RISK MANAGEMENT LESSONS LEARNED: COUNTRYWIDE REPORT

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ABSTRACT

International and U.S. banks should benefit from studying Countrywide Financial Corporation's business practices leading up to the 2008 financial crisis in order to develop lessons learned for improved risk management and corporate governance by both boards of directors and management. Especially for U.S. banks, the 2010 Dodd-Frank Act now requires all U.S. banks supervised by the Federal Reserve Bank to have risk management committees with at least one "risk management expert" on the committee. However, the $6.2 billion "London whale" loss at JPMorgan Chase in 2012 has motivated large institutional shareholders of JPMorgan Chase common stock to demand the removal of three risk management board members. It was hard to determine the "risk management expert" among the four committee members: a JPMorgan Chase director since 1991, the head of Honeywell International, a former KPMG executive, or the president of the American Museum of National History.

Internationally, the proportion of bank boards that have risk committees was significantly higher in Europe in 2005 (26.6%) than in the United States (9.6%) (Allemand et al 2013). When a board decides to create a risk committee, it shows greater awareness of the importance of risk management and control (Hermanson 2003). When risks are complex and when the regulatory environment is strong, the creation of a risk committee becomes necessary and a risk management committee can help to make the profile risk of a bank more intelligible to the board. The presence of such a committee should lead to a lower risk (Brown, Steen and Foreman 2009). However, Countrywide had a risk management committee. Although it was repeatedly warned of investment risks by senior Countrywide executives, it ignored such risk warnings. Similarly, a weak system of management control was found to be a key, recurring structural factor in corporate governance implications from the 2008 financial crisis (Grove et al 2012).

The following excerpts from the forensic accounting report on Countrywide are used to develop six key risk management lessons that should have been learned by any bank risk management committee for improved corporate governance. This forensic accounting report for Countrywide Financial Services was prepared by Gordon Yale, a practicing forensic accountant in Denver, Colorado. This forensic investigation of Countrywide was performed at the request of the Attorney General of the State of Florida who used the resulting forensic report in litigation against Countrywide's Chief Executive Officer, Angelo Mozilo. A Florida court threw the Mozilo case out because Mr. Mozilo was not a resident of the state. Before an appeal by the Florida Attorney General was decided, the Mozilo case was dropped because Bank of America, which had acquired Countrywide as it neared financial collapse in 2008, settled a larger action with eleven states, including Florida, for approximately $8.4 billion. In doing so, Bank of America avoided prosecution for Countrywide's alleged fraudulent conduct – inducing customers into taking out subprime mortgages and other risky, high-cost loans. The State of Florida's share of that settlement was nearly $1 billion. This forensic report was used to develop key risk management lessons learned from Countrywide which was the largest generator of these risky, "no-doc" (no significant applicant qualifications) subprime mortgages and other high-cost loans which helped precipitate the 2008 financial crisis.

Key Words: Risk Management, Lessons Learned, Countrywide Bank

INTRODUCTION

The following summary was from the March 8, 2011 report provided to the Attorney General of the State of Florida by Gordon Yale:

At your request, I have reviewed various documents including annual Countrywide Financial Corporation ("CFC" or "Countrywide") Forms 10-K for the years ended December 31, 2002 through 2007 filed with the U.S. Securities and Exchange Commission ("SEC"). I have also reviewed certain quarterly filings of CFC Forms 10-Q and various other SEC filings by CFC and Angelo R. Mozilo, extracts from transcripts of testimony by various Countrywide executives as well as a limited number of internal CFC e-mail provided to the state of Florida in this matter. In addition, I have read extracts from the deposition taken by the state of Florida of Mr. Mozilo, the former chairman and chief executive officer of Countrywide as well as other documents cited in footnotes to this report. The purpose of this review and analysis was to form certain opinions on matters related to this case. Based upon the endeavors I have described, my findings and opinions, to a reasonable degree of professional certainty, are as follows:

- From at least 2004 through June, 2008, CFC engaged in lending activities that various CFC executives, including Angelo Mozilo, knew were high risk to both to CFC and its borrowers.
- CFC's high-risk loans included subprime mortgages, subprime adjustable rate mortgages ("subprime ARMS"), home equity, home equity lines of credit (or "HELOCs") that were typically second lien loans, and Pay-option ARMS. Pay-option ARMS permitted negative amortization of the loan up to 115 percent of the initial borrowing.
- To reduce its risk of loss on these loans, CFC typically bundled its loans into residential mortgage-backed securities ("RMBS") and sold them to investors in the marketplace, retaining a residual interest. The design of many of these securitizations provided a structured hierarchy of investor rights to the cash flows that the underlying loans were expected to produce.
- Under generally accepted accounting principles ("GAAP") of the period, and since rescinded, CFC could account for a securitization as a sale of assets even if it retained a residual interest. As a result, CFC was permitted to recognize the present value of its estimated share of the future interest and in many instances, servicing income produced by the underlying loans in the RMBS upon the closing of the securitization transaction.
- Under most conditions, this accounting treatment permitted Countrywide to recognize more income during the period than it would have reported had it simply held the underlying loans on its balance sheet.
- The acceleration of CFC earnings, coupled with the securitization of higher risk assets, benefitted both Countrywide and Mr. Mozilo. Higher earnings contributed to higher valuations of CFC stock and increased Mr. Mozilo's earnings-based compensation as well as the value of his stock options until 2007, when home values began what would be a precipitous decline.
- Billions of dollars of these loans were made to CFC customers in Florida, and continued to be serviced by CFC until Bank of America acquired the company in June 2008.
- A recent study concluded that, of the executives of the 14 largest financial institutions in the United States, Mr. Mozilo realized more income than any of his counterparts from

2004 through 2008. He realized approximately $423 million of compensation from salary, bonuses and the sale of CFC stock between 2004 and 2008. Approximately $377 million resulted from the net sales of Countrywide stock.

From Yale's findings and opinions, we have identified six lessons that should be learned from Countrywide's activities and history. Each is discussed below.

LESSON LEARNED NUMBER 1: DO NOT IGNORE INCREASINGLY UBIQUITOUS HIGH RISK LOANS AND OTHER HIGH RISK ACTIVITIES

For the twelve months ended December 31, 2002, Countrywide was the third largest home lender in the United States.[1] On a consolidated basis, CFC originated approximately $251 billion of home loans. The dollar value of its loan production was some 3.8 times larger than the loan production for the fiscal 2000 year. Of these $251 billion of loans originated in calendar 2002, nearly 86 percent were conventional conforming or non-conforming loans. More risky nonprime mortgage loans represented only 3.7 percent of originations while prime home equity loans, typically secured by second liens, were approximately 4.6 percent of originations.[2]

From December 31, 2002 to 2006, the originations of non-prime loans grew by more than 500 percent while prime home equity loans grew by nearly 400 percent during the four-year period. CFC did not specifically disclose the amount of Pay-option loans it originated, but Pay-options were generally classified as prime loans and were apparently classified as conventional and non-conforming.[3] **Table 1,** reproduced from the Countrywide SEC filings, enumerates the dollar volume growth of all loan originations.[4]

======================= INSERT TABLE 1 HERE =======================

By December 31, 2004, Countrywide had grown to become the largest originator of home loans in the U.S. and the company would remain the leader through 2007.[5] CFC's growth in loan originations between 2002 and 2005, which nearly doubled, were not the primary result of the 11.7 percent growth in originations of conventional conforming loans, but were more the product of the 365 percent growth in conventional non-conforming loan originations (including Pay-option ARMs), the nearly 474 percent growth of non-prime mortgage loans, and the approximately 367 percent growth of prime home equity loan originations.

