S. Hrg. 112–675

WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE

REPORT AND APPENDIX

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON
HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

VOLUME 5 OF 5—PART I

APRIL 13, 2011

Available via http://www.gpoaccess.gov/congress/index.html

Printed for the use of the Committee on Homeland Security and Governmental Affairs

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VerDate Nov 24 2008 10:11 May 19, 2011 Jkt 57323 PO 00000 Frm 000002 Fmt 06019 Sfmt 06019 P:\DOCS\57323.TXT SAFFAIRS PsN: PAT

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U.S. GOVERNMENT PRINTING OFFICE

57–323 PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
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WALL STREET AND THE FINANCIAL CRISIS:
Anatomy of a Financial Collapse

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WALL STREET AND THE FINANCIAL CRISIS: Anatomy of a Financial Collapse

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Wall Street and The Financial Crisis: Anatomy of a Financial Collapse

April 13, 2011

In the fall of 2008, America suffered a devastating economic collapse. Once valuable securities lost most or all of their value, debt markets froze, stock markets plunged, and storied financial firms went under. Millions of Americans lost their jobs; millions of families lost their homes; and good businesses shut down. These events cast the United States into an economic recession so deep that the country has yet to fully recover.

This Report is the product of a two-year bipartisan investigation by the U.S. Senate Permanent Subcommittee on Investigations into the origins of the 2008 financial crisis. The goals of this investigation were to construct a public record of the facts in order to deepen the understanding of what happened; identify some of the root causes of the crisis; and provide a factual foundation for the ongoing effort to fortify the country against the recurrence of a similar crisis in the future.

Using internal documents, communications, and interviews, the Report attempts to provide the clearest picture yet of what took place inside the walls of some of the financial institutions and regulatory agencies that contributed to the crisis. The investigation found that the crisis was not a natural disaster, but the result of high risk, complex financial products; undisclosed conflicts of interest; and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street.

While this Report does not attempt to examine every key moment, or analyze every important cause of the crisis, it provides new, detailed, and compelling evidence of what happened. In so doing, we hope the Report leads to solutions that prevent it from happening again.

I. EXECUTIVE SUMMARY

A. Subcommittee Investigation

In November 2008, the Permanent Subcommittee on Investigations initiated its investigation into some of the key causes of the financial crisis. Since then, the Subcommittee has engaged in a wide-ranging inquiry, issuing subpoenas, conducting over 150 interviews and depositions, and consulting with dozens of government, academic, and private sector experts. The Subcommittee has accumulated and reviewed tens of millions of pages of documents, including court pleadings, filings with the Securities and Exchange Commission, trustee reports, prospectuses for public and private offerings, corporate board and committee minutes, mortgage transactions and analyses, memoranda, marketing materials, correspondence, and emails. The Subcommittee has also reviewed documents prepared by or sent to or from banking and securities regulators, including bank examination reports, reviews of securities firms, enforcement actions, analyses, memoranda, correspondence, and emails.

In April 2010, the Subcommittee held four hearings examining four root causes of the financial crisis. Using case studies detailed in thousands of pages of documents released at the hearings, the Subcommittee presented and examined evidence showing how high risk lending by U.S. financial institutions; regulatory failures; inflated credit ratings; and high risk, poor quality financial products designed and sold by some investment banks, contributed to the financial crisis. This Report expands on those hearings and the case studies they featured. The case studies are Washington Mutual Bank, the largest bank failure in U.S. history; the federal Office of Thrift Supervision which oversaw Washington Mutual's demise; Moody's and Standard & Poor's, the country's two largest credit rating agencies; and Goldman Sachs and Deutsche Bank, two leaders in the design, marketing, and sale of mortgage related securities. This Report devotes a chapter to how each of the four causative factors, as illustrated by the case studies, fueled the 2008 financial crisis, providing findings of fact, analysis of the issues, and recommendations for next steps.

B. Overview

(1) High Risk Lending: Case Study of Washington Mutual Bank

The first chapter focuses on how high risk mortgage lending contributed to the financial crisis, using as a case study Washington Mutual Bank (WaMu). At the time of its failure, WaMu was the nation's largest thrift and sixth largest bank, with $300 billion in assets, $188 billion in deposits, 2,300 branches in 15 states, and over 43,000 employees. Beginning in 2004, it embarked upon a lending strategy to pursue higher profits by emphasizing high risk loans. By 2006, WaMu's high risk loans began incurring high rates of delinquency and default, and in 2007, its mortgage backed securities began incurring ratings downgrades and losses. Also in 2007, the bank itself began incurring losses due to a portfolio that contained poor quality and fraudulent loans and securities. Its stock price dropped as shareholders lost confidence,

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and depositors began withdrawing funds, eventually causing a liquidity crisis at the bank. On September 25, 2008, WaMu was seized by its regulator, the Office of Thrift Supervision, placed in receivership with the Federal Deposit Insurance Corporation (FDIC), and sold to JPMorgan Chase for $1.9 billion. Had the sale not gone through, WaMu's failure might have exhausted the entire $45 billion Deposit Insurance Fund.

This case study focuses on how one bank's search for increased growth and profit led to the origination and securitization of hundreds of billions of dollars in high risk, poor quality mortgages that ultimately plummeted in value, hurting investors, the bank, and the U.S. financial system. WaMu had held itself out as a prudent lender, but in reality, the bank turned increasingly to higher risk loans. Over a four-year period, those higher risk loans grew from 19% of WaMu's loan originations in 2003, to 55% in 2006, while its lower risk, fixed rate loans fell from 64% to 25% of its originations. At the same time, WaMu increased its securitization of subprime loans sixfold, primarily through its subprime lender, Long Beach Mortgage Corporation, increasing such loans from nearly $4.5 billion in 2003, to $29 billion in 2006. From 2000 to 2007, WaMu and Long Beach together securitized at least $77 billion in subprime loans.

WaMu also originated an increasing number of its flagship product, Option Adjustable Rate Mortgages (Option ARMs), which created high risk, negatively amortizing mortgages and, from 2003 to 2007, represented as much as half of all of WaMu's loan originations. In 2006 alone, Washington Mutual originated more than $42.6 billion in Option ARM loans and sold or securitized at least $115 billion to investors, including sales to the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). In addition, WaMu greatly increased its origination and securitization of high risk home equity loan products. By 2007, home equity loans made up $63.5 billion or 27% of its home loan portfolio, a 130% increase from 2003.

At the same time that WaMu was implementing its high risk lending strategy, WaMu and Long Beach engaged in a host of shoddy lending practices that produced billions of dollars in high risk, poor quality mortgages and mortgage backed securities. Those practices included qualifying high risk borrowers for larger loans than they could afford; steering borrowers from conventional mortgages to higher risk loan products; accepting loan applications without verifying the borrower's income; using loans with low, short term "teaser" rates that could lead to payment shock when higher interest rates took effect later on; promoting negatively amortizing loans in which many borrowers increased rather than paid down their debt; and authorizing loans with multiple layers of risk. In addition, WaMu and Long Beach failed to enforce compliance with their own lending standards; allowed excessive loan error and exception rates; exercised weak oversight over the third party mortgage brokers who supplied half or more of their loans; and tolerated the issuance of loans with fraudulent or erroneous borrower information. They also designed compensation incentives that rewarded loan personnel for issuing a large volume of higher risk loans, valuing speed and volume over loan quality.

As a result, WaMu, and particularly its Long Beach subsidiary, became known by industry insiders for its failed mortgages and poorly performing residential mortgage backed securities (RMBS). Among sophisticated investors, its securitizations were understood to be some of the worst performing in the marketplace. Inside the bank, WaMu's President Steve Rotella described Long Beach as "terrible" and "a mess," with default rates that were "ugly." WaMu's high risk lending operation was also problem-plagued. WaMu management was provided with compelling evidence of deficient lending practices in internal emails, audit reports, and reviews. Internal reviews of two high volume WaMu loan centers, for example, described "extensive fraud" by employees who "willfully" circumvented bank policies. A WaMu review of internal controls to stop fraudulent loans from being sold to investors described them as "ineffective." On at least one occasion, senior managers knowingly sold delinquency-prone loans to investors. Aside from Long Beach, WaMu's President described WaMu's prime home loan business as the "worst managed business" he had seen in his career.

Documents obtained by the Subcommittee reveal that WaMu launched its high risk lending strategy primarily because higher risk loans and mortgage backed securities could be sold for higher prices on Wall Street. They garnered higher prices because higher risk meant the securities paid a higher coupon rate than other comparably rated securities, and investors paid a higher price to buy them. Selling or securitizing the loans also removed them from WaMu's books and appeared to insulate the bank from risk.

The Subcommittee investigation indicates that unacceptable lending and securitization practices were not restricted to Washington Mutual, but were present at a host of financial institutions that originated, sold, and securitized billions of dollars in high risk, poor quality home loans that inundated U.S. financial markets. Many of the resulting securities ultimately plummeted in value, leaving banks and investors with huge losses that helped send the economy into a downward spiral. These lenders were not the victims of the financial crisis; the high risk loans they issued were the fuel that ignited the financial crisis.

(2) Regulatory Failure: Case Study of the Office of Thrift Supervision

The next chapter focuses on the failure of the Office of Thrift Supervision (OTS) to stop the unsafe and unsound practices that led to the demise of Washington Mutual, one of the nation's largest banks. Over a five year period from 2004 to 2008, OTS identified over 500 serious deficiencies at WaMu, yet failed to take action to force the bank to improve its lending operations and even impeded oversight by the bank's backup regulator, the FDIC.

Washington Mutual Bank was the largest thrift under the supervision of OTS and was among the eight largest financial institutions insured by the FDIC. Until 2006, WaMu was a profitable bank, but in 2007, many of its high risk home loans began experiencing increased rates of delinquency, default, and loss. After the market for subprime mortgage backed securities collapsed in July 2007, Washington Mutual was unable to sell or securitize its subprime loans and its loan portfolio fell in value. In September 2007, WaMu's stock price plummeted against the backdrop of its losses and a worsening financial crisis. From 2007 to 2008, WaMu's depositors withdrew a total of over $26 billion in deposits from the bank, triggering a liquidity crisis, followed by the bank's closure.

OTS records show that, during the five years prior to WaMu's collapse, OTS examiners repeatedly identified significant problems with Washington Mutual's lending practices, risk management, asset quality, and appraisal practices, and requested corrective action. Year after year, WaMu promised to correct the identified problems, but never did. OTS failed to respond with meaningful enforcement action, such as by downgrading WaMu's rating for safety and soundness, requiring a public plan with deadlines for corrective actions, or imposing civil fines for inaction. To the contrary, until shortly before the thrift's failure in 2008, OTS continually rated WaMu as financially sound.

The agency's failure to restrain WaMu's unsafe lending practices stemmed in part from an OTS regulatory culture that viewed its thrifts as "constituents," relied on bank management to correct identified problems with minimal regulatory intervention, and expressed reluctance to interfere with even unsound lending and securitization practices. OTS displayed an unusual amount of deference to WaMu's management, choosing to rely on the bank to police itself in its use of safe and sound practices. The reasoning appeared to be that if OTS examiners simply identified the problems at the bank, OTS could then rely on WaMu's assurances that problems would be corrected, with little need for tough enforcement actions. It was a regulatory approach with disastrous results.

Despite identifying over 500 serious deficiencies in five years, OTS did not once, from 2004 to 2008, take a public enforcement action against Washington Mutual to correct its lending practices, nor did it lower the bank's rating for safety and soundness. Only in 2008, as the bank incurred mounting losses, did OTS finally take two informal, nonpublic enforcement actions, requiring WaMu to agree to a "Board Resolution" in March and a "Memorandum of Understanding" in September, neither of which imposed sufficient changes to prevent the bank's failure. OTS officials resisted calls by the FDIC, the bank's backup regulator, for stronger measures and even impeded FDIC oversight efforts by at times denying FDIC examiners office space and access to bank records. Tensions between the two agencies remained high until the end. Two weeks before the bank was seized, the FDIC Chairman contacted WaMu directly to inform it that the FDIC was likely to have a ratings disagreement with OTS and downgrade the bank's safety and soundness rating, and informed the OTS Director about that communication, prompting him to complain about the FDIC Chairman's "audacity."

Hindered by a culture of deference to management, demoralized examiners, and agency infighting, OTS officials allowed the bank's short term profits to excuse its risky practices and failed to evaluate the bank's actions in the context of the U.S. financial system as a whole. Its narrow regulatory focus prevented OTS from analyzing or acknowledging until it was too late that WaMu's practices could harm the broader economy.

OTS' failure to restrain Washington Mutual's unsafe lending practices allowed high risk loans at the bank to proliferate, negatively impacting investors across the United States and around the world. Similar regulatory failings by other agencies involving other lenders repeated the problem on a broad scale. The result was a mortgage market saturated with risky loans, and financial institutions that were supposed to hold predominantly safe investments but instead held portfolios rife with high risk, poor quality mortgages. When those loans began defaulting in record numbers and mortgage related securities plummeted in value, financial institutions around the globe suffered hundreds of billions of dollars in losses, triggering an economic disaster.

The regulatory failures that set the stage for those losses were a proximate cause of the financial crisis.

(3) Inflated Credit Ratings: Case Study of Moody's and Standard & Poor's

The next chapter examines how inflated credit ratings contributed to the financial crisis by masking the true risk of many mortgage related securities. Using case studies involving Moody's Investors Service, Inc. (Moody's) and Standard & Poor's Financial Services LLC (S&P), the nation's two largest credit rating agencies, the Subcommittee identified multiple problems responsible for the inaccurate ratings, including conflicts of interest that placed achieving market share and increased revenues ahead of ensuring accurate ratings.

Between 2004 and 2007, Moody's and S&P issued credit ratings for tens of thousands of U.S. residential mortgage backed securities (RMBS) and collateralized debt obligations (CDO). Taking in increasing revenue from Wall Street firms, Moody's and S&P issued AAA and other investment grade credit ratings for the vast majority of those RMBS and CDO securities, deeming them safe investments even though many relied on high risk home loans.[1] In late 2006, high risk mortgages began incurring delinquencies and defaults at an alarming rate. Despite signs of a deteriorating mortgage market, Moody's and S&P continued for six months to issue investment grade ratings for numerous RMBS and CDO securities.

Then, in July 2007, as mortgage delinquencies intensified and RMBS and CDO securities began incurring losses, both companies abruptly reversed course and began downgrading at record numbers hundreds and then thousands of their RMBS and CDO ratings, some less than a year old. Investors like banks, pension funds, and insurance companies, who are by rule barred from owning low rated securities, were forced to sell off their downgraded RMBS and CDO holdings, because they had lost their investment grade status. RMBS and CDO securities held by financial firms lost much of their value, and new securitizations were unable to find investors. The subprime RMBS market initially froze and then collapsed, leaving investors and financial firms around the world holding unmarketable subprime RMBS securities that were plummeting in value. A few months later, the CDO market collapsed as well.

[1] S&P issues ratings using the "AAA" designation; Moody's equivalent rating is "Aaa." For ease of reference, this Report will refer to both ratings as "AAA."

Traditionally, investments holding AAA ratings have had a less than 1% probability of incurring defaults. But in 2007, the vast majority of RMBS and CDO securities with AAA ratings incurred substantial losses; some failed outright. Analysts have determined that over 90% of the AAA ratings given to subprime RMBS securities originated in 2006 and 2007 were later downgraded by the credit rating agencies to junk status. In the case of Long Beach, 75 out of 75 AAA rated Long Beach securities issued in 2006, were later downgraded to junk status, defaulted, or withdrawn. Investors and financial institutions holding the AAA rated securities lost significant value. Those widespread losses led, in turn, to a loss of investor confidence in the value of the AAA rating, in the holdings of major U.S. financial institutions, and even in the viability of U.S. financial markets.

Inaccurate AAA credit ratings introduced risk into the U.S. financial system and constituted a key cause of the financial crisis. In addition, the July mass downgrades, which were unprecedented in number and scope, precipitated the collapse of the RMBS and CDO secondary markets, and perhaps more than any other single event triggered the beginning of the financial crisis.

The Subcommittee's investigation uncovered a host of factors responsible for the inaccurate credit ratings issued by Moody's and S&P. One significant cause was the inherent conflict of interest arising from the system used to pay for credit ratings. Credit rating agencies were paid by the Wall Street firms that sought their ratings and profited from the financial products being rated. Under this "issuer pays" model, the rating agencies were dependent upon those Wall Street firms to bring them business, and were vulnerable to threats that the firms would take their business elsewhere if they did not get the ratings they wanted. The rating agencies weakened their standards as each competed to provide the most favorable rating to win business and greater market share. The result was a race to the bottom.

Additional factors responsible for the inaccurate ratings include rating models that failed to include relevant mortgage performance data; unclear and subjective criteria used to produce ratings; a failure to apply updated rating models to existing rated transactions; and a failure to provide adequate staffing to perform rating and surveillance services, despite record revenues. Compounding these problems were federal regulations that required the purchase of investment grade securities by banks and others, which created pressure on the credit rating agencies to issue investment grade ratings. While these federal regulations were intended to help investors stay away from unsafe securities, they had the opposite effect when the AAA ratings proved inaccurate.

Evidence gathered by the Subcommittee shows that the credit rating agencies were aware of problems in the mortgage market, including an unsustainable rise in housing prices, the high risk nature of the loans being issued, lax lending standards, and rampant mortgage fraud. Instead of using this information to temper their ratings, the firms continued to issue a high volume of investment grade ratings for mortgage backed securities. If the credit rating agencies had issued ratings that accurately reflected the increasing risk in the RMBS and CDO markets and appropriately adjusted existing ratings in those markets, they might have discouraged investors from purchasing high risk RMBS and CDO securities, and slowed the pace of securitizations.

It was not in the short term economic interest of either Moody's or S&P, however, to provide accurate credit ratings for high risk RMBS and CDO securities, because doing so would have hurt their own revenues. Instead, the credit rating agencies' profits became increasingly reliant on the fees generated by issuing a large volume of structured finance ratings. In the end, Moody's and S&P provided AAA ratings to tens of thousands of high risk RMBS and CDO securities and then, when those products began to incur losses, issued mass downgrades that shocked the financial markets, hammered the value of the mortgage related securities, and helped trigger the financial crisis.

(4) Investment Bank Abuses:
Case Study of Goldman Sachs and Deutsche Bank

The final chapter examines how investment banks contributed to the financial crisis, using as case studies Goldman Sachs and Deutsche Bank, two leading participants in the U.S. mortgage market.

Investment banks can play an important role in the U.S. economy, helping to channel the nation's wealth into productive activities that create jobs and increase economic growth. But in the years leading up to the financial crisis, large investment banks designed and promoted complex financial instruments, often referred to as structured finance products, that were at the heart of the crisis. They included RMBS and CDO securities, credit default swaps (CDS), and CDS contracts linked to the ABX Index. These complex, high risk financial products were engineered, sold, and traded by the major U.S. investment banks.

From 2004 to 2008, U.S. financial institutions issued nearly $2.5 trillion in RMBS and over $1.4 trillion in CDO securities, backed primarily by mortgage related products. Investment banks typically charged fees of $1 to $8 million to act as the underwriter of an RMBS securitization, and $5 to $10 million to act as the placement agent for a

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CDO securitization. Those fees contributed substantial revenues to the investment banks, which established internal structured finance groups, as well as a variety of RMBS and CDO origination and trading desks within those groups, to handle mortgage related securitizations. Investment banks sold RMBS and CDO securities to investors around the world, and helped develop a secondary market where RMBS and CDO securities could be traded. The investment banks' trading desks participated in those secondary markets, buying and selling RMBS and CDO securities either on behalf of their clients or in connection with their own proprietary transactions.

The financial products developed by investment banks allowed investors to profit, not only from the success of an RMBS or CDO securitization, but also from its failure. CDS contracts, for example, allowed counterparties to wager on the rise or fall in the value of a specific RMBS security or on a collection of RMBS and other assets contained or referenced in a CDO. Major investment banks developed standardized CDS contracts that could also be traded on a secondary market. In addition, they established the ABX Index which allowed counterparties to wager on the rise or fall in the value of a basket of subprime RMBS securities, which could be used to reflect the status of the subprime mortgage market as a whole. The investment banks sometimes matched up parties who wanted to take opposite sides in a transaction and other times took one or the other side of the transaction to accommodate a client. At still other times, investment banks used these financial instruments to make their own proprietary wagers. In extreme cases, some investment banks set up structured finance transactions which enabled them to profit at the expense of their clients.

Two case studies, involving Goldman Sachs and Deutsche Bank, illustrate a variety of troubling practices that raise conflicts of interest and other concerns involving RMBS, CDO, CDS, and ABX related financial instruments that contributed to the financial crisis.

The Goldman Sachs case study focuses on how it used net short positions to benefit from the downturn in the mortgage market, and designed, marketed, and sold CDOs in ways that created conflicts of interest with the firm's clients and at times led to the bank's profiting from the same products that caused substantial losses for its clients.

From 2004 to 2008, Goldman was a major player in the U.S. mortgage market. In 2006 and 2007 alone, it designed and underwrote 93 RMBS and 27 mortgage related CDO securitizations totaling about $100 billion, bought and sold RMBS and CDO securities on behalf of its clients, and amassed its own multi-billion-dollar proprietary mortgage related holdings. In December 2006, however, when it saw evidence that the high risk mortgages underlying many RMBS and CDO securities were incurring accelerated rates of delinquency and default, Goldman quietly and abruptly reversed course.

Over the next two months, it rapidly sold off or wrote down the bulk of its existing subprime RMBS and CDO inventory, and began building a short position that would allow it to profit from the decline of the mortgage market. Throughout 2007, Goldman twice built up and cashed in sizeable mortgage related short positions. At its peak, Goldman's net short position totaled $13.9 billion. Overall in 2007, its net short position produced record profits totaling $3.7 billion for Goldman's Structured Products Group, which when combined with other mortgage losses, produced record net revenues of $1.1 billion for the Mortgage Department as a whole.

Throughout 2007, Goldman sold RMBS and CDO securities to its clients without disclosing its own net short position against the subprime market or its purchase of CDS contracts to gain from the loss in value of some of the very securities it was selling to its clients.

The case study examines in detail four CDOs that Goldman constructed and sold called Hudson 1, Anderson, Timberwolf, and Abacus 2007-AC1. In some cases, Goldman transferred risky assets from its own inventory into these CDOs; in others, it included poor quality assets that were likely to lose value or not perform. In three of the CDOs, Hudson, Anderson and Timberwolf, Goldman took a substantial portion of the short side of the CDO, essentially betting that the assets within the CDO would fall in value or not perform. Goldman's short position was in direct opposition to the clients to whom it was selling the CDO securities, yet it failed to disclose the size and nature of its short position while marketing the securities. While Goldman sometimes included obscure language in its marketing materials about the possibility of its taking a short position on the CDO securities it was selling, Goldman did not disclose to potential investors when it had already determined to take or had already taken short investments that would pay off if the particular security it was selling, or RMBS and CDO securities in general, performed poorly. In the case of Hudson 1, for example, Goldman took 100% of the short side of the $2 billion CDO, betting against the assets referenced in the CDO, and sold the Hudson securities to investors without disclosing its short position. When the securities lost value, Goldman made a $1.7 billion gain at the direct expense of the clients to whom it had sold the securities.

In the case of Anderson, Goldman selected a large number of poorly performing assets for the CDO, took 40% of the short position, and then marketed Anderson securities to its clients. When a client asked how Goldman "got comfortable" with the New Century loans in the CDO, Goldman personnel tried to dispel concerns about the loans, and did not disclose the firm's own negative view of them or its short position in the CDO.

In the case of Timberwolf, Goldman sold the securities to its clients even as it knew the securities were falling in value. In some cases, Goldman knowingly sold Timberwolf securities to clients at prices above its own book values and, within days or weeks of the sale, marked down the value of the sold securities, causing its clients to incur quick losses and requiring some to post higher margin or cash collateral. Timberwolf securities lost 80% of their value within five months of being issued and today are worthless. Goldman took 36% of the short position in the CDO and made money from that investment, but ultimately lost money when it could not sell all of the Timberwolf securities.

In the case of Abacus, Goldman did not take the short position, but allowed a hedge fund, Paulson & Co. Inc., that planned on shorting the CDO to play a major but hidden role in selecting its assets. Goldman marketed Abacus securities to its clients, knowing the CDO was designed to lose value and without disclosing the hedge fund's asset selection role or investment objective to potential investors. Three long investors together lost about $1 billion from their Abacus investments, while the Paulson hedge fund profited by about the same amount. Today, the Abacus securities are worthless.

In the Hudson and Timberwolf CDOs, Goldman also used its role as the collateral put provider or liquidation agent to advance its financial interest to the detriment of the clients to whom it sold the CDO securities.

The Deutsche Bank case study describes how the bank's top global CDO trader, Greg Lippmann, repeatedly warned and advised his Deutsche Bank colleagues and some of his clients seeking to buy short positions about the poor quality of the RMBS securities underlying many CDOs. He described some of those securities as "crap" and "pigs," and predicted the assets and the CDO securities would lose value. At one point, Mr. Lippmann was asked to buy a specific CDO security and responded that it "rarely trades," but he "would take it and try to dupe someone" into buying it. He also at times referred to the industry's ongoing CDO marketing efforts as a "CDO machine" or "ponzi scheme." Deutsche Bank's senior management disagreed with his negative views, and used the bank's own funds to make large proprietary investments in mortgage related securities that, in 2007, had a notional or face value of $128 billion and a market value of more than $25 billion. Despite its positive view of the housing market, the bank allowed Mr. Lippmann to develop a large proprietary short position for the bank in the RMBS market, which from 2005 to 2007, totaled $5 billion. The bank cashed in the short position from 2007 to 2008, generating a profit of $1.5 billion, which Mr. Lippmann claims is more money on a single position than any other trade had ever made for Deutsche Bank in its history. Despite that gain, due to its large long holdings, Deutsche Bank lost nearly $4.5 billion from its mortgage related proprietary investments.

The Subcommittee also examined a $1.1 billion CDO underwritten by Deutsche Bank known as Gemstone CDO VII Ltd. (Gemstone 7), which issued securities in March 2007. It was one of 47 CDOs totaling $32 billion that Deutsche Bank underwrote from 2004 to 2008. Deutsche Bank made $4.7 million in fees from Gemstone 7, while the collateral manager, a hedge fund called HBK Capital Management, was slated to receive $3.3 million. Gemstone 7 concentrated risk by including within a single financial instrument 115 RMBS securities whose financial success depended upon thousands of high risk, poor quality subprime loans. Many of those RMBS securities carried BBB, BBB-, or even BB credit ratings, making them among the highest risk RMBS securities sold to the public. Nearly a third of the RMBS securities contained subprime loans originated by Fremont, Long Beach, and New Century, lenders well known within the industry for issuing poor quality loans. Deutsche Bank also sold securities directly from its own inventory to the CDO. Deutsche Bank's CDO trading desk knew that many of these RMBS securities were likely to lose value, but did not object to their inclusion in Gemstone 7, even securities which Mr. Lippmann was calling "crap" or "pigs." Despite the poor quality of the underlying assets, Gemstone's top three tranches received AAA ratings. Deutsche Bank ultimately sold about $700 million in Gemstone securities, without disclosing to potential investors that its global head trader of CDOs had extremely negative views of a third of the assets in the CDO or that the bank's internal valuations showed that the assets had lost over $19 million in value since their purchase. Within months of being issued, the Gemstone 7 securities lost value; by November 2007, they began undergoing credit rating downgrades; and by July 2008, they became nearly worthless.

Both Goldman Sachs and Deutsche Bank underwrote securities using loans from subprime lenders known for issuing high risk, poor quality mortgages, and sold risky securities to investors across the United States and around the world. They also enabled the lenders to acquire new funds to originate still more high risk, poor quality loans. Both sold CDO securities without full disclosure of the negative views of some of their employees regarding the underlying assets and, in the case of Goldman, without full disclosure that it was shorting the very CDO securities it was marketing, raising questions about whether Goldman complied with its obligations to issue suitable investment recommendations and disclose material adverse interests.

The case studies also illustrate how these two investment banks continued to market new CDOs in 2007, even as U.S. mortgage delinquencies intensified, RMBS securities lost value, the U.S. mortgage market as a whole deteriorated, and investors lost confidence. Both kept producing and selling high risk, poor quality structured finance products in a negative market, in part because stopping the "CDO machine" would have meant less income for structured finance units, smaller executive bonuses, and even the disappearance of CDO desks and personnel, which is what finally happened. The two case studies also illustrate how certain complex structured finance products, such as synthetic CDOs and naked credit default swaps, amplified market risk by allowing investors with no ownership interest in the reference obligations to place unlimited side bets on their performance. Finally, the two case studies demonstrate how proprietary trading led to dramatic losses in the case of Deutsche Bank and undisclosed conflicts of interest in the case of Goldman Sachs.

Investment banks were the driving force behind the structured finance products that provided a steady stream of funding for lenders originating high risk, poor quality loans and that magnified risk throughout the U.S. financial system. The investment banks that engineered, sold, traded, and profited from mortgage related structured finance products were a major cause of the financial crisis.

C. Recommendations

The four causative factors examined in this Report are interconnected. Lenders introduced new levels of risk into the U.S. financial system by selling and securitizing complex home loans with high risk features and poor underwriting. The credit rating agencies labeled the resulting securities as safe investments, facilitating their purchase by institutional investors around the world. Federal banking regulators failed to ensure safe and sound lending practices and risk management, and stood on the sidelines as large financial institutions active in U.S. financial markets purchased billions of dollars in mortgage related securities containing high risk, poor quality mortgages. Investment banks magnified the risk to the system by engineering and promoting risky mortgage related structured finance products, and enabling investors to use naked credit default swaps and synthetic instruments to bet on the failure rather than the success of U.S. financial instruments. Some investment banks also ignored the conflicts of interest created by their products, placed their financial interests before those of their clients, and even bet against the very securities they were recommending and marketing to their clients. Together these factors produced a mortgage market saturated with high risk, poor quality mortgages and securities that, when they began incurring losses, caused financial institutions around the world to lose billions of dollars, produced rampant unemployment and foreclosures, and ruptured faith in U.S. capital markets.

Nearly three years later, the U.S. economy has yet to recover from the damage caused by the 2008 financial crisis. This Report is intended to help analysts, market participants, policymakers, and the public gain a deeper understanding of the origins of the crisis and take the steps needed to prevent excessive risk taking and conflicts of interest from causing similar damage in the future. Each of the four chapters in this Report examining a key aspect of the financial crisis begins with specific findings of fact, details the evidence gathered by the Subcommittee, and ends with recommendations. For ease of reference, all of the recommendations are reprinted here. For more information about each recommendation, please see the relevant chapter.

Recommendations on High Risk Lending

1. **Ensure "Qualified Mortgages" Are Low Risk.** Federal regulators should use their regulatory authority to ensure that all mortgages deemed to be "qualified residential mortgages" have a low risk of delinquency or default.

2. **Require Meaningful Risk Retention.** Federal regulators should issue a strong risk retention requirement under Section 941 by requiring the retention of not less than a 5% credit risk in each, or a representative sample of, an asset backed securitization's tranches, and by barring a hedging offset for a reasonable but limited period of time.

3. **Safeguard Against High Risk Products.** Federal banking regulators should safeguard taxpayer dollars by requiring banks with high risk structured finance products, including complex products with little or no reliable performance data, to meet conservative loss reserve, liquidity, and capital requirements.

4. **Require Greater Reserves for Negative Amortization Loans.** Federal banking regulators should use their regulatory authority to require banks issuing negatively amortizing loans that allow borrowers to defer payments of interest and principal, to maintain more conservative loss, liquidity, and capital reserves.

5. **Safeguard Bank Investment Portfolios.** Federal banking regulators should use the Section 620 banking activities study to identify high risk structured finance products and impose a reasonable limit on the amount of such high risk products that can be included in a bank's investment portfolio.

Recommendations on Regulatory Failures

1. **Complete OTS Dismantling.** The Office of the Comptroller of the Currency (OCC) should complete the dismantling of the Office of Thrift Supervision (OTS), despite attempts by some OTS officials to preserve the agency's identity and influence within the OCC.

2. **Strengthen Enforcement.** Federal banking regulators should conduct a review of their major financial institutions to identify those with ongoing, serious deficiencies, and review their enforcement approach to those institutions to eliminate any policy of deference to bank management, inflated CAMELS ratings, or use of short term profits to excuse high risk activities.

3. **Strengthen CAMELS Ratings.** Federal banking regulators should undertake a comprehensive review of the CAMELS ratings system to produce ratings that signal whether an institution is expected to operate in a safe and sound manner over a specified period of time, asset quality ratings that reflect embedded risks rather than short term profits, management ratings that reflect any ongoing failure to correct identified deficiencies, and composite ratings that discourage systemic risks.

4. **Evaluate Impacts of High Risk Lending.** The Financial Stability Oversight Council should undertake a study to identify high risk lending practices at financial institutions, and evaluate the nature and significance of the impacts that these practices may have on U.S. financial systems as a whole.

Recommendations on Inflated Credit Ratings

1. **Rank Credit Rating Agencies by Accuracy.** The SEC should use its regulatory authority to rank the Nationally Recognized Statistical Rating Organizations in terms of performance, in particular the accuracy of their ratings.

2. **Help Investors Hold CRAs Accountable.** The SEC should use its regulatory authority to facilitate the ability of investors to hold credit rating agencies accountable in civil lawsuits for inflated credit ratings, when a credit rating agency knowingly or recklessly fails to conduct a reasonable investigation of the rated security.

3. **Strengthen CRA Operations.** The SEC should use its inspection, examination, and regulatory authority to ensure credit rating agencies institute internal controls, credit rating methodologies, and employee conflict of interest safeguards that advance rating accuracy.

4. **Ensure CRAs Recognize Risk.** The SEC should use its inspection, examination, and regulatory authority to ensure credit rating agencies assign higher risk to financial instruments whose performance cannot be reliably predicted due to their novelty or complexity, or that rely on assets from parties with a record for issuing poor quality assets.

5. **Strengthen Disclosure.** The SEC should exercise its authority under the new Section 78o-7(s) of Title 15 to ensure that the credit rating agencies complete the required new ratings forms by the end of the year and that the new forms provide comprehensible, consistent, and useful ratings information to investors, including by testing the proposed forms with actual investors.

6. **Reduce Ratings Reliance.** Federal regulators should reduce the federal government's reliance on privately issued credit ratings.

Recommendations on Investment Bank Abuses

1. **Review Structured Finance Transactions.** Federal regulators should review the RMBS, CDO, CDS, and ABX activities described in this Report to identify any violations of law and to examine ways to strengthen existing regulatory prohibitions against abusive practices involving structured finance products.

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2. **Narrow Proprietary Trading Exceptions.** To ensure a meaningful ban on proprietary trading under Section 619, any exceptions to that ban, such as for market-making or risk-mitigating hedging activities, should be strictly limited in the implementing regulations to activities that serve clients or reduce risk.

3. **Design Strong Conflict of Interest Prohibitions.** Regulators implementing the conflict of interest prohibitions in Sections 619 and 621 should consider the types of conflicts of interest in the Goldman Sachs case study, as identified in Chapter VI(C)(6) of this Report.

4. **Study Bank Use of Structured Finance.** Regulators conducting the banking activities study under Section 620 should consider the role of federally insured banks in designing, marketing, and investing in structured finance products with risks that cannot be reliably measured and naked credit default swaps or synthetic financial instruments.

II. BACKGROUND

Understanding the recent financial crisis requires examining how U.S. financial markets have changed in fundamental ways over the past 15 years. The following provides a brief historical overview of some of those changes; explains some of the new financial products and trading strategies in the mortgage area; and provides background on credit ratings, investment banks, government sponsored enterprises, and financial regulators. It also provides a brief timeline of key events in the financial crisis. Two recurrent themes are the increasing amount of risk and conflicts of interest in U.S. financial markets.

A. Rise of Too-Big-To-Fail U.S. Financial Institutions

Until relatively recently, federal and state laws limited federally-chartered banks from branching across state lines.[2] Instead, as late as the 1990s, U.S. banking consisted primarily of thousands of modest-sized banks tied to local communities. Since 1990, the United States has witnessed the number of regional and local banks and thrifts shrink from just over 15,000 to approximately 8,000 by 2009,[3] while at the same time nearly 13,000 regional and local credit unions have been reduced to 7,500.[4] This broad-based approach meant that when a bank suffered losses, the United States could quickly close its doors, protect its depositors, and avoid significant damage to the U.S. banking system or economy. Decentralized banking also promoted competition, diffused credit in the marketplace, and prevented undue concentrations of financial power.

In the mid 1990s, the United States initiated substantial changes to the banking industry, some of which relaxed the rules under which banks operated, while others imposed new regulations, and still others encouraged increased risk-taking. In 1994, for the first time, Congress explicitly authorized interstate banking, which allowed federally-chartered banks to open branches nationwide more easily than before.[5] In 1999, Congress repealed the Glass-Steagall Act of 1933, which had generally required banks, investment banks, securities firms, and

[2] See McFadden Act of 1927, P.L. 69-639 (prohibiting national banks from owning branches in multiple states); Bank Holding Company Act of 1956, P.L. 84-511 (prohibiting banking company companies from owning branches in multiple states). See also "Going Interstate: A New Dawn for U.S. Banking," The Regional Economist, a publication of the Federal Reserve Bank of St. Louis (7/1994).

[3] See U.S. Census Bureau, "Statistical Abstract of the United States 2011," at 735, http://www.census.gov/compendia/statab/2011/tables/11s1175.pdf.

[4] 1/3/2011 chart, "Insurance Fund Ten-Year Trends," supplied by the National Credit Union Administration (showing that, as of 12/31/1993, the United States had 12,317 federal and state credit unions).

[5] Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, P.L. 103-328 (repealing statutory prohibitions on interstate banking).

insurance companies to operate separately,[6] and instead allowed them to openly merge operations.[7] The same law also eliminated the Glass-Steagall prohibition on banks engaging in proprietary trading[8] and exempted investment bank holding companies from direct federal regulation.[9] In 2000, Congress enacted the Commodity Futures Modernization Act which barred federal regulation of swaps and the trillion-dollar swap markets, and which allowed U.S. banks, broker-dealers, and other financial institutions to develop, market, and trade these unregulated financial products, including credit default swaps, foreign currency swaps, interest rate swaps, energy swaps, total return swaps, and more.[10]

In 2002, the Treasury Department, along with other federal bank regulatory agencies, altered the way capital reserves were calculated for banks, and encouraged the retention of securitized mortgages with investment grade credit ratings by allowing banks to hold less capital in reserve for them than if the individual mortgages were held directly on the banks' books.[11] In 2004, the SEC relaxed the capital requirements for large broker-dealers, allowing them to grow even larger, often with borrowed funds.[12] In 2005, when the SEC attempted to assert more control over the growing hedge fund industry, by requiring certain hedge funds to register with the agency, a federal Court of Appeals issued a 2006 opinion that invalidated the SEC regulation.[13]

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[6] Glass-Steagall Act of 1933, also known as the Banking Act, P.L. 73-66.
[7] Gramm-Leach-Bliley Act of 1999, also known as the Financial Services Modernization Act, P.L. 106-102. Some banks had already begun to engage in securities and insurance activities, with the most prominent example at the time being Citicorp's 1998 merger with the Travelers insurance group.
[8] Glass-Steagall Act, Section 16.
[9] Gramm-Leach-Bliley Act of 1999, also known as the Financial Services Modernization Act, P.L. 106-102. See also prepared statement of SEC Chairman Christopher Cox, "Role of Federal Regulators: Lessons from the Credit Crisis for the Future of Regulation," October 23, 2008 House Committee on Oversight and Government Reform Hearing, ("It was a fateful mistake in the Gramm-Leach-Bliley Act that neither the SEC nor any regulator was given the statutory authority to regulate investment bank holding companies other than on a voluntary basis.").
[10] The 2000 Commodity Futures Modernization Act (CFMA) was enacted as a title of the Consolidated Appropriations Act of 2001, P.L. 106-554.
[11] See 66 Fed. Reg. 59614 (Nov. 29, 2011), http://www.federalregister.gov/articles/2001/11/29/01-29179/risk-based-capital-guidelines-capital-adequacy-guidelines-capital-maintenance-capital-treatment-of.
[12] See "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities," RIN 3235-AI96, 17 CFR Parts 200 and 240 (8/20/2004) ("amended the net capital rule under the Securities Exchange Act of 1934 to establish a voluntary alternative method of computing net capital for certain broker-dealers"). The Consolidated Supervised Entities (CSE) program, which provided SEC oversight of investment bank holding companies that joined the CSE program on a voluntarily basis, was established by the SEC in 2004, and terminated by the SEC in 2008, after the financial crisis. The alternative net capital rules for broker-dealers were terminated at the same time.
[13] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

These and other steps paved the way, over the course of little more than the last decade, for a relatively small number of U.S. banks and broker-dealers to become giant financial conglomerates involved in collecting deposits; financing loans; trading equities, swaps and commodities; and issuing, underwriting, and marketing billions of dollars in stock, debt instruments, insurance policies, and derivatives. As these financial institutions grew in size and complexity, and began playing an increasingly important role in the U.S. economy, policymakers began to ask whether the failure of one of these financial institutions could damage not only the U.S. financial system, but the U.S. economy as a whole. In a little over ten years, the creation of too-big-to-fail financial institutions had become a reality in the United States.[14]

Over the last ten years, some U.S. financial institutions have not only grown larger and more complex, but have also engaged in higher risk activities. The last decade has witnessed an explosion of so-called "innovative" financial products with embedded risks that are difficult to analyze and predict, including collateralized debt obligations, credit default swaps, exchange traded funds, commodity and swap indices, and more. Financial engineering produced these financial instruments which typically had little or no performance record to use for risk management purposes. Some U.S. financial institutions became major participants in the development of these financial products, designing, selling, and trading them in U.S. and global markets.

In addition, most major U.S. financial institutions began devoting increasing resources to so-called "proprietary trading," in which the firm's personnel used the firm's capital to gain investment returns for the firm itself rather than for its clients. Traditionally, U.S. banks, broker-dealers, and investment banks had offered investment advice and services to their clients, and did well when their clients did well. Over the last ten years, however, some firms began referring to their clients, not as customers, but as counterparties. In addition, some firms at times developed and used financial products in transactions in which the firm did well only when its clients, or counterparties, lost money. Some U.S. banks also sponsored affiliated hedge funds, provided them with billions of dollars in client and bank funds, and allowed the hedge funds to make high risk investments on the bank's behalf, seeking greater returns.

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[14] The financial crisis has not reversed this trend; it has accelerated it. By the end of 2008, Bank of America had purchased Countrywide and Merrill Lynch; Wells Fargo had acquired Wachovia Bank; and JPMorgan Chase had purchased Washington Mutual and Bear Stearns, creating the largest banks in U.S. history. By early 2009, each controlled more than 10% of all U.S. deposits. See, e.g., "Banks 'Too Big To Fail' Have Grown Even Bigger: Behemoths Born of the Bailout Reduce Consumer Choice, Tempt Corporate Moral Hazard," Washington Post (8/28/2009). Those banks plus Citigroup also issued one out of every two mortgages and two out of every three credit cards. Id.

By 2005, as U.S. financial institutions reached unprecedented size and made increasing use of complex, high risk financial products, government oversight and regulation was increasingly incoherent and misguided.

B. High Risk Mortgage Lending

The U.S. mortgage market reflected many of the trends affecting the U.S. financial system as a whole. Prior to the early 1970s, families wishing to buy a home typically went to a local bank or mortgage company, applied for a loan and, after providing detailed financial information and a down payment, qualified for a 30-year fixed rate mortgage. The local bank or mortgage company then typically kept that mortgage until the homeowner paid it off, earning its profit from the interest rates and fees paid by the borrower.

Lenders were required to keep a certain amount of capital for each loan they issued, which effectively limited the number of loans one bank could have on its books. To increase their capital, some lenders began selling the loans on their books to other financial institutions that wanted to service the loans over time, and then used the profits to make new loans to prospective borrowers. Lenders began to make money, not from holding onto the loans they originated and collecting mortgage payments over the years, but from the relatively short term fees associated with originating and selling the loans.

By 2003, many lenders began using higher risk lending strategies involving the origination and sale of complex mortgages that differed substantially from the traditional 30-year fixed rate home loan. The following describes some of the securitization practices and higher risk mortgage products that came to dominate the mortgage market in the years leading up to the financial crisis.

Securitization. To make home loans sales more efficient and profitable, banks began making increasing use of a mechanism now called "securitization." In a securitization, a financial institution bundles a large number of home loans into a loan pool, and calculates the amount of mortgage payments that will be paid into that pool by the borrowers. The securitizer then forms a shell corporation or trust, often offshore, to hold the loan pool and use the mortgage revenue stream to support the creation of bonds that make payments to investors over time. Those bonds, which are registered with the SEC, are called residential mortgage backed securities (RMBS) and are typically sold in a public offering to investors. Investors typically make a payment up front, and then hold onto the RMBS securities which repay the principal plus interest over time. The amount of money paid periodically to the RMBS holders is often referred to as the RMBS "coupon rate."

For years, securitization worked well. Borrowers paid their 30-year, fixed rate mortgages with few defaults, and mortgage backed securities built up a reputation as a safe investment. Lenders earned fees for bundling the home loans into pools and either selling the pools or securitizing them into mortgage backed securities. Investment banks also earned fees from working with the lenders to assemble the pools, design the mortgage backed securities, obtain credit ratings for them, and sell the resulting securities to investors. Investors like pension funds, insurance companies, municipalities, university endowments, and hedge funds earned a reasonable rate of return on the RMBS securities they purchased.

Due to the 2002 Treasury rule that reduced capital reserves for securitized mortgages, RMBS holdings also became increasingly attractive to banks, which could determine how much capital they needed to hold based on the credit ratings their RMBS securities received from the credit ratings agencies. According to economist Arnold Kling, among other problems, the 2002 rule "created opportunities for banks to lower their ratio of capital to assets through structured financing" and "created the incentive for rating agencies to provide overly optimistic assessment of the risk in mortgage pools."[15]

High Risk Mortgages. The resulting increased demand for mortgage backed securities, joined with Wall Street's growing appetite for securitization fees, prompted lenders to issue mortgages not only to well qualified borrowers, but also higher risk borrowers. Higher risk borrowers were often referred to as "subprime" borrowers to distinguish them from the more creditworthy "prime" borrowers who traditionally qualified for home loans. Some lenders began to specialize in issuing loans to subprime borrowers and became known as subprime lenders.[16] Subprime loans provided new fuel for the securitization engines on Wall Street.

Federal law does not define subprime loans or subprime borrowers, but in 2001, guidance issued by federal banking regulators defined subprime borrowers as those with certain credit risk characteristics, including one or more of the following: (1) two or more 30-day

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[15] "Not What They Had In Mind: A History of Policies that Produced the Financial Crisis of 2008," September 2009, Mercatus Center, http://mercatus.org/sites/default/files/publication/NotWhatTheyHadInMind(1).pdf.

[16] A Federal Reserve Bank of New York research paper identifies the top ten subprime loan originators in 2006 as HSBC, New Century, Countrywide, Citigroup, WMC Mortgage, Fremont, Ameriquest Mortgage, Option One, Wells Fargo, and First Franklin. It identifies the top ten originators of subprime mortgage backed securities as Countrywide, New Century, Option One, Fremont, Washington Mutual, First Franklin, Residential Funding Corp., Lehman Brothers, WMC Mortgage, and Ameriquest. "Understanding the Securitization of Subprime Mortgage Credit," by Adam Ashcraft and Til Schuermann, Federal Reserve Bank of New York Staff Report No. 318, (3/2008) at 4.

delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months; (2) a judgment or foreclosure in the prior 24 months; (3) a bankruptcy in the last five years; (4) a relatively high default probability as evidenced by, for example, a credit score below 660 on the FICO scale; or (5) a debt service-to-income ratio of 50% or more.[17] Some financial institutions reduced that definition to any borrower with a credit score below 660 or even 620 on the FICO scale;[18] while still others failed to institute any explicit definition of a subprime borrower or loan.[19] Credit scores are an underwriting tool used by lenders to evaluate the likelihood that a particular individual will repay his or her debts. FICO credit scores, developed by the Fair Issacs Corporation, are the most widely used credit scores in U.S. financial markets and provide scores ranging from 300 to 850, with the higher scores indicating greater creditworthiness.[20]

High risk loans were not confined, however, to those issued to subprime borrowers. Some lenders engaged in a host of risky lending practices that allowed them to quickly generate a large volume of high risk loans to both subprime and prime borrowers. Those practices, for example, required little or no verification of borrower income, required borrowers to provide little or no down payments, and used loans in which the borrower was not required to pay down the loan amount, and instead incurred added debt over time, known as "negative amortization" loans. Some lenders offered a low initial "teaser rate," followed by a higher interest rate that took effect after a specified event or period of time, to enable borrowers with less income to make the initial, smaller loan payments. Some qualified borrowers according to whether they could afford to pay the lower initial rate, rather than the higher rate that took effect later, expanding the number of borrowers who could qualify for the loans. Some lenders deliberately issued loans that made

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[17] Interagency "Expanded Guidance for Subprime Lending Programs, (1/31/2001) at 3. See also "Understanding the Securitization of Subprime Mortgage Credit," by Adam Ashcraft and Til Schuermann, Federal Reserve Bank of New York Staff Report No. 318, (3/2008) at 14.

[18] See, e.g., 1/2005 "Definition of Higher Risk Lending," chart from Washington Mutual Board of Directors Finance Committee Discussion, JPM_WM00302979, Hearing Exhibit 4/13-2a; 4/2010 "Evaluation of Federal Regulatory Oversight of Washington Mutual Bank," report prepared by the Offices of Inspector General at the Department of the Treasury and Federal Deposit Insurance Corporation, at 8, Hearing Exhibit 4/16-82.

[19] See, e.g., Countrywide Financial Corporation, as described in SEC v. Mozilo, Case No. CV09-03994 (USDC CD Calif.), Complaint (June 4, 2009), at ¶¶ 20-21.

[20] To develop FICO scores, Fair Isaac uses proprietary mathematical models that draw upon databases of actual credit information to identify factors that can reliably be used to predict whether an individual will repay outstanding debt. Key factors in the FICO score include an individual's overall level of debt, payment history, types of credit extensions, and use of available credit lines. See "What's in Your FICO Score," Fair Isaac Corporation, http://www.myfico.com/CreditEducation/WhatsInYourScore.aspx. Other types of credit scores have also been developed, including the VantageScore developed jointly by the three major credit bureaus, Equifax Inc., Experian Group Ltd., and TransUnion LLC, but the FICO score remains the most widely used credit score in U.S. financial markets.

economic sense for borrowers only if the borrowers could refinance the loan within a few years to retain the teaser rate, or sell the home to cover the loan costs. Some lenders also issued loans that depended upon the mortgaged home to increase in value over time, and cover the loan costs if the borrower defaulted. Still another risky practice engaged in by some lenders was to ignore signs of loan fraud and to issue and securitize loans suspected of containing fraudulent borrower information.

These practices were used to qualify borrowers for larger loans than they could have otherwise obtained. When borrowers took out larger loans, the mortgage broker typically profited from higher fees and commissions; the lender profited from higher fees and a better price for the loan on the secondary market; and Wall Street firms profited from a larger revenue stream to support bigger pools of mortgage backed securities.

The securitization of higher risk loans led to increased profits, but also injected greater risks into U.S. mortgage markets. Some U.S. lenders, like Washington Mutual and Countrywide, made wholesale shifts in their loan programs, reducing their sale of low risk, 30-year, fixed rate mortgages and increasing their sale of higher risk loans.[21] Because higher risk loans required borrowers to pay higher fees and a higher rate of interest, they produced greater initial profits for lenders than lower risk loans. In addition, Wall Street firms were willing to pay more for the higher risk loans, because once securitized, the AAA securities relying on those loans typically paid investors a higher rate of return than other AAA investments, due to the higher risk involved. As a result, investors were willing to pay more, and mortgaged backed securities relying on higher risk loans typically fetched a better price than those relying on lower risk loans. Lenders also incurred little risk from issuing the higher risk loans, since they quickly sold the loans and kept the risk off their books.

After 2000, the number of high risk loans increased rapidly, from about $125 billion in dollar value or 12% of all U.S. loan originations in 2000, to about $1 trillion in dollar value or 34% of all loan originations in 2006.[22] Altogether from 2000 to 2007, U.S. lenders originated about

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[21] See, e.g., "Shift to Higher Margin Products," chart from Washington Mutual Board of Directors meeting, at JPM_WM00690894, Hearing Exhibit 4/13-3 (featuring discussion of the larger "gain on sale" produced by higher risk home loans); "WaMu Product Originations and Purchases By Percentage - 2003-2007," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1i (showing how higher risk loans grew from about 19% to about 55% of WaMu's loan originations); SEC v. Mozilo, Case No. CV09-03994 (USDC CD Calif.), Complaint (June 4, 2009), at ¶¶ 17-19 (alleging that higher risk loans doubled at Countrywide, increasing from about 31% to about 64% of its loan originations).

[22] 8/2010 "Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources," Government Accountability Office (GAO), Report No. GAO-10-

14.5 million high risk loans.[23] The majority of those loans, 59%, were used to refinance an existing loan, rather than buy a new home.[24] In addition, according to research performed by GAO, many of these borrowers:

> "refinanced their mortgages at a higher amount than the loan balance to convert their home equity into money for personal use (known as 'cash-out refinancing'). Of the subprime mortgages originated from 2000 through 2007, 55 percent were for cash-out refinancing, 9 percent were for no-cash-out refinancing, and 36 percent were for a home purchase."[25]

Some lenders became known inside the industry for issuing high risk, poor quality loans, yet during the years leading up to the financial crisis were able to securitize and sell their home loans with few problems. Subprime lenders like Long Beach Mortgage Corporation, New Century Financial Corporation, and Fremont Loan & Investment, for example, were known for issuing poor quality subprime loans.[26] Despite their reputations for poor quality loans, leading investment banks continued to do business with them and helped them sell or securitize hundreds of billions of dollars in home mortgages.

These three lenders and others issued a variety of nontraditional, high risk loans whose subsequent delinquencies and defaults later contributed to the financial crisis. They included hybrid adjustable rate mortgages, pick-a-payment or option ARM loans, interest-only loans, home equity loans, and Alt A and stated income loans. Although some of these loans had been in existence for years, they had previously been restricted to a relatively small group of borrowers who were generally able to repay their debts. In the years leading up to the financial crisis, however, lenders issued these higher risk loans to a wide variety of borrowers, including subprime borrowers, who often used them to purchase more expensive homes than they would have been able to buy using traditional fixed rate, 30-year loans.

Hybrid ARMs. One common high risk loan used by lenders in the years leading up to the financial crisis was the short term hybrid adjustable rate mortgage (Hybrid ARM), which was offered primarily to subprime borrowers. From 2000 to 2007, about 70% of subprime loans

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805 at 1. These figures include subprime loans, Alt A, and option payment loans, but not home equity loans, which means the totals for high risk loans are understated.

[23] Id. at 5.

[24] 7/28/2009 "Characteristics and Performance of Nonprime Mortgages," GAO, Report No. GAO-09-848R at 24, Table 3.

[25] Id. at 7.

[26] For more information about Long Beach, see Chapter III of this Report. For more information about New Century and Fremont, see section (D)(2)(c)-(d) of Chapter IV.

were Hybrid ARMs.[27] Hybrid ARMs were often referred to "2/28," "3/27," or "5/25" loans. These 30-year mortgages typically had a low fixed teaser rate, which then reset to a higher floating interest rate, after two years for the 2/28, three years for the 3/27, or five years for the 5/25. The initial loan payment was typically calculated by assuming the initial low, fixed interest rate would be used to pay down the loan. In some cases, the loan used payments that initially covered only the interest due on the loan and not any principal; these loans were called "interest only" loans. After the fixed period for the teaser rate expired, the monthly payment was typically recalculated using the higher floating rate to pay off the remaining principal and interest owing over the course of the remaining loan period. The resulting monthly payment was much larger and sometimes caused borrowers to experience "payment shock" and default on their loans. To avoid the higher interest rate and the larger loan payment, many of the borrowers routinely refinanced their loans; when those borrowers were unable to refinance, many were unable to afford the higher mortgage payment and defaulted.

Pick-A-Payment or Option ARMs. Another common high risk loan, offered to both prime and subprime borrowers during the years leading up to the financial crisis, was known as the "pick-a-payment" or "option adjustable rate mortgage" (Option ARM). According to a 2009 GAO report:

> "[P]ayment-option ARMs were once specialized products for financially sophisticated borrowers but ultimately became more widespread. According to federal banking regulators and a range of industry participants, as home prices increased rapidly in some areas of the country, lenders began marketing payment-option ARMs as affordability products and made them available to less-creditworthy and lower-income borrowers."[28]

Option ARMs typically allowed the borrower to pay an initial low teaser rate, sometimes as low as a 1% annual rate for the first month, and then imposed a much higher interest rate linked to an index, while also giving the borrower a choice each month of how much to pay down the outstanding loan balance. These loans were called "pick-a-payment" or "option" ARMs, because borrowers were typically allowed to choose among four alternatives: (1) paying the fully amortizing amount needed to pay off the loan in 30 years; (2) paying an even higher amount to pay off the loan in 15 years; (3) paying only the interest owed that month and no principal; or (4) making a "minimum" payment that covered only

[27] 8/2010 "Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources," GAO, Report No. GAO-10-805 at 5, 11.
[28] 7/28/2009 "Characteristics and Performance of Nonprime Mortgages," GAO, Report No. GAO-09-848R at 12-13.

a portion of the interest owed and none of the principal. If the minimum payment option were selected, the unpaid interest would be added to the loan principal. If, each month, the borrower made only the minimum payment, the loan principal would increase rather than decrease over time, creating a negatively amortizing loan.

Typically, after five years or when the loan principal reached a designated threshold, such as 110%, 115%, or 125% of the original loan amount, the loan would "recast." The borrower would then be required to make the fully amortizing payment needed to pay off the remaining loan amount within the remaining loan period. The new monthly payment amount was typically much greater, causing payment shock and increasing loan defaults. For example, a borrower taking out a $400,000 loan, with a teaser rate of 1.5% and subsequent interest rate of 6%, might have a minimum payment of $1,333. If the borrower then made only the minimum payments until the loan recast, the new payment using the 6% rate would be $2,786, an increase of more than 100%. What began as a 30-year loan for $400,000 became a 25-year loan for $432,000. To avoid having the loan recast, option ARM borrowers typically sought to refinance their loans. At some lenders, a significant portion of their option ARM business consisted of refinancing existing loans.

Home Equity Loans. A third type of high risk loan that became popular during the years leading up to the financial crisis was the home equity loan (HEL). HELs provided loans secured by the borrower's equity in his or her home, which served as the loan collateral. HELs typically provided a lump sum loan amount that had to be repaid over a fixed period of time, such as 5, 10, or 30 years, using a fixed interest rate, although adjustable rates could also be used. A related loan, the Home Equity Line of Credit (HELOC), created a revolving line of credit, secured by the borrower's home, that the borrower could use at will, to take out and repay various levels of debt over time, typically using an adjustable rate of interest. Both HELs and HELOCs created liens against the borrower's house which, in the event of a default, could be sold to repay any outstanding loan amounts.

During the years leading up to the financial crisis, lenders provided HELs and HELOCs to both prime and subprime borrowers. They were typically high risk loans, because most were issued to borrowers who already had a mortgage on their homes and held only a limited amount of equity. The HEL or HELOC was typically able to establish only a "second lien" or "second mortgage" on the property. If the borrower later defaulted and the home sold, the sale proceeds would be used to pay off the primary mortgage first, and only then the HEL or HELOC. Often, the sale proceeds were insufficient to repay the HEL or HELOC loan. In addition, some lenders created home loan programs in which a HEL was issued as a "piggyback loan" to the primary home mortgage to finance all or part of the borrower's down payment.[29] Taken together, the HEL and the mortgage often provided the borrower with financing equal to 85%, 90%, or even 100% of the property's value.[30] The resulting high loan-to-value ratio, and the lack of borrower equity in the home, meant that, if the borrower defaulted and the home had to be sold, the sale proceeds were unlikely to be sufficient to repay both loans.

Alt A Loans. Another type of common loan during the years leading up to the financial crisis was the "Alt A" loan. Alt A loans were issued to borrowers with relatively good credit histories, but with aggressive underwriting that increased the risk of the loan.[31] For example, Alt A loans often allowed borrowers to obtain 100% financing of their homes, to have an unusually high debt-to-income ratio, or submit limited or even no documentation to establish their income levels. Alt A loans were sometimes referred to as "low doc" or "no doc" loans. They were originally developed for self employed individuals who could not easily establish their income by producing traditional W-2 tax return forms or pay stubs, and so were allowed to submit "alternative" documentation to establish their income or assets, such as bank statements.[32] The reasoning was that other underwriting criteria could be used to ensure that Alt A loans would be repaid, such as selecting only borrowers with a high credit score or with a property appraisal showing the home had substantial value in excess of the loan amount. According to GAO, from 2000 to 2006, the percentage of Alt A loans with less than full documentation of the borrower's income or assets rose from about 60% to 80%.[33]

Stated Income Loans. Stated income loans were a more extreme form of low doc Alt A loans, in that they imposed no documentation requirements and required little effort by the lender to verify the borrower's income. These loans allowed borrowers simply to "state" their income, with no verification by the lender of the borrower's income or assets other than to consider the income's "reasonableness." They were sometimes called "NINA" loans, because "No Income" and "No Assets" of the borrower were verified by the lender. They were also referred to as "liar loans," since borrowers could lie about their

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[29] 7/28/2009 "Characteristics and Performance of Nonprime Mortgages," GAO, Report No. GAO-09-848R at 9.
[30] Id. GAO determined that, in 2000, only about 2.4% of subprime loans had a combined loan-to-value ratio, including both first and second home liens, of 100%, but by 2006, the percentage had climbed tenfold to 29.3%.
[31] Id. at 1. GAO treated both low documentation loans and Option ARMs as Alt A loans. This Report considers Option ARMs as a separate loan category.
[32] See id. at 14.
[33] Id.

incomes, and the lender would make little effort to substantiate the claimed income. Many lenders believed they could simply rely on the other underwriting tools, such as the borrower's credit score and the property appraisal, to ensure the loans would be repaid. Once rare and reserved only for wealthier borrowers, stated income loans became commonplace in the years leading up to the financial crisis. For example, at Washington Mutual Bank, one of the case studies in this Report, by the end of 2007, stated income loans made up 50% of its subprime loans, 73% of its Option ARMs, and 90% of its home equity loans.[34]

Nationwide, the percentage of high risk loans issued with low or no documentation of borrower income or assets was less dramatic. According to GAO, for example, from 2000 to 2006, the nationwide percentage of subprime loans with low or no documentation of borrower income or assets grew from about 20% to 38%.[35]

Volume and Speed. When lenders kept on their books the loans they issued, the creditworthiness of those loans determined whether the lender would turn a profit. Once lenders began to sell or securitize most of their loans, volume and speed, as opposed to creditworthiness, became the keys to a profitable securitization business.

In addition, in the years leading up to the financial crisis, investors that might normally insist on purchasing only high quality securities, purchased billions of dollars in RMBS securities containing poor quality, high risk loans, in part because those securities bore AAA ratings from the credit rating agencies, and in part because the securities offered higher returns compared to other AAA rated investments. Banks also bought investment grade RMBS securities to take advantage of their lower capital requirements. Increasingly, the buyers of RMBS securities began to forego detailed due diligence of the RMBS securities they purchased. Instead, they, like the lenders issuing the mortgages, operated in a mortgage market that came to be dominated by volume and speed, as opposed to credit risk.

Lenders that produced a high volume of loans could sell pools of the loans to Wall Street or to government sponsored entities like Fannie Mae and Freddie Mac. Likewise, they could securitize the loans and work with Wall Street investment banks to sell the securities to investors. These lenders passed on the risk of nonpayment to third

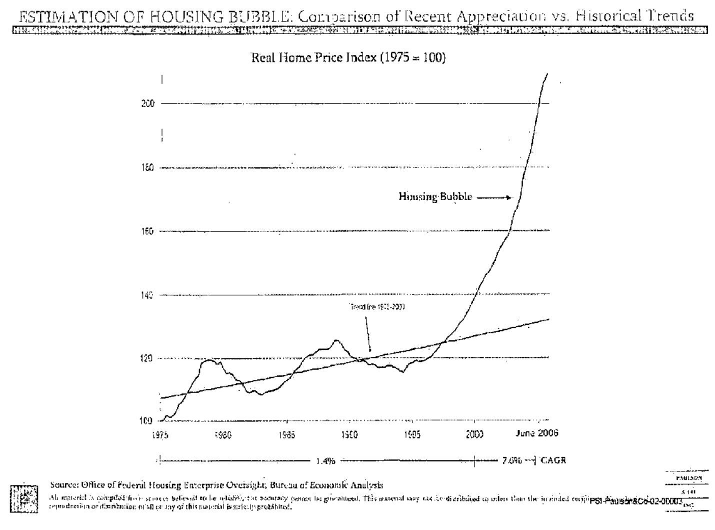
[34] 4/2010 "Evaluation of Federal Regulatory Oversight of Washington Mutual Bank," prepared by the Offices of Inspector General at the Department of the Treasury and Federal Deposit Insurance Corporation, at 10, Hearing Exhibit 4/16-82.
[35] 7/28/2009 "Characteristics and Performance of Nonprime Mortgages," GAO, Report No. GAO-09-848R at 14.

parties, and so lost interest in whether the sold loans would, in fact, be repaid. Investment banks that securitized the loans garnered fees for their services and also typically passed on the risk of nonpayment to the investors who bought the mortgage backed securities. The investment banks were typically interested in loan repayment rates only to the extent needed to ensure defaulting loans did not cause losses to the mortgage backed securities they sold. Even some of the investors who purchased the mortgage backed securities lost interest in their creditworthiness, so long as they could buy "insurance" in the form of credit default swaps that paid off if a mortgage backed security defaulted.

To ensure an ongoing supply of loans for sale, lenders created compensation incentives that encouraged their personnel to quickly produce a high volume of loans. They also encouraged their staffs to issue or purchase higher risk loans, because those loans produced higher sale prices on Wall Street. Loan officers, for example, received more money per loan for originating higher risk loans and for exceeding established loan targets. Loan processing personnel were compensated according to the speed and number of the loans they processed. Loan officers and their sales associates received still more compensation, often called yield spread premiums, if they charged borrowers higher interest rates or points than required in the lender's rate sheets specifying loan prices, or included prepayment penalties in the loan agreements. The Subcommittee's investigation found that lenders employed few compensation incentives to encourage loan officers or loan processors to produce high quality, creditworthy loans in line with the lender's credit requirements.

As long as home prices kept rising, the high risk loans fueling the securitization markets produced few problems. Borrowers who could not make their loan payments could refinance their loans or sell their homes and use the sale proceeds to pay off their mortgages. As this chart shows, over the ten years before the crisis hit, housing prices shot up faster than they had in decades, allowing price increases to mask problems with the high risk loans being issued.[36]

[36] See "Estimation of Housing Bubble: Comparison of Recent Appreciation vs. Historical Trends," chart prepared by Paulson & Co. Inc., Hearing Exhibit 4/13-1j.



Borrowers were able to pay for the increasingly expensive homes, in part, because of the exotic, high risk loans and lax loan underwriting practices that allowed them to buy more house than they could really afford.

C. Credit Ratings and Structured Finance

Despite the increasing use of high risk loans to support mortgage related securities, mortgage related securities continued to receive AAA and other investment grade ratings from the credit rating agencies, indicating they were judged to be safe investments. Those credit ratings gave a sense of security to investors and enabled investors like pension funds, insurance companies, university endowments, and municipalities, which were often required to hold safe investments, to continue to purchase mortgage related securities.

Credit Ratings Generally. A credit rating is an assessment of the likelihood that a particular financial instrument, such as a corporate bond or mortgage backed security, may default or incur losses.[37] A high credit rating indicates that a debt instrument is expected to be repaid and so qualifies as a safe investment.

[37] See 9/3/2009 "Credit Rating Agencies and Their Regulation," prepared by the Congressional Research Service Report No. R40613 (revised report issued 4/9/2010). For more information about the credit rating process and the credit rating agencies, see Chapter V, below.

Credit ratings are issued by private firms that have been officially designated by the SEC as Nationally Recognized Statistical Rating Organizations (NRSROs). NRSROs are usually referred to as "credit rating agencies." While there are ten registered credit rating agencies in the United States, the market is dominated by just three: Moody's Investors Service, Inc. (Moody's); Standard & Poor's Financial Services LLC (S&P); and Fitch Ratings Ltd. (Fitch).[38] By some accounts, these firms issue about 98% of the total credit ratings and collect 90% of total credit rating revenue in the United States.[39]

Credit ratings use a scale of letter grades to indicate credit risk, ranging from AAA to D, with AAA ratings designating the safest investments. Investments with AAA ratings have historically had low default rates. For example, S&P reported that its cumulative RMBS default rate by original rating class (through September 15, 2007) was 0.04% for AAA initial ratings and 1.09% for BBB.[40] Financial instruments bearing AAA through BBB- ratings are generally referred to as "investment grade," while those with ratings below BBB- (or Baa3) are referred to as "below investment grade" or sometimes as having "junk" status. Financial instruments that default receive a D rating from Standard & Poor's, but no rating at all from Moody's.

Investors often rely on credit ratings to gauge the safety of a particular investment. Some institutional investors design an investment strategy that calls for acquiring assets with specified credit ratings. State and federal law also restricts the amount of below investment grade bonds that certain investors can hold, such as pension funds and insurance companies.[41] Banks are also limited by law in the amount of noninvestment grade bonds they can hold, and are typically required to post additional capital for investments carrying riskier ratings. Because so many federal and state statutes and regulations required financial institutions to hold securities with investment grade ratings, the credit rating agencies were not only guaranteed a steady business, but were encouraged to issue AAA and other investment grade ratings. Issuers of securities and other financial instruments also worked hard to obtain favorable credit ratings to ensure more investors could buy their products.

[38] See 9/25/2008 "Credit Rating Agencies—NRSROs," SEC, http://www.sec.gov/answers/nrsro.htm.
[39] See 9/3/2009 "Credit Rating Agencies and Their Regulation," prepared by the Congressional Research Service Report No. R40613 (revised report issued 4/9/2010).
[40] Prepared Statement of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, "The Role of Credit Rating Agencies in the Structured Finance Market," before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Serial No. 110-62 (9/27/2007), S&P SEC-PSI 0001945-71, at 51. (See Chapter V below.) See also 1/2007 "Annual 2006 Global Corporate Default Study and Ratings Transitions," S&P.
[41] For more detail on these matters, see Chapter V, below.

Although the SEC has generally overseen the credit rating industry for many years, it had no statutory basis to exercise regulatory authority until enactment of the Credit Rating Agency Reform Act in September 2006. Concerned by the inflated credit ratings that had been issued for bonds from Enron Corporation and other troubled corporations, Congress strengthened the SEC's authority over the credit rating industry. Among other provisions, the law established criteria for the NRSRO designation and authorized the SEC to conduct examinations of credit rating agencies. The law also, however, prohibited the SEC from regulating credit rating criteria or methodologies used in credit rating models. In June 2007, the SEC issued implementing regulations, which were essentially too late to affect the ratings already provided for mortgage related securities. One month later, in July 2007, the credit rating agencies issued the first of several mass downgrades of the ratings earlier issued for mortgage related securities.

Structured Finance. In recent years, Wall Street firms have devised increasingly complex financial instruments for sale to investors. These instruments are often referred to as structured finance. Because structured finance products are so complicated and opaque, investors often place particular reliance on credit ratings to determine whether they should buy them.

Among the oldest types of structured finance products are RMBS securities. To create these securities, issuers – often working with investment banks – bundle large numbers of home loans into a loan pool, and calculate the revenue stream coming into the loan pool from the individual mortgages. They then design a "waterfall" that delivers a stream of revenues in sequential order to specified "tranches." The first tranche is at the top of the waterfall and is typically the first to receive revenues from the mortgage pool. Since that tranche is guaranteed to be paid first, it is the safest investment in the pool. The issuer creates a security, often called a bond, linked to that first tranche. That security typically receives a AAA credit rating since its revenue stream is the most secure.

The security created from the next tranche receives the same or a lower credit rating and so on until the waterfall reaches the "equity" tranche at the bottom. The equity tranche typically receives no rating since it is the last to be paid, and therefore the first to incur losses if mortgages in the loan pool default. Since virtually every mortgage pool has at least some mortgages that default, equity tranches are intended to provide loss protection for the tranches above it. Because equity tranches are riskier, however, they are often assigned and receive a higher rate of interest and can be profitable if losses are minimal. One mortgage pool might produce five to a dozen or more tranches, each of which is used to create a residential mortgage backed security that is rated and then sold to investors.

Cash CDOs. Collateralized debt obligations (CDOs) are another type of structured finance product whose securities receive credit ratings and are sold to investors. CDOs are a more complex financial product that involves the re-securitization of existing income-producing assets. From 2004 through 2007, many CDOs included RMBS securities from multiple mortgage pools. For example, a CDO might contain BBB rated securities from 100 different RMBS securitizations. CDOs can also contain other types of assets, such as commercial mortgage backed securities, corporate bonds, or other CDO securities. These CDOs are often called "cash CDOs," because they receive cash revenues from the underlying RMBS bonds and other assets. If a CDO is designed so that it contains a specific list of assets that do not change, it is often called a "static" CDO; if the CDO's assets are allowed to change over time, it is often referred to as a "managed" CDO. Like an RMBS securitization, the CDO arranger calculates the revenue stream coming into the pool of assets, designs a waterfall to divide those incoming revenues among a hierarchy of tranches, and uses each tranche to issue securities that can then be marketed to investors. The most senior tranches of a CDO may receive AAA ratings, even if all of its underlying assets have BBB ratings.

Synthetic CDOs. Some investment banks also created "synthetic CDOs" which mimicked cash CDOs, but did not contain actual mortgages or other assets that produced income. Instead, they simply "referenced" existing assets and then allowed investors to use credit default swaps to place bets on the performance of those referenced assets. Investors who bet that the referenced assets would maintain or increase in value bought the CDO's securities and, in exchange, received periodic coupon payments to recoup their principal investment plus interest. Investors who bet that the referenced assets would lose value or incur a specified negative credit event purchased one or more credit default swap contracts referencing the CDO's assets, and paid monthly premiums to the CDO in exchange for obtaining a large lump sum payment if the loss or other negative credit event actually occurred. Investors in synthetic CDOs who bet the referenced assets would maintain or increase in value were said to be on the "long" side, while investors who bet the assets would lose value or fail were said to be on the "short" side. Some investment banks also created "hybrid CDOs" which contained some cash assets as well as credit default swaps referencing other assets. Others created financial instruments called

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CDO squared or cubed, which contained or referenced tranches from other CDOs.

Like RMBS mortgage pools and cash CDOs, synthetic and hybrid CDOs pooled the payments they received, designed a waterfall assigning portions of the revenues to tranches set up in a certain order, created securities linked to the various tranches, and then sold the CDO securities to investors. Some CDOs employed a "portfolio selection agent" to select the initial assets for the CDO. In addition, some CDOs employed a "collateral manager" to select both the initial and subsequent assets that went into the CDO.

Ratings Used to Market RMBS and CDOs. Wall Street firms helped design RMBS and CDO securities, worked with the credit rating agencies to obtain ratings for the securities, and sold the securities to investors like pension funds, insurance companies, university endowments, municipalities, and hedge funds. Without investment grade ratings, Wall Street firms would have had a more difficult time selling structured finance products to investors, because each investor would have had to perform its own due diligence review of the product. In addition, their sales would have been restricted by federal and state regulations limiting certain institutional investors to the purchase of instruments carrying investment grade credit ratings. Still other regulations conditioned capital reserve requirements on the credit ratings assigned to a bank's investments. Investment grade credit ratings, thus, purported to simplify the investors' due diligence review, ensured some investors could make a purchase, reduced banks' capital calls, and otherwise enhanced the sales of the structured finance products. Here's how one federal bank regulator's handbook put it:

> "The rating agencies perform a critical role in structured finance – evaluating the credit quality of the transactions. Such agencies are considered credible because they possess the expertise to evaluate various underlying asset types, and because they do not have a financial interest in a security's cost or yield. Ratings are important because investors generally accept ratings by the major public rating agencies in lieu of conducting a due diligence investigation of the underlying assets and the servicer."[42]

The more complex and opaque the structured finance instruments became, the more reliant investors were on high credit ratings for the instruments to be marketable.

[42] 11/1997 Comptroller of the Currency Administrator of National Banks Comptroller's Handbook, "Asset Securitization," at 11.

In addition to making structured finance products easier to sell to investors, Wall Street firms used financial engineering to combine AAA ratings – normally reserved for ultra-safe investments with low rates of return – with high risk assets, such as the AAA tranche from a subprime RMBS paying a relatively high rate of return. Higher rates of return, combined with AAA ratings, made subprime RMBS and related CDOs especially attractive investments.

Record Ratings and Revenues. From 2004 to 2007, Moody's and S&P produced a record number of ratings and a record amount of revenues for rating structured finance products. A 2008 S&P submission to the SEC indicates, for example, that from 2004 to 2007, S&P issued more than 5,500 RMBS ratings and more than 835 mortgage related CDO ratings.[43] According to a 2008 Moody's submission to the SEC, from 2004 to 2007, Moody's issued over 4,000 RMBS ratings and over 870 CDO ratings.[44]

Revenues increased dramatically over the same time period. The credit rating agencies charged substantial fees to rate a product. To obtain a rating during the height of the market, for example, S&P generally charged from $40,000 to $135,000 to rate tranches of an RMBS and from $30,000 to $750,000 to rate the tranches of a CDO.[45] Surveillance fees generally ranged from $5,000 to $50,000 per year for mortgage backed securities.[46] Over a five-year period, Moody's gross revenues from RMBS and CDO ratings more than tripled, going from over $61 million in 2002, to over $260 million in 2006.[47] S&P's revenue also increased. S&P's gross revenues for RMBS and mortgage related CDO ratings quadrupled, from over $64 million in 2002, to over $265 million in 2006.[48] Altogether, revenues from the three leading

[43] 3/14/2008 compliance letter from S&P to SEC, SEC_OCIE_CRA_011218-59, at 20. These numbers represent the RMBS or CDO pools that were presented to S&P which then issued ratings for multiple tranches per RMBS or CDO pool. (See Chapter V below.)
[44] 3/11/2008 compliance letter from Moody's to SEC, SEC_OCIE_CRA_011212 and SEC_OCIE_CRA_011214. These numbers represent the RMBS or CDO pools that were presented to Moody's which then issued ratings for multiple tranches per RMBS or CDO pool. The data Moody's provided to the SEC on CDOs represented ABS CDOs, some of which may not be mortgage related. However, by 2004, most, but not all, CDOs relied primarily on mortgage related assets such as RMBS securities. Subcommittee interview of Gary Witt, former Managing Director of Moody's RMBS Group (10/29/2009). (See Chapter V below.)
[45] "U.S. Structured Ratings Fee Schedule Residential Mortgage-backed Financings and Residential Servicer Evaluations," prepared by S&P, S&P-PSI 0000028-35; and "U.S. Structured Ratings Fee Schedule Collateralized Debt Obligations Amended 3/7/2007," prepared by S&P, S&P-PSI 0000036-50. (See Chapter V below.)
[46] Id.
[47] 3/11/2008 compliance letter from Moody's to SEC, SEC_OCIE_CRA_011212 and SEC_OCIE_CRA_011214. The 2002 figure does not include gross revenue from CDO ratings as this figure was not readily available due to the transition of Moody's accounting systems. (See Chapter V below.)
[48] 3/14/2008 compliance letter from S&P to SEC, SEC_OCIE_CRA_011218-59, at 18-19. (See Chapter V below.)

credit rating agencies more than doubled from nearly $3 billion in 2002 to over $6 billion in 2007.[49]

Conflicts of Interest. Credit rating agencies are paid by the issuers seeking ratings for the products they sell. Issuers and the investment banks want high ratings, whether to help market their products or ensure they comply with federal regulations. Because credit rating agencies issue ratings to issuers and investment banks who bring them business, they are subject to an inherent conflict of interest that can create pressure on the credit rating agencies to issue favorable ratings to attract business. The issuers and investment banks engage in "ratings shopping," choosing the credit rating agency that offers the highest ratings. Ratings shopping weakens rating standards as the rating agencies who provide the most favorable ratings win more business. In September 2007, Moody's CEO described the problem this way: "What happened in '04 and '05 with respect to subordinated tranches is that our competition, Fitch and S&P, went nuts. Everything was investment grade."[50] In 2003, the SEC reported that "the potential conflicts of interest faced by credit rating agencies have increased in recent years, particularly given the expansion of large credit rating agencies into ancillary advisory and other businesses, and the continued rise in importance of rating agencies in the U.S. securities markets."[51]

Mass Downgrades. The credit ratings assigned to RMBS and CDO securities are designed to last the lifetime of the securities. Because circumstances can change, however, credit rating agencies conduct ongoing surveillance of each rated financial product to evaluate the rating and determine whether it should be upgraded or downgraded. Prior to the financial crisis, the numbers of downgrades and upgrades for structured finance ratings were substantially lower.[52] Beginning in July 2007, however, Moody's and S&P issued hundreds and then thousands of downgrades of RMBS and CDO ratings, the first mass downgrades in U.S. history.

From 2004 through the first half of 2007, Moody's and S&P provided AAA ratings to a majority of the RMBS and CDO securities issued in the United States, sometimes providing AAA ratings to as

[49] "Revenue of the Three Credit Rating Agencies: 2002-2007," chart prepared by the Subcommittee using data from http://thismatter.com/money, Hearing Exhibit 4/23-1g.
[50] 9/10/2007 Transcript of Raymond McDaniel at Moody's MD Town Hall Meeting, Hearing Exhibit 4/23-98.
[51] 1/2003 "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," prepared by the SEC, at 40. The report continued: "[C]oncerns had been expressed that a rating agency might be tempted to give a more favorable rating to a large issue because of the large fee, and to encourage the issuer to submit future large issues to the rating agency." Id. at 40 n.109.
[52] See, e.g., 3/26/2010 "Fitch Ratings Global Structured Finance 2009 Transition and Default Study," prepared by Fitch.

much as 95% of a securitization.[53] By 2010, analysts had determined that over 90% of the AAA ratings issued to RMBS securities originated in 2006 and 2007 had been downgraded to junk status.[54]

Moody's and S&P began downgrading RMBS and CDO products in late 2006, when residential mortgage delinquency rates and losses began increasing. Then, in July 2007, both S&P and Moody's initiated the first of several mass downgrades that shocked the financial markets. On July 10, S&P placed on credit watch the ratings of 612 subprime RMBS with an original value of $7.35 billion. Later that day, Moody's downgraded 399 subprime RMBS with an original value of $5.2 billion. Two days later, S&P downgraded 498 of the ratings it had placed on credit watch.

