John McMurray/Managing Directors/CF/CCI 09/07/2007 02:12 PM	To	Jess Lederman/Managing Directors/CF/CCI
	cc	
	bcc	
	Subject	Fw: World Class Risk Organization

There has been some progress on a few of these items. Some of what I propose is anathematic to the imbedded culture (and thus the slow progress).

----- Forwarded by John McMurray/Managing Directors/CF/CCI on 09/07/2007 02:06 PM -----

John McMurray/Managing Directors/CF/CCI 02/11/2007 02:02 PM	To	Dave Sambol/Managing Directors/CF/CCI, Kevin Bartlett/Managing Directors/CF/CCI
	cc	
	Subject	World Class Risk Organization

This email is a preliminary response to a question you recently posed to me asking what it would take for us to become world class with respect to risk management. At a very high level, I think we need to do the following:

Clarity. We need clarity around several key risk issues, especially:

Risk Vision. We need a clear risk vision as well as guiding principles for managing and retaining risk.

Roles & Responsibilities. We need more precisely defined roles and responsibilities for managing and retaining risk.

Infrastructure. The infrastructure for managing risk needs to be enhanced in three key dimensions, namely: people, processes and systems. The enhancements need to occur both within and outside of my areas.

Allow me to elaborate from this very basic summary.

RISK VISION

After Stan's departure and based on conversations with both of you, I put together a new risk vision. Both of you reacted favorably to the document when I shared it with you. I include a reference copy of this vision at the end of this email under "epilogue."

Matching. Perhaps the biggest lack of clarity contention is around matching. While the risk vision I proposed incorporates matching, it is tempered by our ability to transfer risk. Instead of my risk vision, a key operating unit proposes an approach based on matching alone: "if a product, guideline, or transaction is in the market, than we can (and mostly likely will) offer the same thing."

Global versus Local Optimization. Another area where clarity is lacking is global versus local optimization. Do we want to manage risks such that consolidated results are optimized? Or, do we manage risk and optimize results "locally" for each operating unit separately as a priority over the consolidated picture?

GOVERNMENT EXHIBIT

Irrespective of what vision we adopt, we do need a clear risk vision and guiding principles to provide context and direction around the day-to-day risk decisions we confront. Based on conversations with you (Kevin) late last week, I will move forward with advancing the matching approach that incorporates both a governor and a pricing methodology based on economic capital.

ROLES & RESPONSIBILITIES

We need more clarity around risk roles and responsibilities to avoid duplication, confusion, inconsistency and "holes." More clarity would also allow us to more effectively measure and manage our consolidated risk position. Here's how I propose we sum up my role in one sentence:

> The Chief Risk Officer (CRO) is responsible for managing Countrywide's enterprise risks, which include market, credit, operational and compliance risks.

The rational underlying my proposal is threefold. First, it is the same approach used by large, world-class organizations. Second, it recognizes the multidimensional nature of the risks we face (most risks are some combination of market, credit, operational and/or compliance). Third, it provides clarity.

Primary Functions. The primary functions of the CRO organization would be:

Risk Framework. Establish and maintain an integrated risk framework, including economic capital. "Framework" includes a number of separate elements; some key elements of the framework include:

- a consistent view of risk across the firm

- relevant boundaries, tolerances and limits for measuring and controlling risk

- governance structures across the various operating units that roll up to the CRO (see organizational implications below) and the

Risk Policy. Develop and maintain risk polices, including:

- setting company-wide risk definitions and standards

- determining and enforcing our risk appetite (subject to appeal and overrule by either of you)

Risk Monitoring & Surveillance. Provide, analyze and consolidate the information needed to

- measure, monitor and control risks

- identify firm-wide impacts of diversification and concentration

- facilitate risk-reward choices

Contact. Serve as the central point of contact for external parties on risk related issues.

Risk Systems. Provide leadership for risk related systems.

Organizational Implications. From an organizational perspective, financial officers in operating units or other functions report to the Corporate CFO group on either a hard or dotted line basis. Risk officers in the various units should report in to the Corporate CRO group in a similar fashion. Here's a brief summary of the organizational approach across the main risk areas:

Market Risk. The day-to-day hedging and market risk management would continue to be done outside of the CRO organization. My group would be responsible for "enterprise" market risk functions, including consolidating all of the market risk positions managed by others around the firm (MSR, broker/dealer, bank, etc.) so we have a total picture of our market risk exposure.

Credit Risk. While my group would manage the "enterprise" risk functions, there would also be some day-to-day credit functions managed centrally by my group rather than delegated to the operating units or other corporate areas. Examples of centrally managed functions retained by the CRO include: (1) Asset Quality & Risk Transference (this includes Loan Review and Quality Control), (2) Surveillance and (3) Credit Models & Scorecards, (4) Credit Enhancement Strategy and (5) Mortgage Reinsurance.

