credit cycle.

D. We should confirm where we're comfortable and uncomfortable taking on additional credit risk.

E. We should judiciously choose the opportunities to take additional credit risk (see I.A. in the detail outline below).

F. We should continue pursuing current credit initiatives and consider supplementing these efforts.

G. We should look for ways to further enhance the progress made on credit reserves over the past year.

H. We should look for additional ways to further leverage resident talent and avoid duplication that increases expenses and weakens internal controls.

MORE DETAILED SUMMARY

I. **CONTEXT.** While I do think credit risk is increasing both at Countrywide and in the industry in general, please consider my opinion in the following context:

A. **Expected Return.** The market provides an expected return for taking credit risk in most, but not all, instances.

1. Opportunities to Consider. We should consider those opportunities to take credit risk which provide an adequate risk-adjusted return. For example, the two factors driving most of our growth in credit risk (increased production of HELOCs and subprime) are also where we earn the biggest production margins.

2. Opportunities to Avoid. We should avoid those "opportunities" to take credit risk which do not provide an adequate return. For example, most of our Fast & Easy production is done with no risk-based pricing adjustment even though we now know it performs worse than comparable loans without this feature. We plan to continue selling this particular, uncompensated risk, away.

3. Probability Distribution. We should always remember that "expected return" aggregates the entire probability distribution of possible returns. There are instances where we could do much better or much worse.

B. **Diversification.** We realize diversification benefits since the return from taking credit risk is not always well correlated with other risks we face (primarily interest rate risk).

C. **Economic Forces & Market Synch.** Many of the factors driving the increase in credit risk are the result of economic forces. In addition, the trends we're seeing are evident throughout the primary market -- they're not unique to Countrywide.

D. **Opportunity Set.** Increasing our credit risk position may be the most attractive opportunity in the current market to sustain and grow earnings.

II. **ECONOMIC ENVIRONMENT.** The economic environment affects both house prices and borrower viability.

A. **House Prices.** Countrywide data confirms what I have observed elsewhere: borrower equity is the major driver of default behavior. House prices have performed very well over the past several years.

1. Timing in Cycle. Historical data suggest that house prices follow a cyclical process. House price increases in the near future seem likely to moderate given the length and breadth of house price increases over the past several years.

2. Importance of National Diversification. Over the past 30 years, national home prices have never declined even though we have observed significant declines in individual MSAs.

B. **Interest Rates.** There are several credit issues tied to interest rates. The first is how much correlation exists between interest rates and house prices. Some fear that a rise in rates could have an adverse influence on house prices. Historical correlation between interest rates and house prices is very mixed and has been positive or negative depending on time period.

1. Timing in Cycle. Historical data suggest that interest rates follow a cyclical process. The level and history of interest rates along with the current yield curve suggests we're more likely to be at the bottom rather than the top of a wave in the cycle.

2. ARM/DTI Issues. Increasing interest rates could create incremental DTI pressures when ARMs encounter an adjustment date.

3. House Price Correlation. Despite the history of mixed correlations, an increase in near term interest rates seems likely to put pressure on housing prices for at least several reasons this time.

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First, low interest rates helped convert many previous renters into owners. Second, other consumers used low rates as an opportunity to buy more expensive homes. Third, recent home price appreciation has exceeded income growth.

C. **Credit Spreads**. In virtually all market sectors, including mortgages, credit spreads have continued to narrow for the past several years.

1. Risk Compensation. The consequence of this narrowing is that we generally get paid less for any credit risk positions we retain.

2. Effect on House Prices. Narrowing credit spreads have resulted in lower mortgage rates further fueling house price increases.

D. **Labor Market.** Because most borrowers depend on employment income, labor market conditions can influence loan performance. There does not seem to be a major issue on the horizon here.