In October 2007, Moody's began downgrading CDOs on a daily basis, downgrading more than 270 CDO securities with an original value of $10 billion. In December 2007, Moody's downgraded another $14 billion in CDOs, and placed another $105 billion on credit watch. Moody's calculated that, overall in 2007, "8725 ratings from 2116 deals were downgraded and 1954 ratings from 732 deals were upgraded,"[55] which means that it downgraded over four times more ratings than it upgraded. On January 30, 2008, S&P either downgraded or placed on credit watch over 8,200 ratings of subprime RMBS and CDO securities, representing issuance amounts of approximately $270.1 billion and $263.9 billion, respectively.[56]

These downgrades created significant turmoil in the securitization markets, as investors were required by regulations to sell off assets that had lost their investment grade status, holdings at financial firms plummeted in value, and new securitizations were unable to find investors. As a result, the subprime RMBS and CDO secondary markets slowed and then collapsed, and financial firms around the world were left holding billions of dollars in suddenly unmarketable RMBS and CDO securities.

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[53] See "MBS Ratings and the Mortgage Credit Boom," Federal Reserve Bank of New York Staff Report no. 449, May 2010, at 1.
[54] See, e.g., "Percent of the Original AAA Universe Currently Rated Below Investment Grade," chart prepared by BlackRock Solutions, Hearing Exhibit 4/23-1i. See also 3/2008 "Understanding the Securitization of Subprime Mortgage Credit," Federal Reserve Bank of New York Staff Report no. 318, at 58 and chart 31 ("92 percent of 1st-lien subprime deals originated in 2006 as well as … 91.8 percent of 2nd-lien deals originated in 2006 have been downgraded.").
[55] 2/2008 "Structured Finance Ratings Transitions, 1983-2007," Credit Policy Special Comment prepared by Moody's, at 4.
[56] 6/24/2010 supplemental response from S&P to the Subcommittee, Exhibit N, Hearing Exhibit 4/23-108 (1/30/2008 "S&P Takes Action on 6,389 U.S. Subprime RMBS Ratings and 1,953 CDO Ratings," S&P's RatingsDirect). Ratings may appear on CreditWatch when events or deviations from an expected trend occur and additional information is needed to evaluate the rating.

D. Investment Banks

Historically, investment banks helped raise capital for business and other endeavors by helping to design, finance, and sell financial products like stocks or bonds. When a corporation needed capital to fund a large construction project, for example, it often hired an investment bank either to help it arrange a bank loan or raise capital by helping to market a new issue of shares or corporate bonds to investors. Investment banks also helped with corporate mergers and acquisitions. Today, investment banks also participate in a wide range of other financial activities, including offering broker-dealer and investment advisory services, and trading derivatives and commodities. Many have also been active in the mortgage market and have worked with lenders or mortgage brokers to package and sell mortgage loans and mortgage backed securities. Investment banks have traditionally performed these services in exchange for fees.

If an investment bank agreed to act as an "underwriter" for the issuance of a new security to the public, it typically bore the risk of those securities on its books until the securities were sold. By law, securities sold to the public generally must be registered with the SEC.[57] Registration statements explain the purpose of a proposed public offering, an issuer's operations and management, key financial data, and other important facts to potential investors. Any offering document or prospectus provided to the investing public must also be filed with the SEC. If an issuer decides not to offer a new security to the general public, it can still offer it to investors through a "private placement."[58] Investment banks often act as the "placement agent" in these private offerings, helping to design, market, and sell the security to selected investors. Solicitation documents in connection with private placements are not required to be filed with the SEC. Under the federal securities laws, however, investment banks that act as an underwriter or placement agent may be liable for any material misrepresentations or omissions of material facts made in connection with a solicitation or sale of a security to an investor.[59]

In the years leading up to the financial crisis, RMBS securities were generally registered with the SEC and sold in public offerings, while CDO securities were generally sold to investors through private placements. Investment banks frequently served as the underwriter or placement agent in those transactions, and typically sold both types of securities to large institutional investors.

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[57] Securities Act of 1933, 15 U.S.C. § 77a (1933).
[58] See, e.g., Securities Act of 1933 §§ 3(b) and 4(2); 17 CFR § 230.501 et seq. (Regulation D).
[59] Securities Act of 1933, § 11, 15 U.S.C. § 77k; and Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder.

In addition to arranging for a public or private offering, some investment banks take on the role of a "market maker," standing willing and able to buy or sell financial products to their clients or other market participants. To facilitate client orders to buy or sell those products, the investment bank may acquire an inventory of them and make them available for client transactions.[60] By filling both buy and sell orders, market makers help create a liquid market for the financial products and make it easier and more attractive for clients to buy and sell them. Market makers typically rely on fees in the form of markups in the price of the financial products for their profits.

At the same time, investment banks may decide to buy and sell the financial products for their own account, which is called "proprietary trading." Investment banks often use the same inventory of financial products to carry out both their market making and proprietary trading activities. Investment banks that trade for their own account typically rely on changes in the values of the financial products to turn a profit.

Inventories that are used for market making and short term proprietary trading purposes are typically designated as a portfolio of assets "held for sale." Investment banks also typically maintain an inventory or portfolio of assets that they intend to keep as long term investments. This inventory or portfolio of long-term assets is typically designated as "held for investment," and is not used in day-to-day transactions.

Investment banks that carry out market-making and proprietary trading activities are required – by their banking regulator in the case of banks and bank holding companies[61] and by the SEC in the case of broker-dealers[62] – to track their investments and maintain sufficient capital to meet their regulatory requirements and financial obligations. These capital requirements typically vary based on how the positions are held and how they are classified. For example, assets that are "held for sale" or are in the "trading account" typically have lower capital requirements than those that are "held for investment," because of the expected lower risks associated with what are expected to be shorter term holdings.

[60] For a detailed discussion of market making, see "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds," prepared by the Financial Stability Oversight Council, at 28-29 (Jan. 18, 2011) (citing SEC Exchange Act Rel. No. 34-58775 (Oct. 14, 2008)).
[61] See, e.g., 12 CFR part 3, Appendix A (for the Office of the Comptroller of the Currency), 12 CFR part 208, Appendix A and 12 CFR part 225, Appendix A (for the Federal Reserve Board of Governors) and 12 CFR part 325, Appendix A (for the Federal Deposit Insurance Corporation).
[62] Securities Exchange Act of 1934, Rule 15c3-1.

Many investment banks use complex automated systems to analyze the "Value at Risk" (VaR) associated with their holdings. To reduce the VaR attached to their holdings, investment banks employ a variety of methods to offset or "hedge" their risk. These methods can include diversifying their assets, taking a short position on related financial products, purchasing loss protection through insurance or credit default swaps, or taking positions in derivatives whose values move inversely to the value of the assets being hedged.

Shorting the Mortgage Market. Prior to the financial crisis, investors commonly purchased RMBS or CDO securities as long-term investments that produced a steady income. In 2006, however, the high risk mortgages underlying these securities began to incur record levels of delinquencies. Some investors, worried about the value of their holdings, sought to sell their RMBS or CDO securities, but had a difficult time doing so due to the lack of an active market. Some managed to sell their high risk RMBS securities to investment banks assembling cash CDOs.

Some investors, instead of selling their RMBS or CDO securities, purchased "insurance" against a loss by buying a credit default swap (CDS) that would pay off if the specified securities incurred losses or other negative credit events. By 2005, investment banks had standardized CDS contracts for RMBS and CDO securities, making this a practical alternative.

Much like insurance, the buyer of a CDS contract paid a periodic premium to the CDS seller, who guaranteed the referenced security against loss. CDS contracts referencing a single security or corporate bond became known as "single name" CDS contracts. If the referenced security later incurred a loss, the CDS seller had to pay an agreed-upon amount to the CDS buyer to cover the loss. Some investors began to purchase single name CDS contracts, not as a hedge to offset losses from RMBS or CDO securities they owned, but as a way to profit from particular RMBS or CDO securities they predicted would lose money. CDS contracts that paid off on securities that were not owned by the CDS buyer were known as "naked credit default swaps." Some investors purchased large numbers of these CDS contracts in a concerted strategy to profit from mortgage backed securities they believed would fail.

Some investment banks took the CDS approach a step further. In 2006, a consortium of investment banks led by Goldman Sachs and Deutsche Bank launched the ABX Index, which created five indices that tracked the aggregate performance of a basket of 20 designated subprime RMBS securitizations.[63] Borrowing from longstanding practice in commodities markets, investors could buy and sell contracts linked to the value of one of the ABX indices. Each contract consisted of a credit default swap agreement in which the parties could essentially wager on the rise or fall of the index value. According to a Goldman Sachs employee, the ABX Index "introduced a standardized tool that allow[ed] clients to quickly gain exposure to the asset class," in this case subprime RMBS securities. An investor – or investment bank – taking a short position in an ABX contract was, in effect, placing a bet that the basket of subprime RMBS securities would lose value.

Synthetic CDOs provided still another vehicle for shorting the mortgage market. In this approach, an investment bank created a synthetic CDO that referenced a variety of RMBS securities. One or more investors could take the "short" position by paying premiums to the CDO in exchange for a promise that the CDO would pay a specified amount if the referenced assets incurred a negative credit event, such as a default or credit rating downgrade. If that event took place, the CDO would have to pay an agreed-upon amount to the short investors to cover the loss, removing income from the CDO and causing losses for the long investors. Synthetic CDOs became a way for investors to short multiple specific RMBS securities that they expected would incur losses.

Proprietary Trading. Financial institutions also built increasingly large proprietary holdings of mortgage related assets. Numerous financial firms, including investment banks, bought RMBS and CDO securities, and retained these securities in their investment portfolios. Others retained these securities in their trading accounts to be used as inventory for short term trading activity, market making on behalf of clients, hedging, providing collateral for short term loans, or maintaining lower capital requirements. Deutsche Bank's RMBS Group in New York, for example, built up a $102 billion portfolio of RMBS and CDO securities, while the portfolio at an affiliated hedge fund, Winchester Capital, exceeded $8 billion.[64] Other financial firms, including Bear Stearns, Citibank, JPMorgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley, and UBS also accumulated enormous propriety holdings in mortgage related products. When the value of

[63] Each of the five indices tracked a different tranche of securities from the designated 20 subprime RMBS securitizations. One index tracked AAA rated securities from the 20 subprime RMBS securities; the second tracked AA rated securities from the 20 RMBS securitizations; and the remaining indices tracked baskets of A, BBB, and BBB rated RMBS securities. Every six months, a new set of RMBS securitizations was selected for a new ABX index. See 3/2008 "Understanding the Securitization of Subprime Mortgage Credit," prepared by Federal Reserve Bank of New York, Report No. 318, at 26. Markit Group Ltd. administered the ABX Index which issued indices in 2006 and 2007, but has not issued any new indices since then.
[64] For more information, see Chapter VI, section discussing Deutsche Bank.

these holdings dropped, some of these financial institutions lost tens of billions of dollars,[65] and either declared bankruptcy, were sold off,[66] or were bailed out by U.S. taxpayers seeking to avoid damage to the U.S. economy as a whole.[67]

One investment bank, Goldman Sachs, built a large number of proprietary positions to short the mortgage market.[68] Goldman Sachs had helped to build an active mortgage market in the United States and had accumulated a huge portfolio of mortgage related products. In late 2006, Goldman Sachs decided to reverse course, using a variety of means to bet against the mortgage market. In some cases, Goldman Sachs took proprietary positions that paid off only when some of its clients lost money on the very securities that Goldman Sachs had sold to them and then shorted. Altogether in 2007, Goldman's mortgage department made $1.1 billion in net revenues from shorting the mortgage market.[69] Despite those gains, Goldman Sachs was given a $10 billion taxpayer bailout under the Troubled Asset Relief Program,[70] tens of billions of dollars in support through accessing the Federal Reserve's Primary Dealer Credit Facility,[71] and billions more in indirect government support[72] to ensure its continued existence.

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[65] See, e.g., Goldman Sachs Group, Inc., 2008 Annual Report 27 (2009) (stating that the firm had "long proprietary positions in a number of [its] businesses. These positions are accounted for at fair value, and the declines in the values of assets have had a direct and large negative impact on [its] earnings in fiscal 2008."); see also, Viral V. Acharya and Matthew Richardson, "Causes of the Financial Crisis," 21 Critical Review 195, 199-204 (2009) (citing proprietary holdings of asset backed securities as one of the primary drivers of accumulated risks causing the financial crisis); "Prop Trading Losses Ain't Peanuts," The Street (1/27/2010), http://www.thestreet.com/story/10668047/prop-trading-losses-aint-peanuts.html.

[66] See, e.g., "Lehman Files for Bankruptcy; Merrill is Sold," New York Times (9/14/2008); and discussion in Chapter III of Washington Mutual Bank which was sold to JPMorgan Chase.

[67] See, e.g., Capital Purchase Program Transactions, under the Troubled Asset Relief Program, U.S. Department of the Treasury, at http://www.treasury.gov/initiatives/financial-stability/investment-programs/cpp/Pages/capitalpurchaseprogram.aspx.

[68] For more information, see Chapter VI, section describing Goldman Sachs.

[69] Id. Goldman's Structured Product Group Trading Desk earned $3.7 billion in net revenues, which was offset by losses on other desks within the mortgage department, resulting in the $1.1 billion in total net revenues.

[70] See, e.g., Capital Purchase Program Transactions, under the Troubled Asset Relief Program, U.S. Department of the Treasury, available at http://www.treasury.gov/initiatives/financial-stability/investment-programs/cpp/Pages/capitalpurchaseprogram.aspx and an example of a transactions report at http://www.treasury.gov/initiatives/financial-stability/briefing-room/reports/tarp-transactions/DocumentsTARPTransactions/transactions-report-062309.pdf.

[71] See data available at http://www.federalreserve.gov/newsevents/reform_pdcf.htm showing Goldman Sachs' use of the Primary Dealer Credit Facility 85 times in 2008.

[72] See, e.g., prepared statement of Neil Barofsky, Special Inspector General of the Troubled Asset Relief Program, "The Federal Bailout of AIG," before the House Committee on Oversight and Government Reform (1/27/2010), http://oversight.house.gov/images/stories/Hearings/pdfs/20100127barofsky.pdf (noting that some firms, including Goldman Sachs, disproportionately benefited from the federal government's bailout of AIG).

E. Market Oversight

U.S. financial regulators failed to stop financial firms from engaging in high risk, conflict-ridden activities. Those regulatory failures arose, in part, from the fragmented nature of U.S. financial oversight as well as statutory barriers to regulating high risk financial products.

Oversight of Lenders. At the end of 2005, the United States had about 8,800 federally insured banks and thrifts,[73] plus about 8,700 federally insured credit unions, many of which were in the business of issuing home loans.[74] On the federal level, these financial institutions were overseen by five agencies: the Federal Reserve which oversaw state-chartered banks that were part of the Federal Reserve System as well as foreign banks and others; the Office of the Comptroller of the Currency (OCC) which oversaw banks with national charters; the Office of Thrift Supervision (OTS) which oversaw federally-chartered thrifts; the National Credit Union Administration which oversaw federal credit unions; and the Federal Deposit Insurance Corporation (FDIC) which oversaw financial institutions that have federal deposit insurance (hereinafter referred to as "federal bank regulators").[75] In addition, state banking regulators oversaw the state-chartered institutions and at times took action to require federally-chartered financial institutions to comply with certain state laws.

The primary responsibility of the federal bank regulators was to ensure the safety and soundness of the financial institutions they oversaw. One key mechanism they used to carry out that responsibility was to conduct examinations on a periodic basis of the financial institutions within their jurisdiction and provide the results in an annual Report of Examination (ROE) given to the Board of Directors at each entity. The largest U.S. financial institutions typically operated under a "continuous exam" program, which required federal bank examiners to conduct a series of specialized examinations during the year with the results from all of those examinations included in the annual ROE.

Federal examination activities were typically led by an Examiner in Charge and were organized around a rating system called CAMELS that was used by all federal bank regulators. The CAMELS rating system evaluated a financial institution's: (C) capital adequacy, (A) asset

[73] See FDIC Quarterly Banking Profile, 1 (Fourth Quarter 2005) (showing that, as of 12/31/2005, the United States had 8,832 federal and state chartered insured banks and thrifts).
[74] See 1/3/2011 chart, "Insurance Fund Ten-Year Trends," supplied by the National Credit Union Administration (showing that, as of 12/31/2005, the United States had 8,695 federal and state credit unions).
[75] The Dodd-Frank Act has since abolished one of these agencies, the Office of Thrift Supervision, and assigned its duties to the OCC. See Chapter IV.

quality, (M) management, (E) earnings, (L) liquidity, and (S) sensitivity to market risk. CAMELS ratings are on a scale of 1 to 5, in which 1 signifies a safe and secure bank with no cause for supervisory concern, 3 signifies an institution with supervisory concerns in one or more areas, and 5 signifies an unsafe and unsound bank with severe supervisory concerns. In the annual ROE, regulators typically provided a financial institution with a rating for each CAMELS component, as well as an overall composite rating on its safety and soundness.

In addition, the FDIC conducted its own examinations of financial institutions with federal deposit insurance. The FDIC reviews relied heavily on the examination findings and ROEs developed by the primary regulator of the financial institution, but the FDIC assigned its own CAMELS ratings to each institution. In addition, for institutions with assets of $10 billion or more, the FDIC established a Large Insured Depository Institutions (LIDI) Program to assess and report on emerging risks that may pose a threat to the federal Deposit Insurance Fund. Under this program, the FDIC performed an ongoing analysis of emerging risks within each insured institution and assigned a quarterly risk rating, using a scale of A to E, with A being the best rating and E the worst.

If a regulator became concerned about the safety or soundness of a financial institution, it had a wide range of informal and formal enforcement actions that could be used to require operational changes. Informal actions included requiring the financial institution to issue a safety and soundness plan, memorandum of understanding, Board resolution, or commitment letter pledging to take specific corrective actions by a certain date, or issuing a supervisory letter to the financial institution listing specific "matters requiring attention." These informal enforcement actions are generally not made public and are not enforceable in court. Formal enforcement actions included a regulator issuing a public memorandum of understanding, consent order, or cease and desist order requiring the financial institution to stop an unsafe practice or take an affirmative action to correct identified problems; imposing a civil monetary penalty; suspending or removing personnel from the financial institution; or referring misconduct for criminal prosecution.

A wide range of large and small banks and thrifts were active in the mortgage market. Banks like Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo originated, purchased, and securitized billions of dollars in home loans each year. Thrifts, whose charters typically required them to hold 65% of their assets in mortgage related assets, also originated, purchased, sold, and securitized billions of dollars in home loans, including such major lenders as Countrywide Financial Corporation, IndyMac Bank, and Washington Mutual Bank. Some of these banks and thrifts also had affiliates, such as Long Beach Mortgage Corporation, which specialized in issuing subprime mortgages. Still more lenders operated outside of the regulated banking system, including New Century Financial Corporation and Fremont Loan & Investment, which used such corporate vehicles as industrial loan companies, real estate investment trusts, or publicly traded corporations to carry out their businesses. In addition, the mortgage market was populated with tens of thousands of mortgage brokers that were paid fees for their loans or for bringing qualified borrowers to a lender to execute a home loan.[76]

Oversight of Securities Firms. Another group of financial institutions active in the mortgage market were securities firms, including investment banks, broker-dealers, and investment advisors. These security firms did not originate home loans, but typically helped design, underwrite, market, or trade securities linked to residential mortgages, including the RMBS and CDO securities that were at the heart of the financial crisis. Key firms included Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley, and the asset management arms of large banks, including Citigroup, Deutsche Bank, and JPMorgan Chase. Some of these firms also had affiliates which specialized in securitizing subprime mortgages.

Securities firms were overseen on the federal level by the Securities and Exchange Commission (SEC) whose mission is to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[77] The SEC oversees the "key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisors, and mutual funds," primarily for the purpose of "promoting the disclosure of important market related information, maintaining fair dealing, and protecting against fraud."[78]

The securities firms central to the financial crisis were subject to a variety of SEC regulations in their roles as broker-dealers, investment advisors, market makers, underwriters, and placement agents. Most were also subject to oversight by state securities regulators.[79] The securities firms were required to submit a variety of public filings with

[76] 1/2009 "Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System," prepared by the Government Accountability Office, Report No. GAO-09-216, at 26-27.
[77] See SEC website, "About the SEC: What We Do," www.sec.gov.
[78] Id.
[79] Some firms active in the U.S. securities and mortgage markets, such as hedge funds, operated without meaningful federal oversight by taking advantage of exemptions in the Investment Company Act of 1940.

the SEC about their operations and in connection with the issuance of new securities. The SEC's Office of Compliance Inspections and Examinations (OCIE) conducted inspections of broker-dealers, among others, to understand industry practices, encourage compliance, evaluate risk management, and detect violations of the securities laws. In addition, under the voluntary Consolidated Supervised Entities program, the SEC's Division of Trading and Markets monitored the investment activities of the largest broker-dealers, including Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley, Citigroup, and JPMorgan Chase, evaluating their capital levels, use of leverage, and risk management.[80]

Like bank regulators, if the SEC became concerned about a particular securities firm, it could choose from a range of informal and formal enforcement actions. Informal actions could include issuing a "deficiency letter" identifying problems and requiring the securities firm to take corrective action by a certain date. Formal enforcement actions, undertaken by the SEC's Division of Enforcement, could include civil proceedings before an administrative law judge; a civil complaint filed in federal district court; civil fines; an order to suspend or remove personnel from a firm or bar them from the brokerage industry; or a referral for criminal prosecution. Common securities violations included selling unregistered securities, misrepresenting information about a security, unfair dealing, price manipulation, and insider trading.[81]

Statutory and Regulatory Barriers. Federal and state financial regulators responsible for oversight of banks, securities firms, and other financial institutions in the years leading to the financial crisis operated under a number of statutory and regulatory constraints.

One key constraint was the sweeping statutory prohibition on the federal regulation of any type of swap, including credit default swaps. This prohibition took effect in 2000, with enactment of the Commodity Futures Modernization Act (CFMA).[82] The key statutory section explicitly prohibited federal regulators from requiring the registration of swaps as securities; issuing or enforcing any regulations or orders related to swaps; or imposing any recordkeeping requirements for swaps.[83] In addition, the law explicitly prohibited regulation of any "'interest rate swap,' including a rate floor, rate cap, rate collar, cross-

[80] See 9/2008 "SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Entity Program," report prepared by Office of the SEC Inspector General, Report No. 446-A.

[81] See SEC website, "About the SEC: What We Do," www.sec.gov.
[82] CFMA was included as a title of H.R. 4577, the Consolidated Appropriations Act of 2001, P.L.106-554.
[83] CFMA, § 302, creating a new section 2A of the Securities Act of 1933.

currency rate swap, basis swap, currency swap, equity index swap, equity swap, debt index swap, debt swap, credit spread, credit default swap, credit swap, weather swap, or commodity swap."[84] These prohibitions meant that federal regulators could not even ask U.S. financial institutions to report on their swaps trades or holdings, much less regulate swap dealers or examine how swaps were affecting the mortgage market or other U.S. financial markets.

As a result, the multi-trillion-dollar U.S. swaps markets operated with virtually no disclosure requirements, no restrictions, and no oversight by any federal agency, including the market for credit default swaps which played a prominent role in the financial crisis. On September 23, 2008, in a hearing before the Senate Committee on Banking, Housing, and Urban Affairs, then SEC Chairman Christopher Cox testified that, as a result of the statutory prohibition, the credit default swap market "is completely lacking in transparency," "is regulated by no one," and "is ripe for fraud and manipulation."[85] In a September 26, 2008 press release, he discussed regulatory gaps impeding his agency and again raised the issue of swaps: "Unfortunately, as I reported to Congress this week, a massive hole remains: the approximately $60 trillion credit default swap market, which is regulated by no agency of government. Neither the SEC nor any regulator has authority even to require minimum disclosure."[86] In 2010, the Dodd-Frank Act removed the CFMA prohibition on regulating swaps.[87]

A second significant obstacle for financial regulators was the patchwork of federal and state laws and regulations applicable to high risk mortgages and mortgage brokers. Federal bank regulators took until October 2006, to provide guidance to federal banks on acceptable lending practices related to high risk home loans.[88] Even then, the regulators issued voluntary guidance whose standards were not enforceable in court and failed to address such key issues as the acceptability of stated income loans.[89] In addition, while Congress had authorized the Federal Reserve, in 1994, to issue regulations to prohibit deceptive or abusive mortgage practices – regulations that could have

[84] CFMA, § 301, creating a new section 206A of the Gramm-Leach-Bliley Act.
[85] Statement of SEC Chairman Christopher Cox, "Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions," before the U.S. Senate Committee on Banking, Housing and Urban Affairs, S.Hrg. 110-1012 (9/23/2008).
[86] 9/26/2008 SEC press release, "Chairman Cox Announces End of Consolidated Supervised Entities Program," http://www.sec.gov/news/press/2008/2008-230.htm.
[87] Title VII of the Dodd-Frank Act.
[88] 10/4/2006 "Interagency Guidance on Nontraditional Mortgage Product Risks," (NTM Guidance), 71 Fed. Reg. 192 at 58609.
[89] For more information, see Chapter IV.

applied across the board to all types of lenders and mortgage brokers – the Federal Reserve failed to issue any until July 2008, after the financial crisis had already hit.[90]

A third problem, exclusive to state regulators, was a 2005 regulation issued by the OCC to prohibit states from enforcing state consumer protection laws against national banks.[91] After the New York State Attorney General issued subpoenas to several national banks to enforce New York's fair lending laws, a legal battle ensued. In 2009, the Supreme Court invalidated the OCC regulation, and held that states were allowed to enforce state consumer protection laws against national banks.[92] During the intervening four years, however, state regulators had been effectively unable to enforce state laws prohibiting abusive mortgage practices against federally-chartered banks and thrifts.

Systemic Risk. While bank and securities regulators focused on the safety and soundness of individual financial institutions, no regulator was charged with identifying, preventing, or managing risks that threatened the safety and soundness of the overall U.S. financial system. In the area of high risk mortgage lending, for example, bank regulators allowed banks to issue high risk mortgages as long as it was profitable and the banks quickly sold the high risk loans to get them off their books. Securities regulators allowed investment banks to underwrite, buy, and sell mortgage backed securities relying on high risk mortgages, as long as the securities received high ratings from the credit rating agencies and so were deemed "safe" investments. No regulatory agency focused on what would happen when poor quality mortgages were allowed to saturate U.S. financial markets and contaminate RMBS and CDO securities with high risk loans. In addition, none of the regulators focused on the impact derivatives like credit default swaps might have in exacerbating risk exposures, since they were barred by federal law from regulating or even gathering data about these financial instruments.

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[90] Congress authorized the Federal Reserve to issue the regulations in Section 151 of the Home Ownership and Equity Protection Act of 1994 (HOEPA), P.L. 103-325. The Federal Reserve did not issue any regulations under HOEPA, however, until July 2008, when it amended Regulation Z. The new rules primarily strengthened consumer protections for "higher priced loans," which included many types of subprime loans. See "New Regulation Z Rules Enhance Protections for Mortgage Borrowers," Consumer Compliance Outlook (Fourth Quarter 2008) (Among other requirements, the rules prohibited lenders "from making loans based on collateral without regard to [the borrower's] repayment ability," required lenders to "verify income and obligations," and imposed "more stringent restrictions on prepayment penalties." The rules also required lenders to "establish escrow accounts for taxes and mortgage related insurance for first-lien loans." In addition, the rules "prohibit[ed] coercion of appraisers, define[d] inappropriate practices for loan servicers, and require[d] early truth in lending disclosures for most mortgages.").

[91] 12 CFR § 7.4000.

[92] Cuomo v. Clearing House Association, Case No. 08-453, 129 S.Ct. 2710 (2009).

F. Government Sponsored Enterprises

Between 1990 and 2004, homeownership rates in the United States increased rapidly from 64% to 69%, the highest level in 50 years.[93] While many highly regarded economists and officials argued at the time that this housing boom was the result of healthy economic activity, in retrospect, some federal housing policies encouraged people to purchase homes they were ultimately unable to afford, which helped to inflate the housing bubble.

Fannie Mae and Freddie Mac. Two government sponsored entities (GSE), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), were chartered by Congress to encourage homeownership primarily by providing a secondary market for home mortgages. They created that secondary market by purchasing loans from lenders, securitizing them, providing a guarantee that they would make up the cost of any securitized mortgage that defaulted, and selling the resulting mortgage backed securities to investors. Many believed that the securities had the implicit backing of the federal government and viewed them as very safe investments, leading investors around the world to purchase them. The existence of this secondary market encouraged lenders to originate more loans, since they could easily sell them to the GSEs and use the profits to increase their lending.

Over time, however, Fannie Mae and Freddie Mac began to purchase larger quantities of higher risk loans, providing a secondary market for those loans and encouraging their proliferation. Between 2005 and 2007, Fannie Mae alone purchased billions of dollars in high risk home loans, including Option ARM, Alt A, and loans with subprime characteristics. For example, data from Fannie Mae shows that, in mid 2008, 62% of the Option ARM loans on its books had been purchased between 2005 and 2007.[94] Likewise, 84% of its interest-only loans were purchased in that time frame, as were 57% of those with FICO scores less than 620; 62% of its loans with loan-to-value ratios greater than 90; and 73% of its Alt A loans.[95] While these loans constituted only a small percentage of Fannie Mae's purchases at the time, they came to account for some its most significant losses. By the middle of 2009, Fannie Mae reported an unpaid principal balance of $878 billion for its loans with

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[93] U.S. Census Bureau, "Table 14. Homeownership Rates by Area: 1960 to 2009," http://www.census.gov/hhes/www/housing/hvs/annual09/ann09t14.xls.
[94] Fannie Mae, 2008 Q2 10-Q Investor Summary, August 8, 2008, http://www.fanniemae.com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary.pdf.
[95] Id.

subprime characteristics, nearly a third of its total portfolio of $2.7 trillion.[96]

According to economist Arnold Kling, Fannie Mae and Freddie Mac purchased these loans after "lowering their own credit standards in order to maintain a presence in the market and to meet their affordable housing goals."[97]

Throughout their history, Fannie Mae and Freddie Mac were able to bundle the mortgages they purchased into securities that were popular with investors, because many believed the securities carried the implicit support of the federal government. The Congressional Budget Office found the following:

> "Because of their [Fannie Mae and Freddie Mac] size and interconnectedness with other financial institutions, they posed substantial systemic risk—the risk that their failure could impose very high costs on the financial system and the economy. The GSEs' market power also allowed them to use their profits partly to benefit their other stakeholders rather than exclusively to benefit mortgage borrowers. The implicit guarantee created an incentive for the GSEs to take excessive risks: Stakeholders would benefit when gambles paid off, but taxpayers would absorb the losses when they did not. ...
>
> One way that Fannie Mae and Freddie Mac increased risk was by expanding the volume of mortgages and MBSs held in their portfolios, which exposed them to the risk of losses from changes in interest or prepayment rates. Over the past decade, the two GSEs also increased their exposure to default losses by investing in lower-quality mortgages, such as subprime and Alt-A loans."[98]

The risks embedded in their mortgage portfolios finally overwhelmed the GSEs in September 2008, and both Fannie Mae and Freddie Mac were taken into conservatorship by the federal government. Since that time, the Treasury Department has spent nearly $150 billion

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[96] Fannie Mae, 2009 Second Quarter Credit Supplement, August 6, 2009, http://www.fanniemae.com/ir/pdf/sec/2009/q2credit_summary.pdf.
[97] "Not What They Had In Mind: A History of Policies that Produced the Financial Crisis of 2008," September 2009, Mercatus Center, http://mercatus.org/sites/default/files/publication/NotWhatTheyHadInMind(1).pdf.
[98] Congressional Budget Office, "Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market," December 2010, at x, http://www.cbo.gov/ftpdocs/120xx/doc12032/12-23-FannieFreddie.pdf.

to support the two GSEs, a total which projections show could rise to as high as $363 billion.[99]

Ginnie Mae. Additional housing policies that allowed borrowers with less than adequate credit to obtain traditional mortgages included programs at the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA). Both agencies provided loan guarantees to lenders that originated loans for borrowers that qualified under the agencies' rules. Many of the loans guaranteed by the FHA and VA, some of which required down payments as low as 3%, were bundled and sold as mortgage backed securities guaranteed by the Government National Mortgage Association (Ginnie Mae), a government corporation. Ginnie Mae guaranteed investors the timely payment of principal and interest on mortgage backed securities backed by federally insured or guaranteed loans.

In the years leading up to the financial crisis, FHA guaranteed millions of home loans worth hundreds of billions of dollars.[100] According to FHA data, as of 2011, nearly 20% of all FHA loans originated in 2008 were seriously delinquent, meaning borrowers had missed three or more payments, while loans originated in 2007 had a serious delinquency rate of over 22%. The 2007 and 2008 loans, which currently make up about 15% of FHA's active loan portfolio, remain the worst performing in that portfolio. In 2009 and 2010, FHA tightened its underwriting guidelines, and the loans it guaranteed performed substantially better. By early 2011, the serious delinquency rate for all FHA borrowers was about 8.8%, down from over 9.4% the prior year.

G. Administrative and Legislative Actions

In response to the financial crisis, Congress and the Executive Branch have taken a number of actions. Three that have brought significant changes are the Troubled Asset Relief Program, Federal Reserve assistance programs, and the Dodd-Frank Wall Street and Consumer Protection Act.

Troubled Asset Relief Program (TARP). On October 3, 2008, Congress passed and President Bush signed into law the Emergency Economic Stabilization Act of 2008, P.L. 110-343. This law, which passed both Houses with bipartisan majorities, established the Troubled

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[99] Federal Housing Finance Agency, News Release, "FHFA Releases Projections Showing Range of Potential Draws for Fannie Mae and Freddie Mac," October 21, 2010, http://fhfa.gov/webfiles/19409/Projections_102110.pdf.

[100] The statistics cited in this paragraph are taken from the U.S. Department of Housing and Urban Development, "FHA Single-Family Mutual Mortgage Insurance Fund Programs, Quarterly Report to Congress, FY 2011 Q1," March 17, 2011, at 4 and 19, http://www.hud.gov/offices/hsg/rmra/oe/rpts/rtc/fhartc_q1_2011.pdf.

Asset Relief Program (TARP) and authorized the expenditure of up to $700 billion to stop financial institutions from collapsing and further damaging the U.S. economy. Administered by the Department of the Treasury, with support from the Federal Reserve, TARP funds have been used to inject capital into or purchase or insure assets at hundreds of large and small banks.

The largest recipients of TARP funds were AIG, Ally Financial (formerly GMAC Financial Services), Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, PNC Financial Services, U.S. Bancorp, and Wells Fargo, as well as Chrysler, and General Motors. Most have repaid all or a substantial portion of the TARP funds they received.

Although initially expected to cost U.S. taxpayers more than $350 billion, the Congressional Budget Office estimated in November 2010, that the final cost of the TARP program will be approximately $25 billion.[101]

Federal Reserve Emergency Support Programs. In addition, as the financial crisis began to unfold, the Federal Reserve aggressively expanded its balance sheet from about $900 billion at the beginning of 2008, to more than $2.4 trillion in December 2010, to provide support to the U.S. financial system and economy. Using more than a dozen programs, through more than 21,000 individual transactions, the Federal Reserve provided trillions of dollars in assistance to U.S. and foreign financial institutions in an effort to promote liquidity and prevent a financial collapse.[102] In some instances, the Federal Reserve created new programs, such as its Agency Mortgage Backed Securities Purchase Program which purchased more than $1.25 trillion in mortgage backed securities backed by Fannie Mae, Freddie Mac, and Ginnie Mae.[103] In other instances, it modified and significantly expanded existing programs, such as by lowering the quality of collateral it accepted and increasing lending by the discount window.

Dodd-Frank Act. On July 21, 2010, Congress passed and President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203. This law, which passed both Houses with bipartisan majorities, expanded the authority of regulatory agencies to try to prevent future financial crises. Among other provisions, the law:

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[101] 11/2010 "Report on the Troubled Asset Relief Program," prepared by the Congressional Budget Office, http://www.cbo.gov/ftpdocs/119xx/doc11980/11-29-TARP.pdf.

[102] "Usage of Federal Reserve Credit and Liquidity Facilities," Federal Reserve Board, available at http://www.federalreserve.gov/newsevents/reform_transaction.htm.

[103] "Agency Mortgage-Backed Securities Purchase Program," Federal Reserve Board, available at http://www.federalreserve.gov/newsevents/reform_mbs.htm.

–established a Financial Stability Oversight Council, made up of federal financial regulators and others, to identify and respond to emerging financial risks;

–established a Consumer Financial Protection Bureau to strengthen protection of American consumers from abusive financial products and practices;

– restricted proprietary trading and investments in hedge funds by banks and other large financial institutions;

– prohibited sponsors of asset backed securities from engaging in transactions that would involve or result in a material conflict of interest with investors in those securities;

– established procedures to require nonbank firms whose failure would threaten U.S. financial stability to divest some holdings or undergo an orderly liquidation;

– strengthened regulation of credit rating agencies;

– strengthened mortgage regulation, including by clamping down on high cost mortgages, requiring securitizers to retain limited liability for securities reliant on high risk mortgages, banning stated income loans, and restricting negative amortization loans;

– required better federal regulation of mortgage brokers;

– directed regulators to require greater capital and liquidity reserves;

– required regulation of derivatives and derivative dealers;

– required registration of certain hedge funds and private equity funds;

– authorized regulators to impose standards of conduct that are the same as those applicable to investment advisers on broker-dealers who provide personalized investment advice to retail customers; and

– abolished the Office of Thrift Supervision.

H. Financial Crisis Timeline

This Report reviews events from the period 2004 to 2008, in an effort to identify and explain four significant causes of the financial crisis. A variety of events could be identified as the start of the crisis. Candidates include the record number of home loan defaults that began in December 2006; the FDIC's March 2007 cease and desist order against Fremont Investment & Loan which exposed the existence of unsafe and unsound subprime lending practices; or the collapse of the Bear Stearns hedge funds in June 2007. Still another candidate is the two-week period in September 2008, when half a dozen major U.S. financial institutions failed, were forcibly sold, or were bailed out by U.S. taxpayers seeking to prevent a collapse of the U.S. economy.

This Report concludes, however, that the most immediate trigger to the financial crisis was the July 2007 decision by Moody's and S&P to downgrade hundreds of RMBS and CDO securities. The firms took this action because, in the words of one S&P senior analyst, the investment grade ratings could not "hold." By acknowledging that RMBS and CDO securities containing high risk, poor quality mortgages were not safe investments and were going to incur losses, the credit rating agencies admitted the emperor had no clothes. Investors stopped buying, the value of the RMBS and CDO securities fell, and financial institutions around the world were suddenly left with unmarketable securities whose value was plummeting. The financial crisis was on.

Because of the complex nature of the financial crisis, this chapter concludes with a brief timeline of some key events from 2006 through 2008. The succeeding chapters provide more detailed examinations of the roles of high risk lending, federal regulators, credit ratings agencies, and investment banks in causing the financial crisis.

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Financial Crisis Timeline[104]

December 2006:
Ownit Mortgage Solutions bankruptcy

February 27, 2007:
Freddie Mac announces it will no longer buy the most risky subprime mortgages

March 7, 2007:
FDIC issues cease and desist order against Fremont for unsafe and unsound banking

April 2, 2007:
New Century bankruptcy

June 17, 2007:
Two Bear Stearns subprime hedge funds collapse

July 10 and 12, 2007:
Credit rating agencies issue first mass ratings downgrades of hundreds of RMBS and CDO securities

August 6, 2007:
American Home Mortgage bankruptcy

August 17, 2007:
Federal Reserve: "[M]arket conditions have deteriorated ... downside risks to growth have increased appreciably."

August 31, 2007:
Ameriquest Mortgage ceases operations

December 12, 2007:
Federal Reserve establishes Term Auction Facility to provide bank funding collateral

January 2008:
ABX Index stops issuing new subprime indices

January 11, 2008:
Countrywide announces sale to Bank of America

January 30, 2008:
S&P downgrades or places on credit watch over 8,000 RMBS and CDO securities

March 24, 2008:
Federal Reserve Bank of New York forms Maiden Lane I to help JPMorgan Chase acquire Bear Stearns

May 29, 2008:
Bear Stearns shareholders approve sale

July 11, 2008:
IndyMac Bank fails and is seized by FDIC

July 15, 2008:
SEC restricts naked short selling of some financial stocks

September 7, 2008:
U.S. takes control of Fannie Mae and Freddie Mac

September 15, 2008:
Lehman Brothers bankruptcy

September 15, 2008
Merrill Lynch announces its sale to Bank of America

September 16, 2008:
Federal Reserve offers $85 billion credit line to AIG; Reserve Primary Money Fund NAV falls below $1

September 21, 2008:
Goldman Sachs and Morgan Stanley convert to bank holding companies

September 25, 2008:
WaMu fails, is seized by FDIC, and is sold to JPMorgan Chase

October 3, 2008:
Congress and President Bush establish TARP

October 12, 2008:
Wachovia is sold to Wells Fargo

October 28, 2008:
U.S. uses TARP to buy $125 billion in preferred stock at nine banks

November 25, 2008:
Federal Reserve buys Fannie and Freddie assets

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[104] Many of these events are based upon a timeline prepared by the Federal Reserve Bank of St. Louis, "The Financial Crisis: A Timeline of Events and Policy Actions," http://timeline.stlouisfed.org/index.cfm?p=timeline.

III. HIGH RISK LENDING: CASE STUDY OF WASHINGTON MUTUAL BANK

Washington Mutual Bank, known also as WaMu, rose out the ashes of the great Seattle fire to make its first home loan in 1890. By 2004, WaMu had become one of the nation's largest financial institutions and a leading mortgage lender. Its demise just four years later provides a case history that traces not only the rise of high risk lending in the mortgage field, but also how those high risk mortgages led to the failure of a leading bank and contributed to the financial crisis of 2008.

For many years, WaMu was a mid-sized thrift, specializing in home mortgages. In the 1990s, WaMu initiated a period of growth and acquisition, expanding until it became the nation's largest thrift and sixth largest bank, with $300 billion in assets, $188 billion in deposits, 2,300 branches in 15 states, and over 43,000 employees. In 2003, its longtime CEO, Kerry Killinger, said he wanted to do for the lending industry what Wal-Mart and others did for their industries, by catering to middle and lower income Americans and helping the less well off buy homes.[105] Soon after, WaMu embarked on a strategy of high risk lending. By 2006, its high risk loans began incurring record rates of delinquency and default, and its securitizations saw ratings downgrades and losses. In 2007, the bank itself began incurring losses. Its shareholders lost confidence, and depositors began withdrawing funds, eventually causing a liquidity crisis. On September 25, 2008, 119 years to the day of its founding, WaMu was seized by its regulator, the Office of Thrift Supervision (OTS), and sold to JPMorgan Chase for $1.9 billion. Had the sale not gone through, WaMu's failure might have exhausted the $45 billion Deposit Insurance Fund. Washington Mutual is the largest bank failure in U.S. history.

This case study examines how one bank's strategy for growth and profit led to the origination and securitization of hundreds of billions of dollars in poor quality mortgages that undermined the U.S. financial system. WaMu had held itself out as a prudent lender, but in reality, the bank turned increasingly to higher risk loans. Its fixed rate mortgage originations fell from 64% of its loan originations in 2003, to 25% in 2006, while subprime, Option ARM, and home equity originations jumped from 19% of the originations to 55%. Using primarily loans

[105] "Saying Yes, WaMu Built Empire on Shaky Loans," New York Times (12/27/2008) http://www.nytimes.com/2008/12/28/business/28wamu.html?_r=1 (quoting Mr. Killinger: "We hope to do to this industry what Wal-Mart did to theirs, Starbucks did to theirs, Costco did to theirs and Lowe's-Home Depot did to their industry. And I think if we've done our job, five years from now you're not going to call us a bank.").

from its subprime lender, Long Beach Mortgage Corporation, WaMu's subprime securitizations grew sixfold, increasing from about $4.5 billion in 2003, to $29 billion in securitizations in 2006. From 2000 to 2007, WaMu and Long Beach together securitized at least $77 billion in subprime loans. WaMu also increased its origination of Option ARMs, its flagship product, which from 2003 to 2007, represented as much as half of all of WaMu's loan originations. In 2006 alone, Washington Mutual originated more than $42.6 billion in Option ARM loans and sold or securitized at least $115 billion, including sales to the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). In addition, WaMu dramatically increased its origination and securitization of home equity loan products. By 2007, home equity loans made up $63.5 billion or 27% of its home loan portfolio, a 130% increase from 2003.

At the same time that WaMu was implementing its High Risk Lending Strategy, WaMu and Long Beach engaged in a host of shoddy lending practices that contributed to a mortgage time bomb. Those practices included qualifying high risk borrowers for larger loans than they could afford; steering borrowers to higher risk loans; accepting loan applications without verifying the borrower's income; using loans with teaser rates that could lead to payment shock when higher interest rates took effect later on; promoting negatively amortizing loans in which many borrowers increased rather than paid down their debt; and authorizing loans with multiple layers of risk. In addition, WaMu and Long Beach failed to enforce compliance with their lending standards; allowed excessive loan error and exception rates; exercised weak oversight over the third party mortgage brokers who supplied half or more of their loans; and tolerated the issuance of loans with fraudulent or erroneous borrower information. They also designed compensation incentives that rewarded loan personnel for issuing a large volume of higher risk loans, valuing speed and volume over loan quality.

WaMu's combination of high risk loans, shoddy lending practices, and weak oversight produced hundreds of billions of dollars of poor quality loans that incurred early payment defaults, high rates of delinquency, and fraud. Long Beach mortgages experienced some of the highest rates of foreclosure in the industry and their securitizations were among the worst performing. Senior WaMu executives described Long Beach as "terrible" and "a mess," with default rates that were "ugly." WaMu's high risk lending operation was also problem-plagued. WaMu management knew of evidence of deficient lending practices, as seen in internal emails, audit reports, and reviews. Internal reviews of WaMu's loan centers, for example, described "extensive fraud" from employees "willfully" circumventing bank policy. An internal review found controls to stop fraudulent loans from being sold to investors were "ineffective." On at least one occasion, senior managers knowingly sold delinquency-prone loans to investors. Aside from Long Beach, WaMu's President Steve Rotella described WaMu's prime home loan business as the "worst managed business" he had seen in his career.

Documents obtained by the Subcommittee reveal that WaMu launched its High Risk Lending Strategy primarily because higher risk loans and mortgage backed securities could be sold for higher prices on Wall Street. They garnered higher prices, because higher risk meant they paid a higher coupon rate than other comparably rated securities, and investors paid a higher price to buy them. Selling or securitizing the loans also removed them from WaMu's books and appeared to insulate the bank from risk.

From 2004 to 2008, WaMu originated a huge number of poor quality mortgages, most of which were then resold to investment banks and other investors hungry for mortgage backed securities. For a period of time, demand for these securities was so great that WaMu formed its own securitization arm on Wall Street. Over a period of five years, WaMu and Long Beach churned out a steady stream of high risk, poor quality loans and mortgage backed securities that later defaulted at record rates. Once a prudent regional mortgage lender, Washington Mutual tried – and ultimately failed – to use the profits from poor quality loans as a stepping stone to becoming a major Wall Street player.

Washington Mutual was far from the only lender that sold poor quality mortgages and mortgage backed securities that undermined U.S. financial markets. The Subcommittee investigation indicates that Washington Mutual was emblematic of a host of financial institutions that knowingly originated, sold, and securitized billions of dollars in high risk, poor quality home loans. These lenders were not the victims of the financial crisis; the high risk loans they issued became the fuel that ignited the financial crisis.

A. Subcommittee Investigation and Findings of Fact

As part of its investigation into high risk lending and the Washington Mutual case study, the Subcommittee collected millions of pages of documents from Washington Mutual, JPMorgan Chase, OTS, the FDIC, eAppraiseIT, Lenders Service Inc., Moody's, Standard & Poor's, various investment banks, Fannie Mae, Freddie Mac, and others. The documents included email, correspondence, internal memoranda, reports, legal pleadings, financial analysis, prospectuses, and more. The Subcommittee also conducted more than 30 interviews with former

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WaMu employees and regulatory officials. The Subcommittee also spoke with personnel from the Offices of the Inspector General at the Department of Treasury and the FDIC, who were engaged in a joint review of WaMu's regulatory oversight and the events leading to its demise. In addition, the Subcommittee spoke with nearly a dozen experts on a variety of banking, accounting, regulatory, and legal issues. On April 13, 2010, the Subcommittee held a hearing which took testimony from former WaMu officials and released 86 exhibits.[106]

In connection with the hearing, the Subcommittee released a joint memorandum from Chairman Carl Levin and Ranking Member Tom Coburn summarizing the investigation to date into Washington Mutual and the role of high risk home loans in the financial crisis. The memorandum contained the following findings of fact, which this Report reaffirms.

1. **High Risk Lending Strategy.** Washington Mutual (WaMu) executives embarked upon a High Risk Lending Strategy and increased sales of high risk home loans to Wall Street, because they projected that high risk home loans, which generally charged higher rates of interest, would be more profitable for the bank than low risk home loans.

2. **Shoddy Lending Practices.** WaMu and its affiliate, Long Beach Mortgage Company (Long Beach), used shoddy lending practices riddled with credit, compliance, and operational deficiencies to make tens of thousands of high risk home loans that too often contained excessive risk, fraudulent information, or errors.

3. **Steering Borrowers to High Risk Loans.** WaMu and Long Beach too often steered borrowers into home loans they could not afford, allowing and encouraging them to make low initial payments that would be followed by much higher payments, and presumed that rising home prices would enable those borrowers to refinance their loans or sell their homes before the payments shot up.

4. **Polluting the Financial System.** WaMu and Long Beach securitized over $77 billion in subprime home loans and billions more in other high risk home loans, used Wall Street firms to sell the securities to investors worldwide, and polluted the

[106] "Wall Street and the Financial Crisis: The Role of High Risk Loans," before the U.S. Senate Permanent Subcommittee on Investigations, S.Hrg. 111-67 (April 13, 2010) (hereinafter "April 13, 2010 Subcommittee Hearing").

financial system with mortgage backed securities which later incurred high rates of delinquency and loss.

5. **Securitizing Delinquency-Prone and Fraudulent Loans.** At times, WaMu selected and securitized loans that it had identified as likely to go delinquent, without disclosing its analysis to investors who bought the securities, and also securitized loans tainted by fraudulent information, without notifying purchasers of the fraud that was discovered.

6. **Destructive Compensation.** WaMu's compensation system rewarded loan officers and loan processors for originating large volumes of high risk loans, paid extra to loan officers who overcharged borrowers or added stiff prepayment penalties, and gave executives millions of dollars even when their High Risk Lending Strategy placed the bank in financial jeopardy.

B. Background

Washington Mutual Bank was a federally chartered thrift whose primary federal regulator was the Office of Thrift Supervision (OTS). As an insured depository institution, it was also overseen by the Federal Deposit Insurance Corporation (FDIC). Washington Mutual was a full service consumer and business bank. This Report focuses only on WaMu's home lending and securitization business. As part of that business, WaMu originated home loans, acquired home loans for investment and securitization, sold pools of loans, and also securitized pools of home loans that it had originated or acquired. It was also a leading servicer of residential mortgages.

(1) Major Business Lines and Key Personnel

From 2004 to 2008, WaMu had four major business lines.[107] The Home Loans Group handled WaMu's home mortgage originations, securitizations, and servicing operations. The Commercial Group handled apartment buildings and other commercial properties. The Retail Banking Group provided retail banking services to consumers and businesses across the country. The Card Services Group handled a credit card business purchased from Providian Financial Corporation.

For most of the five-year period reviewed by the Subcommittee, WaMu was led by its longtime Chairman of the Board and Chief Executive Officer (CEO) Kerry Killinger who joined the bank in 1982,

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[107] 9/25/2008 "OTS Fact Sheet on Washington Mutual Bank," Dochow_Darrel-00076154_001.

became bank president in 1988, and was appointed CEO in 1990. Mr. Killinger was the moving force behind WaMu's acquisitions and growth strategy during the 1990s, and made the fateful decision to embark upon its High Risk Lending Strategy in 2005. Mr. Killinger stepped down as Chairman of the Board in June 2008, after shareholders opposed having the same person occupy the bank's two top positions. He was dismissed from the bank on September 8, 2008, the same day WaMu was required by its regulator, OTS, to sign a public Memorandum of Understanding to address its lending and securitization deficiencies. Two weeks later the bank failed.

Other key members of the bank's senior management included President Steve Rotella who joined the bank in January 2005; Chief Financial Officer Tom Casey; President of the Home Loans Division David Schneider who joined the bank in July 2005; and General Counsel Faye Chapman. David Beck served as Executive Vice President in charge of the bank's Capital Markets Division, oversaw its securitization efforts, and reported to the head of Home Loans. Anthony Meola headed up the Home Loans Sales effort. Jim Vanasek was WaMu's Chief Credit Officer from 1999 until 2004, and was then appointed its Chief Risk Officer, a new position, from 2004-2005. After Mr. Vanasek's retirement, Ronald Cathcart took his place as Chief Risk Officer, and headed the bank's newly organized Enterprise Risk Management Division, serving in that post from 2005 to 2007.

(2) Loan Origination Channels

WaMu was one of the largest mortgage originators in the United States.[108] It originated and acquired residential mortgages through several methods, which it referred to as loan origination channels. WaMu referred to them as its retail, wholesale, subprime, correspondent, and conduit channels.

Retail Channel. In WaMu's parlance, "retail channel" loans were loans originated by WaMu employees, typically loan officers or sales associates operating out of WaMu branded loan centers. The prospective borrower typically communicated directly with the WaMu loan officer, who was often called a "loan consultant." WaMu considered all retail channel loans to be "prime" loans, regardless of the characteristics of the loan or the creditworthiness of the borrower, and

[108] See, e.g., "Mortgage Lender Rankings by Residential Originations," charts prepared by MortgageDaily.com (indicating WaMu was one of the top three issuers of U.S. residential mortgages from 2003 to 2005); "Washington Mutual to Acquire PNC's Residential Mortgage Business," Business Wire (10/2/2000), http://findarticles.com/p/articles/mi_m0EIN/is_2000_Oct_2/ai_65635032.

sometimes referred to the retail channel as the "prime" channel. The retail channel originated significant numbers of Option ARM loans, which WaMu treated as prime loans, despite their inherent risks. According to the Inspectors General of the U.S. Treasury Department and the FDIC, who prepared a report on WaMu's failure (hereinafter "IG Report"), "Option ARMs represented as much as half of all loan originations from 2003 to 2007 and approximately $59 billion, or 47 percent, of the home loans on WaMu's balance sheet at the end of 2007."[109] The retail channel was also used to originate substantial numbers of home equity loans and home equity lines of credit.

Wholesale Channel. According to WaMu, its "wholesale channel" loans were loans that the bank acquired from third party mortgage brokers. These brokers, who were not WaMu employees, located borrowers interested in purchasing a home or refinancing an existing mortgage, and explained available loans that could be underwritten by WaMu. The borrower's primary, and sometimes sole, contact was with the mortgage broker. The mortgage broker would then provide the borrower's information to a WaMu loan officer who would determine whether the bank would finance the loan. If the bank decided to finance the loan, the broker would receive a commission for its efforts. Third party mortgage brokers typically received little guidance or training from WaMu, aside from receiving daily "rate sheets" explaining the terms of the loans that WaMu was willing to accept and the available commissions. WaMu treated wholesale loans issued under the WaMu brand as prime loans.

Subprime Channel. WaMu also originated wholesale loans through its subprime affiliate and later subsidiary, Long Beach Mortgage Company (Long Beach). Long Beach was a purely wholesale lender, and employed no loan officers that worked directly with borrowers. Instead, its account executives developed relationships with third party mortgage brokers who brought prospective loans to the company, and if Long Beach accepted those loans, received a commission for their efforts. WaMu typically referred to Long Beach as its "subprime channel." Later, in 2007, when the bank decided to eliminate Long Beach as a separate entity, it rebranded Long Beach as its "Wholesale Specialty Lending" channel.

At times, WaMu also acquired subprime loans through "correspondent" or "conduit" channels, which it used to purchase closed loans – loans that had already been financed – from other lenders for

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[109] 4/2010 "Evaluation of Federal Regulatory Oversight of Washington Mutual Bank," report prepared by the Offices of Inspector General at the Department of the Treasury and Federal Deposit Insurance Corporation, Hearing Exhibit 4/16-82 (hereinafter "IG Report").

investment or securitization. For example, WaMu at times operated a correspondent channel that it referred to as "Specialty Mortgage Finance" and used to purchase subprime loans from other lenders, especially Ameriquest, for inclusion in its investment portfolio. In addition, in 2005, its New York securitization arm, Washington Mutual Capital Corporation, established a "subprime conduit" to purchase closed subprime loans in bulk from other lenders for use in securitizations. At the end of 2006, WaMu reported that its investment portfolio included $4 billion in subprime loans from Long Beach and about $16 billion in subprime loans from other parties.[110]

Other Channels. At times, WaMu also originated or acquired loans in other ways. Its "Consumer Direct" channel, for example, originated loans over the phone or internet; borrowers did not need to meet in person with a WaMu loan officer. In addition, in 2004, Washington Mutual Capital Corporation (WCC) set up a conduit to purchase closed Alt A loans in bulk from other lenders and use them in securitizations. WCC shut down both the Alt A and subprime conduits in April 2008, after it became too difficult to find buyers for new securitizations.[111]

The Treasury and the FDIC IG report examining the failure of WaMu found that, from 2003 to 2007, the bulk of its residential loans – from 48% to 70% – came from third party lenders and brokers.[112] That report also determined that, in 2007, WaMu had 14 full-time employees overseeing 34,000 third party brokers doing business with the bank nationwide, and criticized the Bank's oversight and staffing effort.[113]

(3) Long Beach

WaMu had traditionally originated mortgages to well qualified prime borrowers. But in 1999, WaMu bought Long Beach Mortgage Company,[114] which was exclusively a subprime lender to borrowers whose credit histories did not support their getting a traditional mortgage.[115] Long Beach was located in Anaheim, California, had a

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[110] See 3/1/2007 Washington Mutual Inc. 10-K filing with the SEC, at 56.
[111] See 6/11/2007 chart entitled, "Capital Markets Division Growth," JPM_WM03409858, Hearing Exhibit 4/13-47c.
[112] See prepared statement of Treasury IG Eric Thorson, "Wall Street and the Financial Crisis: Role of the Regulators," before the U.S. Senate Permanent Subcommittee on Investigations, S.Hrg. 111-672 (April 16, 2010) (hereinafter "April 16, 2010 Subcommittee Hearing"), at 5.
[113] See 4/2010 IG Report, at 11, Hearing Exhibit 4/16-82.
[114] Washington Mutual Inc. actually purchased Long Beach Financial Corporation, the parent of Long Beach Mortgage Corporation, for about $350 million.
[115] 12/21/2005 OTS internal memorandum from OTS examiners to Darrel Dochow, OTSWMS06-007 0001009, Hearing Exhibit 4/16-31 ("LBMC was acquired … as a vehicle for

network of loan centers across the country, and at its height had as many as 1,000 employees.

Long Beach made loans for the express purpose of securitizing them and profiting from the gain on sale; it did not hold loans for its own investment. It had no loan officers of its own, but relied entirely on third party mortgage brokers bringing proposed subprime loans to its doors. In 2000, the year after it was purchased by WaMu, Long Beach made and securitized approximately $2.5 billion in home loans. By 2006, its loan operations had increased more than tenfold, and Long Beach securitized nearly $30 billion in subprime home loans and sold the securities to investors.[116]

Long Beach's most common subprime loans were short term, hybrid adjustable rate mortgages, known as "2/28," "3/27," or "5/25" loans. These 30-year mortgages typically had a low fixed "teaser" rate, which then reset to a higher floating rate after two years for the 2/28, three years for the 3/27, or five years for the 5/25.[117] Long Beach typically qualified borrowers according to whether they could afford to pay the initial, low interest rate rather than the later, higher interest rate.[118] For "interest-only" loans, monthly loan payments were calculated to cover only the interest due on the loan and not any principal. After the fixed interest rate period expired, the monthly payment was typically recalculated to pay off the entire remaining loan within the remaining loan period at the higher floating rate. Unless borrowers could refinance, the suddenly increased monthly payments caused some borrowers to experience "payment shock" and default on their loans.

From 1999 to 2006, Long Beach operated as a subsidiary of Washington Mutual Inc., the parent of Washington Mutual Bank. Long Beach's loans repeatedly experienced early payment defaults, high delinquency rates, and losses, and its securitizations were among the worst performing in the market.[119] In 2006, in a bid to strengthen Long Beach's performance, WaMu received permission from its regulator, OTS, to purchase the company from its parent and make it a wholly owned subsidiary of the bank. WaMu installed new management,

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WMI to access the subprime loan market. LBMC's core business is the origination of subprime mortgage loans through a nationwide network of mortgage brokers.").

[116] "Securitizations of Washington Mutual Subprime Home Loans," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1c.

[117] For more information about these types of loans, see Chapter II.

[118] See April 13, 2010 Subcommittee Hearing at 50.

[119] See 4/14/2005 email exchange between OTS examiners, "Fitch – LBMC Review," Hearing Exhibit 4/13-8a (discussing findings by Fitch, a credit rating agency, highlighting poor performance of Long Beach securities).

required the head of Long Beach to report to its Home Loans Division President, and promised OTS that it would improve Long Beach. When Long Beach's loans continued to perform poorly, in June 2007, WaMu shut down Long Beach as a separate entity, and took over its subprime lending operations, rebranding Long Beach as its "Wholesale Specialty Lending" channel. WaMu continued to issue and securitize subprime loans. After the subprime market essentially shut down a few months later in September 2007, WaMu ended all of its subprime lending.

From 2000 to 2007, Long Beach and WaMu together securitized tens of billions of dollars in subprime loans, creating mortgage backed securities that frequently received AAA or other investment grade credit ratings.[120] Although AAA securities are supposed to be very safe investments with low default rates of one to two percent, of the 75 Long Beach mortgage backed security tranches rated AAA by Standard and Poor's in 2006, all 75 have been downgraded to junk status, defaulted, or been withdrawn.[121] In most of the 2006 Long Beach securitizations, the underlying loans have delinquency rates of 50% or more.[122]

(4) Securitization

Washington Mutual depended on the securitization process to generate profit, manage risk, and obtain capital to originate new loans. Washington Mutual and Long Beach sold or securitized most of the subprime home loans they acquired. Initially, Washington Mutual kept most of its Option ARMs in its proprietary investment portfolio, but eventually began selling or securitizing those loans as well. From 2000 to 2007, Washington Mutual and Long Beach securitized at least $77 billion in subprime home loans. Washington Mutual sold or securitized at least $115 billion of Option ARM loans, as well as billions more of other types of high risk loans, including hybrid adjustable rate mortgages, Alt A, and home equity loans.

When Washington Mutual began securitizing its loans, it was dependent upon investment banks to help underwrite and sell its securitizations. In order to have greater control of the securitization process and to keep securitization underwriting fees in house, rather than paying them to investment banks, WaMu acquired a company able to

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[120] "Securitizations of Washington Mutual Subprime Home Loans," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1c.
[121] See Standard and Poor's data at www.globalcreditportal.com.
[122] See, e.g., wamusecurities.com (subscription website maintained by JPMorgan Chase with data on Long Beach and WaMu mortgage backed securities showing, as of March 2011, delinquency rates for particular mortgage backed securities, including LBMLT 2006-1 – 58.44%; LBMLT 2006-6 – 60.06%; and LBMLT 2005-11 – 54.32%).

handle securitizations and renamed it Washington Mutual Capital Corporation (WCC), which became a wholly owned subsidiary of the bank.[123] WCC was a registered broker-dealer and began to act as an underwriter of WaMu and Long Beach securitizations.[124] WCC worked with two other bank subsidiaries, Washington Mutual Mortgage Securities Corp. and Washington Mutual Asset Acceptance Corp., that provided warehousing for WaMu loans before they were securitized. WCC helped to assemble RMBS pools and sell the resulting RMBS securities to investors. At first it worked with other investment banks; later it became the sole underwriter of some WaMu securitizations.

WCC was initially based in Seattle with 30 to 40 employees.[125] In 2004, it moved its headquarters to Manhattan.[126] At the height of WCC operations, right before the collapse of the securitization market, WCC had over 200 employees and offices in Seattle, New York, Los Angeles, and Chicago, with the majority of its personnel in New York.[127] WCC closed its doors in December 2007, after the securitization markets collapsed.

(5) Overview of WaMu's Rise and Fall

Washington Mutual Bank (WaMu) was a wholly owned subsidiary of its parent holding company, Washington Mutual Inc.[128] From 1996 to 2002, WaMu acquired over a dozen other financial institutions, including American Savings Bank, Great Western Bank, Fleet Mortgage Corporation, Dime Bancorp, PNC Mortgage, and Long Beach, expanding to become the nation's largest thrift and sixth largest bank. WaMu also became one of the largest issuers of home loans in the country. Washington Mutual kept a portion of those loans for its own investment portfolio, and sold the rest either to Wall Street investors, usually after securitizing them, or to Fannie Mae or Freddie Mac. From 2000 to 2008, Washington Mutual sold over $500 billion in loans to Fannie Mae and Freddie Mac, representing more than a quarter of its loan production during those years.

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[123] See 6/11/2007 chart entitled, "Capital Markets Division Growth," JPM_WM03409858, Hearing Exhibit 4/13-47c.
[124] Prepared statement of David Beck, April 13, 2010 Subcommittee Hearing at 2.
[125] Subcommittee interview of David Beck (3/2/2010).
[126] Id.
[127] Id.
[128] 9/25/2008 "OTS Fact Sheet on Washington Mutual Bank," Dochow_Darrel-00076154_001, at 002. Washington Mutual Inc. also owned a second, much smaller thrift, Washington Mutual Bank, FSB. Id.

In 2006, WaMu took several major actions that reduced the size of its Home Loans Group. It sold $140 billion in mortgage servicing rights to Wells Fargo; sold a $22 billion portfolio of home loans and other securities; and reduced its workforce significantly.[129]

In July 2007, after the Bear Stearns hedge funds collapsed and the credit rating agencies downgraded the ratings of hundreds of mortgaged backed securities, including over 40 Long Beach securities, the secondary market for subprime loans dried up. In September 2007, due to the difficulty of finding investors willing to purchase subprime loans or mortgage backed securities, Washington Mutual discontinued its subprime lending. It also became increasingly difficult for Washington Mutual to sell other types of high risk loans and related mortgage backed securities, including its Option ARMs and home equity products. Instead, WaMu retained these loans in its portfolios. By the end of the year, as the value of its loans and mortgage backed securities continued to drop, Washington Mutual began to incur significant losses, reporting a $1 billion loss in the fourth quarter of 2007, and another $1 billion loss in the first quarter of 2008.

In February 2008, based upon increasing deterioration in the bank's asset quality, earnings, and liquidity, OTS and the FDIC lowered the bank's safety and soundness rating to a 3 on a scale of 1 to 5, signaling it was a troubled institution.[130] In March 2008, at the request of OTS and the FDIC, Washington Mutual allowed several potential buyers of the bank to review its financial information.[131] JPMorgan Chase followed with a purchase offer that WaMu declined.[132] Instead, in April 2008, Washington Mutual's parent holding company raised $7 billion in new capital and provided $3 billion of those funds to the bank.[133] By June, the bank had shut down its wholesale lending channel.[134] It also closed over 180 loan centers and terminated 3,000

[129] Subcommittee interview of Steve Rotella (2/24/2010). See also 3/1/2007 Washington Mutual Inc. 10-K filing with the SEC, at 1 (Washington Mutual reduced its workforce from 60,789 to 49,824 from December 31, 2005 to December 31, 2006.); "Washington Mutual to cut 2,500 jobs," MarketWatch (2/15/2006), available at http://www.marketwatch.com/story/washington-mutual-cutting-2500-mortgage-jobs.

[130] See 2/27/2008 letter from Kerry Killinger to Washington Mutual Board of Directors, Hearing Exhibit 4/16-41.

[131] Subcommittee interviews of WaMu Chief Financial Officer Tom Casey (2/20/2010); and OTS West Region Office Director Darrel Dochow (3/3/2010); 4/2010 "Washington Mutual Regulators Timeline," prepared by the Subcommittee, Hearing Exhibit 4/16-1j.

[132] Subcommittee interview of Tom Casey (2/20/2010).

[133] 4/2010 "Washington Mutual Regulators Timeline," prepared by the Subcommittee, Hearing Exhibit 4/16-1j.

[134] See 2/27/2008 letter from Kerry Killinger to Washington Mutual Board of Directors, Hearing Exhibit 4/16-41.

employees.[135] In addition, WaMu reduced its dividend to shareholders.[136]

In July 2008, a $30 billion subprime mortgage lender, IndyMac, failed and was placed into receivership by the government. In response, depositors became concerned about Washington Mutual and withdrew over $10 billion in deposits, putting pressure on the bank's liquidity. After the bank disclosed a $3.2 billion loss for the second quarter, its stock price continued to drop, and more deposits left.

On September 8, 2008, Washington Mutual signed a public Memorandum of Understanding that it had negotiated with OTS and the FDIC to address the problems affecting the bank. Longtime CEO Kerry Killinger was forced to leave the bank, accepting a $15 million severance payment.[137] Allen Fishman was appointed his replacement.

On September 15, 2008, Lehman Brothers declared bankruptcy. Three days later, on September 18, OTS and the FDIC lowered Washington Mutual's rating to a "4," indicating that a bank failure was a possibility. The credit rating agencies also downgraded the credit ratings of the bank and its parent holding company. Over the span of eight days starting on September 15, nearly $17 billion in deposits left the bank. At that time, the Deposit Insurance Fund contained about $45 billion, an amount which could have been exhausted by the failure of a $300 billion institution like Washington Mutual. As the financial crisis worsened each day, regulatory concerns about the bank's liquidity and viability intensified.

Because of its liquidity problems and poor quality assets, OTS and the FDIC decided to close the bank. Unable to wait for a Friday, the day on which most banks are closed, the agencies acted on a Thursday, September 25, 2008, which was also the 119th anniversary of WaMu's founding. That day, OTS seized Washington Mutual Bank, placed it into receivership, and appointed the FDIC as the receiver. The FDIC facilitated its immediate sale to JPMorgan Chase for $1.9 billion. The sale eliminated the need to draw upon the Deposit Insurance Fund. WaMu's parent, Washington Mutual, Inc., declared bankruptcy soon after.

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[135] "Washington Mutual to Take Writedown, Slash Dividend," Bloomberg (12/10/2007), available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aNUz6NmbYZCQ.
[136] Id.
[137] "Washington Mutual CEO Kerry Killinger: $100 Million in Compensation, 2003-2008," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1h.

C. High Risk Lending Strategy

In 2004, Washington Mutual ramped up high risk home loan originations to borrowers that had not traditionally qualified for them. The following year, Washington Mutual adopted a high risk strategy to issue high risk mortgages, and then mitigate some of that risk by selling or securitizing many of the loans. When housing prices stopped climbing in late 2006, a large number of those risky loans began incurring extraordinary rates of delinquency as did the securities that relied on those loans for cash flow. In 2007, the problems with WaMu's High Risk Lending Strategy worsened, as delinquencies increased, the securitization market dried up, and the bank was unable to find buyers for its high risk loans or related securities.

The formal initiation of WaMu's High Risk Lending Strategy can be dated to January 2005, when a specific proposal was presented to the WaMu Board of Directors for approval.[138] WaMu adopted this strategy because its executives calculated that high risk home loans were more profitable than low risk loans, not only because the bank could charge borrowers higher interest rates and fees, but also because higher risk loans received higher prices when securitized and sold to investors. They garnered higher prices because, due to their higher risk, the securities paid a higher coupon rate than other comparably rated securities.

Over a five-year period from 2003 to 2008, Washington Mutual Bank shifted its loan originations from primarily traditional 30-year fixed and government backed loans to primarily higher risk home loans. This shift included increased subprime loan activity at Long Beach, more subprime loans purchased through its Specialty Mortgage Finance correspondent channel, and more bulk purchases of subprime loans through its conduit channel for use in securitizations. WaMu also increased its originations and acquisitions of Option ARM, Alt A, and home equity loans. While the shift began earlier, the strategic decision to move toward higher risk loans was not fully articulated to regulators or the Board of Directors until the end of 2004 and the beginning of 2005.[139]

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[138] See 1/2005 "Higher Risk Lending Strategy 'Asset Allocation Initiative,'" submitted to Washington Mutual Board of Directors Finance Committee Discussion, JPM_WM00302975-93, Hearing Exhibit 4/13-2a.

[139] See, e.g., 12/21/2004 "Asset Allocation Initiative: Higher Risk Lending Strategy and Increased Credit Risk Management," Washington Mutual Board of Directors Discussion, JPM_WM04107995-8008, Hearing Exhibit 4/13-2b; 1/2005 "Higher Risk Lending Strategy 'Asset Allocation Initiative,'" submitted to Washington Mutual Board of Directors Finance Committee Discussion, JPM_WM00302975-93, Hearing Exhibit 4/13-2a.

In about three years, from 2005 to 2007, WaMu issued hundreds of billions of higher risk loans, including $49 billion in subprime loans[140] and $59 billion in Option ARMs.[141] Data compiled by the Treasury and the FDIC Inspectors General showed that, by the end of 2007, Option ARMs constituted about 47% of all home loans on WaMu's balance sheet and home equity loans made up $63.5 billion or 27% of its home loan portfolio, a 130% increase from 2003.[142] According to an August 2006 internal WaMu presentation on Option ARM credit risk, from 1999 until 2006, Option ARM borrowers selected the minimum monthly payment more than 95% of the time.[143] The data also showed that at the end of 2007, 84% of the total value of the Option ARMs was negatively amortizing, meaning that the borrowers were going into deeper debt rather than paying off their loan balances.[144] In addition, by the end of 2007, stated income loans – loans in which the bank had not verified the borrower's income – represented 73% of WaMu's Option ARMs, 50% of its subprime loans, and 90% of its home equity loans.[145] WaMu also originated numerous loans with high loan-to-value (LTV) ratios, in which the loan amount exceeded 80% of the value of the underlying property. The Treasury and the FDIC Inspectors General determined, for example, that 44% of WaMu's subprime loans and 35% of its home equity loans had LTV ratios in excess of 80%.[146] Still another problem was that WaMu had high geographic concentrations of its home loans in California and Florida, states that ended up suffering above-average home value depreciation.[147]

(1) Strategic Direction

In 2004, WaMu set the stage for its High Risk Lending Strategy by formally adopting aggressive financial targets for the upcoming five-year time period. The new earnings targets created pressure for the bank to shift from its more conservative practices toward practices that carried more risk. Mr. Killinger described those targets in a June 2004 "Strategic Direction" memorandum to WaMu's Board of Directors: "Our primary financial targets for the next five years will be to achieve an average ROE [Return on Equity] of at least 18%, and average EPS

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[140] "Securitizations of Washington Mutual Subprime Home Loans," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1c.
[141] 4/2010 IG Report, at 9, Hearing Exhibit 4/16-82.
[142] Id. at 9-10.
[143] See 8/2006 Washington Mutual internal report, "Option ARM Credit Risk," chart entitled, "Borrower-Selected Payment Behavior," at 7, Hearing Exhibit 4/13-37. The WaMu report also stated: "Almost all Option ARM borrowers select the minimum payment every month with very high persistency, regardless of changes in the interest rates or payment adjustments." Id. at 2.
[144] 4/2010 IG Report, at 9, Hearing Exhibit 4/16-82.
[145] Id. at 10.
[146] Id.
[147] Id. at 11.

[Earnings Per Share] growth of at least 13%."[148] In his memorandum to the Board, Mr. Killinger predicted continuing growth opportunities for the bank:

> "In a consolidating industry, it is appropriate to continually assess if shareholder value creation is best achieved by selling for a short-term change of control premium or to continue to build long-term value as an independent company. We believe remaining an independent company is appropriate at this time because of substantial growth opportunities we see ahead. We are especially encouraged with growth prospects for our consumer banking group. We would also note that our stock is currently trading at a price which we believe is substantially below the intrinsic value of our unique franchise. This makes it even more important to stay focused on building long-term shareholder value, diligently protecting our shareholders from inadequate unsolicited takeover proposals and maintaining our long held position of remaining an independent company."[149]

Mr. Killinger identified residential nonprime and adjustable rate mortgage loans as one of the primary bank businesses driving balance sheet growth.[150] Mr. Killinger also stated in the memorandum: "Wholesale and correspondent will be nationwide and retooled to deliver higher margin products."[151]

(2) Approval of Strategy

After 2002, Washington Mutual stopped acquiring lenders specializing in residential mortgages,[152] and embarked upon a new strategy to push the company's growth, focused on increasing its issuance and purchase of higher risk home loans. OTS took note of this strategy in WaMu's 2004 Report on Examination:

> "Management provided us with a copy of the framework for WMI's 5-year (2005-2009) strategic plan [which] contemplates asset growth of at least 10% a year, with assets increasing to near $500 billion by 2009."[153]

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[148] 6/1/2004 Washington Mutual memorandum from Kerry Killinger to the Board of Directors, "Strategic Direction," JPM_WM05385579 at 581.
[149] Id. at 582.
[150] Id.
[151] Id. at 585.
[152] The only new lender that Washington Mutual acquired after 2004 was Commercial Capital Bancorp in 2006.
[153] See 3/15/2004 OTS Report of Examination, at OTSWMS04-0000001509, Hearing Exhibit 4/16-94 [Sealed Exhibit].

OTS directed the bank to spell out its new lending strategy in a written document that had to be presented to and gain approval by the WaMu Board of Directors.[154]

In response, in January 2005, WaMu management developed a document entitled, "Higher Risk Lending Strategy" and presented it to its Board of Directors for approval to shift the bank's focus from originating low risk fixed rate and government backed loans to higher risk subprime, home equity, and Option ARM loans.[155] The Strategy disclosed that WaMu planned to increase both its issuance of higher risk loans and its offering of loans to higher risk borrowers. The explicit reasoning for the shift was the increased profitability of the higher risk loans, measured by actual bank data showing that those loans produced a higher "gain on sale" or profit for the bank compared to lower risk loans. For example, one chart supporting the Strategy showed that selling subprime loans garnered more than eight times the gain on sale as government backed loans.[156]

The WaMu submission to the Board noted that, in order for the plan to be successful, WaMu would need to carefully manage its residential mortgage business as well as its credit risk, meaning the risk that borrowers would not repay the higher risk loans.[157] During the Board's discussion of the strategy, credit officers noted that losses would likely lag by several years.[158] These documents show that WaMu knew that, even if loan losses did not immediately come to pass after initiating

[154] 6/30/2004 OTS Memo to Lawrence Carter from Zalka Ancely, OTSWME04-0000005357 at 61 ("Joint Memo #9 - Subprime Lending Strategy"); 3/15/2004 OTS Report of Examination, at OTSWMS04-0000001483, Hearing Exhibit 4/16-94 [Sealed Exhibit]. See also 1/2005 "Higher Risk Lending Strategy Presentation," submitted to Washington Mutual Board of Directors, at JPM_WM00302978, Hearing Exhibit 4/13-2a ("As we implement our Strategic Plan, we need to address OTS/FDIC 2004 Safety and Soundness Exam Joint Memos 8 & 9 . . . Joint Memo 9: Develop and present a SubPrime/Higher Risk Lending Strategy to the Board.").

[155] 1/2005 "Higher Risk Lending Strategy Presentation," submitted to Washington Mutual Board of Directors, at JPM_WM00302978, Hearing Exhibit 4/13-2a; see also 4/2010 "WaMu Product Originations and Purchases by Percentage – 2003-2007," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1i.

[156] 4/18/2006 Washington Mutual Home Loans Discussion Board of Directors Meeting, at JPM_WM00690894, Hearing Exhibit 4/13-3 (see chart showing gain on sale for government loans was 13 basis points; for 30-year, fixed rate loans was 19; for option loans was 109; for home equity loans was 113; and for subprime loans was 150.).

[157] See 4/18/2006 Washington Mutual Home Loans Discussion Board of Directors Meeting, at JPM_WM00690899, Hearing Exhibit 4/13-3 (acknowledging that the risks of the High Risk Lending Strategy included managing credit risk, implementing lending technology and enacting organizational changes).

[158] 1/18/2005 Washington Mutual Inc. Washington Mutual Bank FA Finance Committee Minutes, JPM_WM06293964; see also 1/2005 "Higher Risk Lending Strategy Presentation," submitted to Washington Mutual Board of Directors, at JPM_WM00302987, Hearing Exhibit 4/13-2a ("Lags in Effects of Expansion," chart showing peak loss rates in 2007).

the High Risk Lending Strategy, it did not mean the strategy was free of problems.

(3) Definition of High Risk Lending

As part of the 2005 presentation to the Board of Directors outlining the strategy, OTS recommended that WaMu define higher risk lending.[159] The January 2005 presentation contained a slide defining "Higher Risk Lending":

> "For the purpose of establishing concentration limits, Higher Risk Lending strategies will be implemented in a 'phased' approach. Later in 2005 an expanded definition of Higher Risk Lending – encapsulating multiple risk layering and expanded underwriting criteria – and its corresponding concentration limit – will be presented for Board approval.
>
> "The initial definition is '<u>Consumer Loans to Higher Risk Borrowers</u>', which at 11/30/04 totaled $32 Billion or 151% of total risk-based capital, comprised of:
>
> > -Subprime loans, or all loans originated by Long Beach Mortgage or purchased through our Specialty Mortgage Finance program
> >
> > -SFR [Single Family Residential] and Consumer Loans to Borrowers with low credit scores at origination."[160]

A footnote on the slide defined "low credit scores" as less than a 620 FICO score for first lien single family residence mortgages, home equity loans, and home equity lines of credit. It defined low credit scores as less than 660 for second lien home equity loans (HEL) and home equity lines of credit (HELOC), and other consumer loans.[161]

While the January 2005 presentation promised to present a fuller definition of higher risk loans for Board approval at some future date, a more complete definition had already been provided to the Board a few weeks earlier in a December 21, 2004 presentation entitled, "Asset

[159] 6/30/2004 OTS Memo to Lawrence Carter from Zalka Ancely ("Joint Memo #8 - Loans to 'Higher-Risk Borrowers'"), OTSWME04-0000005357 at 61.
[160] 1/2005 "Higher Risk Lending Strategy Presentation," submitted to Washington Mutual Board of Directors, at JPM_WM00302979, Hearing Exhibit 4/13-2a.
[161] Id. at JPM_WM00302979.