Operational Risk. The day-to-day operational risk management would continue to be done outside of the CRO organization. My group would be responsible for "enterprise" operational risk functions, including consolidating all of the operational risk positions managed by others around the firm (MSR, broker/dealer, bank, etc.) so we have a total picture of our operational risk exposure.

Central Compliance. Here again, the day-to-day operational risk management would continue to be done outside of the CRO and Chief Compliance Officer organization. The Chief Compliance Officer responsibilities would include creating policy, assessing operating unit performance and reporting consolidated results to senior management. NOTE: Central Compliance could be either inside or outside of the CRO organization.

INFRASTRUCTURE

To achieve world class status we need to make improvements in people, processes and systems. I plan to outline what we need here in a subsequent email(s). Having clarity around risk vision as well as risk roles and responsibilities will optimize the return on our infrastructure investments.

In closing, I am very anxious to get your thoughts to what I've proposed and move forward. Thanks.

EPILOGUE

Although the basic theme of this email is achieving more clarity, I wanted to provide my recommendations with respect to the risk vision. I recommend that we use a global rather than local optimization approach simply because the local approach will almost never optimize consolidated results. I also recommend that we temper the matching approach with a risk transfer and/or capital allocation governor. My concerns with an untempered matching include:

Composite Match. Since we match numerous competitors over an extended time frame, our menu ends up being a composite of the most aggressive offerings in the market.

Optics. I doubt this approach would play well with regulators, investors, rating agencies, etc. To some, this approach might seem like we've simply ceded our risk standards and balance sheet to whoever has the most liberal guidelines.

Pricing. We normally employ risk-based pricing to mitigate the effects of higher risk. There are at least two aspects of risk-based pricing we should consider:

RBP Limits. Risk-based pricing works only if borrowers "pay and don't prepay." By "pay and don't prepay," I mean that a sufficient number of borrowers need to pay without defaulting or prepaying prematurely so that adequate risk compensation is collected. Said differently, there are transactions which cannot be risk-based priced successfully, especially if the risk premium is collected in rate rather than price.

Slope, Precision & Amplitude. We should always worry whether our pricing is "steep" enough, granular enough or in sufficient numbers to achieve acceptable results. Pricing which is not sufficiently steep or granular will discourage low-risk and encourage (and underprice) high-risk transactions. Insufficient numbers will create "lumpiness."

Balance Sheet Capacity. Since no provision is made for risk transfer, we risk using up our capital and/or our ability to fund assets over time as high-risk assets accumulate on the balance sheet.

Matching Ability. Our ability to thoroughly understand and/or precisely match what competitors are offering has often been less than perfect.

The economic capital approach may be a good compromise between untempered matching and what I proposed (a reference copy of what I proposed appears below).

Reference Copy of Risk Vision. My proposed risk vision and guiding principles appear below. You have seen this before, but I wanted to provide a copy here for reference. I am revising this to include a provision for economic capital based matching.

RISK VISION

Returns above the risk-free rate are earned only through exposure to one or more risks. We seek risk exposures that we can: (1) understand, (2) manage and which (3) provide adequate compensation.

GUIDING PRINCIPLES for TAKING RISK

Compatibility with Risk Vision. Our first risk principle is to take only those risks that are compatible with our risk vision; viz:

Understand. "Understand" means that we have the capability and tools to estimate both expected returns, costs and losses as well as the distribution of these items.

Manage. "Manage" means that we can employ measures and controls to limit and/or transform risk to fit within our financial and operational capacities.

Compensation. Adequate "compensation" means that we are earning an acceptable risk-adjusted return.

Distributed Risk. We often engage in transaction where most (but never all) of the risk can ultimately be transferred to other parties through hedging/derivatives, sales/securitizations, and/or insurance. Requirements for transactions and products where risk is being distributed include:

Market Reference. The transaction or product creating the risk exposure must be offered in the market by a "legitimate" institution.

Reputational Risk. The transaction or product creating the risk exposure should not pose unacceptable levels of reputational risk.

Operational Risk. The transaction or product creating the risk exposure should not pose unacceptable levels of operational risk. Operational controls must be sufficient to reduce operational risks to a tolerable level.

Governance. The transaction or product creating the risk exposure must be formally approved through the firm's official governance process.

Retained Risk. Requirements for transactions and products where risk is being retained include the requirements for distributed risk (as applicable) plus:

<u>Capital.</u> We allocate current and future capital to all known risks. Individual risk positions will be limited by the amount of capital (regulatory, rating agency and economic) they consume in the context of
our aggregate capital.

<u>Return.</u> Individual and aggregate risk positions should generate and acceptable RORAC (return on risk adjusted capital) and should be marked and base-priced accordingly.

<u>Risk-Based Pricing.</u> To the extent risk compensation is provided through risk-based pricing (especially a high coupon in lieu of a lower price), a reasonable basis must exist for concluding that the compensation will actually be realized (not lost through early prepayments and/or defaults).