A September 2004 report to the CFC Corporate Credit Risk Committee provided substantially more detail than CFC's Form 10-K filings. The committee members were informed that in the last year *"non-conforming funding rose from 23% to 41%, subprime rose from 5% to 12% and Home Equity products rose from 5% to 9%. Relatively new products such as Pay-option, Interest Only LIBOR and FlexSaver now represent 18% of conventional volume. ARM products represented 15% of conventional funding a year ago and now represent 50%. Interest Only (sic)*

[1] See Page 17 of the CFC 2002 Form 10-K
[2] See Page 24 of the CFC 2005 Form 10-K
[3] See Page 2 of Angelo R. Mozilo Memorandum, dated August 16, 2006 at SEC-Melone-0001147
[4] See Page 24 of the CFC 2005 Form 10-K and Page 29 of the CFC 2007 10-K
[5] See Page 105 of the 2005 CFC Form 10-K and Page 146 of the 2007 CFC Form 10-K

funding represent 45% of conventional ARMs."[6] However, the Corporate Credit Risk Committee took no action to reduce this increasing dependence on high risk loans.

LESSON LEARNED NO. 2: DO NOT IGNORE THE INITIAL RISK WARNINGS OF SENIOR MANAGEMENT EXECUTIVES

Mr. Mozilo and other Countrywide executives were apparently well aware of the increased risks of subprime, home equity and Pay-option loans. In September 2004, for example, Mr. Mozilo wrote:

> *"As I look at production trends, not only at Countrywide but also with other lenders, there is a clear deterioration in the credit quality of loans being originated over the past several years. In addition, from my point of view, the trend is getting worse as the competition for subprime, Alt-A and nonconforming in general continues to accelerate. GE, Ameriquest and others, excluding Wells, Chase and BofA, have not only become more price competitive but have substantially lowered credit, down payment and income requirements. This trend could cause borrowers to be more vulnerable to adverse changes in interest rates, the economy or both. It appears that home buyers, driven by a strong desire to own a home combined with rapidly increasing values, are stretching themselves beyond any historical standards to get into the home of their dreams. The bottom line of my perspective on this trend is that we should seriously consider securitizing and selling (NIMS) a substantial portion (sic) of our current and future subprime residuals even though the value in retaining such residuals "appears" to be a better economic execution than a NIMS* (net interest margin securities) *execution.*
>
> *I fully understand that our residuals have been modeled on a conservative basis but it is only conservative based upon historical performances. But the type of loans currently being originated combined with the unprecedented stretching of all aspects of credit standards could cause a bump in the road that could bring with it catastrophic consequences. If that were to happen, the .50 basis points (sic) additional cost of the NIM versus retention on our balance sheet would look like a bargain…*[7]*"*

As will be more fully discussed in a subsequent section, Countrywide securitized most of the loans it originated. Conventional conforming, and initially some non-conforming, conventional loans could be securitized with no structured recourse to CFC. Subprime and home equity loans securitization structures, however, frequently provided that CFC (as the sponsor) retain a subordinated interest (or tranche) in the securitization to provide additional collateral to the more senior tranches. Such was the market in 2004 that Countrywide could securitize and sell some of these retained interests. Thus, Countrywide's structural exposure to loss would be limited to the retained interest in the retained interests it had sold through subsequent securitizations.

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6 See Corporate Credit Risk Committee Minutes, dated September 21, 2004 at CFCP001241531

7 See Mozilo e-mail to Stan Kurland dated September 1, 2004 at NYF-SEC 009492

In an August 2005 email, before homes sales and home prices had fully peaked, Mr. Mozilo wrote about the risks of Pay-Option loans in Florida:

> "*I am becoming increasingly concerned about the environment surrounding the borrowers who are utilizing the pay option loan and the price level of real estate in general but particularly relative to condos and specifically condos being purchased by speculators (non-owner occupants). I have been in contact with developers who told me that they are anticipating a collapse in the condo market very shortly simply related to the fact that in Dade County alone 70% of the condos being sold are being purchased by speculators. This situation is being repeated in Broward County, Las Vegas as well as other so called "hot" areas of the Country.*
>
> *We must therefore re-think what assets we should be putting into the bank. For example you should never put a non-owner occupied pay option ARM on the balance sheet. I know you have already done this but it is unacceptable. Secondly only 660 FICO's and above, owner occupied pay options should be accepted and only on a limited basis. The focus should be 700* (FICO scores) *and above (owner occupied) for this product. The simple reason is that when the loan resets in five years there will be an enormous payment shock and if the borrower is not sufficiently sophisticated to truly understand this consequence, then the bank will be dealing with foreclosure in potentially a deflated real estate market. This would be both a financial and reputational catastrophe.*
>
> *Frankly, I am no longer concerned about the pace of growth of the bank. In fact if there was little to no growth over the next six months until we can assure ourselves of high quality performing assets, I would be a supporter of little to no growth. Since we own the assets of the bank and (are) responsible for the long-term performance of those assets, we must focus on quality and not quantity if that's the choice we have to make. I feel strongly that over the next twelve months we are going to be facing one of the most difficult and challenging real estate and mortgage markets in decades and I want to take steps now to mitigate and hopefully avoid any damage to the bank.*
>
> *On Sunday I met a mortgage broker from a town near Troy, Michigan who told me that he does all of his business with Countrywide. First I was pleased with the news until he told me why. He said that the area he serves is severely economically depressed and that the only way he can qualify his borrowers is (sic) via the pay option ARM. I have heard this story many times over from mortgage brokers who utilize the pay option for very marginal borrowers for the sole purpose of creating volumes and commissions. We simply cannot and will not allow our Company to be victimized by this pervasive behavior and since we can't control the behavior of others, it is essential that we control our own actions…*[8]"

[8] See Mozilo e-mail to Carlos Garcia dated August 1, 2005 at CFC20071061393

The Corporate Credit Risk Committee ignored these initial risk warnings of senior managers and took no action to reduce this increasing dependence on high risk loans.

LESSON LEARNED NO. 3: DO NOT STAY THE COURSE AGAINST ONGOING RISK WARNINGS

While the e-mail discussed above precipitated a series of e-correspondence from Carlos Garcia, the CEO of Countrywide Bank, and to other CFC executives, the simple fact was that Countrywide continued making high-risk loans. As **Table 1** above enumerates, CFC originated more subprime loans in 2006 than it did in 2005 and originated only a marginally smaller volume of conventional non-conforming and prime home equity loans.