Allocation Initiative: Higher Risk Lending Strategy and Increased Credit Risk Management."[162] This presentation contained the same basic definition of higher risk borrowers, but also provided a definition of higher risk loans.

Higher risk loans were defined as single family residence mortgages with a loan-to-value (LTV) ratio of equal to or greater than 90% if not credit enhanced, or a combined-loan-to-value (CLTV) ratio of 95%. These numbers are a notable departure from the 80% LTV ratio traditionally required for a prime loan.[163] For home equity loans and lines of credit, WaMu considered a first lien to be high risk if it had a greater than 90% LTV ratio, and considered a second lien to be high risk if had a greater than 80% CLTV ratio.[164]

The December 2004 presentation also defined higher risk lending on the basis of expanded underwriting criteria and multiple risk layering:

> "Expanded Criteria
>
> -'No Income' loan documentation type
>
> -All Manufactured Housing loans ...
>
> Multiple Risk Layering in SF[R] and 1st lien HEL/HELOC loans
>
> -Higher A- credit score or lacking LTV as strong compensating factor and
>
> -An additional risk factor from at least three of the following:
>
> -Higher uncertainty about ability to pay or 'stated income' documentation type
>
> -higher uncertainty about willingness to pay or collateral value[.]"[165]

This document indicates that WaMu considered a mortgage to be higher risk if it lacked documentation regarding the borrower's income, described as a "no income" or "stated income" loan.

WaMu held billions of dollars in loans on its balance sheet.[166] Those assets fluctuated in value based on the changes in the interest rate.

[162] 12/21/2004 "Asset Allocation Initiative: Higher Risk Lending Strategy and Increased Credit Risk Management," Washington Mutual Board of Directors Presentation, at JPM_WM04107995-8008, Hearing Exhibit 4/13-2b.

[163] See, e.g., 10/8/1999 "Interagency Guidance on High LTV Residential Real Estate Lending," http://www.federalreserve.gov/boarddocs/srletters/1993/SR9301.htm, and discussion of high LTV loans in section D(2)(b), below.

[164] 12/21/2004 "Asset Allocation Initiative: Higher Risk Lending Strategy and Increased Credit Risk Management," Washington Mutual Board of Directors Presentation, JPM_WM04107995-8008 at 7999, Hearing Exhibit 4/13-2b.

[165] Id. This slide lists only the two additional risk factors quoted, despite referring to "at least three of the following."

Fixed rate loans, in particular, incurred significant interest rate risk, because on a 30-year fixed rate mortgage, for example, WaMu agreed to receive interest payments at a certain rate for 30 years, but if the prevailing interest rate went up, WaMu's cost of money increased and the relative value of the fixed mortgages on its balance sheet went down. WaMu used various strategies to hedge its interest rate risk. One way to incur less interest rate risk was for WaMu to hold loans with variable interest rates, such as Hybrid ARMs typical of WaMu's subprime lending, or Option ARMs, WaMu's flagship "prime" product. These adjustable rate mortgages paid interest rates that, after the initial fixed rate period expired, were typically pegged to the Cost of Funds Index (COFI) or the Monthly Treasury Average (MTA), two common measures of prevailing interest rates.

(4) Gain on Sale

WaMu's internal documents indicate that the primary motivation behind its High Risk Lending Strategy was the superior "gain on sale" profits generated by high risk loans.[167] Washington Mutual management had calculated that higher risk loans were more profitable when sold or securitized. Prior to sale, higher risk loans also produced greater short term profits, because the bank typically charged the borrowers a higher rate of interest and higher fees.

Higher risk home loans placed for sale were more profitable for WaMu, because of the higher price that Wall Street underwriters and investors were willing to pay for them. The profit that WaMu obtained by selling or securitizing a loan was known as the "gain on sale." Gain on sale figures for the loans produced by the bank were analyzed and presented to the WaMu Board of Directors. On April 18, 2006, David Schneider, the President of WaMu Home Loans division, provided the Board of Directors a confidential presentation entitled, "Home Loans Discussion."[168] The third slide in the presentation was entitled, "Home Loans Strategic Positioning," and stated: "Home Loans is accelerating significant business model changes to achieve consistent, long term financial objectives."[169] Beneath this heading the first listed objective

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[166] See 9/25/2008 "OTS Fact Sheet on Washington Mutual Bank," Dochow_Darrel-00076154_001 ("Loans held: $118.9 billion in single-family loans held for investment – this includes $52.9 billion in payment option ARMs and $16.05 billion in subprime mortgage loans").

[167] 1/18/2005 Washington Mutual Inc. Washington Mutual Bank FA Finance Committee Minutes at JPM_WM06293964; see also 1/2005 "Higher Risk Lending Strategy Presentation," submitted to Washington Mutual Board of Directors, at JPM_WM00302977, Hearing Exhibit 4/13-2a

[168] 4/18/2006 "Home Loans Discussion Board of Directors Meeting," WaMu presentation, JPM_WM00690890-901, Hearing Exhibit 4/13-3.

[169] Id. at 893 [emphasis in original removed].

was: "Shift from low-margin business to high-margin products,"[170] meaning from less profitable to more profitable loan products. The next slide in the presentation was entitled: "Shift to Higher Margin Products," and elaborated on that objective. The slide listed the actual gain on sale obtained by the bank, in 2005, for each type of loan WaMu offered, providing the "basis points" (bps) that each type of loan fetched on Wall Street:

2005 WaMu Gain on Sale
Margin by Product
in bps[171]

Government	13
Fixed	19
Hybrid/ARM	25
Alt A	40
Option ARM	109
Home Equity	113
Subprime	150

Mr. Schneider told the Subcommittee that the numbers listed on the chart were not projections, but the numbers generated from actual, historical loan data.[172] As the chart makes clear, the least profitable loans for WaMu were government backed and fixed rate loans. Those loans were typically purchased by the government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac which paid relatively low prices for them. Instead of focusing on those low margin loans, WaMu's management looked to make profits elsewhere, and elected to focus on the most profitable loans, which were the Option ARM, home equity, and subprime loans. In 2005, subprime loans, with 150 basis points, were eight times more profitable than a fixed rate loan at 19 basis points and more than 10 times as profitable as government backed loans.

The gain on sale data WaMu collected drove not only WaMu's decision to focus on higher risk home loans, but also how the bank priced those loans for borrowers. In determining how much it would charge for a loan, the bank calculated first what price the loan would obtain on Wall Street. As Mr. Beck explained in his testimony before the Subcommittee:

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[170] Id.
[171] Id. at 894 [formatting as in the original].
[172] Subcommittee interview of David Schneider (2/16/2010).

> "Because WaMu's capital markets organization was engaged in the secondary mortgage market, it had ready access to information regarding how the market priced loan products. Therefore my team helped determine the initial prices at which WaMu could offer loans by beginning with the applicable market prices for private or agency-backed mortgage securities and adding the various costs WaMu incurred in the origination, sale, and servicing of home loans."[173]

(5) Acknowledging Unsustainable Housing Price Increases

In 2004, before WaMu implemented its High Risk Lending Strategy, the Chief Risk Officer Jim Vanasek expressed internally concern about the unsustainable rise in housing prices, loosening lending standards, and the possible consequences. On September 2, 2004, just months before the formal presentation of the High Risk Lending Strategy to the Board of Directors, Mr. Vanasek circulated a prescient memorandum to WaMu's mortgage underwriting and appraisal staff, warning of a bubble in housing prices and encouraging tighter underwriting. The memorandum also captured a sense of the turmoil and pressure at WaMu. Under the subject heading, "Perspective," Mr. Vanasek wrote:

> "I want to share just a few thoughts with all of you as we begin the month of September. Clearly you have gone through a difficult period of time with all of the changes in the mortgage area of the bank. Staff cuts and recent defections have only added to the stress. Mark Hillis [a Senior Risk Officer] and I are painfully aware of the toll that this has taken on some of you and have felt it is important to tell you that we recognize it has been and continues to be difficult.
>
> "In the midst of all this change and stress, patience is growing thin. We understand that. We also know that loan originators are pushing very hard for deals. But we need to put all of this in perspective.
>
> "At this point in the mortgage cycle with prices having increased far beyond the rate of increase in personal incomes, there clearly comes a time when prices must slow down or perhaps even decline. There have been so many warnings of a Housing Bubble that we all tend now to ignore them because thus far it has not happened. I am not in the business of forecasting, but I have a

[173] April 13, 2010 Subcommittee Hearing at 53.

> healthy respect for the underlying data which says ultimately this environment is no longer sustainable. Therefore I would conclude that now is not the time to be pushing appraisal values. If anything we should be a bit more conservative across the board. Kerry Killinger and Bill Longbrake [a Vice Chair of WaMu] have both expressed renewed concern over this issue.
>
> "This is a point where we should be much more careful about exceptions. It is highly questionable as to how strong this economy may be; there is clearly no consensus on Wall Street. If the economy stalls, the combination of low FICOs, high LTVs and inordinate numbers of exceptions will come back to haunt us."[174]

Mr. Vanasek was the senior-most risk officer at WaMu, and had frequent interactions with Mr. Killinger and the Board of Directors. While his concerns may have been heard, they were not heeded.

Mr. Vanasek told the Subcommittee that, because of his predictions of a collapse in the housing market, he earned the derisive nickname "Dr. Doom."[175] But evidence of a housing bubble was overwhelming by 2005. Over the prior ten years, housing prices had skyrocketed in an unprecedented fashion, as the following chart prepared by Paulson & Co. Inc., based on data from the Bureau of Economic Analysis and the Office of Federal Housing Enterprise Oversight, demonstrates.[176]

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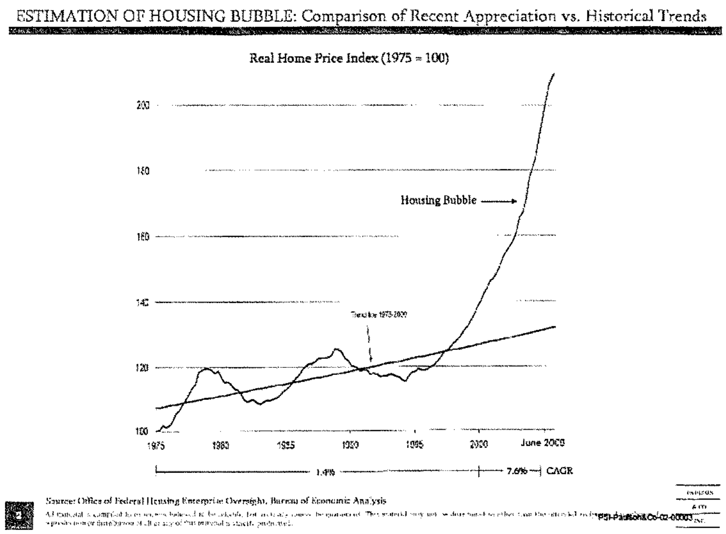
[174] 9/2/2004 Washington Mutual memorandum from Jim Vanasek, "Perspective," Hearing Exhibit 4/13-78b.

[175] Subcommittee interview of Jim Vanasek (12/18/2009).

[176] "Estimation of Housing Bubble," PSI-Paulson&Co-02-00003, Hearing Exhibit 4/13-1j.



Mr. Vanasek shared his concerns with Mr. Killinger. At the Subcommittee's hearing, Mr. Killinger testified: "Now, beginning in 2005, 2 years before the financial crisis hit, I was publicly and repeatedly warning of the risks of a potential housing downturn."[177] In March 2005, he engaged in an email exchange with Mr. Vanasek, in which both agreed the United States was in the midst of a housing bubble. On March, 10, 2005, Mr. Vanasek emailed Mr. Killinger about many of the issues facing his risk management team, concluding:

> "My group is working as hard as I can reasonably ask any group to work and in several cases they are stretched to the absolute limit. Any words of support and appreciation would be very helpful to the morale of the group. These folks have stepped up to fixing any number of issues this year, many not at all of their own making."[178]

Mr. Killinger replied:

> "Thanks Jim. Overall, it appears we are making some good progress. Hopefully, the Regulators will agree that we are making some progress. I suspect the toughest thing for us will be to navigate through a period of high home prices, increased competitive conditions for reduced underwriting standards, and our need to grow the balance sheet. I have never seen such a high risk housing market as market after market thinks they are unique and

[177] April 13, 2010 Subcommittee Hearing at 85.
[178] 3/2005 WaMu internal email chain, Hearing Exhibit 4/13-78.

for whatever reason are not likely to experience price declines. This typically signifies a bubble."

Mr. Vanasek agreed:

> "I could not agree more. All the classic signs are there and the likely outcome is probably not great. We would all like to think the air can come out of the balloon slowly but history would not lean you in that direction. Over the next month or so I am going to work hard on what I hope can be a lasting mechanism (legacy) for determining how much risk we can afford to take ...."

Despite Mr. Killinger's awareness that housing prices were unsustainable, could drop suddenly, and could make it difficult for borrowers to refinance or sell their homes, Mr. Killinger continued to push forward with WaMu's High Risk Lending Strategy.

(6) Execution of the High Risk Lending Strategy

WaMu formally adopted the High Risk Lending Strategy in January 2005.[179] Over the following two years, management significantly shifted the bank's loan originations towards riskier loans as called for in the plan, but had to slow down the pace of implementation in the face of worsening market conditions. In retrospect, WaMu executives tried to portray their inability to fully execute the plan as a strategic choice rather than the result of a failed strategy. For example, Mr. Killinger testified at the Subcommittee hearing that the bank's High Risk Lending Strategy was only contemplated, but not really executed:

> "First, we had an adjustment in our strategy that started in about 2004 to gradually increase the amount of home equity, subprime, commercial real estate, and multi-family loans that we could hold on the balance sheet. We had that long-term strategy, but ... we quickly determined that the housing market was increasing in its risk, and we put most of those strategies for expansion on hold."[180]

Mr. Killinger's claim that the High Risk Lending Strategy was put "on hold" is contradicted, however, by WaMu's SEC filings, its internal documents, and the testimony of other WaMu executives.

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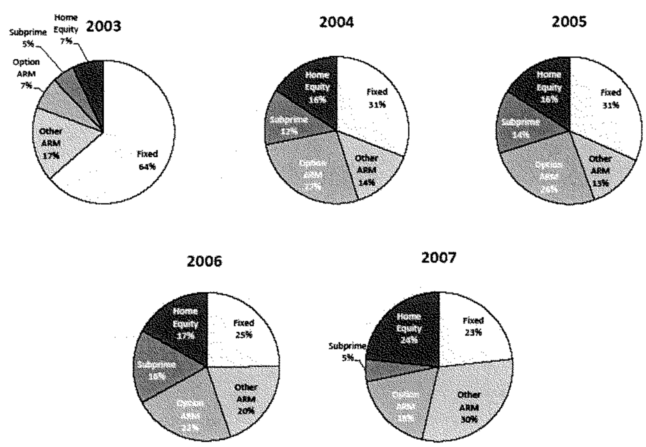
[179] See 3/13/2006 OTS Report of Examination, at OTSWMS06-008 0001677, Hearing Exhibit 4/16-94 [Sealed Exhibit].

[180] April 13, 2010 Subcommittee Hearing at 88.

Washington Mutual's SEC filings contain loan origination and acquisition data showing that the bank did implement its High Risk Lending Strategy. Although rising defaults and the 2007 collapse of the subprime secondary market prevented WaMu from fully executing its plans, WaMu dramatically shifted the composition of the loans it originated and purchased, nearly doubling the percentage of higher risk home loans from 36% to 67%. The following chart, prepared by the Subcommittee using data from WaMu's SEC filings, demonstrates the shift.[181]

WAMU PRODUCT ORIGINATIONS AND PURCHASES BY PERCENTAGE - 2003-2007



Source: Washington Mutual Inc. SEC Filings, 2003-2007. Prepared by the U.S. Senate Permanent Subcommittee on Investigations, April 2010

In 2003, 64% of WaMu's mortgage originations and purchases were fixed rate loans, and only 19% were subprime, Option ARM, or home equity loans. In 2004, 31% of WaMu's mortgage originations and purchases were fixed rate loans, and 55% were subprime, Option ARM, or home equity loans. In 2005, 31% of WaMu's mortgage originations and purchases were fixed rate loans, and 56% were subprime, Option ARM, or equity loans. By 2006, only 25% of WaMu's mortgage originations and purchases were fixed rate loans, and 55% were subprime, Option ARM, or home equity loans.[182] Even after market forces began taking their toll in 2007, and WaMu ended all subprime

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[181] 4/2010 "WaMu Product Originations and Purchases by Percentage – 2003-2007," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1i.
[182] Id.

lending in the fall of that year, its higher risk originations and purchases at 47% were double its fixed rate loans at 23%.[183]

Mr. Killinger's annual "Strategic Direction" memoranda to the Board in 2005, 2006, and 2007, also contradict his testimony that the strategy of expanding high risk lending was put on hold. On the first page of his 2005 memorandum, Mr. Killinger wrote: "We continue to see excellent long-term growth opportunities for our key business lines of retail banking, mortgage banking, multi-family lending and sub-prime residential lending."[184] Rather than hold back on WaMu's stated strategy of risk expansion, Mr. Killinger told the Board that WaMu should accelerate it:

> "In order to reduce the impact of interest rate changes on our business, we have accelerated development of Alt-A, government and sub-prime loan products, as well as hybrid ARMs and other prime products, specifically for delivery through retail, wholesale and correspondent channels."[185]

The 2005 strategic direction memorandum also targeted Long Beach for expansion:

> "Long Beach is expected to originate $30 billion of loans this year, growing to $36 billion in 2006. To facilitate this growth, we plan to increase account managers by 100. We expect Long Beach to have 5% of the sub-prime market in 2005, growing to [a] 6% share in 2006."[186]

Despite warning against unsustainable housing prices in March 2005, Mr. Killinger's 2006 "Strategic Direction" memorandum to the Board put even more emphasis on growth than the 2005 memorandum. After reviewing the financial targets set in the five-year plan adopted in 2004, Mr. Killinger wrote: "To achieve these targets, we developed aggressive business plans around the themes of growth, productivity, innovation, risk management and people development."[187] His memorandum expressed no hesitation or qualification as to whether the high risk home lending strategy was still operative in 2006. The memorandum stated:

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[183] Id.
[184] 6/1/2005 Washington Mutual memorandum from Kerry Killinger to the Board of Directors, "Strategic Direction," JPMC/WM - 0636-49 at 36, Hearing Exhibit 4/13-6c.
[185] Id. at 644.
[186] Id. at 646.
[187] 6/6/2006 Washington Mutual memorandum from Kerry Killinger to the Board of Directors, "Strategic Direction," JPM_00808312-324 at 314, Hearing Exhibit 4/13-6d.

> "Finally, our Home Loan Group should complete its repositioning within the next twelve months and it should then be in position to grow its market share of Option ARM, home equity, sub prime and Alt. A loans. We should be able to increase our share of these categories to over 10%."[188]

Contrary to Mr. Killinger's hearing testimony, the 2006 memorandum indicates an expansion of WaMu's high risk home lending, rather than any curtailment:

> "We are refining our home loans business model to significantly curtail low margin Government and conventional fixed rate originations and servicing, and to significantly increase our origination and servicing of high margin home equity, Alt. A, sub prime and option ARMs. Action steps include merging Longbeach sub prime and the prime business under common management, merging correspondent activities into our correspondent channel, getting out of Government lending, curtailing conventional fixed rate production, expanding distribution of targeted high margin products through all distribution channels and potentially selling MSRs [Mortgage Servicing Rights] of low margin products. We expect these actions to result in significantly higher profitability and lower volatility over time."[189]

The April 16, 2006 "Home Loans Discussion" presentation by Home Loans President David Schneider, discussed above, also confirms WaMu's ongoing efforts to shift its loan business toward high risk lending. Page four of that presentation, entitled, "Shift to Higher Margin Products," shows two pie charts under the heading, "WaMu Volume by Product."[190] One chart depicts loan volume for 2005, and the second chart depicts projected loan volume for 2008:

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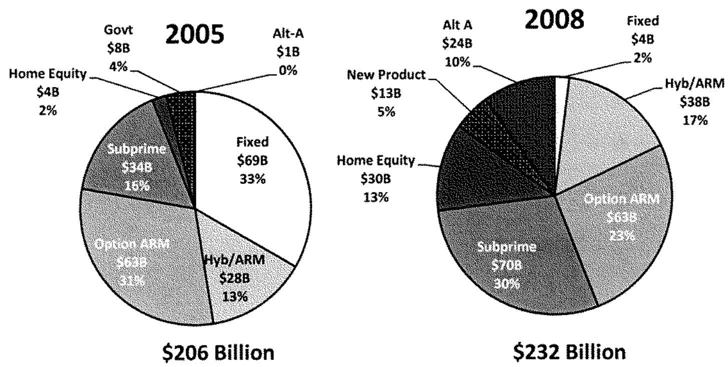
[188] Id. at 315 [emphasis in original removed].
[189] Id. at 319.
[190] 4/18/2006 "Home Loans Discussion Board of Directors Meeting," WaMu PowerPoint presentation, JPM_WM00690890-901 at 894, Hearing Exhibit 4/13-3.

WaMu Volume By Product
$ In Billions[191]



These charts demonstrate WaMu's intention to increase its loan originations over three years by almost $30 billion, focusing on increases in high risk loan products. Subprime originations, for example, were expected to grow from $34 billion in 2005 to $70 billion in 2008; Alt A originations were projected to grow from $1 billion in 2005 to $24 billion in 2008; and Home Equity originations were projected to grow from $4 billion in 2005 to $30 billion in 2008. On the other hand, WaMu's low risk originations were expected to be curtailed dramatically. Government backed loan originations, which totaled $8 billion in 2005, were projected to be eliminated by 2008. Fixed rate loan originations were projected to decline from $69 billion in 2005 to $4 billion in 2008.

The 2007 "Strategic Direction" memorandum to the Board is dated June 18, 2007, well after U.S. housing prices had begun to decline, as Mr. Killinger acknowledged:

> "For the past two years, we have been predicting the bursting of the housing bubble and the likelihood of a slowing housing market. This scenario has now turned into a reality. Housing prices are declining in many areas of the country and sales are rapidly slowing. This is leading to an increase in delinquencies and loan losses. The sub-prime market was especially rocked as many sub-prime borrowers bought houses at the peak of the cycle and now

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[191] Id. [formatted for clarity].

find their houses are worth less and they are having difficulties refinancing their initial low-rate loans."[192]

While the memorandum's section on home loan strategy no longer focused on overall growth, it continued to push the shift to high risk lending, despite problems in the subprime market:

> "Home Loans is a large and important business, but at this point in the cycle, it is unprofitable. The key strategy for 2008 is to execute on the revised strategy adopted in 2006. ... We need to optimize the sub-prime and prime distribution channels with particular emphasis on growing the retail banking, home loan center and consumer direct channels. We also expect to portfolio more of Home Loans' originations in 2008, including the new Mortgage Plus product. We will continue to emphasize higher-risk adjusted return products such as home equity, sub-prime first mortgages, Alt A mortgages and proprietary products such as Mortgage Plus."[193]

The testimony of other WaMu executives further confirms the bank's implementation of its High Risk Lending Strategy. Ronald Cathcart, who joined WaMu in 2006, to become the company's Chief Risk Officer, testified:

> "The company's strategic plan to shift its portfolios towards higher margin products was already underway when I arrived at WaMu. Basically, this strategy involved moving away from traditional mortgage lending into alternative lending programs involving adjustable-rate mortgages as well as into subprime products. The strategic shift to higher-margin products resulted in the bank taking on a higher degree of credit risk because there was a greater chance that borrowers would default."[194]

Likewise, Steven Rotella, WaMu's President and Chief Operating Officer, who began with the bank in January 2005, testified before the Subcommittee:

> "In particular, I want to be very clear on the topic of high-risk lending, this Subcommittee's focus today. High-risk mortgage

[192] 6/18/2007 Washington Mutual memorandum from Kerry Killinger to the Board of Directors, "Strategic Direction," JPM_WM03227058-67 at 60, Hearing Exhibit 4/13-6a.
[193] Id. at 66 [emphasis in original removed]. See also 1/2007 Washington Mutual presentation, "Subprime Mortgage Program," JPM_WM02551400, Hearing Exhibit 4/13-5 (informing potential investors in its subprime RMBS securities that: "WaMu is focusing on higher margin products").
[194] April 13, 2010 Subcommittee Hearing at 18-19.

lending in WaMu's case, primarily Option ARMs and subprime loans through Long Beach Mortgage, a subsidiary of WaMu, were expanded and accelerated at explosive rates starting in the early 2000s, prior to my hiring in 2005.... In 2004 alone, the year before I joined, Option ARMs were up 124 [percent], and subprime lending was up 52 percent."[195]

In his testimony, Mr. Rotella took credit for curtailing WaMu's growth and high risk lending.[196] Mr. Rotella's own emails, however, show that he supported the High Risk Lending Strategy. On October 15, 2005, Mr. Rotella emailed Mr. Killinger about WaMu's 2006 strategic plan: "I think our focus needs to be on organic growth of home eq, and subprime, and greater utilization of [the Home Loans division] as we know it today to facilitate that at lower acquisition costs and greater efficiency."[197]

Mr. Killinger replied by email the next day: "Regarding Longbeach, I think there is a good opportunity to be a low cost provider and gain significant share when the industry implodes."[198] Responding to Mr. Rotella's ideas about the Home Loans division, Mr. Killinger wrote: "It makes sense to leverage the home loans distribution channels with home equity, sub prime, and alt. A."[199] In this late 2005 email exchange, WaMu's two senior-most executives contemplate reducing prime lending, not subprime. Mr. Killinger wrote: "If we can't make a shift in our business model, we might be better off exiting the prime space."[200]

Mr. Rotella replied to Mr. Killinger's email later on October 16, 2005. He continued to emphasize the importance of focusing on high risk lending, referring to his previous experience as a mortgage banker at JPMorgan Chase:

> "We did these kinds of analyses all the time at Chase which led us to run as fast as we could into home eq, alt a, subprime (our investment banking brethren stopped us from going too far here). We viewed prime as a source of scale benefits in servicing for the other areas and a conduit of higher margin product and aimed to hold our prime servicing flat to down. I feel strongly that where

[195] Id. at 83.
[196] See id., e.g., at 83-84.
[197] 10/15/2005-10/16/2005 email from Steve Rotella to Kerry Killinger, JPM_WM00665373-75.
[198] Id. at JPM_WM00665374.
[199] Id.
[200] Id.

we need to land is a new home loan unit that includes prime, heq, and subprime. It is a far superior model."[201]

In July 2008, just two months before the collapse of WaMu, Home Loans President David Schneider prepared an internal presentation entitled, "Home Loans Story, External & Internal Views."[202] The presentation was retrospective, providing timelines of WaMu's major strategy, policy, and personnel changes. The first substantive page of the presentation bears the heading, "Three fundamental business shifts occurred in Home Loans this millennium which shaped its performance and position in a volatile competitive landscape":

> **"2001 to 2005**
> 'Mono-line' business model focused on generating high volume of low-margin, prime products ....
>
> **2006**
> Targeted production franchise toward higher margin products to become a market leader in specific product segments ....
>
> **2007 & Beyond**
> Subprime mortgage implosion fuels credit and liquidity crisis and the non-agency secondary market disappears[.]"

Mr. Scheider's retrospective presentation of the changes that occurred at WaMu is unambiguous: by 2006, WaMu had "[t]argeted production franchise toward higher margin products."[203] According to the same presentation, that model change also lowered earnings volatility for WaMu by lessening exposure to Mortgage Servicing Rights.[204] Later slides provide more detail. A quarterly timeline is presented with the heading: "In an environment of internal and external large-scale change, Home Loans took bold actions to redefine its business into a sustainable model." In the strategy section for the second quarter of 2006, Mr. Schneider wrote: "New business model, high margin products."[205]

Despite warnings by some within its management about unsustainable housing prices, WaMu pursued a High Risk Lending Strategy to generate short term profits from the favorable gain-on-sale

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201 Id. at JPM_WM00665373.
202 7/2008 "Home Loans Story, External & Internal Views," Washington Mutual PowerPoint presentation, Hearing Exhibit 4/13-80.
203 Id. at 1.
204 Id.
205 Id. at 4.

margins offered by Wall Street for high risk loans and securitizations, for which the credit rating agencies continued to award AAA ratings. To succeed, the strategy was premised upon borrowers being able to refinance or sell their homes to pay off their loans in the event of a default. Stagnant or declining house prices made refinancing and home sales more difficult.

Effective implementation of the High Risk Lending Strategy also required robust risk management. But while WaMu was incurring significantly more credit risk than it had in the past, risk managers were marginalized, undermined, and subordinated to WaMu's business units. As a result, when credit risk management was most needed, WaMu found itself lacking in effective risk management and oversight.

D. Shoddy Lending Practices

At the same time they increased their higher risk lending, WaMu and Long Beach engaged in a host of poor lending practices that produced billions of dollars in poor quality loans. Those practices included offering high risk borrowers large loans; steering borrowers to higher risk loans; accepting loan applications without verifying the borrower's income; using loans with low teaser rates to entice borrowers to take out larger loans; promoting negative amortization loans which led to many borrowers increasing rather than paying down their debt over time; and authorizing loans with multiple layers of risk. WaMu and Long Beach also exercised weak oversight over their loan personnel and third party mortgage brokers, and tolerated the issuance of loans with fraudulent or erroneous borrower information.

(1) Long Beach

Throughout the period reviewed by the Subcommittee, from 2004 until its demise in September 2007, Long Beach was plagued with problems. Long Beach was one of the largest subprime lenders in the United States,[206] but it did not have any of its own loan officers. Long Beach operated exclusively as a "wholesale lender," meaning all of the loans it issued were obtained from third party mortgage brokers who had brought loans to the company to be financed. Long Beach "account executives" solicited and originated the mortgages that were initiated by mortgage brokers working directly with borrowers. Long Beach account executives were paid according to the volume of loans they originated, with little heed paid to loan quality.

[206] See 1/2007 Washington Mutual Presentation, "Subprime Mortgage Program," Hearing Exhibit 4/13-5 (slide showing Long Beach Annual Origination Volume).

Throughout the period reviewed by the Subcommittee, Long Beach's subprime home loans and mortgage backed securities were among the worst performing in the subprime industry. Its loans repeatedly experienced early payment defaults, its securities had among the highest delinquencies in the market, and its unexpected losses and repurchase demands damaged its parent corporation's financial results. Internal documentation from WaMu shows that senior management at the bank was fully aware of Long Beach's shoddy lending practices, but failed to correct them.

2003 Halt in Securitizations. For a brief period in 2003, Long Beach was required by WaMu lawyers to stop all securitizations until significant performance problems were remedied. While the problems were addressed and securitizations later resumed, many of the issues returned and lingered for several years.

The problems with Long Beach's loans and securitizations predated the company's purchase by WaMu in 1999, but continued after the purchase. An internal email at WaMu's primary federal regulator, the Office of Thrift Supervision (OTS), observed the following with respect to Long Beach's mortgage backed securities:

> "Performance data for 2003 and 2004 vintages appear to approximate industry average while issues prior to 2003 have horrible performance. LBMC finished in the top 12 worst annualized NCLs [net credit losses] in 1997 and 1999 thru 2003. LBMC nailed down the worst spot at top loser ... in 2000 and placed 3rd in 2001."[207]

In 2003, Long Beach's performance deteriorated to the point that WaMu's legal department put a stop to all Long Beach securitizations until the company improved its operations.[208] An internal review of Long Beach's first quarter 2003 lending "concluded that 40% (109 of 271) of loans reviewed were considered unacceptable due to one or more critical errors."[209] According to a 2003 joint report issued by regulators from the FDIC and Washington State: "This raised concerns over LBMC's ability to meet the representations and warrant[ies] made to facilitate sales of loan securitizations, and management halted

[207] 4/2005 OTS internal email, Hearing Exhibit 4/13-8(a).
[208] Subcommittee interview of Faye Chapman, WaMu General Counsel (2/9/2010). See also 12/21/2005 OTS memorandum, "Long Beach Mortgage Corporation (LBMC)," OTSWMS06-007 0001010, Hearing Exhibit 4/16-31.
[209] 1/13/2004 report on "Joint Visitation Dated October 14, 2003," jointly prepared by the FDIC and the State of Washington Department of Financial Institutions, FDIC-E_00102515, at 3, Hearing Exhibit 4/13-8b (citing a Long Beach quality assurance report).

securitization activity."[210] A Long Beach corporate credit review in August 2003 confirmed that "credit management and portfolio oversight practices were unsatisfactory."[211]

As a result of the halt in securitizations, Long Beach had to hold loans on its warehouse balance sheet, which increased by approximately $1 billion per month and reached nearly $5 billion by the end of November 2003. Long Beach had to borrow money from WaMu and other creditors to finance the surge.[212] The joint visitation report noted that unless Long Beach executed a $3 billion securitization by January 2004, "liquidity will be strained."[213] WaMu initiated a review of Long Beach led by its General Counsel Faye Chapman.[214] Her team evaluated the loans that had accumulated during the halt in securitizations. The joint visitation report noted that of 4,000 Long Beach loans reviewed by WaMu by the end of November 2003, less than one quarter, about 950, could be sold to investors, another 800 were unsaleable, and the rest – over half of the loans – had deficiencies that had to be remediated before a sale could take place.[215]

After a short hiatus, WaMu allowed Long Beach to resume securitizing subprime loans in 2004.[216] An internal WaMu memorandum, later prepared by a WaMu risk officer who had been asked to review Long Beach in 2004, recalled significant problems:

> "You've asked for a chronological recap of ERM [Enterprise Risk Management] market risk involvement with Longbeach and the sub prime conduit. ... [In] 2004: I conducted an informal but fairly intensive market risk audit of Longbeach .... The climate was very adversarial. ... We found a total mess."[217]

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[210] Id.
[211] Id. (citing a Long Beach Corporate Credit Review report).
[212] Id.
[213] Id.
[214] Subcommittee interview of Fay Chapman (2/9/2010).
[215] 1/13/2004 report on "Joint Visitation Dated October 14, 2003," jointly prepared by the FDIC and the State of Washington Department of Financial Institutions, FDIC-E_00102515, at 3, Hearing Exhibit 4/13-8b.
[216] Subcommittee interview of Fay Chapman (2/9/2010). See also 12/21/2005 OTS memorandum, "Long Beach Mortgage Corporation (LBMC)," OTSWMS06-007 0001010, Hearing Exhibit 4/16-31 ("In 2003, adverse internal reviews of LBMC operations led to a decision to temporarily cease securitization activity. WMU's Legal Department then led a special review of all loans in LBMC's pipeline and held-for-sale warehouse in order to ensure file documentation adequately supported securitization representations and warranties and that WMI was not exposed to a potentially significant contingent liability. Securitization activity was reinstated in early 2004 after the Legal Department concluded there was not a significant liability issue.").
[217] Undated memorandum from Dave Griffith to Michelle McCarthy, "Sub Prime Chronology," likely prepared in early 2007, JPM_WM02095572.

A November 2004 email exchange between two WaMu risk officers provides a sense that poor quality loans were still a problem. The first WaMu risk officer wrote:

> "Just a heads-up that you may be getting some outreach from Carroll Moseley (or perhaps someone higher up in the chain) at Long Beach regarding their interest in exploring the transfer of … a small amount (maybe $10-20mm in UPB [unpaid principal balance]) of Piggieback 'seconds' (our favorite toxic combo of low FICO borrower and HLTV loan) from HFS [hold for sale portfolio] to HFI [hold for investment portfolio].
>
> "As Carroll described the situation, these are of such dubious credit quality that they can't possibly be sold for anything close to their 'value' if we held on to them. … I urged him to reach out to you directly on these questions. (E.g., it's entirely possible we might want to make a business decision to keep a small amount of this crap on our books if it was already written down to near zero, but we would want all parties to be clear that no precedent was being set for the product as a whole, etc., etc.)."[218]

The second risk officer sent the email to the head of Long Beach, with the comment, "I think it would be prudent for us to just sell all of these loans."

2005 Early Payment Defaults. Early in 2005, a number of Long Beach loans experienced "early payment defaults," meaning that the borrower failed to make a payment on the loan within three months of the loan being sold to investors. That a loan would default so soon after origination typically indicates that there was a problem in the underwriting process. Investors who bought EPD loans often demanded that Long Beach repurchase them, invoking the representations and warranties clause in the loan sales agreements.

To analyze what happened, WaMu conducted a "post mortem" review of 213 Long Beach loans that experienced first payment defaults in March, April, and May of 2005.[219] The review found that many early defaults were not only preventable, but that in some instances fraud should have been easily detected from the presence of "White Out" on an application or a borrower having two different signatures:

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[218] 11/24/2004 email from Michael Smith to Mark Hillis and others, "LBMC Transfer of Piggiebacks from HFS to HFI," JPM_WM01407692.
[219] 11/1/2005 "LBMC Post Mortem – Early Findings Read Out," prepared by WaMu, JPM_WM03737297, Hearing Exhibit 4/13-9.

"First Payment Defaults (FPD's) are preventable and / or detectable in nearly all cases (~99%)[.] Most FPD cases (60%) are failure of current control effectiveness[.] ... High incident rate of potential fraud among FPD cases[.] ... All roles in the origination process need to sharpen watch for misrepresentation and fraud[.] ... Underwriting guidelines are not consistently followed and conditions are not consistently or effectively met[.] ... Underwriters are not consistently recognizing non-arm's length transactions and/or underwriting associated risk effectively[.] ... Credit Policy does not adequately address certain key risk elements in layered high risk transactions[.] ...

"66% of reviewed FPD cases had significant variances in the file[.] ... Stated Income should be reviewed more closely ([fraud] incidence rate of 35%) .... Signatures should be checked – 14% Borrowers signature vary[.] Altered documents are usually detectable –5% White-out on documentation[.] ... 92% of the Purchases reviewed are 100% CLTV [combined loan-to-value][.] ... 52% are Stated Income."[220]

A subsequent review conducted by WaMu's General Auditor of the "root causes" of the Long Beach loans with early payment defaults pointed not only to lax lending standards and a lack of fraud controls, but also to "a push to increase loan volume":

"In 2004, LBMC [Long Beach] relaxed underwriting guidelines and executed loan sales with provisions fundamentally different from previous securitizations. These changes, coupled with breakdowns in manual underwriting processes, were the primary drivers for the increase in repurchase volume. The shift to whole loan sales, including the EPD provision, brought to the surface the impact of relaxed credit guidelines, breakdowns in manual underwriting processes, and inexperienced subprime personnel. These factors, coupled with a push to increase loan volume and the lack of an automated fraud monitoring tool, exacerbated the deterioration in loan quality."[221]

Due to the early payment defaults, Long Beach was forced to repurchase loans totaling nearly $837 million in unpaid principal, and

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[220] Id.
[221] 4/17/2006 WaMu memorandum to the Washington Mutual Inc. and WaMu Board of Directors' Audit Committee, "Long Beach Mortgage Company - Repurchase Reserve Root Cause Analysis," prepared by WaMu General Auditor, JPM_WM02533760-61, Hearing Exhibit 4/13-10.

incurred a net loss of about $107 million.[222] This loss overwhelmed Long Beach's repurchase reserves, leading to a reserve shortfall of nearly $75 million.[223] Due to its insufficient loss reserves, its outside auditor, Deloitte and Touche, cited Long Beach for a serious deficiency in its financial reporting.[224] These unexpected repurchases were significant enough that Washington Mutual Inc., Long Beach's parent company, made special mention of them in its 2005 10-K filing:

> "In 2004 and 2005, the Company's Long Beach Mortgage Company subsidiary engaged in whole loan sale transactions of originated subprime loans in which it agreed to repurchase from the investor each 'early payment default' loan at a price equal to the loan's face value plus the amount of any premium paid by the investor. An early payment default occurs when the borrower fails to make the first post-sale payment due on the loan by a contractually specified date. Usually when such an event occurs, the fair value of the loan at the time of its repurchase is lower than the face value. In the fourth quarter of 2005, the Company experienced increased incidents of repurchases of early payment default loans sold by Long Beach Mortgage Company and this trend is expected to continue in the first part of 2006.[225]

In addition to the early payment default problem, a September 2005 WaMu audit observed that at Long Beach, policies designed to mitigate the risk of predatory lending practices were not always followed. The audit report stated: "In 24 of 27 (88%) of the refinance transactions reviewed, policies established to preclude origination of loans providing no net tangible benefit to the borrower were not followed."[226] In addition, in 8 out of 10 of the newly issued refinance loans that WaMu reviewed, Long Beach had not followed procedures designed to detect "loan flipping," an industry term used to describe the practice of unscrupulous brokers or lenders quickly or repeatedly refinancing a borrower's loan to reap fees and profits but provide no benefit to the borrower.[227]

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[222] Id. (Long Beach "experienced a dramatic increase in EPD's [early payment defaults], during the third quarter of 2005 [which] ... led to a large volume of required loan repurchases. The unpaid principal balance repurchased as a result of the EPD provision for the year ended December 31, 2005 was $837.3 million. The net loss from these repurchases was approximately $107 million.").

[223] Id.

[224] Id.

[225] Washington Mutual Inc. 2005 10-K filing with the SEC.

[226] 9/21/2005 WaMu audit of Long Beach, JPM_WM04656627.

[227] Id.

2006 Purchase of Long Beach. In response to all the problems at Long Beach, at the end of 2005, WaMu fired Long Beach's senior management and moved the company under the direct supervision of the President of WaMu's Home Loans Division, David Schneider.[228] Washington Mutual promised its regulator, OTS, that Long Beach would improve.[229] The bank also filed a formal application, requiring OTS approval, to purchase Long Beach from its parent company, so that it would become a wholly owned subsidiary of the bank.[230] WaMu told OTS that making Long Beach a subsidiary would give the bank greater control over Long Beach's operations and allow it to strengthen Long Beach's lending practices and risk management, as well as reduce funding costs and administrative expenses.[231] In addition, WaMu proposed that it replace its current "Specialty Mortgage Finance" program, which involved purchasing subprime loans for its portfolio primarily from Ameriquest, with a similar loan portfolio provided by Long Beach.[232] OTS had expressed a number of concerns about Long Beach in connection with the purchase request,[233] but in December 2005, after obtaining commitments from WaMu to strengthen Long Beach's lending and risk management practices, OTS agreed to the purchase.[234] The actual purchase date was March 1, 2006.[235]

Immediately after the purchase, in April 2006, after reviewing Long Beach's operations, WaMu President Rotella sent an email to WaMu CEO Killinger warning about the extent of the problems: "[D]elinquencies are up 140% and foreclosures close to 70%. ... First payment defaults are way up and the 2005 vintage is way up relative to previous years. It is ugly."[236] Mr. Rotella, however, expressed hope that operations would improve:

> "Early changes by the new team from HL [Home Loans], who have deep subprime experience, indicate a solid opportunity to mitigate some of this. I would expect to see this emerge in 3 to 6 months. That said, much of the paper

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228 Subcommittee interview of David Schneider (2/17/2010).
229 See, e.g., 12/21/2005 OTS memorandum, "Long Beach Mortgage Corporation (LBMC)," OTSWMS06-007 0001009, Hearing Exhibit 4/16-31.
230 Id. at OTSWMS06-007 0001009 (stating WaMu filed a 12/12/2005 application to acquire Long Beach).
231 Id. at OTSWMS06-007 0001010.
232 Id. at OTSWMS06-007 0001011.
233 See, e.g., 6/3/2005 OTS internal memorandum by OTS examiner to OTS Deputy Regional Director, at OTSWMS06-007 0002683, Hearing Exhibit 4/16-28.
234 See 12/21/2005 OTS memorandum, "Long Beach Mortgage Corporation (LBMC)," OTSWMS06-007 0001009, Hearing Exhibit 4/16-31.
235 "Washington Mutual Regulators Timeline," chart prepared by the Subcommittee, Hearing Exhibit 4/16-1j.
236 4/27/2006 email from Steve Rotella to Kerry Killinger, JPM_WM05380911, Hearing Exhibit 4/13-11.

> we originated in the 05 growth spurt was low quality. ... I have the utmost confidence in the team overseeing this now and no doubt this unit will be more productive and better controlled, but I figured you should know this is not a pretty picture right now. We are all over it, but as we saw with repurchases, there was a lot of junk coming in."

Despite the new management and direct oversight by WaMu's Home Loans Division, Long Beach continued to perform poorly. Five months later, expected improvements had not materialized. In September 2006, Mr. Rotella sent another email to Mr. Killinger stating that Long Beach was still "terrible":

> "[Long Beach] is terrible, in fact negative right now. ... We are being killed by the lingering movement of EPDs [early payment defaults] and other credit related issues .... [W]e are cleaning up a mess. Repurchases, EPDs, manual underwriting, very weak servicing/collections practices and a weak staff. Other than that, well you get the picture."[237]

Again, he expressed hope that the situation would improve: "The good news is David and his team are pros and are all over it."[238] Two months later, in November 2006, however, the head of WaMu Capital Markets in New York, David Beck, relayed even more bad news to Mr. Schneider, the Home Loans President: "LBMC [Long Beach] paper is among the worst performing in the mkt [market] in 2006."[239]

Despite the additional focus on improving its lending operations throughout 2006, Long Beach was once again flooded with repurchase requests. According to a memorandum later written by an FDIC examination specialist, "[d]uring 2006, more than 5,200 LBMC loans were repurchased, totaling $875.3 million."[240] Even though, in January 2006, the bank had ceased executing whole loan sales which allowed an automatic repurchase in the event of an EPD, 46% of the repurchase volume was as a result of EPDs. Further, 43% of the repurchase volume resulted from first payment defaults (FPDs) in which the borrower missed making the first payment on the loan after it was sold.[241] Another 10% of the repurchases resulted from violations related to representation and warranties (R&W) not included in the EPD or FPD

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[237] 9/14/2006 WaMu internal email, Hearing Exhibit 4/13-12.
[238] Id.
[239] 11/7/2006 WaMu internal email, Hearing Exhibit 4/13-50.
[240] See 6/5/2007 memorandum by Christopher Hovik, Examination Specialist, sent to FDIC Dedicated Examiner Steve Funaro, "WaMu – Long Beach Mortgage Company (LMC) Repurchases," at 1, FDIC_WAMU_000012348, Hearing Exhibit 4/13-13b.
[241] Id.

numbers, meaning the violations were identified only later in the life of the loan.

R&W repurchases generally pose a challenge for a bank's loss reserves, because the potential liability – the repurchase request – continues for the life of the loan. The FDIC memorandum observed:

> "Management claims that R&W provisions are industry standard and indeed they may be. However, I still found that the Mortgage Loan Purchase Agreement contains some representations and warranties worth noting. For example, not only must the loans be 'underwritten in accordance with the seller's underwriting guideline,' but the 'origination, underwriting, and collection practices used by the seller with respect to each mortgage loan have been in all material respects legal, proper, prudent, and customary in the subprime mortgage business.' This provision elevates the potential that investors can put back a problem loan years after origination and not only must the loan have been underwritten in line with bank guidelines but must also have been underwritten in accordance with what is customary with other subprime lenders."[242]

R&W repurchase requests and loss reserves continued to be an issue at Long Beach. The fourth quarter of 2006 saw another spike in R&W repurchase requests, and in December the required amount of R&W loss reserves jumped from $18 million to $76 million.[243]

On December 22, 2006, the FDIC Dedicated Examiner at WaMu, Steve Funaro, sent an email to Mr. Schneider, the Home Loans President, raising questions about the unexpected loan defaults and repurchase demands. He wrote that Long Beach had the "[s]ame issues as FPD last quarter ... Current forecast of 35 to 50m [million] risk." His email also noted potentially insufficient loss reserves related to WaMu's own subprime conduit that purchased subprime loans from other lenders and mortgage brokers, some of which were going out of business and would be unable to shoulder any liability for defaulting loans. His email noted forecasts of early payment defaults totaling $15.6 million and loan delinquencies totaling $10.7 million, in addition to other problems, and asked: "Why the miss? ... Who is accountable?"[244]

Mr. Schneider forwarded the email to his team and expressed frustration at Long Beach's continuing problems:

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[242] Id.
[243] Id. at 3.
[244] 12/22/2006 email from Steve Funaro to David Schneider, Hearing Exhibit 4/13-13a.

"Short story is this is not good. ... There is [a] growing potential issue around Long Beach repurchases .... [W]e have a large potential risk from what appears to be a recent increase in repurchase requests. ... We are all rapidly losing credibility as a management team."[245]

Performance in 2007 Worsens. The following year, 2007, was no better as the performance of WaMu's loan portfolio continued to deteriorate. WaMu's chief risk officer, Ron Cathcart, asked WaMu's Corporate Credit Review team to assess the quality of Long Beach loans and RMBS securities in light of the slowdown and decline in home prices in some areas.[246] In January 2007, he forwarded an email with the results of the review, which identified "key risk issues" related to recent loans and described deteriorating loan performance at Long Beach. The "top five priority issues" were:

"Appraisal deficiencies that could impact value and were not addressed[;]
Material misrepresentations relating to credit evaluation were confirmed[;]
Legal documents were missing or contained errors or discrepancies[;]
Credit evaluation or loan decision errors[; and]
Required credit documentation was insufficient or missing from the file."[247]

The review also found: "[D]eterioration was accelerating in recent vintages with each vintage since 2002 having performed worse than the prior vintage." Mr. Cathcart also expressed concern that problems were not being reported to senior management. He wrote: "Long Beach represents a real problem for WaMu. ... I am concerned that Credit Review may seem to have been standing on the sidelines while problems continue. For instance, why have Cathcart, Schneider, Rotella and Killinger received NO report on any of this?"[248]

In February 2007, WaMu senior managers discussed "how best to dispose" of $433 million in Long Beach performing second lien loans, due to "disarray" in the securitization market.[249] David Beck, head of

[245] 12/2006 WaMu internal email, Hearing Exhibit 4/13-13a.
[246] 12/7/2006 email from Ron Cathcart to his colleagues, Hearing Exhibit 4/13-15.
[247] 1/2/2007 email from Ron Cathcart to Cory Gunderson, Hearing Exhibit 4/13-16.
[248] Id.
[249] 2/2007 email chain among WaMu personnel, JPM_WM00673101-03, Hearing Exhibit 4/13-17.

WaMu's Wall Street operation, wrote that securitizing the loans was "not a viable exit strategy" and noted:

> "Investors are suffering greater than expected losses from subprime in general as well as subprime 2nd lien transactions. As you know, they are challenging our underwriting representations and warrants. Long Beach was able to securitize 2nd liens once in 2006 in May. We sold the BBB- bonds to investors at Libor +260. To date, that transaction has already experienced 7% foreclosures."[250]

WaMu CEO Killinger complained privately to President Steve Rotella:

> "Is this basically saying that we are going to lose 15 [percent] on over $400 million of this product or 60 million. That is a pretty bad hit that reflects poorly on credit and others responsibility for buying this stuff. Is this showing up in hits to compensation or personnel changes."[251]

WaMu President Rotella responded:

> "This is second lien product originated 7-10 months ago from Long Beach. ... In 2006 Beck's team started sprinkling seconds in deals as they could. And, we now have the % down to the low single digits, so that we can sell all into our deals (assuming the market doesn't get even worse)."

He continued: "In terms of folks losing their jobs, the people largely responsible for bringing us this stuff are gone, the senior management of LB."[252]

Also in February 2007, early payment defaults again ticked up. A review of the first quarter of 2007 found: "First payment defaults (FPDs) rose to 1.96% in March but are projected to fall back to 1.87% in April based on payments received through May 5th."[253] It also reported that the findings from a "deep dive into February FPDs revealed" that many of the problems could have been eliminated had existing guidelines been followed:

[250] Id. at JPM_WM00673103.
[251] Id. at JPM_WM00673101.
[252] Id.
[253] "Quarterly Credit Risk Review SubPrime," prepared by WaMu Home Loans Risk Management (1st Quarter, 2007), Hearing Exhibit 4/13-18.

"The root cause of over 70% of FPDs involved operational issues such as missed fraud flags, underwriting errors, and condition clearing errors. This finding indicates there may be opportunities to improve performance without further restricting underwriting guidelines."[254]

In June 2007, WaMu decided to discontinue Long Beach as a separate entity, and instead placed its subprime lending operations in a new WaMu division called "Wholesale Specialty Lending." That division continued to purchase subprime loans and issue subprime securitizations.

Some months later, an internal WaMu review assessed "the effectiveness of the action plans developed and implemented by Home Loans to address" the first payment default problem in the Wholesale Specialty Lending division.[255] After reviewing 187 FPD loans from November 2006 through March 2007, the review found:

"The overall system of credit risk management activities and process has major weaknesses resulting in unacceptable level of credit risk. Exposure is considerable and immediate corrective action is essential in order to limit or avoid considerable losses, reputation damage, or financial statement errors."[256]

In particular, the review found:

"Ineffectiveness of fraud detection tools – 132 of the 187 (71%) files were reviewed … for fraud. [The review] confirmed fraud on 115 [and 17 were] … 'highly suspect'. ... Credit weakness and underwriting deficiencies is a repeat finding …. 80 of the 112 (71%) stated income loans were identified for lack of reasonableness of income[.] 133 (71%) had credit evaluation or loan decision errors …. 58 (31%) had appraisal discrepancies or issues that raised concerns that the value was not supported."[257]

July 2007 was a critical moment not only for WaMu, but also for the broader market for mortgage securities. In that month, Moody's and S&P downgraded the ratings of hundreds of RMBS and CDO securities, including 40 Long Beach subprime securities.[258] The mass downgrades

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254 Id.
255 9/28/2007 "Wholesale Specialty Lending-FPD," WaMu Corporate Credit Review, JPM_WM04013925, Hearing Exhibit 4/13-21.
256 Id. at 2.
257 Id. at 3.
258 7/10/2007-7/12/2007 excerpts from Standard & Poor's and Moody's Downgrades, Hearing Exhibit 4/23-99.

caused many investors to immediately stop buying subprime RMBS securities, and the securities plummeted in value. Wall Street firms were increasingly unable to find investors for new subprime RMBS securitizations.

In August 2007, WaMu's internal audit department released a lengthy audit report criticizing Long Beach's poor loan origination and underwriting practices.[259] By that time, Long Beach had been rebranded as WaMu's Wholesale Specialty Lending division, the subprime market had collapsed, and subprime loans were no longer marketable. The audit report nevertheless provided a detailed and negative review of its operations:

> "[T]he overall system of risk management and internal controls has deficiencies related to multiple, critical origination and underwriting processes .... These deficiencies require immediate effective corrective action to limit continued exposure to losses. ... Repeat Issue – Underwriting guidelines established to mitigate the risk of unsound underwriting decisions are not always followed .... Improvements in controls designed to ensure adherence to Exception Oversight Policy and Procedures is required .... [A]ccurate reporting and tracking of exceptions to policy does not exist."[260]

In response, Mr. Rotella wrote to WaMu's General Auditor: "This seems to me to be the ultimate in bayonetting the wounded, if not the dead."[261]

Subprime Lending Ends. In September 2007, with investors no longer interested in buying subprime loans or securitizations, WaMu shut down all of its subprime operations.[262] During the prior year, which was their peak, Long Beach and WaMu had securitized $29 billion in subprime loans; by 2007, due to the collapse of the subprime secondary market, WaMu's volume for the year dropped to $5.5 billion. Altogether, from 2000 to 2007, Long Beach and WaMu had securitized at least $77 billion in subprime loans.[263]

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[259] 8/20/2007 "Long Beach Mortgage Loan Origination & Underwriting," WaMu audit report, JPM_WM02548939, Hearing Exhibit 4/13-19.
[260] Id. at JPM_WM02548940-41.
[261] 8/21/2007 email from Steve Rotella to Randy Melby, JPM_WM04859837, Hearing Exhibit 4/13-20.
[262] "Washington Mutual Regulators Timeline," chart prepared by the Subcommittee, Hearing Exhibit 4/16-1j.
[263] "Securitizations of Washington Mutual Subprime Home Loans," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1c.

When asked about Long Beach at the Subcommittee's hearing, all of the WaMu former managers who testified remembered its operations as being problematic, and could not explain why WaMu failed to strengthen its operations. Mr. Vanasek, former Chief Risk Officer, testified that Long Beach did not have an effective risk management regime when he arrived at WaMu in 1999, and that it had not developed an effective risk management regime by the time he retired at the end of 2005.[264] Likewise, Mr. Cathcart, who replaced Mr. Vanasek as Chief Risk Officer, testified that Long Beach never developed effective risk management during the course of his tenure.[265]

At the April 13 Subcommittee hearing, Senator Levin asked Mr. Vanasek: "Is it fair to say that WaMu is not particularly worried about the risk associated with Long Beach subprime mortgages because it sold those loans and passed the risk on to investors?" Mr. Vanasek replied: "Yes, I would say that was a fair characterization."[266]

Home Loans President David Schneider, who had direct responsibility for addressing the problems at Long Beach, testified that he tried to improve Long Beach, but "ultimately decided … Long Beach was an operation that we should shut down."[267] WaMu President Steve Rotella also acknowledged the inability of WaMu management to resolve the problems at Long Beach:

> "We did bring the volume in Long Beach down substantially every quarter starting in the first quarter of 2006. As we went through that process, it became increasingly clear, as I have indicated in here, that the problems in Long Beach were deep and the only way we could address those were to continue to cut back volume and ultimately shut it down."[268]

Community Impact. Long Beach's poor quality loans not only proved unprofitable for many investors, they were often devastating for the borrowers and their communities. Mr. Killinger testified at the Subcommittee hearing that WaMu, "entered the subprime business with our purchase of Long Beach Mortgage in 1999 to better serve an underserved market."[269] But the unfortunate result of many Long Beach loans was that they left communities reeling from widespread foreclosures and lost homes.

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[264] April 13, 2010 Subcommittee Hearing at 22.
[265] Id.
[266] Id. at 23.
[267] Id. at 55.
[268] Id. at 90.
[269] Id. at 86.

In November 2008, the Office of the Comptroller of the Currency (OCC) which oversees all nationally chartered banks, identified the ten metropolitan areas across the United States with the highest rates of foreclosure for subprime and Alt A mortgages originated from 2005 through 2007.[270] Those ten areas were, in order: Detroit, Cleveland, Stockton, Sacramento, Riverside/San Bernardino, Memphis, Miami/Fort Lauderdale, Bakersfield, Denver, and Las Vegas. The OCC then identified the lenders with the highest foreclosure rates in each of those devastated cities. Long Beach had the worst foreclosure rate in four of those areas, and was near the worst in five more, with the lone exception being Las Vegas. The OCC data also showed that, overall in the ten metropolitan areas, Long Beach mortgages had the second worst foreclosure rate of all the lenders reviewed, with over 11,700 foreclosures at the time of the report. Only New Century was worse.

(2) WaMu Retail Lending

Washington Mutual's problems were not confined to its subprime operations; they also affected its retail operations. WaMu loosened underwriting standards as part of its High Risk Lending Strategy, and received repeated criticisms from its regulators, as outlined in the next chapter, for weak underwriting standards, risk layering, excessive loan error and exception rates, appraisal problems, and loan fraud. In August 2007, more than a year before the collapse of the bank, WaMu's President Steve Rotella emailed CEO Kerry Killinger saying that, aside from Long Beach, WaMu's prime home loan business "was the worst managed business I had seen in my career."[271]

(a) Inadequate Systems and Weak Oversight

One reason for WaMu's poor lending practices was its failure to adequately monitor the hundreds of billions of dollars of residential loans being issued each year by its own loan personnel. From 1990 until 2002, WaMu acquired more than 20 new banks and mortgage companies, including American Savings Bank, Great Western Bank, Fleet Mortgage Corporation, Dime Bancorp, PNC Mortgage, and Long Beach. WaMu struggled to integrate dozens of lending platforms, information technology systems, staffs, and policies, whose inconsistencies and gaps exposed the bank to loan errors and fraud.

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[270] 11/13/2008 "Worst Ten in the Worst Ten," document prepared by the Office of the Comptroller of the Currency, http://www.occ.treas.gov/news-issuances/news-releases/2009/nr-occ-2009-112b.pdf, Hearing Exhibit 4/13-58.

[271] 8/23/2007 email from Mr. Rotella to Mr. Killinger, JPM_WM00675851, Hearing Exhibit 4/13-79.

To address the problem, WaMu invested millions of dollars in a technology program called Optis, which WaMu President Rotella described in the end as "a complete failure" that the bank "had to write off" and abandon.[272] In 2004, an OTS Report of Examination (ROE), which was given to the bank's Board of Directors, included this observation:

> "Our review disclosed that past rapid growth through acquisition and unprecedented mortgage refinance activity placed significant operational strain on [Washington Mutual] during the early part of the review period. Beginning in the second half of 2003, market conditions deteriorated, and the failure of [Washington Mutual] to fully integrate past mortgage banking acquisitions, address operational issues, and realize expectations from certain major IT initiatives exposed the institution's infrastructure weaknesses and began to negatively impact operating results."[273]

The records reviewed by the Subcommittee showed that, from 2004 until its shuttering in 2008, WaMu constantly struggled with information technology issues that limited its ability to monitor loan errors, exception rates, and indicators of loan fraud.

From 2004 to 2008, WaMu's regulators also repeatedly criticized WaMu's failure to exercise sufficient oversight of its loan personnel to reduce excessive loan error and exception rates that allowed the issuance of loans in violation of WaMu's credit standards.[274] In 2004, Craig Chapman, then the President of WaMu Home Loans, visited a number of the bank's loan centers around the country. Lawrence Carter, then OTS Examiner-in-Charge at WaMu, spoke with Mr. Chapman about what he found. Recalling that conversation in a later email, Mr. Carter wrote:

> "Craig has been going around the country visiting home lending and fulfillment offices. His view is that band-aids have been used to address past issues and that there is a fundamental absence of process."[275]

The regulators' examination reports on WaMu indicate that its oversight efforts remained weak. In February 2005, OTS stated that

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[272] Subcommittee interview of Steve Rotella (2/24/2010).

[273] See 3/15/2004 OTS Report of Examination, at OTSWMS04-0000001482, Hearing Exhibit 4/16-94 [Sealed Exhibit]. See also, e.g., 12/17/2004 email exchange among WaMu executives, "Risks/Costs to Moving GSE Share to FH," JPM_WM05501400, Hearing Exhibit 4/16-88 (noting that Fannie Mae "is well aware of our data integrity issues (miscoding which results in misdeliveries, expensive and time consuming data reconciliations), and has been exceedingly patient.").

[274] See, e.g., OTS examination reports cited in Chapter IV, below.

[275] 8/13/2004 email from Lawrence Carter to Michal Finn, Finn_Michael-00005331.

WaMu's loan underwriting "has been an area of concern for several exams."[276] In June 2005, OTS expressed concern about the bank's underwriting exceptions and policy compliance.[277] In August of the same year, the OTS Report of Examination stated that, "the level of deficiencies, if left unchecked, could erode the credit quality of the portfolio," and specifically drew attention to WaMu concentrations in higher risk loans that were a direct result of its High Risk Lending Strategy.[278] 2006 was no better. OTS repeatedly criticized the level of underwriting exceptions and errors.[279]

Another problem was the weak role played by WaMu's compliance department. In March 2007, an OTS examiner noted that WaMu had just hired its "ninth compliance leader since 2000," and that its "compliance management program has suffered from a lack of steady, consistent leadership." The examiner added: "The Board of Directors should commission an evaluation of why smart, successful, effective managers can't succeed in this position. ... (HINT: It has to do with top management not buying into the importance of compliance and turf warfare and Kerry [Killinger] not liking bad news.)"[280]

Still another problem was that WaMu failed to devote sufficient resources to overseeing the many loans it acquired from third party lenders and mortgage brokers. The 2010 Treasury and FDIC IG report found that, from 2003 to 2007, a substantial portion of WaMu's residential loans – from 48% to 70% – came from third party lenders and brokers.[281] The IG report also found:

> "The financial incentive to use wholesale loan channels for production was significant. According to an April 2006 internal presentation to the WaMu Board, it cost WaMu about 66 percent less to close a wholesale loan ($1,809 per loan) than it did to close a retail loan ($5,273). Thus, WaMu was able to reduce its cost of

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[276] 2/7/2005 OTS Letter to Washington Mutual Board of Directors on Matters Requiring Board Attention, OTSWMEF-0000047591, Hearing Exhibit 4/16-94 [Sealed Exhibit]. See the Regulator Chapter of this Report for more information.

[277] 6/3/2005 OTS Findings Memorandum, "Single Family Residential Home Loan review," OTSWME05-004 0000392, Hearing Exhibit 4/16-26. For more information, see Chapter IV, below.

[278] 3/14/2005 OTS Report of Examination, OTSWMS05-004 0001794, Hearing Exhibit 4/16-94 [Sealed Exhibit]. (Examination findings were issued to WaMu on August 28, 2005.)

[279] See, for example, 5/23/2006 OTS Exam Finding Memo, "Home Loan Underwriting, " OTSWMS06-008 0001299, Hearing Exhibit 4/16-33; and 8/29/2006 OTS Report of Examination, OTSWMS06-008 0001690, Hearing Exhibit 4/16-94 [Sealed Exhibit].

[280] 5/31/2007 Draft OTS Findings Memorandum, "Compliance Management Program," Franklin_Benjamin-00020408_001, Hearing Exhibit 4/16-9.

[281] 4/2010 IG Report, at 23, Hearing Exhibit 4/16-82.

operations through the use of third-party originators but had far less oversight over the quality of originations."[282]

During its last five years, WaMu accepted loans from tens of thousands of third party brokers and lenders across the country, not only through its wholesale and correspondent channels, but also through its securitization conduits that bought Alt A and subprime loans in bulk. Evidence gathered by the Subcommittee from OTS examination reports, WaMu internal documents, and oral testimony shows that WaMu exercised weak oversight over the thousands of brokers submitting loans. For example, a 2003 OTS report concluded that WaMu's "annual review and monitoring process for wholesale mortgage brokers was inadequate, as management did not consider key performance indicators such as delinquency rates and fraud incidents."[283] A 2003 WaMu quality assurance review found an "error rate of 29 percent for wholesale mortgage loans, more than triple the acceptable error rate of 8 percent established by WaMu."[284] A 2004 OTS examination noted that 20,000 brokers and lenders had submitted loans to WaMu for approval during the year, a volume that was "challenging to manage."[285] A 2005 internal WaMu investigation of two high volume loan centers in Southern California that accepted loans from brokers found that "78% of the funded retail broker loans reviewed were found to contain fraud."[286] A 2006 internal WaMu inquiry into why loans purchased through its subprime conduit were experiencing high delinquency rates found the bank had securitized broker loans that were delinquent, not underwritten to standards, and suffering from "lower credit quality."[287]

OTS examinations in 2006 and 2007 also identified deficiencies in WaMu's oversight efforts.[288] For example, a 2007 OTS memorandum found that, in 2007, Washington Mutual had only 14 full-time employees overseeing more than 34,000 third party brokers submitting loans to the bank for approval,[289] which meant that each WaMu employee oversaw more than 2,400 brokers. The OTS examination not only questioned the staffing level, but also criticized the scorecard WaMu used to rate the mortgage brokers, which did not include the rates at which significant lending or documentation deficiencies were

[282] Id. at 23.
[283] Id.
[284] Id. at 24.
[285] Id.
[286] 11/16/2005 "Retail Fraud Risk Overview," prepared by WaMu Credit Risk Management, at JPM_WM02481938, Hearing Exhibit 4/13-22b.
[287] 12/12/2006 WaMu Market Risk Committee Minutes, JPM_WM02095545, Hearing Exhibit 4/13-28.
[288] 4/2010 IG Report, at 24-25, Hearing Exhibit 4/16-82.
[289] 6/7/2007 OTS Asset Quality Memo 11, "Broker Credit Administration," Hedger_Ann-00027930_001, Hearing Exhibit 4/16-10.

attributed to the broker, the rate at which the broker's loans were denied or produced unsaleable loans, or any indication of whether the broker was included on industry watch lists for prior or suspected misconduct.

In 2006, federal regulators issued Interagency Guidance on Nontraditional Mortgage Product Risks (NTM Guidance) providing standards on how banks "can offer nontraditional mortgage products in a safe and sound manner."[290] It focused, in part, on the need for banks to "have strong systems and controls in place for establishing and maintaining relationships" with third party lenders and brokers submitting high risk loans for approval. It instructed banks to monitor the quality of the submitted loans to detect problems such as "early payment defaults, incomplete documentation, and fraud." If problems arose, the NTM Guidance directed banks to "take immediate action":

> "Oversight of third party brokers and correspondents who originate nontraditional mortgage loans should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations. ... If appraisal, loan documentation, credit problems or consumer complaints are discovered, the institution should take immediate action."[291]

WaMu did, at times, exercise oversight of its third party brokers. A 2006 credit review of its subprime loans, for example, showed that Long Beach – which by then reported to the WaMu Home Loans Division – had terminated relationships with ten brokers in 2006, primarily because their loans had experienced high rates of first payment defaults requiring Long Beach to repurchase them at significant expense.[292] But terminating those ten brokers was not enough to cure the many problems with the third party loans WaMu acquired. The report also noted that, in 2006, apparently for the first time, Long Beach had introduced "collateral and broker risk" into its underwriting process.[293]

WaMu closed down its wholesale and subprime channels in 2007, and its Alt A and subprime securitization conduits in 2008.

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[290] 10/4/2006 "Interagency Guidance on Nontraditional Mortgage Product Risks," (NTM Guidance), 71 Fed. Reg. 192 at 58609.
[291] Id. at 58615.
[292] 12/2006 "Home Loans – SubPrime Quarterly Credit Risk Review," JPM_WM04107374, Hearing Exhibit 4/13-14.
[293] Id. at JPM_WM04107375.

(b) Risk Layering

During the five-year period reviewed by the Subcommittee, from 2004 to 2008, WaMu issued many loans with multiple higher risk features, a practice known as "risk layering." At the April 13 Subcommittee hearing, Mr. Vanasek, its Chief Risk Officer from 2004 to 2005, testified about the dangers of this practice:

> "It was the layering of risk brought about by these incremental changes that so altered the underlying credit quality of mortgage lending which became painfully evident once housing prices peaked and began to decline. Some may characterize the events that took place as a 'perfect storm,' but I would describe it as an inevitable consequence of consistently adding risk to the portfolio in a period of inflated housing price appreciation."[294]

Stated Income Loans. One common risk layering practice at WaMu was to allow borrowers to "state" the amount of their annual income in their loan applications without any direct documentation or verification by the bank. Data compiled by the Treasury and the FDIC IG report showed that, by the end of 2007, 50% of WaMu's subprime loans, 73% of its Option ARMs, and 90% of its home equity loans were stated income loans.[295] The bank's acceptance of unverified income information came on top of its use of loans with other high risk features, such as borrowers with low credit scores or the use of low initial teaser interest rates followed by much higher rates.

Stated income loans were originally developed to assist self employed individuals that had good credit and high net worth to obtain loans they could afford. But from 2004 to 2008, stated income loans became much more widespread, including with respect to a wide variety of high risk loans.[296] Mr. Cathcart testified at the Subcommittee hearing:

> "[Stated income loans] originated as a product for self-employed individuals who didn't have pay stubs and whose financial statements didn't necessarily reflect what they made. It was intended to be available for only the most creditworthy borrowers and it was supposed to be tested for reasonableness so that a person

[294] April 13, 2010 Subcommittee Hearing at 16.
[295] 4/2010 IG Report, at 10, Hearing Exhibit 4/16-82.
[296] See, e.g., NTM Guidance at 58614 ("Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans."). The NTM Guidance directed banks to use stated income loans "with caution," but did not prohibit them or even issue guidance limiting their use. Id. at 58611.

who said that they were a waiter or a lower-paid individual couldn't say that they had an income of $100,000.

"I think that the standards eroded over time. At least I have become aware, reading all that has happened ... standards eroded over time and that it became a competitive tool that was used by banks to gather business, so that if a loan consultant could send his loan to Bank A or Bank B, the consultant would say, well, why don't you go to Bank B? You don't have to state your income.

"I do think, thinking it through, that there was a certain amount of coaxing that was possible between the loan consultant and the individual, which would be something which would be invisible to a bank that received the application and the only test for that would be reasonableness, which as you have heard there were some issues within the portfolio."[297]

WaMu required its loan personnel to determine whether a loan applicant's stated income was reasonable, but evidence obtained by the Subcommittee indicates that requirement was not effectively implemented. A 2008 press report about a WaMu stated income loan is illustrative:

"As a supervisor at a Washington Mutual mortgage processing center, John D. Parsons was accustomed to seeing baby sitters claiming salaries worthy of college presidents, and schoolteachers with incomes rivaling stockbrokers. He rarely questioned them. A real estate frenzy was under way and WaMu, as his bank was known, was all about saying yes.

"Yet even by WaMu's relaxed standards, one mortgage four years ago raised eyebrows. The borrower was claiming a six-figure income and an unusual profession: mariachi singer.
"Mr. Parsons could not verify the singer's income, so he had him photographed in front of his home dressed in his mariachi outfit. The photo went into a WaMu file. Approved."[298]

Instead of verifying borrower income, WaMu loan personnel apparently focused instead on borrower credit scores, as a proxy measure of a borrower's creditworthiness. The problem with this

[297] April 13, 2010 Subcommittee Hearing at 41.
[298] "Saying Yes, WaMu Built Empire on Shaky Loans," New York Times (12/27/08). When asked about this press report, WaMu told the Subcommittee that it had no record of this loan, but could not deny that the incident took place as reported. See also, in the following subsection, a WaMu loan issued to a "Sign Designer" who claimed earnings of $34,000 per month.

approach, however, was that a person could have a high credit score – reflecting the fact that they paid their bills on time – and still have an income that was insufficient to support the mortgage amount being requested.

High LTV Ratios. A second risk-layering practice at WaMu involved loan-to-value (LTV) ratios. LTV ratios are a critical risk management tool, because they compare the loan amount to the estimated dollar value of the property. If an LTV ratio is too high and the borrower defaults, the sale of the property may not produce sufficient proceeds to pay off the loan. In interagency guidance, federal banking regulators noted that banks should generally avoid issuing loans with LTV ratios over 80%, and directed banks to ensure that loans with LTV ratios of 90% or more have additional credit support such as mortgage insurance or added collateral.[299] The Treasury and the FDIC IG report found that WaMu held a "significant percentage" of home loans in which the LTV ratios exceeded 80%.[300]

These loans were the result of explicit WaMu policies allowing high LTV ratios to be used in loans that already had other high risk features. In February 2005, for example, WaMu set up automated loan approval parameters to approve loans with a 90% LTV in Option ARM and interest-only loans providing financing of up to $1 million.[301] Still another layer of risk was added to these loans by permitting the borrowers to have credit scores as low as 620.

The Treasury and the FDIC IG report determined that 44% of WaMu's subprime loans and 35% of its home equity loans had LTV ratios in excess of 80%.[302] These loans resulted in part from a 2006 WaMu decision to combine home equity loans bearing high LTV ratios with borrowers bearing low credit scores. That initiative was discussed in a June 2006 email sent to Mr. Rotella, after he inquired about the project. He was informed:

> "$4 billion home equity investment program [was] approved … last Friday. High CLTVs [Combined Loan-to-Value ratios] (up to

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[299] See 10/8/1999 "Interagency Guidance on High LTV Residential Real Estate Lending," http://www.federalreserve.gov/boarddocs/srletters/1993/SR9301.htm.
[300] 4/2010 IG Report, at 10, Hearing Exhibit 4/16-82.
[301] 2/2005 email chain between Timothy Bates, Tony Meola, Mr. Rotella and others, JPM_WM00616783-84.
[302] 4/2010 IG Report, at 10, Hearing Exhibit 4/16-82. See also 3/1/2007 Washington Mutual Inc. 10-K filing with the SEC, at 52 (showing that, as of 12/31/2006, WaMu held $7.4 billion in home mortgages without private mortgage insurance or government guarantees with LTV ratios in excess of 80%, and $15 billion in home equity loans and lines of credit with LTV ratios in excess of 80%).

100%) and lower FICOs (down to 600) permitted with some concentration limits."[303]

In order to issue these loans as soon as possible in 2006, WaMu set up an underwriting team to provide "manual" approvals outside of its automated systems:

> "Our team is currently focused on several HE [Home Equity] modeling initiatives to include higher risk lending .... [W]e are adjusting our decision engine rules for a July roll out to allow for 580-620 [FICO scores] and LT 80% CLTV [combined loan-to-value] loans to be referred to a manual 'sub-prime' underwriting team that we are putting in place. ... [W]e see this 580-620 segment as the biggest opportunity where we aren't lending today."[304]

Also in 2006, WaMu began issuing so-called "80/20 loans," in which a package of two loans are issued together, imposing an 80% LTV first lien and a 20% LTV second lien on the property, for a total combined LTV (CLTV) of 100%.[305] Loans that provide financing for 100% of a property's value are extremely high risk, because the borrower has no equity in the property, the borrower can stop payments on the loan without losing a personal investment, and a subsequent home sale may not produce sufficient funds to pay off the debt.[306] Yet in 2006, Home Loans Division President David Schneider approved issuing 80/20 loans despite the risk and despite the fact that WaMu's automatic underwriting system was not equipped to accept them, and loan officers initially had to use a manual system to issue the loans.[307]

Using Low Interest Rates to Qualify Borrowers. A third risk layering practice at WaMu was allowing loan officers to qualify prospective borrowers for short term hybrid ARMs or Option ARMs based upon only the initial low rate and not the higher interest rate that

[303] 6/13/2006 email from Cheryl Feltgen to David Schneider who forwarded it to Steve Rotella, JPM_WM01311922-23.
[304] 6/14/2006 email from Mark Hillis to Cheryl Feltgen, included in a longer email chain involving Mr. Rotella and Mr. Schneider, among others, JPM_WM01311922.
[305] See, e.g., 6/2006 email chain between Mr. Rotella, Mr. Schneider, Mr. Hillis, and Ms. Feltgen, JPM_WM01311922-23.
[306] See NTM Guidance at 58614. See also SEC v. Mozilo, Case No. CV09-03994 (USDC CD Calif.), Complaint (June 4, 2009), at ¶ 50 (quoting an email by Countrywide CEO Angelo Mozilo who, when discussing the 80/20 loans being issued by his bank, wrote: "In all my years in the business I have never seen a more toxic pr[o]duct.").
[307] Id.; Subcommittee interview of Cheryl Feltgen (2/6/2010). 2/2006 WaMu internal email chain, "FW: 80/20," JPM_WM03960778. See also 3/19/2007 email from Ron Cathcart to David Schneider, JPM_WM02571598, Hearing Exhibit 4/16-75 (indicating WaMu issued loans with CLTVs in excess of 95% until ending the practice in March 2007).

would take effect later on. In a filing with the SEC, for example, Washington Mutual Inc. wrote that its "underwriting guidelines" allowed "borrowers with hybrid adjustable-rate home loans … where the initial interest rate is fixed for 2 to 5 years" to be "qualified at the payment associated with the fixed interest rate charged in the initial contractual period."[308] In addition, in 2005, WaMu personnel informed OTS that, since 2004, the bank had not been qualifying its Option ARM borrowers using the "fully indexed rate."[309] Instead, WaMu was using a lower "administrative" rate that was "significantly less than the fully indexed rate."[310]

Borrowers, loan officers, and WaMu executives often assumed that hybrid and Option ARMs could be refinanced before the payments reset to higher levels – an expectation that eventually proved to be unfounded. In a November 30, 2007 email discussing loan modifications from Mr. Schneider to Mr. Killinger, Mr. Rotella and other senior executives, Mr. Schneider described WaMu's faulty assumptions about the "start rate" and life span of these loans:

> "I also think it is clear that the economic benefit of providing modifications for these borrowers is compelling for the following reasons:
>
> - None of these borrowers ever expected that they would have to pay at a rate greater than the start rate. In fact, for the most part they were qualified at the start rate
> - We need to provide incentive to these borrowers to maintain the home – especially if the home value has declined
> - When we booked these loans, we anticipated an average life of 2 years and never really anticipated the rate adjustments …."[311]

Qualifying borrowers using the lower initial interest rate enabled banks to qualify more borrowers for those loans and enabled them to issue loans for larger amounts. Concerned that more banks were beginning to use this risky practice, federal banking regulators addressed it in the October 2006 NTM Guidance, which cautioned banks to use the

[308] See 3/1/2007 Washington Mutual Inc. 10-K filing with the SEC at 56.

[309] 9/15/2005 email from Darrel Dochow to OTS Examiner-In-Charge at WaMu, OTSWMS05-002 0000537, Hearing Exhibit 4/16-6. The "fully indexed rate" is the prevailing interest rate in the published index to which an adjustable rate mortgage is tied, plus the additional percentage points that the lender adds to the index value to calculate the loan's interest rate. See NTM Guidance at 58614, n.5.

[310] Id.

[311] 11/30/2007 email from David Schneider to John McMurray, Kerry Killinger and others, JPM_WM05382127-28.

fully indexed rate when qualifying borrowers for a loan, including loans with lower initial teaser rates.[312] In addition, the Guidance provided that for negatively amortizing loans, banks should consider not only the "initial loan amount" but also "any balance increase that may accrue from the negative amortization provision."[313] After the NTM Guidance was issued, a WaMu analyst calculated that applying the new requirement to all of its loans would cause a 33% drop in its loan volume due to borrowers who would no longer qualify for its loans:

> "Implementing the NTM change for Purchase only drops additional 2.5% of volume ... If we implement the NTM changes to all loans, then we'll see additional drop of 33% of volume."[314]

In response to this information, WaMu's chief risk officer wrote that the impact on the bank "argues in favor of holding off on implementation until required to act for public relations ... or regulatory reasons."

Because OTS gave the bank more than six months to come into compliance with the NTM Guidance, WaMu continued qualifying high risk borrowers using the lower interest rate, originating billions of dollars in new loans that would later suffer significant losses.

WaMu's risk-layering practices went beyond its use of stated income loans, high LTV ratios, and the qualification of borrowers using low initial interest rates. The bank also allowed its loan officers to issue large volumes of high risk loans to borrowers who did not occupy the homes they were purchasing or had large debt-to-income ratios.[315] On top of those risks, WaMu concentrated its loans in a small number of states, especially California and Florida, increasing the risk that a downturn in those states would have a disproportionate impact upon the delinquency rates of its already high risk loans.

At one point in 2004, Mr. Vanasek made a direct appeal to WaMu CEO Killinger, urging him to scale back the high risk lending practices that were beginning to dominate not only WaMu, but the U.S. mortgage market as a whole. Despite his efforts, he received no response:

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[312] NTM Guidance at 58614.
[313] Id.
[314] 3/19/2007 email from Ron Cathcart to David Schneider, JPM_WM02571598, Hearing Exhibit 4/16-75.
[315] See, e.g., OTS document, "Hybrid ARM Lending Survey" (regarding WaMu), undated but the OTS Examiner-in-Charge estimated it was prepared in March or mid-2007, JPM_WM03190673 ("For Subprime currently up to 100% LTV/CLTV with 50% DTI is allowed for full Doc depending on FICO score. Up to 95% LTV/CLTV is allowed with 50% DTI for Stated Doc depending on FICO score. ... For No Income Verification, No Income No Ratio, and No Income No Asset only up to 95% LTV/CLTV is allowed.").

