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Corporate Credit Risk Committee

Final Minutes

June 28, 2005

Attendance:

Stan Kurland -V	Christian Ingerslev	Erik Stein	Marc Fisher
Eric Sieracki - V	Mitch Turley	Frank Aguilera	Cliff Rossi
John Mc Murray -V	Pauline Kennedy	Rod Williams	David Spector
Nick Krsnich – V	Jeff Speakes	Jack Schakett	Drew Gissinger III

V = voting member

Available Handouts;

Corporate Credit Risk Committee Presentation
Credit Risk Trends – May 2005
Product books for Subprime, Conventional, HELOC and Government products.

Meeting started at 2:00 PM PST.
Headquarters Boardroom

Topics:

1) Risk Position summary

- John McMurray reviewed the Risk Position Summary on page 3. John pointed out that the three key pieces where CFC retained risk are HELOC and Sub prime residuals, Treasury Bank portfolio and the reinsurance portfolio in Balboa reinsurance. The residual and reinsurance reserves are for the lifetime of the loans. The Treasury Bank reserve is based on GAAP losses for the next 12 months.
- Jack Schakett asked if there is a trend of the reserve information. John directed the committee to page 28 of the presentation and reviewed the residual loss reserve increase of the past year.
- Nick said the $1.4 billion is made up of $1 billion related to the residual assets and $439 million of other reserves on balance sheet.
- Drew commented that if the treasury bank portfolio has a low CLTV then even if the loans default there is not much impact.
- Stan said we are taking too much balance sheet risk. We should stratify our portfolio and look at our warehouse loans and BC/HELOC residuals. Nick said we need to pay attention to the volatile soft markets and we should stratify our risk by geography.
- Stan said there are two rules, model it or sell it. He sees this as a Secondary issue to sell credit risk on higher risk loans such as HELOCs and BC 100% 1st. A brief discussion of possibly restructuring high risk

transactions to 1st liens with MI and away from HELOC originations occurred with no resulting action steps.

2) Rep & Warrant breach exposure

- John McMurray discussed the past trends of foreclosure repurchase request percentages from agencies, whole loan investors and MI companies.
- FNMA and FHLMC request repurchases on 14% and 22% of foreclosures, respectively. The approved repurchases have averaged 9% and 11% respectively.
- MI Co's rescind coverage on 11% of foreclosures and have an approved rate of 8%. There has been a large difference in rescission rate by MI Company.
- John stated the whole loan investor CBASS requests a much higher percentage of repurchases than any other whole loan investor. In general there is very little rep & warrant repurchase risk from whole loan investors.
- Rod Williams talked about on going discussions with FNMA & FHLMC regarding the claims and repurchase request process and as of the date of this meeting there is no agreement.
- Rod said discussions have occurred with the MI companies and progress is being made in establishing guidelines for the claims process. One example of a standard relates to occupancy fraud. CFC originates a loan with a written statement from the borrower saying they plan to occupy the property. If the MI Company wants to rescind coverage there needs to be similar documentation that the borrower did not intend to occupy the property. Previously the MI Company would say that someone talked to the borrower and the borrower told them they did not intend to occupy the property. This verbal evidence is no longer sufficient. Triad's rescission rate has improved from 23% to 12%.
- Drew Gissinger asked if CFC has a written agreement for the claims process with FNMA & FHLMC. Rod said there is a written set of claim process guidelines that he, John and legal created based on reviewing the industry practices and presented to FNMA & FHLMC. John said FNMA & FHLMC have not agreed in writing to these guidelines thus far. Nick felt the best stance is state that these guidelines are the industry standards – take it or leave it.
- Stan asked about a borrower who committed employment fraud on a reduced doc loan by saying they were a surgeon when they were a manicurist. Christian said that on reduced doc loans there is a verbal verification of employment to discover this type of fraud.
- John said the best execution model does not consider the claims process.
- Rod followed up saying people committing fraud are not price sensitive so they migrate to reduced doc loans. Stan agreed.
- John reviewed the repurchase trend for Agencies and MI companies over the past five years and pointed out the correlation between the portfolio

size and the volume of repurchase requests. The graph on page 5 shows the active portfolio in a two year lag to repurchases and MI rescissions. Currently there is $100 million in losses on the current inventory of breach notifications.

- Rod reviewed the repurchase requests and actual repurchases for past eight years on page 7 of the presentation. Rod showed there is a lot of progress reducing the volume of actual repurchases since a spotlight was put on the claims process opposite the new product types originated over the past eight years.
- Stan suggested part of the reason the repurchases were down was due to higher property values.