Further, despite Mr. Mozilo's alarmist but prescient e-mail, the portfolio of Pay-option loans retained in CFC's Banking Operations segment actually grew from $26.1 billion at December 31, 2005 to $32.7 billion at December 31, 2006.[9] The increase of approximately 25.4 percent occurred despite significant increases in borrowers choosing low payment options that did not fully pay interest as due. In 2005, more than 53 percent of Pay-option loans were amortizing negatively. By December 31, 2006, more than 88 percent of Pay-option loans had negative amortization.[10]

Moreover, CFC also retained more home equity loans in 2006 than it retained in 2005. According to the 2006 Countrywide Form 10-K, CFC retained nearly $15 billion of prime home equity loans as investments in 2005 and more than $20.2 billion in 2006, an increase of approximately 35 percent.[11] The result of the decision to retain more Pay-option and home equity loans in 2006 was to expose Countrywide to the full risk of loss should the loans fail. Had Countrywide reduced these originations, CFC's risks would have been reduced.

Although home equity loans were not mentioned in the Mozilo e-mails, CFC knew that it was exposed to losses on its home equity loan and HELOC products because the loans were typically second lien loans and in some instances, these loans were piggybacked to make down payments on home purchases or were used in tandem with Pay-option loans. For example, in response to Mr. Mozilo's August, 2005 e-mail, Mr. Garcia wrote to CFC executives:

> "*Pursuant to Angelo's (sic) direction, please make every effort to further accelerate the assessment of low FICO borrowers and appropriate action on pay options (sic). Also are there additional markets besides South Florida and Vegas that merit discontinuation of lending to investors or condo borrowers? We still have South Florida and Vegas lending shut down for all products, right? (sic) I want to get with Stan and back to Angelo this week. In the meantime, pending the completion of analyses and deliberation, we should now stop investing in pay option loans less than 660 FICO unless the CLTV* (current loan-to-value) *is 70 percent or lower or they have MI* (mortgage insurance). *Likewise stop loaning on*

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9 See Page 64 of the 2006 CFC Form 10-K
10 Ibid.
11 See Page F-36 of 2006 CFC Form 10-K

HELOCS with underlying pay options unless the CLTV is under 70 and the FICO is over 660 unless we can buy MI economically…"

And to Mr. Mozilo, Mr. Garcia wrote[12]:

> *"No lending to investors in any market is the direction we are following/implementing immediately without waiting on analyses or deliberation … I do agree with your concern, particularly given the fact that credit availability is going to tighten or at least get a lot more expensive due to the growing concerns over pay option and IO* (interest only) *loans, rising rates, housing bubbles and ensuring regulatory and lender actions."*

While Countrywide did not enumerate losses on home equity portfolios in 2004 through 2006, it did disclose delinquencies and foreclosures in its loan-servicing portfolio. While delinquencies in home equity loans in 2004 were less than delinquencies on conventional mortgage loans (.79 percent vs. 2.24 percent), by 2006, the trend had reversed. Delinquencies on home equity loans were 2.93 percent in 2006 while conventional delinquencies were 2.76 percent. Of more concern was that delinquencies of subprime loans in the servicing portfolio grew to 19.03 percent.[13]

Disclosure in Countrywide filings also detailed growing credit losses on the residuals it held as a result of home equity loan securitizations. These losses were taken despite the fact that during the three-year period between 2004 and 2006, home prices in the U.S. increased more than 34 percent. In 2007, home prices declined by approximately 9 percent, and the credit losses on home equity residuals ballooned.[14] **Table 2** below illustrates CFC's losses on home equity residuals.[15]

====================== INSERT TABLE 2 HERE ======================

Once again, the Corporate Credit Risk Committee ignored the ongoing risk warnings of senior managers and took no action to reduce this increasing dependence on high risk loans.

LESSON LEARNED NO. 4: DO NOT BE SEDUCED BY SIGNIFICANT PROFITS ON HIGH RISK LOANS AND OTHER HIGH RISK ACTIVITIES

Despite Mr. Mozilo's expressed concerns about the risks of Pay-option and subprime loans as well as the significant write-offs of home equity residuals while home prices were rising in 2004 and 2005, Countrywide increased its exposure to these high-risk loans. Documents in this matter do not fully establish why CFC made these decisions, but disclosures in CFC SEC filings clearly establish that higher risk loans were clearly more profitable. **Table 3** illustrates the CFC gains on sale from the securitization from various loan classes.[16]

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[12] See Garcia e-mail to Angelo Mozilo dated August 2, 2005 at CFC20071061392
[13] See Page 9 of 2006 CFC Form 10-K
[14] See Case-Shiller 20-City Composite Index
[15] See Pages 95 and F-38 of the CFC 2005 10-K and Page 120 of the CFC 2007 10-K
[16] See Pages 81, 61 and 78 of the CFC 2005, 2006 and 2007 Forms 10-K, respectively and Page 60 of the CFC Form 10-Q for the six months ended June 30, 2008

====================== INSERT TABLE 3 HERE ======================

Clearly, from 2003 through 2006, the securitization or sale of subprime and home equity loans generated substantially greater relative returns than the securitization or sale of prime mortgage loans. While the Countrywide SEC filings don't enumerate gains on sale or profits from Pay-option lending, Mr. Mozilo established the importance of Pay-option loans to CFC in a memorandum to the CFC Board of Directors in August 2006[17]:

> "*… Countrywide's Option ARM, which is called Pay Option, is an important product in several respects. Consumers have responded favorably to this product due to the flexibility it offers and as such, it represent a significant portion of our volume (around 20% in recent quarters) and is the most profitable prime product in our origination channels. The Pay Option also comprises the bulk of the Bank's investment loan portfolio. Pay Option loans are therefore a very important contributor to the Company's earnings…*
>
> *… From a Market Risk perspective, Pay Options are the safest first lien choice because the underlying accrual rate on the loan changes each month as a function of interest rates. From a Credit perspective, Pay Option loans are riskier because the loan balance can increase (from the negative amortization) and because the borrower is exposed to payment shocks (especially at the recast where the payment increase can be very large). However, Pay Option loans have the highest Expected Return compared to all other first liens we could retain as an investment.*"

Table 4 estimates the impact of the gains on sale from Pay-option,[18] subprime and home equity loans[19] as well as the net interest income from Pay-option loans on Countrywide's consolidated revenue.[20] The estimates below exclude mortgage-servicing income by category because the amounts were not disclosed in CFC SEC filings. Clearly, the revenues from these products that Mr. Mozilo understood to be high risk were significant to Countrywide.

====================== INSERT TABLE 4 HERE ======================

Clearly, the Corporate Risk Management Committee was also enticed by these high profits and recommended no action to reduce dependence on such high risk investments.