"As the market deteriorated, in 2004, I went to the Chairman and CEO with a proposal and a very strong personal appeal to publish a full-page ad in the *Wall Street Journal* disavowing many of the then-current industry underwriting practices, such as 100 percent loan-to-value subprime loans, and thereby adopt what I termed responsible lending practices. I acknowledged that in so doing the company would give up a degree of market share and lose some of the originators to the competition, but I believed that Washington Mutual needed to take an industry-leading position against deteriorating underwriting standards and products that were not in the best interests of the industry, the bank, or the consumers. There was, unfortunately, never any further discussion or response to the recommendation."[316]

(c) Loan Fraud

Perhaps the clearest evidence of WaMu's shoddy lending practices came when senior management was informed of loans containing fraudulent information, but then did little to stop the fraud.

Downey and Montebello Fraud Investigations. The most significant example involves an internal WaMu investigation that, in 2005, uncovered substantial evidence of loan fraud involving two top producing loan offices in Southern California. WaMu management was presented with the findings, but failed to respond, leading to the same fraud allegations erupting again in 2007. According to the WaMu Home Loans Credit Risk Mitigation Team that conducted the 2005 internal investigation, it was initiated in response to "a sustained history of confirmed fraud findings over the past three years" involving the two offices, known as Downey and Montebello.[317] Each office was located in a low-income area of Los Angeles and headed by a loan officer who had won repeated WaMu awards for high volume loan production.

To conduct its inquiry, the WaMu Risk Mitigation Team reviewed all of the loans produced by the two offices over a two-month period from August to September 2005, which totaled 751 loans. Analysts scored the loans using a standard electronic fraud detection program, and then reviewed all of the loans flagged for possible fraud, as well as ten percent of the remaining loans.[318] A November 2005 memorandum

[316] April 13, 2010 Subcommittee Hearing at 17.
[317] 11/17/2005 WaMu internal memorandum, "So. CA Emerging Markets Targeted Loan Review Results," JPM_WM01083051, Hearing Exhibit 4/13-22a.
[318] Id.

summarizing the review stated that it found an "extensive level of loan fraud" caused primarily by employees "circumventing" bank policies:

> "[A]n extensive level of loan fraud exists in the Emerging Markets [loan processing centers], virtually all of it stemming from employees in these areas circumventing bank policy surrounding loan verification and review. Of the 129 detailed loan review[s] ... conducted to date, 42% of the loans reviewed contained suspect activity or fraud, virtually all of it attributable to some sort of employee malfeasance or failure to execute company policy. In terms of employee activity enabling this perpetration of fraud, the following categories of activity appeared most frequently: inconsistent application of credit policy, errors or negligence, process design flaws, intentional circumvention of established processes, and overriding automated decisioning recommendations. ... Based on the consistent and pervasive pattern of activity among these employees, we are recommending firm action be taken to address these particular willful behaviors on the part of the employees named."[319]

A presentation prepared for WaMu management provided additional detail.[320] It stated that, out of the 751 loans produced, the Risk Mitigation Team had selected 180 loans for detailed review, of which 129 had been completed.[321] It stated that 42% of the reviewed loans had "contained excessive levels of fraud related to loan qualifying data."[322] It also stated that the fraud findings did not differ between loans originated by WaMu's own loan officers and loans originated by third party brokers and brought to the loan centers.[323] The presentation also stated that the fraud uncovered by the review was found to be "preventable with improved processes and controls."

The presentation indicated that the loan fraud involved primarily "misrepresentation of loan qualifying data," including misrepresentations of income and employment, false credit letters and appraisal issues.[324] The presentation included a few examples of misrepresentations, including:

> "Loan #0694256827[:] Misrepresentation [of] the borrower's identification and qualifying information were confirmed in every

[319] Id.
[320] 11/16/2005 "Retail Fraud Risk Overview," prepared by Credit Risk Management, JPM_WM02481934, Hearing Exhibit 4/13-22b.
[321] Id. at JPM_WM02481940.
[322] Id. at JPM_WM02481936.
[323] Id. at JPM_WM02481936.
[324] Id. at JPM_WM02481938.

aspect of this file, including: – Income – SSN – Assets – Alternative credit reference letters – Possible Strawbuyer or Fictitious borrower[.] The credit package was found to be completely fabricated. Throughout the process, red flags were over-looked, process requirements were waived, and exceptions to policy were granted."[325]

The presentation noted that the loan delinquency rate for Luis Fragoso, the loan officer heading the Montebello loan office, was "289% worse than the delinquency performance for the entire open/active retail channel book of business," while the delinquency rate for Thomas Ramirez, the loan officer heading the Downey loan office was 157% worse.[326] The message from the Risk Mitigation Team was clear that the two head loan officers were willfully flouting bank policy, issuing poor quality loans, and needed to be the subject of "firm action" by the bank.

Three months prior to its formal presentation on the fraud, the Risk Mitigation Team supplied a lengthy email with its fraud findings to colleagues in the credit risk department. The August 2005 email provided spreadsheets containing data collected on the loans from the two offices as well as figures about the types of loans reviewed and fraud found.[327] Among other information, it indicated that at the Downey office, 83 loans had been reviewed, including 28 originated by the WaMu loan officer Thomas Ramirez, and 54 submitted to him by third party brokers; while at the Montebello office, 48 loans had been reviewed, including 19 originated by the WaMu loan officer Luis Fragoso and 29 submitted to him by third party brokers. The email was forwarded by a credit risk officer to WaMu's Chief Risk Officer Jim Vanasek, with the following comment:

> "As you requested in our Enterprise Fraud Committee meeting last Friday, the attached email contains a high-level summary of the investigations the Home Loans Risk Mit team has conducted on [the two offices] over the past year and a half, based on loans that were referred to them. ... As you can see, among the referred cases there is an extremely high incidence of confirmed fraud (58% for Ramirez, 83% for Fragoso) .... [Additional analysis] will allow us to substantially validate what we suspect, which is that the

[325] Id. at JPM_WM02481943.
[326] Id. at JPM_WM02481948.
[327] 8/29/2005 email from Jill Simons to Tim Bates, JPM_WM04026076-77, Hearing Exhibit 4/13-23b.

incidence of fraud in this area is greater than with other producers."[328]

At the Subcommittee hearing, Mr. Vanasek agreed these were "eye popping" rates of fraud.[329]

On November 18, 2005, Cheryl Feltgen, the Home Loans Chief Credit Officer, "had a very quick meeting" with Home Loans President David Schneider, the head of Home Loans sales, Tony Meola, and others in which she reviewed the memorandum and presentation on the fraud investigation.[330] After the meeting, she sent an email to the Risk Mitigation Team stating: "The good news is that people are taking this very seriously. They requested some additional information that will aid in making some decisions on the right course of action."[331] She asked the Risk Mitigation Team to prepare a new spreadsheet with the loan information, which the team did over the weekend in anticipation of a Monday meeting.

The trail of documentation in 2005 about the fraud investigation ends there. Despite the year-long effort put into the investigation, the written materials prepared, the meetings held, and fraud rates in excess of 58% and 83% at the Downey and Montebello offices, no discernable actions were taken by WaMu management to address the fraud problem in those two offices. No one was fired or disciplined for routinely violating bank policy, no anti-fraud program was installed, no notice of the problem was sent to the bank's regulators, and no investors who purchased RMBS securities containing loans from those offices were alerted to the fraud problem underlying their high delinquency rates. Mr. Vanasek retired from the bank in December 2005, and the new Chief Risk Officer Ron Cathcart was never told about the fraud investigation. Senior personnel, including Mr. Schneider, Mr. Meola, and Ms. Feltgen, failed to follow up on the matter.

Over the next two years, the Downey and Montebello head loan officers, Messrs. Ramirez and Fragoso, continued to issue high volumes of loans[332] and continued to win awards for their loan productivity, including winning trips to Hawaii as members of WaMu's "President's

[328] 8/30/2005 email from Tim Bates to Jim Vanasek and others, JPM_WM04026075, Hearing Exhibit 4/13-23b.
[329] April 13, 2010 Subcommittee Hearing at 28.
[330] 11/18/2005 email from Cheryl Feltgen to Nancy Gonseth on the Risk Mitigation Team and Tim Bates, JPM_WM03535695, Hearing Exhibit 4/13-23a.
[331] Id.
[332] At the Subcommittee's hearing, Mr. Vanasek testified that as much as $1 billion in loans originated out of these two offices per year. April 13, 2010 Subcommittee Hearing at 27.

Club." One of the loan officers even suggested to bank President Steve Rotella ways to further relax bank lending standards.[333]

In June 2007, however, the fraud problem erupted again. That month, AIG, which provided mortgage insurance for some of WaMu's residential mortgages, contacted the bank with concerns about material misrepresentations and fraudulent documents included in mortgages being issued by Mr. Fragoso, the loan officer heading the Montebello office.[334] When no one responded to its concerns, in September 2007, AIG filed a Suspected Fraud Claim with the California Department of Insurance which, in turn, notified OTS of the problem.[335] The OTS Examiner-in-Charge at WaMu at the time, Benjamin Franklin, asked the bank to conduct an investigation into the matter.[336] WaMu's legal department asked the WaMu Corporate Fraud Investigation (CFI) group and the Audit department to conduct a joint inquiry.

Seven months later, in April 2008, CFI and the Audit department issued a 12-page memorandum with their findings.[337] The memorandum not only confirmed the presence of fraud in the Montebello office, citing a loan file review that found a fraud rate of 62%, it also uncovered the 2005 investigation that had identified the problem two years earlier, but was ignored by management. The 2008 memorandum stated:

> "In 2005, HL [Home Loans] Risk Mitigation provided Senior HL Management with an assessment of fraud and loan performance in the Retail Broker Program and two Southern California Emerging Markets [loan centers] for the period of September 2003 through August 2005. This assessment identified excessive levels of fraud related to loan qualifying data .... It also highlighted the Downey and Montebello [loan centers] as the primary contributors of these fraudulent loan documents based upon volume and articulated strategies to mitigate fraud. The report also stated that delinquency performance on these [loan centers] ... were significantly worse that the delinquency performance for the entire open/active retail channel book of business. In 2007, HL Risk Mitigation mirrored their 2005 review with a smaller sample of loans and found that, for the September and October 2007 sampled time period, the

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333 See, e.g., 3/2006 WaMu email chain, JPM_WM03985880-83.
334 4/4/2008 WaMu Memorandum of Results, "AIG/UG and OTS Allegation of Loan Frauds Originated by [name redacted]," at 1, Hearing Exhibit 4/13-24.
335 Id.
336 Subcommittee interview of Benjamin Franklin (2/18/2010).
337 4/4/2008 WaMu Memorandum of Results, "AIG/UG and OTS Allegation of Loan Frauds Originated by [name redacted]," at 1, Hearing Exhibit 4/13-24.

volume of misrepresentation and suspected loan fraud continued to be high for this [loan center] (62% of the sampled loans)."[338]

Examples of fraudulent loan information uncovered in the 2007 review included falsified income documents, unreasonable income for the stated profession, false residency claims, inflated appraisal values, failure of the loan to meet bank guidelines, suspect social security numbers, misrepresented assets, and falsified credit information.[339]

The memorandum found that, in 2005, the WaMu Risk Mitigation Team had reported its findings to several WaMu managers whom it "felt were very aware of high volumes of fraud" in the loans issued by the two loan officers.[340] The memorandum reported that one individual believed that David Schneider "was made aware of these findings" and wanted Risk Mitigation to "monitor the situation."[341] But no one knew "of additional monitoring that was done, or efforts to bring additional attention to" the fraudulent loans from the Downey and Montebello offices. The memorandum also noted that no personnel action had been taken against either of the loan officers heading the two offices.[342] David Schneider was interviewed and "recalled little about the 2005 fraud findings or actions taken to address them."[343] He "thought the matter was handled or resolved." The WaMu memorandum concluded:

> "Outside of training sessions ... in late 2005, there was little evidence that any of the recommended strategies were followed or that recommendations were operationalized. There were no targeted reviews conducted ... on the Downey or Montebello loan portfolios between 2005 and the actions taken in December 2007."[344]

After the memorandum was issued, WaMu initially resisted providing a copy to OTS, claiming it was protected by attorney-client privilege.[345] The OTS Examiner-in-Charge Benjamin Franklin told the Subcommittee that he insisted on seeing the memorandum. After finally receiving it and reading about the substantial loan fraud occurring at the two loan offices since 2005, he told the Subcommittee that it was "the last straw" that ended his confidence that he could rely on WaMu to combat fraudulent practices within its own ranks.

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338 Id. at 2.
339 Id. at 3.
340 Id. at 7.
341 Id.
342 Id.
343 Id. at 8.
344 Id. at 9.
345 Subcommittee interview of Benjamin Franklin (2/18/2010).

The 2008 WaMu memorandum and a subsequent OTS examination memorandum[346] included a number of recommendations to address the fraud problem at the Downey and Montebello offices. The recommendations in the WaMu memorandum included actions to "[d]etermine appropriate disciplinary actions for employees"; "[e]nhance Code of Conduct training to stress each employee's role as a corporate steward and the consequences for passively facilitating the placement of loans into the origination process that could be suspect"; enhance WaMu compensation incentives "to support loan quality"; and determine if further analysis was required of the loans originated by the Montebello office or "the broader loan population (bank owned and securitized)" including "if actions are needed to address put backs or sales to investors of loans that contain misrepresentation[s] or other fraud findings."[347]

By the time WaMu issued the April 2008 memorandum on the Downey and Montebello fraud problem, however, the bank was already experiencing serious liquidity problems and was cutting back on its loan operations and personnel. On April 30, 2008, WaMu put an end to its wholesale loan channel which had accepted loans from third party mortgage brokers, closed 186 stand-alone loan centers, and reduced its workforce by 3,000.[348] The Downey and Montebello offices were closed as part of that larger effort. The two loan officers heading those offices left the bank and found other jobs in the mortgage industry that involve making loans to borrowers.

Other Fraud Problems. The loan fraud problems at the Downey and Montebello offices were not the only fraud problems plaguing WaMu. The Subcommittee uncovered three additional examples that demonstrate the problem was not isolated.

The first example involves the Westlake Village loan office outside of Los Angeles. On April 1, 2008, WaMu's Risk Mitigation Team sent 13 home loans with early payment defaults to the WaMu Corporate Fraud Investigations (CFI) group for further examination.[349] All 13, whose unpaid loan balances totaled about $14.3 million, had

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[346] 1/7/2008 OTS Asset Quality Memo 22, "Loan Fraud Investigation," JPM_WM02448184, Hearing Exhibit 4/13-25.
[347] 4/4/2008 WaMu Memorandum of Results, "AIG/UG and OTS Allegation of Loan Frauds Originated by [name redacted]," at 4, Hearing Exhibit 4/13-24.
[348] Subcommittee interview of Brian Minkow (2/16/2010); 5/27/2008 "Internal Investigative Report" on Westlake Home Loan Center, JPM_WM03171384, Hearing Exhibit 4/13-31. See also "Washington Mutual Exits Wholesale Lending Business, Will Close Home-Loan Centers," Mercury News, 4/7/2008, http://blogs.mercurynews.com/realestate/2008/04/07/washington-mutual-exits-wholesale-lending-business-will-close-home-loan-centers.
[349] 5/12/2008 "WaMu Significant Incident Notification (SIN)," JPM_WM05452386, Hearing Exhibit 4/13-30.

been issued in 2007, by the Westlake Village loan office which was one of WaMu's top loan producers. Two loan officers, Chris O'Brien and Brian Minkow, who worked in tandem, had won multiple awards for their loan production and had a team of 14 sales associates assisting them.[350] CFI reviewed the referred loans which contained a variety of fraud indicators, including "fabricated asset statements, altered statements, income misrepresentation and one altered statement that is believed to have been used in two separate loans."[351] CFI then interviewed the loan officers, sales associates, and personnel at the WaMu "loan fulfillment center" (LFC) that processed Westlake Village loan applications.

In one egregious example of document "manufacturing," a sales associate confessed that if "it was too late to call the borrower," the "sales associates would take [bank] statements from other [loan] files and cut and paste the current borrower's name and address" onto the old bank statements.[352] The same sales associate "admitted that during that crunch time some of the Associates would 'manufacture' asset statements from previous loan docs," because end-of-month loans would often get funded without full documentation. The pressure to get the necessary documentation was "tremendous" and they had been told to get the loans funded "with whatever it took."[353]

The LFC loan processor in charge of handling Westlake Village's loan applications was fired, as was the sales associate who confessed to manufacturing false documents. The rest of the employees were also let go, when the office itself was closed on April 30, 2008, in connection with WaMu's reorganization and downsizing. One of the loan officers who headed the office told the Subcommittee, however, that he had been offered another job within the bank, but declined it due to lower compensation.[354] He went on to work in the mortgage industry arranging residential loans.

The second example involves 25 Home Equity Lines of Credit (HELOCs) totaling $8.5 million that were originated in 2008 by a WaMu loan officer at the Sunnyvale loan office in California. Before all

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[350] Subcommittee interview of Brian Minkow (2/16/2010). See also 2005 "President's Club 2005 - Maui, Awards Night Show Script," Washington Mutual, Home Loans Group, Hearing Exhibit 4/13-63a (stating Mr. O'Brien and Mr. Minkow had produced $1.2 billion in loans in 2005).
[351] Id.
[352] 5/27/2008 "Internal Investigative Report" on Westlake Home Loan Center, JPM_WM03171384, Hearing Exhibit 4/13-31.
[353] 5/12/2008 "WaMu Significant Incident Notification (SIN)," JPM_WM05452386, Hearing Exhibit 4/13-30.
[354] Subcommittee interview of Brian Minkow (2/16/2010).

of the loans were funded, they were referred to the Risk Mitigation Team because of fraud indicators. On May 1, 2008, the loan files were sent on to the CFI group for further inquiry. An internal document summarizing the CFI investigation stated:

> "The review found that the borrowers indicated they owned the property free and clear when in fact existing liens were noted on the properties. The properties are located in California, Arizona and Washington. ... WaMu used ... Abbreviated Title reports [that] ... do not provide existing lien information on the subject property."[355]

Of the 25 loan applications, 22 were ultimately terminated or declined. The employee involved in originating the loans was terminated as part of the April 30, 2008 reorganization.

The third example involves a review of 2006 and 2007 WaMu loans conducted by Radian Guaranty Inc., a company which provided mortgage insurance for those loans.[356] Radian's objectives were to test WaMu's "compliance with Radian's underwriting guidelines and eligible loan criteria," assess the quality of WaMu's underwriting decisions, "rate the risk of the individual loans insured," and identify any errors in the loan data transmitted to Radian.[357] The review looked at a random selection of 133 loans and found enough problems to give WaMu an overall rating of "unacceptable."[358]

The Radian review identified a number of problems in the loan files it deemed ineligible for insurance. In one, WaMu issued a $484,500 loan to a "Sign Designer" who claimed to be making $34,000 in income every month.[359] The Radian review observed: "Borrower's stated monthly income of $34,000 does not appear reasonable for a 'Sign Designer.'" The review also noted several high risk elements in the loan, which was an 85% LTV loan given to a borrower with a 689 credit score who used the loan to refinance an existing loan and "cash-out" the equity in the house. The review noted that the borrower received $203,000 at the loan closing. In addition, the review stated that WaMu had appraised the house at $575,000, but an automated appraisal verification program assigned the house a probable value of only $321,000, less than the amount of the loan.

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355 5/15/2008 "WaMu Significant Incident Notification (SIN)," JPM_WM05452389, Hearing Exhibit 4/13-32b.
356 2/7/2008 Radian Guaranty Inc. review of Washington Mutual Bank loans, JPM_WM02057526, Hearing Exhibit 4/13-33.
357 Id. at 1.
358 Id.
359 Id. at 5.

Extent of Fraud. At the Subcommittee hearing, when asked about these matters, Mr. Vanasek, WaMu's Chief Risk Officer from 2004 to 2005, attributed the loan fraud to compensation incentives that rewarded loan personnel and mortgage brokers according to the volume of loans they processed rather than the quality of the loans they produced:

> "Because of the compensation systems rewarding volume versus quality and the independent structure of the originators, I am confident at times borrowers were coached to fill out applications with overstated incomes or net worth to meet the minimum underwriting requirements. Catching this kind of fraud was difficult at best and required the support of line management. Not surprisingly, loan originators constantly threatened to quit and to go to Countrywide or elsewhere if the loan applications were not approved."[360]

When asked by Senator Coburn if he thought the type of fraud at the Downey and Montebello loan offices extended beyond those two offices, Mr. Vanasek replied: "Yes, Senator."[361]

Another sobering internal WaMu report, issued in September 2008, a few weeks before the bank's failure, found that loans marked as containing fraudulent information had nevertheless been securitized and sold to investors. The report blamed ineffective controls that had "existed for some time":

> "The controls that are intended to prevent the sale of loans that have been confirmed by Risk Mitigation to contain misrepresentations or fraud are not currently effective. There is not a systematic process to prevent a loan in the Risk Mitigation Inventory and/or confirmed to contain suspicious activity from being sold to an investor. ... Of the 25 loans tested, 11 reflected a sale date after the completion of the investigation which confirmed fraud. There is evidence that this control weakness has existed for some time."[362]

Loans not meeting the bank's credit standards, deliberate risk layering, sales associates manufacturing documents, offices issuing loans in which 58%, 62%, or 83% contained evidence of loan fraud, and selling fraudulent loans to investors are evidence of deep seated problems that existed within WaMu's lending practices. Equally

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[360] April 13, 2010 Subcommittee Hearing at 17.
[361] Id. at 30.
[362] 9/8/2008 "WaMu Risk Mitigation and Mortgage Fraud 2008 Targeted Review," JPM_WM00312502, Hearing Exhibit 4/13-34.

disturbing is evidence that when WaMu senior managers were confronted with evidence of substantial loan fraud, they failed to take corrective action. WaMu's failure to strengthen its lending practices, even when problems were identified, is emblematic of how lenders and mortgage brokers produced billions of dollars in high risk, poor quality home loans that contributed to the financial crisis.

(d) Steering Borrowers to High Risk Option ARMs

In addition to subprime loans, Washington Mutual made a variety of high risk loans to "prime" borrowers, including its flagship product, the Option Adjustable Rate Mortgage (Option ARM). Washington Mutual's Option ARMs typically offered borrowers an initial teaser rate, sometimes as low as 1% for the first month, which later adjusted to a much higher floating interest rate linked to an index, but gave borrowers the choice each month of paying a higher or lower amount. These loans were called "Option" ARMs, because borrowers were typically given four options: (1) paying the fully amortizing amount needed to pay off the loan in 30 years; (2) paying an even higher amount to pay off the loan in 15 years; (3) paying only the interest owed that month and no principal; or (4) making a "minimum payment" that covered only a portion of the interest owed and none of the principal.[363] If the borrower selected the minimum payment option, unpaid interest would be added to the loan principal. If the borrower repeatedly selected the minimum payment, the loan principal would increase rather than decrease over time, creating a negatively amortizing loan.

Negative amortization created additional credit risk for WaMu and posed a challenge to risk managers. At the April 13 Subcommittee hearing, Mr. Vanasek testified:

> "We had concerns from the standpoint of negative amortization that was accumulating and we had been reassured that in the past, borrowers would negatively amortize during difficult times and then make up for the lost payments in good times. But the percentage and the potential percentage for negative amortization was very large, and, of course the attendant payment shock was also very large, which was a concern to credit."[364]

[363] See 8/2006 "Option ARM Credit Risk," WaMu presentation, at 3, Hearing Exhibit 4/13-37; 10/17/2006 "Option ARM" draft presentation to the WaMu Board of Directors, JPM_WM02549027, Hearing Exhibit 4/13-38.
[364] April 13, 2010 Subcommittee Hearing at 49.

Few executives at WaMu shared Mr. Vansek's concern about the Option ARM. To the extent that risk managers expressed concern, it was outweighed by the product's favorable gain-on-sale margin.

As part of its High Risk Lending Strategy, WaMu determined to increase its issuance of its Option ARM loans. To do that, WaMu had to convince customers to forego a simple, low risk conventional loan in favor of the complex and higher risk Option ARM. In late 2003, WaMu conducted two focus group studies to "explore ways to increase sales of Option ARMs, Washington Mutual's most profitable mortgage loan products."[365] The first focus group examined the views of WaMu loan consultants and third party mortgage brokers. The second focus group examined the views of WaMu Option ARM customers.

The report following the first focus group with WaMu loan consultants and mortgage brokers identified a number of impediments to selling Option ARMs. It noted that Option ARM loans had to be "sold" to customers asking for a 30-year fixed loan, and training was needed to overcome the feeling of "many" WaMu loan consultants that Option ARMs were "bad" for their customers. The report also recommended increasing commissions so salespersons would take the "hour" needed to sell an Option ARM, and increasing loan processing times so salespersons and brokers were not inconvenienced. The report stated in part:

> "Option ARMs are **sold** to customers and few walk through the door and ask for them. ...
>
> If salespeople don't understand Option ARMs, they won't sell them. Many felt that more training would be needed to better educate salespeople about this type of loan, and to change the mindset of current Loan Consultants. Some felt there were many within Washington Mutual who simply felt these loans were 'bad' for customers, probably from a lack of understanding the product and how it could benefit customers. ...
>
> It is critical that salespeople fully understand a customer's financial situation and motivation for the loan. By taking into account these factors, they can recommend the loan that will best fit their customers' needs. Given today's low interest rate environment, it can be challenging to get salespeople to take the time to do this. Currently it is easier to give customers what they

[365] 9/17/2003 "Option ARM Focus Groups – Phase II, WaMu Option ARM Customers," WaMu research report, at 3, Hearing Exhibit 4/13-35.

> ask for (a 30 year fixed loan) than to sell them an Option ARM. They can take 20 minutes and sell a 30 fixed-rate loan, or spend an hour trying to sell an Option ARM.
>
> Commission caps make it unappealing for Mortgage Brokers to sell Washington Mutual Option ARMs. Most would not sell loans to customers with prepayment penalties, and given the low commission rate for selling them without the prepayment penalty, many simply go to another company or product where they can make more money.
>
> Slow ARM processing times (up to 90 days) can cause Mortgage Brokers to take business elsewhere. ...
>
> Improving collateral would help salespeople better explain Option ARMs to customers and take away some of the mystery. ... They also would like improved brochures which talk to the customer in simple, easy to understand terms about features and benefits. They liked the current sample statements they are provided."[366]

The second focus group with existing Option ARM customers showed they were also unenthusiastic about the product. The focus group report stated:

> "In general, people do not seem to have a good understanding of their mortgage and its terms. What understanding they do have is framed by the concept of a 30-year fixed mortgage. Option ARMs are very complicated and need to be explained in simple, easy to understand terms, prospective borrowers need to be educated about the loan – this is not a product that sells itself."[367]

The focus group identified several reasons that borrowers were leery of Option ARMs and suggested ways to address the unease: "Helping prospective borrowers understand payment and interest rate caps may mitigate fears of wild monthly payment swings .... Similarly, fears about negative amortization, a concept also not very well understood by the participants, could be reduced or eliminated by showing how much residential properties in the local market have appreciated over time."[368]

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[366] 8/14/2003 "Option ARM Focus Groups – Phase I, WaMu Loan Consultants and Mortgage Brokers," WaMu research report, at 2, Hearing Exhibit 4/13-36 [emphasis in original].
[367] 9/17/2003 "Option ARM Focus Groups – Phase II, WaMu Option ARM Customers," WaMu research report, at 4, Hearing Exhibit 4/13-35.
[368] Id.

The main findings of the focus group included:

> "Few participants fully understood the Option ARM and its key benefits. A number of them were not familiar with the payment options or how they could be used. … Additionally, most did not understand how their interest rate was derived, how often their payments would change, and what, if any, were the interest and/or payment caps.
>
> Perhaps the best selling point for the Option ARM loan was being shown how much lower their monthly payment would be by choosing an Option ARM versus a fixed-rate loan.
>
> Many participants did not know what happened to their loan at the end of the fixed interest rate period. Most of them assumed they would have to sell or refinance because of a potential balloon payment or a steep jump in their payments. Because of these misperceptions, most participants expect to refinance their loans within the next three to five years."[369]

To increase Option ARM sales, WaMu increased the compensation paid to its loan personnel and outside mortgage brokers for the loans.[370] The bank also qualified borrowers for Option ARMs by using a monthly payment amount that was less than what the borrower would likely pay once the loan recast.[371]

The Option ARM was also frequently featured in sales promotion efforts communicated to loan officers through WaMu's internal alert email system known as, "e-Flash." For example, a June 5, 2006 e-Flash from Steve Stein, the Director of Retail Lending in the Home Loans division, to the entire retail sales team announced:

> "We are beginning to focus on higher-margin products like our flagship product, the Option ARM. This is a fantastic product for almost any borrower. To help our sales force feel more comfortable with selling the Option ARM to a wide variety of borrowers, we are rolling out a comprehensive skills assessment and training initiative. ... This initiative is not about selling the Option ARM to everyone. We will always stay true to our values and provide the right loan for every customer. … Through the skills assessment, training, role playing and a best-practices selling

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[369] Id. at 5 [emphasis in original].
[370] Subcommittee interview of David Schneider (2/17/2010).
[371] See April 13, 2010 Subcommittee Hearing at 50.

> tips video, I think this retail sales team will be unstoppable with the Option ARM. ... The Option ARM is our product and we can sell it better than anyone. I have great confidence that we'll improve our Option ARM market share quickly, like the experts that we are."[372]

One month later, Mr. Stein announced increased compensation incentives for selling Option ARMs. In another e-Flash to the entire retail sales team, Mr. Stein wrote:

> "You've seen and heard a lot recently about our refined business model and focus on higher margin products, especially Option ARMs. To further drive this focus, I'm pleased to announce the 2006 Option ARM Blitz – Quarterly Incentive Campaign. This will allow eligible Loan Consultants to earn 5 additional basis points on all Option ARM volume funded during the 3rd quarter 2006."[373]

Under the rules of the Option ARM Blitz, loan consultants who increased the percentage of Option ARMs they sold by at least 10% would receive an additional bonus. In August 2006, an e-Flash announced that the underwriting guidelines for Option ARMs had been loosened, allowing higher loan amounts for "condos and co-ops" and greater loan-to-value ratios for "low-doc" second home mortgages.[374] Also in August, an e-Flash announced that the "Option ARM Sales Mastery Program" that was launched in June, would now become part of the mandatory loan originator training curricula.[375]

In September 2006, WaMu introduced pricing incentives for Option ARMs in the consumer direct channel which waived all closing costs for Option ARMs except for an appraisal deposit.[376] In the fourth quarter of 2006, the consumer direct channel also held a contest called the "Fall Kickoff Contest." For each of the 13 weeks in the quarter, the loan consultant who scored the most points would receive a $100 gift card. An Option ARM sale was a "touchdown" and worth seven points; jumbo-fixed, equity, and nonprime mortgages were only "field goals" worth three points. At the end of the quarter the top five point winners were awarded with a $1,000 gift card.[377] In addition, from November

[372] 6/5/2006 "e-Flash" from Steve Stein to Retail Production Sales, JPM_WM03246053.
[373] 7/3/2006 "e-Flash" from Steve Stein to Retail Production Sales, JPM_WM04471136-37.
[374] 8/17/2006 "e-Flash" from Steve Stein, Arlene Hyde, and John Schleck to Production and Operations, JPM_WM03277786-87.
[375] 8/18/2006 "e-Flash" from Allen Myers to Retail Production Sales Managers, JPM_WM03277758.
[376] 8/31/2006 "e-Flash" from Mary Ann Kovach to Consumer Direct, JPM_WM03077747.
[377] 10/12/2006 "e-Flash" from Mary Ann Kovach to Consumer Direct, JPM_WM03627448-49.

2006 through January 2007, e-Flashes sent to consumer direct originators promoted Option ARM sales specials offering $1,000 off closing costs for loans under $300,000 and a waiver of all fees for loans greater than $300,000.[378]

Judging by sales of Option ARMs in 2004, after the completion of the focus groups, WaMu's strategy to push sales of Option ARM loans was successful. In 2003, WaMu originated $30.1 billion in Option ARMs; in 2004 WaMu more than doubled its Option ARM originations to $67.5 billion. Although sales of Option ARMs declined thereafter because of challenges in the market, in 2006, WaMu still originated $42.6 billion in Option ARMs. According to its internal documents, by 2006, Washington Mutual was the second largest Option ARM originator in the country.[379]

As WaMu's Option ARM portfolio grew, and as the wider economy worsened, the prevalence of negative amortization in the Option ARMs increased. While WaMu risk managers viewed negative amortization as a liability, WaMu accountants, following generally accepted accounting practices, treated negative amortization as an asset. In 2003, WaMu recognized $7 million in earnings from deferred interest due to negative amortization.[380] By 2006, capitalized interest recognized in earnings that resulted from negative amortization surpassed $1 billion; by 2007 it exceeded $1.4 billion.[381] In other words, as WaMu customers stopped paying down their mortgages, WaMu booked billions of dollars in earnings from the increasing unpaid balances. By another measure, in 2003, $959 million in Option ARM loans that WaMu held in its investment portfolio experienced negative amortization; in 2007, the figure was more than $48 billion.[382]

According to data compiled by the Treasury and the FDIC Inspectors General, in 2005, WaMu borrowers selected the minimum monthly payment option for 56% of the value of the Option ARM loans in its investment portfolio. By the end of 2007, 84% of the total value of the Option ARMs in WaMu's investment portfolio was negatively amortizing.[383] To avoid having their loans recast at a higher interest rate, Option ARM borrowers typically refinanced the outstanding loan

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[378] See, e.g., 11/13/2006 "e-Flash" from Mary Ann Kovack to Consumer Direct, JPM_WM03077089-90.
[379] 2007 "Home Loans Product Strategy," WaMu presentation at JPM_WM03097203, Hearing Exhibit 4/13-60a (only Countrywide ranked higher).
[380] 2005 Washington Mutual Inc. 10-K filing with the SEC at 27.
[381] Id.
[382] Id. at 55; 3/2007 Washington Mutual Inc. 10-K filing with the SEC at 57.
[383] 4/2010 IG Report, at 9, Hearing Exhibit 4/16-82.

balance. Some borrowers chose to refinance every year or two.[384] The Treasury and the FDIC IG report determined that a significant portion of Washington Mutual's Option ARM business consisted of refinancing existing loans.[385]

One WaMu loan officer, Brian Minkow, told the Subcommittee that he expected the vast majority of Option ARMs borrowers to sell or refinance their homes before their payments increased.[386] As long as home prices were appreciating, most borrowers were able to refinance if they chose to. According to Mr. Minkow, who was one of WaMu's top loan consultants and in some years originated more than $1 billion in loans, 80% of his business was in Option ARMs, and 70% of his business consisted of refinances.[387] Once housing prices stopped rising, however, refinancing became difficult. At recast, many people found themselves in homes they could not afford, and began defaulting in record numbers.

WaMu was one of the largest originators of Option ARMs in the country. In 2006 alone, WaMu securitized or sold $115 billion in Option ARMs.[388] Like Long Beach securitizations, WaMu Option ARM securitizations performed badly starting in 2006, with loan delinquency rates between 30 and 50%, and rising.[389]

(e) Marginalization of WaMu Risk Managers

WaMu knowingly implemented a High Risk Lending Strategy, but failed to establish a corresponding system for risk management. Instead, it marginalized risk managers who warned about and attempted to limit the risk associated with the high risk strategy.

At the time it formally adopted its High Risk Lending Strategy, WaMu executives acknowledged the importance of managing the risks it created. For example, the January 2005 "Higher Risk Lending Strategy 'Asset Allocation Initiative'" presentation to the Board of Directors Finance Committee stated in its overview:

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384 Subcommittee interview of Brian Minkow (2/16/2010).
385 4/2010 IG Report, Hearing Exhibit 4/16-82.
386 Subcommittee interview of Brian Minkow (2/16/2010).
387 Id.
388 10/17/2006 "Option ARM" draft presentation to the WaMu Board of Directors, JPM_WM02549027, Hearing Exhibit 4/13-38, chart at 2.
389 See wamusecurities.com (subscription website maintained by JPMorgan Chase with data on Long Beach and WaMu mortgage backed securities showing, as of January 2011, delinquency rates for particular mortgage backed securities, including WMALT 2006 OA-3 – 57.87% and WAMU 2007-OA4 – 48.43%).

"In order to generate more sustainable, consistent, higher margins within Washington Mutual, the **2005 Strategic Plan** calls for a shift in our mix of business, increasing our Credit Risk tolerance while continuing to mitigate our Market and Operational Risk positions.

The Corporate Credit Risk Management Department has been tasked, in conjunction with the Business Units, to develop a framework for the execution of this strategy. Our numerous activities include:

-Selecting best available credit loss models
-Developing analytical framework foundation
-Identifying key strategy components per Regulatory Guidance documents

A strong governance process will be important as peak loss rates associated with this higher risk lending strategy will occur with a several year lag and the correlation between high risk loan products is important. For these reasons, the Credit Department will pro-actively review and manage the implementation of the Strategic Plan and provide quarterly feedback and recommendations to the Executive Committee and timely reporting to the Board."[390]

The robust risk management system contemplated by in the January 2005 memorandum, which was critical to the success of the High Risk Lending Strategy, was never meaningfully implemented. To the contrary, risk managers were marginalized, undermined, and often ignored. As former Chief Risk Manager Jim Vanasek testified at the April 13 Subcommittee hearing:

"I made repeated efforts to cap the percentage of high-risk and subprime loans in the portfolio. Similarly, I put a moratorium on non-owner-occupied loans when the percentage of these assets grew excessively due to speculation in the housing market. I attempted to limit the number of stated income loans, loans made without verification of income. But without solid executive management support, it was questionable how effective any of these efforts proved to be."[391]

[390] 1/2005 "Higher Risk Lending Strategy 'Asset Allocation Initiative,'" Washington Mutual Board of Directors Finance Committee Discussion, JPM_WM00302975, Hearing Exhibit 4/13-2a [emphasis in original].
[391] April 13, 2010 Subcommittee Hearing at 17.

Later in the hearing, Mr. Vanasek had the following exchange with Senator Coburn:

> Senator Coburn: Did you ever step in and try to get people to take a more conservative approach at WaMu?
>
> Mr. Vanasek: Constantly.
>
> Senator Coburn: Were you listened to?
>
> Mr. Vanasek: Very seldom.
>
> Senator Coburn: [Had] you ever felt that your opinions were unwelcomed, and could you be specific?
>
> Mr. Vanasek: Yes. I used to use a phrase. It was a bit of humor or attempted humor. I used to say the world was a very dark and ugly place in reference to subprime loans. I cautioned about subprime loans consistently.[392]

Mr. Vanasek's description of his efforts is supported by contemporaneous internal documents. In a February 24, 2005 memorandum to the Executive Committee with the subject heading, "Critical Pending Decisions," for example, Mr. Vanasek cautioned against expanding WaMu's "risk appetite":

> "My credit team and I fear that we are considering expanding our risk appetite at exactly the wrong point and potentially walking straight into a regulatory challenge and criticism from both the Street and the Board. Said another way I fear that the timing of further expansion into higher risk lending beyond what was contemplated in the '05 Plan and most especially certain new products being considered is ill-timed given the overheated market and the risk [of] higher interest rates ....
>
> So we come down to the basic question, is this the time to expand beyond the '05 Plan and/or to expand into new categories of higher risk assets? For my part I think not. We still need to complete EDE [Enterprise Decision Engine, an automated underwriting system], reduce policy exception levels, improve the pricing models, build our sub-prime collection capability, improve our modeling etc. We need to listen to our instincts about the overheated housing market and the likely outcome in our primary

[392] Id. at 32.

markets. We need to build further credibility with the regulators about the control exercised over our SFR underwriting and sub-prime underwriting particularly in LBMC."[393]

Mr. Vanasek retired in December 2005, in part, because the management support for his risk policies and culture was lacking.[394] When Mr. Vanasek left WaMu, the company lost one of the few senior officers urging caution regarding the high risk lending that came to dominate the bank. After his departure, many of his risk management policies were ignored or discarded. For example, by the end of 2007, stated income loans represented 73% of WaMu's Option ARMs, 50% of its subprime loans, and 90% of its home equity loans.[395]

Ronald Cathcart was hired in December 2005 to replace Mr. Vanasek, and became the Chief Enterprise Risk Officer. He had most recently been the Chief Risk Officer for Canadian Imperial Bank of Commerce's retail bank.[396] Although the High Risk Lending Strategy was well underway, after Mr. Vanasek's departure, risk management was in turmoil. Mr. Cathcart testified at the Subcommittee hearing: "When I arrived at WaMu, I inherited a Risk Department that was isolated from the rest of the bank and was struggling to be effective at a time when the mortgage industry was experiencing unprecedented demand for residential mortgage assets." In early 2006, the bank reorganized WaMu's risk management.[397] Under the new system, much of the risk management was subordinated to the WaMu business divisions, with each business division's Chief Risk Officer reporting to two bosses, Mr. Cathcart and the head of the business unit to which the division's Chief Risk Officer was assigned. WaMu referred to this system of reporting as a "Double-Double."[398]

Cheryl Feltgen, for example, was the Chief Risk Officer for the Home Loans division. She reported both to Mr. Cathcart and to Mr. Schneider, the Home Loans President, setting up a tension between the two.[399] Mr. Schneider had hired Ms. Feltgen from Citi Mortgage, where she had been the Chief Marketing Officer, not a risk manager. Mr.

[393] 2/24/2005 Washington Mutual memorandum from Jim Vanasek to the Executive Committee, "Critical Pending Decisions," JPM_WM01265462-64.
[394] Subcommittee interview of Jim Vanasek (12/18/2009 and 1/19/2010).
[395] 4/2010 IG Report, at 10, Hearing Exhibit 4/16-82.
[396] Subcommittee interview of Ronald Cathcart (2/23/2010).
[397] Id.
[398] Id.; Subcommittee interviews of David Schneider (2/17/2010) and Cheryl Feltgen (2/6/2010).
[399] See April 13, 2010 Subcommittee Hearing at 34; Subcommittee interviews of Mr. Cathcart (2/23/2010), Mr. Schneider (2/17/2010), and Ms. Feltgen (2/6/2010).

Cathcart told the Subcommittee that he would not have hired her for the role, because of her lack of risk management experience.[400]

Ms. Feltgen told the Subcommittee that, although she was the Home Loans Chief Risk Officer, she also had responsibility to meet business goals. She indicated that she did not see her role as one of risk minimization, but rather of risk optimization.[401] Her 2007 performance evaluation reflected her dual responsibilities, but clearly subordinated her risk management duties to the achievement of business growth objectives. For example, the evaluation identified a series of goals and assigned each a percentage weighting to determine their precedence. Instead of assigning priority to her performance in the area of managing risk, Ms. Feltgen's number one performance goal for 2007 was "GROWTH" in home loans, given a weighting of 35%, followed by "RISK MANAGEMENT," given a weighting of only 25%.[402] Her performance review even listed specific sales targets:

> "Employee Goals
>
> **GROWTH 35%**
> 1. Achieve Net Income - $340 MM for 2007
> 2. HL [Home Loan] Product Sales (Incl. Conduit)
>   1. Home Equity - $18B
>   2. Subprime - $32B
>   3. Option ARM - $33B
>   4. Alt A - $10B
> 3. Customer Satisfaction (Total HL) – 55%"[403]

By conditioning her evaluation on whether her division hit pre-determined sales figures, the performance evaluation made her compensation more dependent upon the Home Loans division hitting revenue growth and product sales than upon her contributions to risk management.

Further complicating matters were Ms. Feltgen's two supervisors. In an interview, Ms. Feltgen stated that Ron Cathcart, her supervisor on risk matters, was "not well respected" and did not have "a strong voice."[404] On the other hand, she described David Schneider, her supervisor on loan origination matters, as having a strong voice and acting more as her

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[400] Subcommittee interview of Ronald Cathcart (2/23/2010).
[401] Subcommittee interview of Cheryl Feltgen (2/6/2010).
[402] "Performance Review Form: Leadership," Hearing Exhibit 4/13-64 (the form is not dated, but Ms. Feltgen confirmed that it is the 2007 review).
[403] Id.
[404] Subcommittee interview of Cheryl Feltgen (2/6/2010).

boss. This arrangement again de-emphasized the importance of her risk duties.

Ms. Feltgen's dedication to the growth of the Home Loans business is apparent in her communications with her staff. For example, on December 26, 2006, she sent a year-end email to her staff. Under the subject line, "Year-End 2006 Message for the Home Loans Risk Management Team," Ms. Feltgen wrote:

> "As we approach the close of 2006, it is fitting to reflect on the challenges and accomplishments of this past year and to look forward to 2007 and beyond. Earlier this year David Schneider and the leadership team of Home Loans articulated a new business strategy that included: (1) a shift to higher margin products (Alt-A, subprime and home equity); (2) reducing market risk … and taking on more credit risk and (3) aggressively attacking the cost structure. We have made great strides as a business on all of those fronts and you have all been a part of those accomplishments. You have partnered successfully with the business units of Home Loans in pursuit of our collective goal to drive profitable growth with the right balance of risk and return."[405]

The email continued with a list of "accomplishments of the Home Loans Risk Management Team in support of business goals," that included the following accomplishment: "Our appetite for credit risk was invigorated with the expansion of credit guidelines for various product segments including the 620 to 680 FICO, low docs and also for home equity."[406] The email continued with Ms. Feltgen stating her commitment to the High Risk Lending Strategy and emphasizing revenue and sales despite an acknowledgement of the worsening condition of the mortgage market:

> "The year 2007 will be another challenging year for the mortgage industry with mortgage origination volumes down, the inverted yield curve putting pressure on profitability and gain on sale margins at lower level than prior years. The focus on the three key elements of our 2006 strategy remains important: shift to higher margin products, reduce market risk and increase credit risk and attack the cost structure. … In 2007, we must find new ways to grow our revenue. Home Loans Risk Management has an important role to play in that effort.

[405] 1/3/2007 email from Cheryl Feltgen, "Year-End 2006 Message for the Home Loans Risk Management Team," Hearing Exhibit 4/13-73.
[406] Id.

David Schneider has encouraged us to 'BE BOLD'.... Recognize that 'we are all in sales' passionately focused on delivering great products and service to our customers."[407]

Ms. Feltgen's year-end bonus was based upon her performance review.[408] According to Mr. Cathcart, in 2007, the bank made bonus distributions more dependent on the performance of each business line, rather than the performance of the bank as a whole, which largely removed his control over compensation of his risk managers. Mr. Cathcart told the Subcommittee that he disagreed with this change because it made his risk managers, who reported to him and to the heads of the business units, more beholden to the business heads. Mr. Cathcart said he approached the head of Human Resources, and strongly objected to the change, but was told to take it up with Mr. Killinger. Mr. Cathcart told the Subcommittee that he voiced his objection to Mr. Killinger, but Mr. Killinger told him to talk to Mr. Rotella. He said that he took his objection to Mr. Rotella, but was unsuccessful at preventing the policy change.

Mr. Cathcart told the Subcommittee that this change created further separation between him and his risk managers, and compromised the independence of risk management.[409] He testified at the Subcommittee hearing:

> Mr. Cathcart: The chairman adopted a policy of what he called double reporting, and in the case of the Chief Risk Officers, although it was my preference to have them reporting directly to me, I shared that reporting relationship with the heads of the businesses so that clearly any of the Chief Risk Officers reporting to me had a direct line to management apart from me.
>
> Senator Coburn: And was that a negative or a positive in terms to the ultimate outcome in your view?
>
> Mr. Cathcart: It depended very much on the business unit and on the individual who was put in that double situation. I would say that in the case of home loans, it was not satisfactory because the Chief Risk Officer of that business favored the reporting relationship to the business rather than to risk.[410]

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[407] Id.
[408] Subcommittee Interview of Ronald Cathcart (2/23/2010).
[409] Id.
[410] April 13, 2010 Subcommittee Hearing at 34.

The subordination of risk management to sales was apparent at WaMu in many other ways as well. Tony Meola, the head of home loans sales, reported directly to David Schneider. He had direct access to Mr. Schneider and often pushed for more lenient lending standards. According to Ms. Feltgen, the sales people always wanted more lenient standards and more mortgage products, and Mr. Meola advocated for them.[411]

One example was the 80/20 loan, which consisted of a package of two loans issued together, an 80% LTV first lien and a 20% LTV second lien, for a total CLTV of 100%. Ms. Feltgen said she was nervous about the product, as a 100% CLTV was obviously very risky. WaMu's automatic underwriting system was not set up to accept such loans, but Mr. Meola wanted permission to "side step" the systems issue.[412] Mr. Schneider approved the product, and Ms. Feltgen ultimately signed off on it. She told the Subcommittee that it was a high risk product, but was priced accordingly, and that it might have been successful if housing prices had not declined.[413]

When the housing market began to collapse, a time in which prudent risk management became even more critical, Mr. Cathcart, the Chief Enterprise Risk Manager, was accorded even less deference and authority. Mr. Cathcart testified at the April 13 Subcommittee hearing:

> "Financial conditions … deteriorated further in 2007 and 2008. As head of risk, I began to be excluded from key management decisions. By February 2008, I had been so fully isolated that I initiated a meeting with the Director, where I advised that I was being marginalized by senior management to the point that I was no longer able to discharge my responsibilities as Chief Enterprise Risk Officer of WaMu. Within several weeks, I was terminated by the Chairman."[414]

During his interview with the Subcommittee Mr. Cathcart provided additional details about his marginalization by senior management.[415] He said that he initially had extensive interaction with the WaMu Board of Directors and presented to the full Board every six months. According to Mr. Cathcart, he attended all of the Board meetings until the end of 2007 or the beginning of 2008, at which time he was no

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411 Subcommittee Interview of Cheryl Feltgen (2/6/2010).
412 See 2/2006 WaMu internal email chain, "FW: 80/20," JPM_WM03960778.
413 Subcommittee Interview of Cheryl Feltgen (2/6/2010). See also 2/2006 WaMu internal email chain, "FW: 80/20," JPM_WM03960778.
414 April 13, 2010 Subcommittee Hearing at 19.
415 Subcommittee interview of Ronald Cathcart (2/23/2010).

longer invited. Mr. Cathcart felt he was excluded from Board meetings and calls with investment bankers because he was forthright about WaMu's mortgage loss rates, whereas senior management used older, more favorable numbers. According to Mr. Cathcart, during one of the last Board meetings he attended, after a presentation on expected mortgage losses, he interjected that the loan loss data being presented were already out of date, and the real figures would be much worse. He also recalled speaking up in a 2007 conference call with investment bankers to correct an overly optimistic loss figure. According to Mr. Cathcart, he was chastised for his corrections by WaMu management and told to leave the credit discussions to another senior manager.

Mr. Cathcart told the Subcommittee that regulators were also given out-of-date loss projections as the situation worsened, because Mr. Killinger and Mr. Rotella wanted to prevent a negative reaction. Mr. Cathcart said that the loss rates were increasing every week, and the regulators were being provided with three-week old information. Mr. Cathcart told the Subcommittee that in February or March 2008, he discovered that Mr. Killinger had provided the Director of OTS, John Reich, with out-of-date loss rates. Mr. Cathcart said that he called a meeting with Mr. Dochow, head of the OTS West Regional Office, and provided him with the current numbers. Mr. Cathcart said that Mr. Killinger found out about the meeting and was upset. In April, Mr. Killinger fired Mr. Cathcart.

E. Polluting the Financial System

Washington Mutual, as the nation's largest thrift, was a leading issuer of home loans. When many of those loans began to go bad, they caused significant damage to the financial system.

Washington Mutual originated or acquired billions of dollars of home loans through multiple channels, including loans originated by its own loan officers, loans brought to the bank by third party mortgage brokers, and loans purchased in bulk from other lenders or firms. Its subprime lender, Long Beach, originated billions of dollars in home loans brought to it by third party mortgage brokers across the country. According to a 2007 WaMu presentation, by 2006, Washington Mutual was the second largest nonagency issuer of mortgage backed securities in the United States, behind Countrywide.[416]

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[416] See 6/11/2007 chart entitled, "Rate of Growth Exceeds the Industry," JPM_WM03409860, Hearing Exhibit 4/13-47c.

Washington Mutual and Long Beach sold or securitized the vast majority of their subprime home loans. Initially, Washington Mutual kept most of its Option ARMs in its proprietary investment portfolio, but eventually began selling or securitizing those loans as well. With respect to other loans, such as fixed rate 30-year, Alt A, home equity, and jumbo loans, WaMu kept a portion for its own investment portfolio, and sold the rest either to Wall Street investors, usually after securitizing them, or to Fannie Mae or Freddie Mac.

By securitizing billions of dollars in poor quality loans, WaMu and Long Beach were able to decrease their risk exposure while passing along risk to others in the financial system. They polluted the financial system with mortgage backed securities which later incurred high rates of delinquency and loss. At times, WaMu securitized loans that it had identified as likely to go delinquent, without disclosing its analysis to investors to whom it sold the securities, and also securitized loans tainted by fraudulent information, without notifying purchasers of the fraud that was discovered and known to the bank.

(1) WaMu and Long Beach Securitizations

From 2000 to 2007, Washington Mutual and Long Beach securitized at least $77 billion in subprime and home equity loans.[417] WaMu also sold or securitized at least $115 billion in Option ARM loans.[418] Between 2000 and 2008, Washington Mutual sold over $500 billion in loans to Fannie Mae and Freddie Mac, accounting for more than a quarter of every dollar in loans WaMu originated.[419]

According to a 2007 WaMu presentation at a securities investor meeting in New York, in 2004, WaMu issued $37.2 billion in RMBS securitizations and was the sixth largest RMBS issuer in the United States.[420] In 2005, it doubled its production, issuing $73.8 billion in securitizations, and became the third largest issuer. In 2006, it issued $72.8 billion and was the second largest issuer, behind Countrywide.[421]

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[417] 6/2008 "WaMu Wholesale Specialty Lending Securitization Performance Summary," JPM_WM02678980, Hearing Exhibit 4/13-45.
[418] 10/17/2006 "Option ARM" draft presentation to the WaMu Board of Directors, JPM_WM02549027, Hearing Exhibit 4/13-38 (see chart at 2). See also 8/2006 "Option ARM Credit Risk," WaMu presentation, at JPM_WM00212644, Hearing Exhibit 4/13-37 (see chart at 5).
[419] See chart in section E(4), below, using loan data from Inside Mortgage Finance.
[420] See 6/11/2007 chart entitled, "Rate of Growth Exceeds the Industry," JPM_WM03409860, Hearing Exhibit 4/13-47c.
[421] Id. WaMu attributed its rapid rise in the issuer rankings over the three-year period to its establishment of a Conduit Program, which began buying loans in bulk in 2004. Id.

WaMu and Long Beach's securitizations produced only RMBS securities. Although WaMu considered issuing CDO securities as well, it never did so.[422] From 2004 to 2006, WaMu and Long Beach securitized dozens of pools of prime, subprime, Alt A, second lien, home equity, and Option ARM loans.[423] WaMu and Long Beach also sold "scratch and dent" pools of nonperforming loans, including nonperforming primary mortgages, second lien, and Option ARMs.[424]

At first, Washington Mutual worked with Wall Street firms to securitize its home loans, but later built up its own securitization arm, Washington Mutual Capital Corporation (WCC), which gradually took over the securitization of both WaMu and Long Beach loans. WCC was a private Washington State corporation that WaMu acquired from another bank in 2001, and renamed.[425] WCC became a wholly owned subsidiary of Washington Mutual Bank. In July 2002, WaMu announced that WCC would act as an institutional broker-dealer handling RMBS securities and would work with Wall Street investment banks to market and sell WaMu and Long Beach RMBS securities.[426]

WCC was initially based in Seattle, and by 2003, had between 30 and 40 employees.[427] In 2004, due to increasing securitizations, WaMu decided to move the headquarters of WCC to Manhattan.[428] In 2004, for the first time, WCC acted as the lead manager of a WaMu securitization. That same year, WCC initiated a "conduit program" to buy Alt A and subprime loans in bulk for securitization.[429] WCC issued its first Alt A securitization in 2005, and its first subprime securitization in 2006.[430] It also conducted whole loan sales and credit card securitizations.[431] At its peak, right before the collapse of the subprime securitization market, WCC had over 200 employees and offices in Seattle, New York, Los Angeles, and Chicago. The majority of WCC employees were based in New York.[432] WCC was headed by Tim Maimone, WCC President,

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[422] See 12/15/2006 Enterprise Risk Management Committee, JPM_WM02656967. See also 10/25/2006 Asset-Liability Management Committee Meeting Agenda, JPM_WM02406624.
[423] See 6/2008 "WaMu Wholesale Specialty Lending Securitization Performance Summary," JPM_WM02678980, Hearing Exhibits 4/13-45 and 46; 6/11/2007 chart entitled, "WaMu Capital Corp Sole/Lead Underwriter," JPM_WM03409861, Hearing Exhibit 4/13-47c.
[424] See, e.g., undated "List of WaMu-Goldman Loans Sales and Securitizations," Hearing Exhibit 4/13-47b; 2/2007 internal WaMu email chain, JPM_WM00652762.
[425] See 6/11/2007 chart entitled, "Capital Markets Division Growth," JPM_WM03409858, Hearing Exhibit 4/13-47c.
[426] Id.
[427] Subcommittee interview of David Beck (3/2/2010).
[428] Id.
[429] See 6/11/2007 chart entitled, "Capital Markets Division Growth," JPM_WM03409858, Hearing Exhibit 4/13-47c.
[430] Id.
[431] Id.
[432] Subcommittee interview of David Beck (3/2/2010).

who reported to David Beck, Executive Vice President in charge of WaMu's Capital Markets Division. Mr. Beck reported to the President of WaMu's Home Loans Division, David Schneider.[433]

At the Subcommittee hearing on April 13, 2010, Mr. Beck explained the role of WCC in WaMu and Long Beach securitizations as follows:

> "WaMu Capital Corp. acted as an underwriter of securitization transactions generally involving Washington Mutual Mortgage Securities Corp. or WaMu Asset Acceptance Corp. Generally, one of the two entities would sell loans into a securitization trust in exchange for securities backed by the loans in question, and WaMu Capital Corp. would then underwrite the securities consistent with industry standards. As an underwriter, WaMu Capital Corp. sold mortgage-backed securities to a wide variety of institutional investors.[434]

WCC sold WaMu and Long Beach loans and RMBS securities to insurance companies, pension funds, hedge funds, other banks, and investment banks.[435] It also sold WaMu loans to Fannie Mae and Freddie Mac. WCC personnel marketed WaMu and Long Beach loans both in the United States and abroad.

Before WCC was able to act as a sole underwriter, WaMu and Long Beach worked with a variety of investment banks to arrange, underwrite, and sell its RMBS securitizations, including Bank of America, Credit Suisse, Deutsche Bank, Goldman Sachs, Lehman Brothers, Merrill Lynch, Royal Bank of Scotland, and UBS. To securitize its loans, WaMu typically assembled and sold a pool of loans to a qualifying special-purpose entity (QSPE) that it established for that purpose, typically a trust.[436] The QSPE then issued RMBS securities

[433] Id.

[434] April 13, 2010 Subcommittee Hearing at 53. Washington Mutual Mortgage Securities Corp. (WMMSC) and WaMu Asset Acceptance Corp. (WAAC) served as warehouse entities that held WaMu loans intended for later securitization. Mr. Beck explained in his prepared statement: "WMMSC and WAAC purchased loans from WaMu, and from other mortgage originators, and held the loans until they were sold into the secondary market. WCC was a registered broker-dealer and acted as an underwriter of securitization deals for a period of time beginning in 2004 and ending in the middle of 2007. In addition to buying and selling mortgage loans, WMMSC acted as a 'master servicer' of securitizations. The master servicer collects and aggregates the payments made on loans in a securitized pool and forwards those payments to the Trustee who, in turn, distributes those payments to the holders of the securities backed by that loan pool." Id. at 163.

[435] See 6/11/2007 chart entitled, "Origination Through Distribution," JPM_WM03409859, Hearing Exhibit 4/13-47c; Subcommittee interview of David Beck (3/2/2010).

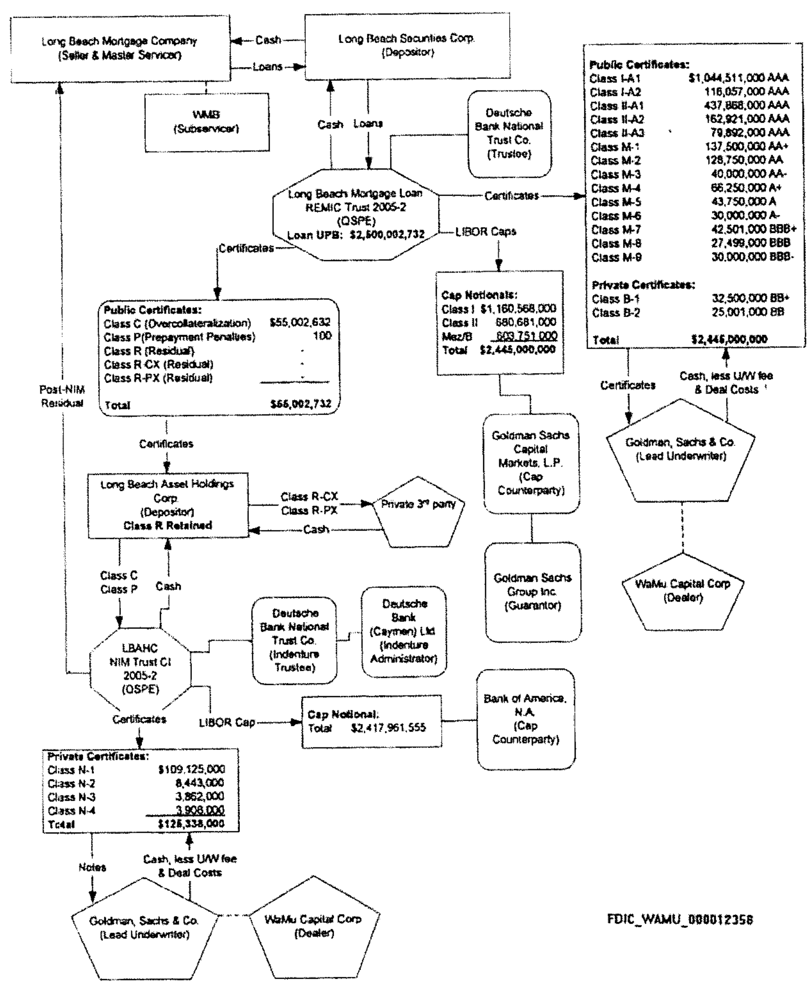
[436] See 3/2007 Washington Mutual Inc. 10-K filing with the SEC, at 45 (describing securitization process).

secured by future cash flows from the loan pool. Next, the QSPE – working with WCC and usually an investment bank – sold the RMBS securities to investors, and used the sale proceeds to repay WaMu for the cost of the loan pool. Washington Mutual Inc. generally retained the right to service the loans. WaMu or Long Beach might also retain a senior, subordinated, residual, or other interest in the loan pool.

The following two diagrams created for a 2005 Long Beach securitization, LBMC 2005-2, demonstrate the complex structures created to issue the RMBS securities, as well as the "waterfall" constructed to determine how the mortgage payments being made into the securitization pool would be used.[437]

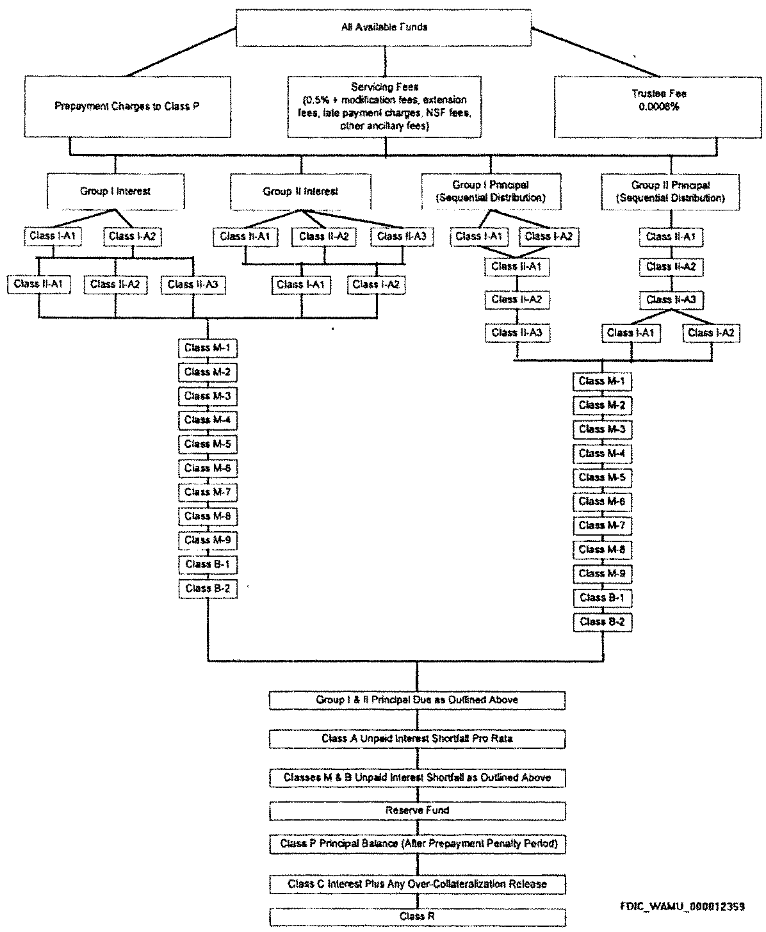
[437] See "LBMC 2005-2 Structure" and "LBMC 2005-2 Cash Flow Waterfall," FDIC_WAMU_000012358-59, Hearing Exhibit 47a.

LBMC 2005-2 Structure



FDIC_WAMU_000012358

LBMC 2005-2 Cash Flow Waterfall



In that particular securitization, Goldman Sachs served as the lead underwriter, WCC served as the securities dealer, Deutsche Bank served as the trustee of the trust set up to hold the securities, and Long Beach served as the mortgage servicer.

Another document, prepared by Goldman Sachs, shows the variety of relationships that WaMu engaged in as part of its securitization efforts.[438] That document, which consists of a list of various loan pools

[438] Undated "List of WaMu-Goldman Loans Sales and Securitizations," Hearing Exhibit 4/13-47b.

and related matters, shows that WaMu worked with Goldman Sachs to make whole loan sales; securitize loans insured by the Federal Home Administration or Veterans Administration; and securitize prime, subprime, Alt A, second lien, and scratch and dent nonperforming loans. It also shows that Goldman Sachs asked WaMu and Long Beach to repurchase more than $19.7 million in loans it had purchased from the bank.[439]

Goldman Sachs handled a number of securitizations for Long Beach. At one point in 2006, Goldman Sachs made a pitch to also handle loans issued by WaMu. One Goldman Sachs broker explained to a colleague in an email: "They have possibly the largest subprime portfolio on the planet."[440]

(2) Deficient Securitization Practices

Over the years, both Long Beach and Washington Mutual were repeatedly criticized by the bank's internal auditors and reviewers, as well as its regulators, OTS and the FDIC, for deficient lending and securitization practices. Their mortgage backed securities were among the worst performing in the marketplace due to poor quality loans that incurred early payment defaults, fraud, and high delinquency rates.

Long Beach Securitizations. In April 2005, an internal email sent by an OTS regulator recounted eight years of abysmal performance by Long Beach securities, noting that loan delinquencies and losses occurred in pools containing both fixed rate and adjustable rate mortgages:

> "[Securitizations] prior to 2003 have horrible performance .... For FRM [fixed rate mortgage] losses, LBMC finished in the top 12 worst annual NCLs [net credit losses] in 1997 and 1999 thru 2003. LBMC nailed down the number 1 spot as top loser with an NCL of 14.1% in 2000 and placed 3rd in 2001 with 10.5% .... For ARM losses, LBMC really outdid themselves with finishes as one of the top 4 worst performers for 1999 thru 2003. For specific ARM deals, LBMC made the top 10 worst deal list from 2000 thru 2002. LBMC had an extraordinary year in 2001 when their securitizations had 4 of the top 6 worst NCLs (range: 11.2% to 13.2%).

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[439] Id.

[440] 3/24/2005 email from Kevin Gasvoda of Goldman Sachs to Christopher Gething, others, Hearing Exhibit 4/27-167b.

"Although underwriting changes were made from 2002 thru 2004, the older issues are still dragging down overall performance. Despite having only 8% of UPB [unpaid balances] in 1st lien FRM pools prior to 2002 and only 14.3% in 2002 jr. lien pools, LBMC still had third worst delinquencies and NCLs for most of [the] period graphed from 11/02 thru 2/05 and was 2nd worst in NCLs in 2005 out of 10 issuers graphed. ... At 2/05, LBMC was #1 with a 12% delinquency rate. Industry was around 8.25%. At 3/05, LBMC had a historical NCL rate of 2% smoking their closest competitor by 70bp and tripling the industry average."[441]

This email, which is based upon a 2005 Fitch analysis of Long Beach, shows that, from 1997 to March 2005, due to loan delinquencies and losses, Long Beach securities were among the very worst performing in the entire subprime industry.[442]

Long Beach's performance did not improve after 2005. In April 2006, for example, Nomura Securities issued an analysis of the ABX Index that tracked a basket of 20 subprime RMBS securities and identified Long Beach as the worst performer:

"Long Beach Mortgage Loan Trust appears to be the poorest performing issuer, with its three deals averaging 15.67% in 60+ day delinquency and 12.75% in 90+ day delinquency. Unsurprisingly, all three deals issued by LBMLT have exceeded their delinquency trigger limits."[443]

In November 2006, while attending the Asset Backed Securities East Conference for the securitization industry, the head of WaMu's Capital Markets Division, David Beck, emailed WaMu's Home Loans President, David Schneider, that with respect to RMBS securities carrying noninvestment grade ratings, "LBMC [Long Beach] paper is among the worst performing paper in the mkt [market] in 2006. Subordinate buyers want answers."[444]

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[441] 4/14/2005 email from Steve Blelik to David Henry, "Fitch – LBMC Review," Hearing Exhibit 4/13-8a.
[442] Id.
[443] 4/19/2006 "ABX Index – The Constituent Breakdown," prepared by Nomura Securities International Inc., http://www.scribd.com/doc/19606903/Nomura-ABX-Index-The-Constituent-Breakdown.
[444] 11/7/2006 email from David Beck to David Schneider, Hearing Exhibit 4/13-50. See also 4/19/2006 "ABX Index – The Constituent Breakdown," prepared by Nomura Securities International Inc., http://www.scribd.com/doc/19606903/Nomura-ABX-Index-The-Constituent-Breakdown.

In March 2007, an analysis by JPMorgan Chase again singled out Long Beach securities for having the worst delinquency rates among the subprime securities tracked by the ABX Index:

> "Washington Mutual Inc.'s subprime bonds are suffering from some of the worst rates of delinquency among securities in benchmark indexes, according to JPMorgan Chase & Co. research. … Delinquencies of 60 days or more on loans supporting WaMu's Long Beach LBMLT 2006-1 issue jumped … to 19.44 percent … the highest among the 20 bonds in the widely watched ABX-HE 06-2 index of bonds backed by residential loans to risky borrowers."[445]

In July 2007, Moody's and S&P downgraded the credit ratings of hundreds of subprime RMBS and CDO securities, due to rising mortgage delinquencies and defaults. Included were approximately 40 Long Beach securities.[446] A July 12, 2007 presentation prepared by Moody's to explain its ratings action shows that Long Beach was responsible for only 6% of all the subprime RMBS securities issued in 2006, but received 14% of the subprime RMBS ratings downgrades that day.[447] Only Fremont had a worse ratio.

Over time, even AAA rated Long Beach securities performed terribly. Of the 75 Long Beach mortgage backed security tranches rated AAA by Standard and Poor's in 2006, all 75 have been downgraded to junk status, defaulted, or been withdrawn.[448] In most of the 2006 Long Beach securitizations, the underlying loans have delinquency rates of 50% or more.[449]

The problems were not confined to Long Beach loans. In early 2008, for example, an investment adviser posted information on his personal blog about a WaMu-sponsored RMBS securitization known as WMALT 2007-OC1. Formed in May 2007, this pool contained about 1,700 Alt A loans with a total outstanding balance of about $515 million. WaMu was the sole underwriter. The credit rating agencies gave AAA and other investment grade ratings to more than 92% of the

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[445] "WaMu subprime ABS delinquencies top ABX components," Reuters (3/27/2007), Hearing Exhibit 4/13-52.
[446] 7/10/2007-7/12/2007 excerpts from Standard & Poor's and Moody's Downgrades, Hearing Exhibit 4/23-99.
[447] 7/12/2007 "Moody's Structured Finance Teleconference and Web Cast: RMBS and CDO Rating Actions," MOODYS-PSI2010-0046902, Hearing Exhibit 4/23-106.
[448] See Standard and Poor's data at www.globalcreditportal.com.
[449] See, e.g., wamusecurities.com (subscription website maintained by JPMorgan Chase with data on Long Beach and WaMu mortgage backed securities showing, as of March 2011, delinquency rates for particular mortgage backed securities, including LBMLT 2006-1 – 58.44%; LBMLT 2006-6 – 60.06%; and LBMLT 2005-11 – 54.32%).

securitization, but within eight months, 15% of the pool was in foreclosure. The posting suggested that the poor performance of WaMu securities was systemic.

When informed by David Schneider of the complaint about the negative publicity surrounding the pool, David Beck responded:

> "Yes (ughh!) we are doing some peer group performance and looking at the servicing data … and putting together an analysis. … The collateral is full of limited doc layered risk alt a paper and at least half is TPO [third party originated]. The performance is not great but my opinion is not a WaMu specific issue."[450]

Home Loans President David Schneider replied: "Ok – thanks …. Are we sure there isn't a reporting issue?" Today, those securities have all been downgraded to junk status and more than half of the underlying loans are delinquent or in foreclosure.[451]

Despite their poor performance, it is unclear that any investment bank refused to do business with either Long Beach or WaMu. As long as investors expressed interest in purchasing the securities, banks continued selling them until the entire subprime market collapsed. Before the market collapsed, WaMu earned hundreds of millions of dollars a year from its home loans sales and securitizations.[452]

Securitizing Fraudulent Loans. WaMu and Long Beach securitized not just poor quality loans, but also loans that its own personnel had flagged as containing fraudulent information. That fraudulent information included, for example, misrepresentations of the borrower's income and of the appraised value of the mortgaged property. In September 2008, WaMu's Corporate Credit Review team released a report which found that internal controls intended to prevent the sale of fraudulent loans to investors were ineffective:

> "The controls that are intended to prevent the sale of loans that have been confirmed by Risk Mitigation to contain misrepresentations or fraud are not currently effective. There is not a systematic process to prevent a loan in the Risk Mitigation Inventory and/or confirmed to contain suspicious activity from being sold to an investor. ... Of the 25 loans tested, 11 reflected a

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[450] 2/2/2008 email from David Beck to David Schneider and others, JPM_WM02445758, Hearing Exhibit 4/13-51.

[451] As of December 2010, the total loan delinquency rate of the WMALT 2007-OC1 series was 57.37%. See wamusecurities.com.

[452] See 3/1/2007 Washington Mutual Inc. 10-K filing with the SEC, at 82, 87.

sale date after the completion of the investigation which confirmed fraud. There is evidence that this control weakness has existed for some time."[453]

In other words, even loans marked with a red flag indicating fraud were being sold to investors. The review identified several factors contributing to the problem, including insufficient resources devoted to anti-fraud work, an absence of automated procedures to alert personnel to fraud indicators, and inadequate training on fraud awareness and prevention. The 2008 review warned: "Exposure is considerable and immediate corrective action is essential in order to limit or avoid considerable losses, reputation damage, or financial statement errors."[454]

(3) Securitizing Delinquency-Prone Loans

The Subcommittee uncovered an instance in 2007 in which WaMu securitized certain types of loans that it had identified as most likely to go delinquent, but did not disclose its analysis to investors who bought the securities. Investors who purchased these securities without the benefit of that analysis quickly saw the value of their purchases fall.

WaMu securitization agreements prohibited the bank from using an "adverse selection" process when including loans within a securitized pool. On March 22, 2007, WaMu filed a prospectus for WMALT Series 2007-OA3, in which Washington Mutual Bank and Washington Mutual Mortgage Securities Corp. co-sponsored a securitization of a $2.3 billion pool of Option ARM loans. In the section entitled, "Representations and Warranties Regarding the Mortgage Loans," the prospectus stated:

> "Washington Mutual Mortgage Securities Corp. and Washington Mutual Bank, as applicable, used no adverse selection procedures in selecting the mortgage loans from among the outstanding adjustable rate conventional mortgage loans owned by it which were available for sale and as to which the representations and warranties in the mortgage loan sale agreement could be made."[455]

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[453] 9/8/2008 "Risk Mitigation and Mortgage Fraud 2008 Targeted Review," WaMu Corporate Credit Review, JPM_WM00312502, Hearing Exhibit 4/13-34.
[454] Id.
[455] 3/22/2007 WaMu Prospectus Supplement, "Washington Mutual Mortgage Pass-Through Certificates, WMALT Series 2007-OA3," at S-102, Hearing Exhibit 4/13-86b.

On the following page of the prospectus, under the section heading, "Criteria for Selection of Mortgage Loans," it stated:

> "Each co-sponsor selected the mortgage loans it sold to the depositor from among its portfolio of mortgage loans held for sale based on a variety of considerations, including type of mortgage loan, geographic concentration, range of mortgage interest rates, principle balance, credit scores and other characteristics described in Appendix B to this prospectus supplement, and taking into account investor preferences and the depositor's objective of obtaining the most favorable combination of ratings on the certificates."[456]

WaMu emails and memoranda obtained by the Subcommittee indicate that, prior to assembling the loan pool used in the WMALT 2007-OA3 securitization, WaMu identified delinquency-prone Option ARM mortgages in its "Held for Investment" loan portfolio and transferred those loans to its portfolio of mortgages available for sale or securitization. WaMu then used its "Held for Sale" loan portfolio to select the loans for the loan pool used in the WMALT 2007-OA3 securitization. The prospectus provides a list of criteria used to select the loans in the WMALT 2007-OA3 loan pool, but omits any mention of the fact that some of the loans were selected using statistical analysis designed to identify Option ARM loans likely to go delinquent quickly. The internal emails demonstrate that WaMu selected delinquency-prone loans for sale in order to move risk from the bank's books to the investors in WaMu securities, and profit from its internal analysis, which was not available to the market.

On Thursday, September 14, 2006, John Drastal, then Senior Managing Director of WCC, sent David Beck, head of WaMu's Capital Markets Division, with copies to others, an email regarding "Tom Casey visit," with the importance marked "high." Tom Casey was then the Chief Financial Officer of Washington Mutual Bank. In the email Mr. Drastal relayed Mr. Casey's concern about WaMu's exposure to Option ARM loans:

> "David,
>
> "Tom just stopped by after the Lehman investor conference. He says equity investors are totally freaking about housing now. He asked how we could prepare for this. A few items ....

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[456] Id. at S-103.

"2. On the portfolio side, he asked about exposure on option ARMs. We talked about looking to potentially sell '06 production Option ARMs in portfolio. He even said looking at this quarter. I don't think that this is possible but we should look at what the credit composition of this product is and see if we can sell quickly if it's the right thing to do (see Nagle's message). He doesn't for[e]see a tainting issue if we are doing it for credit issues. Youyi, can you get me a collateral strat from the portfolio?"[457]

Three months later, on Wednesday, February 14, 2007, a WaMu portfolio analyst and trader, Michael Liu, sent an email to a senior official in WaMu's portfolio management department, Richard W. Ellson, with the subject line: "Option ARM MTA and Option ARM MTA Delinquency." The email included the abbreviations "MTA," which stands for "Monthly Treasury Average," and "PPD," which stands for "Payment Past Due." The email provided a description of Option ARM loans in WaMu's investment portfolio that were delinquent in the fourth quarter of 2006:

"Hi Rick,

"Attached is the spreadsheet with the total Option ARM MTA … and Option ARM MTA >=1 PPD summary. Some points for the Option ARM MTA >=1PPD:

- $105mm in Nonaccrual is between FICO 501-540.
- $222mm in Nonaccrual between LTV 61-80.
- CA [California] represents the greatest amount of Delinquency (1PPD, 2PPD, 3PPD, nonaccrual)[.]
- Loans originated in 2004 and 2005 represent the highest amount of 3 PPD and nonaccrual[.]"[458]

On the same day, Mr. Ellson forwarded the email to the Division Executive for Portfolio Management and Research, Youyi Chen, with the following comments:

"Youyi – attached is a description of the Option ARMs that were delinquent in the 2006q4 [fourth quarter]. You can see that it is very much a function of FICOs and Low Doc loans. We are in the process of updating the optimum pricing matrix. Mike did the work. Your comments are appreciated."[459]

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[457] 9/14/2006 email from John Drastal to David Beck, with Youyi Chen and Doug Potolsky copied, "Tom Casey visit," Hearing Exhibit 4/13-40a.
[458] 2/2007 WaMu internal email chain, Hearing Exhibit 4/13-40b.
[459] Id.

Mr. Chen, in turn, forwarded the email to the head of WaMu's Capital Markets Division, David Beck. Mr. Chen's introductory comments indicated that the research had been performed in response to a question from WaMu Home Loans President David Schneider and was intended to identify criteria for the loans driving delinquencies in the Option ARM portfolio:

> "This answers partially [David] Schneider's questions on break down of the option arm delinquencies.
>
> The details (1PPD tab) shows Low fico, low doc, and newer vintages are where most of the delinquency comes from, not a surprise."[460]

On the same day, February 14, Mr. Beck forwarded the entire email chain to David Schneider and WaMu Home Loans Risk Officer Cheryl Feltgen, adding his own view:

> "Please review. The performance of newly minted option arm loans is causing us problems. Cheryl can validate but my view is our alt a (high margin) option arms [are] not performing well.
>
> We should address selling 1Q [first quarter] as soon as we can before we loose [sic] the oppty. We should have a figure out how to get this feedback to underwriting and fulfillment."[461]

Mr. Beck's message indicated that recently issued Option ARM loans were not performing well, and suggested selling them before the bank lost the opportunity. WaMu would lose the opportunity to sell those loans if, for example, they went delinquent, or if the market realized what WaMu analysts had already determined about their likelihood of going delinquent. Mr. Beck's email proposed selling the loans during the first quarter of the year, already six weeks underway, and "as soon as we can."