3) Product Line Evolution

- Christian Ingerslev reviewed pages 8 through 12. These pages exclude the correspondent division and percentages are based upon loan count not on loan balance. Non-conforming programs now account for 40% of all loans and 44% of all purchase loans. Jumbo balance originations have risen from 5% to 13%. Sub-prime has risen from 4% to 14%. Non-owner and second homes have risen to 17% of total purchases and 63% of these are non-conforming programs. Coinciding with this growth of new products CFC now participate in the credit risk to nearly 50% of all loans.
- John explained that where CFC originated 80/20 sub prime loans the 20% second lien risk is sold. Even though the default frequency is higher on the 80/20, CFC has 20% equity in front of our position.
- Stan said the issue we have is the amount of credit risk we put on our balance sheet unintentionally. He directed attention to the amount of 100% and 95% CLTV First Time Home Buyer loans at 48% and 14% respectively.
- Nick pointed to several categories of high risk product such as 100% CLTV sub prime, and Low doc, I/O, PayOption >90 CLTV. The whole loan bids reflect these types of high risk loans included in the pools and effects our secondary execution.
- John directed the committee to page 42 and pointed to the higher percentage of ever 90+ delinquencies as a result of the higher percentage of reduced doc loans originated in 2004.
- Christian focused on page 11 and the non-owner second home purchase loans. This category has nearly tripled during the past two years. CFC participates in credit risk on 32% of these loans almost all via home equity piggy-back loans. The field is putting a lot of pressure to go to 100% CLTV on non-owner loans.
- Stan asked why we have 5% of non-owner second home purchases at 95% CLTVs. Drew said production makes exceptions to guidelines. Stan said we appear to have unacceptable risk on our balance sheet from this

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type of loan. Stan asked the purpose of these loans, is it an investment flip?

- Nick stated that the non-owner HELOCs we originate are put into the bank portfolio. Nick is concerned we are participating in a speculative market and is concerned about soft market areas.
- Stan said CFC should be set up to make loans that are marketable and meet responsible lending criteria. Loans where we accept the risk must have equity. The exception process must identify the third party to take the risk on the loan when there is not equity. We must clearly identify who besides us will take the risk of these exception loans.
- Christian recommended standard product and credit risk exposure reporting to include specific risk categories including volume, performance, credit scores and profitability. Also review value of overlaying geographic concentration.
- Christian recommended development of external corporate position statements covering sensitive risk categories. John said he is working with Sandy Samuels on this.

4) Subprime Market Position

- Frank Aguilera described the grid on page 13 and CFCs position in each segment.
- Stan keyed in on the 100% 1st lien category and said it is fundamental that CFC will make subprime loans as long as we have equity. If we have a 100% borrower then we need to sell the residual or the loan as a whole loan sale.

5) Loan Exceptions

- John reviewed the loan exceptions starting on page 14. These are the exceptions to major product guidelines only. All CLUES referred loans break out into three categories; 1/3 miss the scorecard, 1/3 miss major guidelines and 1/3 miss minor guidelines. **Based upon the discussion we are taking direction not to originate HELOCs behind these exceptions, they must have mortgage insurance.**
- Jack Schakett asked that the rules in XENA be changed so that the structured loan desk cannot make an exception loan with a HELOC. **John said some rules have been implemented and additional rules are being worked on.**
- Looking at page 15 Stan asked if the 4.1% ever 60 day % is close to the subprime default rates. If so, are we collecting subprime rates on these loans? Frank said the 12 month subprime rate is 5.2% for ever 60 day delinquency.
- John explained the seconds pricing model does not have combined loan amounts and Spector's people are working on adding that feature. The model validation minutes from the ALCO meeting will show changes in

models. Drew asked how add-on pricing gets trued up to actual experience. John said the price production receives includes actual default experience and models are priced to a mean. The models include a geographic variable to help modify for various markets. The models have transition matrices that take 60 day delinquencies to foreclosure.

6) PayOption

- On page 18 Christian showed the start rate has remained unchanged at 1% over the last 12 months while fully indexed rates have risen 200-250 bps. John stated the big increase in short term rates have created more negative amortization during the first 11 month negative amortization period. The current product has more negative amortization and payment shock potential than when the product was started. The qualification interest rate has remained unchanged at the greater of 4.25% or the fully indexed rate. Today the fully indexed rate is 5.375 to 6.375%.
- Nick suggested we move the negative amortization period to 12 months from 11 months to get a more updated index rate.
- Christian explained there is a 7.5% payment cap every year and if the negative amortization causes the loan to reach 115% then the loan recasts with no payment cap. More recent fundings show 70% have experienced neg am after 3 months.
- Christian showed the competitive landscape and suggested the whole industry is waiting to see who will move the start rate up first. Drew said we should build out the models before making a decision on changing the start rate. Stan said the Fed might move to cause us to change the start rate. Where is the market for these loans? Nick said we sell the loans and the risk off.
- Drew said we are working toward a risk based pricing policy. We need to get more granular.
- Stan asked if we could create a product that gave the borrower the option of the start rate and we priced accordingly. The market will change this product. CFC should pick the likely attitude of investors and move toward that point. CFC needs to work aggressively ready to go with systems, programs and servicing changes so we can switch over as soon as needed.
- Christian said WAMU already has risk based pricing. He went through the short tem response alternatives on page 21 which included increasing the base start rate, change the qualification rate and reduce max LTV.
- Drew asked if the whole loan demand is still there. Nick said yes the demand is still there.

10) Odds Ratios/NPM

- On page 23 John showed the correlation between the prediction of default on the origination portfolio and the net profit margin. The higher the predicted default range the higher the net profit margin.

11) Other sections summary

- John briefly directed the committee's attention to the sections covering the MI captive books, Housing Values and Unemployment state rates and the QC underwriting and compliance summary results.

Meeting ended at 5:30 PM PST.

Note: Action Items are in bold.

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