LESSON LEARNED NO. 5: DO A COST/BENEFIT ANALYSIS ON THE SECURITIZATION OF LOANS AND OTHER HIGH RISK ACTIVITIES

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[17] See Angelo Mozilo Memorandum to CFC Board of Directors dated August 16, 2006 beginning at SEC-Melone-0001147

[18] Estimate based on Pay-option loans representing 10 percent of CFC's total loan production (Mozilo said it was 20 percent of production for recent quarters) divided by Prime Mortgage Loans Sold times the actual gain on sales for prime loans as disclosed on Page 81 and Page 69 of 2005 and 2006 CFC Forms 10-K

[19] Actual, per CFC Forms 10-K. See Pages 81 and 61 of CFC 2005 and 2006 Forms 10-K, respectively

[20] Estimated utilizing average actual Pay-option loan balances in CFC Banking Operations Segment times spread between actual annualized yield on mortgage loans less annualized rate of interest-bearing liabilities. See Pages 76 and 65 of CFC's 2005 and 2006 Forms 10-K. See Pages F-5 and F-4 of CFC 2005 and 2006 Forms 10-K for CFC Total Consolidated Revenue

Securitization—the bundling, sectioning and remarketing of financial assets—was the financial structure of choice in the mortgage markets of the new millennium. Financial institutions, like Countrywide, realized three primary benefits from securitization structures largely because of permissive accounting rules under U.S. generally accepted accounting principles ("GAAP"). These primary benefits included:

- Off balance sheet treatment of assets and liabilities arising from transactions that were often, in substance, secured loans with limited recourse to the borrower.
- The immediate recognition of interest income, typically earned only with the passage of time.
- The immediate recognition of revenue from mortgage loan servicing prior to doing the actual work.

Until the rules were reversed for calendar-year companies beginning on January 1, 2010, these benefits were perfectly legitimate under GAAP for an entire generation. Securitizations took many forms and employed a variety of structures, but the elements common to each are the aggregation of income producing financial assets that are in turn transferred to a bankruptcy remote entity, typically a trust, and then carved into pieces (or tranches) that have a structured hierarchy of rights to the anticipated cash that the assets were expected to generate.

The financially engineered product was then remarketed much as a note or a bond—that is, a debt instrument secured in this case by mortgage loans—but sold as a series of tranches, each with different risks and correspondingly different returns. In many securitizations, the tranches were (and continue to be) parsed so that the most senior tranche has the first right to virtually all the cash generated by the underlying assets that collateralized the security.

When and only when the periodic interest and principal due the senior tranche were paid, the remaining cash flowed to the next, most senior tranche in the hierarchy and so on down to each of the remaining subordinate tranches. Deconstructed to their simplest terms, many securitization transactions were (and continue to be) little more than a secured loan with recourse, often limited recourse, to the borrower. But because GAAP treated even these securitization transactions as a sale, the benefits of the structure multiplied.

First, qualifying securitizations were off balance sheet. Countrywide, for example, typically bundled the mortgage loans it originated and sold them. If it sold virtually all of its economic interests in a particular pool of mortgages and had no meaningful continuing economic rights or obligations, then the transaction was clearly a sale. The underlying mortgages would be removed from Countrywide's balance sheet and transferred to the purchaser. The amounts paid to Countrywide would be revenue and profit, and could be determined simply by subtracting Countrywide's cost of the mortgages and the retained benefits from the revenue it received from their sale.

On the other hand, if the purchasers of the various tranches insisted that Countrywide continue to hold a significant interest in the security, and the interest retained by Countrywide was the most subordinate tranche, reducing it to the first loss piece in the event that the underlying mortgages

defaulted, then the economic substance of the securitization looked more like a secured loan, with limited recourse, than a sale.

Further, if that same subordinate tranche held by Countrywide had the right to the excess cash flows, from the difference between the interest generated by the underlying mortgages and the interest paid to the holders of the more senior tranches, then the subordinate tranche was not just excess collateral for the benefit of the more senior tranches. It provided Countrywide the continuing economic benefit of the interest spread that could be valuable.

Under this scenario—where the securitization structure produced substantially the same benefits of a secured loan with limited recourse—it should have been hard to argue that it wasn't a secured loan with limited recourse. Despite the logic, if the transaction met GAAP requirements, GAAP permitted such transactions to be treated as asset sales. As asset sales, mortgages would be removed from Countrywide's balance sheet and no debt obligation to security holders would be recorded.

Gain on Sale

Countrywide and every other sponsor of securitizations realized other benefits of securitization to their bottom line. Because the accounting rules treated such conforming transactions as sales, Countrywide was permitted to recognize a profit (or loss) when the securitization transaction closed. One element of the determination of the profit was the valuation of the sponsor's continuing interest in the spread between the interest received from the underlying mortgages and the interest paid to security holders and other retained interests. That spread was typically greater on the securitization of high-risk loans such as subprime and home equity products. As a result, the gains from the sale of subprime or home equity securitizations were larger. This was consistently true at Countrywide (See **Table 3** above).

A number of factors, including prepayments and defaults, impacted the value of the interest spread. For example, the duration of a mortgage impacted the length of time the interest spread would be realized. Similarly, defaulted loans had the potential to lower the interest spreads. Thus, the valuation of the sponsor's residual in the interest spread from the securitization was something of a guess. And because credit standards were deteriorating and new products were introduced, the estimation process had significant uncertainty. In a September, 2006 e-mail, Mr. Mozilo wrote[21]:

> *"... 1. Pay Options have become the lightening rod in the arena of "exotic loans." It is getting the attention of ratings agencies, regulators and the press. 2. We have no way, with any reasonable certainty, to assess the real risk of holding these loans on our balance sheet. The only history we can look to is that of World Savings; however, their portfolio was fundamentally different than ours in that their focus was equity and ours is FICO. In my judgment (sic), as a long time lender, I would always trade off FICO for equity. The bottom line is we are flying blind on how these loans will perform in a stressed environment of higher unemployment, reduced values and slowing home sales ... I therefore believe the*

[21] See Mozilo e-mail, dated September 26, 2006 at CFC2007B786677

timing is right for us to sell all newly originated pay options and begin rolling off the bank balance sheet, in an orderly manner, pay options in their portfolio."

If Countrywide couldn't assess the risk of Pay-Option loans in 2006, they certainly couldn't assess it in 2004. Nevertheless, Countrywide, like every sponsor, was permitted to recognize gains on sale even if it retained residual interests of a highly uncertain value. Further, the interest spread component of the valuation permitted Countrywide and other sponsors to recognize the present worth of the interest spread even though such interest had neither been earned nor paid.

GAAP was wholly inconsistent on this issue. The senior tranche owners of securitizations recognized interest earnings in their financial statements only if mortgages remained outstanding and interest accrued. In other words, they recognized interest earnings periodically, with the passage of time, which determined whether interest on a loan was earned and ultimately, whether it would be paid. Securitization sponsors, however, recognized the present worth of the estimated interest due them upfront.