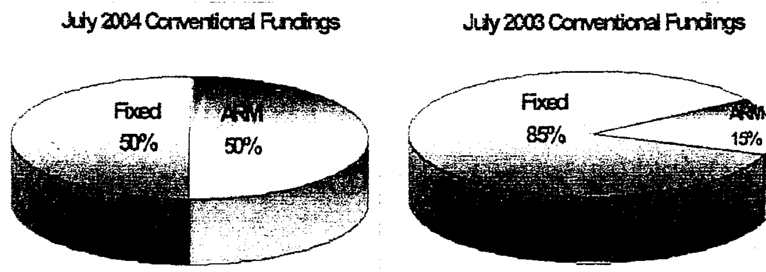
III. **LOAN QUALITY.** Loan quality is a significant credit risk factor. Developments in this vein, particularly the market's move to more aggressive underwriting guidelines, have increased credit risk.

A. **CLTV/LTVs.** High CLTV/LTV programs have a long history. The key difference in this credit cycle is the combination of high CLTV/LTVs with other risk factors such as low documentation and/or borrowers with weak credit. Borrowers are increasingly using Piggyback seconds to avoid MI (similar return but higher risk than our captives).

% of Fundings with CLTV > 95%

	Jul-04	Jul-03	Jul-02
HELOCs	23%	14%	15%
BC 2nds	89%	83%	68%

B. **ARMs.** Adjustable rate mortgages represent not only a larger portion of the industry's production, but also a much larger percentage of our production. The key credit concern with ARMs is potential payment shock when the ARMs adjust.



C. **Interest Only.** IOs (interest only loans) have emerged as a major product feature. Previously not part of our product line, IOs now represent most of the ARMs we now originate and a significant percentage of <u>all</u> loans:

% Interest Only

	Jul-04	Jul-03	Jul-02
Conventional	23%	3%	1%
Subprime	24%	0%	0%

D. **Low & No Documentation.** An increasing portion of our loans are originated with some type of low

documentation feature.

	Jul-04	Jul-03	Jul-02
	Conventional		
Full/Alt	54%	65%	64%
F&E	26%	23%	26%
Fastrack	1%	6%	3%
Reduced	16%	3%	2%
Other EC	4%	2%	6%

	Jul-04	Jul-03	Jul-02
	Subprime 1st Lien		
Full/Alt	61%	74%	82%
Stated	39%	26%	16%
	HELOC		
Full/Alt	42%	53%	65%
Reduced	28%	11%	7%

E. **DTI Ratios.** We've seen deterioration in DTIs in two dimensions.

1. Higher DTIs. The industry has moved to accepting higher DTIs on individuals loans. We are now seeing loans with DTIs in excess of 50%.

2. Mix. The percentage of high DTIs has increased.

3. Data. There are DTI data related issues to be aware of. One, the reliability of this data is generally poor across the industry (applicants tend to report just what they need to qualify). Two, data here and elsewhere indicate that DTI is not a reliable variable for predicting default (perhaps because of the poor data). Three, we have data issues over and above the industry problems.

F. **AVMs.** An increasing portion of our loans are originated using AVMs in lieu of a standard appraisal. While not bad per se, current practice often allows the potential for adverse selection because it inherently allows the borrower (or broker) to pick the higher of AVM or appraisal.

	Home Equity		
	Jul-04	Jul-03	Jul-02
AVM Usage	21%	14%	13%

G. **Manufactured Housing.** With the demise of the lenders that traditionally served this segment, MH loans have migrated into the lending mainstream. Not only do these loans have higher frequencies and higher severities, but the CE provider (usually Fannie or Freddie) is also very aggressive about putting these loans back to the lender. Another issue is coding; many MH loans are coded and delivered as SFR, which provides the CE provider with a reason to put back defaulted (miscoded) MH loans.

H. **Origination Process.** Several developments in the loan manufacturing process could increase credit risk.

1. Loan Officers. With the advent of EHLCs in CMD, much of our production is now originated by a commissioned loan officer or broker.