Four days later, on Sunday, February 18, Mr. Schneider replied to the email chain by requesting Ms. Feltgen's thoughts. Later that day, Ms. Feltgen responded with additional analysis and an offer to help further analyze the Option ARM delinquencies:

> "The results described below are similar to what my team has been observing. California, Option ARMs, large loan size ($1 to $2.5

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[460] Id.
[461] Id.

> million) have been the fastest increasing delinquency rates in the SFR [Single Family Residence] portfolio. Although the low FICO loans have … higher absolute delinquency rates, the higher FICOs have been increasing at a faster pace than the low FICOs. Our California concentration is getting close to 50% and many submarkets within California actually have declining house prices according to the most recent OFHEO [Office of Federal Housing Enterprise Oversight] data from third quarter of 2006. There is a meltdown in the subprime market which is creating a 'flight to quality'. I was talking to Robert Williams just after his return from the Asia trip where he and Alan Magleby talked to potential investors for upcoming covered bond deals backed by our mortgages. There is still strong interest around the world in USA residential mortgages. Gain on sale margins for Option ARMs are attractive. This seems to me to be a great time to sell as many Option ARMs as we possibly can. Kerry Killinger was certainly encouraging us to think seriously about it at the MBR [Monthly Business Review] last week. What can I do to help? David, would your team like any help on determining the impact of selling certain groupings of Option ARMs on overall delinquencies? Let me know where we can help. Thanks."[462]

As Chief Risk Officer in WaMu's Home Loans division, Ms. Feltgen pointed out some counterintuitive features of the latest delinquencies, noting that the fastest increases in delinquencies occurred in large loans and loans with high FICO scores. She also noted that the subprime meltdown had led to a "flight to quality," and that foreign investors still had a strong interest in U.S. residential mortgages, suggesting that WaMu might be able to sell its likely-to-go delinquent Option ARMs to those foreign investors. From her perspective as a risk manager, she urged selling "as many Option ARMs as we can."

Her email also indicated that the topic of selling more Option ARMs had come up during the prior week at the monthly business review meeting, in which WaMu CEO Killinger expressed interest in exploring the idea.[463] Finally, Ms. Feltgen offered help in analyzing the impact of selling "certain groupings of Options ARMs" on overall delinquencies. Removing those problematic loans from the larger pool of Option ARM loans in the bank's investment portfolio would reduce loan delinquencies otherwise affecting the value of the portfolio as a whole.

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[462] Id.

[463] At the end of 2006, WaMu held about $63.5 billion in Option ARM mortgages, then comprising about 28% of its investment portfolio. See 3/2007 Washington Mutual Inc. 10-K filing with the SEC, at 52.

Mr. Schneider sent a second email at 11:00 at night that same Sunday providing instructions for moving forward:

> "Let[']s do the following:
> 1. db [David Beck] - please select the potential sample portfolios - along the lines we discussed at the mbr [Monthly Business Review]
> 2. cf [Cheryl Feltgen] - please run credit scenarios
> 3. db - coordinate with finance on buy/sell analysis
> 4. db/cf – recommendation[.]"[464]

On Tuesday morning, February 20, 2007, Mr. Beck replied with additional analysis:

> "Here's how I see this going.
>
> From the MBR [Monthly Business Review], my notes indicate two portfolios we discussed for sale; the 2007 high margin production (Jan and Feb so far) and the seasoned COFI book.[465]
>
> I will supply to Cheryl the loan level detail on both pools and the pricing assumptions for losses. Cheryl, you need to run scenario analysis and on losses versus pricing AND reserving assumptions. I can supply pricing assumptions but would like you to pull the ALLL [Allowance for Loan and Lease Losses] against these pools."[466]

Later that day, Ms. Feltgen forwarded the email chain to her team, changing the subject line to read: "URGENT NEED TO GET SOME WORK DONE IN THE NEXT COUPLE DAYS: Option ARM MTA and Option ARM MTA Delinquency." Clearly, time was of the essence:

> "See the attached string of emails. We are contemplating selling a larger portion of our Option ARMs than we have in the recent past. Gain on sale is attractive and this could be a way to address California concentration, rising delinquencies, falling house prices in California with a favorable arbitrage given that the market seems not to be yet discounting a lot for those factors. David

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[464] 2/2007 WaMu internal email chain, Hearing Exhibit 4/13-40b.
[465] Option ARMs were considered a "high margin" product within WaMu, because they produced a relatively high gain on sale when sold. See 4/18/2006 Washington Mutual Home Loans Discussion Board of Directors Meeting, at JPM_WM00690894, Hearing Exhibit 4/13-3 (chart showing gain on sale margin by product). "COFI" stands for "Cost of Funds Index" which is an index used to set variable interest rates. "Seasoned" means the loans are older production.
[466] 2/2007 WaMu internal email chain, Hearing Exhibit 4/13-40b.

Schneider has set a meeting for Friday morning with David Beck and me to hear our conclusions and recommendations. See the comments below about the information that we need to provide for this analysis. We will get the pools by tomorrow at the latest. We will need to coordinate with Joe Mattey and get input from him in order to make a judgment regarding the ALLL impact. ...

In addition to the specific information that David Beck asks for, I would like your input on portions of the Option ARM portfolio that we should be considering selling. We may have a different view than David Beck's team as to the most desirable to sell and we should provide that input. Our suggestion, for instance, might include loans in California markets where housing prices are declining. There may be other factors.

I will need to get from you by Thursday, February 22 end of day a summary of our conclusions and recommendations."[467]

A WaMu risk analyst, Robert Shaw, replied the same day and identified specific factors that were driving delinquencies in the Option ARM portfolio:

"Cheryl,

I reviewed the HFI [Hold for Investment] prime loan characteristics that contributed to rising 60+ delinquency rates[468] between 1/06 - 1/07 [January 6 and 7]. The results of this analysis show that seven combined factors contain $8.3 billion HFI Option ARM balances which experienced above-average increases in the 60+ delinquency rate during the last 12 months (a 821% increase, or 10 times faster than the average increase of 79%). I recommend that we select loans with some or all of these characteristics to develop a HFS [Hold for Sale] pool.

Below, I have listed the factors (layered), their percentage change in 60+ delinquency rate over the last 12 months, and HFI balances as of January 2007.[469]

1) HFI Option ARMs – 79% increase (.56% to 1.0%), $60.6 billion
2) Above + Vintages 2004-2007 – 179% increase (.33% to .92%), $47.8 billion

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[467] Id.
[468] A "60+ delinquency rate" applies to loans in which a payment is late by 60 days or more.
[469] 2/2007 WaMu internal email chain, Hearing Exhibit 4/13-40b.

3) Above + CA – 312% increase (.16 to .66%), $23.7 billion
4) Above + NY/NJ/CT – 254% increase (.21 to .76%), $29.3 billion
5) Above + $351k-1mil – 460% increase (.12 to .70%), $17.2 billion
6) Above + FICO 700-739 – 1197% increase (.03% to .40%), $4.2 billion
7) Above + FICO 780+ – 1484% increase (.02% to .38%), $5.2 billion
8) Above + FICO 620-659 – 821% increase (.07 to .67%), $8.3 billion[.]"[470]

Essentially, the key factors identified Option ARMs that were in certain states, like California, had certain FICO scores or certain loan amounts, or were issued during the period 2004-2007.

Later that same day, Ms. Feltgen forwarded Mr. Shaw's email to Mr. Beck, Mr. Chen, and Mr. Ellson. Her email carried the subject line: "Some thoughts on target population for potential Option ARM MTA loan sale." She wrote:

> "David, Youyi and Rick:
>
> My team and I look forward to receiving the loan level detail on the pools of Option ARMs we are considering for sale. I thought it might be helpful insight to see the information Bob Shaw provides below about the components of the portfolio that have been the largest contributors to delinquency in recent times. I know this is mostly an exercise about gain on sale, but we might also be able to accomplish the other purpose of reducing risk and delinquency at the same time. Talk to you soon."[471]

A week later, on Sunday, February 25, 2007, Mr. Beck sent an email with the subject heading, "HFI Option Arms redirect to HFS," to much of WaMu's top management, including Mr. Schneider, Mr. Rotella, Mr. Casey, as well as the FDIC Examiner-In-Charge Steve Funaro, and others. The email indicated that a decision had been made to sell $3 billion in recent Option ARM loans, with as many as possible to be sold before the end of the quarter, which was four weeks away:

> "David [Schneider] and I spoke today. He's instructed me to take actions to sell all marketable Option Arms that we intend to

[470] 2/20/2007 email from Robert Shaw to Cheryl Feltgen, Hearing Exhibit 4/13-41.
[471] 2/20/2007 email from Cheryl Feltgen to David Beck, Youyi Chen, and Richard Ellson, Hearing Exhibit 4/13-41.

transfer to portfolio in 1Q[first quarter], 2007. That amounts to roughly 3B [$3 billion] option arms availab[l]e for sale. I would like to get these loans into HFS [the Hold for Sale portfolio] immediately so that [I] can sell as many as possible in Q1.

John [Drastal], we are only targeting to sell Option Arms destined for portfolio since year end at this point. I'll need direction from you on any special accounting concerns or documentation you will need to get these loans in the warehouse without tainting the HFI [Hold for Investment] book.[472]

Michelle, I believe this action requires MRC [Market Risk Committee] approval. Please advise.

This week I'll work to get the necessary governance sign offs in place. Cheryl, please direct me on what form the approval request should take and what committees should review and authorize the request. I can pull all of the data.

We continue to work with Cheryl and the credit risk team to analyze emerging credit risks in our prime portfolio and recommend actions to mitigate them.

Thanks for your help,
DJB"[473]

Two days later, on Tuesday, February 27, 2007, Mr. Chen sent an email with the subject line, "HFI selection criteria changes," to Michelle McCarthy, who was head of WaMu's Market Risk Management department[474] as well as chair of both its Market Risk Committee and Asset Liability Committee.[475] The email was copied to Mr. Beck, Ms. Feltgen and others, and showed that the implementation of the plan was underway:

"After careful review with David and the teams, David suggested me to make the following recommendations to MRC [Market Risk Committee] on the existing prime HFI/HFS selection criteria

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[472] Loans in a bank's Hold for Investment portfolio receive different accounting treatment than loans in the bank's Hold for Sale portfolio, and generally accepted accounting principles (GAAP) frown upon frequent transfers between the two portfolios. The GAAP principles were a key reason for Mr. Beck's instruction that the transfer of the Option ARM loans from WaMu's HFI to HFS portfolios proceed "without tainting the HFI book."

[473] 2/25/2007 email from David Beck to himself, David Schneider, Steve Rotella, Ron Cathcart, Tom Casey, Cheryl Feltgen, others, Hearing Exhibit 4/13-42b.

[474] 12/28/2007 WaMu internal report, "Disclosure Management," JPM_WM02414318.

[475] 3/9/2007 WaMu Market Risk Committee Meeting Minutes, Hearing Exhibit 4/13-43.

1. Effective March 7th 2007, modify the portfolio option ARM and COFI ARM retention criteria (see attached 'existing HFI descriptions', 'section 1.01 to 1.11 and section 2.01 to 2.08') to include only following loans for the portfolio (HFI)

    a. Super jumbo of size greater or equal to $ 3 MM (Risk based pricing applied, but difficult to sale)
    b. Advantage 90 (high LTV loans without MI, very little production as 80/10/10 gets popularity)
    c. Foreign Nationals (Risk based pricing applied, but difficult to sale due to FICO problems)
    d. FICO less than 620, except employee loans in which case FICO can be re-stated after closing.
    e. 3-4 units (excessive S & P level hit calls for portfolio execution)

2. Further more, we would like to request, transferring from HFI to HFS, all the MTA option ARMs and COFI ARMs, **funded or locked between January 1st, 2007 to Mach [sic] 7th, 2007,** and DO NOT fit the criteria listed above, and DO NOT fit the criteria section 3.02 to 4.07 in the attached 'existing HFI descriptions')

As a result of this change, we expected to securitize and settle about $ 2 billion more option/COFI ARMs in Q1-07 (mostly margin greater than 295), and going forward $ 1 billion per month potential incremental volume into HFS. For your information, the impact to gain on sale for the year is estimated to be about $180 MM pretax based on current market, and the impacts to 2007 portfolio NII is estimated to be about - $ 80 MM pretax.

Also included in the attachment, is a pool of $1.3 billion option/COFI ARMs funded to portfolio between January 1st and February 22nd that will be re-classified as HFS based on the above recommendations. We understand that this population of loans will be growing from now to March 7th until the portfolio selection criteria are officially modified.

We expected to start marketing the deal on March 12th, your prompt response will be greatly appreciated as the TSG [Technology Solutions Group] and QRM [Quantitative Risk

Management] teams also need time to implement the coding changes."[476]

This email proposed several significant changes to WaMu's treatment of its Option ARMs. First, WaMu decided to require most of its Option ARMs to go directly into its Hold for Sale portfolio instead of going into its Held for Investment portfolio. In light of its analysis that Option ARM loans were rapidly deteriorating, the bank no longer wanted to treat them as investments it would keep, but immediately sell them. Second, the only Option ARMs that it would automatically direct into its investment portfolio were those that the bank considered to be so obviously of poor quality that they were "non-salable," according to another internal email.[477] Third, WaMu proposed transferring all Option ARM loans originated in 2007 from the investment portfolio to the sale portfolio. Since these three changes in how WaMu would treat its Option ARMs had compliance, accounting, and tax consequences, they had to be approved by the Market Risk Committee. That Committee was composed of senior risk officers throughout the bank as well as senior managers in the bank's finance, treasury, and portfolio management departments. The email indicated that the changes needed to be implemented within about a week so that marketing of some of the Option ARMs could begin by March 12.

On March 9, 2007 the Market Risk Committee met and approved the Option ARM proposal. The minutes of that meeting describe the changes that had been proposed:

> "- Change the Held for Investment (HFI) ARM and COFI ARM retention criteria to include only the following loans for HFI effective March 12, 2007; Super jumbo ≥ \$3.0 million, Advantage 90, Foreign Nationals, FICO < 620 except employee loans in which case FICO can be re-stated after closing, and 3 to 4 units.
> - Increase Prime Option ARM's (including Second Liens) from \$26.0 billion to \$37.0 billion.
> - Transfer up to \$3.0 billion of saleable Option ARM and COFI ARM loans originated between January 1, 2007 and March 12, 2007 from HFI to HFS (excluding HFI loans described above)."[478]

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[476] 2/27/2007 email from Youyi Chen to Michelle McCarthy, with copies to David Beck, Cheryl Feltgen, Steve Fortunato, and others, "HFI selection criteria changes," Hearing Exhibit 4/13-42a [emphasis in original].

[477] 2/27/2007 email from Youyi Chen to David Griffith, "Option ARM," JPM_WM03117796 ("David, we sell all 295+ margin and other OA and COFI, and KEEP the 4 categories going forward due mostly to non-salable reasons.").

[478] 3/9/2007 WaMu Market Risk Committee Meeting Minutes, Hearing Exhibit 4/13-43.

The minutes also recorded an exchange between Ms. McCarthy and another Committee member, Mr. Woods, who was the Chief Financial Officer of WaMu's Home Loans division:

> "A second part of the proposal requests approval to transfer up to $3.0 billion of saleable Option ARM and COFI ARM loans originated since January 1, 2007 from HFI to Held for Sale (HFS). In response to a question from Mr. Woods, Ms. McCarthy explained that there are other Option ARM loans not included in the criteria that we are retaining in portfolio. Ms. McCarthy noted that Ms. Feltgen ha[d] reviewed and approved this proposal. Mr. Woods noted that Deloitte has reviewed the proposal as well."[479]

This exchange acknowledges that not all of the saleable Option ARM loans were diverted from the HFI to the HFS portfolio. WaMu chose to keep some Option ARMs and make other Option ARMs available for sale. The internal WaMu documents and communications reviewed by the Subcommittee strongly suggest that the decision to transfer the most recently originated Option ARMs from the Held-for-Investment portfolio to the Held-for-Sale portfolio was part of an effort to sell loans thought to be prone to delinquency, before they became delinquent. None of the hearing witnesses recalled how these loans were specifically selected for securitization, nor did any deny that they may have been selected for their propensity toward delinquency.[480]

The Subcommittee investigation determined that WaMu carried out the plan as approved, and transferred at least $1.5 billion Option ARMs originated in the first quarter of 2007, from the HFI to HFS portfolio. Of these loans, about 1,900 with a total value of a little over $1 billion were assembled into a pool and used in the WMALT 2007-OA3 securitization in March 2007.[481] WMALT 2007-OA3 securities were issued with WaMu as the sole underwriter and sold to investors.[482]

None of the materials associated with the sale of the WMALT 2007-OA3 securities informed investors of the process used to select the delinquency-prone Option ARMs from WaMu's investment portfolio and include them in the securitization.[483] Nor did WaMu inform investors of the internal analysis it performed to identify the

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[479] Id.
[480] Mr. Schneider and Mr. Beck were asked about this matter at the hearing. See April 13, 2010 Subcommittee Hearing at 75-82.
[481] 4/10/2010 Subcommittee email from Brent McIntosh, Sullivan & Cromwell LLP, Counsel for JPMorgan Chase [Sealed Exhibit].
[482] 3/22/2007 WaMu Prospectus Supplement, "Washington Mutual Mortgage Pass-Through Certificates, WMALT Series 2007-OA3," at S-102, Hearing Exhibit 4/13-86b.
[483] See, e.g., id. See also April 13, 2010 Subcommittee Hearing at 80.

delinquency-prone loans. Senator Levin questioned Mr. Beck about this point at the April 13 Subcommittee hearing:

> Senator Levin. When you said that investors were told of the characteristics of loans, they were told of all the characteristics of loans. Did they know, were they informed that loans with those or some of those characteristics had a greater propensity towards delinquency in WaMu's analysis? Were they told that?
>
> Mr. Beck. They were not told of the WaMu analysis.[484]

Predictably, the securitization performed badly. Approximately 87% of the securities received AAA ratings.[485] Within 9 months, by January 2008, those ratings began to be downgraded.[486] As of February 2010, more than half of the loans in WMALT Series 2007-OA3 were delinquent, and more than a quarter were in foreclosure.[487] All of the investment grade ratings have been downgraded to junk status, and the investors have incurred substantial losses.

(4) WaMu Loan Sales to Fannie Mae and Freddie Mac

Washington Mutual had longstanding relationships with a number of government sponsored enterprises (GSEs), including the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac).[488] Between 2000 and 2008, Washington Mutual sold over $500 billion in loans to Fannie Mae and Freddie Mac, accounting for more than a quarter of every dollar in loans WaMu originated.[489] While the majority of those loans involved lower risk, fixed rate mortgages, WaMu also sold Fannie and Freddie billions of dollars in higher risk Option ARMs.

Relationships with Fannie and Freddie. Fannie Mae and Freddie Mac purchase residential mortgages that meet specified

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[484] April 13, 2010 Subcommittee Hearing at 82.
[485] 4/11/2007 "New Issue: Washington Mutual Mortgage Pass-Through Certificates WMALT Series 2007-OA3 Trust," S&P's Global Credit Portal, www.globalcreditportal.com.
[486] See 1/14/2008 "Moody's takes negative rating actions on certain WaMu Option Arm deals issued in 2007," Moody's, http://www.moodys.com/viewresearchdoc.aspx?lang=en&cy=global&docid=PR_147683.
[487] "Select Delinquency and Loss Data for Washington Mutual Securitizations," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1g.
[488] See 9/29/2005 "GSE Forum," internal presentation prepared by WaMu, Hearing Exhibit 4/16-91 at JPM_WM02575608. As mentioned earlier, GSEs are Congressionally chartered, nongovernment owned financial institutions created for public policy purposes. At the time of the financial crisis, the GSEs included Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (FHLBS), all of which were created by Congress to strengthen the availability of capital for home mortgage financing.
[489] See chart, below, using loan data from Inside Mortgage Finance.

underwriting standards and fall below a specified dollar threshold, so-called "conforming loans." They often enter into multi-year contracts with large mortgage issuers to purchase an agreed-upon volume of conforming loans at agreed-upon rates. Prior to 2005, Washington Mutual sold most of its conforming loans to Fannie Mae, with relatively little business going to Freddie Mac.[490] From at least 1999 through 2004, WaMu sold those loans to Fannie Mae through a long term "Alliance Agreement,"[491] that resulted in its providing more than 85% of its conforming loans to Fannie Mae.[492] In 2004, WaMu calculated that it "contributed 15% of Fannie Mae's 2003 mortgage business,"[493] and was "Fannie Mae's 2nd largest provider of business (behind Countrywide)."[494] Among the advantages that WaMu believed it gained from its relationship with Fannie Mae were help with balance sheet management, underwriting guidance, and support for WaMu's Community Reinvestment Act initiatives.[495]

The following slide, created by Washington Mutual in March 2004, provides an overview of the GSEs' impact on the mortgage market at the time as well as the status of WaMu's relationship with Fannie Mae in early 2004.[496]

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[490] See 4/12/2004 "Pre-Meeting for Fannie Mae," internal presentation prepared by WaMu, at JPM_WM02405463, Hearing Exhibit 4/16-86 ("At current level, alternative executions, e.g., Freddie Mac, FHLB, and private investors, do not win a significant level of business.").
[491] See 4/12/2004 "Pre-Meeting for Fannie Mae," internal presentation prepared by WaMu, at JPM_WM02405462, Hearing Exhibit 4/16-86 (chart entitled, "Timeline of the Alliance Agreement").
[492] See 4/12/2004 "Pre-Meeting for Fannie Mae," internal presentation prepared by WaMu, at JPM_WM02405461, Hearing Exhibit 4/16-86 ("Under this Alliance Agreement with Fannie Mae, WaMu has agreed to deliver no less than 75% of eligible, conforming loans to Fannie Mae."); 2/23/2005 email exchange between David Beck and WaMu executives, Hearing Exhibit 4/16-85 ("5 years of 85%+ share with Fannie").
[493] 4/12/2004 "Pre-Meeting for Fannie Mae," internal presentation prepared by WaMu, at JPM_WM02405459, Hearing Exhibit 4/16-86.
[494] Id. at JPM_WM02405467, Subcommittee Hearing Exhibit 4/16-86.
[495] Id. at JPM_WM02405461, Subcommittee Hearing Exhibit 4/16-86. The Community Reinvestment Act (CRA) was passed by Congress to encourage banks to make loans in low- and moderate-income neighborhoods. See website of the Federal Financial Institutions Examination Council, "Community Reinvestment Act," http://www.ffiec.gov/cra/history.htm. Regulators, including the Office of Thrift Supervision, periodically reviewed banks' CRA activities and took them into account if a bank applied for deposit facilities or a merger or acquisition. Id. A 2005 presentation prepared by WaMu stated that its relationship with Freddie Mac helped the bank meet its CRA goals by purchasing more than $10 billion in qualifying loans. See 9/29/2005 "GSE Forum," presentation prepared by WaMu Capital Markets, at JPM_WM02575611, Hearing Exhibit 4/16-91. Between 1991 and 2006, WaMu was evaluated 20 times by OTS and the FDIC, achieving the highest possible CRA rating of "Outstanding" in each evaluation. See website of the Federal Financial Institutions Examination Council, ratings search for "Washington Mutual," http://www.ffiec.gov/craratings/default.aspx. Regulations state that an "outstanding" institution is one that not only meets the needs of its surrounding community, but utilizes "innovative or flexible lending practices." See 12 C.F.R. 345, Appendix A, http://www.fdic.gov/regulations/laws/rules/2000-6600.html#fdic2000appendixatopart345.
[496] Id. at JPM_WM02405459, Subcommittee Hearing Exhibit 4/16-86.

Washington Mutual

GSE's Impact in the Market

- Total Single Family originations were $3 76 trillion in 2003.
- Combined new business activity of Fannie Mae and Freddie Mac combined (including MBS securitizations and purchases) were $2.25 trillion in 2003 – or 59.8% of market originations.
- Fannie Mae was responsible for 60% of the GSE's new business activity in 2003.
- WaMu contributed 15% of Fannie Mae's 2003 mortgage purchases.
- GSEs dominate the automated underwriting decisioning technology through LP and DU.
- Credit guidelines for the market, in general, follow the GSE's lead.

3

Despite Fannie Mae's long history with WaMu, in 2005, the bank made a major change and shifted the majority of its conforming loan business to Freddie Mac. WaMu made the change in part because its long term contract with Fannie Mae was up for renegotiation,[497] and Freddie Mac offered better terms. According to WaMu, Freddie Mac had purchased $6 billion of its Option ARM loans in 2004, without a contract in place, and WaMu wanted to sell more of those loans.[498] WaMu conducted detailed negotiations with both firms that lasted more than six months.[499] Internally, it considered a number of issues related to switching the majority of its conforming loans to Freddie Mac.[500] The deciding factor was Freddie Mac's offer to purchase 100% of WaMu's conforming Option ARM mortgages which were among the bank's most

[497] See 4/12/2004 "Pre-Meeting for Fannie Mae," internal presentation prepared by WaMu, at JPM_WM02405468, Hearing Exhibit 4/16-86.

[498] See, e.g., 2/23/2005 email exchange between David Beck and WaMu executives, Hearing Exhibit 4/16-85 (reporting that Freddie Mac was "very aggressive in 2004 buying 6B of option arm without a share agreement in place.").

[499] See, e.g., 4/12/2004 "Pre-Meeting for Fannie Mae," internal presentation prepared by WaMu, Hearing Exhibit 4/16-86; 12/17/2004 email exchange among WaMu executives, "Risks/Costs to Moving GSE Share to FH [Freddie Mac]," JPM_WM05501399, Hearing Exhibit 4/16-88; 1/5/2005 "Business Relationship Proposal Issues," document prepared by WaMu, Hearing Exhibit 4/16-90 (describing multiple issues negotiated with both firms); 2/23/2005 email exchange between David Beck and WaMu executives, Hearing Exhibit 4/16-85 (David Beck wrote: "Fannie negotiated hard for our business especially in the 11th hour." CEO Killinger responded: "Good work David. It appears we got a good economic outcome and haven't burnt any bridges for the future.").

[500] See 12/17/2004 email exchange among WaMu executives, "Risks/Costs to Moving GSE Share to FH [Freddie Mac]," at JPM_WM05501401, Hearing Exhibit 4/16-88 (listing multiple issues including whether Fannie Mae would "be less supportative [sic] of using their balance sheet to support our quarter-end liquidity needs").

profitable loans.[501] In January 2005, in a document comparing the proposals from Fannie and Freddie, WaMu wrote:

> "The Freddie Mac Business Relationship [proposal] dated 12/21/2004 establishes another execution opportunity that diversifies WaMu's execution risk and confers material financial benefits for the Option ARM product. The key to the Freddie proposal is that it provides significant liquidity for our Option ARM originations, with more advantageous credit parameters, competitive g-fees and preferred access to their balance sheet relative to our current agreement with Fannie. Fannie has made it very clear to us that we should not expect to retain the same pricing and credit parameters for Option ARMs in our 2005 pricing agreement that we have enjoyed during 2004. For fixed rate loans and hybrids, g-fe[e]s adjusted for MAP Pricing and credit parameters are roughly equivalent to the Fannie Agreement."[502]

In April 2004, at the conclusion of its negotiations with Fannie and Freddie, WaMu entered into a one-year contract with Freddie Mac, switching the lion's share of the bank's conforming loans to that company and away from Fannie Mae.[503] According to WaMu, Freddie Mac's share of its conforming loans "went from 20% in Q1 [first quarter of 2005] to 81% in Q2 [second quarter of 2005]."[504] WaMu reported internally that, as a result of the new contract, it became the second largest seller of mortgages to Freddie Mac behind Wells Fargo, and that "[f]orty percent of FRE's [Freddie Mac's] portfolio growth in '05 can be attributed to WM's $8 billion sale of option ARMS."[505]

As the 2005 contract's expiration date neared, WaMu developed a list of issues to be negotiated with Freddie Mac for a new contract,

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501 Id. at JPM_WM05501399 (describing Fannie Mae's offer to purchase two-thirds of WaMu's Option ARM production); 2/23/2005 email exchange between David Beck and WaMu executives, Hearing Exhibit 4/16-85 ("I reviewed the most recent proposals from Freddie and Fannie today with Steve. We agreed that the Freddie 65% minimum share (100% of option arms) proposal offers us between 26MM and 37MM of benefit depending on volume ... 39% of our 2005 home loans gain on sale comes from conforming option arm sales. FH [Freddie Mac] stepped up with 21B of committed balance sheet and aggressive forward pricing for OA [Option ARMs] that result in the financial benefit over FN [Fannie Mae]."). WaMu originated both conforming and nonconforming Option ARMs, depending upon whether the loan exceeded the GSEs' dollar limit for the loans they would purchase.

502 1/5/2005 "Business Relationship Proposal Issues," document prepared by WaMu, Hearing Exhibit 4/16-90.

503 See 7/5/2006 "Freddie Mac – WaMu Meeting," document prepared by WaMu, JPM_WM03200453, Hearing Exhibit 4/16-87 ("WM executed a majority share arrangement w/FRE [Freddie Mac], effective 4/1/05 thru 3/31/06; included in that arrangement was a market-leading opportunity to sell up to $21 billion of option ARMs to the FRE portfolio.").

504 Id.

505 Id.

noting that Freddie Mac "does not want to be a 'one-year' wonder."[506] WaMu also observed that "FRE is not likely to outbid FNM by such a wide margin on option ARMS like in the current contract."[507] In a list of "asks ... to cement our relationship" with Freddie Mac, WaMu indicated, among other issues, that it would press Freddie Mac to buy more subprime and "lower quality loans":

- "**Credit** ...
  - WM [WaMu] wants FRE [Freddie Mac] to expand the eligibility of lower quality loans to ensure WM is 'market competitive'. ...
- **Non-prime**
  - Potential securitization of SMF [Specialty Mortgage Finance] assets ($1.5 - $10 bil) that will create liquidity for WM and create a positive affordability profile for FRE;
  - Expansion of credit profile into subprime; (Keith Johnson wants to keep this point very general); ...
- **Liquidity** – we want to understand how we can best help the FRE portfolio w/Product.
  - Longer term portfolio commitment on option ARMS;
  - Broader deliverability guidelines w/respect to option ARMs."[508]

WaMu wrote that it also expected Freddie Mac to discuss trends related to accepting "lower documentation standards."[509]

In April 2006, WaMu signed a new, two-year contract with Freddie Mac, again agreeing to sell the majority of its conforming loans to that company.[510] WaMu President Steve Rotella wrote: "Congratulations to the team for getting this done and with terrific results for the company."[511] In a document describing the "highlights" of the new agreement, a Wamu employee wrote:

> "Aligns WM with the stronger GSE over the next 12-18 months; we fully expect once FNM [Fannie Mae] gets its financial house in order to become a very aggressive competitor – just when this contract is coming up for renewal."[512]

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[506] Id.
[507] Id.
[508] Id. [italics in original omitted].
[509] Id. at JPM_WM03200454.
[510] See 4/28/2006 email exchange between WaMu executives, JPM_WM02521921, Hearing Exhibit 4/16-89 (celebrating contract that "David Schneider signed today").
[511] Id.
[512] Id.

WaMu's reference to the "stronger GSE" was in response to accounting scandals that, over the prior year, had weakened both Freddie Mac and Fannie Mae. In 2003, Freddie Mac announced that it had misstated its earnings by at least $4.5 billion, mostly by under-reporting its earnings in order to smooth the volatility of its quarterly earnings reports, and would be restating its earnings for the prior three years.[513] Later that year, Freddie Mac paid a $125 million civil fine to settle civil charges of accounting fraud brought by its regulator, the Office of Federal Housing Enterprise Oversight (OFHEO).[514] In September 2004, OFEHO issued a report finding that Fannie Mae had also violated accounting rules to smooth its earnings reports.[515] Fannie Mae later filed a $6.3 billion restatement of earnings and paid a $400 million fine.[516] Both GSEs also changed their senior management.

When asked at the Subcommittee hearing to define Washington Mutual's relationship with Fannie Mae and Freddie Mac, Mr. Rotella provided the following response:

> "Well, like all big mortgage lenders, Senator, Fannie Mae and Freddie Mac were important .... [T]here was a substantial amount of production that was sold off to either Fannie or Freddie. ... [A]ny mortgage lender that is in the mortgage business, given the government advantages and the duopoly that Fannie and Freddie had, needed to do business with them. It would be very difficult to be a mortgage player without them."[517]

Loan Sales to Fannie and Freddie. During the years examined by the Subcommittee, WaMu sold a variety of loans to both Fannie Mae and Freddie Mac, including 15, 20, and 30-year fixed rate mortgages; Option ARMs; interest-only ARMs; and hybrid ARMs.[518]

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[513] See "Freddie Mac Raises its Estimate of Errors," Associated Press (9/26/2003).
[514] See "Freddie to Settle with Fat Civil Fine," Associated Press (12/11/2003). In 2007, Freddie Mac paid an additional $50 million civil fine to the SEC to settle civil charges of securities fraud, without admitting or denying wrongdoing. "Freddie Mac to Pay $50 million," Associated Press (9/28/2007).
[515] 9/17/2004 Office of Federal Housing Enterprise Oversight Report of Findings to Date, "Special Examination of Fannie Mae," available at http://www.fhfa.gov/Preview-FHFAWWW/webfiles/748/FNMfindingstodate17sept04.pdf.
[516] See 2004 10-K filing with the SEC. Fannie Mae paid the $400 million civil fine in May 2006, to settle accounting fraud charges brought by OFHEO and SEC. See also "Fannie Settles Fraud Charges," National Mortgage News (5/29/2006).
[517] April 13, 2010 Subcommittee Hearing at 105, Senator Coburn question to Mr. Rotella.
[518] See 9/29/2005 "GSE Forum," internal presentation prepared by WaMu, at JPM_WM02575611, Hearing Exhibit 4/16-91 (chart entitled, "WaMu's Deliveries – Contract to Date 2005"). For more information on these types of loans, see Chapter II, above. WaMu did not sell loans directly to Ginnie Mae which, instead, guaranteed certain government backed mortgages when they were securitized by one of its approved securitizers. The WaMu chart showed that, in 2005, WaMu originated 35,291 loans with a total loan amount of about $4.6 billion that were securitized with Ginnie Mae guarantees. Id.

A September 2005 chart prepared by WaMu, identifying the loans it sold to Fannie Mae and Freddie Mac during the first part of that year, details the types and volumes of loans involved.[519] The chart showed, for example, that the largest category of loans that WaMu sold to Fannie and Freddie at that point in 2005 was fixed rate loans, which together totaled nearly 140,000 loans with a collective, total loan amount of about $24.3 billion.[520] The next largest category of loans was Option ARMs, which WaMu sold only to Freddie Mac and which consisted of 35,421 loans with a total loan amount of about $7.9 billion.[521] The third largest category was interest-only ARMs, totaling about 8,400 loans with a total loan amount of about $2 billion.[522] The fourth largest category was hybrid ARMs, totaling 6,500 loans with a total loan amount of about $1.4 billion.[523] WaMu also sold other loans to Fannie and Freddie which included 6,020 loans of various types bearing a total loan amount of about $2 billion.[524]

The chart showed that, altogether by September 2005, WaMu had sold Fannie and Freddie about 196,000 loans with a total loan amount of $36.5 billion.[525] About 70% were fixed rate loans;[526] about 20% were Option ARMs;[527] and other types of loans made up the final 10%. In addition to those single family mortgages, WaMu had an active business with Fannie and Freddie regarding loans related to multifamily apartment buildings.[528] The 2005 loan data indicates that WaMu sold twice as many loans to Fannie and Freddie as it did to all other buyers combined.[529] Most of those loans were fixed rate mortgages, but they

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[519] Id.
[520] Id. The WaMu chart showed that WaMu sold 31,460 fixed rate loans with a total loan amount of about $5.2 billion to Fannie Mae, and 108,246 loans with a total loan amount of about $19.1 billion to Freddie Mac.
[521] Id.
[522] Id. The WaMu chart showed that WaMu sold 5,350 interest-only ARMs with a total loan amount of about $1.3 billion to Fannie Mae, and 3,016 interest-only ARMs with a total loan amount of $724 million to Freddie Mac.
[523] Id. The WaMu chart showed that WaMu sold 3,250 hybrid ARMs with with a total loan amount of nearly $700 million to Fannie Mae, and 3,303 hybrid ARMs with a total loan amount of nearly $700 million to Freddie Mac.
[524] Id. See chart for more detail.
[525] Id. The chart showed that, altogether, WaMu sold about 45,000 loans with a total loan amount of $7.9 billion to Fannie Mae and 151,000 loans with a total loan amount of about $28.6 billion to Freddie Mac.
[526] By loan number, the percentage is 71%; by loan amount, the percentage is 67%.
[527] By loan number, the percentage is 18%; by loan amount, the percentage is 22%.
[528] See, e.g., 4/12/2004 "Pre-Meeting for Fannie Mae," internal presentation prepared by WaMu, at JPM_WM02405461, JPM_WM02405467, Hearing Exhibit 4/16-86 (chart entitled, "Overview of the Alliance," and "WaMu was responsible for 34.7% of Fannie Mae's Multifamily business").
[529] See 9/29/2005 "GSE Forum," internal presentation prepared by WaMu, at JPM_WM02575611, Hearing Exhibit 4/16-91 (chart entitled, "WaMu's Deliveries – Contract to Date 2005"). During the same time period in 2005, WaMu sold about 99,000 loans with a total loan amount of about $35 billion to buyers other than Fannie and Freddie. The two largest

also included the higher risk Option ARMs. In 2005, for example, WaMu sold three times as many Option ARMs to Freddie Mac than to all of its other buyers combined.[530]

The amount and variety of the loans that WaMu sold to the GSEs fluctuated over time. For example, the following chart, which is taken from data compiled by *Inside Mortgage Finance*, presents the total dollar volume of loans sold by WaMu to Fannie and Freddie from 2000 until 2008 when WaMu was sold, as well as the percentage those loans represented compared to WaMu's total loan originations.[531]

Year	Sold to Freddie Mac (in billions)	Sold to Fannie Mae (in billions)	Percent of Total WaMu Originations Sold to GSEs
2000	$ 0	$ 7.1	14%
2001	$ 1.4	$ 35.3	20%
2002	$ 0.2	$ 95.7	29%
2003	$ 2.2	$ 174.3	40%
2004	$ 1.1	$ 25.9	10%
2005	$ 34.6	$ 20.3	20%
2006	$ 32.3	$ 11.2	23%
2007	$ 31.8	$ 8.2	29%
2008	$ 20.8	$ 2.1	70%
TOTAL	**$ 124.4**	**$ 380.1**	**27.3%**

Source: Inside Mortgage Finance

The data indicates that, in total, WaMu sold more than half a trillion dollars in loans to the two GSEs in the nine years leading up to the bank's collapse, accounting for more than a quarter of all of the loans WaMu originated.

categories of loans sold to buyers other than Fannie or Freddie were jumbo loans (43,758 loans with a total loan amount of $26.9 billion) and government backed loans in securities guaranteed by Ginnie Mae (35,291 loans with a total loan amount of $4.6 billion). Id.

[530] Id. The chart indicates that WaMu sold over 17,000 loans with a total loan amount of nearly $4 billion to Freddie Mac, but only 5,841 Option ARMs with a total loan amount of $1.2 billion to all other buyers. It is possible, however, that the data on Option ARMs sold to other buyers is understated if some portion of the loans categorized on the chart as "jumbo" loans were, in fact, also Option ARMs. See, e.g., Id. at JPM_WM02575611, Hearing Exhibit 4/16-91 (interpretive note below chart); 8/2006 WaMu chart entitled, "WaMu Originations Product Mix," at JPM_WM00212644, Hearing Exhibit 4/13-37 (showing that WaMu used Option ARMs in both conforming and jumbo loans). In addition to selling Option ARMs to Freddie Mac and others, WaMu kept a portion of the Option ARMs it originated in its investment portfolio and securitized still others.

[531] "Historical Data from Inside Mortgage Finance, Inside Mortgage Finance, www.imfpubs.com/data.

The documents obtained by the Subcommittee indicate that, from 2004 to 2008, Fannie Mae and Freddie Mac competed to purchase billions of dollars in WaMu's residential mortgage loans, and WaMu used that competition to negotiate better terms for its loan sales. Twice during that period, WaMu successfully played one GSE off the other to sell more high risk Option ARM loans under better terms to Freddie Mac.

F. Destructive Compensation Practices

Washington Mutual and Long Beach's compensation practices contributed to and deepened its high risk lending practices. Loan officers and processors were paid primarily on volume, not primarily on the quality of their loans, and were paid more for issuing higher risk loans. Loan officers and mortgage brokers were also paid more when they got borrowers to pay higher interest rates, even if the borrower qualified for a lower rate – a practice that enriched WaMu in the short term, but made defaults more likely down the road. Troubling compensation practices went right to the top. In 2008, when he was asked to leave the bank that failed under his management, CEO Kerry Killinger received a severance payment of $15 million.[532]

(1) Sales Culture

WaMu's compensation policies were rooted in the bank culture that put loan sales ahead of loan quality. As early as 2004, OTS expressed concern about WaMu's sales culture: "The overt causes for past underwriting concerns were many, but included: (1) A sales culture focused heavily on market share via loan production, (2) extremely high lending volumes."[533] In early 2005, WaMu's Chief Credit Officer complained to Mr. Rotella that: "[a]ny attempts to enforce [a] more disciplined underwriting approach were continuously thwarted by an aggressive, and often times abusive group of Sales employees within the organization."[534] The aggressiveness of the sales team toward underwriters was, in his words, "infectious and dangerous."[535]

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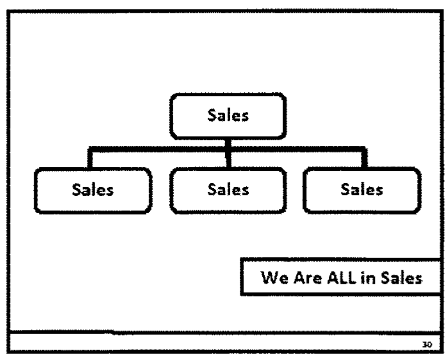
[532] See "Washington Mutual CEO Kerry Killinger: $100 Million in Compensation, 2003-2008," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1h.

[533] 5/12/2004 OTS Safety & Soundness Examination Memo 5, "SFR Loan Origination Quality," at 1, Hearing Exhibit 4/16-17.

[534] Undated draft WaMu memorandum, "Historical Perspective HL – Underwriting: Providing a Context for Current Conditions, and Future Opportunities," JPM_WM00783315 (a legal pleading states this draft memorandum was prepared for Mr. Rotella by WaMu's Chief Credit Officer in or about February or March 2005; FDIC v. Killinger, Case No. 2:2011cv00459 (W.D. Wash.), Complaint (March 16, 2011), at ¶ 35).

[535] Undated draft WaMu memorandum, "Historical Perspective HL – Underwriting: Providing a Context for Current Conditions, and Future Opportunities," JPM_WM00783315, at JPM_WM00783322.

In late 2006, as home mortgage delinquency rates began to accelerate and threaten the viability of WaMu's High Risk Lending Strategy, Home Loans President David Schneider presided over a "town hall" meeting to rally thousands of Seattle based employees of the WaMu Home Loans Group.[536] At the meeting, Mr. Schneider made a presentation, not just to WaMu's sales force, but also to the thousands of risk management, finance, and technology staff in attendance.[537] The title and theme of his presentation was: "Be Bold."[538] One slide demonstrates the importance and pervasiveness of the sales culture at WaMu:[539]



When asked about this presentation, Mr. Schneider told the Subcommittee it was an appropriate message, even for WaMu's risk managers.[540]

The sales culture was also promoted through WaMu's "President's Club," which sponsored an annual all-expense-paid gala and retreat in an exotic locale, such as Hawaii or the Bahamas, where the top producing loan officers were feted and lavished with gifts and plaudits.[541] Only a limited number of top producing loan officers were made members of the club, and the President's Club trips were used to incentivize sales volume. Loan officers were encouraged to look up their sales rankings on the company's intranet to see if they would qualify for a trip.

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536 Mr. Schneider told the Subcommittee that this meeting was held in early 2007, but Ms. Feltgen's end of 2006 email to her staff quotes Mr. Schneider's language from this presentation. 1/3/2007 email from Ron Cathcart to Cheryl Feltgen, Hearing Exhibit 4/13-73.
537 Subcommittee interview of David Schneider (2/17/2010).
538 "Way2Go, Be Bold!," WaMu presentation prepared by David Schneider, Home Loans President, at 28, Hearing Exhibit 4/13-4.
539 Id. at 30 [recreated by the Subcommittee staff from an image].
540 Subcommittee interview of David Schneider (2/17/2010).
541 Subcommittee interviews of Brian Minkow (2/16/2010), David Schneider (2/17/2010), and Kerry Killinger (2/5/2010).

In November 2006, as subprime mortgages began to incur delinquencies, Mr. Schneider sent a letter about the President's Club to WaMu loan consultants. Under a photo of the Grand Hyatt Kauai in Hawaii and the banner headline, "President's Club – Take the Lead!," Mr. Schneider wrote:

> "I attended WaMu's President's Club last year for the first time and had an awesome time getting to know the stars of our sales force. You work hard, but you know how to have a good time too ....
>
> "At the first-class awards dinner, I looked around the room and felt honored to be with so many talented people. Congratulations to those of you who were repeat President's Club honorees. Of those of you who have not yet reached the President's Club, I want each and every one of you to believe you have the potential to achieve this great reward.
>
> "Now is the time to really kick it into high gear and drive for attending this awesome event! Rankings are updated and posted monthly on the DashBoards (under reports) and on WaMu.net: <u>President's Club Rankings</u>. Where do you rank? What can you do to take your business [to] the next level? Your management team is here to help."[542]

At the April 13 Subcommittee hearing, Mr. Schneider testified:

> "As housing prices peaked, the economy softened, and credit markets tightened, WaMu adopted increasingly conservative credit policies and moved away from loan products with greater credit risk. ... During my time at WaMu, we reduced and then entirely stopped making Alt A loans and Option ARM loans."[543]

However, his November 2006 letter to WaMu loan consultants showed no reticence about the High Risk Lending Strategy. The letter went on to say:

> "As you know, growth is a key area of focus for WaMu and Home Loans. I am extremely proud of the achievements in Production so far this year – and I know it's been tough. I'm especially pleased with your ability to change with the market and responsibly sell more higher-margin products – Option ARM, Home Equity, Non-

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[542] 11/2006 "President's Club - Take the Lead!," WaMu Home Loans flier, Hearing Exhibit 4/13-62.

[543] Prepared statement of David Schneider, April 13, 2010 Subcommittee Hearing.

prime, and Alt A. I also know that you – truly the best sales team in the industry – are up to the challenge of doing even more by year end. ...
"I hope to see you in Kauai!"[544]

The 2005 President's Club retreat had taken place in Maui. The awards night was hosted by Magic Johnson. An excerpt of the script from the evening gives a sense of the proceedings:

> **"VOICE-OVER ANNOUNCER**
> Good evening ladies and gentleman and welcome to your President's Club 2005 Awards Night program!
>
> Please welcome the host of President's Club, the President of the Washington Mutual Home Loans Group, Mr. David Schneider!
> **WALK-UP MUSIC**
> FOR DAVID SCHNEIDER
>
> **DAVID SCHNEIDER**
> Thank you ladies and gentlemen, and welcome to this very special Awards Evening.
>
> Wow, could you feel the energy and excitement tonight out on the Red Carpet?! Talk about star power!
>
> And it was great fun to learn so much more about some of you during the interviews … and at the bar.
>
> But don't worry. I'm told that the age-old tradition here at Washington Mutual is, 'What happens at President's Club stays at President's Club.' And who am I to mess with tradition?
>
> Tonight we are gathered together to pay the highest respects and honors to those who deserve them the most, the President's Club Class of 2005. …
>
> And of course I want to pay special homage to all of you astonishing returning champions of President's Club. You multiple award-winning superstars clearly lead our entire industry as the standard others can only attempt to match.

[544] 11/2006 "President's Club - Take the Lead!," WaMu Home Loans flier, Hearing Exhibit 4/13-62.

> You folks really do make this feel like the academy awards tonight because everywhere I turn I see another star of another box office sensation."[545]

This 2005 awards ceremony was attended by WaMu loan officers Luis Fragoso and Thomas Ramirez at the same time they were under investigation for fraud. Both were members of the President's Club in 2005 and 2006.

When asked about the sales culture at the bank, Mr. Vanasek testified at the hearing that he tried in vain to counter it. He recalled one occasion at an annual management retreat in 2004, in which the bank was promoting a new advertising slogan called, "The Power of Yes":

> "I stood in front of thousands of senior Washington Mutual managers and executives in an annual management retreat in 2004 and countered the senior executive ahead of me on the program who was rallying the troops with the company's advertising line, 'The power of yes.' The implication of that statement was that Washington Mutual would find some way to make a loan. The tag line symbolized the management attitude about mortgage lending more clearly than anything I can tell you.
>
> "Because I believed this sent the wrong message to the loan originators, I felt compelled to counter the prior speaker by saying to the thousands present that the power of yes absolutely needed to be balanced by the wisdom of no. This was highly unusual for a member of the management team to do, especially in such a forum. In fact, it was so far out of the norm for meetings of this type that many considered my statement exceedingly risky from a career perspective."[546]

The President's Club annual trip was the pinnacle of WaMu awards to its top producing loan consultants. One loan consultant interviewed by the Subcommittee described it as an incredible experience, with first class airfare, daily gifts, lavish food, and top entertainment for both employees and their spouses.[547] It was also an opportunity to meet WaMu's top executives, including Mr. Killinger, Mr. Rotella, and Mr. Schneider. It sent a powerful message about the priority that WaMu placed on loan volume and sales of higher risk loans.

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[545] 2005 "President's Club 2005 - Maui, Awards Night Show Script," Washington Mutual Home Loans Group, Hearing Exhibit 4/13-63a.
[546] April 13, 2010 Subcommittee Hearing at 16-17.
[547] Subcommittee interview of Brian Minkow (2/16/2010).

(2) Paying for Speed and Volume

The Long Beach and Washington Mutual compensation systems encouraged high volumes of risky loans but provided little or no incentive to ensure high quality loans that complied with the bank's credit requirements. WaMu loan officers or their sales associates typically interacted directly with customers interested in obtaining loans. Some also were allowed to accept loans brought to them by third party lenders or mortgage brokers. Long Beach account executives dealt only with third party lenders or mortgage brokers; they did not deal directly with customers. After reaching agreement on a loan, the WaMu or Long Beach loan officers or executives completed the loan application and sent it to a loan processing center where the application was reviewed by an underwriter and, if approved, underwent further processing and brought to a loan closing.

Long Beach and Washington Mutual loan officers received more money per loan for originating higher risk loans and for exceeding established loan targets. Loan processing personnel were compensated according to the speed and number of the loans they processed. Loan officers and their sales associates received still more compensation if they charged borrowers higher interest rates or points than required in bank rate sheets specifying loan prices, or included prepayment penalties in the loan agreements. That added compensation created incentives to increase loan profitability, but not loan quality. A 2008 OTS review elaborated:

> "[T]he review defines an origination culture focused more heavily on production volume rather than quality. An example of this was a finding that production personnel were allowed to participate in aspects of the income, employment, or asset verification process, a clear conflict of interest. … Prior OTS examinations have raised similar issues including the need to implement incentive compensation programs to place greater emphasis on loan quality."[548]

(a) Long Beach Account Executives

Despite the years of internal and external audits that found a lack of internal controls at Long Beach that led to some of the worst rates of loan delinquency in the subprime industry, Long Beach continued to

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[548] 6/19/2008 OTS Findings Memorandum, "Loan Fraud Investigation," JPM_WM02448184, Hearing Exhibit 4/13-25.

incentivize production volume over sound lending. The Subcommittee obtained a presentation of the Long Beach 2004 Incentive Plan.[549] The plan outlines four compensation tiers based on volume, creating a system where the largest producers not only make more money by issuing more loans, but rather, as producers climb more of the tiers, they earn a higher rate of commission as well. Tier 1 Long Beach account executives, those who closed 1-6 loans or funded up to $899,000 in loans per month, received 40 basis points (bps) commission for each broker sourced loan.[550] Tier 2 Long Beach account executives, those who closed 7-12 loans or funded between $900,000 and $2,499,999 in loans per month, received 50 bps commission for each broker sourced loan plus $30 per loan in additional compensation. Tier 3 Long Beach account executives, those who closed 13-26 loans or funded between $2,500,000 and $4,999,999 in loans per month, received 55 bps commission for each broker sourced loan plus $30 additional per loan. Tier 4 Long Beach account executives, those who closed more than 26 loans or funded more than $5,000,000 in loans per month, received 60 bps commission for each broker sourced loan.[551]

The 2004 Long Beach Incentive Plan also introduced a contingent compensation program called, "Long Term Cash Incentive Program," which provided bonuses tied to the performance of WaMu stock and could be converted to cash over a three-year period. Top producing Long Beach account executives received the Long Term Cash Incentive bonus calculated as a small percentage of overall volume. Like the tier system, as volume increased so did the percentage used to calculate the bonus. Account executives ranked in the top 25% in volume received a five bps bonus on their total production, account executives in the top 15% received a 7.5 bps bonus, and account executives in the top 5% received a 10 bps bonus. These bonuses could add up to tens of thousands, if not hundreds of thousands of dollars.[552]

In addition, in 2004, the top 40 Long Beach account executives were rewarded with a trip to the President's Club. Long Beach used a point system to calculate the top account executives for this purpose. Three points were awarded for each loan funded for first mortgages, two points were awarded for each purchase loan funded (as opposed to a

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[549] Documents regarding Long Beach compensation, Hearing Exhibit 4/13-59a.
[550] Id. The "units" referred to in the document are "loans." Subcommittee interview of Brian Minkow (2/16/2010). By awarding "basis points" the compensation system ensured that the account executives got a percentage of the loan amounts that they successfully issued after receiving loan information from a broker, incentivizing them to maximize the dollar amount of the loans they issued. Some were also paid a per loan fee, incentivizing them to sell as many loans as possible.
[551] Id.
[552] Id.

refinance), and two points were awarded for each $100,000 funded. The point system created a competition that focused primarily on volume. The 2004 incentive plan makes no reference to loan quality.[553]

Long Beach regularly made changes to the compensation plan, but the basic volume incentives remained. In the 2007 incentive plan, which took effect after the collapse of the subprime market, the volume requirements were even greater than 2004 requirements. In 2007, the Tier 1 represented 1-9 qualified loans and up to $1,499,999 funded; Tier 2 was 10-13 qualified loans and between $1,500,000 and $2,399,000 funded; Tier 3 was 14-35 qualified loans and between $2,400,000 and $5,999,999 funded; Tier 4 was 36 or more loans and $6,000,000 or more funded.[554]

(b) WaMu Loan Consultants

Like Long Beach, at WaMu loan officers were compensated for the volume of loans closed and loan processors were compensated for speed of loan closing rather than a more balanced scorecard of timeliness and loan quality. According to the findings and recommendations from an April 2008 internal investigation into allegations of loan fraud at WaMu:

> "A design weakness here is that the loan consultants are allowed to communicate minimal loan requirements and obtain various verification documents from the borrower that [are] need[ed] to prove income, employment and assets. Since the loan consultant is also more intimately familiar with our documentation requirements and approval criteria, the temptation to advise the borrower on means and methods to game the system may occur. Our compensation and reward structure is heavily tilted for these employees toward production of closed loans."[555]

An undated presentation obtained by the Subcommittee entitled, "Home Loans Product Strategy, Strategy and Business Initiatives Update," outlines WaMu's 2007 Home Loans Strategy and shows the decisive role that compensation played, while providing still more evidence of WaMu's efforts to execute its High Risk Lending Strategy:

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553 Id.
554 Documents regarding Long Beach compensation, Hearing Exhibit 4/13-59b.
555 4/4/2008 WaMu Memorandum of Results, "AIG/UG and OTS Allegation of Loan Frauds Originated by [name redacted]," at 11, Hearing Exhibit 4/13-24.

> **"2007 Product Strategy**
> ***Product strategy designed to drive profitability and growth***
>
> -Driving growth in higher margin products (Option ARM, Alt A, Home Equity, Subprime) ...
>
> -Recruit and leverage seasoned Option ARM sales force, refresh existing training including top performer peer guidance
>
> -Maintain a compensation structure that supports the high margin product strategy"[556]

The presentation goes on to explain the Retail Loan Consultant incentive plan: "Incentive Tiers reward high margin products ... such as the Option ARM, Non-Prime referrals and Home Equity Loans .... WaMu also provides a 15 bps 'kicker' for selling 3 year prepayment penalties."[557]

In order to promote high risk, high margin products, WaMu paid its loan consultants more to sell them. WaMu divided its products into four categories: "W," "A," "M," and "U." WaMu paid the highest commissions for "W" category products, and in general, commissions decreased though the other categories. "W" products included new Option ARMs, "Non-prime" referrals, and home equity loans. "A" products included Option ARM refinancings, new hybrid ARMs, new Alt A loans, and new fixed rate loans. Like Long Beach, WaMu also created four compensation tiers with increasing commissions based on volume. The tiers were called: "Bronze," "Silver," "Gold," and "Platinum."[558] Even in 2007, WaMu's compensation plan continued to incentivize volume and high risk mortgage products.

In 2007, WaMu also adopted a plan to pay "overages," essentially a payment to loan officers who managed to sell mortgages to clients with higher rates of interest than the clients qualified for or were called for in WaMu's daily rate sheets. The plan stated:

> "Overages ... [give a] Loan Consultant [the] [a]bility to increase compensation [and] [e]nhance compensation/incentive for Sales

[556] 2007 WaMu Home Loans Product Strategy, "Strategy and Business Initiatives Update," JPM_WM03097217, Hearing Exhibit 4/13-60a [emphasis in original].
[557] Id.
[558] Id.

> Management .... Major national competitors have a similar plan in place in the market."[559]

Under the 2007 plan, if a loan officer sold a loan that charged a higher rate of interest than WaMu would have accepted according to its rate sheet, WaMu would split the additional profit with the loan officer.[560] This compensation practice, often referred to as awarding "yield spread premiums," has been barred by the Dodd-Frank Act implementing financial reforms.[561]

(c) Loan Processors and Quality Assurance Controllers

At Long Beach and WaMu, volume incentives were not limited to the sales people. Back office loan processors and quality control personnel were also compensated for volume. While WaMu executives and senior managers told the Subcommittee that quality control was emphasized and considered as part of employee compensation, the back office staff said otherwise.[562] Diane Kosch worked as a Quality Assurance Controller in a Long Beach Loan Fulfillment Center (LFC) in Dublin, California, east of San Francisco Bay. She told the Subcommittee that the pressure to keep up with the loan volume was enormous. Each month the LFC would set volume goals, measured in dollar value and the number of loans funded. At the end of each month the pressure to meet those goals intensified. Ms. Kosch said that at month's end, she sometimes worked from 6 a.m. until midnight reviewing loan files. Monthly rallies were held, and prizes were awarded to the underwriters and loan processors who had funded the most loans.[563]

Documents obtained by the Subcommittee confirm Ms. Kosch's recollections. A September 2004 email sent to all Dublin LFC employees with the subject line, "Daily Productivity – Dublin," by the area manager uses creative formatting to express enthusiasm:

> ***"Less than 1 week*** and we have a long way to go to hit our 440M! including today, we have 4 days of

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[559] 12/6/2006 WaMu Home Loan Credit Risk F2F, JPM_WM02583396-98, Hearing Exhibit 4/13-60b (The proposal to pay overages, adopted in 2007, increased compensation for loan officers who sold loans with a higher interest rate or more points than required on WaMu's daily rate sheet.)

[560] Subcommittee interview of David Schneider (2/17/2010).

[561] Section 1403 of the Dodd-Frank Act (prohibiting "steering incentives").

[562] Subcommittee interview of Mark Brown (2/19/2010). Mr. Brown, WaMu National Underwriting Director, told the Subcommittee that incentives for loan processors were based on quality standards and monthly volume.

[563] Subcommittee interview of Diane Kosch (2/18/2010).

> fundings to end the Quarter with a ***bang!*** With all the new UW changes, we will be swamped next month, **so don't hold any back!**
>
> 4 days…..it's time for the mad dash to the finish line! ***Who is in the running……***
>
> **Loan Set Up – Phuong** is pulling away with another 18 files set up yesterday for 275 MTD! 2nd place is held by **Jean** with 243…can you catch **Phuong**? Get ready Set Up – come October, it's going to get a ***little crazy!***
>
> **Underwriting – Michelle** did it! She broke the **200 mark** with 4 days left to go! ***Nice job Michelle!*** 2nd place is held by **Andre** with 176 for the month! Way to go **Andre!** Four other UW's had solid performances for the day as well including **Mikhail** with **15! Jason** and **Chioke** with 11 and June with 10 – The double digit club!"[564]

Ms. Kosch told the Subcommittee that from late 2005 until early 2007, loan volume increased and loan quality remained very poor. She said that just about every loan she reviewed was a stated income loan, sloppy, or appeared potentially fraudulent. Yet she was not given the resources or support to properly review each loan. Ms. Kosch said that she was told by a Quality Control manager that she should spend 15 minutes on each file, which she felt was insufficient. Yet, because Quality Assurance Controllers received a bonus on the basis of the number of loans they reviewed, she said some of her colleagues spent only ten minutes on each file.[565]

Ms. Kosch found that often, when she tried to stop the approval of a loan that did not meet quality standards, it would be referred to management and approved anyway. She said good Quality Assurance Controllers were treated like "black sheep," and hated because they got in the way of volume bonuses. She said certain brokers were identified as "elite," and the Dublin LFC employees were told to, "take care of them." Ms. Kosch even suspected some underwriters were getting kickbacks, in part, because of the clothes they wore and cars they drove, which she believed would have been unaffordable to even the top back

[564] 9/2004 Long Beach processing center internal email, Hearing Exhibit 4/13-61. In the email, "UW" stands for Underwriting or Underwriter, and "SLC" stands for Senior Loan Coordinator.
[565] Subcommittee interview of Diane Kosch (2/18/2010).

office employees. She reported her suspicions to her supervisor, but she was not aware of any action taken as a result.

As it turns out, Ms. Kosch's concerns about fraud were not unfounded. The September 2004 Daily Productivity email also lauds the work of a Senior Loan Coordinator (SLC) named John Ngo:

> "**SLC** – This one is still tight with **Sandy** holding on to the first place slot! **Sandy** funded 4 more on Friday for a MTD total of 46! 2nd place is **John Ngo** with 4 fundings on Friday and 44 MTD – only 2 back!"

About a year after this email was sent, the FBI began to question Mr. Ngo about a scheme to buy houses in Stockton, California with fake documents and stolen identities. According to court records, the FBI had uncovered documents that showed Mr. Ngo had received more than $100,000 in payments from a mortgage broker, allegedly bribes to approve bad loans. Mr. Ngo's estranged wife told the FBI that she didn't know how he could afford their $1.4 million home for which he made a down payment of $350,000. At the time, his salary at Long Beach was $54,000. [566]

Mr. Ngo later pled guilty to perjury and agreed to testify against his Long Beach sales associate, Joel Blanford. Long Beach paid Mr. Blanford more than $1 million in commissions each year from 2003-2005. According to the Department of Justice:

> "NGO admitted in his plea agreement that most of the payments were to ensure that fraudulent loan applications were processed and funded. NGO also admitted he received payments from Long Beach Mortgage sales representatives to push applications through the funding process. He knew many of these applications were fraudulent, and he and others took steps to 'fix' applications by creating false documents or adding false information to the applications or the loan file."[567]

[566] "At Top Subprime Mortgage Lender, Policies Were an Invitation to Fraud," Huffington Post Investigative Fund (12/21/2009), http://www.huffingtonpost.com/2009/12/21/at-long-beach-mortgage-a_n_399295.html.

[567] 6/19/2008 Department of Justice press release, "Federal Authorities Announce Significant Regional Federal Mortgage Fraud Investigations and Prosecutions Coinciding with Nationwide 'Operation Malicious Mortgage' Takedown," http://sacramento.fbi.gov/dojpressrel/pressrel08/sc061908a.htm.

(3) WaMu Executive Compensation

Questionable compensation practices did not stop in the loan offices, but went all the way to the top of the company. WaMu's CEO received millions of dollars in pay, even when his high risk loan strategy began unraveling, even when the bank began to falter, and even when he was asked to leave his post. From 2003 to 2007, Mr. Killinger was paid between $11 million and $20 million each year in cash, stock, and stock options. In addition, WaMu provided him with four retirement plans, a deferred bonus plan, and a separate deferred compensation plan. In 2008, when he was asked to leave to leave the bank, Mr. Killinger was paid $25 million, including $15 million in severance pay. Altogether, from 2003 to 2008, Washington Mutual paid Mr. Killinger nearly $100 million, on top of multi-million-dollar corporate retirement benefits.[568]

As WaMu began losing billions of dollars due to the declining value of its loans and mortgage backed securities, top management paid significant attention to ensuring that they would be well compensated despite the crisis. In January 2008, Mr. Killinger sent Mr. Rotella an email with the subject "comp," seeking input on formulating compensation recommendations for the Board of Directors' Human Resources Committee. The email discussed compensation for WaMu's top executives. Mr Killinger wrote: "Our current thinking is to recommend that equity grants be in options this year. ... I am considering an additional restricted stock grant which would help a bit on retention and to help offset the low bonus for 2007." [569]

Mr. Rotella responded that he thought WaMu executives would want more of their bonuses in cash:

> "[T]he feeling people will have about this is tied to the level of pain on the cash bonus side .... Unfortunately more than a few feel that our stock price will not easily recover, that it is highly dependent on housing and credit and they can't influence that at all. This will come on the heels of what will be a terrible fourth qtr, and likely very poor results in the first half along with continued bad news in the environment. So we will have some people thinking, 'this is nice but I don't see the upside in a time frame that works.' Also, as you know folks feel very burned by the way their paper was tied to performance targets that they now see as unrealistic and tied to housing and have a jaundiced view of

[568] "Washington Mutual CEO Kerry Killinger: $100 Million in Compensation, 2003-2008," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1h.

[569] 1/3/2008 email chain between Kerry Killinger and Steve Rotella, JPM_WM01335818, Hearing Exhibit 4/13-65.

paper. … People want more certainty now with some leverage, not a high dose of leverage with low cash."[570]

Mr. Killinger replied: "In short, the success of the comp program is up to you and me. I think we are putting the right economics and opportunities on the table. But we have to convince our folks that they will all make a lot of money by being with WaMu."[571]

In February 2008, the Human Resources Committee approved a bonus plan for executive officers that tried to shield the executive bonuses from any impact caused by WaMu's mounting mortgage losses. The Committee established a formula consisting of four weighted performance measures, but took steps to exclude mortgage losses. The first performance measure, for example, set a goal for WaMu's 2008 net operating profit, but adjusted the profit calculation to exclude: "(i) loan loss provisions other than related to our credit card business and (ii) expenses related to foreclosed real estate assets."[572] The second performance measure set a target limiting WaMu's 2008 noninterest expense, but excluded expenses related to: "(i) business resizing or restructuring and (ii) foreclosed real estate assets."[573]

WaMu filed its executive compensation plan with the SEC, as required. The exclusion of mortgage related losses and expenses in the plan attracted notice from shareholders and the press. One March 5, 2008 article entitled, "WaMu Board Shields Executives' Bonuses," reported: "The board of Washington Mutual Inc. has set compensation targets for top executives that will exclude some costs tied to mortgage losses and foreclosures when cash bonuses are calculated this year."[574] WaMu employees circulated the article through company email.[575] Investors and analysts raised concerns.

Mr. Killinger sought to respond to the controversy in a way that would placate investors without alienating executives. His solution was to eliminate bonuses for the top five executives, and make cash payments to the other executives, without making that fact public. In July, Mr. Killinger emailed Steve Frank, the Chairman of the Board of Directors, with his proposal:

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[570] Id.
[571] Id.
[572] 2/28/2008 email from David Schneider, "FW: 2008 Leadership Bonus," JPM_WM02446549.
[573] Id.
[574] "WaMu Board Shields Executives' Bonuses," Wall Street Journal (3/5/2008), Hearing Exhibit 4/13-67.
[575] Id.

"We would like to have the HR [Human Resources] committee approve excluding the exec com [Executive Committee] from the 2008 bonus and to approve the cash retention grants to the non NEOs [Named Executive Officers]. This would allow me to respond to questions next week regarding the bonus plan on the analyst call. And it would help calm down some of the EC [Executive Committee] members."[576]

In other words, WaMu would announce publicly that none of the Executive Committee members would receive bonuses in 2008, while quietly paying "retention grants" rather than "bonuses" to the next tier of executives. Mr. Frank replied, "Sounds OK to me." Mr. Killinger followed up with the explanation: "We would disclose the exclusion of EC [Executive Committee] members from the bonus plan. There would be no disclosure of the retention cash payments. Option grants would be held off until whenever other comp. actions were done."[577] At WaMu's annual meeting with shareholders, the Board indicated that it had "reversed" the decision to exclude mortgage losses when calculating executive bonuses and made no mention of the cash retention payments planned for some executives.[578]

When WaMu failed, shareholders lost all of their investments. Yet in the waning days of the company, top executives were still well taken care of. On September 8, 2008, Mr. Killinger walked away with $25 million, including $15 million in severance pay. His replacement, Allen Fishman, received a $7.5 million signing bonus for taking over the reins from Mr. Killinger in September 2008.[579] Eighteen days later, WaMu failed, and Mr. Fishman was out of a job. According to his contract, he was eligible for about $11 million in severance pay when the bank failed.[580] It is unclear how much of the severance he received.

G. Preventing High Risk Lending

Washington Mutual was a $300 billion, 120-year-old financial institution that was destroyed by high risk lending practices. By 2007, stated income loans – loans in which Washington Mutual made no effort to verify the borrower's income or assets – made up 50% of its subprime

[576] 7/16/2008 email from Kerry Killinger, JPM_WM01240144, Hearing Exhibit 4/13-66.
[577] 7/16/2008 email from Kerry Killinger, JPM_WM01240144, Hearing Exhibit 4/13-66.
[578] See, e.g., "Shareholders Score at WaMu," Bloomberg BusinessWeek (4/15/2008) ("And perhaps most notable: WaMu reversed a much-criticized decision to leave out the company's mortgage related losses when calculating profits that determine executive bonuses for the year ahead.").
[579] "WaMu Creditors could Challenge Payments to Killinger, Others," Seattle Times (10/1/2008), Hearing Exhibit 4/13-68.
[580] "WaMu CEO: 3 Weeks Work, $18M," CNNMoney.com (9/26/2008).

loans, 73% of its Option ARMs, and 90% of its home equity loans. Nearly half of its loans were Option ARMs of which 95% of the borrowers were making minimum payments and 84% were negatively amortizing. Numerous loans had loan-to-value ratios of over 80%, and some provided 100% financing. Loans issued by two high volume loan offices in the Los Angeles area were found to have loan fraud rates of 58, 62, and even 83%. Loan officer sales assistants were manufacturing borrower documentation. The bank's issuance of hundreds of billions of dollars in high risk, poor quality loans not only destroyed confidence in the bank, but also undermined the U.S. financial system.

The consequences of WaMu's High Risk Lending Strategy and the proliferation of its RMBS structured finance products incorporating high risk, poor quality loans provide critical lessons that need to be learned to protect the U.S. financial system from similar financial disasters. A number of developments over the past two years hold promise in helping to address many of the problems identified in the Washington Mutual case history.

(1) New Developments

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), P.L. 111-203, which the President signed into law on July 21, 2010, contains a number of changes in law that will be implemented over the course of 2011. The Dodd-Frank Act changes include banning stated income loans; restricting negative amortization loans; requiring lenders to retain an interest in high risk loan pools that they sell or securitize; prohibiting lenders from steering borrowers to poor quality, high risk loans; and re-evaluating the role of high risk, structured finance products in bank portfolios.

Ban on Stated Income Loans. Multiple witnesses at the Subcommittee's April 16, 2010 hearing on the role of bank regulators expressed support for banning stated income loans. The FDIC Chairman Sheila Bair testified: "We are opposed to stated income. ... We think you should document income."[581] When asked for his opinion of stated income loans, the FDIC Inspector General Jon Rymer responded: "I do not think they should be allowed,"[582] stressing the fraud risk: "I really can see no practical reason from a banker's perspective or a lender's perspective to encourage that. ... That is just, to me, an opportunity to essentially encourage fraud." [583] Treasury Inspector General Eric Thorson also criticized stated income loans, explaining: "[T]he problem is, you can't assess the strength of the borrower and that has got to be at

[581] April 16, 2010 Subcommittee Hearing at 88.
[582] Id. at 27.
[583] Id. at 15.

the foundation of underwriting, risk assessment, risk management."[584] Even the former head of OTS called stated income loans an "anathema" and expressed regret that OTS had allowed them.[585]

The Dodd-Frank Act essentially bans stated income loans by establishing minimum standards for residential mortgages in Title XIV of the law. Section 1411 establishes a new Section 129C of the Truth in Lending Act (TILA) prohibiting lenders from issuing a residential mortgage without first conducting a "good faith and reasonable" determination, based upon "verified and documented information," that a borrower has a "reasonable ability to repay the loan" and all applicable taxes, insurance, and assessments. Subsection 129C(a)(4) states the lender "shall verify" the borrower's income and assets by reviewing the borrower's W-2 tax form, tax returns, payroll receipts, financial institution records, or "other third-party documents that provide reasonably reliable evidence" of the borrower's income or assets. In addition, Section 1412 of the Dodd-Frank Act adds a new Subsection 129C(b) to TILA establishing a new category of "qualified mortgages" eligible for more favorable treatment under federal law. It states that, in all "qualified mortgages," the "income and financial resources" of the borrower must be "verified and documented."

These statutory requirements, by prohibiting lenders from issuing a residential mortgage without first verifying the borrower's income and assets, essentially put an end to stated income loans.[586]

Restrictions on Negative Amortization Loans. Witnesses at the Subcommittee's April 16 hearing also criticized WaMu's heavy reliance on Option ARM loans. These loans provided borrowers with a low initial interest rate, which was followed at a later time by a higher variable rate. Borrowers were generally qualified for the loans by assuming they would pay the lower rather than the higher rate. In addition, borrowers were allowed to select one of four types of monthly payments, including a "minimum payment" that was less than the interest and principal owed on the loan. If the borrower selected the minimum payment, the unpaid interest was added to the unpaid loan principal, which meant that the loan debt could increase rather than decrease over time, resulting in negative amortization.

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[584] Id.

[585] Id. at 42, 142.

[586] The Federal Reserve is charged with issuing regulations to implement Section 1411. Federal Reserve regulations issued in July 2008, under the authority of the Home Ownership and Equity Protection Act (HOEPA) of 1994, which took effect in October 2009, already require lenders issuing certain high cost mortgages to verify a borrower's ability to repay the loan. 73 Fed. Reg. 147, at 44543 (7/30/2008). Since the Dodd-Frank Act applies to all types of mortgage loans, the Federal Reserve is expected to issue revised regulations during 2011, expanding the verification requirement to all mortgage loans.

At the Subcommittee hearing, the FDIC Inspector General Jon Rymer warned that negative amortization loans are "extraordinarily risky" for both borrowers and banks.[587] The FDIC Chairman Sheila Bair testified:

> "We are opposed to teaser rate underwriting. You need to underwrite at the fully indexed rate. You should document the customer's ability to repay, not just the initial introductory rate, but if it is an adjustable product, when it resets, as well."[588]

The Dodd-Frank Act does not ban negatively amortizing loans, but does impose new restrictions on them. Section 1411 amends TILA by adding a new Section 129C(6) that requires, for any residential mortgage that allows a borrower "to defer the repayment of any principal or interest," that the lender vet potential borrowers based upon the borrower's ability to make monthly loan payments on a fully amortizing schedule – meaning a schedule in which the loan would be fully repaid by the end of the loan period – instead of evaluating the borrower's ability to make payments at an initial teaser rate or in some amount that is less than the amount required at a fully amortized rate. The law also requires the lender, when qualifying a borrower, to "take into consideration any balance increase that may accrue from any negative amortization provision." This provision essentially codifies the provisions in the 2006 Nontraditional Mortgage Guidance regarding qualification of borrowers for negatively amortizing loans.

In addition, Section 1414 of the Dodd-Frank Act adds a new Section 129C(c) to TILA prohibiting lenders from issuing a mortgage with negative amortization without providing certain disclosures to the borrower prior to the loan. The lender is required to provide the borrower with an explanation of negative amortization in a manner prescribed by regulation as well as describe its impact, for example, how it can lead to an increase in the loan's outstanding principal balance. In the case of a first-time home buyer, the lender must also obtain documentation that the home buyer received homeownership counseling from a HUD-certified organization or counselor. Finally, Section 1412 of the Dodd-Frank Act, establishing the new favored category of "qualified mortgages," states those mortgages cannot negatively amortize.

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[587] April 16, 2010 Subcommittee Hearing at 16.
[588] Id. at 88.

Together, these borrower qualification and disclosure requirements, if well implemented, should reduce, although not eliminate, the issuance of negative amortization mortgages.

Risk Retention. One of the root causes of the financial crisis was the ability of lenders like Washington Mutual to securitize billions of dollars in high risk, poor quality loans, sell the resulting securities to investors, and then walk away from the risky loans it created. At the April 16 Subcommittee hearing, the FDIC Chairman Bair testified:

> "[W]e support legislation to require that issuers of mortgage securitizations retain some 'skin in the game' to provide added discipline for underwriting quality. In fact, the FDIC Board will consider … a proposal to require insured banks to retain a portion of the credit risk of any securitizations that they sponsor."[589]

Section 941(b) of the Dodd-Frank Act adds a new section 15G to the Securities Exchange Act of 1934 to require the federal banking agencies, SEC, Department of Housing and Urban Development, and Federal Housing Finance Agency jointly to prescribe regulations to "require any securitizer to retain an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party."[590] The retained economic interest must be "not less than 5 percent of the credit risk" of the assets backing the security, with an exception made for "qualified residential mortgages," to be further defined by the regulators. The regulators issued a proposed rule early in 2011, which is currently the subject of a public comment period.

In the meantime, the FDIC has issued a new regulation, effective September 30, 2010, that imposes a range of disclosure, risk retention, and other obligations on all insured banks that issue asset backed securitizations.[591] One of the provisions imposes a 5% risk retention requirement on all asset backed securitizations issued by an insured bank, whether backed by mortgages or other assets. The provision states that the bank sponsoring the securitization must:

> "retain an economic interest in a material portion, defined as not less than five (5) percent, of the credit risk of the financial assets. This retained interest may be either in the form of an interest of not less than five (5) percent in each of the credit tranches sold or transferred to the investors or in a representative sample of the

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[589] Id. at 81.

[590] Section 941(b) also imposes risk retention requirements on other types of asset backed securities and collateralized debt obligations.

[591] 12 CFR § 360.6.

> securitized financial assets equal to not less than five (5) percent of the principal amount of the financial assets at transfer. This retained interest may not be sold or pledged or hedged, except for the hedging of interest rate or currency risk, during the term of the securitization."[592]

The provision also states that this risk retention requirement applies only until the "effective date" of the regulations to be issued under Section 941 of the Dodd-Frank Act.

The FDIC risk retention requirement, followed by the risk retention requirement to be developed under the Dodd-Frank Act, should, if well implemented, end the ability of banks to magnify risk through issuing asset backed securities and then walking away from that risk. Instead, banks will be required to keep "skin in the game" until each securitization concludes.

Ban on Steering. The Washington Mutual case history also exposed another problem: compensation incentives that encouraged loan officers and mortgage brokers to steer borrowers to higher risk loans. Compensation incentives called "overages" at WaMu and "yield spread premiums" at other financial institutions also encouraged loan officers and mortgage brokers to charge borrowers higher interest rates and points than the bank would accept, so that the loan officer or mortgage banker could split the extra money taken from the borrower with the bank.

To ban these compensation incentives, Section 1403 of the Dodd-Frank Act creates a new Section 129B(c) in TILA prohibiting the payment of any steering incentives, including yield spread premiums. It states: "no mortgage originator shall receive from any person and no person shall pay to a mortgage originator, directly or indirectly, compensation that varies based on the terms of loan (other than the amount of the principal)." It also states explicitly that no provision of the section should be construed as "permitting any yield spread premium or other similar compensation." In addition, it directs the Federal Reserve to issue regulations to prohibit a range of abusive and unfair mortgage related practices, including prohibiting lenders and brokers from steering borrowers to mortgages for which they lack a reasonable ability to repay.

The Dodd-Frank provisions were enacted into law shortly before the Federal Reserve, in September 2010, promulgated new regulations

[592] 12 CFR § 360.6(b)(5)(i).

prohibiting a number of unfair or abusive lending practices, including certain payments to mortgage originators.[593] In its notice, the Federal Reserve noted that its new regulations prohibit many of the same practices banned in Section 1403 of the Dodd Frank Act, but that it will fully implement the new Dodd-Frank measures in a future rulemaking.[594]

High Risk Loans. Still another problem exposed by the Washington Mutual case history is the fact that, in the years leading up to the financial crisis, many U.S. insured banks held highly risky loans and securities in their investment and sale portfolios. When those loans and securities lost value in 2007, many banks had to declare multi-billion-dollar losses that triggered shareholder flight and liquidity runs.

Section 620 of the Dodd-Frank Act requires the federal banking regulators, within 18 months, to prepare a report identifying the activities and investments that insured banks and their affiliates are allowed to engage in under federal and state law, regulation, order, and guidance, and analyzing the risks associated with those activities and investments. The federal banking agencies are also asked to make recommendations on whether each allowed activity or investment is appropriate, could negatively affect the safety and soundness of the banking entity or the U.S. financial system, and should be restricted to reduce risk.

(2) Recommendations

To further strengthen standards and controls needed to prevent high risk lending and safeguard the Deposit Insurance Fund, this Report makes the following recommendations.

1. **Ensure "Qualified Mortgages" Are Low Risk.** Federal regulators should use their regulatory authority to ensure that all mortgages deemed to be "qualified residential mortgages" have a low risk of delinquency or default.
2. **Require Meaningful Risk Retention.** Federal regulators should issue a strong risk retention requirement under Section 941 by requiring the retention of not less than a 5% credit risk in each, or a representative sample of, an asset backed securitization's tranches, and by barring a hedging offset for a reasonable but limited period of time.

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[593] 75 Fed. Reg. 185 (9/24/2010).
[594] Id. at 58509.

3. **Safeguard Against High Risk Products.** Federal banking regulators should safeguard taxpayer dollars by requiring banks with high risk structured finance products, including complex products with little or no reliable performance data, to meet conservative loss reserve, liquidity, and capital requirements.