Mortgage Servicing Rights

The third primary benefit of securitization was the recognition of profit on mortgage servicing rights ("MSRs"). Countrywide, like a number of sponsors, sold loans into securitization pools of mortgages, but retained the right to administer or service the mortgage for a fee of between 25 and 50 bps annually.[22] When sponsors securitized mortgage loans, but retained mortgage servicing rights, the MSRs were considered to be a retained interest requiring valuation. Moreover, the estimated value of MSRs was utilized in the determination of the gain on sale from the securitization. The values were derived from the present worth of the estimated future cash flows from mortgage servicing fees.

And like the interest spread, estimated value of the MSRs was recorded at the close of the securitization transaction although the 25 to 50 bps of fee income would be earned in each future year that the mortgages were outstanding. Because many factors, including interest rate movements, loan prepayments, delinquencies and defaults impacted the length of time a mortgage loan would remain outstanding as well as how long servicing fees would be paid, the estimate was uncertain and somewhat volatile.

Despite the uncertainty in estimating the value of residual interests and MSRs, two primary components of the gain on sale calculation, the impact on Countrywide's financial statements was highly significant. **Table 5** recapitulates CFC's gains on sale related to home equity and subprime loans securitizations and the related, estimated income from mortgage servicing on home equity and subprime loans as well as income from CFC residual interests from its high risk loan securitizations.[23] These amounts were recorded in Countrywide's income statements.

======================= INSERT TABLE 5 HERE =======================

[22] See, for example, Page F-20 of 2006 CFC 10-K

[23] See Pages 52, 73 and F-22 of 2005 CFC Form 10-K and Pages 47, 68 and F-24 of 2007 CFC Form 10-K

The tenuous nature of recognizing massive gains on sale that were largely dependent on estimates of revenue that had been recognized, but not earned, did not become fully apparent in CFC financial statements until 2007, when declining home prices and other factors compelled CFC to record multi-billion dollar impairment charges against its retained interests. Once again, the Corporate Risk Management Committee did not analyze possible risks by doing a cost/benefit or other analysis on the securitization of loans or any other high risk business strategies since the benefits were so appealing and enticing.

LESSON LEARNED NO. 6: DO STRESS TESTS ON KEY RISKS WHICH MAY BE REALIZED

By the end of 2006, it was clear that home prices in most markets had peaked. The Case-Shiller 20-city composite index indicated a less than one percent increase year-over-year and three California markets—San Diego, San Francisco and Los Angeles—experienced larger changes. According to Case-Shiller, home values in San Diego and San Francisco declined approximately 4.2 percent and 1.4 percent, respectively, while in Los Angeles, home prices increased by approximately 2 percent.[24]

Mr. Mozilo remained both vigilant and prescient. In a June, 2006 e-mail, the Countrywide CEO wrote:[25]

> *"In my discussions with Stan* (Kurland, the CFC President and Chief Operating Officer) *and Dave* (Sambol, the CFC Chief of Production and soon to become president), *it came to my attention that the majority of pay options originated by us, both wholesale and retail, are based upon stated income. There is also some evidence that the information that the borrower is providing us relative to their income does not match up with IRS records. As rates continue to climb, it is evident that two things are going to happen relative to the loans on the Bank's balance sheet:*
>
> 1. *That the time of reset is going to accelerate because the 115% of the original loan amount will be reached sooner than scheduled.*
> 2. *That the reset payments are going to be substantially higher than the buyer expects and what was used in the initial qualification.*
>
> *We have at least 20% or more of the Bank's pay option loans at a FICO of 700 or less. It is clear that the lower FICO borrowers are going to experience a payment shock, which is going to be difficult if not impossible for them to manage. Since we know or can reliably predict what's going to happen in the next couple of years, it is imperative that we address the issue now. First and foremost the Bank should not be accumulating any loans below 680 unless the LTV is 75% or lower. Secondly we should comb the assets to assess the risks that we face on FICO's under 700 and determine if we can sell them out of the Bank and replace them*

24 See Case-Shiller 20-City Composite Index

25 See Mozilo e-mail to Carlos Garcia et al, dated June 1, 2006 at CFC2007A371364

with higher quality paper. Thirdly we should take a careful look at our reserves and begin to assume the worst …"

Mr. Mozilo had every right to be concerned. Despite the modest prices changes between 2005 and 2006, there had been a substantial increase in California home prices between December, 2000 and December, 2005.[26] **Table 6** summarizes the Case-Shiller data.

======================= INSERT TABLE 6 HERE =======================

But despite Mr. Mozilo's continued and well founded concern, the Pay-option ARM loan balance held for investment in the CFC Banking Operations segment grew from $26.1 billion to $32.7 billion at calendar year-over-year and peaked at nearly $35.4 billion September 30, 2006.[27] The average loan-to-value on Pay-option ARM products did not decline from 2005 to 2006, but the average FICO score decreased slightly from 720 to 718. Pay-option ARM delinquencies grew from .1 percent to .63 percent of bank operating assets, but the allowance for loan losses as a percentage of non-accruing loans actually declined year-over-year.[28]

Mr. Mozilo was also rightly concerned about CFC's subprime products. In a March 28, 2006 e-mail, apparently written in reaction to a CFC buy back of a pool of 100 percent LTV subprime loans as a result of indemnifications provisions, Mr. Mozilo wrote[29]:

"*Based upon our meeting today we agreed to the following…*

… 2. Sambol will make certain that the people responsible for the origination process understand the necessity for adhering to the guidelines for 100% LTV sub-prime product. This is the most dangerous product in existence and there can be nothing more toxic and therefore requires that no deviation from guidelines irrespective of the circumstances …

… 4. Spector to review the buybacks and to take every step possible to correct the deficiencies and look to another secondary sale opportunity in order to reduce the loans of this type on our balance sheet …

… Again it is important that we take all of the corrective measures to resolve the outstanding issues with this product but more important to establish all of the necessary protocols to assure that we are originating these loans in a manner which takes us out of harm's way and that the loans are sold in a manner to avoid further and unnecessary exposure to the Company …"

Within two weeks, Mr. Mozilo amplified his concerns in an e-mail regarding first quarter 2006 earnings.[30] In part, he wrote:

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26 See Case-Shiller 20-City Composite Index
27 See Page 53 of CFC Form 10-Q for the nine months ended September 30, 2006
28 See Pages 107 and 108 of 2006 CFC Form 10-K
29 See Angelo Mozilo e-mail to Stan Kurland et al dated March 28, 2006 at CFC2007A370003
30 See Angelo Mozilo e-mail to Stan Kurland et al dated April 13, 2006 at CFC2007B008980

"As per our conversation this morning, it appears to me that there are several important issues which must be addressed relative to our 100% sub prime second business ... I have personally observed a serious lack of compliance within our origination system as it relates to documentation and generally a deterioration (sic) in the quality of loans originated versus the pricing of those loan (sic). In my conversations with (David) *Sambol, he calls the 100% sub prime seconds as the "milk" of the business. Frankly, I consider that the product line to be the poison of ours. Obviously, as CEO I cannot continue the sanctioning of the origination of this product until such time I can get concrete assurances that we are not facing a continuous catastrophe ..."*