2. Exceptions. We're doing more exceptions than in the past.

3. Volume Pressure. As volume cools, loan originators both internally (EHLCs) and externally (brokers, loan officers at correspondents) will strive to maintain previous income levels. This pressure may increase the temptation to engage in fraudulent practices.

I. **Risk Layering.** We're seeing more loans with layered risk factors (e.g., high CLTV + low documentation + weak FICO + ...)

IV. **LOAN MIX.** An increasing portion of our production are HELOC and subprime loans which require us to retain at least some significant portion of the credit risk in addition to being riskier because of lien position, CLTV and/or borrower credit.

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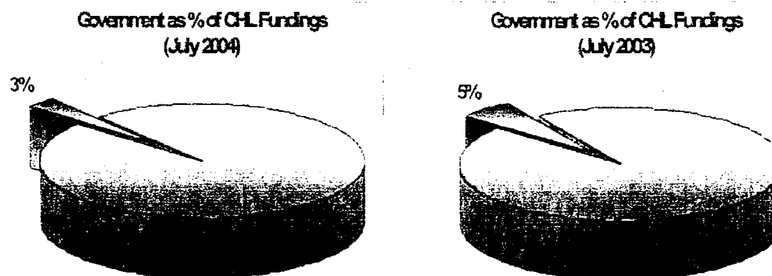
A. **Government.** The percentage of our loans originated as an FHA or VA has been declining over the past several years.

1. Execution. Credit risk with this execution is generally very low with our key risks arising from uninsured loans and VA no-bids.

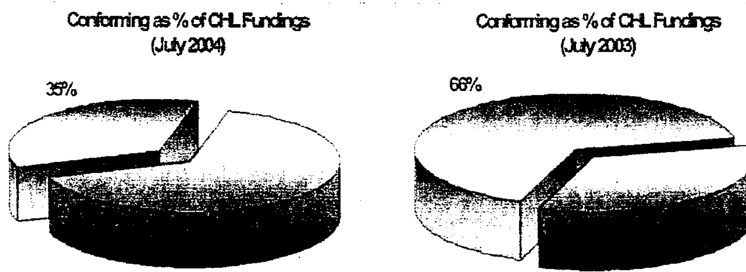
2. Loan Quality. There have been few changes to these programs in recent years.



B. **Conforming Conventional.** Much of volume continues to be originated as a conforming conventional for sale using one of the GSE executions.

1. Execution. Credit risk is generally low with our key risk being repurchase/indemnifications requested by Fannie Mae or Freddie Mac. Because of our size and prominence, we now have more leverage in repurchase discussions. Freddie Mac recently provided creditworthiness R&W relief for CLUES and DU further strengthening our position.

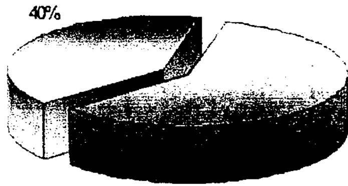
2. Loan Quality. While our conforming guidelines have become more aggressive over time, the GSEs bear the brunt of this incremental risk.

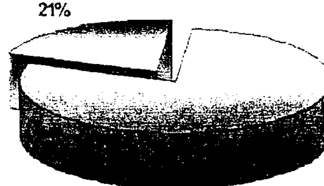


C. **Nonconforming.** An increasing portion of our production is nonconforming.

1. Execution. Credit risk is generally low with our key risk being repurchase or a make-whole on an MI claim denial.

2. Loan Quality. Guidelines have become more aggressive in all of the dimensions described in "loan quality" above. Furthermore, the portion of our nonconforming loans that are expanded criteria has increased. Because the sub holders bear most of the credit risk we are not directly exposed to the expansion of guidelines or change in mix. We do have reputational exposure to how well the rating agencies have done in sizing credit enhancements. If the credit enhancements (subs, MI, etc.) are too small, the investment grade bonds have heightened risk of being downgraded.