4. **Require Greater Reserves for Negative Amortization Loans.** Federal banking regulators should use their regulatory authority to require banks issuing negatively amortizing loans that allow borrowers to defer payments of interest and principal, to maintain more conservative loss, liquidity, and capital reserves.

5. **Safeguard Bank Investment Portfolios.** Federal banking regulators should use the Section 620 banking activities study to identify high risk structured finance products and impose a reasonable limit on the amount of such high risk products that can be included in a bank's investment portfolio.

IV. REGULATORY FAILURE: CASE STUDY OF THE OFFICE OF THRIFT SUPERVISION

Washington Mutual Bank (WaMu), with more than $300 billion in assets, $188 billion in deposits, over 2,300 branches in 15 states, and 43,000 employees, was by late 2008 the largest thrift under the supervision of the Office of Thrift Supervision (OTS) and among the eight largest financial institutions insured by the Federal Deposit Insurance Corporation (FDIC). The bank's collapse in September 2008 came on the heels of the Lehman Brothers bankruptcy filing, accelerating the unraveling of the financial markets. WaMu's collapse marked one of the most spectacular failures of federal bank regulators in recent history.

In 2007, many of WaMu's home loans, especially those with the highest risk profile, began experiencing increased rates of delinquency, default, and loss. After the subprime mortgage backed securities market collapsed in September 2007, Washington Mutual was unable to sell or securitize subprime loans and its loan portfolio began falling in value. By the fourth quarter of 2007, the bank recorded a loss of $1 billion, and then in the first half of 2008, WaMu lost $4.2 billion more. WaMu's stock price plummeted against the backdrop of these losses and a worsening financial crisis elsewhere on Wall Street, which was witnessing the forced sales of Countrywide Financial Corporation and Bear Stearns, the government takeover of IndyMac, Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, the taxpayer bailout of AIG, and the conversion of Goldman Sachs and Morgan Stanley into bank holding companies. From 2007 to 2008, WaMu's depositors withdrew a total of over $26 billion in deposits from the bank, triggering a liquidity crisis. On September 25, 2008, OTS placed Washington Mutual Bank into receivership, and the FDIC, as receiver, immediately sold it to JPMorgan Chase for $1.9 billion. Had the sale not gone through, Washington Mutual's failure could have exhausted the FDIC's entire $45 billion Deposit Insurance Fund.

OTS records show that, during the five years prior to its collapse, OTS examiners repeatedly identified significant problems with Washington Mutual's lending practices, risk management, and asset quality, and requested corrective action. Year after year, WaMu promised to correct the identified problems, but failed to do so. OTS, in turn, failed to respond with meaningful enforcement action, choosing instead to continue giving the bank inflated ratings for safety and soundness. Until shortly before the thrift's failure in 2008, OTS regularly gave WaMu a CAMELS rating of "2" out of "5," which signaled to the bank and other regulators that WaMu was fundamentally sound.

Federal bank regulators are charged with ensuring that U.S. financial institutions operate in a safe and sound manner. However, in the years leading up to the financial crisis, OTS failed to prevent Washington Mutual's increasing use of high risk lending practices and its origination and sale of tens of billions of dollars in poor quality home loans. The agency's failure to adequately monitor and regulate WaMu's high risk lending stemmed in part from an OTS regulatory culture that viewed its thrifts as "constituents," relied on them to correct the problems identified by OTS with minimal regulatory intervention, and expressed reluctance to interfere with even unsound lending and securitization practices. OTS displayed an unusual amount of deference to WaMu's management, choosing to rely on the bank to police itself. The reasoning appeared to be that if OTS examiners simply identified the problems at the bank, OTS could then rely on WaMu's assurances that problems were corrected, with little need for tough enforcement actions. It was a regulatory approach with disastrous results.

Over the five-year period reviewed by the Subcommittee, OTS examiners identified over 500 serious deficiencies in WaMu operations. Yet OTS did not once, from 2004 to 2008, take a public enforcement action against Washington Mutual, even when the bank failed to correct major problems. Only in late 2008, as the bank incurred mounting losses, did OTS finally take two informal, nonpublic enforcement actions, requiring WaMu to agree to a Board Resolution in March and a Memorandum of Understanding in September, but neither action was sufficient to prevent the bank's failure. OTS officials resisted calls by the FDIC, the bank's backup regulator, for stronger measures and even impeded FDIC oversight efforts at the bank. Hindered by a culture of deference to management, demoralized examiners, and agency infighting, OTS officials allowed the bank's short term profits to excuse its risky practices and failed to evaluate the bank's actions in the context of the U.S. financial system as a whole.

OTS not only failed to prevent Washington Mutual from engaging in unsafe and unsound lending practices, it gave its tacit approval and allowed high risk loans to proliferate. As long as Washington Mutual was able to sell off its risky loans, neither OTS nor the FDIC expressed concerns about the impact of those loans elsewhere. By not sounding the alarm, OTS and the FDIC enabled WaMu to construct a multi-billion-dollar investment portfolio of high risk mortgage assets, and also permitted WaMu to sell hundreds of billions of dollars in high risk, poor quality loans and securities to other financial institutions and investors in the United States and around the world. Similar regulatory failings by

OTS, the FDIC, and other agencies involving other lenders repeated these problems on a broad scale. The result was a mortgage market saturated with risky loans, and financial institutions that were supposed to hold predominantly safe investments but instead held portfolios rife with high risk, poor quality mortgages. When those loans began defaulting in record numbers and mortgage related securities plummeted in value, financial institutions around the globe suffered hundreds of billions of dollars in losses, triggering an economic disaster. The regulatory failures that set the stage for these losses were a proximate cause of the financial crisis.

A. Subcommittee Investigation and Findings of Fact

To analyze regulatory oversight of Washington Mutual, the Subcommittee subpoenaed documents from OTS, the FDIC, and WaMu, including bank examination reports, legal pleadings, reports, internal memoranda, correspondence, and email. The Subcommittee also conducted over two dozen interviews with OTS, FDIC, and WaMu personnel, including the FDIC Chairman, OTS Director, OTS and the FDIC senior examiners assigned to Washington Mutual, and senior WaMu executives. The Subcommittee also spoke with personnel from the Offices of the Inspector General (IG) at the FDIC and the Department of Treasury, who were engaged in a joint review of WaMu's failure. In addition, the Subcommittee spoke with nearly a dozen experts on a variety of banking, accounting, regulatory, and legal issues. On April 16, 2010, the Subcommittee held a hearing at which OTS, the FDIC, and IG officials provided testimony; released 92 hearing exhibits; and released the FDIC and Treasury IGs' joint report on Washington Mutual.[595]

In connection with the hearing, the Subcommittee released a joint memorandum from Chairman Levin and Ranking Member Coburn summarizing the investigation to date into the role of the regulators overseeing WaMu. That memorandum stated:

> "Federal bank regulators are supposed to ensure the safety and soundness of individual U.S. financial institutions and, by extension, the U.S. banking system. Washington Mutual was just one of many financial institutions that federal banking regulators allowed to engage in such high risk home loan lending practices that they resulted in bank failure and damage to financial markets. The ineffective role of bank regulators was a major contributor to

[595] See "Wall Street and the Financial Crisis: Role of the Regulators," before the U.S. Senate Permanent Subcommittee on Investigations, S.Hrg. 111-672 (April 16, 2010) (hereinafter "April 16, 2010 Subcommittee Hearing").

the 2008 financial crisis that continues to afflict the U.S. and world economy today."

On March 16, 2011, the FDIC sued the three top former executives of Washington Mutual for pursuing a high risk lending strategy without sufficient risk management practices and despite their knowledge of a weakening housing market.[596] The FDIC complaint stated:

> "Chief Executive Officer Kerry K. Killinger ("Killinger"), Chief Operating Officer Stephen J. Rotella ("Rotella"), and Home Loans President David C. Schneider ("Schneider") caused Washington Mutual Bank ("WaMu" or "the Bank") to take extreme and historically unprecedented risks with WaMu's held-for-investment home loans portfolio. They focused on short term gains to increase their own compensation, with reckless disregard for WaMu's longer term safety and soundness. Their negligence, gross negligence and breaches of fiduciary duty caused WaMu to lose billions of dollars. The FDIC brings this Complaint to hold these three highly paid senior executives, who were chiefly responsible for WaMu's higher risk home lending program, accountable for the resulting losses."

The Levin-Coburn memorandum contained joint findings of fact regarding the role of federal regulators in the Washington Mutual case history. Those findings of fact, which this Report reaffirms, are as follows.

1. **Largest U.S. Bank Failure.** From 2003 to 2008, OTS repeatedly identified significant problems with Washington Mutual's lending practices, risk management, and asset quality, but failed to force adequate corrective action, resulting in the largest bank failure in U.S. history.

2. **Shoddy Lending and Securitization Practices.** OTS allowed Washington Mutual and its affiliate Long Beach Mortgage Company to engage year after year in shoddy lending and securitization practices, failing to take enforcement action to stop its origination and sale of loans with fraudulent borrower information, appraisal problems, errors, and notoriously high rates of delinquency and loss.

[596] The Federal Deposit Insurance Corporation v. Kerry K. Killinger, Stephen J. Rotella, David C. Schneider, et al., Case No. 2:11-CV-00459 (W.D. Wash.), Complaint (March 16, 2011), at http://graphics8.nytimes.com/packages/pdf/business/conformedcomplaint.pdf (hereinafter "FDIC Complaint Against WaMu Executives").

3. **Unsafe Option ARM Loans.** OTS allowed Washington Mutual to originate hundreds of billions of dollars in high risk Option Adjustable Rate Mortgages, knowing that the bank used unsafe and unsound teaser rates, qualified borrowers using unrealistically low loan payments, permitted borrowers to make minimum payments resulting in negatively amortizing loans (*i.e.*, loans with increasing principal), relied on rising house prices and refinancing to avoid payment shock and loan defaults, and had no realistic data to calculate loan losses in markets with flat or declining house prices.

4. **Short Term Profits Over Long Term Fundamentals.** OTS abdicated its responsibility to ensure the long term safety and soundness of Washington Mutual by concluding that short term profits obtained by the bank precluded enforcement action to stop the bank's use of shoddy lending and securitization practices and unsafe and unsound loans.

5. **Impeding FDIC Oversight.** OTS impeded FDIC oversight of Washington Mutual by blocking its access to bank data, refusing to allow it to participate in bank examinations, rejecting requests to review bank loan files, and resisting the FDIC recommendations for stronger enforcement action.

6. **FDIC Shortfalls.** The FDIC, the backup regulator of Washington Mutual, was unable to conduct the analysis it wanted to evaluate the risk posed by the bank to the Deposit Insurance Fund, did not prevail against unreasonable actions taken by OTS to limit its examination authority, and did not initiate its own enforcement action against the bank in light of ongoing opposition by the primary federal bank regulators to FDIC enforcement authority.

7. **Recommendations Over Enforceable Requirements.** Federal bank regulators undermined efforts to end unsafe and unsound mortgage practices at U.S. banks by issuing guidance instead of enforceable regulations limiting those practices, failing to prohibit many high risk mortgage practices, and failing to set clear deadlines for bank compliance.

8. **Failure to Recognize Systemic Risk.** OTS and the FDIC allowed Washington Mutual and Long Beach to reduce their own risk by selling hundreds of billions of dollars of high risk mortgage backed securities that polluted the financial system with poorly performing loans, undermined investor confidence

in the secondary mortgage market, and contributed to massive credit rating downgrades, investor losses, disrupted markets, and the U.S. financial crisis.

9. **Ineffective and Demoralized Regulatory Culture.** The Washington Mutual case history exposes the regulatory culture at OTS in which bank examiners are frustrated and demoralized by their inability to stop unsafe and unsound practices, in which their supervisors are reluctant to use formal enforcement actions even after years of serious bank deficiencies, and in which regulators treat the banks they oversee as constituents rather than arms-length regulated entities.

B. Background

At the time of its collapse, Washington Mutual Savings Bank was a federally chartered thrift with over $188 billion in federal insured deposits. Its primary federal regulator was OTS. Due to its status as an insured depository institution, it was also overseen by the FDIC.

(1) Office of Thrift Supervision

The Office of Thrift Supervision was created in 1989, in response to the savings and loan crisis, to charter and regulate the thrift industry.[597] Thrifts are required by their charters to hold most of their assets in mortgage lending, and have traditionally focused on the issuance of home loans.[598] OTS was part of the U.S. Department of the Treasury and headed by a presidentially appointed director. Like other bank regulators, OTS was charged with ensuring the safety and soundness of the financial institutions it oversaw. Its operations were funded through semiannual fees assessed on the institutions it regulated, with the fee amount based on the size, condition, and complexity of each institution's portfolio. Washington Mutual was the largest thrift overseen by OTS and, from 2003 to 2008, paid at least $30 million in fees annually to the agency, which comprised 12-15% of all OTS revenue.[599]

[597] Twenty years after its establishment, OTS was abolished by the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, (Dodd-Frank Act) which has transferred the agency's responsibilities to the Office of the Comptroller of the Currency (OCC), and directed the agency to cease all operations by 2012. This Report focuses on OTS during the time period 2004 through 2008.

[598] 6/19/2002 OTS Regulatory Bulletin, "Thrift Activities Regulatory Handbook Update" (some educational loans, SBLs, and credit card loans also count towards qualifying as a thrift), http://files.ots.treas.gov/74081.pdf.

[599] See April 16, 2010 Subcommittee Hearing at 11 (testimony of Treasury IG Eric Thorson).

In 2009, OTS oversaw about 765 thrift-chartered institutions.[600] OTS supervised its thrifts through four regional offices, each led by a Regional Director, Deputy Director, and Assistant Director. Regional offices assigned an Examiner-in-Charge to each thrift in its jurisdiction, along with other supporting examination personnel. Approximately three-quarters of the OTS workforce reported to its four regional offices, while the remaining quarter worked at OTS headquarters in Washington, D.C. Washington Mutual, whose headquarters were located in Seattle, was supervised by the Western Region Office which, through the end of 2008, was based in Daly City, California.

During the years reviewed by the Subcommittee, the OTS Executive Director was John Reich; the Deputy Director was Scott Polakoff; the Western Region Office Director was Michael Finn and later Darrel Dochow; and the Examiners-in-Charge at WaMu were Lawrence Carter and later Benjamin Franklin.

(2) Federal Deposit Insurance Corporation

WaMu's secondary federal regulator was the FDIC. The FDIC's mission is to maintain stability and public confidence in the nation's financial system by insuring deposits, examining and supervising financial institutions for safety and soundness and consumer protection, and managing failed institutions placed into receivership.[601] The FDIC administers the Deposit Insurance Fund, which is the primary mechanism used to protect covered deposits at U.S. financial institutions from loss. The Deposit Insurance Fund is financed through fees assessed on the insured institutions, with assessments based on the amount of deposits requiring insurance, the amount of assets at each institution, and the degree of risk posed by each institution to the insurance fund.

To minimize withdrawals from the Deposit Insurance Fund, the FDIC is assigned backup supervisory authority over approximately 3,000 federally insured depository institutions whose primary regulators are the Federal Reserve, OCC, and, until recently, OTS. Among other measures, the FDIC is authorized to conduct a "special examination" of any insured institution "to determine the condition of such depository institution for insurance purposes."[602] To facilitate and coordinate its oversight obligations with those of the primary bank regulators and ensure it is able to protect the Deposit Insurance Fund, the FDIC has entered into an inter-agency agreement with the primary bank

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[600] 2009 OTS Annual Report, "Agency Profile," http://www.ots.treas.gov/_files/482096.pdf.
[601] See "FDIC Mission, Vision, and Values," http://www.fdic.gov/about/mission/index.html.
[602] 12 U.S.C. § 1820(b)(3).

regulators.[603] The 2002 version of that agreement, which was in effect until 2010, stated that the FDIC was authorized to request to participate in examinations of large institutions or higher risk financial institutions, recommend enforcement actions to be taken by the primary regulator, and if the primary regulator failed to act, take its own enforcement action with respect to an insured institution.

For the eight largest insured institutions at the time, the FDIC assigned at least one Dedicated Examiner to work on-site at the institution. The examiner's obligation is to evaluate the institution's risk to the Deposit Insurance Fund and work with the primary regulator to lower that risk. During the period covered by this Report, Washington Mutual was one of the eight and had an FDIC-assigned Dedicated Examiner who worked with OTS examiners to oversee the bank.

During the years examined by the Subcommittee, the FDIC Chairman was Sheila Bair; the Acting Deputy Director for the FDIC's Division of Supervision and Consumer Protection's Complex Financial Institution Branch was John Corston; in the San Francisco Region, the Director was John Carter and later Stan Ivie, and the Assistant Director was George Doerr. At WaMu, the FDIC's Dedicated Examiner was Stephen Funaro.

(3) Examination Process

The stated mission of OTS was "[t]o supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs." The OTS Examination Handbook required "[p]roactive regulatory supervision" with a focus on evaluation of "future needs and potential risks to ensure the success of the thrift system in the long term."[604] OTS, like other bank regulators, had special access to the financial information of the thrifts under its regulation, which was otherwise kept confidential from the market and other parties.

To carry out its mission, OTS traditionally conducted an examination of each of the thrifts within its jurisdiction every 12 to 18 months and provided the results in a Report of Examination (ROE). In 2006, OTS initiated a "continuous exam" program for its largest thrifts,

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[603] The interagency agreement is entitled, "Coordination of Expanded Supervisory Information Sharing and Special Examinations." During the time period of the Subcommittee's investigation, the 2002 version of the interagency agreement, signed by the FDIC, Federal Reserve, OCC, and OTS, was in effect. In July 2010, the federal financial regulators agreed to adopt a stronger version, discussed later in this Report.

[604] 2004 OTS Examination Handbook, Section 010.2, OTSWMEF-0000031969, Hearing Exhibit 4/16-2.

requiring its examiners to conduct a series of specialized examinations during the year with the results from all of those examinations included in an annual ROE. The Examiner-in-Charge led the examination activities which were organized around the CAMELS rating system used by all federal bank regulators. The CAMELS rating system evaluates a bank's: (C) capital adequacy, (A) asset quality, (M) management, (E) earnings, (L) liquidity, and (S) sensitivity to market risk. A CAMELS rating of 1 is the best rating, while 5 is the worst. In the annual ROE, OTS provided its thrifts with an evaluation and rating for each CAMELS component, as well as an overall composite rating on the bank's safety and soundness.[605]

At Washington Mutual, OTS examiners conducted both on-site and off-site activities to review bank operations, and maintained frequent communication with bank management through emails, telephone conferences, and meetings. During certain periods of the year, OTS examiners had temporary offices at Washington Mutual for accessing bank information, collecting data from bank employees, performing analyses, and conducting other exam activities. Washington Mutual formed a Regulatory Relations office charged with overseeing its interactions and managing its relationships with personnel at OTS, the FDIC, and other regulators.

During the year, OTS examiners issued "findings memoranda," which set forth particular examination findings, and required a written response and corrective action plan from WaMu management. The memoranda contained three types of findings. The least severe was an "observation," defined as a "weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. … Observations may or may not be reviewed during subsequent examinations." The next level of finding was a "recommendation," defined as a "secondary concern requiring corrective action. … They may be included in the Report of Examination … Management's actions to address Recommendations are reviewed at subsequent or follow-up examinations." The most severe type of finding was a "criticism," defined as a "primary concern requiring corrective action … often summarized in the 'Matters Requiring Board Attention' … section of the Report of Examination. … They are subject to formal

[605] A 1 composite rating in the CAMELS system means "sound in every respect"; a 2 rating means "fundamentally sound"; a 3 rating means "exhibits some degree of supervisory concern in one or more of the component areas"; a 4 rating means "generally exhibits unsafe and unsound practices or conditions"; and a 5 rating means "exhibits extremely unsafe and unsound practices or conditions" and is of "greatest supervisory concern." See chart in the prepared statement of Treasury IG Eric Thorson at 7, reprinted in April 16, 2010 Subcommittee Hearing at 107.

follow-up by examiners and, if left uncorrected, may result in stronger action."[606]

The most serious OTS examination findings were elevated to Washington Mutual Bank's Board of Directors by designating them as a "Matter Requiring Board Attention" (MRBA). MRBAs were set forth in the ROE and presented to the Board in an annual meeting attended by OTS and FDIC personnel. Washington Mutual tracked OTS findings, along with its own responses, through an internal system called Enterprise Risk Issue Control System (ERICS). ERICS was intended to help WaMu manage its relationship with its regulators by storing the regulators' findings in one central location. In one of its more unusual discoveries, the Subcommittee learned that OTS also came to rely largely on ERICS to track its dealings with WaMu. OTS' reliance on WaMu's tracking system was a unique departure from its usual practice of separately tracking the status of its past examination findings and a bank's responses.[607]

The FDIC also participated in the examinations of Washington Mutual. Because WaMu was one of the eight largest insured banks in the country, the FDIC assigned a full-time Dedicated Examiner to oversee its operations. Typically, the FDIC examiners worked with the primary regulator and participated in or relied upon the examinations scheduled by that regulator, rather than initiating separate FDIC examinations. At least once per year, the FDIC examiner performed an evaluation of the institution's risk to the Deposit Insurance Fund, typically relying primarily on the annual Report on Examination (ROE) issued by the primary regulator and the ROE's individual and composite CAMELS ratings for the institution. After reviewing the ROE as well as other examination and financial information, the FDIC examiner reviewed the CAMELS ratings for WaMu to ensure they were appropriate.

In addition, for institutions with assets of $10 billion or more, the FDIC had established a Large Insured Depository Institutions (LIDI) Program to assess and report on emerging risks that may pose a threat to the Deposit Insurance Fund. Under that program, the FDIC Dedicated Examiner and other FDIC regional case managers performed ongoing analysis of emerging risks within each covered institution and assigned it a quarterly risk rating, using a scale of A to E, with A being the best rating and E the worst. In addition, senior FDIC analysts within the

[606] Descriptions of these terms appeared in OTS findings memoranda. See, e.g., 6/19/2008 OTS Findings Memorandum of Washington Mutual Bank, at Bisset_John-00046124_002, Hearing Exhibit 4/16-12a.

[607] See April 16, 2010 Subcommittee Hearing at 21 (information supplied by Treasury IG Thorson for the record).

Complex Financial Institutions Branch analyzed specific bank risks and developed supervisory strategies. If the FDIC viewed an institution as imposing an increasing risk to the Deposit Insurance Fund, it could perform one or more "special examinations" to take a closer look.

C. Washington Mutual Examination History

For the five-year period, from 2004 to 2008, OTS repeatedly identified significant problems with Washington Mutual's lending practices, risk management, appraisal procedures, and issued securities, and requested corrective action. WaMu promised to correct the identified deficiencies, but failed to do so. OTS failed, in turn, to take enforcement action to ensure the corrections were made, until the bank began losing billions of dollars. OTS also resisted and at times impeded FDIC examination efforts at Washington Mutual.

(1) Regulatory Challenges Related to Washington Mutual

Washington Mutual was a larger and more complex financial institution than any other thrift overseen by OTS, and presented numerous regulatory challenges. By 2007, Washington Mutual had over $300 billion in assets, 43,000 employees, and over 2,300 branches in 15 states, including a securitization office on Wall Street, a massive loan portfolio, and several lines of business, including home loans, credit cards, and commercial real estate.

Integration Issues. During the 1990s, as described in the prior chapter, WaMu embarked upon a strategy of growth through acquisition of smaller institutions, and over time became one of the largest mortgage lenders in the United States. One consequence of its acquisition strategy was that WaMu struggled with the logistical and managerial challenges of integrating a variety of lending platforms, information technology systems, staff, and policies into one system.

OTS was concerned about and critical of WaMu's integration efforts. In a 2004 Report on Examination (ROE), OTS wrote:

> "Our review disclosed that past rapid growth through acquisition and unprecedented mortgage refinance activity placed significant operational strain on [Washington Mutual] during the early part of the review period. Beginning in the second half of 2003, market conditions deteriorated, and the failure of [Washington Mutual] to fully integrate past mortgage banking acquisitions, address operational issues, and realize expectations from certain major IT

initiatives exposed the institution's infrastructure weaknesses and began to negatively impact operating results."[608]

Long Beach. One of WaMu's acquisitions, in 1999, was Long Beach Mortgage Company (Long Beach), a subprime lender that became a source of significant management, asset quality, and risk problems. Long Beach's headquarters were located in Long Beach, California, but as a subsidiary of Washington Mutual Inc., the parent holding company of Washington Mutual Bank, it was subject to regulation by the State of Washington Department of Financial Institutions and the FDIC. Long Beach's business model was to purchase subprime loans from third party mortgage brokers and lenders and then sell or securitize the loans for sale to investors.

For the first seven years, from 1999 to 2006, OTS had no direct jurisdiction over Long Beach, since it was a subsidiary of WaMu's parent holding company, but not a subsidiary of the bank itself. OTS was limited to reviewing Long Beach indirectly by examining its effect on the holding company and WaMu. In late 2003, OTS examiners took greater notice of Long Beach after WaMu's legal department halted Long Beach's securitizations while it helped the company strengthen its internal controls. As many as 4,000 Long Beach loans were of such poor quality that three quarters of them could not be sold to investors. In 2005, Long Beach experienced a surge in early payment defaults, was forced to repurchase a significant number of loans, lost over $107 million, and overwhelmed its loss reserves. Washington Mutual requested permission to make Long Beach a division of the bank, so that it could assert greater control over Long Beach's operations, and in March 2006, OTS approved the purchase with conditions. In 2006, Long Beach experienced another surge of early payment defaults and was forced to repurchase additional loans. When Long Beach loans continued to have problems in 2007, Washington Mutual eliminated Long Beach as a separate operation and rebranded it as a Washington Mutual "Wholesale Specialty Lending" division. In August 2007, after the collapse of the subprime secondary market, WaMu stopped offering subprime loans and discontinued the last vestiges of the Long Beach operation.

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[608] See 3/15/2004 OTS Report of Examination, at OTSWMS04-0000001482, Hearing Exhibit 4/16-94 [Sealed Exhibit]. See also, e.g., 12/17/2004 email exchange among WaMu executives, "Risks/Costs to Moving GSE Share to FH," JPM_WM05501400, Hearing Exhibit 4/16-88 (noting that Fannie Mae "is well aware of our data integrity issues (miscoding which results in misdeliveries, expensive and time consuming data reconciliations), and has been exceedingly patient.").

High Risk Lending. In 2004, Washington Mutual shifted its strategy toward the issuance and purchase of higher risk home loans. OTS took note of the strategic shift in WaMu's 2004 ROE:

> "Management provided us with a copy of the framework for WMI's 5-year (2005-2009) strategic plan [which] contemplates asset growth of at least 10% a year, with assets increasing to near $500 billion by 2009."[609]

OTS recommended, and the bank agreed, to spell out its new lending strategy in a written document that had to be approved by the WaMu Board of Directors.[610]

The result was the bank's January 2005 High Risk Lending Strategy, discussed in the prior chapter, in which WaMu management obtained the approval of its Board to shift its focus from originating lower risk fixed rate and government backed loans to higher risk subprime, home equity, and Option ARM loans.[611] The High Risk Lending Strategy also outlined WaMu's plans to increase its issuance of higher risk loans to borrowers with a higher risk profile. The purpose of the shift was to maximize profits by originating loans with the highest profit margins, which were usually the highest risk loans. According to actual loan data analyzed by WaMu, higher risk loans, such as subprime, Option ARM, and home equity loans, produced a higher "gain on sale" or profit for the bank compared to lower risk loans. For example, a presentation supporting the High Risk Lending Strategy indicated that selling subprime loans garnered more than eight times the gain on sale as government backed loans.[612]

The WaMu submission to the Board noted that, in order for the plan to be successful, WaMu would need to carefully manage its

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609 See 3/15/2004 OTS Report of Examination, at OTSWMS04-0000001509, Hearing Exhibit 4/16-94 [Sealed Exhibit].

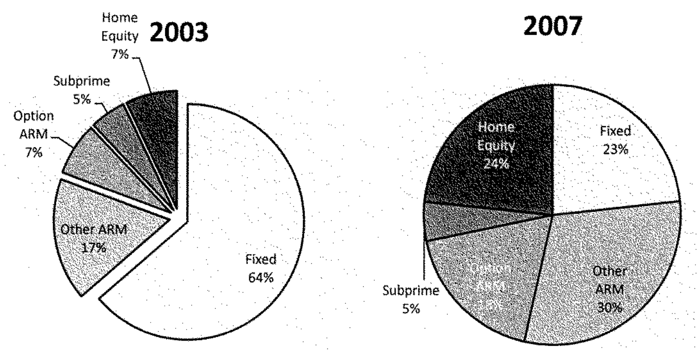
610 6/30/2004 OTS Memo to Lawrence Carter from Zalka Ancely, OTSWME04-0000005357 at 61 ("Joint Memo #9 - Subprime Lending Strategy"); 3/15/2004 OTS Report of Examination, at OTSWMS04-0000001483 [Sealed Exhibit]. See also 1/2005 "Higher Risk Lending Strategy Presentation," submitted to Washington Mutual Board of Directors, at JPM_WM00302978, Hearing Exhibit 4/13-2a ("As we implement our Strategic Plan, we need to address OTS/FDIC 2004 Safety and Soundness Exam Joint Memos 8 & 9 . . . Joint Memo 9: Develop and present a SubPrime/Higher Risk Lending Strategy to the Board.").

611 1/2005 "Higher Risk Lending Strategy Presentation," submitted to Washington Mutual Board of Directors, at JPM_WM00302978, Hearing Exhibit 4/13-2a; see also "WaMu Product Originations and Purchases by Percentage – 2003-2007," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1i.

612 4/18/2006 Washington Mutual Home Loans Discussion Board of Directors Meeting, at JPM_WM00690894, Hearing Exhibit 4/13-3 (see chart showing gain on sale for government loans was 13 basis points (bps); for 30-year, fixed rate loans was 19 bps; for Option ARMs was 109 bps; for home equity loans was 113 bps; and for subprime loans was 150 bps.)

residential mortgage business as well as its credit risk, meaning the risk that borrowers would not repay the higher risk loans.[613] During the Board's discussion of the strategy, credit officers noted that losses would likely lag by several years.[614] WaMu executives knew that even if loan losses did not immediately materialize, the strategy presented potentially significant risks down the road. OTS did not object to the High Risk Lending Strategy, even though OTS noted that the bank's five-year plan did not articulate a robust plan for managing the increased risk.[615]

Even before it received formal Board approval, Washington Mutual had begun shifting its loan originations toward higher risk loans. By 2007, rising defaults and the collapse of the subprime secondary market prevented WaMu from fully implementing its plans, but it did have time to shift the composition of the loans it originated and purchased, increasing the percentage of higher risk home loans from at least 19% in 2003, to over 47% in 2007.[616]



Over the course of nearly three years, from 2005 to 2007, WaMu issued and securitized hundreds of billions of high risk loans, including \$49 billion in subprime loans[617] and \$59 billion in Option ARMs.[618]

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[613] The Home Loans presentation to the Board acknowledged that risks of the High Risk Lending Strategy included managing credit risk, implementing lending technology and enacting organizational changes. 4/18/2006 Washington Mutual Home Loans Discussion Board of Directors Meeting, at JPM_WM00690899, Hearing Exhibit 4/13-3.

[614] 1/18/2005 Washington Mutual Inc. Washington Mutual Bank FA Finance Committee Minutes, JPM_WM06293964-68 at 67; see also 1/2005 Washington Mutual, Higher Risk Lending Strategy Presentation, at JPM_WM00302987, Hearing Exhibit 4/13-2a (chart showing peak loss rates in 2007).

[615] See 3/15/2004 OTS Report of Examination, at OTSWMS04-0000001509, Hearing Exhibit 4/16-94 [Sealed Exhibit].

[616] "WaMu Product Originations and Purchases by Percentage – 2003-2007," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1i.

[617] "Securitizations of Washington Mutual and Long Beach Subprime Home Loans," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1c.

[618] 4/2010 "Evaluation of Federal Regulatory Oversight of Washington Mutual Bank," report prepared by the Offices of Inspector General at the Department of the Treasury and Federal

Data compiled by the Treasury and the FDIC Inspectors General showed that, by the end of 2007, Option ARMs constituted about 47% of all home loans on WaMu's balance sheet, of which about 56% of the borrowers were making the minimum payment amounts.[619] The data also showed that 84% of the total value of the Option ARMs was negatively amortizing, meaning that the borrowers were going into deeper debt rather than paying off their loan balances.[620] In addition, by the end of 2007, stated income loans – loans in which the bank had not verified the borrower's income – represented 73% of WaMu's Option ARMs, 50% of its subprime loans, and 90% of its home equity loans.[621] WaMu also originated numerous loans with high loan-to-value (LTV) ratios, in which the loan amount exceeded 80% of the value of the underlying property. The Inspectors General determined, for example, that 44% of WaMu's subprime loans and 35% of its home equity loans had LTV ratios in excess of 80%.[622] Still another problem was that WaMu had high concentrations of its home loans in California and Florida, states that ultimately suffered above-average home value depreciation.[623]

WaMu issued loans through its own retail loan offices, through Long Beach, which issued subprime loans initiated by third party mortgage brokers, and through correspondent and conduit programs in which the bank purchased loans from third parties. The Treasury and the FDIC Inspectors General observed that, from 2003 to 2007, 48 to 70% of WaMu's residential mortgages came from third party mortgage brokers, and that only 14 WaMu employees were responsible for overseeing more than 34,000 third party brokers,[624] requiring each WaMu employee to oversee more than 2,400 third party brokers.

When the subprime market collapsed in July 2007, Washington Mutual was left holding a portfolio saturated with high risk, poorly performing loans. Prior to the collapse, WaMu had sold or securitized the majority of the loans it had originated or purchased, undermining the U.S. home loan mortgage market with hundreds of billions of dollars in high risk, poor quality loans. OTS documentation shows that WaMu's regulators saw what was happening, identified the problems, but then

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Deposit Insurance Corporation (hereinafter "Treasury and FDIC IG Report"), at 9, Hearing Exhibit 4/16-82.

[619] Id. An August 2006 WaMu internal presentation indicated that over 95% of its Option ARM borrowers were making minimum payments. See 8/2006 chart, "Borrower-Selected Payment Behavior," in WaMu internal presentation entitled, "Option ARM Credit Risk," JPM_WM00212646, Hearing Exhibit 4/13-37.

[620] See Treasury and FDIC IG Report, at 9, Hearing Exhibit 4/16-82.

[621] Id. at 10.

[622] Id.

[623] Id. at 11.

[624] See Thorson prepared statement, at 5, April 16, 2010 Subcommittee Hearing at 105.

took no enforcement actions to protect either Washington Mutual or the U.S. financial system from the bank's shoddy lending practices.

(2) Overview of Washington Mutual's Ratings History and Closure

An overview of Washington Mutual's ratings history shows how OTS and the FDIC were required to work together to oversee Washington Mutual, which the two agencies did with varying levels of success. At times, the relationship was productive and useful, while at others they found themselves bitterly at odds over how to proceed. As Washington Mutual's problems intensified, the working relationship between OTS and the FDIC grew more dysfunctional.

From 2004 to 2006, Washington Mutual was a profitable bank and enjoyed a 2 CAMELS rating from both agencies, signifying it was a fundamentally sound institution. In late 2006, as housing prices began to level off for the first time in years, subprime loans began to experience delinquencies and defaults. In part because borrowers were unable to refinance their loans, those delinquencies and defaults accelerated in 2007. The poorly performing loans began to affect the payments supporting subprime mortgage backed securities, which began to incur losses. In July 2007, the subprime market was performing so poorly that the major credit rating agencies suddenly downgraded hundreds of subprime mortgage backed securities, including over 40 issued by Long Beach. The subprime market slowed and then collapsed, and Washington Mutual was suddenly left with billions of dollars in unmarketable subprime loans and securities that were plummeting in value. WaMu stopped issuing subprime loans. In the fourth quarter of 2007, WaMu reported a $1 billion loss.

As housing prices slowed and even began declining in some parts of the country, high risk prime loans, including hybrid adjustable rate mortgages, Alt A, and Option ARMs, also began incurring delinquencies and defaults.[625] By March 2008, the total delinquency rate for prime/Alt A loans underlying WaMu and Long Beach securitizations was 8.57%, more than twice the industry average.[626] In 2008, WaMu did not issue

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[625] WaMu's Chief Credit Officer informed the Board of Directors that WaMu was "heavily concentrated" in residential mortgages and high risk products as well as in "highly stressed" geographic markets, which negatively affected WaMu's portfolio performance. See 2/25/2008 Credit Risk Overview Report to the Board of Directors, prepared by John McMurray, WaMu Chief Credit Officer, JPM_WM02548447, at 28-29. He reported that WaMu's mortgages were 1366% of its common tangible equity, the highest percentage of any of the top 20 banks. He also informed the Board that the bank's residential mortgages "performed very poorly" and WaMu had "generally retained higher risk products (e.g., Option ARMS, 2nd Liens, Subprime, Low Doc)."

[626] OTS Fact Sheet 12, "Securitizations," Dochow_Darrel-00001364_001.

any new high risk, nonconforming mortgage securitizations due to, in the words of OTS, "continued market illiquidity, deterioration in the financial condition of the market, and the poor performance of WaMu's outstanding securitizations."[627]

In the first quarter of 2008, WaMu continued to incur losses as the value of its loan portfolio and mortgage backed securities continued to drop. In February 2008, OTS downgraded Washington Mutual for the first time, changing its CAMELS rating from a 2 to a 3, signifying that the bank was in trouble. Unfortunately, OTS did not follow up with a suitable enforcement action. Consistent with its own practice, OTS should have required WaMu to enter into a public Memorandum of Understanding specifying the measures WaMu would take to remedy its problems. Instead, in March, OTS allowed WaMu to issue a nonpublic Board Resolution in which the WaMu Board generally promised to address various problems, but did not identify any specific actions or deadlines.[628]

Also in March 2008, at the urging of the FDIC, OTS required Washington Mutual to allow potential buyers of the bank to conduct due diligence of its assets and operations.[629] Several institutions participated, and JPMorgan Chase made an offer to buy the bank which Washington Mutual turned down. By the end of the first quarter of 2008, Washington Mutual had lost another $1 billion. In April 2008, to reassure the market and its depositors, the holding company raised additional capital of $7 billion from the private sector and provided $3 billion of those funds to the bank. But by the end of the second quarter, WaMu lost another $3.2 billion. Its stock price plummeted, and depositors began withdrawing substantial sums from the bank.

In June 2008, as a result of the bank's financial and deposit losses, the FDIC downgraded WaMu to its lowest internal LIDI rating, an E, indicating "serious concern" that the bank would cause a loss to the Deposit Insurance Fund. It also initiated a special insurance examination of WaMu, which it conducted concurrently with ongoing OTS examination efforts.[630]

Other financial institutions were also failing, compounding the concern of those who worried whether the Deposit Insurance Fund had

[627] Id.
[628] 3/17/2008 letter from Kerry Killinger to Darrel Dochow with enclosed Board Resolution, OTSWMS08-015 0001216. See also Treasury and FDIC IG Report at 31.
[629] Subcommittee interviews of WaMu Chief Financial Officer Tom Casey (2/20/2010); WaMu Controller Melissa Ballenger (2/14/2010); and OTS Western Region Office Director Darrel Dochow (3/3/2010); 4/2010 "Washington Mutual Regulators Timeline," prepared by the Subcommittee, Hearing Exhibit 4/16-1j.
[630] See 7/21/2008 letter from FDIC to OTS, FDIC_WAMU_000001730, Hearing Exhibit 4/16-59.

sufficient funds. In July 2008, IndyMac Bank, another thrift with high risk loans, failed and was taken over by the FDIC.[631] In response, Washington Mutual depositors began to withdraw more funds from the bank, eventually removing over $10 billion.[632] The Federal Home Loan Bank of San Francisco also began to limit WaMu's borrowing, further straining its liquidity.[633] The parent holding company supplied an additional $2 billion in capital to the bank.

In the final three months before WaMu's collapse, tensions increased further between OTS and the FDIC as they disagreed on the course of action. On July 3, 2008, the head of OTS sent an email to the CEO of WaMu informing him that the agency had decided to require the bank to issue a nonpublic Memorandum of Understanding (MOU).[634] On July 15, OTS and the FDIC met with the WaMu Board of Directors to discuss the latest examination findings and formally advise the Board of the OTS decision to require the MOU. On July 21, 2008, the FDIC sent a letter to OTS urging it to take tough supervisory action in the MOU, including by requiring WaMu to increase its loan loss reserves, begin providing regular financial updates, and raise an additional $5 billion in capital.[635] OTS rejected the FDIC's advice.[636] On July 31, 2008, both OTS and FDIC officials met with WaMu's Board. An FDIC official suggested at the Board meeting that WaMu look for a strategic partner to buy or invest in the bank; OTS expressed anger that the FDIC had raised the issue without first clearing it with OTS.[637]

On August 1, 2008, the FDIC informed OTS that it thought WaMu should be downgraded to a 4 CAMELS rating, signaling it was a troubled bank exhibiting unsafe and unsound practices.[638] OTS strongly disagreed.[639] Also on August 1, OTS provided WaMu with the proposed MOU. The proposed MOU would require the bank to correct lending

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[631] For more information on IndyMac Bank, see section E(2), below.
[632] See undated charts prepared by FDIC on "Daily Retail Deposit Change," FDIC-PSI-01-000009.
[633] See, e.g., 12/1/2008 "WaMu Bank Supervisory Timeline," prepared by OTS Examiner-in-Charge Benjamin Franklin, at Franklin_Benjamin-00035756_001, at 032 (7/22/2008 entry: "Although they have $60 billion in borrowing capacity, the FHLB is not in a position to fund more than about $4 to $5 billion a week"). See also FDIC LIDI Report for the Second Quarter of 2008, at FDIC_WAMU_000014991 [Sealed Exhibit].
[634] 7/3/2008 email from John Reich to Kerry Killinger, "MOU vs. Board Resolution," Hearing Exhibit 4/16-44.
[635] 7/21/2008 letter from FDIC to OTS, FDIC_WAMU_000001730, Hearing Exhibit 4/16-59.
[636] 7/22/2008 letter from OTS to FDIC, OTSWMS08-015 0001312, Hearing Exhibit 4/16-60.
[637] See 8/1/2008 email exchange among FDIC colleagues, FDIC-EM_00246958, Hearing Exhibit 4/16-64.
[638] 8/1/2008 email exchange among OTS officials, Hearing Exhibit 4/16-62. The FDIC had performed a capital analysis earlier in the summer and had been pushing for a downgrade for weeks. See 7/21/2008 letter from FDIC to OTS, FDIC_WAMU_000001730, Hearing Exhibit 4/16-59.
[639] 8/1/2008 email from OTS Director John Reich to FDIC Chairman Sheila Bair, Hearing Exhibit 416-63.

and risk management deficiencies identified in a June 30 examination report, develop a capital contingency plan (rather than, as the FDIC originally urged, raise additional capital), submit a 3-year business plan, and engage a consultant to review its underwriting, risk management, management, and board oversight. On August 4, WaMu asked OTS to drop the requirement that the consultant review the Board's oversight efforts, and OTS agreed.

On August 6, the FDIC Chairman asked the OTS Director to discuss contingency plans for an emergency closure of the bank. The OTS Director reacted negatively and sent an email criticizing the FDIC Chairman for acting as if it were the primary regulator of the bank.[640] As the agencies argued amongst themselves, the bank's condition continued to deteriorate.

By August 25, OTS and WaMu reached agreement on the terms of the MOU, but it was not actually signed until September 7, 2008.[641] Apart from the capitalization plan, OTS Deputy Director Scott Polakoff described the final MOU as a "benign supervisory document,"[642] meaning it would not bring about meaningful change at WaMu.[643]

On September 10, 2008, the FDIC Chairman, Sheila Bair, informed WaMu that there was a ratings disagreement between the FDIC and OTS, and that the FDIC was likely to downgrade WaMu to a 4. When she informed the OTS Director, John Reich, of her conversation with WaMu, he sent an internal email to his deputy, Scott Polakoff, venting his frustration that she had not discussed the matter with him first and allowed OTS to break the news to the bank: "I cannot believe the continuing audacity of this woman."[644]

Six days later, on September 16, 2008, Lehman Brothers declared bankruptcy, triggering another run on Washington Mutual. Over the next eight days, depositors pulled $17 billion in cash from WaMu's coffers, leading to a second liquidity crisis.[645] On September 18, the FDIC downgraded the bank to a 4 rating, and OTS agreed to the lower rating. Within days, because of the bank's accelerating liquidity

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640 See 8/6/2008 email from John Reich, OTS Director, to Sheila Bair, FDIC Chairman, "Re: W," FDIC-EM_00110089, Hearing Exhibit 4/16-66.

641 9/11/2008 OTS document, "WaMu Ratings," Hearing Exhibit 4/16-48.

642 7/28/2008 email from OTS Deputy Director Scott Polakoff to Timothy Ward, "Re: WAMU MOU," Polakoff_Scott-00060660_001, Hearing Exhibit 4/16-45.

643 Subcommittee interview of Tim Ward, OTS Deputy Director of Examinations, Supervision and Consumer Protection (2/12/2010).

644 9/10/2008 email from OTS Director John Reich to OTS Deputy Director Scott Polakoff, Polakoff_Scott-00065461_001, Hearing Exhibit 4/16-68.

645 See undated charts prepared by FDIC on "Daily Retail Deposit Change," FDIC-PSI-01-000009.

problems, portfolio losses, share price decline, and other problems, OTS and the FDIC decided they had to close the bank.[646]

Due to the bank's worsening liquidity crisis, the regulators abandoned their customary practice of waiting until markets closed on Friday, and on Thursday, September 25, 2008, OTS closed Washington Mutual Bank and appointed the FDIC as receiver. The FDIC immediately sold the bank to JPMorgan Chase for $1.9 billion. If the sale had not gone through, Washington Mutual's $300 billion failure might have exhausted the entire $45 billion Deposit Insurance Fund.

(3) OTS Identification of WaMu Deficiencies

During the five-year period reviewed by the Subcommittee, from 2004 through 2008, OTS examiners identified over 500 serious deficiencies in Washington Mutual's lending, risk management, and appraisal practices.[647] OTS examiners also criticized the poor quality loans and mortgage backed securities issued by Long Beach, and received FDIC warnings regarding the bank's high risk activities. When WaMu failed in 2008, it was not a case of hidden problems coming to light; the bank's examiners were well aware of and had documented the bank's high risk, poor quality loans and deficient lending practices.

(a) Deficiencies in Lending Standards

From 2004 to 2008, OTS Findings Memoranda and annual Reports of Examination (ROE) repeatedly identified deficiencies in WaMu's lending standards and practices. Lending standards, also called "underwriting" standards, determine the types of loans that a loan officer may offer or purchase from a third party mortgage broker. These standards determine, for example, whether the loan officer may issue a "stated income" loan without verifying the borrower's professed income, issue a loan to a borrower with a low FICO score, or issue a loan providing 90% or even 100% of the appraised value of the property being purchased.

When regulators criticize a bank's lending or "underwriting" standards as weak or unsatisfactory, they are expressing concern that the bank is setting its standards too low, issuing risky loans that may not be repaid, and opening up the bank to later losses that could endanger its safety and soundness. When they criticize a bank for excessively high lending or underwriting "errors," regulators are expressing concern that the bank's loan officers are failing to comply with the bank's standards, such as by issuing a loan that finances 90% of a property's appraised

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[646] See IG Report at 13.
[647] See IG Report at 28.

value when the bank's lending standards prohibit issuing loans that finance more than 80% of the appraised value.

In addition to errors, regulators may express concern about the extent to which a bank allows its loan officers to make "exceptions" to its lending standards and issue a loan that does not comply with some aspects of its lending standards. Exceptions that are routinely approved can undermine the effectiveness of a bank's formal lending standards. Another common problem is inadequate loan documentation indicating whether or not a particular loan complies with the bank's lending standards, such as loan files that do not include a property's appraised value, the source of the borrower's income, or key analytics such as the loan-to-value or debt-to-income ratios. In the case of Washington Mutual, from 2004 to 2008, OTS examiners routinely found all four sets of problems: weak standards, high error and exception rates, and poor loan documentation.

2004 Lending Deficiencies. In 2004, OTS examiners identified a variety of problems with WaMu's lending standards. In May of that year, an OTS Findings Memorandum stated:

> "Several of our recent examinations concluded that the Bank's single family loan underwriting was less than satisfactory due to excessive errors in the underwriting process, loan document preparation, and in associated activities."[648]

After reviewing an OTS examination of a loan sample, the FDIC examiner wrote that the loans:

> "reflected inconsistencies with underwriting and documentation practices, particularly in the brokered channel. Additionally, examiners noted that Washington Mutual's SFR [Single Family Residential] portfolio has an elevated level of risk to a significant volume of potential negative amortization loans, high delinquency and exception rates, and a substantial volume of loans with higher risk characteristics, such as low FICO scores."[649]

A few months later, in September, an OTS review of a sample of 2003 WaMu loans found "critical error rates as high as 57.3%":

> "[Residential Quality Assurance]'s review of 2003 originations disclosed critical error rates as high as 57.3 percent of certain loan samples, thereby indicating that SFR [Single Family Residential] underwriting still requires much improvement. While this group

[648] 5/12/2004 OTS Memo 5, "SFR Loan Origination Quality," OTSWME04-0000004883.
[649] 5/20/2004 FDIC-DFI Memo 3, "Single Family Residential Review," OTSWME04-0000004889.

has appropriately identified underwriting deficiencies, it has not been as successful in effecting change."[650]

The same OTS Report of Examination observed that one of the three causes of underwriting deficiencies was "a sales culture focused on building market share." It also stated:

"Notwithstanding satisfactory asset quality overall, some areas still require focused management and Board attention. Most important is the need to address weaknesses in single-family residential (SFR) underwriting, which is an ongoing issue from prior exams."[651]

The OTS ROE concluded: "Underwriting of SFR loans remains less than satisfactory."[652]

The next month, when OTS conducted a field visit to follow up on some of the problems identified earlier, it concluded:

"The level of SFR [Single Family Residential] underwriting exceptions in our samples has been an ongoing examination issue for several years and one that management has found difficult to address. The institution instituted a major organizational/staffing realignment in September 2003 and has continued to make additional adjustments since that time to address accumulating control issues."[653]

2005 Lending Deficiencies. In early 2005, OTS elevated the problems with the bank's lending standards to the attention of the WaMu Board of Directors. In a letter to the Board, OTS wrote:

"SFR Loan Underwriting – This has been an area of concern for several exams. As management continues to make change in organization, staffing, and structure related to SFR loan underwriting, delays in meeting target dates become inevitable. The board should closely monitor these delays to ensure they do not become protracted."[654]

OTS officials attended a Board meeting to address this and other concerns. Yet a few months later, in June, an OTS examiner wrote:

[650] 9/13/2004 OTS Report of Examination, at OTSWMS04-0000001498, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[651] 9/13/2004 OTS Report of Examination, at OTSWMS04-0000001492, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[652] 9/13/2004 OTS Report of Examination, at OTSWMS04-0000001497, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[653] 10/18/2004 OTS Field Visit Report of Examination, at OTSWMEF-0000047576-78, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[654] 2/7/2005 OTS Letter to Washington Mutual Board of Directors on Matters Requiring Board Attention, OTSWMEF-0000047591 [Sealed Exhibit].

"We continue to have concerns regarding the number of underwriting exceptions and with issues that evidence lack of compliance with Bank policy."[655] The examination findings memorandum also noted that, while WaMu tried to make changes, those changes produced "only limited success" and loan underwriting remained "less than satisfactory."[656]

In August 2005, the OTS ROE for the year indicated that the lending standards problem had not been resolved:

> "[W]e remain concerned with the number of underwriting exceptions and with issues that evidence lack of compliance with bank policy .... [T]he level of deficiencies, if left unchecked, could erode the credit quality of the portfolio. Our concerns are increased with the risk profile of the portfolio is considered, including concentrations in Option ARM loans to higher-risk borrowers, in low and limited documentation loans, and loans with subprime or higher-risk characteristics. We are concerned further that the current market environment is masking potentially higher credit risk."[657]

2006 Lending Deficiencies. The same problems continued into 2006. In March 2006, OTS issued the same strong warning about WaMu's loan portfolio that it had provided in August 2005:

> "We believe the level of delinquencies, if left unchecked, could erode the credit quality of the portfolio. Our concerns are increased when the risk profile of the portfolio is considered, including concentrations in Option ARMS to higher-risk borrowers, in low and limited documentation loans, and loans with subprime or higher-risk characteristics. We are concerned further that the current market environment is masking potentially higher credit risk."[658]

Two months later, in May 2006, an OTS examiner wrote:

> "During the prior examination, we noted numerous instances of underwriters exceeding underwriting guidelines, errors in income calculations, errors in debt-to-income (DTI) calculations, lack of sufficient mitigating factors for credit-quality related issues, and insufficient title insurance coverage on negative amortization

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655 6/3/2005 OTS Findings Memorandum, "Single Family Residential Home Loan Review," OTSWME05-004 0000392, Hearing Exhibit 4/16-26.
656 Id. at OTSWME05-004 0000392.
657 8/29/2005 OTS Report of Examination, at OTSWMS05-004 0001794, Hearing Exhibit 4/16-94 [Sealed Exhibit].
658 3/14/2006 OTS Report of Examination, at 19, OTSWMEF-0000047030, Hearing Exhibit 4/16-94 [Sealed Exhibit].

loans. ... [U]nderwriting errors [] continue to require management's attention."[659]

While OTS was documenting its concerns, however, it is apparent in hindsight that the agency tempered its criticism. The OTS examiner who authored the memo found that in his review, none of the negatively amortizing loans he analyzed for safety and soundness carried an "exception," meaning it "probably should not have been made."[660] Many of the loans made in this time period would later default.

Another OTS Findings Memorandum the same month concluded: "Overall, we concluded that the number and severity of underwriting errors noted remain at higher than acceptable levels."[661]

The 2006 OTS ROE for the year concluded:

> "[S]ubprime underwriting practices remain less than satisfactory. ... [T]he number and severity of underwriting exceptions and errors remain at higher than acceptable levels. ... The findings of this judgmental sample are of particular concern since loans with risk layering ... should reflect more, rather than less, stringent underwriting."[662]

2007 Lending Deficiencies. In 2007, the problems with WaMu's lending standards were no better, and the acceleration of high risk loan delinquencies and defaults threatened serious consequences.

By July 2007, the major credit rating agencies had begun mass ratings downgrades of hundreds of mortgage backed securities, the subprime secondary market froze, and WaMu was left holding billions of dollars worth of suddenly unmarketable subprime and other high risk loans. In September, the OTS ROE for the year concluded:

> "Underwriting policies, procedures, and practices were in need of improvement, particularly with respect to stated income lending. Based on our current findings, and the fact that a number of similar concerns were raised at prior examinations, we concluded that too much emphasis was placed on loan production, often at the expense of loan quality."[663]

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[659] 5/23/2006 OTS Findings Memorandum, "Home Loan Underwriting," OTSWMS06-008 0001299, Hearing Exhibit 4/16-33.
[660] Id.
[661] 5/25/2006 OTS Findings Memorandum, "Loan Underwriting Review - Long Beach Mortgage," OTSWMS06-008 0001243, Hearing Exhibit 4/16-35.
[662] 8/26/2006 OTS Report of Examination, at OTSWMS06-008 0001680, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[663] 9/18/2007 OTS Report of Examination, at OTSWMEF-0000046679, Hearing Exhibit 4/16-94 [Sealed Exhibit].

The ROE also reported on an unsatisfactory review of loans that had been originated by Long Beach and warned that, if the problems were not promptly corrected, "heightened supervisory action would be taken":

> "Based on our review of 75 subprime loans originated by [Long Beach], we concluded that subprime underwriting practices remain less than satisfactory .... Given that this is a repeat concern and MRBA [Matter Requiring Board Attention], we informed management that underwriting must be promptly corrected, or heightened supervisory action would be taken, including limiting the Bank's ability to continue SFR subprime underwriting."[664]

In the fourth quarter of 2007, WaMu's loan portfolio lost $1 billion in value. Despite that loss, and the strong language in the 2007 examinations, OTS took no enforcement action against the bank that would result in WaMu's tightening its lending standards or strengthening compliance with the standards it had.

2008 Lending Deficiencies. In the first six months of 2008, WaMu continued to incur billions of dollars in losses, as its high risk loan portfolio lost value and its share price fell. In July 2008, about two months before the bank failed, OTS met with the WaMu Board of Directors to discuss, among other matters, the bank's deficient lending standards. While the presentation to the Board reiterated the concerns from past years, it failed to convey a sense of urgency to a bank on the verge of collapse. Instead, the presentation focused on long term corrective action that WaMu should take. The OTS written presentation to the Board included the following:

> "High SFR [Single Family Residential] losses due in part to downturn in real estate market but exacerbated by: geographic concentrations[,] risk layering[,] liberal underwriting policy[,] poor underwriting. ... Discontinuing higher risk lending and tightened underwriting policy should improve asset quality; however, actions should have been taken sooner. ...
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> Significant underwriting and process weaknesses noted again in the Home Loans Group[.] ... Reducing higher risk lending products and practices should have been done sooner."[665]

Failure to Correct Deficient Lending Practices. In various reports for nearly five consecutive years, OTS criticized WaMu's lending standards, error and exception rates, and loan documentation, and directed the bank to improve its performance. When WaMu failed

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[664] 9/18/2007 OTS Report of Examination, at OTSWMEF-0000047146, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[665] 7/15/2008 OTS Presentation to WaMu Board of Directors based on Comprehensive Examinations, Polakoff_Scott-00061303_007, 012, 027, Hearing Exhibit 4/16-12b.

to improve during that span, OTS failed to take action, such as requiring a board resolution, memorandum of understanding, or cease and desist order compelling WaMu to tighten its lending standards and increase oversight of its loan officers to reduce underwriting error and exception rates and improve loan documentation. The result was that WaMu originated or purchased hundreds of billions of dollars of high risk loans, including stated income loans without verification of the borrower's assets or ability to repay the loan; loans with low FICO scores and high loan-to-value ratios; loans that required interest-only payments; and loan payments that did not cover even the interest owed, much less the principal.

(b) Deficiencies in Risk Management

Over the same five-year period, from 2004 to 2008, in addition to identifying deficiencies associated with WaMu's lending practices, OTS repeatedly identified problems with WaMu's risk management practices. Risk management involves identifying, evaluating, and mitigating the risks that threaten the safety, soundness, and profitability of an institution. At thrifts, the primary risk issues include setting lending standards that will produce profitable loans, enforcing those standards, evaluating the loan portfolio, identifying home loans that may default, establishing adequate reserves to cover potential losses, and advising on measures to lower the identified risks. When regulators criticize a bank's risk management practices as weak or unsatisfactory, they are expressing concern that the bank is failing to identify the types of risk that threaten the bank's safety and soundness and failing to take actions to reduce and manage those risks.

Within WaMu, from 2004-2005, oversight of risk management practices was assigned to a Chief Risk Officer. In 2006, it was assigned to an Enterprise Risk Management (ERM) Department headed by a Chief Enterprise Risk Officer. ERM employees reported, not only to the department, but also to particular lines of business such as the WaMu Home Loans Division, and reported both to the Chief Risk Officer and to the head of the business line, such as the president of the Home Loans Division. WaMu referred to this system of reporting as a "Double-Double."[666]

As with the bank's poor lending standards, OTS allowed ongoing risk management problems to fester without taking enforcement action. From 2004 to 2008, OTS explicitly and repeatedly alerted the WaMu Board of Directors to the need to strengthen the bank's risk management practices.

[666] Subcommittee interviews of Ronald Cathcart (2/23/2010), David Schneider (2/17/2010), and Cheryl Feltgen (2/6/2010).

2004 Risk Management Deficiencies. In 2004, prior to the bank's adoption of its High Risk Lending Strategy, OTS expressed concern about the bank's risk management practices, highlighted the issue in the annual ROE, and brought it to the attention of the WaMu Board of Directors. The 2004 ROE stated:

> "Board oversight and management performance has been satisfactory … but … increased operational risks warrant prompt attention. These issues limit the institution's flexibility and may threaten its ability to remain competitive and independent."[667]

At another point, the ROE warned: "Ensure cost-cutting measures are not impacting critical risk management areas."[668]

Another OTS examination that focused on WaMu's holding company identified multiple risks associated with Long Beach: "[P]rimary risks associated with Long Beach Mortgage Company remain regulatory risk, reputation risk, and liquidity of the secondary market in subprime loans."[669]

Its concern about WaMu's risk management practices prompted, in part, OTS' requirement that WaMu commit its high risk lending strategy to paper and gain explicit approval from the Board of Directors.

2005 Risk Management Deficiencies. In 2005, after adoption of the High Risk Lending Strategy, OTS again highlighted risk management issues in its examination reports and again brought the matter to the attention of WaMu's Board of Directors.

In March 2005, OTS observed that WaMu's five-year strategy, which increased credit risk for the bank, did not "clearly articulate the need to first focus on addressing the various operational challenges before embarking on new and potentially more risky growth initiatives."[670] OTS also wrote: "We discussed the lack of a clear focus in the plan on resolving operational challenges with CEO Killinger and the Board."[671] OTS continued to express concerns about the bank's weak risk management practices for the rest of the year, yet took no concrete enforcement action to compel the bank to address the issue. In June 2005, OTS described risk management weaknesses within WaMu's Corporate Risk Oversight group, a sub-group within the ERM

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[667] 9/13/2004 OTS Report of Examination, at OTSWMS04-0000001504, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[668] Id. at OTSWMS04-000001488.
[669] 4/5/2004 OTS Report of Examination, at OTSWMEF-0000047477, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[670] 3/15/2004 OTS Report of Examination, at OTSWMS04-0000001509, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[671] Id.

Department responsible for evaluating credit and compliance risk. OTS wrote that it had deemed its comments as "criticisms" of the bank, because of the significance of the risk management function in addressing ongoing problems with the bank's lending standards and loan error rates:

> "Most of the findings are considered 'criticisms' due to the overall significance of CRO [Corporate Risk Oversight] activities and the fact that we have had concerns with quality assurance and underwriting processes within home lending for several years."[672]

In August 2005, in its annual Report on Examination, OTS urged the WaMu Board to obtain progress reports from the ERM Department and ensure it had sufficient resources to become an effective counterweight to the increased risk-taking entailed in the High Risk Lending Strategy:

> "Monitor and obtain reports from management on status of [Enterprise Risk Management] in terms of effectiveness and resource adequacy. ... ERM provides an important check and balance on the company's profit-oriented units and warrants ongoing strong Board commitment given the institution's current strategic direction."[673]

The same ROE noted that the bank did not have effective procedures in place to evaluate the many exceptions being granted to allow loan officers to issue loans that failed to comply with the bank's lending standards, and urged attention to the risks being established:

> "Until full exception data collection, reporting, and follow-up processes are in place and stabilized, senior management and the Board cannot fully assess whether quality assurance processes are having a meaningful impact on line activities, including loan underwriting. We are particularly concerned with the establishment of good quality assurance process for SFR underwriting, which has been an issue for the past several examinations."[674]

A follow-up field examination, conducted in September 2005, stated:

> "We criticized the lack of Trend and Dashboard Report to senior management and the board, without which it is impossible to

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[672] 6/1/2005 OTS Findings Memorandum, "Corporate Risk Oversight," OTSWMS05-005 0002046, Hearing Exhibit 4/16-23.

[673] 8/29/2005 OTS Report of Examination, at OTSWMS05-003 0001783, Hearing Exhibit 4/16-94 [Sealed Exhibit].

[674] Id. at OTSWMS05-004 0001792.

determine whether line functions are performing acceptably and, more specifically, whether the quality assurance process is having a meaningful impact on improving loan underwriting."[675]

2006 Risk Management Deficiencies. In 2006, OTS again expressed concern about WaMu's risk management practices, but took no further steps to compel improvements. The annual ROE urged the Board of Directors to:

> "[c]ontinue to monitor and obtain reports from management on the status of ERM to ensure its effectiveness and adequacy of resources. . . . ERM should provide an important check and balance on profit-oriented units ... particularly given the bank's current strategy involving increased credit risk." [676]

The 2006 ROE also commented that: "[w]ithin ERM, fraud risk management at the enterprise level is in the early stage of development. ... Currently, fraud management is decentralized and does not provide a streamlined process to effectively track fraud events across all business lines. In addition, consistent fraud reporting capabilities are not in place to consolidate data for analysis, reporting, and risk management at the enterprise level."[677]

2007 Risk Management Deficiencies. In 2007, as high risk loan delinquencies and defaults accelerated and WaMu began to incur losses, OTS examiners used harsher language to describe the deficiencies in WaMu's risk management practices, criticizing the bank's failure to institute stronger risk controls and procedures at an earlier date, as recommended.

In June 2007, for example, OTS examiners completed a review critical of WaMu procedures to oversee the loans it purchased from third party mortgage brokers.[678] From 2003 to 2007, 48 to 70% of WaMu's loans were purchased from third parties.[679] An OTS memorandum noted that Washington Mutual had only 14 full-time employees overseeing more than 34,000 third party brokers submitting loans to the bank for approval. OTS also criticized the scorecard used to rate those brokers which, among other problems, did not include the rate at which significant lending or documentation deficiencies were attributed to the broker, the rate at which its loans were denied or produced unsaleable

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675 10/3/2005 OTS Field Visit Report of Examination, at OTSWMEF-0000047602, Hearing Exhibit 4/16-94 [Sealed Exhibit].
676 8/29/2006 OTS Report of Examination, at OTSWMS06-008 0001671, Hearing Exhibit 4/16-94 [Sealed Exhibit].
677 Id. at OTSWMS06-008 0001687, 91.
678 6/7/2007 OTS Asset Quality Memo 11, "Broker Credit Administration," Hedger_Ann-00027930_001, Hearing Exhibit 4/16-10.
679 Prepared statement of Treasury IG Thorson, April 16, 2010 Subcommittee Hearing, at 5.

loans, or an indication of whether the broker was included in industry watchlists for misconduct. After describing these and other problems, rather than lower WaMu's safety and soundness scores for its poor oversight, however, the OTS memorandum made only the following observation: "Given the . . . increase in fraud, early payment defaults, first payment defaults, subprime delinquencies, etc., management should re-assess the adequacy of staffing."[680] WaMu management agreed with the finding, but provided no corrective action plan, stating only that "[s]taffing needs are evaluated continually and adjusted as necessary."[681]

In the September 2007 annual ROE, OTS wrote:

> "Risk management practices in the HLG (Home Loans Group) during most of the review period were inadequate .... We believe that there were sufficient negative credit trends that should have elicited more aggressive action by management with respect to limiting credit exposure. In particular, as previously noted, the risk misrepresentation in stated income loans has been generally reported for some time. This information should have led management to better assess the prudence of stated income lending and curtail riskier products well before we indicated during this examination that we would limit the Bank's ability to continue such lending." [682]

The ROE also faulted management and Board inaction:

> "Board oversight and management's performance was less than satisfactory. ... Contributing factors should have been more proactively managed by the Board and management. The most significant of these factors include Matters Requiring Board Attention that were noted in prior examinations but were not adequately addressed, including ... an ERM function that was not fully effective."[683]

The ROE concluded: "The ERM function has been less than effective for some time. ... ERM has not matured in a timely manner and other ERM functions have been generally ineffective."[684]

A separate OTS examination of WaMu's compliance function observed that WaMu had hired nine different compliance officers in the

[680] 6/7/2007 OTS Asset Quality Memo 11, "Broker Credit Administration," Hedger_Ann-00027930_001, Hearing Exhibit 4/16-10.
[681] Id. at 011.
[682] 9/18/2007 OTS Report of Examination, at OTSWMEF-0000046681, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[683] Id. at OTSWMEF-0000046690.
[684] Id. at OTSWMEF-0000046691.

past seven years, and that "[t]his amount of turnover is very unusual for an institution of this size and is a cause for concern."[685]

Despite these harsh assessments in 2007, OTS again refrained from taking any enforcement action against the bank such as developing a nonpublic Memorandum of Understanding or a public Cease and Desist Order with concrete plans for strengthening WaMu's risk management efforts.

2008 Risk Management Deficiencies. In 2008, as WaMu continued to post billions of dollars in losses, OTS continued to express concerns about its risk management practices. In February 2008, OTS downgraded WaMu to a 3 CAMELS rating and required the bank to issue a Board Resolution committing to certain strategic initiatives including "a more disciplined framework for the identification and management of compliance risks."[686]

In June 2008, OTS issued a Findings Memorandum reacting to a WaMu internal review that found significant levels of loan fraud at a particular loan office, and expressed concern "as to whether similar conditions are systemic throughout the organization."[687] The memorandum noted that "a formalized process did not exist to identify, monitor, resolve, and escalate third party complaints" about loan fraud, expressed concern about "an origination culture focused more heavily on production volume rather than quality"; noted that the WaMu review had found the "loan origination process did not mitigate misrepresentation/fraud"; and described the "need to implement incentive compensation programs to place greater emphasis on loan quality."

As referenced above, in July 2008, two months before the bank's failure, OTS made a presentation to the WaMu Board which, among other problems, criticized its risk management efforts:

> "An adequate [Enterprise Risk Management] function still does not exist although this has been an MRBA [Matter Requiring Board Attention] for some time. Critical as a check and balance for profit oriented units[.] Necessary to ensure that critical risks are

[685] 5/31/2007 Draft OTS Findings Memorandum, "Compliance Management Program," Franklin_Benjamin-00020408_001, Hearing Exhibit 4/16-9.
[686] 3/11/2008 WaMu presentation, "Summary of Management's Action to Address OTS Concerns," JPM_WM01022322; 3/17/2008 letter from Kerry Killinger to Darrel Dochow with enclosed Board Resolution, OTSWMS08-015 0001216 (committing to initiatives outlined by management).
[687] 6/19/2008 OTS Asset Quality Memo 22, Bisset_John-00046124_002, Hearing Exhibit 4/16-12a.

identified, measured, monitored and communicated[.] Even more critical given increased credit, market, and operational risk."[688]

Failure to Correct Poor Risk Management. By neglecting to exercise its enforcement authority, OTS chronicled WaMu's inadequate risk management practices over a period of years, but ultimately failed to change its course of action. During a hearing of the Subcommittee, the Department of the Treasury Inspector General, Eric Thorson, whose office conducted an in-depth review of WaMu's regulatory oversight, testified:

> "Issues related to poor underwriting and weak risk controls were noted as far back as 2003, but the problem was OTS did not ensure that WaMu ever corrected those weaknesses. We had a hard time understanding why OTS would allow these satisfactory ratings to continue given that, over the years, they found the same things over and over."[689]

(c) Deficiencies in Home Appraisals

Still another area in which OTS failed to take appropriate enforcement action involves WaMu's appraisal practices. OTS failed to act even after other government entities accused WaMu of systematically inflating property values to justify larger and more risky home loans.

Appraisals provide estimated dollar valuations of property by independent experts. They play a key role in the mortgage lending process, because a property's appraised value is used to determine whether the property provides sufficient collateral to support a loan. Lending standards at most banks require loans to meet, for example, certain loan-to-value (LTV) ratios to ensure that, in the event of a default, the property can be sold and the proceeds used to pay off any outstanding debt.

From 2004 to mid-2006, WaMu conducted its own property appraisals as part of the loan approval process. During that period, OTS repeatedly expressed concerns about WaMu's appraisal efforts.[690] In May 2005, OTS criticized WaMu – the most severe type of finding – regarding its practice of allowing sellers to estimate the value of their property. OTS directed WaMu to stop including an Owner's Estimate of Value in documents sent to appraisers since it biased the review; this

[688] 7/15/2008 OTS presentation to WaMu Board of Directors based on Comprehensive Examinations, Polakoff_Scott-00061303-028, Hearing Exhibit 4/16-12b.
[689] See April 16, 2010 Subcommittee Hearing at 25.
[690] See, e.g., 10/3/2005 OTS Report of Examination, at OTSWMEF-0000047601, Hearing Exhibit 4/16-94 [Sealed Exhibit].

criticism had been repeatedly noted in prior examinations, yet WaMu did not satisfactorily address it until the end of 2005.[691] A second finding criticized WaMu's use of automated appraisal software, noting "significant technical document weaknesses."[692] OTS ultimately determined that none of WaMu's automated appraisals complied with standard appraisal practices and some even had "highly questionable value conclusions."[693] Despite this dramatic criticism, OTS found in the next year's examination that WaMu had continued to use noncompliant automated appraisals.[694] Before any enforcement action was taken, WaMu management agreed to cease using automated appraisals by October 2006.

To address the issue, WaMu decided in mid-2006 to outsource its appraisal function to two vendors: eAppraiseIT and Lender Service Incorporated (LSI).[695] Calling the move "Project Cornerstone," WaMu fired all of its residential staff appraisers, reducing a staff of about 400 to 30,[696] and eAppraiseIT and LSI were tasked with conducting appraisals of homes purchased with WaMu loans.[697] WaMu assigned oversight of the outside appraisals to a new Appraisal Business Oversight (ABO) group, a unit within the WaMu Home Loans Risk Management division.

The Decision to Outsource. WaMu's decision to outsource the appraisal function received minimal attention from OTS. Documentation obtained by the Subcommittee indicates only a few meetings took place between OTS examiners and the WaMu staff tasked with the outsourcing. During a Subcommittee interview, the key OTS appraisal expert, Bruce Thorvig, explained that it was his first time supervising a large institution that decided to outsource the appraisal function.[698] Though the bank had repeatedly delayed taking action or failed to respond to OTS recommendations and criticisms in the appraisal area in the past, the OTS appraisal expert told the Subcommittee that he saw nothing to indicate that WaMu management could not competently handle a large appraisal outsourcing project of this scale.[699] In one of the few meetings that did occur between WaMu and OTS staff on appraisal issues, the bank's management came away with what they thought was full OTS approval for the outsourcing

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[691] 5/20/2005 OTS Memo 4, "Safety and Soundness Examination," at OTSWME06-039 0000214.
[692] Id.
[693] 3/14/2005 OTS Report of Examination, at OTSWMEN-000001794, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[694] 5/23/2006 OTS Memo 2, "Safety and Soundness Examination," at OTSWME06-039 0000205.
[695] Undated OTS internal memo, OTSWMSP-00000001936-51 at 39 [Sealed Exhibit].
[696] Undated OTS internal memo, OTSWMEN-0000015926-31 at 28 [Sealed Exhibit].
[697] Undated OTS internal memo, OTSWMSP-00000001936-51 at 39 [Sealed Exhibit].
[698] Subcommittee Interview of Bruce Thorvig (2/24/2010).
[699] Id.

project,[700] though OTS' appraisal expert disputed that he was even in a position to grant approval and was instead simply receiving notification of WaMu's plans.[701]

Appraisal Problems. Problems began almost immediately after WaMu outsourced the appraisal function. Whether appraisals are conducted internally by the bank or through a vendor, the bank must take responsibility for establishing a standard process to ensure accurate, unbiased home appraisal values. One, for example, was a repeat problem from when WaMu did its own appraisals: "WaMu allowed a homeowner's estimate of the value of the home to be included on the form sent from WaMu to third party appraisers, thereby biasing the appraiser's evaluation" toward a higher home value, in violation of standard residential appraisal methods.[702] A seasoned appraisal compliance manager, who oversaw WaMu as an FDIC examiner prior to coming to work for the bank, drafted a February 2007 Residential Appraisal Department Review which included a long list of issues. Problems included: "undefined" appraisal standards and processes; "loosely defined" vendor management; "unreasonable and imprudent sales force influence over the appraisal function;" and a "broken" third party appraisal risk control process that "may be contributing to the increasing incidence of mortgage fraud."[703]

These problems continued without resolution or enforcement action from OTS throughout 2007. In an April 2007 memorandum, OTS detailed its concerns, both old and new, with WaMu's appraisal operations. OTS found that WaMu had failed to update and revise its appraisal manual after outsourcing, which put the bank at risk of regulatory violations. In addition, an OTS review of 54 WaMu appraisals identified a number of concerns:

> "Primary appraisal issues (red flags requiring attention by the underwriter or review appraiser) included seller paid closing costs and concession, misstatements/ contradictions, inadequate/incomplete explanations and support for the value conclusion, reconciliation of the sales comparison approach, and weakness in the appraisal review process."[704]

Despite the extent of these concerns, OTS issued a "recommendation" to the bank that it address the identified problems, rather than the stronger

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[700] 5/22/2006 WaMu internal email, OTSWMEN-0000020983.
[701] Subcommittee Interview of Bruce Thorvig (2/24/2010).
[702] IG Report, at 11, Hearing Exhibit 4/16-82.
[703] 2/21/2007 draft internal WaMu report, "Residential Appraisal Department Review," OTSWMEN-0000000274 (drafted by Mark Swift).
[704] 4/5/2007 OTS Asset Quality Memo 2, OTSWME07-067 0001082.

"criticism" which would have elevated the issue to the bank's senior management or Board of Directors.[705]

Attorney General Complaint. On November 1, 2007, the New York Attorney General issued a complaint against WaMu's appraisal vendors, LSI and eAppraiseIT, alleging fraud and collusion with WaMu to systematically inflate real estate values.[706] The complaint stated in part:

> "[F]irst American and eAppraiseIT have abdicated their role in providing 'third-party, unbiased valuations' for eAppraiseIT's largest client, WaMu. Instead, eAppraiseIT improperly allows WaMu's loan production staff to hand-pick appraisers who bring in appraisal values high enough to permit WaMu's loans to close, and improperly permits WaMu to pressure eAppraiseIT appraisers to change appraisal values that are too low to permit loans to close."[707]

Though OTS had been aware of the Attorney General's investigation in May 2007, it took no action until after the Attorney General issued the complaint. Even then, OTS did not initiate its own investigation until after an internal WaMu investigation was already underway. The OTS Western Region Director advised: "I believe OTS needs to open up its own special investigation. WaMu started their own special investigation a few days ago when this broke."[708]

It took nearly a month for OTS to launch its own investigation into the allegations set out in the New York Attorney General's complaint.[709] In November 2007, when the director of OTS, John Reich, was presented with his agency's investigation plan, he responded:

> "This appears to be a comprehensive (and impressive) review schedule. It doesn't appear, on the surface anyway, to leverage off of WaMu's own review. Do you think we might be totally reinventing the wheel and possibly taking too long to complete our review?"[710]

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[705] Id.
[706] 11/1/2007 New York Attorney General press release, http://www.ag.ny.gov/media_center/2007/nov/nov1a_07.html. Both companies appraised property in New York, which provided jurisdiction for the complaint.
[707] New York v. First American Corporation, et al., (N.Y. Sup.), Complaint (November 1, 2007), at 3.
[708] 11/7/2007 email from Darrel Dochow to Benjamin Franklin, Randy Thomas, others, OTSWMS07-011 0001294.
[709] See undated OTS internal memo to John Bowman, OTSWMSP-0000001936 [Sealed Exhibit].
[710] 11/16/2007 email from OTS Director John Reich to OTS Operations Director Scott Polakoff, Reich_John-00040045_001.

Despite his concerns about how long the planned investigation might take, the OTS investigation proceeded as proposed. It took over 10 months, until September 2008, for OTS to gather, analyze, and reach conclusions about WaMu's appraisal practices.

The OTS investigation uncovered many instances of improper appraisals. After reviewing 225 loan files, the OTS appraisal expert found that "[n]umerous instances were identified where, because of undue influence on the appraiser, values were increased without supporting documentation."[711] OTS also found that WaMu had violated the agency's appraisal regulations by failing to comply with appraisal independence procedures after they outsourced the function.[712] The OTS investigation concluded that WaMu's appraisal practices constituted "unsafe or unsound banking practices."[713] The OTS investigation also concluded that WaMu was not in compliance with the Uniform Standards of Professional Appraisal Practice and other minimum appraisal standards.[714]

Failure to Correct Appraisal Deficiencies. Shortly before WaMu was sold, OTS' staff prepared a draft recommendation that the agency issue a cease and desist order to bar the bank from engaging in any activity that would lead to further violation of the appraisal regulations.[715] A cease and desist order would have been the first public enforcement action against WaMu regarding its lending practices. Ultimately, the legal staff submitted the memorandum to OTS' Deputy Director and Chief Counsel on October 3, 2008, more than a week after the bank collapsed and was sold.[716] By this point, the recommendation was too late and the issue was moot.

(d) Deficiencies Related to Long Beach

In 1999, WaMu's parent holding company, Washington Mutual Inc., purchased Long Beach Mortgage Company (Long Beach). Long Beach's business model was to issue subprime loans initiated by third party mortgage lenders and brokers and then sell or package those loans into mortgage backed securities for sale to Wall Street firms. Beginning in 1999, Washington Mutual Bank worked closely with Long Beach to sell or securitize its subprime loans and exercised oversight over its lending and securitization operations. Because Long Beach was a

711 7/28/2008 Draft Memo to Hugo Zia from Bruce Thorvig, OTSWMEN-0000015851 [Sealed Exhibit].
712 See 12 CFR Part 564.
713 Undated OTS internal memo, OTSWMSP-00000001936-51 at 47 [Sealed Exhibit].
714 Id. at 37 [Sealed Exhibit]. The Subcommittee found no evidence that anyone in OTS senior management disputed the conclusions of the investigation.
715 Id.
716 OTS internal document, OTS Enforcement Status of Formal Investigations, Quigley_Lori-00231631_001.

subsidiary of Washington Mutual Inc., the holding company, however, and not a subsidiary of Washington Mutual Bank, OTS did not have direct regulatory authority over the company, but could review its operations to the extent they affected the holding company or the bank itself.