According to the CFC Form 10-Q for the quarter ended March 31, 2006, nonprime delinquencies in the servicing portfolio were 12.51 percent, some 292 bps greater than the first quarter of 2005.[31] The delinquency rate on nonprime mortgage loans in the servicing portfolio would continue to grow to 19.03 percent by year-end.[32]

Mr. Mozilo also remained troubled by the risks of Pay-option and HELOCs. In a May, 2006 e-mail to David Sambol, he wrote:[33]

"*… In addition, per our conversations of this week, I want you to examine our risk profile as it relates to the assets of the balance sheets of both CFC and the Bank. Although all assets should be reviewed including exposure on our residuals and excess servicing, we must pay special attention to HELOCs and pay options…*

... Per some of the suggestions offered during our meeting we should take every step possible to reduce balance sheet risk by:

1. *Taking steps to encourage pay option mortgagors to refinance into IO's.*
2. *Where deemed appropriate the Bank should forgive the prepayment penalty if it appears obvious that the borrower will potentially default upon reset.*
3. *Through our payment coupon, we should alert all Pay-option borrowers what could happen upon reset.*

Obviously there is much more that we can do to manage risk much more carefully during this period of uncertainty both as to the rate environment and untested behavior of Pay-options. Work closely with Carlos (Garcia) *and Stan on the execution of the strategies that we pursue. The combination of effectively managing our expenses and finessing off potential risks should keep us in good shape until the storm clears ..."*

Despite these expressions of caution, CFC originated more prime home equity loans in 2006 than it did in 2005 and subprime loan production decreased only by 10 percent (See **Table 7**).[34]

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[31] See Page 63 of CFC Form 10-Q for the quarter ended March 31, 2006
[32] See Page 9 of 2006 CFC Form 10-K
[33] See Angelo Mozilo e-mail to David Sambol dated May 18, 2006 at CFC2007B061677
[34] See Page 29 of 2007 CFC Form 10-K

======================== INSERT TABLE 7 HERE ========================

Running in Place

Despite the record price of Countrywide common shares in early 2007 and the share repurchases in late 2006, CFC's earnings had been largely stagnant since 2003 and its returns on equity had declined sharply. Countrywide's price earnings multiple had rarely been higher, but the Company's performance was unremarkable.

Despite generally increasing volumes in higher risk loan production—particularly subprime, home equity and non-conforming products (including Pay-options and Alt-A loans)—Countrywide's earnings grew a total of 12.7 percent in the four-year period from 2003 through 2006, but the growth rate in CFC's production of risky products was substantially faster. **Table 8** recapitulates growth by loan category.[35]

======================== INSERT TABLE 8 HERE ========================

The growth in higher risk loan production (See **Table 1** above), the majority of which was shoveled off of Countrywide's balance sheet through securitizations, did not produce increases in CFC's gains on sale. In fact, gains on sale declined between 2003 and 2006 from nearly $5.9 billion to almost $5.7 billion.

One of the reasons CFC's gains on sale declined and its net income increased only modestly between 2003 and 2006 was that spreads on higher risk loans had narrowed. Per **Table 3** above, gains on sale as a percentage of loans sold declined significantly in three major categories: prime loan gains on sale declined from 1.40 percent of loans sold to 1.07 percent; subprime dropped from 4.43 percent to 1.84 percent and prime home equity declined from 1.90 percent to 1.71 percent.[36] The decline in prime loan spreads occurred despite the fact that CFC's mix of loans changed dramatically. In 2003, conforming loan originations totaled approximately $236 billion but by 2006, had declined to approximately $149.1 billion. Prime non-conventional originations, including Pay-option and Alt-A loans, grew from $136 billion in 2003 to $211 billion in 2006.

Coupled with increasing operating expenses, the declines in securitization gain on sale margins apparently compelled Countrywide not only to originate and sell more high risk loans, but also to keep substantially greater amounts of loans it knew to be high risk on its balance sheet. In other words, to grow profits, CFC took substantially more risk**. A**dditional risks included holding increasing amounts of nonprime and home equity retained interests—often the first loss tranche of the securitization—as well as carrying significantly greater amounts of home equity, subprime and Pay-option loans on its balance sheet.

In other words, while net income was substantially stagnant between 2003 and 2006, Countrywide literally put the company on the line when it more than doubled its exposure to

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[35] See Page 24 of the CFC 2005 Form 10-K and Page 29 of the CFC 2007 10-K

[36] Countrywide changed its reporting on home equity lending so the more highly profitable subsequent draws on home equity loans have not been considered in this analysis.

high-risk loans and residual interests to generate earnings and meet competitive demands.[37] Moreover, despite the higher risks, profits on securitizations were declining. **Table 9** summarizes the magnitude of high-risk assets from 2003 through 2007.

======================== INSERT TABLE 9 HERE ========================

Despite the additional risk embedded in Countrywide's balance sheet, in the fourth quarter of 2006, CFC repurchased some 38.6 million shares of its common stock for approximately $1.51 billion or an average of slightly more than $39 per share.[38]

A Very Bad Year

By August 2007, many of Mr. Mozilo's fears about toxic loans were realized. Between January 2 and December 31, 2007, prices for home equity loans originated in 2006 were collapsing. Mr. Mozilo clearly foresaw what was to follow. In a March 2007 email to various CFC executives, he wrote:[39]

> "*Our production in Pay Options is increasing. How is this happening when the underwriting guidelines have been so severely restricted? I also see that we continue to have a substantial inflow of subprime. In light of the fact that we are taking substantial losses on subprime and its attendant residuals, how do we justify continuing intake of such substantial volumes? I do not want to continue to have to hold subprime for investments on our balance sheet because of the lack of liquidity and the adverse pricing environment. Have you sold the Pay-options in the Bank as we had discussed about a month ago?"*

In April, 2007, New Century Financial Corporation, the nation's second largest originator of subprime loans filed for bankruptcy. New Century had initially securitized nearly all of the subprime loans it originated, but by the third quarter of 2006, the company reported an inventory of nearly $9 billion of mortgage loans held for sale and an additional $14 billion held for investment. The $23 billion of largely subprime loans were funded by approximately $22.4 billion of debt.