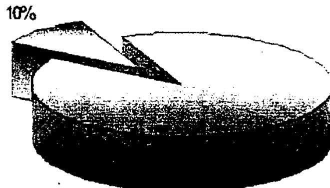


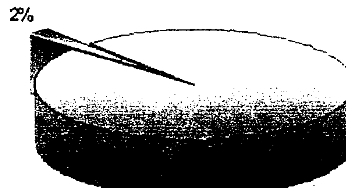


D. Subprime. An increasing portion of our production is subprime.

1. Execution. Because we provide a substantive credit enhancement (residual, corporate guarantees, etc.) in most executions, we retain more credit risk on subprime loans.

2. Loan Quality. We are doing less and less mainstream product and more products with one or more incremental risk features. A significant portion of our recent subprime production is now 80/20, IO, stated doc, etc. Many of these loans have layered risks (e.g., high CLTV + IO + stated).



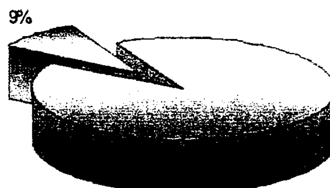


E. HELOCs. An increasing portion of our production are HELOCs.

1. Severity. HELOC severities are much more severe, generally around 100%, compared to first liens.

2. Execution. We have a significant HELOC whole loan position at CHL and the Bank where we take virtually all of the credit risk (the Bank does have mortgage insurance on a portion of their portfolio).

3. Loan Quality. Loan Quality has generally been stable except for an increase in reduced documentation loans.



V. **CONCLUSION & RECOMMENDATIONS**. Following are my conclusions and recommendations with respect to the increasing credit risk outlined above:

A. **Sale of Credit Risk**. While we still sell much of our credit risk away, this picture is changing with increased production of HELOCs and subprime as well as growth in the Bank's WL portfolio. We should continue to seek any opportunity to sell away credit risk we're not comfortable with.

B. **Risk-Based Pricing**. While the credit risk we retain is priced to provide an expected return, there are additional measures we should consider in light of the changing credit environment and our retention of more credit risk. We should continue to refine and supplement our pricing and cash-flow models.

C. **Credit Cycle**. We should confirm that the relevant parties understand where we are in the credit cycle.

D. **Comfort**. We should confirm where we're comfortable and uncomfortable taking on additional credit risk. Are we, for instance, more comfortable with HELOCs (either WLs or residuals) or subprime residuals?

E. **Choices**. We should judiciously choose the opportunities to take additional credit risk.

What Risk. As mentioned in I.A. above, we should focus on those credit risk opportunities that provide a sufficient expected return along with a probability distribution we're comfortable with.

How. We should consider how we take credit risk. By how, I mean what execution (structure, layer) and what entity (Bank, CHL, Balboa, etc.).

F. **Credit Initiatives**. We should continue pursuing, and consider supplementing, current credit initiatives; these include:

1. Stochastic Credit Model. We already use a stochastic approach for interest rate risk evaluation and should for credit risk too. The work and meetings to establish the concept and approach are complete. We now need to decide priorities and assignments (i.e. who is going to build which pieces).

2. Exception Processing. This project is underway.

3. Credit Scoring Models. Several scoring model related projects are underway, including:

   a. *Acquisition*. The existing CLUES scorecard is very old and has a number of shortcomings. We now have three new scorecards ready to be implemented.

   b. *Servicing*. We are beginning work on credit scorecards to improve how we manage loans, particularly HELOCs.

4. Shore Up R&W Defenses. We are working with Legal to shore up our defenses against repurchase, indemnification and claim denial requests as a result of alleged R&W (representation and warranty) breaches.

5. Mark-to-Markets. We should continue and expand the credit mark-to-markets projects already initiated.

G. **Credit Reserves**. We should look for ways to extend the progress made on credit reserves over the past year.

H. **Leverage, Don't Duplicate**. We should look for additional ways to further leverage resident talent and avoid duplication that increases expenses and weakens internal controls.