OTS was aware of ongoing problems with Long Beach's management, lending and risk standards, and issuance of poor quality loans and mortgage backed securities. OTS reported, for example, that Long Beach's "early operations as a subsidiary of [Washington Mutual Inc.] were characterized by a number of weaknesses" including "loan servicing weaknesses, documentation exceptions, high delinquencies, and concerns regarding compliance with securitization-related representations and warranties."[717] OTS also reported that, in 2003, "adverse internal reviews of [Long Beach] operations led to a decision to temporarily cease securitization activity" until a "special review" by the WaMu legal department ensured that file documentation "adequately supported securitization representations and warranties" made by Long Beach.[718] OTS was aware of an examination report issued by a state regulator and the FDIC after a review of 2003 Long Beach loans, which provides a sense of the extent of problems with those loans at the time:

> "An internal residential quality assurance (RQA) report for [Long Beach]'s first quarter 2003 … concluded that 40% (109 of 271) of loans reviewed were considered unacceptable due to one or more critical errors. This raised concerns over [Long Beach]'s ability to meet the representations and warranty's made to facilitate sales of loan securitizations, and management halted securitization activity. A separate credit review report … disclosed that [Long Beach]'s credit management and portfolio oversight practices were unsatisfactory. … Approximately 4,000 of the 13,000 loans in the warehouse had been reviewed … of these, approximately 950 were deemed saleable, 800 were deemed unsaleable, and the remainder contained deficiencies requiring remediation prior to sale. … [O]f 4,500 securitized loans eligible for foreclosure, 10% could not be foreclosed due to documentation issues."[719]

Despite these severe underwriting and operational problems, Long Beach resumed securitization of its subprime loans in 2004. In April 2005, OTS examiners circulated an internal email commenting on the

[717] 12/21/2005 OTS internal memorandum by OTS examiners to OTS Deputy Regional Director, OTSWMS06-007 0001010, Hearing Exhibit 4/16-31.
[718] Id.
[719] 1/13/2004 FDIC-Washington State joint visitation report, FDIC-EM_00102515-20, Hearing Exhibit 4/13-8b. OTS held a copy of this report in its files, OTSWME04-0000029592.

poor quality of Long Beach loans and mortgage backed securities compared to its peers:

> "Performance data for 2003 and 2004 vintages appear to approximate industry average while issues prior to 2003 have horrible performance. . . . [Long Beach] finished in the top 12 worst annualized [Net Credit Losses] in 1997 and 1999 thru 2003. [Long Beach nailed down the number 1 spot as top loser with an [Net Credit Loss] of 14.1% in 2000 and placed 3rd in 2001 with 10.5%. … For ARM [adjustable rate mortgage] losses, [Long Beach] really outdid themselves with finishes as one of the top 4 worst performers from 1999 through 2003. For specific ARM deals, [Long Beach] made the top 10 worst deal list from 2000 thru 2002. … Although underwriting changes were made from 2002 thru 2004, the older issues are still dragging down overall performance. … At 2/05, [Long Beach] was #1 with a 12% delinquency rate. Industry was around 8.25%."[720]

Six months later, after conducting a field visit, an OTS examiner wrote: "Older securitizations of [Long Beach] continue to have some issues due to previously known underwriting issues in some vintages. The deterioration in these older securitizations is not unexpected."[721]

Purchase of Long Beach. In 2005, Washington Mutual Bank proposed purchasing Long Beach from its holding company so that Long Beach would become a wholly owned subsidiary of the bank. In making the case for the purchase, which required OTS approval, WaMu contended that making Long Beach a subsidiary would give the bank greater control over Long Beach's operations and allow it to strengthen Long Beach's lending practices and risk management, as well as reduce funding costs and administrative expenses. In addition, WaMu proposed that it could replace its current "Specialty Mortgage Finance" program, which involved purchasing subprime loans for its portfolio primarily from Ameriquest, with a similar loan portfolio provided by Long Beach.[722]

In June 2005, an OTS examiner expressed concerns about the purchase in an internal memorandum to OTS regional management and recommended that the purchase be conditioned on operational improvements:

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[720] 4/14/2005 OTS internal email, OTSWME05-012 0000806, Hearing Exhibit 4/16-19.
[721] 10/3/2005 OTS Holding Company Field Visit Report of Examination, at OTSWMS06-010 00002532, Hearing Exhibit 4/16-94 [Sealed Exhibit].
[722] See 12/21/2005 OTS internal memorandum by OTS examiners to OTS Deputy Regional Director, at OTSWMS06-007 0001011, Hearing Exhibit 4/16-31.

"At the start of this examination, it was our intent to perform a review of the operation of [Long Beach] with the expectation that [Washington Mutual Inc.] or the bank would be requesting approval to move [Long Beach] as an operating subsidiary of the bank. Such a move would obviously place the heightened risks of a subprime lending operation directly within the regulated institution structure. Because of the high profile nature of the business of [Long Beach] and its problematic history, we believe that any and all concerns regarding the subprime operation need to be fully addressed prior to any move."[723]

The memorandum identified several matters that required resolution prior to a WaMu purchase of Long Beach, including the establishment of pre- and post-funding loan quality reviews that were already in place at the bank. The memorandum also stated that Long Beach management had "worked diligently to improve its operation and correct significant deficiencies ... reported in prior years," and observed, "there is definitely a new attitude and culture."[724]

OTS continued to review Long Beach's lending practices and found additional deficiencies throughout the year. Those deficiencies included errors in loan calculations of debt-to-income ratios, lack of documentation to support the reasonableness of borrower income on stated income loans, and lack of explanation of a borrower's ability to handle payment shock on loans with rising interest rates.[725] OTS also determined that Long Beach's newly created portfolio of subprime loans "had attributes that could result in higher risk" than WaMu's existing subprime loan portfolio.[726]

Nevertheless, in December 2005, OTS examiners wrote that, even though Long Beach was "engaged in a high-risk lending activity and we are not yet fully satisfied with its practices," they recommended approving WaMu's purchase of the company with certain conditions.[727] Those conditions included WaMu's reconsidering its high risk lending concentration limits, including "stated income loans with low FICOs and high LTV ratios"; WaMu's assurance that Long Beach would comply with certain loan guidance; a WaMu commitment to continue to bring down its loan exception and error rates; and a WaMu commitment to

[723] 6/3/2005 OTS memorandum from Rich Kuczek to Darrel Dochow, "Long Beach Mortgage Corporation (LBMC) Review," OTSWMS06-007 0002683, Hearing Exhibit 4/16-28.
[724] Id. See also 5/19/2005 OTS email, "LBMC Fair Lending," OTSWMS05-005 0002002, Hearing Exhibit 4/16-20 ("I would not ... feel comfortable with their moving [Long Beach] under the thrift without some conditions").
[725] See 12/21/2005 OTS internal memorandum by OTS examiners to OTS Deputy Regional Director Darrel Dochow, OTSWMS06-007 0001009-16, Hearing Exhibit 4/16-31.
[726] Id. at OTSWMS06-007 0001011.
[727] See 12/21/2005 OTS internal memorandum by OTS examiners to OTS Deputy Regional Director Darrel Dochow, OTSWMS06-007 0001009-16, Hearing Exhibit 4/16-31.

ensure its Enterprise Risk Management division would provide a "countervailing balance" to "imprudent" desires to expand Long Beach's subprime lending.[728]

About the same time as this memorandum was completed, OTS learned that, during the fourth quarter of 2005, Long Beach had been required to repurchase tens of millions of dollars of loans it had sold to third parties due to early payment defaults.[729] By December, this unexpected wave of repurchases had overwhelmed Long Beach's repurchase reserves, leading to a reserve shortfall of nearly $75 million. Altogether in the second half of 2005, Long Beach had to repurchase loans with about $837 million in unpaid principal, and incurred a net loss of about $107 million.[730] In response, its auditor, Deloitte and Touche, cited Long Beach for a Significant Deficiency in its financial reporting. Despite the sudden evidence of Long Beach's poor quality loans, inadequate repurchase reserves, and negative earnings impact on its parent company, Washington Mutual Inc., OTS approved the bank's application to purchase Long Beach. OTS explained its decision to the Subcommittee by contending that the change in status gave WaMu more control over Long Beach to ensure its improvement.[731]

WaMu ultimately purchased Long Beach on March 1, 2006.[732] After the purchase, Long Beach's practices did not improve, but continued to exhibit numerous problems, as described in the prior chapter. A May 2006 OTS examination of Long Beach loans concluded, for example, "that the number and severity of underwriting errors noted remain at higher than acceptable levels."[733] In a June 2006 internal email to his colleagues, the OTS Regional Deputy Director wrote:

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[728] Id. at OTSWMS06-007 0001015-16.
[729] See 10/3/2005 OTS Report of Examination, OTSWMS06-010 0002530, Hearing Exhibit 4/16-94 [Sealed Exhibit] (noting that, after a field visit to Long Beach that concluded in December 2005, OTS learned that loan repurchases had surged: "Subsequent to our on-site field visit, management informed us that loan repurchases had increased considerably. … Management indicated that approximately $0.6 billion in loans were repurchased during the fourth quarter of 2005 out of approximately $13.2 billion in total whole loan sales. The gross financial impact at December 31, 2005, was $72.3 million."); 1/20/2006 email from Darrel Dochow to Michael Finn and others, with chart, OTSWMS06-007 0001020 to 1021 (describing Long Beach repurchases).
[730] See 4/17/2006 memorandum by WaMu General Auditor to Board of Directors' Audit Committees of Washington Mutual Inc. and Washington Mutual Bank, "Long Beach Repurchase Reserve Root Cause Analysis," JPM_WM02533760, Hearing Exhibit 4/13-10 (Long Beach "experienced a dramatic increase in EPD's [early payment defaults], during the third quarter of 2005 [which] … led to a large volume of required loan repurchases. The unpaid principal balance repurchased as a result of the EPD provision for the year ended December 31, 2005 was $837.3 million. The net loss from these repurchases was approximately $107 million.").
[731] Subcommittee interview of Benjamin Franklin (2/18/2010).
[732] See "Washington Mutual Regulators Timeline," chart prepared by the Subcommittee, Hearing Exhibit 4/16-1j.
[733] 5/25/2006 OTS Findings Memorandum, "Loan Underwriting Review - Long Beach Mortgage," OTSWMS06-008 0001243, Hearing Exhibit 4/16-35. See also 1/20/2006 email from

"We gave them the benefit of doubt based on commitments and some progress when we allowed them to bring [Long Beach] into the bank, but ... we have the same type of concerns remaining 6 months later."[734]

In the annual 2006 ROE and again in the annual 2007 ROE, OTS found that Long Beach's lending practices "remain[ed] less than satisfactory."[735] At a hearing of the Subcommittee on April 13, 2010, WaMu's chief credit risk officers from 2004 to 2008 uniformly condemned Long Beach's poor performance and testified that it had never developed an effective risk management system.[736]

(e) Over 500 Deficiencies in 5 Years

As part of their review of Washington Mutual, the Treasury and the FDIC Inspectors General determined that, over a five-year period, 2004-2008, OTS examiners identified a total of over 540 criticisms, observations, and recommendations related to WaMu operations.[737] At the Subcommittee hearing, when asked whether those 540 findings constituted "serious criticisms" of the bank, Treasury IG Eric Thorson responded: "Absolutely."[738] The FDIC Inspector General, Jon Rymer, agreed:

"[T]he examiners, from what I have seen here, were pointing out the problems, underwriting problems, riskier products, concentrations, distributions, and markets that may display more risk – they were all significant problems and they were identified. At the end of the day, though, I don't think forceful enough action was taken."[739]

As WaMu accumulated hundreds of infractions from OTS, longstanding problems with asset quality in the bank's portfolio continued. While some observers have blamed WaMu's failure on its liquidity troubles in late 2008, years of unresolved problems festered below the surface.

Darrel Dochow to Michael Finn, et al., "LBMC EDP Impact," OTSWMS06-007 0001020 (emphasis added).

[734] 6/9/2006 email from Darrel Dochow to Richard Kuczek, Lawrence Carter, and Benjamin Franklin, "Findings Memos," OTSWMS06-008 0001253, Hearing Exhibit 4/16-36.

[735] 8/29/2006 OTS Report of Examination, at OTSWMS06-008 0001680, Hearing Exhibit 4/16-94 [Sealed Exhibit]; 9/18/2007 OTS Report of Examination, OTSWMEF-0000047146, Hearing Exhibit 4/16-94 ("Based on our review of 75 subprime loans originated by LBMC, we concluded that subprime underwriting practices remain less than satisfactory .... Given that this is a repeat concern and MRBA, we informed management that underwriting must be promptly corrected, or heightened supervisory action would be taken, including limiting the Bank's ability to continue SFR subprime underwriting.") [Sealed Exhibit].

[736] April 13, 2010 Subcommittee Hearing at 22.

[737] Id. at 20. See also IG Report at 28.

[738] April 16, 2010 Subcommittee Hearing at 17.

[739] Id. at 18.

The consequences of WaMu's failure to address its underwriting problems, risk concentrations, risk layering, and other problems were exponential increases in its loss rates. The FDIC later calculated the loss rates for several WaMu products. In WaMu's held-for-investment Option ARM portfolio, delinquency rates nearly doubled every year, rising from 0.48% at the end of 2005 to 0.90% a year later, to 2.63% at year end 2007, and up to 4.63% by June 30, 2008.[740] In its subprime portfolio, its delinquency rate increased from 7.39% in 2005 to 25.20% in June 2008.[741] The delinquency rate in its HELOC portfolio rose from 0.58% in 2005 to 4.00% in June 2008.[742] As a result, net charge-offs for WaMu's Option ARM portfolio rose from $15 million at year end 2005 to $37 million in 2006, to $147 million in 2007, and to $777 million by June 2008.[743] HELOC net charge-offs likewise increased, rising from $21 million in 2005, to $23 million in 2006, to $424 million in 2007, and to $1.19 billion by June 2008.[744] Subprime net charge-offs expanded even more rapidly, rising from $47 million in 2005, to $134 million in 2006, to $550 million in 2007, and $956 million by June 2008.[745] To account for these losses, WaMu's loss provisions jumped from $218 million in 2006 to over $2 billion in 2007, and an additional $6 billion by June 2008.[746]

The joint report of the Treasury and the FDIC Inspectors General specifically identified WaMu's poor quality loans and poor risk management practices as the real cause of its failure, rather than the liquidity crisis that hit the bank in 2008.[747] During the Subcommittee's hearing, when asked why WaMu failed, a senior FDIC official put it this way: "Asset quality. Weak asset quality. It brought on the liquidity problems."[748] He explained:

> "If you have strong asset quality, you will not have liquidity issues because your assets – you can borrow either against them or you can sell them. If you have weak asset quality, then you are going to have liquidity issues at some point."[749]

[740] See FDIC Complaint Against WaMu Executives at ¶ 79.
[741] Id.
[742] Id.
[743] Id. at ¶ 81.
[744] Id.
[745] Id.
[746] Id. at ¶ 82.
[747] IG Report at 8.
[748] April 16, 2010 Subcommittee Hearing at 76. John Corston was the Acting Deputy Director of the FDIC's Division of Supervision and Consumer Protection, Complex Financial Institution Branch.
[749] Id.

(4) OTS Turf War Against the FDIC

As WaMu approached the end, tensions between OTS and the FDIC that had built up over two years evolved into a turf war. OTS examination and regional officials began to express distrust of their FDIC counterparts. The conflict was elevated to the top leaders of both agencies, who came to take different views of what to do with WaMu – the FDIC becoming more aggressive and OTS becoming more protective. When the bank's imminent collapse was no longer a question, the result was a hasty seizure and sale. Had the two government agencies acted in concert, rather than as adversaries, it is likely that WaMu's problems would have been resolved earlier and with less collateral damage. During an interview, the chairman of the FDIC, Sheila Bair, stated pointedly that WaMu "could have sold themselves in July if they had tried."[750] The same outcome was not accomplished until two months later in September when no other options remained, and OTS worked with the FDIC to make it happen.

As mentioned earlier, OTS was the primary, but not the only, federal bank regulator that oversaw Washington Mutual. Since WaMu was also an insured institution, the FDIC served as a backup examiner responsible for evaluating the risk that the bank posed to the Deposit Insurance Fund. Because WaMu was one of the eight largest insured institutions in the country, the FDIC had assigned a Dedicated Examiner whose full time responsibility was to determine whether the bank was operating in a safe and sound manner. The FDIC Examiner reviewed all OTS ROEs and examination findings, participated on many occasions in OTS examinations, and reviewed bank documents. The FDIC reviewed the CAMELS ratings for the bank, as well as LIDI ratings under its Large Insured Depository Institutions Program.

For many years, FDIC examiners worked cooperatively with OTS examiners to conduct oversight of WaMu. But beginning in 2006, OTS management expressed increasing reluctance to allow FDIC examiners to participate in WaMu examinations and review bank documents. Claiming that joint efforts created confusion about which agency was WaMu's primary regulator,[751] OTS officials employed a variety of tactics to limit the FDIC oversight of the bank, including restricting its physical access to office space at the bank, its participation in bank examinations, and its access to loan files. In addition, as the FDIC began to express greater concern about the bank's viability, recommend

[750] Subcommittee interview of Sheila Bair (4/5/2010).
[751] See, e.g., April 16, 2010 Subcommittee Hearing at 61 (testimony of OTS Director Reich: "[F]irst of all, the primary regulator is the primary Federal regulator, and when another regulator enters the premises, when the FDIC enters the premises, confusion develops about who is the primary regulator, who really is calling the shots, and who do we report to, which agency.")

ratings downgrades, and urge enforcement action, OTS officials displayed increasing resistance to its advice. In the end, OTS not only undermined years of cooperative oversight efforts, but at times actively impeded FDIC oversight of one of the largest insured banks in the country.

Resisting FDIC Advice. During the period 2004-2008, internal FDIC evaluations of Washington Mutual were consistently more negative than those of OTS, at times creating friction between the two agencies. OTS also resisted the FDIC's advice to subject WaMu to stronger enforcement actions, downgrade its CAMELS rating, and solicit buyers for the bank.

As early as 2005, the FDIC examination team expressed concerns about WaMu's high risk lending strategy, even though the bank's management expressed confidence that the risks were manageable. In an internal memorandum, for example, the FDIC team identified multiple negative impacts on WaMu's loan portfolio if housing prices were to stop climbing. The memorandum stated in part:

> "Washington Mutual Bank's (WMB) single-family residential (SRF) loan portfolio has embedded risk factors that increase exposure to a widespread decline in housing prices. The overall level of risk is moderate, but increasing. … A general decline in housing prices would adversely impact: a) The SRF loan portfolio; b) The home equity loan portfolio; and c) Mortgage banking revenue. … In January 2005, management developed a higher-risk lending (HRL) strategy and defined company-wide higher-risk loans as … sub prime loans … SFR loans with FICO scores below 620, … consumer loans with FICO scores below 660, and … [the] Long Beach … portfolio. Management intends to expand the HRL definition and layer additional risk characteristics in the future. … Management acknowledges the risks posed by current market conditions and recognizes that a potential decline in housing prices is a distinct possibility. Management believes, however that the impact on WMB would be manageable, since the riskiest segments of production are sold to investors, and that these investors will bear the brunt of a bursting housing bubble."[752]

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[752] Undated draft memorandum from the WaMu examination team at the FDIC to the FDIC Section Chief for Large Banks, FDIC-EM_00251205-10, Hearing Exhibit 4/16-51a (likely mid-2005). In an interview, when shown the draft memorandum, FDIC Assistant Regional Director George Doerr, who was a member of the WaMu examination team, told the Subcommittee that this type of analysis was prepared for a select group of mortgage lenders, including WaMu, to understand where the mortgage market was headed and how it would affect those insured thrifts. He did not have a copy of the final version of the memorandum, but said the FDIC's analysis was discussed with OTS. Subcommittee interview of George Doerr (3/30/2010).

In mid-2005, an internal FDIC memorandum discussed the increased risk associated with the new types of higher risk mortgage loans being issued in the U.S. housing market:

> "Despite the favorable history, we believe recent lending practices and buyer behavior have elevated the risk of residential lending. Concerns are compounded by significantly increased investor activity and new loan products that allow less creditworthy borrowers to obtain mortgages. The new loan products of most concern include Option Adjustment Rate Mortgage (ARM) Loans, Interest Only (IO) Loans, and Piggyback Home Equity Loans."[753]

WaMu offered all three types of loans, in addition to subprime loans through Long Beach.

In 2007, an FDIC memorandum again identified WaMu's high risk home loans as its "primary risk," singling out both its subprime and Option ARM loans:

> "SFR [Single Family Residential loan] credit risk remains the primary risk. The bank has geographic concentrations, moderate exposure to subprime assets, and significant exposure to mortgage products with potential for payment shock. ... The bank's credit culture emphasized home price appreciation and the ability to perpetually refinance. ... In the past, the bank relied on quarterly sales of delinquent residential loans to manage its non performing assets. The bank's underwriting standards were lax as management originated loans under an originate to sell model. When the originate to sell model collapsed in July 2007 for private and subprime loans, management was no longer able to sell non performing assets. Consequently, non performing assets are now mounting, and the bank's credit risk mitigation strategy is no longer effective."[754]

From 2004 to 2008, the FDIC assigned LIDI ratings to WaMu that indicated a higher degree of risk at the bank than portrayed by the bank's CAMELS ratings. LIDI ratings are intended to convey the degree of risk that a bank might cause loss to the Deposit Insurance Fund, with A being the best rating and E the worst.[755] The FDIC IG explained the

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[753] 7/5/2005 memorandum from FDIC Associate Director John H. Corston to FDIC Associate Director Michael Zamorski, "Insured Institutions' Exposures to a Housing Slowdown," FDIC_WAMU_000015114, Hearing Exhibit 4/16-51b.

[754] FDIC Washington Mutual Bank LIDI Report, Q307, FDIC_WAMU_000014851, Hearing Exhibit 4/16-94 [Sealed Exhibit].

[755] An A rating indicates a "low risk" of concern that an institution will cause a loss to the Deposit Insurance Fund, a B rating indicates an "ordinary level of concern," a C rating indicates a "more than an ordinary level of concern," a D rating conveys a "high level of concern," and an E rating conveys "serious concerns." See prepared statement of FDIC IG Rymer at 5 (chart

difference between LIDI and CAMELS ratings as follows: "LIDI ratings consider future risks at an institution, where CAMELS rating, in practice, are more point-in-time measures of performance."[756] As early as 2004, the FDIC viewed WaMu as having higher levels of risk than indicated by its CAMELS ratings. This chart shows the comparable ratings over time:

WaMu CAMELS and LIDI Ratings, 2004-2008[757]

Assessment Period	CAMELS Composite Rating	LIDI Rating
January 2004	2	B
July 2004	2	B/C
January 2005	2	B/C
July 2005	2	B/C
January 2006	2	B/C
July 2006	2	B/C
March 2007	2	B/C
June 2007	2	C
September 2007	2	C
December 2007	2	C
March 2008	3	D
June 2008	3	E
September 2008	4	E

FDIC IG Rymer explained that the B/C rating meant that the FDIC viewed WaMu as posing a "somewhat more than ordinary risk" to the Deposit Insurance Fund, the C rating meant it "posed more than an ordinary risk," D meant the FDIC had "a high level of concern," and E meant that the FDIC had "serious concerns" that WaMu would cause a loss to the Fund.[758]

Despite assigning lower LIDI ratings to the bank, indicating the increasing risk it posed to the Deposit Insurance Fund, the FDIC – like OTS – continued to support a 2 CAMELS rating throughout 2007. The result of both regulators delaying a downgrade in WaMu's rating had a direct impact on FDIC operations. According to the FDIC Inspector General, WaMu's CAMELS rating of 2 prevented the FDIC from charging higher premiums for the Deposit Insurance Fund until February

showing FDIC LIDI ratings descriptions), April 16, 2010 Subcommittee Hearing, at 124 (showing FDIC LIDI ratings description).

[756] Id.

[757] See prepared statement of FDIC IG Rymer at 6 (chart showing WaMu ratings and insurance assessments), April 16, 2010 Subcommittee Hearing at 125.

[758] Id.

2008, when its rating was dropped to a 3.[759] Higher premiums are one of the tools used by the FDIC to signal to financial institutions that they should better control their risk. Unfortunately, in this case, that tool was not available in 2005, 2006, or 2007.

OTS downgraded the bank to a 3 CAMELS rating in February 2008, after WaMu incurred substantial losses. OTS also required WaMu to issue a nonpublic Board Resolution making general commitments to strengthen its operations. The FDIC undertook a special insurance examination of the bank, analyzed its capital, and concluded that the bank should raise additional capital.[760] The FDIC staff attempted to engage OTS staff in discussions about increasing the bank's capital and downgrading its CAMELS ratings, but OTS was not persuaded.[761]

In July 2008, tensions between the FDIC and OTS flared after the FDIC sent a letter to OTS urging it to take additional enforcement action: "As we discussed, we believe that [WaMu's] financial condition will continue to deteriorate unless prompt and effective supervisory action is taken."[762] The letter urged OTS to impose a "corrective program" that included requiring the bank to raise $5 billion in additional capital and provide quarterly reports on its financial condition. OTS not only rejected that advice, but also expressed the hope that the FDIC would refrain from future "unexpected letter exchanges."[763] In a separate email, Scott Polakoff, a senior OTS official called the FDIC letter "inappropriate and disingenuous":

> "I have read the attached letter from the FDIC regarding supervision of Wamu and am once again disappointed that the FDIC has confused its role as insurer with the role of the Primary Federal Regulator. Its letter is both inappropriate and disingenuous. I would like to see our response to the FDIC, which I assume will remind it that we, as the PFR, will continue to effectively supervise the entity and will continue to consider the FDIC's views."[764]

Two weeks later, on July 31, both OTS and the FDIC met with the WaMu Board of Directors to discuss the bank's problems. At that meeting, the FDIC Dedicated Examiner suggested that the bank look for

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[759] Prepared statement of FDIC IG Rymer at 6-7, April 16, 2010 Subcommittee Hearing, at 125-26. See also IG Report at 40-42.
[760] See 7/21/2008 letter from FDIC to OTS, FDIC_WAMU_000001730, Hearing Exhibit 4/16-59.
[761] Subcommittee interview of Steve Funaro (3/18/2010).
[762] 7/21/2008 letter from the FDIC to OTS, FDIC_WAMU_000001730, Hearing Exhibit 4/16-59.
[763] 7/22/2008 letter from OTS to the FDIC, OTSWMS08-015 0001312, Hearing Exhibit 4/16-60.
[764] 7/22/2008 email from OTS Deputy Director Scott Polakoff to OTS colleagues, Hearing Exhibit 4/16-59.

a "strategic partner" who could buy or invest in the bank. The OTS director, John Reich, later expressed anger at the FDIC for failing to clear that suggestion first with OTS as the bank's primary regulator. An FDIC examiner wrote to his colleagues:

> "Major ill will at WAMU meeting yesterday caused by FDIC suggestion in front of WAMU management that they find a strategic partner. [OTS Director] Reich reportedly indicated that was totally inappropriate and that type of conversation should have occurred amongst regulatory agencies before it was openly discussed with management."[765]

The next day, on August 1, 2008, due to WaMu's increasing financial and deposit losses, the FDIC Chairman, Sheila Bair, suggested that the bank's condition merited a downgrade in its CAMELS rating to a 4, signaling a troubled bank.[766] The head of OTS sent an email to the head of the FDIC responding that "rating WaMu a 4 would be a big error":

> "In my view rating WaMu a 4 would be a big error in judging the facts in this situation. It would appear to be a rating resulting from fear and not a rating based on the condition of the institution. WaMu has both the capital and the liquidity to justify a 3 rating. It seems based on email exchanges which have taken place that FDIC supervisory staff in San Francisco is under pressure by the fear in Washington to downgrade this institution. ... [P]rior to such action I would request a[n FDIC] Board meeting to consider the proper rating on this institution."[767]

The FDIC Chairman responded: "We will follow the appropriate procedures if the staff cannot agree."[768]

A few days later, Ms. Bair sent an email to Mr. Reich requesting a discussion of "contingency planning" for WaMu, including making "discrete inquiries" to determine whether any institution would be willing to buy the bank. The OTS Director responded with a lengthy email criticizing the request and stating in part:

> "I do not under any circumstances want to discuss this on Friday's conference call .... I should not have to remind you the FDIC has no role until the PFR [Primary Federal Regulator] (i.e. the OTS) rules on solvency .... You personally, and the FDIC as an agency,

[765] 8/1/2008 email from David Promani to FDIC colleagues, FDIC-EM_00246958, Hearing Exhibit 4/16-64.
[766] See 8/1/2008, email from Darrell Dochow to OTS senior officials, Hearing Exhibit 4/16-62.
[767] 8/1/2008 email from OTS Director John Reich to FDIC Chairman Sheila Bair, Hearing Exhibit 416-63.
[768] Id.

> would likely create added instability if you pursue what I strongly believe would be a precipitous and unprecedented action. ... It seems as though the FDIC is behaving as some sort of super-regulator – which you and it are not."[769]

In September 2008, Ms. Bair informed WaMu that there was a likely ratings disagreement between the FDIC and OTS, and that the FDIC intended to lower the bank's rating to a 4. After the FDIC Chairman informed the OTS Director by email of her conversation with WaMu, Mr. Reich forwarded the exchange to his OTS Deputy Director, upset that she had not come to him first with that information: "I cannot believe the continuing audacity of this woman."[770] Two weeks later, the bank failed.

Restricting Office Space and Information. Throughout the period examined by the Subcommittee, OTS not only rebuffed the FDIC's analysis and advice, it began to actively impede FDIC oversight efforts at WaMu. OTS even went so far as to limit the FDIC's physical access to office space, as well as to needed information, at WaMu's new headquarters. Prior to 2006, OTS had always provided the FDIC examiners with space in its on-site offices at the bank, making it easy for FDIC examiners to participate in OTS examinations. In the summer of 2006, however, following WaMu's move to a new headquarters in Seattle, OTS did not provide any of its desks for the FDIC examiners. OTS also restricted the FDIC's access to an important database that all examiners used to review WaMu documents, referred to as the "examiner's library." From July until November 2006, a period of about four months, the FDIC examiners were denied access to both office space on the bank's premises and the examiner's library. The FDIC had to make multiple requests, taking the issue up through the OTS hierarchy in Washington, D.C. headquarters, to regain the access it had enjoyed for years at WaMu.

In an October 2006 email to the FDIC Assistant Regional Director, George Doerr, the FDIC Dedicated Examiner at WaMu, described in exasperation how he had been promised permanent space at the bank, but still did not have it. Demonstrating how poisoned the relationship was at that point, the FDIC examiner blamed the lack of cooperation on "stalling tactics and misrepresentations:"

> "Our issue is with OTS management (Finn and Dochow) and how they have apparently mislead RD [Regional Director] Carter, DRD [Deputy Regional Director] Villalba, you, and me. This regards

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[769] 8/6/2008 email from OTS Director John Reich to FDIC Chairman Sheila Bair, "Re: W," FDIC-EM_00110089, Hearing Exhibit 4/16-66.

[770] 9/10/2008 email from OTS Director John Reich to OTS Deputy Director Scott Polakoff, Polakoff_Scott-00065461_001, Hearing Exhibit 4/16-68.

> space for the dedicated examiner and access to information .... I met with OTS examiners yesterday and they have not made arrangements for permanent space for me at the new location and protocols for information sharing have not been developed .... In July RD Carter [from FDIC] talked with Finn [from OTS] and he agreed to space and access. On 8/17 you and DRD Villalba had a telephone conversation with Dochow and he agreed it was not necessary to fix what was not broken and he promised access to space and information. On 9/15 I met with Dochow and he agreed to space and information sharing .... I am prepared for more of Dochow's stalling tactics and misrepresentations."[771]

Mr. Doerr forwarded the "info about OTS denying us space and access to information" to other FDIC officials stating: "The situation has gone from bad to worse."[772]

At the Subcommittee hearing, when asked why OTS took four months to restore FDIC access to office space and WaMu documents, Mr. Doerr of the FDIC responded:

> Mr. Doerr: I can't explain what the reason was. I personally think they didn't want us there. I mean, we were denied physical access and the access to this examiner library ... of electronic materials that WaMu puts together for the regulators .... [Y]ou shouldn't have to go 4 months without having to have that. ...
>
> Senator Levin: And it was essential that Mr. Funaro [the FDIC Dedicated Examiner] have access to that library in order to get information about the Washington Mutual?
>
> Mr. Doerr: Absolutely.[773]

By November 2006, when OTS relented and provided desk space and database access to the FDIC Dedicated Examiner, it did little to ameliorate the situation. Its actions contributed to a worsening relationship between the two agencies, impeded FDIC oversight efforts, and weakened oversight of WaMu's activities.[774]

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771 10/13/2006 email chain from Vanessa Villalba to J. George Doerr, John F. Carter, and John H. Corston, "Re: wamu quarterly," FDIC_WAMU_000014449, Hearing Exhibit 4/16-53. See also 9/6/2006 FDIC internal email chain, "OTS re: WAMU," FDIC-EM_00252239, Hearing Exhibit 4/16-51c ("He absolutely agreed you'd have access to the Examiner Library. And he hasn't arranged that.").

772 Id.

773 April 16, 2010 Subcommittee Hearing at 72-73.

774 See also IG Report at 42-45 ("It appears that 2006 was a turning point in the relationship between FDIC and OTS in terms of information sharing that carried through to 2008.").

Restricting FDIC Examinations. At the same time OTS was withholding office space and database access from the FDIC examination team, it also, for the first time, refused an FDIC request to participate in an OTS examination of WaMu.

Although the FDIC has a broad statutory right to participate in examinations of insured depository institutions,[775] it had agreed to spell out how it would exercise that statutory authority in a 2002 Interagency Agreement with the Federal Reserve, OCC, and OTS.[776] The Interagency Agreement authorized the FDIC to conduct "special examinations" of insured institutions that "represent a heightened risk" to the Deposit Insurance Fund, defined as institutions with a 3, 4, or 5 rating on the CAMELS scale or which were "undercapitalized as defined under Prompt Corrective Action" standards.[777] Other FDIC bank examinations had to be authorized by the primary regulator. Prior to 2006, OTS had routinely authorized joint OTS-FDIC examinations without regard to the CAMELS ratings, but in January 2006, OTS suddenly changed its policy. The change was signaled in an email sent by a senior OTS official to his colleagues:

> "The message was crystal clear today. Absolutely no FDIC participation on any OTS 1 and 2 rated exams. . . . We should also deny FDIC requests to participate on HC [holding company] or affiliate exams.
>
> Permission for FDIC to join us on WaMu … will stand for now, but they should not be [in] direct contact with thrift management or be requesting info directly from the thrift."[778]

This email signaled the beginning of a much more restrictive policy toward the FDIC participation in OTS examinations, even though in January 2006, OTS indicated it would allow an exception for the FDIC examiners to continue participating in its scheduled examination of WaMu. The reasons for this change in policy were never made clear, but in several interviews, OTS and FDIC officials attributed it to certain senior OTS officials who were reluctant to share thrift oversight responsibilities with the FDIC.

In August 2006, the FDIC made what it viewed as a routine request to join in the next OTS examination of WaMu, which was designed to focus, in part, on WaMu's subprime lending. To the

[775] See 12 U.S.C. § 1820(b)(3).
[776] See "Coordination of Expanded Supervisory Information Sharing and Special Examinations," PSI-FDIC-10-0001.
[777] Id.
[778] 1/24/2006 email from OTS senior official Michael Finn to Edwin Chow and Darrel Dochow, OTSWM06-006 0000129, Hearing Exhibit 4/16-49.

surprise and consternation of the FDIC, the OTS Regional Director Michael Finn sent a letter denying the request and stating that OTS would instead "share our exam findings with the FDIC, as we have in the past."[779] Mr. Finn wrote that because WaMu's CAMELS rating was a 2 and FDIC had not shown "any concerns regarding our past or planned examination activities, and our continued commitment to share all appropriate information, the FDIC has not shown the regulatory need to participate in the upcoming Washington Mutual examination."

After discussing the Finn letter in an internal email, the FDIC Assistant Regional Director, George Doerr, wrote to his colleagues:

> "Obviously, we have a major problem here. OTS is taking the approach we need to establish a 'regulatory need to participate' on an exam, and that the basis would have to be disagreement on exam findings. Mr. Finn is totally missing the point on our need for timely accurate information to properly categorize WAMU for deposit insurance premium purposes, more so now than ever in the past."[780]

In October 2006, John Carter with the FDIC sent Michael Finn of OTS a letter repeating the FDIC's request to participate in the WaMu examination:

> "I have received your response to our August 14 2006 letter in which we request permission to participate in aspects of the upcoming examination of Washington Mutual Bank. Regarding your reasoning for rejecting our participation in these target reviews, you are correct that our request is not predicated on any current disagreement related to examination findings or concerns regarding supervisory activities at Washington Mutual. Such criteria are not prerequisite for requesting – or for the OTS granting – FDIC staff participation in target examination activities.
>
> As you are aware, the FDIC and the OTS have a long, cooperative, and productive working relationship with respect to the examination of Washington Mutual Bank, which we hope to continue. Past experience has proven that our participation in targeted reviews is beneficial to our respective Agencies, as well as to the Bank. … The 2002 Agreement clearly allows for FDIC staff participation in examination activities to evaluate the risk of a particular banking activity to the deposit insurance fund.

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[779] 9/6/2006 FDIC internal email chain, "OTS re: WAMU," FDIC-EM_00252239-40, Hearing Exhibit 4/16-51c.
[780] Id. at FDIC-EM_00252240.

Washington Mutual Bank is very large insured financial institution, and in our view participation on the upcoming targeted reviews is necessary to fulfill our responsibilities to protect the deposit insurance fund."[781]

On November 10, 2006, Mr. Finn responded with a letter that, again, refused to allow the FDIC to participate in the WaMu examination:

> "OTS does not seek to have FDIC staff actively participate in our examination activities and conclusions at Washington Mutual. We do understand your need for access to examination information and your need to meet with OTS staff to discuss our supervisory activities at Washington Mutual. To facilitate this information sharing and discussions, we have agreed to allow your Dedicated Examiner … to conduct his FDIC risk assessment activities on site at Washington Mutual when our examination team is on site. All FDIC requests for information should continue to be funneled through our examiner-in-charge."[782]

The OTS letter also restricted the ability of the FDIC to place more than one examiner on site at WaMu, even though the bank, with $300 billion in assets, was one of the largest insured institutions in the country and was engaged in a high risk lending strategy:

> "We also understand that the FDIC may occasionally request OTS permission to have FDIC examination staff assist [its Dedicated Examiner] on site at Washington Mutual in his risk assessment activities. We will consider these limited requests to send additional FDIC staff to Washington Mutual on a case-by-case basis."[783]

Despite the negative tone of the OTS letter, the FDIC persisted in its request, and OTS eventually allowed the FDIC examiners to participate in some WaMu examinations in 2006 and 2007, though it continued to press the FDIC to limit its requests and personnel.[784]

During the Subcommittee hearing, the FDIC staff described their surprise at the new OTS policy and frustration at its seemingly circular reasoning – that the FDIC needed to specify a "basis" and "disagreement" with OTS to justify joining an OTS examination, but the

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781 10/6/2006 letter from FDIC senior official John Carter to OTS senior official Michael Finn, FDIC_WAMU_000014445-46, Hearing Exhibit 4/16-52a.
782 11/10/2006 letter from OTS senior official Michael Finn to FDIC Regional Director John Carter, OTSWMS06-008 0001827, Hearing Exhibit 4/16-52b.
783 Id.
784 See, e.g., 1/22/2007 letter from Michael Finn to John Carter, Hearing Exhibit 4/16-52d.

FDIC was also barred from participating in the very examinations that could develop that basis and disagreement.[785]

Restricting Access to Loan Files. Even after OTS reluctantly allowed the FDIC to participate in some OTS examinations, it held firm in its refusal to allow the FDIC to directly review WaMu loan files, insisting that the FDIC instead rely on the findings and conclusions of OTS examiners who conducted the loan file reviews.

In September 2006, when OTS first refused to give the FDIC direct access to WaMu loan files, an FDIC senior official commented: "The OTS must really be afraid of what we might come across, but bottom line is we need access to the information."[786] The FDIC explained to the Subcommittee that it needed direct access to the loan files to assess the higher risk loans WaMu was issuing, both to evaluate what insurance fees should be imposed on Washington Mutual and to assess the extent of any threat to the Deposit Insurance Fund.

In February 2007, OTS refused an FDIC request to review WaMu loan files to evaluate the bank's compliance with recently issued federal guidance on how to handle nontraditional mortgages, such as subprime, stated income, and negatively amortizing loans. Even though Washington Mutual was issuing exactly those types of loans under its High Risk Lending Strategy, OTS indicated that it did not plan to evaluate WaMu's compliance with the guidance and did not want the FDIC to perform that evaluation either. In a February email, the FDIC Dedicated Examiner at WaMu informed the FDIC Assistant Regional Director: "OTS is restricting FDIC on the current examination in the SFR [single family residential loan] review segment. OTS will not allow us to review SFR loan files."[787] The Assistant Regional Director relayed the development to the Regional Director: "John, here we go again. ... OTS wants to draw a distinction between loan file review as an examination activity (that they object to) vs. risk assessment (which they do not object to). I don't fathom the distinction."[788]

Two months later, in April 2007, the FDIC continued to press for permission to review WaMu loan files. The FDIC Assistant Regional Deputy wrote in an email to a colleague:

> "[OTS Regional Director] Finn pushed back on his previous approval of our participation in the 2007 exam targets, specifically as to our ability to work loan files alongside OTS examiner, and

[785] See, e.g., April 16, 2010 Subcommittee Hearing at 73-74.
[786] 9/7/2006 email from FDIC senior official John Carter to George Doerr, FDIC-EM_00252239, Hearing Exhibit 4/16-51c.
[787] 2/6/2007 email from Stephen Funaro to George Doerr, Hearing Exhibit 4/16-55.
[788] 2/6/2007 email from George Doerr to John Carter and others, Hearing Exhibit 4/16-55.

we were particularly interested in WAMU's compliance with nontraditional mortgage guidance. ... Mr. Finn and his examiner, Ben Franklin, stated that OTS did not intend to look at files for purposes of testing nontraditional mortgage guidance until after the bank made a few changes they had agreed to. I asked if we could then join the file review whenever ots did look at this, and he said, 'No.'"[789]

At the Subcommittee hearing, when asked about these incidents, the FDIC Chairman Sheila Bair testified:

> "[I]n 2005 … OTS management determined that FDIC should not actively participate in OTS examinations at WaMu, citing the 2002 interagency agreement. In subsequent years, FDIC faced repeated resistance to its efforts to fully participate in examinations of WaMu. Even as late as 2008, as problems at WaMu were becoming more apparent, OTS management sought to limit the number of FDIC examiners involved in the examination and did not permit the FDIC to review loan files."[790]

Both the Treasury and the FDIC Inspectors General were critical of OTS' actions. In response to a question about "[w]hether or not OTS should have allowed the FDIC to help" with the examinations of WaMu, FDIC IG Rymer responded:

> "[I]t is clear to me that they [OTS] should have. … [T]hey [the FDIC] had concerns and those concerns were principally driven by its own LIDI analysis. … [T]here is no question in my mind that the FDIC's request for back-up authority, simply given the sheer size of WaMu, was, to me, enough reason for FDIC to ask for back-up authority."[791]

Treasury IG Thorson agreed:

> "I agree with Mr. Rymer. … [T]he sheer size of the bank would say that there should be a maximum of cooperation, not to mention the fact that it is dictated by statute, as well. … [A]s a matter of policy, I think they [OTS] should have allowed that. No matter what their reasoning was, as a matter of policy, they should have, yes."[792]

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[789] 4/30/2007 email from George Doerr to David Collins, FDIC_WAMU 000014457, Hearing Exhibit 4/16-57.
[790] April 16, 2010 Subcommittee Hearing at 80-81 (testimony of Sheila Bair).
[791] April 16, 2010 Subcommittee Hearing at 34.
[792] Id. at 35.

OTS Turf War. At the Subcommittee hearing, John Reich, the OTS Director, was asked about the friction between the two agencies. In response to a question about the August 2008 email in which he wrote that the FDIC had "no role" at WaMu until OTS "rules on solvency,"[793] Mr. Reich stressed that the key point he was trying to convey was that OTS was WaMu's primary federal regulator:

> Mr. Reich: I think basically and fundamentally it was who was the primary Federal regulator.
>
> Senator Levin: It was turf, in a word.
>
> Mr. Reich: I think OTS had the responsibility as the primary Federal regulator.
>
> Senator Levin: Turf.
>
> Mr. Reich: We had the statutory responsibility.
>
> Senator Levin: Instead of going at this as partners –
>
> Mr. Reich: I have more than most – an understanding of the role of the FDIC and their need to participate. I have been there.[794]

The evidence shows that OTS senior officials not only resisted, but resented the FDIC participation in the oversight of Washington Mutual Bank and deliberately took actions that limited the FDIC oversight, even in the face of a deteriorating $300 billion institution whose failure could have exhausted the entire Deposit Insurance Fund. After contrasting OTS' hard-edged treatment of the FDIC with the collaborative approach it took towards WaMu, Senator Levin observed:

> "About the only time OTS showed backbone was against another agency's moving, in your view, into your turf. Boy, that really got your dander up. That got your blood pressure up. I do not see your blood pressure getting up against a bank which is engaged in the kind of dangerous practices that the bank engaged in, dangerous to their solvency, dangerous to their investors, dangerous to their depositors, dangerous to this economy."[795]

Because OTS has been abolished, its turf war with the FDIC is over. But witnesses from the FDIC told the Subcommittee that the remaining banking regulators also sometimes resist its participation in bank oversight. In particular, a senior FDIC official told the Subcommittee that, although the FDIC has the statutory authority to take

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[793] See 8/6/2008 email from OTS Director John Reich to FDIC Chairman Sheila Bair, "Re: W," FDIC-EM_00110089, Hearing Exhibit 4/16-66 ("I should not have to remind you the FDIC has no role until the PFR [Primary Federal Regulator] (i.e. the OTS) rules on solvency.").
[794] April 16, 2010 Subcommittee Hearing at 64.
[795] Id. at 66.

an enforcement action against a bank, the FDIC has never used that authority because the other regulators would view it as "an act of war." The WaMu case history demonstrates how important it is for our federal regulators to view each other as partners rather than adversaries in the effort to ensure the safety and soundness of U.S. financial institutions.

D. Regulatory Failures

In a market economy, the purpose of regulation within the financial markets is to provide a level playing field that works for everyone involved, from the financial institutions, to the investors, to the consumers and businesses that rely on well functioning financial systems. When financial regulators fail to enforce the rules in an effective and even handed manner, they not only tilt the playing field in favor of some and not others, but also risk creating systemic problems that can damage the markets and even the entire economy.

At the April 16, 2010 hearing of the Subcommittee, Senator Coburn had the following exchange with Inspectors General Thorson and Rymer, which explains in part why OTS failed as a regulator to address WaMu's harmful lending policies:

> Senator Coburn: As I sat here and listened to both the opening statement of the Chairman and to your statements, I come to the conclusion that actually investors would have been better off had there been no OTS because, in essence, the investors could not get behind the scene to see what was essentially misled by OTS because they had faith the regulators were not finding any problems, when, in fact, the record shows there are tons of problems, just there was no action taken on it. ... I mean, we had people continually investing in this business on the basis—as a matter of fact, they raised an additional $7 billion before they collapsed, on the basis that OTS said everything was fine, when, in fact, OTS knew everything was not fine and was not getting it changed. Would you agree with that statement or not?
>
> Mr. Thorson: Yes, sir. I think ... basically assigning a 'satisfactory' rating when conditions are not is contradictory to the very purpose for which regulators use a rating system. I think that is what you are saying.
>
> Senator Coburn: Any comments on that Mr. Rymer?
>
> Mr. Rymer: I would agree with Mr. Thorson. ...

Senator Coburn: [To Mr. Thorson] By your statement, it would imply almost that OTS is an enabler of this effort rather than an enabler of making sure that the American people's taxpayer dollars and the trust in institutions that are supposed to be regulated by an agency of the Federal Government can be trusted.

Mr. Thorson: Right.

In trying to understand why OTS failed to make use of its enforcement tools to compel WaMu to operate in a safe and sound manner, the Subcommittee investigation has identified factors that have resonance not only in the recent financial crisis, but are critical for regulators and policymakers to address in order to avoid future financial disasters as well.

(1) OTS' Failed Oversight of WaMu

During the five-year period of the Subcommittee's inquiry, from 2004 to 2008, OTS identified over 500 serious operational deficiencies at WaMu and Long Beach. At WaMu, the problems included weak lending standards, high loan exception and error rates, noncompliance with bank loan policy, weak risk management, poor appraisal practices, and poor quality loans. At Long Beach, OTS identified many of the same problems and added on top of those, weak management, poor quality mortgage backed securities, and inadequate repurchase reserves. The problems are described in examination report after examination report, and OTS raised many of the same concerns, in writing and in person, with WaMu's Board of Directors.

But for all those years, OTS did little beyond describing the problems and asking bank executives to make improvements. When the reforms failed to materialize, the problems continued, and the risk increased, OTS stood on the sidelines. Subcommittee interviews found that, until 2008, OTS regulators never even held internal discussions about taking an enforcement action against the bank. In 2008, in the face of mounting losses, OTS took two informal, nonpublic enforcement actions, which contained few mandatory measures or deadlines and were together insufficient to save the bank.

In trying to understand the agency's years of inaction, the Subcommittee's investigation concluded that the lack of enforcement reflected an OTS culture of deference to bank management, demoralized examiners whose oversight efforts were unsupported by their supervisors, and a narrow regulatory focus that allowed short term profits to excuse high risk activities and disregarded systemic risk. Inflated CAMELS ratings may have further reduced the pressure to act, while conflicts of interest may have also tempered OTS' willingness to take tough enforcement action against WaMu.

(a) Deference to Management

Part of the reason that OTS declined to take enforcement action against Washington Mutual was a posture of deference to the management of the institutions it regulated. Ronald Cathcart, WaMu's chief enterprise risk officer from 2006-2008, described OTS as essentially believing in "self-regulation":

> "I ... have actually operated in banks under three regulators, in Canada under the Office of the Supervisor of Financial Institutions, at Bank One under the OCC, and then at Washington Mutual under the OTS[.] ... [T]he approach that the OTS took was much more light-handed than I was used to. It seemed as if the regulator was prepared to allow the bank to work through its problems and had a higher degree of tolerance that I had ... seen with the other two regulators. ... I would say that the OTS did believe in self-regulation."[796]

A former OTS regulator who later took a job with WaMu, was quoted in a press report as saying that OTS provided "by far the softest" oversight of any federal bank regulator.[797]

Evidence of OTS' unusually deferential approach can be found in its internal documents, starting at the top. In a May 2007 email, for example, cancelling lunch with a colleague so he could instead have lunch with WaMu's CEO, Kerry Killinger, OTS Director, John Reich, described the bank as "my largest constituent."[798] At the Subcommittee hearing, Mr. Reich defended using the term, testifying that referring to others as constituents was a "habit" he had picked up while working on Capitol Hill.[799] One Senator pointed out that OTS' true constituents were not the banks it regulated, but "the American people it was supposed to protect from unsafe and unsound banking practices."[800]

On another occasion in July 2008, Mr. Reich sent an email to Mr. Killinger informing him that OTS had decided to issue a Memorandum of Understanding (MOU) to address issues of concern at the bank. In the email, the OTS Director apologized twice for his method of

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[796] April 13, 2010 Subcommittee Hearing, at 39-40 (Testimony of Ronald J. Cathcart, former WaMu Chief Enterprise Risk Officer, 2006-2008).
[797] "Lax Regulators Helped Doom Washington Mutual," Associated Press (4/16/2010).
[798] 5/2/2007 email from OTS Director John Reich to Shelley Hymes, "Re: Lunch Friday," Reich_John-00025837_001, Hearing Exhibit 4/16-78.
[799] April 16, 2010 Subcommittee Hearing at 36.
[800] Id. at 5 (opening statement of Senator Levin).

communication, but also sounded a note of regret for his decision to take a tougher approach:

> "Kerry,
>
> I'm sorry to communicate by email – I've left a couple of messages on your office phone, but I'm guessing you may be off for a long weekend.
>
> I've been wrestling with the issue of an MOU versus a Board Resolution as a result of our conversation in my office last week. And I've decided that an MOU is the right approach for OTS to do in this situation ....
>
> We almost always do an MOU for 3-rated institutions, and if someone were looking over our shoulders, they would probably be surprised we don't already have one in place. ...
>
> So as much as I would like to be able to say a Board Resolution is the appropriate regulatory response, I don't really believe it is. I do believe we need to do an MOU. We don't consider it a disclosable event, and we also think the investment community won't be surprised if they learn of it, and would probably only be surprised to learn one didn't already exist.
>
> Again, I'm sorry to communicate this decision by email, but I'm scheduled to be out of the office next week myself and wanted you to have this information.
>
> Best regard, Kerry,
>
> John"[801]

The email does not convey a message from an arms-length regulator concerned about a failing bank. To the contrary, the email conveys a sense of familiarity and discloses that the head of OTS knew his agency had already been providing preferential treatment to the bank by failing to impose an MOU after its downgrade to a 3 rating five months earlier, in February 2008. Mr. Reich stated that others "looking over our shoulders ... would probably be surprised" an MOU was not already in place at WaMu.

When asked about this email at the Subcommittee hearing, the Treasury and the FDIC Inspectors General both expressed discomfort with its language and tone:

[801] 7/3/2008 email from OTS Director John Reich to WaMu CEO Kerry Killinger, OTSWMS08-014 0000912-13, Hearing Exhibit 4/16-44.

> Mr. Thorson: Again, he sort of apologizes in the previous document that this could become known. This gets right to the heart of what you were talking about, the culture. ... [T]here is not an acceptance of the fact that a strong regulatory control helps them.
>
> Senator Levin: This is far too cozy?
>
> Mr. Thorson: Absolutely, as far as I am concerned, yes.
>
> Senator Levin: Mr. Rymer, do you have any reaction to this?
>
> Mr. Rymer: It does indicate a level of familiarity that makes me uncomfortable.[802]

Equally telling is the fact that, even after sending the email, OTS delayed imposing the MOU on WaMu for another two months, waiting until September 2008, just three weeks before the bank's failure.[803]

Like the head of the agency, OTS examiners also took a deferential approach to WaMu. In a January 2006 email discussing WaMu's desire to purchase Long Beach, for example, the OTS Examiner-in-Charge indicated that, rather than insist the bank clean up Long Beach problems before the purchase, OTS would have to rely on its "relationship" with WaMu to get the job done:

> "The letter [from WaMu] seems okay. They obviously want to leave it a little squishy, of course, on the growth plans, but at least they make a firm commitment to clean up the underwriting issues. At some level, it seems we have to rely on our relationship and their understanding that we are not comfortable with current underwriting practices and don't want them [Long Beach] to grow significantly without having the practices cleaned up first."[804]

On another occasion in June 2006, the same OTS Examiner-in-Charge sent a lengthy email to his Regional Director discussing plans for the annual WaMu Report on Examination (ROE). His email expressed concern about losing credibility with the bank if OTS pressed too hard on certain reforms, twice noted the bank's size and complexity, and stressed that the bank was making progress in fixing identified problems:

[802] April 16, 2010 Subcommittee Hearing at 34.
[803] See also id. at 46 (When asked why OTS took so long to complete the MOU, former OTS Director John Reich testified: "I don't know, to tell you the truth. I do not know why it took so long to implement the MOU. ... I regret [the] ... delay.").
[804] 1/27/2006 email from Lawrence Carter to Darrel Dochow, OTSWMS06-008 0001082, Hearing Exhibit 4/16-32.

"[W]e still have some strong feelings on some items that I'd like to 'push back' … some on. Generally we feel that we are quite balanced and do not have any gloves on in our approach to our findings and conclusions at WAMU. We have some concern that if we press forward with some things … we may run the risk of losing some credibility in terms of understanding the size and complexity of their business and looking as though we do not have a balanced perspective. My own fear is that we may not have done enough to communicate to you [the Regional Director] why we feel that the few negative things we have brought up through findings memos and meetings, while important to keep in front of management, are not so serious they wipe out all the right things the institution is doing in all those areas we reviewed and did not have any issues, nor should they negate the ongoing good progress in making improvements in a manner that seems reasonable given the size, complexity, and status of the institution."[805]

The Examiner-in-Charge then listed three areas of concern, problems at Long Beach which he seemed to downplay, the need to limit the number of corrective actions listed in the ROE, and the need to review how OTS cited the bank for compliance violations. In the Long Beach discussion, he wrote that improvements "will take time because of size and complexity …. We don't feel demanding more than providing us with an acceptable action plan with realistic timelines is appropriate or necessary at this time." On the corrective actions, he wrote that the list had to be limited or "more important findings will get lost. … We feel strongly that we should not cite all findings and corrective actions within the body of the ROE … [which] is already not getting read I believe." He also expressed concern that OTS was "starting to 'over-meeting' the institution" and suggested that "the exit meeting" with the bank to discuss the ROE findings had "become almost unnecessary."

After urging patience on WaMu reforms, suggesting a limit on the corrective actions listed in the ROE, and recommending fewer meetings with WaMu management, the curious final line in the email is: "My management class this week has made me feel empowered! Can you tell? Please don't fire me!"

Additional evidence of OTS deference is its reliance on WaMu to track its own compliance with OTS findings calling for corrective action. At all other thrifts, OTS tracked the extent to which the thrift implemented OTS findings, using its own systems. But at WaMu, OTS did not keep its own records, but relied on WaMu's Enterprise Risk

[805] 6/15/2006 email from Lawrence Carter to Darrel Dochow, Dochow_Darrel-00022908_001, Hearing Exhibit 4/16-7.

Issue Control System (ERICS). The Treasury and the FDIC Inspectors General criticized this arrangement, noting that they were unable to use WaMu's system to determine the status of multiple OTS findings.[806] In addition, they noted that, in 2006, ERICS discontinued its practice of identifying "repeat findings," making it difficult to identify and track those findings.[807] Their report explicitly recommends against OTS' relying on a bank's systems in the future to track compliance.

Finally, the actual language used by OTS in its reports and memoranda that described deficiencies demonstrated a passive approach to dealing with management. Common phrases noted that the bank's practices were "less than satisfactory," error rates were at "higher than acceptable levels," and "management's actions did not improve underwriting to a satisfactory level." OTS reports rarely used more assertive language that, for example, called the bank's efforts unsatisfactory, inadequate, or ineffective. An exchange at the Subcommittee hearing between Senator Levin and the OTS Examiner-in-Charge at WaMu from 2004 to 2006, Lawrence Carter, captured the issue:

> Mr. Carter: I think that what I said here is that we could not conclude that their progress was wholly inadequate, because they did make some progress.
>
> Senator Levin: … Can you use the words, 'Folks, your progress was inadequate?' Are you able to tell them that?
>
> Mr. Carter: For their progress on this specific action plan, I did not conclude we could tell them that.
>
> Senator Levin: That it was inadequate?
>
> Mr. Carter: That is right.
>
> Senator Levin: You could tell them it was not wholly adequate.
>
> Mr. Carter: Yes.
>
> Senator Levin: But not inadequate.
>
> Mr. Carter: I do not think I could say it was wholly inadequate.
>
> Senator Levin: I did not use the word 'wholly.' You could tell them it was not wholly adequate, but you could not tell them it was inadequate. That is what you are telling us.
>
> Mr. Carter: Yes.

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[806] See, e.g., IG Report at 30.

[807] See Thorson prepared statement, April 16, 2010 Subcommittee Hearing at 12.

> Senator Levin: That is the kind of bureaucratic speech which I think sends the message to people you regulate that, hey, folks, you are making progress, instead of telling them it is inadequate.[808]

At times, WaMu took advantage of its special relationship with OTS and lobbied for leniency. In one instance from May 2006, a WaMu official from the Regulatory Relations division sent an email to his colleagues stating that he was able to convince the agency to reduce an audit "criticism" to the less serious category of a "recommendation": "OTS confirmed today that they will re-issue this memo without the 'Criticism.' It will be a 'Recommendation.'"[809] His colleague forwarded the email to bank executives noting: "Good news - John was able to get the OTS to see the light and revise the Underwriting rating to a Recommendation."[810]

A more serious incident involved WaMu's 2005 discovery, after almost a year-long investigation by an internal Home Loans Risk Mitigation Team, of substantial loan fraud taking place at two high volume loan offices in California, known as Downey and Montebello. The WaMu investigators found that 83% of the loans reviewed from the Downey office and 58% of the loans reviewed from the Montebello office contained fraudulent information, either with respect to the borrower or the appraised value of the property. The investigators wrote up their findings and presented them to WaMu's Chief Risk Officer and the President of Home Loans.[811] No one, however, informed OTS, and WaMu took no action to stop the fraudulent loans.

Two years later, in 2007, after a mortgage insurer refused to insure any more loans issued by the lead loan officer in the Montebello office, OTS directed WaMu to investigate the matter. WaMu's internal auditors launched an investigation, confirmed the loan fraud problem at the Montebello office, and also uncovered the 2005 investigation whose fraud findings had been ignored. WaMu took until April 2008 to produce a report documenting its findings.[812] WaMu also initially

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[808] April 16, 2010 Subcommittee Hearing at 60-61.
[809] 5/30/2006 email from John Robinson, WaMu VP of Regulatory Relations, to colleagues, JPM_WM02619435. Hearing Exhibit 4/16-34.
[810] 5/30/2006 email from Wayne Pollack, WaMu SVP, to David Schneider, et al., JPM_WM02619434, Hearing Exhibit 4/16-34.
[811] See 11/17/2005 WaMu internal memorandum, "re So. CA Emerging Markets Targeting Loan Review Results," JPM_WM01083051, Hearing Exhibit 4/13-22a; 11/16/2005 WaMu internal PowerPoint presentation, "Retail Fraud Risk Overview," JPM_WM02481934-49, Hearing Exhibit 4/13-22b; 11/19/2005 email from Cheryl Feltgen to colleagues, "Re: Retail Fraud Risk Overview," JPM_WM03535694-95, Hearing Exhibit 4/13-23a; 8/29/2005 email from Jill Simons to Timothy Bates, "Risk Mit Loan review data 'Confidential,'" JPM_WM04026076-77, Hearing Exhibit 4/13-23b.
[812] 4/4/2008 WaMu internal memorandum, from June Thoreson-Rogers, Corporate Fraud Investigations, and Michele Snyer, Deputy General Auditor, to Stewart Landefeld, Acting Chief Legal Officer, and others, Hearing Exhibit 4/13-24.

resisted providing the report to OTS, claiming it was protected by attorney-client privilege.[813] The OTS Examiner-in-Charge at the time told the Subcommittee that he insisted on seeing the report. After finally receiving it and reading about the substantial loan fraud occurring at the two loan offices since 2005, he told the Subcommittee that it was "the last straw" that ended his confidence that he could rely on WaMu to combat fraudulent practices within its own ranks.

OTS' deference to WaMu management appeared to be the result of a deliberate posture of reliance on the bank to take the steps needed to ensure that its personnel were engaged in safe and sound practices. The reasoning appeared to be that if OTS examiners simply identified the problems at the bank, OTS could then rely on WaMu's own self interest, competence, and discipline to ensure the problems were corrected, with no need for tough enforcement action. It was a regulatory approach with disastrous results. While OTS may have hoped that it could accomplish its regulatory responsibilities by simply identifying problems without the threat of enforcement action, that approach proved ineffective.

(b) Demoralized Examiners

For five years, OTS examiners identified serious problems with WaMu's lending practices and risk management, but OTS senior officials failed to support their efforts by using the agency's enforcement tools to compel the bank to correct the identified problems. WaMu's chief risk officer from 2004 to 2005, James Vanasek, remarked at the Subcommittee hearing on how OTS examiners seemed to receive little support from more senior officials in terms of enforcement:

> "[T]he OTS Examiner-in-Charge during the period time in which I was involved … did an excellent job of finding and raising the issues. Likewise, I found good performance from … the FDIC Examiner-in-Charge. … What I cannot explain is why the superiors in the agencies didn't take a tougher tone with the banks given the degree of … negative findings. My experience with the OTS, versus with the OCC, was completely different. So there seemed to be a tolerance there or a political influence on senior management of those agencies that prevent them from taking a more active stance. By a more active stance, I mean putting the banks under letters of agreement and forcing change."[814]

Internal OTS documents and emails indicate that the result was a cadre of OTS examiners who were skeptical of their ability to effect meaningful change at WaMu, who were too often rebuffed by their own

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[813] Subcommittee interview of OTS Examiner-in-Charge Benjamin Franklin (2/17/2010).
[814] April 13, 2010 Subcommittee Hearing at 39 (testimony of James G. Vanasek, former WaMu Chief Risk Officer, 2004-2005).

management when they tried to reduce risk or strengthen bank controls, and whose leaders worked to weaken rather than strengthen the standards used by examiners to hold banks accountable.

Low Expectations. The documents show that OTS examiners had low expectations that WaMu would actually implement recommended changes at the bank. Ultimately, OTS examiners adapted to the situation, they gave up trying to make the bank act more quickly, and WaMu was able to delay needed changes for long periods of time if it wished.

In 2003, for example, one OTS examiner wrote to the Examiner-in-Charge:

> "It is clear from my experience that changes seem to progress slowly at WaMu so I don't know if we can expect faster progress .... If any target is missed, as happens at WaMu, then we may not be in a position to determine the effectiveness of the corrective actions."[815]

In 2005, another OTS examiner wrote: "They agree to take all action required to correct the problem. The Target Completion Dates are not real timely but fine for WaMu."[816]

Other examiners were more critical. In 2007, for example, one OTS examiner wrote:

> "Regulatory Relations [the WaMu office established to work with regulators] is a joke. The purpose of this group seems to be how can we give the regulators the bare minimum without them raising a fuss."[817]

The examiner also wrote:

> "WaMu's compliance management program has suffered from a lack of steady, consistent leadership. Dick Stevenson, who took over as Chief Compliance Officer on March 2, 2007, is the bank's ninth compliance leader since 2000. ... The OTS is very concerned that this lack of consistent, stable leadership leaves the program vulnerable. This amount of turnover is very unusual for an institution of this size and is a cause for concern. The Board of Directors should commission an evaluation of why smart, successful, effective managers can't succeed in this position. If you

[815] 6/27/2003 email from Dennis Fitzgerald, OTS Examiner, to Lawrence Carter, OTSWEM04-0000006748, Hearing Exhibit 4/16-15.
[816] 6/8/2005 email from Verlin Campbell, OTS Examiner, to Zalka Ancely, OTS Examiner, OTSWME05-003 0000634, Hearing Exhibit 4/16-29.
[817] 5/31/2007 Draft Compliance Memo from Susie Clark, OTS Compliance Specialist, Franklin_Benjamin-00020408_002, Hearing Exhibit 4/16-9.

would like my opinion, just ask. (HINT: It has to do with top management not buying into the importance of compliance and turf warfare and Kerry [Killinger] not liking bad news.)"[818]

In an interview, OTS examiner Benjamin Franklin, who worked at the agency for 24 years, told the Subcommittee that the thrifts he oversaw generally did not "collaborate" with the agency but would "fight" OTS reviews and resist OTS recommendations. He said that at WaMu, "for the most part" OTS examiners were "butting heads" with bank personnel and it was difficult to effect change.[819]

Weak Standards. The documents show that the OTS examiners were also frustrated by the agency's weak standards, which made it difficult to cite WaMu for violations or require the bank to strengthen its operations.

In 2007, for example, an examiner critical of WaMu's compliance procedures wanted to downgrade the bank's compliance rating from 2 to 3, but told the OTS Examiner-in-Charge that, due to the lack of standards on compliance matters, she didn't believe she could win a battle with the bank:

> "I'm not up for the fight or the blood pressure problems. ... It doesn't matter that we are right, what matters is how it is framed. ... They [Washington Mutual] aren't interested in our 'opinions' of the [compliance] program. They want black and white, violations or not. ... [O]ur training always emphasizes 'Best Practices' but when it comes down to it, we don't have the resources to show the risk."[820]

At another point, when discussing standards for calculating acceptable loan error rates, an OTS examiner wrote:

> "We will need additional discussion of acceptable error rates and how we view their [WaMu's] standard. ... [A] 2.5 percent error rate would mean that approximate[ly] $600.0 million could be originated and be within acceptable guidelines. A 20.0 percent medium error rate means that $4.8 billion of loans with these types of errors could be originated without a criticism. The latter seem[s] especially high when you consider that their medium criteria includes loans that we don't think should be made."[821]

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[818] Id. at Franklin_Benjamin-00020408_001.
[819] Subcommittee interview of Benjamin Franklin (2/17/2010).
[820] 6/3/2007 email from OTS examiner Mary Clark to Examiner-in-Charge Benjamin Franklin, "Compliance Rating," OTSWMS07-013 0002576, Hearing Exhibit 4/16-39.
[821] 11/21/2005 email exchange between OTS examiner Benjamin Franklin and Examiner-in-Charge Lawrence Carter and others, OTSEMS05-004 0001911-12, Hearing Exhibit 4/16-30.

The OTS Examiner-in-Charge responded with a lengthy email criticizing outdated, unclear OTS standards on the acceptable loan error rate for a portfolio of subprime loans:

> "Unfortunately, our sampling standards are 10 years old and we have no standards of acceptance really. It depends on our own comfort levels, which differ. … Moreover, our guidance requires that an exception be SIGNIFICANT, which ... we have over time interpreted as loans that should not have been made. … While we may (and have) questioned the reasonableness of these standards, they are all we have at this time. If our tolerance for some reason is now a lot lower than our handbook standards, it would be nice to have this clarified. I have always used these standards as rough benchmarks and not absolutes myself, upping my expectations for higher risk portfolios. … It would be nice if they [higher risk loan portfolios] could meet even higher expectations, but that would require us to agree on what the standard should be."[822]

At another point, the same Examiner-in-Charge wrote a long email discussing issues related to a decision by WaMu to qualify borrowers for adjustable rate mortgages using an interest rate that was less than the highest rate that could be charged under the loan. He complained that it was difficult to force WaMu to comply with the OTS "policy of underwriting at or near the fully indexed rate," when "in terms of policy, I am not sure we have ever had a really hard rule that institutions MUST underwrite to the fully indexed rate."[823] He also noted that OTS sometimes made an exception to that rule for loans held for sale.

NTM Guidance. While some OTS examiners were complaining about the agency's weak standards, other OTS officials worked to ensure that new standards being developed for high risk mortgages would not restrain WaMu's lending practices. The effort began in 2006 with an aim to address concerns about lax lending standards and the risks posed by subprime, negatively amortizing, and other exotic home loans. The federal banking agencies convened a joint effort to reduce the risk associated with those mortgages by issuing interagency guidance for "nontraditional mortgage" products (NTM Guidance). Washington Mutual filed public comments on the proposed NTM Guidance and argued that Option ARM and Interest-Only loans were "considered more safe and sound for portfolio lenders than many fixed rate mortgages," so regulators should "not discourage lenders from offering these

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[822] Id.
[823] 9/15/2005 email from OTS Examiner-in-Charge Lawrence Carter to OTS Western Region Deputy Director Darrel Dochow, OTSWMS05-002 0000535, Hearing Exhibit 4/16-6.

products."[824] It also stated that calculating a potential borrower's "DTI [debt-to-income ratio] based on the potential payment shock from negative amortization would be highly speculative" and "inappropriate to use in lending decisions."[825] During subsequent negotiations to finalize that guidance, OTS argued for less stringent lending standards than other regulators were advocating and bolstered its points using data supplied by Washington Mutual.[826]

In one July 2006 email, for example, an OTS official expressed the view that early versions of the new guidance focused too much on negative amortization loans, which were popular with several thrifts and at WaMu in particular, and failed to also look closely at other high risk lending products more common elsewhere.[827] He also wrote that OTS needed to address this issue and "should consider going on the offensive, rather than defensive to refute the OCC's positions" on negatively amortizing loans, defending the loans using WaMu Option ARM loan data.[828] In August, several OTS officials discussed over email how to prevent the proposed restrictions on negatively amortizing loans from going farther than they believed necessary, noting in part the "profitable secondary market" for Option ARMs and the fact that "hybrid IO [interest only] ARMs are a huge product for Wamu." One OTS official wrote:

> "We have dealt with this product [negatively amortizing loans] longer than any other regulator and have a strong understanding of best practices. I just don't see us taking a back seat on guidance that is so innate to the thrift industry."[829]

OTS officials argued variously that the new proposal would wrongly put the focus on "products" instead of "underwriting," as well as that it would hurt the business of large thrifts like WaMu.[830]

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[824] 3/29/2006 letter from Washington Mutual Home Loans President David C. Schneider to OTS Chief Counsel, Proposed Guidance – Interagency Guidance on Nontraditional Mortgage Products 70 Fed. Reg. 77249, JPM_WM04473292.
[825] Id. at JPM_WM04473298.
[826] Subcommittee interviews of Sheila Bair (4/5/2010) and George Doerr (3/30/2010). The Subcommittee was told that OTS was the "most sympathetic to industry" concerns of the participating agencies and was especially protective of Option ARMs.
[827] 7/27/2006 email from Steven Gregovich to Grovetta Gardineer and others, "NTM Open Issues," OSWMS06-008 0001491-495, Hearing Exhibit 4/16-71.
[828] Id.
[829] 8/14/2006 email from Kurt Kirch to David Henry and Steven Gregovich, "Latest AMP Guidance," Hearing Exhibit 4/16-72.
[830] 7/27/2006 email from Steven Gregovich to Grovetta Gardineer, et al., "NTM Open Issues," OSWMS06-008 0001491-495, Hearing Exhibit 4/16-71.

The NTM Guidance was finally issued on October 4, 2006.[831] The final version did not fully reflect the recommendations of OTS on negatively amortizing loans. Among other matters, it called on banks to:

- evaluate a borrower's ability to fully repay a prospective loan, including any balance increase from negative amortization;
- qualify borrowers using the higher interest rate that would apply after any teaser or introductory interest rate;
- avoid loans whose repayment was dependent solely upon the value of the collateral or the borrower's ability to refinance the loan; and
- implement strong quality control and risk mitigation procedures for loans containing layers of risk, including loans with no documentation requirements, no verification of the borrower's income or assets, or high loan-to-value ratios.

The Guidance also called for capital levels commensurate with risk and adequate allowances for loan losses.

The Guidance was not promulgated as a bank regulation that could be enforced in court, and it contained no explicit deadline for compliance. Instead, it provided policies and procedures that regulators could use as benchmarks during examinations. Agencies could penalize noncompliance with the standards through lower CAMELS ratings or enforcement actions. FDIC officials told the Subcommittee that the FDIC expected banks to come into immediate compliance with the Guidance, and that no agency should have been telling a bank that it did not have to comply with the new standards.[832]

A few days after the NTM Guidance went into effect, WaMu officials met with OTS about implementation and reported back that OTS had indicated that compliance was something institutions "should" do, not something they "must" do.[833] According to a written summary by WaMu of its October 12, 2006 meeting with OTS to discuss the new rules, OTS told the bank that it "view[ed] the guidance as flexible" and "specifically pointed out that the language in the guidance says 'should'

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[831] 10/4/2006 "Interagency Guidance on Nontraditional Mortgage Product Risks," (NTM Guidance), 71 Fed. Reg. 192 at 58609.
[832] Subcommittee interviews of Sheila Bair (4/5/2010) and George Doerr (3/30/2010).
[833] See 10/2006 OTS Meeting, "Washington Mutual Alternative Mortgage Guidance Implementation Plan," JPM_WM02549033, Hearing Exhibit 4/16-73.

vs. 'must' in most cases and they [were] looking to WaMu to establish our position on how the guidance impacts our business processes."[834]

In 2007, OTS conducted a review of WaMu's Option ARM activities and compliance efforts and found that three months after the NTM Guidance had become effective, the bank was not yet complying with the new standards when issuing Option ARMs.[835] The OTS review noted that as of January 31, 2007, the bank had a total of $62 billion in outstanding Option ARMs in its investment portfolio, of which 80% were negatively amortizing.[836] The review stated that, as of December 31, 2006, WaMu was not in compliance with the NTM Guidance, because it continued not to consider potential negative amortization amounts when qualifying borrowers for Option ARMs; placed too much reliance on FICO scores instead of income verification to qualify borrowers for nontraditional mortgages; failed to consider amortizing payments or payment shocks when qualifying borrowers for interest only loans; and placed too much reliance on collateral, rather than borrower income, as the primary repayment source in the event of a loan default.[837] The review contained no recommendations for actions to ensure WaMu changed its procedures.

In April 2007, the FDIC asked OTS for permission to conduct its own review of WaMu loan files to evaluate the bank's compliance with the NTM Guidance.[838] OTS refused, however, to provide the FDIC with access to the relevant loan files and effectively blocked the review.[839] The FDIC Assistant Regional Director George Doerr told the Subcommittee that when he contacted OTS official Mike Finn about the FDIC's request to review WaMu loan files to test NTM compliance, Mr. Finn said that OTS was giving its institutions more time to comply with the guidance, even though it had taken effect more than six months earlier.[840] The FDIC Chairman Sheila Bair told the Subcommittee that

[834] Id. at JPM_WM02549037. Subcommittee interview of Darrel Dochow (3/3/2010) (indicating that the NTM Guidance used "should" instead of "must" to avoid being a "one-size-fits-all" set of requirements). See also Subcommittee interview of John Bowman (4/6/2010) (indicating that guidance is not enforceable and that giving banks more time to comply was a reasonable approach).
[835] See undated OTS document, "Option ARM Neg Am Review Workprogram 212A(1) & Nontraditional Mortgage Guidance Review," OTSWMEF-0000009888, Hearing Exhibit 4/16-74. The document quotes Option ARM data from March 31, 2007, indicating that the document was prepared after that date.
[836] Id. at OTSWMEF-0000009890.
[837] Id. at OTSWMEF-0000009893-94.
[838] See, e.g., 4/30/2007 email from FDIC Western Region Assistant Director George Doerr to FDIC official David Collins, FDIC_WAMU 000014457, Hearing Exhibit 4/16-57.
[839] See April 16, 2010 Subcommittee Hearing at 33 (Testimony of FDIC IG John Rymer: "OTS did grant FDIC greater access at WaMu, but limited FDIC's review of WaMu's residential loan files. The FDIC wanted to review these files to assess underwriting and WaMu's compliance with the Non-Traditional Mortgage Guidance."); See also April 16, 2010 Subcommittee Hearing at 187 (Testimony of George Doerr, FDIC).
[840] Subcommittee interview of George Doerr (3/30/2010).

the FDIC had not known until then that OTS was allowing institutions to delay compliance with the NTM Guidance and were "surprised" by the agency's actions. She said that normally, if an institution needs more time to comply with new standards, a regulator required it to provide a written plan with milestones for achieving compliance.[841]

Documents uncovered by the Subcommittee show how WaMu took advantage of the delay to continue its high risk lending practices. The NTM Guidance directed banks, for example, to evaluate a borrower's ability to repay a mortgage using the highest interest rate that would be charged under the loan and the fully amortized payment amount rather than any smaller or minimum payment amount. After determining that those new requirements could lead to a 33% drop in Option ARM loan volume due to borrowers who would no longer qualify for the loans, WaMu's Chief Enterprise Risk Officer, Ron Cathcart, advised "holding off on implementation until required to act for public relations (CFC [Countrywide] announces unexpectedly) or regulatory reasons."[842] When he made that suggestion in March 2007, OTS had already allowed Washington Mutual to delay its compliance with the Guidance for six months, resulting in the bank's originating billions of dollars in new Option ARM loans that would later suffer significant losses.[843] Instead of using the NTM Guidance as an opportunity to strengthen WaMu's lending standards and reduce its loan risk, OTS chose to delay its implementation.

In addition, in May 2007, when an OTS official attempted to stop WaMu from issuing mortgages without verifying borrower incomes, relying on the NTM Guidance and other rules as justification, OTS senior management rebuffed the official's efforts. Instead, OTS senior managers interpreted its standards as allowing thrifts to continue issuing "stated income loans," also called "No Income No Asset" (NINA) or "no doc" loans, because they permitted lenders to provide credit without verifying the borrower's income or assets. On May 15, 2007, after reviewing a summary of WaMu's loans, an OTS official in Washington, Bill Magrini, sent an email to the OTS Examiner-in-Charge with responsibility for WaMu stating:

> "I note that WAMU makes a significant amount of No-doc loans. OTS policy states that no-doc loans are unsafe and unsound. I assume they mean no doc regarding NINA or no income-no asset loans.

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[841] Subcommittee interview of Sheila Bair (4/5/2010).
[842] 3/19/2007 email from Ron Cathcart to David Schneider, JPM_WM02571598, Hearing Exhibit 4/16-75.
[843] See wamusecurities.com. (subscription website maintained by JPMorgan Chase with data on Long Beach and WaMu mortgage backed securities showing, as of January 2011, delinquency rates for particular mortgage backed securities, including WMALT 2006 OA-3 – 57.87%).

Without even asking for income or assets/liabilities, the loans are collateral-dependent. This is imprudent ... [T]he interagency NTM Guidance states specifically that collateral dependent loans are unsafe and unsound. ...

Does WAMU have any plans to amend its policies per no doc loans?"[844]

The Examiner-in-Charge, Benjamin Franklin, relayed the inquiry to the then Director of the OTS Western Region Office, Darrel Dochow, and stated that, while WaMu had not issued "true NINAs" in the past, the bank had begun "doing NINA's in 2006 through their conduit program. As such, all these loans are held for sale." He estimated WaMu then had about $90 million of NINA loans held for sale, had originated about $600 million in 2006, and would originate the same amount again in 2007.[845]

Mr. Dochow responded that he was already in regular contact with OTS officials in Washington about WaMu and "there is no need to duplicate with Bill Magrini as far as I know."[846] Later the same day, Mr. Dochow wrote:

"I am being told that Bill's views may not necessarily represent OTS policy in these matters. I value Bill's input, but we should be careful about relaying his views to others as being OTS policy, absent collaborating written guidance. [His] views ... are somewhat inconsistent with NTM guidance and industry practice. I also understand Grovetta [another OTS official] promised to clarify section 212 of the handbook in several areas as a result of the NTM roundtable discussion in Wash DC last month."[847]

That same day, another OTS official, Mark Reiley, sent an email indicating his belief that sections of the OTS handbook barred WaMu

[844] See 5/15/2007 email from OTS Examiner-in-Charge Benjamin Franklin to OTS Western Region Director Darrel Dochow, Franklin_Benjamin-00020449_001, Hearing Exhibit 4/16-79 (quoting email from Bill Magrini). See also 3/27/2007 email from OTS official Bill Magrini to OTS colleagues, Quigley_Lori-00110324, Hearing Exhibit 4/16-76 ("I noted that several of our institutions make NINA loans. That, in my humble opinion is collateral dependent lending and deemed unsafe and unsound by all the agencies. ... It is not at all surprising that delinquencies are up, even among Alt-A. In my opinion, credit standards have gone too low."). See also undated OTS document, "Option ARM Neg Am Review Workprogram 212A(1) & Nontraditional Mortgage Guidance Review," at OTSWMEF-0000009891, Hearing Exhibit 4/16-74 (determining that 73% of the Option ARMs in WaMu's portfolio were "low doc" loans).
[845] 5/16/2007 email from OTS Western Region Director Darrel Dochow to OTS Examiner-in-Charge Benjamin Franklin, Franklin_Benjamin-00020449_001, Hearing Exhibit 4/16-79.
[846] Id.
[847] Id.

from issuing NINA loans, even when those loans were originated for sale to Wall Street:

> "The Handbook guidance Section 212 states that no-doc loans (NINAs) are unsafe and unsound loans (Pg. 212.7). Furthermore, even if the no-doc (NINA) loans are originated and held for sale the guidance indicates (pg. 212.8) the association must use prudent underwriting and documentation standards and we have already concluded they are unsafe and unsound. Even if the institution holds the loans for a short period of time. ... [T]his is a hot topic in DC and we are getting a significant amount of push back from the industry. ... At this point I don't think a memo is the best avenue, I think we need to request in writing that WAMU respond to us on how the NINA's comply with the handbook guidance?"