According to the New Century Bankruptcy Examiner, the immediate causes of New Century's failure were the announcement that interim 2006 financial statements would require restatement and a sharp increase in the number of home foreclosures, about half of which were subprime by the fourth quarter of 2006.[40] As a result, lenders began pulling their credit lines. In June 2007, two Bear Stearns hedge funds announced that redemptions would be suspended. The highly

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[37] For 2003, see Pages F-22 and F-44 of 2003 CFC Form 10-K and Page F-22 of 2004 CFC Form 10-K
For 2004, see Pages F-22, F-25, F-33 and F-44 of 2004 CFC Form 10-K
For 2005, see Pages F-35 and F-38 of 2005 CFC Form 10-K and Page 34 of 2006 CFC Form 10-K
For 2006, see Page F-39 of 2006 CFC Form 10-K and Pages F-36, F-45, F-46 of 2007 CFC 10-K
For 2007, see F-36, F-40, F-45 and F-46 of 2007 CFC Form 10-K

[38] See Page F-6 of the 2006 CFC Form 10-K

[39] See Angelo Mozilo e-mail, dated March 9, 2007 at CFC2007C097767

[40] See Pages 1 and 47 of Final Report of Michael J. Missal, Bankruptcy Court Examiner, dated February 29, 2008, New Century TRS Holdings, Inc., Case No. 07-10416 (KJC)

leveraged funds held collateralized debt obligations ("CDOs") largely backed by subprime loans. Losses in the two funds were nearly total.[41]

During this same period, delinquency rates on home loans continued to increase, further exacerbating the descent of home values at alarming rates. Six of the top ten communities suffering the highest rates of mortgage delinquencies were in California and Florida, Countrywide's two largest markets. In the second quarter of 2007, Merced, Stockton, Riverside and Modesto, California, experienced delinquency rates that ranged from nearly 5.1 percent to 8.1 percent. In Miami and Ft. Lauderdale, Florida, delinquencies were 5.4 and 5.1 percent, respectively.[42] By July 2007, home values in Los Angeles had declined 3.4 percent from December 2006, while values in San Diego and San Francisco fell 3.7 percent and 1.6 percent, respectively. In Florida, conditions were worse. Miami home values dropped 7.3 percent for the period while the Tampa decline was 5.96 percent.[43]

On July 24, 2007, in a conference call that reportedly lasted more than three hours, Countrywide announced its earnings for the second quarter ended June 30. While the company realized earnings of $919 million for the six months then ended, the results represented a decline of approximately 35 percent from the comparable period in 2006. Operating cash flow deficits were some $6.8 billion, partly as a result of Countrywide's inability to sell off loans.

Delinquencies on Countrywide's sub-prime loan servicing portfolio rose to more than 20 percent, up from 13.7 percent in the prior year and home equity loan delinquencies jumped to 3.7 percent. In all, Countrywide announced that it recorded nearly $445 million of loan losses and took an additional $697 million impairment charge on its retained interests from securitizations, a tenfold increase over the comparable six-month period in the prior year. Trends matter and Countrywide's reports drove a broader market selloff that resulted in a two percent decline in the S & P 500, its largest drop in 5 months, and Countrywide's shares declined by 11 percent that day to $30.50.[44]

When Countrywide filed its Form 10-Q with the SEC on August 9, 2007, it stated, in part:

… As of June 30, 2007, we have $190.3 billion in available sources of short-term liquidity, of which we consider $46.2 billion highly reliable and available. We believe we have adequate financing available to meet our currently foreseeable needs …[45]

In fact, at the date of its filing, CFC had less than a week. On August 15, 2007, the market for Countrywide's commercial paper simply shut down. Within eight days, Bank of America purchased some $2 billion of Countrywide's preferred shares, paying a 7.25 percent dividend. Along with the preferred share purchase, Bank of America acquired an option to convert the preferred into CFC common shares at $18 each. On August 23, 2007, the day the transaction was announced, CFC common shares traded as high as $24.46 and closed the day at $22.02. The

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[41] See *Bear Stearns' Bad Bet*, by Matthew Goldstein and David Henry, BusinessWeek.com, October 11, 2007
[42] See Mortgage Delinquencies, WSJ.com, July 19, 2007
[43] See Case-Shiller Composite 20-City Index for respective cities at December, 2006 and July, 2007
[44] See *Home Lender's Woes Fuel Market's Decline*, The New York Times, July 24, 2007 and Page 2 of CFC Form 10 Q for the three months ended June 30, 2007
[45] See Page 93 of CFC Form 10-Q for the quarter ended June 30, 2007

Bank of America equity infusion coupled with Countrywide's draw down of its $11.5 billion bank lines, allowed CFC to survive the August liquidity crunch, but the transaction was widely viewed as a rescue because of the onerous preferred share dividend and the in-the-money option exercise price. [46]

The benefits of the new equity also permitted Countrywide to endure as an independent entity until January 11, 2008, when Bank of America announced it would acquire Countrywide for approximately $4.1 billion in an all-stock transaction.[47] The $4.1 billion valuation was at a massive discount to CFC's December 31, 2007 book value of nearly $14.7 billion,[48] but by then, much of Wall Street shared much of Mr. Mozilo's early and apocalyptic vision of subprime, home equity and Pay-option lending.

For the year ended December 31, 2007, CFC reported a net loss of more than $703 million. The amount included nearly $2.3 billion of loan loss provisions and some $2.38 billion of impairment charges on its retained interests from securitizations. The day before the Bank of America announcement that it would acquire Countrywide for about $7.16 per share, CFC shares increased 51 percent to $7.75. After the official announcement on January 11, 2008, Countrywide's shares declined to $6.33.

Once again, the Corporate Risk Management Committee did no stress tests or other analyses to assess any of the risks related to these mortgage investments and securitizations and continued to ignore the CEO's repeated risk warnings.

SUMMARY

Howard Schilit (2010), the well-known forensic accountant, has stated that the one lesson we have learned from history is that we have learned nothing from history, and he has recommended that to find fraud, we must study the history of fraud. Similarly, this observation can carry over to study the history of risk management leading up to the economic recession in order to understand and develop good risk management practices by both management and boards of directors for better corporate governance. Thus, this paper has developed six risk management lessons learned from the history of Countrywide:

1. Do not ignore ubiquitous high risk loans and other high risk activities
2. Do not ignore the initial risk warnings of senior management executives
3. Do not stay the course against ongoing risk warnings
4. Do not be seduced by significant profits on high risk loans and other high risk activities
5. Do a cost/benefit analysis on the securitization of loans and other high risk activities
6. Do stress tests on key risks which may be realized

Also, the Securities and Exchange Commission (SEC) charged Mozilo with insider trading and securities fraud on June 4, 2009. On Friday, October 15, 2010, Mozilo reached a settlement with the SEC. He agreed to pay $67.5 million in fines and accepted a lifetime ban from serving as an

[46] See *Countrywide Gives Bank of American $447 Million Gain, Bloomberg.com, dated August 23, 2007*
[47] See *Countrywide rescue: $4 billion,* CNNMoney.com, dated January 11, 2008
[48] See Page 48 of 2007 CFC Form 10-K

officer or director of any public company. The SEC settlement was the largest by an executive connected to the 2008 housing collapse and financial crisis. The fine represented a small fraction of Mozilo's estimated net worth of $600 million and Countrywide paid $20 of the $67.5 million penalty, due to an indemnification agreement that was part of Mozilo's employment contract. The terms of the settlement allowed Mozilo to avoid acknowledging any wrongdoing and in February 2011, the criminal investigation against him was dropped.

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Table 1
Countrywide Financial Corporation
Consolidated Loan Production
2001 through 2007

	2007	2006	2005	2004 In Millions	2003	2002	2001 10 Months
Conventional Conforming Loans	$216,829	$149,095	$167,675	$138,845	$235,868	$150,110	$76,432
Conventional Non-Conforming Loans	$117,634	$211,841	$225,217	$140,580	$136,664	$61,627	$22,209
Nonprime Mortgage Loans	$34,399	$47,876	$44,637	$39,441	$19,827	$9,421	$5,580
Prime Home Equity Loans	$16,993	$40,596	$42,706	$30,893	$18,103	$11,650	$5,639
FHA/VA Loans	$22,379	$13,093	$10,712	$13,247	$24,402	$19,093	$14,109
Commercial Real Estate Loans	$7,400	$5,671	$3,925	$358	$ -	$ -	$ -
	$415,634	**$468,172**	**$494,872**	**$363,364**	**$434,864**	**$251,901**	**$123,969**

Table 2
Countrywide Financial Corporation
Losses on Home Equity Residuals
For the Years Ended December 31, 2004-2007

	2007	2006	2005	2004
	In Thousands, except for Percentages			
Net Prime Home Equity Residuals	$422,681	$1,506,109		
Available for Sale			$143,950	$275,598
Trading			$782,172	$533,554
Total Net Prime Home Equity Residuals	$422,681	$1,506,109	$926,122	$809,152
Credit Losses on Prime Home Equity Residuals	$896,020	$79,359	$34,173	$29,370
Gross Total Prime Home Equity Residuals	**$1,318,701**	**$1,585,468**	**$960,295**	**$838,522**
Credit Loss as % of Gross Prime Home Equity Residuals	**67.95%**	**5.01%**	**3.56%**	**3.50%**

Table 3
Countrywide Financial Corporation
Gain on Sale as a Percent of Loans Sold
For the Periods Ended December 31, 2003 through June 30, 2008

	6/30/2008	12/31/2007	12/31/2006	12/31/2005	12/31/2004	12/31/2003
Prime Mortgage Loans	1.36%	0.80%	1.07%	0.82%	0.93%	1.40%
Nonprime Mortgage Loans	N/M	-1.91%	1.84%	2.01%	3.64%	4.43%
Prime Home Equity Loans						
Initial	N/M	-4.16%	1.71%	2.10%	2.78%	1.90%
Subsequent Draws	2.56	2.30%	3.52%	-	-	-

Table 4
Countrywide Financial Corporation
Significance of Pay-option, Subprime and Home Equity Revenues
For the Years Ended December 31, 2003 through 2006

	2006	2005	2004	2003
Gains on Sale				
Pay-Option Estimate	$502,835	$405,088	$337,647	N/A
Nonprime Mortgage Loans	$703,686	$881,843	$1,115,450	$452,866
Prime Home Equity Loans			$778,622	$15,566
Initial	$459,158	$510,109		
Subsequent Draws	$151,611	$121,519		
Estimated Net Interest-Pay-Option	$723,240	$363,711	$55,941	N/A
Total	**$2,540,530**	**$2,282,270**	**$2,287,660**	**$468,432**
Consolidated Total Revenue	**$11,417,128**	**$10,016,708**	**$8,566,627**	**$7,978,642**
Nonprime and Home Equity as % of Consolidated Total Revenue	**22.3%**	**22.8%**	**26.7%**	**5.9%**

Table 5
Countrywide Financial Corporation
Significance of Gain on Sale
on Home Equity and Subprime Loans
For the Years Ended December 31, 2003 through 2007

	2007	2006	2005	2004	2003
Gain on Sale	$(574,649)	$1,314,455	$1,517,471	$1,894,072	$468,432
Servicing Fees, Net	$333,212	$154,496	$120,503	$87,473	$(120,263)
Income from Retained Interests	$505,325	$513,136	$455,986	$388,474	$410,346
Gain Related Income	$263,888	$1,982,087	$2,093,960	$2,370,019	$290,083
Total Revenue	$6,061,437	$11,417,128	$10,016,708	$8,566,627	$7,978,642
Gain Related Income as % of Total Revenue	**4.4%**	**17.4%**	**20.9%**	**27.7%**	**3.6%**

Table 6
Case-Shiller Home Value Changes in California Markets
From the Period December 31, 2000 through 2005

	2000 Index	2005 Index	% Change
Los Angeles	110.12	264.77	263.8%
San Francisco	128.58	215.11	214.1%
San Diego	116.32	248.55	247.5%

Table 7
Countrywide Financial Corporation Loan Production by Type
As Percent of Total Production
For the Years Ended December 31, 2005 through 2006

	2006	2005
Conventional Conforming	31.9%	32.0%
Conventional Non-Conforming	45.2%	47.2%
Nonprime Mortgage Loans	10.2%	9.0%
Prime Home Equity Loans	8.7%	8.9%
FHA/VA Loans	2.8%	2.1%
Commercial Real Estate Loans	1.2%	0.8%
	100.0%	**100.0%**

Table 8
Countrywide Financial Corporation
Comparison of Growth Between Earnings and Higher Risk Loan Production
2003 through 2006

	2006	2003 In Millions	% Total Growth
Conventional Non-Conforming Loans	$211,841	$136,664	55.0%
Nonprime Mortgage Loans	$47,876	$19,827	141.5%
Prime Home Equity Loans	$40,596	$18,103	124.3%
CFC Net Income	$2,674.8	$2,372.9	12.7%

Table 9
Countrywide Financial Corporation
Summary of High Risk Residuals and Loans Compared to Shareholders' Equity
For the Years Ended December 31, 2003 through 2007

	2007	2006	2005	2004	2003
			In Thousands		
High Risk Financial Instruments and Loans					
Available for Sale					
Nonprime Mortgage Loans	$3,038,980	$4,917,895	$6,736,946	$9,882,701	$7,193,075
Home Equity Loans	$82,131	$1,813,947	$1,948,874	$1,033,653	$551,310
Nonprime and Home Equity Retained Interests	$123,917	$343,593	$587,076	$899,716	
Trading Securities					
Nonprime and Home Equity Retained Interests	$591,847	$1,567,863	$1,448,464	$721,480	
Held for Investment					
Prime Home Equity Loans	$34,539,144	$20,093,644	$14,991,351	$11,435,792	$12,804,356
Nonprime Loans	$2,725,407	$115,054	$255,677	$171,592	$175,331
Pay-Option ARMs Loans	$28,973,498	$32,732,581	$26,101,306	$4,698,665	
Investments in Other Financial Instruments					
Home Equity and Subprime Securities					$5,332,548
Nonprime and Home Equity Retained Interests					$691,575
Total High Risk Financial Instruments and Loans	**$70,074,924**	**$61,584,577**	**$52,069,694**	**$28,843,599**	**$26,748,195**
Shareholders' Equity	$14,655,871	$14,317,846	$12,815,860	$10,310,076	$8,084,716
Excess of High Risk Instruments to S/H Equity	**$55,419,053**	**$47,266,731**	**$39,253,834**	**$18,533,523**	**$18,663,479**
High Risk Instruments to Shareholders' Equity	**478%**	**430%**	**406%**	**280%**	**331%**