The WaMu Examiner-in-Charge, Benjamin Franklin, responded:

> "I didn't intend to send a memo until I got a blessing from [the Western Region Director] or DC on what our official policy is on this. ... [M]any of our larger institutions now do NINAs (including Countrywide) .... Apparently [OTS policy official] Bill Magrini is the lone ranger in his view that NINA's are imprudent. West region position seems to be that FICO, appraisal, and other documentation ... is sufficient to assess the borrower's ability to repay in all but subprime loans. While I probably fall more into the Magrini camp (until we get empirical data to support NINAs are not imprudent) we will just document our findings ... until the 'official' policy on this has been worked out."[848]

A year later, in October 2008, after WaMu's failure, the same Examiner-in-Charge, Benjamin Franklin, wrote to a colleague:

> "[N]ot one regulatory agency had a rule or guideline saying you couldn't do stated income lending, even to this day. That, I find incredible. We criticized stated income lending at WaMu but they never got it completely fixed. ... [I]n hindsight, I'm convinced that it is just a flawed product that can't be fixed and never should have been allowed in the first place. How do you really assess underwriting adequacy when you allow the borrower to tell you what he makes without verification. We used to have documentation requirements for underwriting in the regs, but when those were taken out, the industry slowly migrated to an anything goes that got us into this mess. ... When I told Scott Polakoff [OTS Deputy Director] that stated income subprime should not be made under any circumstance, I was corrected by Mike Finn [OTS

[848] Id.

Western Region head] that that was not the West Region's position. I rest my case."[849]

Data compiled by the Treasury and FDIC Inspectors General shows that, by the end of 2007, stated income loans – loans in which the bank did not verify the borrower's income – represented 50% of WaMu's subprime loans, 73% of its Option ARMs, and 90% of its home equity loans.[850] At the Subcommittee hearing, virtually every witness condemned stated income loans as unsafe and unsound.[851] OTS Director John Reich testified that he regretted not doing more to prevent supervised thrifts from issuing stated income loans.[852]

Subcommittee interviews with OTS examiners who worked at WaMu found those examiners to be demoralized and frustrated at their inability to effect change at the bank. They had identified serious deficiencies at the bank year after year, with no enforcement consequences; some tried to interpret OTS standards in ways that would reduce risk, only to be rebuffed by their leaders; and others were told that the NTM Guidance being enforced by other agencies did not have standards that could be enforced by OTS examiners. Days after WaMu's failure, one OTS examiner had this to say about OTS leadership:

> "My examination history here is filled with the editing and removal of my comments as well as predictions (that turned out to be true) by EICs [Examiners-in-Charge]. No system in place to keep that from happening. Instead we put whitewashers and scaredity cats in charge of the most problematic shops. I don't know what happened to you at WAMU, but I was critical of their accounting at Card Services and the AP. Fortunately, I think I made the 'don't let him come back here' list. … [O]ur leadership screwed us and can't acknowledge it. They should resign."[853]

(c) Narrow Regulatory Focus

In addition to a policy of deference to management, weak standards, and demoralized examiners, OTS employed an overly narrow regulatory focus that allowed WaMu's short term profits to excuse its

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[849] 10/7/2008 email exchange between OTS Examiner-in-Charge Benjamin Franklin and OTS examiner Thomas Constantine, "West Region Update," Franklin_Benjamin-00034415_001, Hearing Exhibit 4/16-14.
[850] 4/2010 "Evaluation of Federal Regulatory Oversight of Washington Mutual Bank," prepared by the Offices of Inspector General at the Department of the Treasury and Federal Deposit Insurance Corporation, at 10, Hearing Exhibit 4/16-82.
[851] See, e.g., April 16, 2010 Subcommittee Hearing at 14-15, 41-42.
[852] Id. at 42 ("In hindsight, I regret it.").
[853] 10/7/2008 emails from OTS examiner Thomas Constantine to OTS Examiner-in-Charge Benjamin Franklin, "West Region Update," Franklin_Benjamin-00034415_002, Hearing Exhibit 4/16-14.

risky practices and that ignored systemic risk. For a time, its short term profits masked the problems at Washington Mutual, and regulators allowed practices which they knew to be risky and problematic to continue. Because it mishandled its responsibilities, OTS gave the illusion to investors, economists, policy makers, and others that the bank was sound, when in reality, it was just the opposite. Unfortunately, the truth of the matter was not revealed until it was too late, and the bank collapsed.

Using Short Term Profits to Excuse Risk. OTS justified not taking enforcement action against WaMu in part by pointing to Washington Mutual's profits and low loss rates during the height of the mortgage boom, claiming they made it difficult to require the bank to reduce the risks threatening its safety and soundness. In 2005, when faced with underwriting problems at WaMu, the OTS Examiner-in-Charge put it this way:

"It has been hard for us to justify doing much more than constantly nagging (okay, 'chastising') through ROE [Reports of Examination] and meetings, since they [WaMu] have not been really adversely impacted in terms of losses. It has been getting better and has not recently been bad enough to warrant any ratings downgrade."[854]

The OTS Handbook was explicit, however, in stating that profits should not be used to overlook or excuse high risk activities:

> "If an association has high exposure to credit risk, it is not sufficient to demonstrate that the loans are profitable or that the association has not experienced insignificant losses in the near term."[855]

But in the case of Washington Mutual, profits did make a difference. At the Subcommittee hearing, when asked by Senator Kaufman to identify one or two reasons why no regulatory action was taken against WaMu, the FDIC IG Jon Rymer testified as follows:

> "[L]et me start by saying I think the problem in 2005, 2006, and into 2007, the problem was the bank was profitable. I think there was a great reluctance to [take action], even though problems were there in underwriting, the product mix, the distribution process, the

[854] 9/15/2005 email from Examiner-in-Charge Lawrence Carter to Western Region Deputy Director Darrel Dochow, OTSWMS05-002 0000535, Hearing Exhibit 4/16-6.
[855] 11/2004 Office of Thrift Supervision Examination Handbook, at 070.8, OTSWMEF-0000032053; 2/2011 Office of Thrift Supervision Examination Handbook, at 070.9, http://www.ots.treas.gov/_files/422008.pdf (quote is the same in updated version of handbook). See also April 16, 2010 Subcommittee Hearing at 19 (testimony of FDIC and Treasury Inspectors General).

origination process, all in my view extraordinarily risky .... [T]he people in [agency] leadership positions have to be willing to make the tough calls and be experienced enough to know that today's risky practices may show today profitability, but to explain to management and enforce with regulatory action that risky profitability is going to have a cost. It either has a cost in control processes an institution would have to invest in now, or it is going to have a cost ultimately to the bank's profitability and perhaps eventually to the Deposit Insurance Fund."[856]

In his prepared statement, the Treasury Inspector General, Eric Thorson, noted that OTS examiners told his staff they did not lower WaMu's CAMELS ratings because "even though underwriting and risk management practices were less than satisfactory, WaMu was making money and loans were performing."[857]

This problem was not isolated within OTS, however, but applied to other regulatory agencies as well. The FDIC Inspector General noted, for example, that the bank's profitability also tempered the FDIC views of the bank. He explained that, prior to 2008, the FDIC did not challenge WaMu's 2 CAMELS ratings, because "the risks in WaMu's portfolio had not manifested themselves as losses and nonperforming loans, and therefore did not impact WaMu's financial statements."[858] At the same time, an internal FDIC analysis of the bank identified a long list of "embedded risk factors" in WaMu's home loans that, despite the bank's profitability, exposed the bank to losses in the event of "a widespread decline in housing prices."[859]

In the financial industry, high risk activities are undertaken by financial institutions to earn higher marginal returns. The role of the regulator is to enforce rules that ensure the risks an institution undertakes do not unfairly transfer that risk to others or threaten the safety and soundness of the economy, despite any short term profits. In the case of the FDIC, the judgment includes whether the risk threatens loss to the Deposit Insurance Fund. Any firm that decides to take a risk should be the only firm, along with its investors, to bear the brunt of the problem if it turns out to have been a mistake. Regulators that, when faced with short term profits, stop evaluating or downplay attendant risks that could produce later losses fail in their obligation to ensure the safety and soundness of the financial institutions they are regulating. In

[856] April 16, 2010 Subcommittee Hearing at 24-26.
[857] Thorson prepared statement at 10, April 16, 2010 Subcommittee Hearing at 110.
[858] Rymer prepared statement at 10, April 16, 2010 Subcommittee Hearing at 129.
[859] Undated draft memorandum from the WaMu examination team at the FDIC to the FDIC Section Chief for Large Banks, FDIC-EM_00251205-10, Hearing Exhibit 4/16-51a (likely mid-2005).

the case of WaMu, both OTS and the FDIC allowed the bank's success in the short term to paper over its underlying problems.

In October 2008, after Washington Mutual failed, the OTS Examiner-in-Charge at the bank, Benjamin Franklin, deplored OTS' failure to prevent its thrifts from engaging in high risk lending because "the losses were slow in coming":

> "You know, I think that once we (pretty much all the regulators) acquiesced that stated income lending was a reasonable thing, and then compounded that with the sheer insanity of stated income, subprime, 100% CLTV [Combined Loan-to-Value], lending, we were on the figurative bridge to nowhere. Even those of us that were early opponents let ourselves be swayed somewhat by those that accused us of being 'chicken little' because the losses were slow in coming, and let[']s not forget the mantra that 'our shops have to make these loans in order to be competitive'. I will never be talked out of something I know to be fundamentally wrong ever again!!"[860]

Failure to Consider Financial System Impacts. A related failing was that OTS took a narrow view of its regulatory responsibilities, evaluating each thrift as an individual institution without evaluating the effect of thrift practices on the financial system as a whole. The U.S. Government Accountability Office, in a 2009 evaluation of how OTS and other federal financial regulators oversaw risk management practices, concluded that none of the regulators took a systemic view of factors that could harm the financial system:

> "Even when regulators perform horizontal examinations across institutions in areas such as stress testing, credit risk practices, and the risks of structured mortgage products, they do not consistently use the results to identify potential system risks."[861]

Evidence of this narrow regulatory focus includes the fact that OTS examiners carefully evaluated risk factors affecting home loans that WaMu kept on its books in a portfolio of loans held for investment, but paid less attention to the bank's portfolio of loans held for sale. OTS apparently reasoned that the loans held for sale would soon be off WaMu's books so that little analysis was necessary. From 2000 to 2007, WaMu securitized about $77 billion in subprime loans, mostly from

[860] 10/7/2008 email from OTS Examiner-in-Charge Benjamin Franklin to OTS Examiner Thomas Constantine, Franklin_Benjamin-00034415, Hearing Exhibit 4/16-14.
[861] 3/18/2009 Government Accountability Office, "Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions," Testimony of Orice M. Williams, Hearing Exhibit 4/16-83 (GAO reviewed risk management practices of OTS, as well as the Federal Reserve, the Office of the Comptroller of the Currency, the SEC, and self-regulatory organizations.).

Long Beach, as well as about $115 billion in Option ARM loans.[862] Internal documents indicate that OTS did not consider the problems that could result from widespread defaults of poorly underwritten mortgage securities from WaMu and other thrifts.

Numerous documents show that OTS and the FDIC were, in fact, aware that WaMu was issuing high risk loans that led to poor quality securitizations:

> 2005 OTS email describing poor quality Long Beach mortgage backed securities: "Performance data for 2003 and 2004 vintages appear to approximate industry average while issues [of securities] prior to 2003 have horrible performance. ... [Long Beach] finished in the top 12 worst annualized [net credit losses] in 1997 and 1999 thru 2003. ... At 2/05, [Long Beach] was #1 with a 12% delinquency rate. Industry was around 8.25%."[863]
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> 2005 FDIC analysis of WaMu high risk loans: "Management acknowledges the risks posed by current market conditions and recognizes that a potential decline in housing prices is a distinct possibility. Management believes, however that the impact on [WaMu] would be manageable, since the riskiest segments of production are sold to investors, and that these investors will bear the brunt of a bursting housing bubble."[864]
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> 2005 OTS email discussing allowing lower standards for loans held for sale: "[L]oans held for sale could be underwritten to secondary market standards .... I believe we would still find that secondary market requirements are more lax than our policy on underwriting to fully indexed rates. ... [I]f you allow them [WaMu] the exception for loans held for sale ... they probably do not have a ton of loans that fall far outside our policy guidance."[865]
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> 2006 OTS email discussing Long Beach loans that had to be repurchased from buyers: "The primary reasons for the problem were ... [g]eneral lower quality 2005 production due to economy and lowered standards .... The $4.749 billion in loans on [Long Beach] books at 12/31/05 are largely comprised of the same 2005 vintage production that was sold in the whole loan sales and are

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862 "Securitizations of Washington Mutual and Long Beach Subprime Home Loans," chart prepared by the Subcommittee, Hearing Exhibit 4/13-1c; 10/17/2006 "Option ARM" draft presentation to the WaMu Board of Directors, JPM_WM02549027, chart at 2, Hearing Exhibit 4/13-38.

863 4/14/2005 email from OTS examiner to colleagues, OTSWME05-0120000806, Hearing Exhibit 4/13-8a.

864 Undated draft memorandum from WaMu examination team to the FDIC Section Chief for Large Banks, FDIC-EM_00251205-10, Hearing Exhibit 4/16-51a (likely mid-2005).

865 9/16/2005 email from OTS Examiner-in-Charge at WaMu, OTSWMS05-002 0000535, Hearing Exhibit 4/16-6.

> now subject to the increased repurchases. … Management is balancing the probability that these loans will perform worse than expected and priced for, versus the increased income they generate … in considering whether to [sell] some or all of the portfolio."[866]
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> 2008 OTS email after WaMu's failure: "We were satisfied that the loans were originated for sale. SEC and FED [were] asleep at the switch with the securitization and repackaging of the cash flows, irrespective of who they were selling to."[867]
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> 2005 WaMu audit of Loan Sales and Securitization planned no further audit for three years. In March 2007, OTS informally suggested that more frequent audits would be appropriate given the high volume and high risk nature of WaMu's securitization activity and "data integrity issues surrounding the creation of securitization trusts, resulting in loan repurchases from those trusts."[868] OTS was two years too late, however; the secondary market for subprime securities collapsed four months later.

Neither OTS nor the FDIC saw preventing WaMu's sale of high risk mortgages into U.S. securitization markets as part of its regulatory responsibilities.

(d) Inflated CAMELS Ratings

Still another possible explanation for OTS' inaction may have been the overly positive CAMELS ratings it assigned WaMu. From 2004 until early 2008, WaMu held a 2 rating, which meant that it was "fundamentally sound," had "satisfactory risk management," and had "only moderate weaknesses that [were] within the board's and management's capability and willingness to correct."[869] A lower CAMELS rating would have represented one of the strongest actions that OTS and the FDIC could have taken, because it would have required changes from WaMu.

Both the Treasury and the FDIC Inspector General criticized the assignment of the 2 ratings as inaccurate and inappropriate, highlighting how those inflated ratings masked the true problems.[870] Treasury IG

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[866] 1/20/2006 email from Darrel Dochow to Michael Finn and others, OTSWMS06-007 0001020.
[867] 10/7/2008 email from OTS examiner Thomas Constantine to OTS colleague Benjamin Franklin, Franklin_Benjamin-00034415_001, Hearing Exhibit 4/16-14.
[868] See 3/5/2007 WAMU Examination "Review of Securitization," OTSWME07-075 0000780-791 at 789 (data gathered from WaMu's Market Risk Committee minutes, Dec. 2006 and Jan. 2007).
[869] Thorson prepared statement at 7, April 16, 2010 Subcommittee Hearing at 107.
[870] See, e.g., Treasury and FDIC IG Report at 16.

Thorson focused in particular on the 2 rating assigned to WaMu's high risk home loans:

> "[W]e find it difficult to understand how OTS could assign WaMu a satisfactory asset quality 2-rating for so long. Assigning a satisfactory rating when conditions are not satisfactory sends a mixed and inappropriate supervisory message to the institution and its board. It is also contrary to the very purpose for which regulators use the CAMELS rating system."[871]

Inspector General Thorson also criticized the 2 rating assigned to WaMu's management, which signaled "satisfactory performance by management and the Board of Directors and satisfactory risk management practices."[872] He noted that OTS gave management this positive rating until June 2008, despite the bank's ongoing failure to correct the many deficiencies identified by OTS examiners and the fact that management problems at WaMu were longstanding. At the Subcommittee hearing, the FDIC Inspector General Rymer also criticized the 2 rating assigned to WaMu's management:

> "[T]he management piece should be, in my view, downgraded if management has not demonstrated that it has built the adequate systems and control processes and governance processes to help manage problems when they eventually do occur in assets. ... I find it difficult to understand why the management rating at a minimum was not lowered much earlier on."[873]

The FDIC Inspector General also noted that, from 2004 to 2008, the FDIC had assigned LIDI ratings to WaMu that indicated a higher degree of risk at the bank than portrayed by the bank's CAMELS ratings. He observed that LIDI ratings, which are intended to convey the degree of risk that a bank might cause loss to the Deposit Insurance Fund, are designed to be more forward-looking and incorporate consideration of future risks to a bank, as compared to CAMELS ratings, which are designed to convey the state of an institution at a particular point in time.[874]

WaMu kept its 2 rating despite the five-year litany of lending, risk management, appraisal, and Long Beach deficiencies identified by OTS examiners from 2004 to 2008. It was only in February 2008, after the bank began to incur substantial losses, that OTS downgraded the bank to

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[871] Thorson prepared statement at 10, April 16, 2010 Subcommittee Hearing at 110. See also id. at 8, April 16, 2010 Subcommittee Hearing at 108.
[872] See Thorson prepared statement at 11, April 16, 2010 Subcommittee Hearing at 111.
[873] April 16, 2010 Subcommittee Hearing at 24-26.
[874] See, e.g., Rymer prepared statement at 5.

a 3. When the FDIC urged a further downgrade to a 4 rating in the summer of 2008, OTS disagreed. In September 2008, however, while still resisting the ratings downgrade, OTS acknowledged internally that WaMu's poor quality loans and poor risk management were the source of its problems:

> "The bank's overall unsatisfactory condition is primarily the result of the poor asset quality and operating performance in the bank's major Home Loans Group area of business. ... The deteriorating asset quality in the Home Loans Group is accompanied by inadequacies in risk management, internal controls, and oversight that made more vulnerable to the current housing and economic downturn. The examination criticized past liberal home loan underwriting practices and concentrated delivery of nontraditional mortgage products to higher risk geographic markets."[875]

It was only on September 18, 2008, after the bank began to run out of the cash needed to conduct its affairs and the FDIC independently downgraded the bank to a 4, that OTS finally agreed to the downgrade. One week later, OTS placed the bank into receivership.

Hindsight establishes that the CAMELS ratings assigned to Washington Mutual Bank were inflated. Whether the ratings inflation was attributable to the OTS culture of deference to management, examiners who were too intimidated to downgrade the agency's largest institution, an overly narrow regulatory focus that was blinded by WaMu's short term profits and ignored systemic risk, or an absence of forward-looking risk analysis, the WaMu collapse suggests that the CAMELS rating system did not work as it should.

(e) Fee Issues

During the investigation, when asked why OTS senior officials were not tougher on Washington Mutual Bank, several persons brought up the issue of fees – that WaMu supplied $30 million or nearly 15% of the fees per year that paid for OTS' operating expenses. WaMu's former Chief Risk Officer James Vanasek offered this speculation:

> "I think you have to look at the fact that Washington Mutual made up a substantial portion of the assets of the OTS and one wonders if the continuation of the agency would have existed had Washington Mutual failed."[876]

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[875] 9/11/2008 OTS document, "WaMu Ratings of 3/343432," Polakoff_Scott-00065325, Hearing Exhibit 4/16-48.

[876] April 13, 2010 Subcommittee Hearing at 40 (Testimony of James Vanasek).

The issue was also raised by Treasury IG Thorson who warned that OTS should have been "very clear from top to bottom" that WaMu's payment of $30 million in fees per year to OTS was "not a factor. It just [was] not."[877]

The OCC and OTS are the only federal banking regulators reliant on fees paid by their regulated entities to fund their operations. At OTS, Washington Mutual was far larger than any other thrift overseen by the agency and was a far larger and more important contributor to the agency's budget. It is possible that the agency's oversight was tempered by recognition of the thrift's unique importance to the agency's finances and a concern that tough regulation might cause WaMu to convert its charter and switch to a different regulator. Its dependence on WaMu fees may have given OTS the incentive to avoid subjecting WaMu to regulatory enforcement actions and ultimately compromised its judgments.

Conclusion. WaMu is the largest bank failure in the history of the United States. When OTS seized it, WaMu had $307 billion in assets. By comparison, the next largest U.S. bank failure was Continental Illinois, which had $40 billion in assets when it collapsed in 1984. OTS' failure to act allowed Washington Mutual to engage in unsafe and unsound practices that cost borrowers their homes, led to a loss of confidence in the bank, and sent hundreds of billions of dollars of toxic mortgages into the financial system with its resulting impact on financial markets at large. Even more sobering is the fact that WaMu's failure was large enough that, if the bank had not been purchased by JPMorgan Chase, it could have exhausted the entire Deposit Insurance Fund which then contained about $45 billion. Exhausting the Deposit Insurance Fund could have triggered additional panic and loss of confidence in the U.S. banking system and financial markets.

(2) Other Regulatory Failures

Washington Mutual was not the only failed thrift overseen by OTS. In 2008, OTS closed the doors of five thrifts with combined assets of $354 billion.[878] Another seven thrifts holding collective assets of $350 billion were sold or declared bankruptcy.[879] Virtually all of these thrifts conducted high risk lending, accumulated portfolios with high risk assets, and sold high risk, poor quality mortgages to other financial institutions and investors. At the Subcommittee hearing, the Treasury

[877] See April 16, 2010 Subcommittee Hearing at 25.
[878] 1/2009 Center for Responsible Lending report, "The Second S&L Scandal," at 1, Hearing Exhibit 4/16-84.
[879] Id.

Inspector General testified that, after completing 17 reviews and working on another 33 reviews of a variety of failed financial institutions, he could say that OTS' lack of enforcement action was "not unique to WaMu" and lax enforcement by the relevant federal banking regulator was "not unique to OTS."[880]

Mortgage lenders other than banks also failed. Many of these mortgage lenders had operated as private firms, rather than as depository institutions, and were not overseen by any federal or state bank regulator. Some were overseen by the SEC; others were not overseen by any federal financial regulator. Some became large companies handling billions of dollars in residential loans annually, yet operated under minimal and ineffective regulatory oversight. When residential loans began to default in late 2006, and the subprime securitization market dried up in 2007, these firms were unable to sell their loans, developed liquidity problems, and went out of business. Together, these failed mortgage lenders, like the failed thrifts, contributed to systemic risk that damaged the U.S. banking system, U.S. financial markets, and the U.S. economy as a whole.

(a) Countrywide

Countrywide Financial Corporation, now a division of Bank of America and known as Bank of America Home Loans, was formerly the largest independent mortgage lender in the United States and one of the most prolific issuers of subprime mortgages.[881] For a number of years, Countrywide operated as a national bank under the OCC. In March 2007, it converted to a thrift charter and operated for its last 18 months under the regulatory supervision of OTS.[882] At its height, Countrywide had approximately $200 billion in assets, 62,000 employees, and issued in excess of $400 billion in residential mortgages each year. In 2008, Countrywide originated nearly 20% of all mortgages in the United States.[883] But in August 2008, after the collapse of the subprime secondary market, Countrywide could no longer sell or securitize its subprime loans and was unable to obtain replacement financing, forcing

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[880] April 16, 2010 Subcommittee Hearing at 18 (Testimony of Treasury IG Thorson). The Treasury IG also reviewed, for example, failed banks overseen by the OCC.
[881] See, e.g., "Mortgage Lender Rankings by Residential Originations," charts prepared by MortgageDaily.com, http://www.mortgagedaily.com/MortgageLenderRanking.asp (indicating Countrywide was one of the top three issuers of U.S. residential mortgages from 2003 to 2008); "A Mortgage Crisis Begins to Spiral, and the Casualties Mount," New York Times (3/5/2007).
[882] 3/5/2007 OTS press release, "OTS Approves Countrywide Application," http://www.ots.treas.gov/_files/777014.html.
[883] OCC, "Annual Report: Fiscal Year 2009," http://www.occ.gov/static/publications/annrpt/2009AnnualReport.pdf.

the bank into a liquidity crisis.[884] By the end of the summer of 2008, it would have declared bankruptcy, but for its sale to Bank of America for $2.8 billion.[885]

Neither the OCC nor OTS ever filed a public enforcement action against the bank. In June 2009, the SEC filed suit against the three most senior Countrywide executives, the chief executive officer, the chief operating officer and president, and the chief financial officer, charging them with fraudulently misleading investors by representing that Countrywide had issued loans primarily to "prime" or low risk borrowers, when it had actually written increasingly risky loans that senior executives knew would result in substantial defaults and delinquencies.[886] In addition, the SEC charged that CEO Angelo Mozilo had violated his federal disclosure obligations and engaged in insider trading.[887]

The SEC complaint detailed the bank's increasingly risky underwriting and lending practices from 2005 to 2007, including its use of stated income loans, loan-to-value ratios in excess of 95%, loans to borrowers with low FICO scores, frequent use of loan exceptions, and willingness to match the loan terms of any competitor. Like WaMu, from 2003 to 2007, the bank switched from issuing primarily low risk, 30-year loans, to subprime and other high risk mortgages.[888]

The complaint also described how Mr. Mozilo was internally alarmed and critical of the increased credit risks that Countrywide was incurring, while at the same time telling investors that the bank was more prudent than its competitors.[889] The SEC complaint cited, for example, an April 2006 email from Mr. Mozilo discussing Countrywide's issuance of subprime 80/20 loans, which are loans that have no down payment and are comprised of a first loan for 80% of the home's value and a second loan for the remaining 20% of the value, resulting in a loan-to-value ratio of 100%. Mr. Mozilo wrote: "In all my years in the business I have never seen a more toxic pr[o]duct."[890] In another email that same month, after being informed that most borrowers were making the minimum payments allowed on Option ARM loans, Mr. Mozilo wrote: "Since over 70% have opted to make the lower payment it appears it is just a matter of time that we will be faced with much higher resets and therefore much higher

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[884] See, e.g., SEC v. Mozilo, Case No. CV09-03994 (USDC CD Calif.), Complaint (June 4, 2009), at ¶¶ 102-104 (hereinafter "SEC Complaint against Countrywide Executives").
[885] "Countrywide Financial Corporation," New York Times (10/15/2010).
[886] SEC Complaint against Countrywide Executives.
[887] Id.
[888] See, e.g., SEC Complaint against Countrywide Executives, at ¶¶ 17-19.
[889] See, e.g., id. at ¶¶ 6-7.
[890] Id. at ¶ 50.

delinquencies."[891] Later he warned that the bank was "flying blind" on the ultimate delinquency rate and should consider selling the loans.[892] The SEC complaint also stated:

> "Mozilo went on to write that he had 'personally observed a serious lack of compliance within our origination system as it relates to documentation and generally a deterioration in the quality of loans originated versus the pricing of those loan[s].' Mozilo noted that, 'In my conversations with Sambol [Countrywide's chief operating officer] he calls the 100% sub prime seconds as the 'milk' of the business. Frankly, I consider that product line to be the poison of ours."[893]

On October 15, 2010, the SEC announced a record settlement with the three Countrywide executives.[894] Mr. Mozilo agreed to pay $22.5 million to settle the disclosure fraud allegations and $45 million to settle the insider trading allegations, bringing his total settlement to $67.5 million.[895] He also agreed to be permanently barred from serving as an officer or director of a publicly traded corporation. Countrywide's former chief operating officer paid $5.5 million and agreed to a three-year bar. The chief financial officer paid $130,000 and agreed to a one-year bar on practicing before the SEC.

In June 2010, in a case brought by the Federal Trade Commission, Countrywide agreed to pay penalties of $108 million for charging inflated mortgage servicing fees to homeowners in delinquency, including excessive fees to inspect property or mow lawns for people struggling to keep their homes.[896] In August 2010, Countrywide and some former executives agreed to pay $600 million to settle several class action lawsuits.[897]

(b) IndyMac

IndyMac Bank was established in 1985 by Countrywide co-founders Angelo Mozilo and David Loeb. While its lines of business changed over time, in 2000, it became a chartered thrift overseen by OTS, and grew to become the country's ninth-largest originator of

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[891] Id. at ¶ 63.
[892] Id. at ¶ 68-69.
[893] Id. at ¶ 49.
[894] 10/15/2010 SEC Press Release, "Former Countrywide CEO Angelo Mozilo to Pay SEC's Largest-Ever Financial Penalty Against a Public Company's Senior Executive," http://www.sec.gov/news/press/2010/2010-197.htm.
[895] Id.
[896] 6/7/2010 U.S. Federal Trade Commission press release, "Countrywide Will Pay $108 Million for Overcharging Struggling Homeowners; Loan Servicer Inflated Fees, Mishandled Loans of Borrowers in Bankruptcy," http://www.ftc.gov/opa/2010/06/countrywide.shtm.
[897] See, e.g., "$600 Million Countrywide Settlement," Associated Press (8/3/2010).

residential mortgage loans.[898] IndyMac specialized in two types of high risk home loans, Alt A loans which did not require verification or documentation of the borrower's income, assets or employment; and Option ARM loans which allowed borrowers to pay less than the fully amortized cost of the mortgage. From 2004 to 2006, Option ARMs made up 75% of IndyMac's home loans and, in 2006, IndyMac allowed 75% of its Option ARM borrowers to make only the minimum payment required by the loan, triggering negative amortization. In addition to originating loans, IndyMac packaged them into securities and sold them on the secondary market.[899]

In July 2007, after the credit rating agencies downgraded the ratings on most subprime mortgage backed securities and the subprime secondary market collapsed, IndyMac – like WaMu – was left holding a large inventory of poor quality mortgage loans it could not sell. As delinquencies increased and the value of the mortgages fell, IndyMac incurred substantial losses, and its depositors began withdrawing funds. The withdrawals continued throughout 2007 and into 2008, eventually reaching $1.55 billion and triggering a liquidity crisis at the bank.[900] In July 2008, IndyMac collapsed and was seized by the FDIC, which had to pay more than $10 billion from the Deposit Insurance Fund to protect insured deposits and pay related expenses.[901]

As it did with WaMu, OTS gave IndyMac high CAMELS ratings until shortly before the thrift's failure, despite the fact that OTS had identified numerous problems with IndyMac's subprime mortgage business practices.[902] Those problems included adopting an overly narrow definition of "subprime," so that IndyMac could maintain a lower level of capital reserves;[903] poor underwriting and sloppy property appraisal practices;[904] and improper risk mitigation.[905] Neither OTS nor the FDIC ever took a public enforcement action against the bank.

After IndyMac's failure, the Treasury Inspector General conducted a review and issued a report evaluating OTS' oversight efforts.[906] The

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[898] 2/26/2009 Office of Inspector General, Dept. of the Treasury Audit Report, "Safety and Soundness: Material Loss Review of IndyMac Bank," at 40, http://www.treasury.gov/about/organizational-structure/ig/Documents/oig09032.pdf (hereinafter "IG Report on IndyMac Bank").
[899] Id. at 7.
[900] Id. at 3.
[901] Id. at 1.
[902] Id. at 8.
[903] Id. at 18.
[904] Id. at 21-31.
[905] Id.
[906] Id. In addition to the Material Loss Review, the Treasury Inspector General investigated OTS' conduct in permitting thrifts, including IndyMac to backdate certain capital infusions. See 12/22/2008 Office of the Inspector General, Dept. of the Treasury, Letter to Ranking Member Charles Grassley, Senate Committee on Finance,

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report attributed IndyMac's collapse to its strategy of rapid growth; originating and securitizing nontraditional, high risk loans; lack of verification of borrowers' income or assets; lax underwriting; and reliance on high interest loans for its own operations.[907] The Treasury IG found that OTS was aware of IndyMac's problems, but did not take sufficient enforcement action to correct them.[908] According to the Inspector General, OTS typically relied on the "cooperation of IndyMac management to obtain needed improvements" – which was usually not forthcoming – to remedy identified problems.[909]

In February 2011, the SEC charged three former senior IndyMac executives with securities fraud for misleading investors about the company's deteriorating financial condition.[910] The SEC alleged that the former CEO and two former CFOs participated in the filing of false and misleading disclosures about the financial stability of IndyMac and its main subsidiary, IndyMac Bank F.S.B. One of the executives – S. Blair Abernathy, former CFO – has agreed to settle the SEC's charges without admitting or denying the allegations for approximately $125,000. The SEC's complaint against former CEO Michael W. Perry and former CFO A. Scott Keys seeks, among other things, disgorgement, financial penalties, and a bar on their acting as an officer or director of a publicly traded corporation.[911]

IndyMac was the third-largest bank failure in U.S. history and the largest collapse of a FDIC-insured depository institution since 1984.[912] At the time of its collapse, IndyMac had $32 billion in assets and $19 billion in deposits, of which approximately $18 billion were insured by the FDIC.[913] IndyMac's failure cost the FDIC $10.7 billion,[914] a figure

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http://media.washingtonpost.com/wp-srv/business/documents/Indymac_Thorson_122308pdf.pdf?sid=ST2008122202386. Darrel Dochow was removed from his position as Director of the OTS West Division for having allowed IndyMac to backdate a capital contribution of $18 million, which made it appear stronger than it really was in the relevant financial statement. Then Acting OTS Director Scott Polakoff was also placed on leave during the backdating investigation, but he disputed that he directed anyone to allow backdated capital injections and asserted that the real impetus for his being placed on leave was his Congressional testimony critical of the agency's conduct related to AIG. Subcommittee interview of Scott Polakoff (3/16/10).

[907] 3/31/2009 Office of the Inspector General, Dept. of the Treasury, "Semiannual Report to Congress," at 15, http://www.treasury.gov/about/organizational-structure/ig/Documents/sar042009.pdf.

[908] Id. at 31.

[909] Id. at 38.

[910] 2/11/2011 SEC press release, "SEC Charges Former Mortgage Lending Executives With Securities Fraud," http://www.sec.gov/news/press/2011/2011-43.htm.

[911] Id.

[912] "The Fall of IndyMac," CNNMoney.com (7/13/2008).

[913] Id.

[914] 3/31/2010 Office of Inspector General, Dept. of the Treasury, "Semiannual Report to Congress," http://www.treasury.gov/about/organizational-structure/ig/Documents/March%202010%20SAR%20Final%20%20(04-30-10).pdf.

which, at the time, represented over 10% of the federal Deposit Insurance Fund.[915]

(c) New Century

New Century Financial Corporation is an example of a failed mortgage lender that operated largely without federal or state oversight, other than as a publicly traded corporation overseen by the SEC. New Century originated, purchased, sold, and serviced billions of dollars in subprime residential mortgages, operating not as a bank or thrift, but first as a private corporation, then as a publicly traded corporation, and finally, beginning in 2004, as a publicly traded Real Estate Investment Trust (REIT).[916] By 2007, New Century had approximately 7,200 employees, offices across the country, and a loan production volume of $51.6 billion, making it the second largest subprime lender in the country.[917] Because it did not accept deposits or have insured accounts, it was not overseen by any federal or state bank regulator.

In 2007, after the company announced its intent to restate its 2006 financial results, investors lost confidence in the company, its stock plummeted, and New Century collapsed. In April 2007, it filed for bankruptcy.[918] In February 2008, the bankruptcy examiner released a detailed report that found New Century was responsible for "significant improper and imprudent practices related to its loan originations, operations, accounting and financial reporting processes."[919] Like WaMu, New Century had engaged in a number of harmful mortgage practices, including "increasing loan originations, without due regard to the risks associated with that business strategy"; risk layering in which it issued high risk loans to high risk borrowers, including originating in excess of 40% of its loans on a stated income basis; allowing multiple exceptions to underwriting standards; and utilizing poor risk management practices that relied on the company's selling or securitizing its high risk mortgages rather than retaining them.

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[915] "Crisis Deepens as Big Bank Fails; IndyMac Seized in Largest Bust in Two Decades," Wall Street Journal (7/12/2008).
[916] See SEC v. Morrice, Case No. SACV09-01426 (USDC CD Calif.), Complaint (Dec. 7, 2009), ¶¶ 12-13 (hereinafter "SEC Complaint against New Century Executives"). See also In re New Century, Case No. 2:07-cv-00931-DDP (USDC CD Calif.), Amended Consolidated Class Action Complaint (March 24, 2008), at ¶¶ 55-58 (hereinafter "New Century Class Action Complaint").
[917] In re New Century TRS Holdings, Inc., Case No. 07-10416 (KJC) (US Bankruptcy Court, Del.), 2/29/2008 Final Report of Michael J. Missal, Bankruptcy Court Examiner, at 2, http://graphics8.nytimes.com/packages/pdf/business/Final_Report_New_Century.pdf (hereinafter "New Century Bankruptcy Report"). See also New Century Class Action Complaint at ¶ 59-60.
[918] In re New Century TRS Holdings, Inc., Case No. 07-10416 (KJC) (US Bankruptcy Court, Del.).
[919] New Century Bankruptcy Report.

After New Century's bankruptcy, a 2007 class action complaint was filed by the New York State Teachers' Retirement System and others alleging that New Century executives had violated federal securities laws and committed fraud.[920] Among other matters, the complaint alleged that the company sold poor quality loans that incurred early payment defaults, received numerous demands from third party buyers of the loans to repurchase them, and built up a huge backlog of hundreds of millions of dollars in repurchase requests that the company deliberately delayed paying to make its 2005 and 2006 financial results appear better than they actually were.[921] The complaint also alleged that New Century issued loans using lax underwriting standards to maximize loan production,[922] and "routinely and increasingly lent money to people who were unable to repay the debt shortly after the loans were closed."[923] The suit took note of a news article stating: "Loans made by New Century, which filed for bankruptcy protection in March, have some of the highest default rates in the industry."[924]

In December 2009, the SEC filed a civil complaint charging three former New Century executives, the CEO, CFO, and controller, with fraudulent accounting that misled investors about the company's finances.[925] The SEC alleged that, while the company's financial disclosures painted a picture that the company's performance exceeded that of its peers, its executives had failed to disclose material negative information, such as significant increases in its loans' early payment defaults and a backlog of loan repurchases, which had the effect of materially overstating the company's financial results. The SEC complaint also stated that, although New Century had represented itself as a prudent subprime lender, it "soon became evident that its lending practices, far from being 'responsible,' were the recipe for financial disaster."[926] The complaint detailed a number of high risk lending practices, including the issuance of interest only loans; 80/20 loans with loan-to-value ratios of 100%; and stated income loans in which the borrower's income and assets were unverified.[927] The complaint charged the New Century executives with downplaying the riskiness of the company's loans and concealing their high delinquency rates.

In July 2010, the three former New Century executives settled the SEC complaint for about $1.5 million, without admitting or denying

[920] New Century Class Action Complaint.
[921] Id. at ¶¶ 75-79.
[922] Id. at ¶ 112. See also ¶¶ 126-130.
[923] Id. at ¶ 113. See also ¶¶ 114-116.
[924] Id. at ¶ 123.
[925] SEC Complaint against New Century Executives; See also 12/7/2009 SEC Press Release, "SEC Charges Former Offices of Subprime Lender New Century With Fraud."
[926] SEC Complaint against New Century Executives at 3.
[927] See, e.g., SEC Complaint against New Century Executives at ¶¶ 24-32.

wrongdoing.[928] Each also agreed to be barred from serving as an officer or director of any publicly traded corporation for five years. A larger group of about a dozen former New Century officers and directors settled several class action and other shareholder lawsuits for $88.5 million.[929]

In 2007, New Century reported publicly that it was under criminal investigation by the U.S. Attorney's Office for the Central District of California, but no indictment of the company or any executive has been filed.[930]

(d) Fremont

Fremont Investment & Loan was once the fifth largest subprime mortgage lender in the United States.[931] At its peak in 2006, it had $13 billion in assets, 3,500 employees, and nearly two dozen offices.[932] Fremont Investment & Loan was neither a bank nor a thrift, but an "industrial loan company" that issued loans and held insured deposits.[933] It was owned by Fremont General Credit Corporation which was owned, in turn, by Fremont General Corporation. In 2007, the bank was the subject of an FDIC cease and desist order which identified multiple problems with its operations and ordered the bank to cease its subprime lending.[934] In 2008, due to insufficient capital, the FDIC ordered Fremont General Corporation to either recapitalize the bank or sell it. The bank was then sold to CapitalSource, Inc.[935] In June 2008, Fremont General Corporation declared bankruptcy under Chapter 11 and has since reorganized as Signature Group Holdings, Inc.[936]

As a California based industrial loan company, Fremont Investment & Loan was overseen by the California Department of Financial Institutions, a state bank regulator. Since it had deposits that were federally insured, Fremont was also regulated by the FDIC.[937] The

[928] See 7/30/2010 SEC Litigation Release No. 21609, "SEC Settles With Former Officers of Subprime Lender New Century, " http:www.sec.gov/litigation/litreleases/2010/lr21609.htm.
[929] See, e.g., "New Century Ex-leaders to Pay $90 Million in Settlements," Los Angeles Times (7/31/2010).
[930] See 3/12/2007 New Century Financial Corporation Form 8-K, Item 8.01.
[931] "Fremont Ordered by FDIC to Find Buyer; Curbs Imposed," Bloomberg (3/28/2010), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=atIgi9otRZ3k.
[932] 3/2006 Fremont General Corporation Form 10-K filed with the SEC.
[933] Id.
[934] In re Fremont Investment & Loan, Order to Cease and Desist, Docket No. FDIC-07-035b (March 7, 2007) (hereinafter "Fremont Cease and Desist Order").
[935] In re Fremont Investment & Loan, Supervisory Prompt Corrective Action Directive, Docket No. FDIC-08-069 PCAS (March 26, 2008); "CapitalSource, Inc.," Hoover's Company Records. See also "CapitalSource to Acquire Fremont's Retail Arm," New York Times (4/14/2008).
[936] In re Fremont General Corporation, Case No. 8:08-bk-13421-ES (US Bankruptcy Court, CD Calif.), First Status Report (July 30, 2010) (included in 7/30/2010 Fremont General Corporation 8K filing with the SEC).
[937] 2006 Fremont 10-K Statement with the SEC.

March 2007 FDIC cease and desist order required the bank to end its subprime lending business, due to "unsafe and unsound banking practices and violations of law," including operating with "a large volume of poor quality loans"; "unsatisfactory lending practices"; "excessive risk"; and inadequate capital.[938] The FDIC also determined that the bank lacked effective risk management practices, lacked adequate mortgage underwriting criteria, and was "approving loans with loan-to-value ratios approaching or exceeding 100 percent of the value of the collateral."[939]

Many of the specific practices cited in the cease and desist order mirror the FDIC and OTS criticisms of WaMu. For example, the FDIC determined that Fremont was "marketing and extending adjustable-rate mortgage ('ARM') products to subprime borrowers in an unsafe and unsound manner that greatly increase[d] the risk that borrowers will default"; "qualifying borrowers for loans with low initial payments based on an introductory or 'start' rate that will expire after an initial period"; "approving borrowers without considering appropriate documentation and/or verification of the their income"; and issuing loans with "features likely to require frequent refinancing to maintain an affordable monthly payment and/or to avoid foreclosure."[940] Fremont later reported receiving default notices on $3.15 billion in subprime mortgages it had sold to investors.[941]

One year later, in March 2008, the FDIC filed another public enforcement action against the bank, for failing to provide an acceptable capital restoration plan or obtaining sufficient capital, and ordered the bank's parent company to either adequately capitalize the bank within 60 days or sell it.[942] The bank was then sold to CapitalSource, Inc.

The FDIC took action against Fremont much earlier – in March 2007 – than other regulators did with respect to other financial institutions, including OTS' nonpublic enforcement actions against WaMu in March and September 2008; the FDIC's seizure of IndyMac in July 2008; the SEC's action against Countrywide in June 2009; and the SEC's action against New Century in December 2009. By putting an

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[938] Fremont Cease and Desist Order at 1-3. See also 3/7/2007 FDIC press release, "FDIC Issues Cease and Desist Order Against Fremont Investment & Loan, Brea, California, and its Parents."
[939] Fremont Cease and Desist Order at 2-4.
[940] Id. at 3.
[941] See 3/4/2008 Fremont General Corporation press release, "Fremont General Corporation Announces Receipt of Notice of Covenant Default With Respect to Guaranties Issued in Connection With Certain Prior Residential Sub-Prime Loan Sale Transactions," http://media.corporate-ir.net/media_files/irol/10/106265/08-03-04N%20FGCAnnouncesDefaultNoticewithRRELoanTransactions.pdf. See also "CapitalSource to Acquire Fremont's Retail Arm," New York Times (4/14/2008).
[942] In re Fremont Investment & Loan, Supervisory Prompt Corrective Action Directive, Docket No. FDIC-08-069 PCAS (March 26, 2008).

early end to Fremont's subprime lending, the FDIC stopped it from selling additional poor quality mortgage backed securities into U.S. securitization markets.

In November 2008, the OCC researched the ten metropolitan areas with the highest foreclosure rates and identified the ten lenders in each area with the most foreclosed loans; Long Beach, Countrywide, IndyMac, New Century, and Fremont all made the list of the "Worst Ten in the Worst Ten."[943] Moody's, the credit rating agency, later calculated that, in 2006 alone, Long Beach, New Century, and Fremont were responsible for 24% of the residential subprime mortgage backed securities issued, but 50% of the subsequent credit rating downgrades of those securities.[944] The fact is that each of these lenders issued billions of dollars in high risk, poor quality home loans. By allowing these lenders, for years, to sell and securitize billions of dollars in poor quality, high risk home loans, regulators permitted them to contaminate the secondary market and introduce systemic risk throughout the U.S. financial system.

E. Preventing Regulatory Failures

Regulators stood on the sidelines as U.S. mortgage lenders introduced increasingly high risk mortgage products into the U.S. mortgage market. Stated income loans, NINA loans, and so-called "liar loans" were issued without verifying the borrower's income or assets. Alt A loans also had reduced documentation requirements. Interest-only loans, Option ARMs, and hybrid ARMs involved charging low introductory interest rates on loans that could be refinanced before much higher interest rates took effect. Negative amortization loans – loans that became bigger rather than smaller over time – became commonplace. Home equity loans and lines of credit, piggybacks and silent seconds, 100% financing – all involved loans that required the borrower to make virtually no down payment or equity investment in the property, relying instead on the value of the property to ensure repayment of the loan. All of these loans involved higher risks than the 30-year and 15-year fixed rate mortgages that dominated the U.S. mortgage market prior to 2004. When property values stopped climbing in late 2006, these higher risk loans began incurring delinquencies, losses, and defaults at record rates.

A number of new developments have occurred in the past several years to address the problems highlighted throughout this Report.

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[943] See 11/13/2008 "Worst Ten in the Worst Ten," document prepared by the OCC, Hearing Exhibit 4/13-58.

[944] 7/12/2007 "Moody's Structured Finance Teleconference and Web Cast: RMBS and CDO Rating Actions," prepared by Moody's Investors Service, Hearing Exhibit 4/23-106.

(1) New Developments

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which the President signed into law on July 21, 2010, contains many changes in the law that will be implemented over the next year. The Dodd-Frank changes include abolishing OTS, banning stated income loans, and restricting negative amortization loans. Other developments include a revised interagency agreement strengthening the FDIC's ability to conduct examinations of insured depository institutions and a new FDIC deposit insurance pricing system that requires higher risk institutions to pay higher insurance fees.

OTS Abolished. One significant new change brought about by the Dodd-Frank Act is the abolishment of the Office of Thrift Supervision. Title III of the Dodd-Frank Act reassigned OTS' duties and personnel to other agencies, primarily the Office of the Comptroller of the Currency (OCC).[945] Although some OTS officials claim the law intended OTS to be a merger partner with the OCC, the statute is clear in its intent to abolish OTS, rather than effect a merger of equals.

Revised Interagency Agreement. A second important change is that the interagency agreement that guides when the FDIC can examine an insured institution was altered to give the FDIC increased authority. Under federal law, the FDIC can conduct an examination of an insured depository institution "whenever the [FDIC] Board of Directors determines a special examination ... is necessary to determine the condition of such depository institution for insurance purposes."[946] Despite this broad statutory grant of examination authority, in 2002, the FDIC agreed to limit the circumstances in which it would examine banks subject to regulation by another agency. The resulting interagency agreement essentially required the FDIC to establish that an institution was at "heightened risk" of causing loss to the Deposit Insurance Fund before the FDIC could compel another banking regulator to allow the FDIC to participate in an examination of its operations. OTS used that agreement to impede the FDIC's participation in examinations of WaMu.

In 2010, the FDIC renegotiated that agreement with the other financial regulators, and they signed a revised version that will facilitate more cooperation on a less bureaucratic and more timely basis.[947]

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945 See, e.g., Section 312 of the Dodd-Frank Act.

946 12 U.S.C. § 1820(b)(3).

947 9/17/2010 letter from FDIC Chairman Sheila C. Bair to the Subcommittee, PSI-FDIC-13-000001 ("Enclosed please find a signed copy of a revised and much-strengthened memorandum of understanding among the FDIC and other bank regulators which will greatly enhance our ability to continually access and monitor information related to our risks as deposit insurer. I believe this is a very strong agreement and one which we accomplished due in no small part to

Compared to the 2002 version, the revised agreement explicitly provides for special examinations of a broader scope of insured depository institutions. It also streamlined the process for resolving differences in CAMELS ratings between financial regulators. In the case of WaMu, this new process would have helped facilitate a quicker response to WaMu's deteriorating condition. Additionally, the new agreement establishes a continuous on-site FDIC presence, with five or more examiners, at certain large institutions, including those that receive ratings under the FDIC's Large Insured Depository Institutions Program. This new provision ensures the FDIC has consistent access to information about big banks that, by virtue of their size, pose the most risk to the Deposit Insurance Fund. Finally, after first discussing it with the primary federal regulator, the FDIC is permitted to gather information directly from financial institutions. These provisions will help ensure that the FDIC can obtain the information needed to safeguard the Deposit Insurance Fund.

Risk Factors in Insurance Fees. Under a new FDIC deposit insurance pricing system that takes effect in 2011, large depository institutions with higher risk activities will be required to pay higher fees into the Deposit Insurance Fund.[948] This new assessment system is designed to "better capture risk at the time large institutions assume the risk, to better differentiate among institutions for risk and take a more forward-looking view of risk, [and] to better take into account the losses that the FDIC may incur if such an insured depository institution fails."[949] It is the product of both past FDIC revisions and changes to the insurance fund assessment system made by the Dodd-Frank Act.[950] It is intended to impose higher assessments on large banks "with high-risk asset concentrations, less stable balance sheet liquidity, or potentially higher loss severity in the event of failure," and impose those higher assessments when the banks "assume these risks rather than when conditions deteriorate."[951] Under this new system, banks with higher risk activities will be assessed higher fees, not only to safeguard the insurance fund and allocate insurance costs more fairly, but also to help discourage high risk activities.

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the work of your Subcommittee in identifying weaknesses in the supervisory processes leading up to the failure of Washington Mutual.").

948 See 2/7/2011 FDIC Final Rule of Assessments, Dividends, Assessment Base and Large Bank Pricing, RIN 3064.

949 Id.

950 See Sections 331, 332 and 334 of the Dodd-Frank Act.

951 2/7/2011 FDIC press release, "FDIC Approves Final Rule of Assessments, Dividends, Assessment Base and Large Bank Pricing," http://www.fdic.gov/news/news/press/2011/pr11028.html.

Financial Stability Oversight Council. The Dodd-Frank Act has also established a new intra-governmental council, the Financial Stability Oversight Council (FSOC), to identify systemic risks and respond to emerging threats to the stability of the U.S. financial system.[952] The council is comprised of ten existing regulators in the financial services sector, including the Chairman of the Federal Reserve Board of Governors, the Chairman of the FDIC, and the Comptroller of the Currency, and is chaired by the Secretary of the Treasury. This Council is intended to ensure that U.S. financial regulators consider the safety and soundness of not only individual financial institutions, but also of U.S. financial markets and systems as a whole.

(2) Recommendations

To further strengthen oversight of financial institutions to reduce risk, protect U.S. financial markets and the economy, and safeguard the Deposit Insurance Fund, this Report makes the following recommendations.

1. **Complete OTS Dismantling.** The Office of the Comptroller of the Currency (OCC) should complete the dismantling of the Office of Thrift Supervision (OTS), despite attempts by some OTS officials to preserve the agency's identity and influence within the OCC.

2. **Strengthen Enforcement.** Federal banking regulators should conduct a review of their major financial institutions to identify those with ongoing, serious deficiencies, and review their enforcement approach to those institutions to eliminate any policy of deference to bank management, inflated CAMELS ratings, or use of short term profits to excuse high risk activities.

3. **Strengthen CAMELS Ratings.** Federal banking regulators should undertake a comprehensive review of the CAMELS ratings system to produce ratings that signal whether an institution is expected to operate in a safe and sound manner over a specified period of time, asset quality ratings that reflect embedded risks rather than short term profits, management ratings that reflect any ongoing failure to correct identified deficiencies, and composite ratings that discourage systemic risks.

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[952] See Title I, Subtitle A, of the Dodd-Frank Act establishing the Financial Stability Oversight Council, including Section 112(a) which provides its purposes and duties.

4. **Evaluate Impacts of High Risk Lending.** The Financial Stability Oversight Council should undertake a study to identify high risk lending practices at financial institutions, and evaluate the nature and significance of the impacts that these practices may have on U.S. financial systems as a whole.

V. INFLATED CREDIT RATINGS: CASE STUDY OF MOODY'S AND STANDARD & POOR'S

Moody's Investors Service, Inc. (Moody's) and Standard & Poor's Financial Services LLC (S&P), the two largest credit rating agencies (CRAs) in the United States, issued the AAA ratings that made residential mortgage backed securities (RMBS) and collateralized debt obligations (CDOs) seem like safe investments, helped build an active market for those securities, and then, beginning in July 2007, downgraded the vast majority of those AAA ratings to junk status.[953] The July mass downgrades sent the value of mortgage related securities plummeting, precipitated the collapse of the RMBS and CDO secondary markets, and perhaps more than any other single event triggered the financial crisis.

In the months and years of buildup to the financial crisis, warnings about the massive problems in the mortgage industry were not adequately addressed within the ratings industry. By the time the rating agencies admitted their AAA ratings were inaccurate, it took the form of a massive ratings correction that was unprecedented in U.S. financial markets. The result was an economic earthquake from which the aftershocks continue today.

Between 2004 and 2007, taking in increasing revenue from Wall Street firms, Moody's and S&P issued investment grade credit ratings for the vast majority of the RMBS and CDO securities issued in the United States, deeming them safe investments even though many relied on subprime and other high risk home loans. In late 2006, high risk mortgages began to go delinquent at an alarming rate. Despite signs of a deteriorating mortgage market, Moody's and S&P continued for six months to issue investment grade ratings for numerous subprime RMBS and CDO securities. In July 2007, as mortgage defaults intensified and subprime RMBS and CDO securities began incurring losses, both companies abruptly reversed course and began downgrading at record numbers hundreds and then thousands of their RMBS and CDO ratings, some less than a year old. Investors like banks, pension funds, and insurance companies were suddenly forced to sell off their RMBS and CDO holdings, because they had lost their investment grade status. RMBS and CDO securities held by financial firms lost much of their value, and new securitizations were unable to find investors. The subprime RMBS market initially froze and then collapsed, leaving investors and financial firms around the world holding unmarketable

[953] S&P issues ratings using the "AAA" designation; Moody's equivalent rating is "Aaa." For ease of reference, this Report will refer to both ratings as "AAA."

subprime RMBS securities plummeting in value. A few months later, the CDO market collapsed as well.

Traditionally, investments holding AAA ratings have had a less than 1% probability of incurring defaults. But in the financial crisis, the vast majority of RMBS and CDO securities with AAA ratings incurred substantial losses; some failed outright. Investors and financial institutions holding those AAA securities lost significant value. Those widespread losses led, in turn, to a loss of investor confidence in the value of the AAA rating, in the holdings of major U.S. financial institutions, and even in the viability of U.S. financial markets. Inaccurate AAA credit ratings introduced systemic risk into the U.S. financial system and constituted a key cause of the financial crisis.

The Subcommittee's investigation uncovered a host of factors responsible for the inaccurate credit ratings issued by Moody's and S&P. One significant cause was the inherent conflict of interest arising from the system used to pay for credit ratings. Credit rating agencies were paid by the Wall Street firms that sought their ratings and profited from the financial products being rated. The rating companies were dependent upon those Wall Street firms to bring them business and were vulnerable to threats that the firms would take their business elsewhere if they did not get the ratings they wanted. Rating standards weakened as each credit rating agency competed to provide the most favorable rating to win business and greater market share. The result was a race to the bottom.

Additional factors responsible for the inaccurate ratings include rating models that failed to include relevant mortgage performance data, unclear and subjective criteria used to produce ratings, a failure to apply updated rating models to existing rated transactions, and a failure to provide adequate staffing to perform rating and surveillance services, despite record revenues. Compounding these problems were federal regulations that required the purchase of investment grade securities by banks and others, thereby creating pressure on the credit rating agencies to issue investment grade ratings. Still another factor were the Securities and Exchange Commission's (SEC) regulations which required use of credit ratings by Nationally Recognized Statistical Rating Organizations (NRSRO) for various purposes but, until recently, resulted in only three NRSROs, thereby limiting competition.[954]

[954] See, e.g., 1/2003 "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," prepared by the SEC, at 5-6 (explaining how the SEC came to rely on NRSRO credit ratings); 9/3/2009 "Credit Rating Agencies and Their Regulation," report prepared by the Congressional Research Service, Report No. R40613 (revised report issued 4/9/2010) (finding that, prior to the 2006 Credit Rating Agency Reform Act, "[t]he SEC never defined the term NRSRO or specified how a CRA might become one. Its

Evidence gathered by the Subcommittee shows that credit rating agencies were aware of problems in the mortgage market, including an unsustainable rise in housing prices, the high risk nature of the loans being issued, lax lending standards, and rampant mortgage fraud. Instead of using this information to temper their ratings, the firms continued to issue a high volume of investment grade ratings for mortgage backed securities. If the credit rating agencies had issued ratings that accurately exposed the increasing risk in the RMBS and CDO markets and appropriately adjusted existing ratings in those markets, they might have discouraged investors from purchasing high risk RMBS and CDO securities, slowed the pace of securitizations, and as a result reduced their own profits. It was not in the short term economic self interest of either Moody's or S&P to provide accurate credit ratings for high risk RMBS and CDO securities, because doing so would have hurt their own revenues. Instead, the credit rating agencies' profits became increasingly reliant on the fees generated by issuing a large volume of investment grade ratings.

Looking back after the first shock of the crisis, one Moody's managing director offered this critical self analysis:

> "[W]hy didn't we envision that credit would tighten after being loose, and housing prices would fall after rising, after all most economic events are cyclical and bubbles inevitably burst. Combined, these errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both."[955]

A. Subcommittee Investigation and Findings of Fact

For more than one year, the Subcommittee conducted an in-depth investigation of the role of credit rating agencies in the financial crisis, using as case histories Moody's and S&P. The Subcommittee subpoenaed and reviewed hundreds of thousands of documents from both companies including reports, analyses, memoranda, correspondence, and email, as well as documents from a number of financial institutions that obtained ratings for RMBS and CDO securities. The Subcommittee also collected and reviewed documents from the SEC and reports produced by academics and government agencies on credit rating issues. In addition, the Subcommittee

approach has been described as essentially one of 'we know-it-when-we-see-it.' The resulting limited growth in the pool of NRSROs was widely believed to have helped to further entrench the three dominant CRAs: by some accounts, they have about 98% of total ratings and collect 90% of total rating revenue." 9/3/2009 version of the report at 2-3).

[955] 9/2007 anonymous Moody's Managing Director after a Moody's Town Hall meeting on the financial crisis, at 763, Hearing Exhibit 4/23-98.

conducted nearly two dozen interviews with current and former Moody's and S&P executives, managers, and analysts, and consulted with credit rating experts from the SEC, Federal Reserve, academia, and industry. On April 23, 2010, the Subcommittee held a hearing and released 100 hearing exhibits.[956]

In connection with the hearing, the Subcommittee released a joint memorandum from Chairman Levin and Ranking Member Coburn summarizing the investigation into the credit rating agencies and the problems with the credit ratings assigned to RMBS and CDO securities. The memorandum contained joint findings regarding the role of the credit rating agencies in the Moody's and S&P case histories, which this Report reaffirms. The findings of fact are as follows.

1. **Inaccurate Rating Models.** From 2004 to 2007, Moody's and S&P used credit rating models with data that was inadequate to predict how high risk residential mortgages, such as subprime, interest only, and option adjustable rate mortgages, would perform.

2. **Competitive Pressures.** Competitive pressures, including the drive for market share and need to accommodate investment bankers bringing in business, affected the credit ratings issued by Moody's and S&P.

3. **Failure to Re-evaluate.** By 2006, Moody's and S&P knew their ratings of RMBS and CDOs were inaccurate, revised their rating models to produce more accurate ratings, but then failed to use the revised model to re-evaluate existing RMBS and CDO securities, delaying thousands of rating downgrades and allowing those securities to carry inflated ratings that could mislead investors.

4. **Failure to Factor in Fraud, Laxity, or Housing Bubble.** From 2004 to 2007, Moody's and S&P knew of increased credit risks due to mortgage fraud, lax underwriting standards, and unsustainable housing price appreciation, but failed adequately to incorporate those factors into their credit rating models.

5. **Inadequate Resources.** Despite record profits from 2004 to 2007, Moody's and S&P failed to assign sufficient resources to adequately rate new products and test the accuracy of existing ratings.

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[956] "Wall Street and the Financial Crisis: The Role of Credit Rating Agencies," before the U.S. Senate Permanent Subcommittee on Investigations, S.Hrg. 11-673 (4/23/2010) (hereinafter "April 23, 2010 Subcommittee Hearing").

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6. **Mass Downgrades Shocked Market.** Mass downgrades by Moody's and S&P, including downgrades of hundreds of subprime RMBS over a few days in July 2007, downgrades by Moody's of CDOs in October 2007, and actions taken (including downgrading and placing securities on credit watch with negative implications) by S&P on over 6,300 RMBS and 1,900 CDOs on one day in January 2008, shocked the financial markets, helped cause the collapse of the subprime secondary market, triggered sales of assets that had lost investment grade status, and damaged holdings of financial firms worldwide, contributing to the financial crisis.

7. **Failed Ratings.** Moody's and S&P each rated more than 10,000 RMBS securities from 2006 to 2007, downgraded a substantial number within a year, and, by 2010, had downgraded many AAA ratings to junk status.

8. **Statutory Bar.** The SEC is barred by statute from conducting needed oversight into the substance, procedures, and methodologies of the credit rating models.

9. **Legal Pressure for AAA Ratings.** Legal requirements that some regulated entities, such as banks, broker-dealers, insurance companies, pension funds, and others, hold assets with AAA or investment grade credit ratings, created pressure on credit rating agencies to issue inflated ratings making assets eligible for purchase by those entities.

B. Background

(1) Credit Ratings Generally

Credit ratings, which first gained prominence in the late 1800s, are supposed to provide independent assessments of the creditworthiness of particular financial instruments, such as a corporate bond, mortgage backed security, or CDO. Essentially, credit ratings predict the likelihood that a debt will be repaid.[957]

The United States has three major credit rating agencies: Moody's, S&P, and Fitch Rating Ltd., each of which is a NRSRO. By some accounts, these three firms issue about 98% of total credit ratings and collect 90% of total credit rating revenue.[958]

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[957] 9/3/2009 "Credit Rating Agencies and Their Regulation," report prepared by the Congressional Research Service, Report No. R40613 (revised report issued 4/9/2010).
[958] Id.

Paying for Ratings. Prior to the 1929 crash, credit rating agencies made money by charging subscription fees to investors who were considering investing in the financial instruments being rated. This method of payment was known as the "subscriber-pays" model. Following the 1929 crash, the credit rating agencies fell out of favor. As one academic expert has explained:

> "Investors were no longer very interested in purchasing ratings, particularly given the agencies' poor track record in anticipating the sharp drop in bond values beginning in late 1929. … The rating business remained stagnant for decades."[959]

In 1970, the credit rating agencies changed to an "issuer-pays" model and have used it since.[960] In this model, the party seeking to issue a financial instrument, such as a bond or security, pays the credit rating agency to analyze the credit risk and assign a credit rating to the financial instrument.

Credit Ratings. Credit ratings use a scale of letter grades, from AAA to C, with AAA ratings designating the safest investments and the other grades designating investments at greater risk of default.[961] Investments with AAA ratings have historically had low default rates. For example, S&P reported that its cumulative RMBS default rate by original rating class (through September 15, 2007) was 0.04% for AAA initial ratings and 1.09% for BBB.[962] Financial instruments bearing AAA through BBB- ratings are generally called "investment grade," while those with ratings below BBB- (or Baa3) are referred to as "below investment grade" or sometimes as "junk" investments. Financial instruments that default receive a D rating from S&P, but no rating at all by Moody's.

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[959] "How and Why Credit Rating Agencies Are Not Like Other Gatekeepers," Frank Partnoy, University of San Diego Law School Legal Studies Research Paper Series (5/2006), at 63.
[960] 9/3/2009 "Credit Rating Agencies and Their Regulation," report prepared by the Congressional Research Service, Report No. R40613 (revised report issued 4/9/2010). A few small credit rating agencies use the "subscriber-pays" model. However, 99% of outstanding credit ratings are issued by agencies using the "issuer-pays" model. 1/2011 "Annual Report on Nationally Recognized Statistical Rating Organizations," report prepared by the SEC, at 6.
[961] The Moody's rating system is similar in concept but with a slightly different naming convention. For example its top rating scale is Aaa, Aa1, Aa2, Aa3, A1, A2, A3.
[962] Prepared statement of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, "The Role of Credit Rating Agencies in the Structured Finance Market," before U.S. House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Cong.Hrg. 110-62 (9/27/2007), S&P SEN-PSI 0001945-71, at 51. See also 1/2007 S&P document, "Annual 2006 Global Corporate Default Study and Ratings Transitions."

Investors often rely on credit ratings to gauge the safety of a particular investment. A former senior credit analyst at Moody's explained that investors use ratings to:

> "satisfy any number of possible needs: institutional investors such as insurance companies and pension funds may have portfolio guidelines or requirements, investment fund portfolio managers may have risk-based capital requirements or investment committee requirements. And of course, private investors lacking the resources to do separate analysis may use the published ratings as their principal determinant of the risk of the investment."[963]

Legal Requirements. Some state and federal laws restrict the amount of below investment grade bonds that certain investors can hold, such as pension funds, insurance companies, and banks. Banks, for example, are limited by law in the amount of non-investment grade bonds they can hold, and are sometimes required to post additional capital for those higher risk instruments.[964] Broker-dealers and money market funds that register with the SEC operate under similar restrictions.[965] The rationale behind these legal requirements is to require or provide economic incentives for banks and other financial institutions to purchase investments that have been identified as liquid and "safe" by an independent third party with a high level of market expertise, such as a credit rating agency. Because so many federal and state statutes and regulations require the purchase of investment grade ratings, issuers of securities and other instruments work hard to obtain favorable credit ratings to ensure regulated financial institutions can buy their products. As a result, those legal requirements not only increased the demand for investment grade ratings, but also created pressure on credit rating agencies to issue top ratings in order to make the rated products eligible for purchase by regulated financial institutions. The

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[963] Prepared statement of Richard Michalek, Former VP/Senior Credit Officer, Moody's Investors Service, April 23, 2010 Subcommittee Hearing, at 2. See also 8/29/2006 email from Greg Lippmann, (Deutsche Bank), to Paolo Pellegrini (Paulson & Co.) and others, DBSI_PSI_EMAIL01625848 at 52 ("Since a CDO without a triple-A-rated senior tranche would be unmarketable, their imprimatur is indispensable."); 11/13/2007 email from Ralph Silva (Goldman Sachs), GS MBS-E-010023525, Tri-Lateral Combined Comments Attachment, GS MBS-E-01035693-715, at 713 ("Investors in subprime related securities, especially higher rated bonds, have historically relied significantly on bond ratings particularly when securities are purchased by structured investing vehicles."); M&T Bank Corporation v. Gemstone CDO VII, Ltd., Index No. 200800764 (N.Y. Sup.), Complaint, (June 16, 2008) at 12.

[964] See, e.g., Section 28 (d) and (e) of the Federal Deposit Insurance Act, codified at 12 U.S.C. § 1831e(d)-(e).

[965] See, e.g., Rule 15c3-1 of the Securities Exchange Act of 1934 (allowing broker-dealers to avoid "haircuts" for net capital requirements provided they hold instruments with investment grade credit ratings); and Rule 2a-7 of the Investment Company Act of 1940 (limiting money market funds to investments in "high quality" securities).

legal requirements also generated more work and greater profits for the credit rating agencies.

CRA Oversight and Accountability. The credit rating agencies are currently subject to regulation by the SEC. In September 2006, Congress enacted the Credit Rating Agency Reform Act, P.L. 109-291, to require SEC oversight of the credit rating industry. Among other provisions, the law charged the SEC with designating NRSROs and defined that term for the first time. By 2008, the SEC had granted NRSRO status to ten credit rating agencies (CRA).[966] The Act also directed the SEC to conduct examinations of the CRAs, while at the same time prohibiting the SEC from regulating the substance, criteria, or methodologies used in credit rating models.[967]

Prior to the 2006 Reform Act, CRAs had been subject to uneven or limited regulatory oversight by state and federal agencies. The SEC had developed the NRSRO system, for example, but had no clear statutory basis for establishing that system or exercising regulatory authority over the credit rating agencies. Because the requirements for the NRSRO designation were not defined in law, the SEC had designated only three rating agencies, limiting competition. No government agency conducted routine examinations of the credit rating agencies or the procedures they used to rate financial products.

In addition, private investors have generally been unable to hold CRAs accountable for poor quality ratings or other malfeasance through civil lawsuits.[968] The CRAs have successfully won dismissal of investor lawsuits, claiming that they are in the financial publishing business and their opinions are protected under the First Amendment.[969] In addition, the CRAs have attempted to avoid any legal liability for their ratings by making disclaimers to investors who potentially may rely on their opinions. For example, S&P's disclaimer reads in part as follows:

> "<u>Standard & Poor's Ratings</u>
> Analytic services provided by Standard & Poor's Ratings Services ('Ratings Services') are the result of separate activities designed to

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[966] The ten NRSROs are Moody's; Standard & Poor's; Fitch; A.M. Best Company, Inc.; DBRS Ltd.; Egan-Jones Rating Company; Japan Credit Rating Agency, Ltd.; LACE Financial Corp.; Rating and Investment Information, Inc.; and Realpoint LLC. 9/25/2008 "Credit Rating Agencies – NRSROs," SEC, available at http://www.sec.gov/answers/nrsro.htm.
[967] See Sections 15E(c)(2) and 17(a)(1) of the Securities Exchange Act of 1934, as amended by the Credit Rating Agency Reform Act of 2006, codified at 15 U.S.C. § 78o-7(c)(2) and § 78q(a)(1).
[968] "How and Why Credit Rating Agencies Are Not Like Other Gatekeepers," Frank Partnoy, University of San Diego Law School Legal Studies Research Paper Series (5/2006), at 61.
[969] Id.

preserve the independence and objectivity of ratings opinions. The credit ratings and observations contained herein are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Accordingly, any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision. Ratings are based on information received by Ratings Services."[970]

RMBS and CDO Ratings. Over the last ten years, Wall Street firms have devised ever more complex financial instruments for sale to investors, including the RMBS and CDO securities that played a key role in the financial crisis. Because of the complexity of the instruments, investors often relied heavily on credit ratings to determine whether they could or should buy the products. For a fee, Wall Street firms helped design the RMBS and CDO securities, worked with the credit rating agencies to obtain ratings, and sold the securities to investors like pension funds, insurance companies, university endowments, municipalities, and hedge funds.[971] Without investment grade ratings, Wall Street firms would have had a much more difficult time selling these products to investors, because each investor would have had to perform its own due diligence review of the financial instrument. Credit ratings simplified the review and enhanced sales. Here's how one federal bank regulatory handbook put it:

> "The rating agencies perform a critical role in structured finance – evaluating the credit quality of the transactions. Such agencies are considered credible because they possess the expertise to evaluate various underlying asset types, and because they do not have a financial interest in a security's cost or yield. Ratings are important because investors generally accept ratings by the major public rating agencies in lieu of conducting a due diligence investigation of the underlying assets and the servicer."[972]

In addition to making structured finance products easier to sell to investors, Wall Street firms used financial engineering to create high risk assets that were given AAA ratings – ratings which are normally reserved for ultra-safe investments with low rates of return. Firms combined high risk assets, such as the BBB tranches from subprime

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[970] Standard & Poor's ClassicDirect website, https://www.eclassicdirect.com/NASApp/cotw/CotwLogin.jsp.
[971] See 9/2009 "The Financial Crisis of 2007-2009: Causes and Circumstances," report prepared by the Task Force on the Cause of the Financial Crisis, Banking Law Committee, Section of Business Law, American Bar Association.
[972] 11/1997 Comptroller of the Currency Administrator of National Banks Comptroller's Handbook, "Asset Securitization," at 11.

mortgage backed securities paying a relatively high rate of return, in a new financial instrument, such as a CDO, that issued securities with AAA ratings and were purportedly safe investments. Higher rates of return, combined with AAA ratings, made subprime RMBS and related CDO securities especially attractive investments.

(2) The Rating Process

Prior to the massive ratings downgrade in mid-2007, the RMBS and CDO rating process followed a generally well-defined pattern. It began with the firm designing the securitization – the arranger – sending a detailed proposal to the credit rating agency. The proposal contained information on the mortgage pools involved and how the security would be structured. The rating agency examined the proposal and provided comments and suggestions, before ultimately agreeing to run the securitization through one of its models. The results from the model were used by a rating committee within the agency to determine a final rating, which was then published.

Arrangers. For RMBS, the "arranger" – typically an investment bank – initiated the rating process by sending to the credit rating agency information about a prospective RMBS and data about the mortgage loans included in the prospective pool. The data typically identified the characteristics of each mortgage in the pool including: the principal amount, geographic location of the property, FICO score, loan to value ratio of the property, and type of loan. In the case of a CDO, the process also included a review of the underlying assets, but was based primarily on the ratings those assets had already received.

In addition to data on the assets, the arranger provided a proposed capital structure for the financial instrument, identifying, for example, how many tranches would be created, how the revenues being paid into the RMBS or CDO would be divided up among those tranches, and how many of the tranches were designed to receive investment grade ratings. The arranger also identified one or more "credit enhancements" for the pool to create a financial cushion that would protect the designated investment grade tranches from expected losses.[973]

Credit Enhancements. Arrangers used a variety of credit enhancements. The most common was "subordination" in which the arranger "creates a hierarchy of loss absorption among the tranche securities."[974] To create that hierarchy, the arranger placed the pool's

[973] See, e.g., 7/2008 "Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies," report prepared by the SEC, at 6-10.
[974] Id. at 6.

tranches in an order, with the lowest tranche required to absorb any losses first, before the next highest tranche. Losses might occur, for example, if borrowers defaulted on their mortgages and stopped making mortgage payments into the pool. Lower level tranches most at risk of having to absorb losses typically received noninvestment grade ratings from the credit rating agencies, while the higher level tranches that were protected from loss typically received investment grade ratings. One key task for both the arrangers and the credit rating agencies was to calculate the amount of "subordination" required to ensure that the higher tranches in a pool were protected from loss and could be given AAA or other investment grade ratings.

A second common form of credit enhancement was "over-collateralization." In this credit enhancement, the arranger ensured that the revenues expected to be produced by the assets in a pool exceeded the revenues designated to be paid out to each of the tranches. That excess amount provided a financial cushion for the pool and was used to create an "equity" tranche, which was the first tranche in the pool to absorb losses if the expected payments into the pool were reduced. This equity tranche was subordinate to all the other tranches in the pool and did not receive any credit rating. The larger the excess, the larger the equity tranche, and the larger the cushion created to absorb losses and protect the more senior tranches in the pool. In some pools, the equity tranche was also designed to pay a relatively higher rate of return to the party or parties who held that tranche due to its higher risk.

Still another common form of credit enhancement was the creation of "excess spread," which involved designating an amount of revenue to pay the pool's monthly expenses and other liabilities, but ensuring that the amount was slightly more than what was likely needed for that purpose. Any funds not actually spent on expenses would provide an additional financial cushion to absorb losses, if necessary.

Credit Rating Models. After the arranger submitted the pool information, proposed capital structure, and proposed credit enhancements to the CRA, a CRA analyst was assigned to evaluate the proposed financial instrument. The first step that most CRA analysts took was to use a credit rating model to evaluate the rate of probable defaults or expected losses from the asset pool. Credit rating models are mathematical constructs that analyze a large number of data points related to the likelihood of an asset defaulting. RMBS rating models typically use statistical analyses of past mortgage performance data to calculate expected RMBS default rates and losses. In contrast, rather than statistics, CDO models use assumptions to build simulations that can be used to project likely CDO defaults and losses.

The major RMBS credit rating model at Moody's was called the Mortgage Metrics Model (M3), while the S&P model was called the Loan Evaluation and Estimate of Loss System (LEVELS). Both models used large amounts of statistical data related to the performance of residential mortgages over time to develop criteria to analyze and rate submitted mortgage pools. CRA analysts relied on these quantitative models to predict expected loss (Moody's) or the probability of default (S&P) for a pool of residential loans.

To derive the default or loss rate for an RMBS pool of residential mortgages, the CRA analyst typically fed a "loan tape" – most commonly a spreadsheet provided by the arranger with details on each loan – into the credit rating model. The rating model then automatically assessed the expected credit performance of each loan in the pool and aggregated that information. To perform this function, the model selected certain data points from the loan tape, such as borrower credit scores or loan-to-value ratios, and compared that information to past mortgage data using various assumptions, to determine the likely "frequency of foreclosure" and "loss severity" for the particular types of mortgages under consideration. It then projected the level of "credit enhancement," or cushion needed to protect investment grade tranches from loss.

For riskier loans, the model required a larger cushion to protect investment grade tranches from losses. For example, the model might project that 30% of the pool's incoming revenue would need to be set aside to ensure that the remaining 70% of incoming revenues would be protected from any losses. Tranches representing the 70% of the incoming revenues could then receive AAA ratings, while the remaining 30% of incoming revenues could be assigned to support the payment of expenses, an equity tranche, or one or more of the subordinated tranches.

In addition to using quantitative models, Moody's analysts also took into account qualitative factors in their analysis of expected default and loss rates. For example, Moody's analysts considered the quality of the originators and servicers of the loans included in a pool. Originators known for issuing poor quality loans or servicers known for providing poor quality servicing could increase the loss levels calculated for a pool by a significant degree, up to a total of 20%.[975] Moody's only began incorporating that type of analysis into its M3 ratings process in

[975] See 2008 SEC Examination Report for Moody's Investor Services Inc., PSI-SEC (Moodys Exam Report)-14-0001-16, at 2-3, footnote 5.

December 2006, only six months before the mass downgrades began.[976] In contrast, S&P analysts did not conduct this type of analysis of mortgage originators and servicers during the time period examined in this Report.[977]

Credit Analysis. After obtaining the model's projections for the cushion or subordination needed to protect the pool's investment grade tranches from loss, the CRA analyst compared that projection to the tranches and credit enhancements actually proposed for the particular pool to evaluate their sufficiency.

In addition to evaluating an RMBS pool's expected default and loss rates, credit enhancements, and capital structure, CRA analysts conducted a cash flow analysis of the interest and principal payments to be made into the proposed pool to determine that the revenue generated would be sufficient to pay the rates of return projected for each proposed tranche. CRA analysts also reviewed the proposed legal structure of the financial instrument to understand how it worked and how revenues and losses would be allocated. Some RMBS and CDO transactions included complex "waterfalls" that allocated projected revenues and expected losses among an array of expenses, tranches, and parties. The CRA analyst was expected to evaluate whether the projected revenues were sufficient for the designated purposes. The CRA review also included a legal analysis "ensuring that there was no structural risk presented due to a failure to fulfill minimally necessary legal requirements … and confirming that the deal documentation accurately and faithfully described the structure modeled by the Quant [quantitative analyst]."[978]

The process for assigning credit ratings to cash CDOs followed a similar path. CRA analysts used CDO rating models to predict the CDO's expected defaults and losses. However, unlike RMBS statistical models that used past performance data to predict RMBS default and loss rates, the CDO models relied primarily on the underlying ratings of the assets as well as on a set of assumptions, such as asset correlation, and ran multiple simulations to predict how the CDO pool would perform. The CDO simulation model at Moody's was called

[976] Id. See also 7/2008 "Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies," report prepared by the Securities and Exchange Commission, at 35, n.70.
[977] In November 2008, after the time period examined in this Report, S&P published enhanced criteria requiring the quality of mortgage originators and their underwriting processes to be factored into its RMBS rating analyses. 6/24/2010 supplemental letter from S&P to the Subcommittee, Hearing Exhibit 4/23-108, Exhibit W, 11/25/2008 "Standard &Poor's Enhanced Mortgage Originator and Underwriting Review Criteria for U.S. RMBS."
[978] Prepared statement of Richard Michalek at 4, April 23, 2010 Subcommittee hearing.

"CDOROM," while the S&P CDO model was called the "CDO Evaluator," which was repeatedly updated, eventually to "Evaluator 3" or "E3." Both companies' CDO models analyzed the likely rates of loss for assets within a particular CDO, but neither model re-analyzed any underlying RMBS securities included within a CDO. Instead, both models simply relied on the credit rating already assigned to those securities.[979]

After calculating the CDO's default and loss rates and the cushion or subordination needed to protect the pool's investment grade tranches from loss, the CRA analyst examined the CDO's capital structure, credit enhancements, cash flow, and legal structure, in the same manner as for an RMBS pool.

Evidence gathered by the Subcommittee indicates that it was common for a CRA analyst to speak with the arranger or issuer of an RMBS or CDO to gather additional information and discuss how a proposed financial instrument would work. Among other tasks, the analyst worked with the arranger or issuer to evaluate the cash flows, the number and size of the tranches, the size and nature of the credit enhancements, and the rating each tranche would receive. Documents obtained by the Subcommittee show that CRA analysts and investment bankers often negotiated over how specific deal attributes would affect the credit ratings of particular tranches.

Rating Recommendations. After completing analysis of a proposed financial instrument, the CRA analyst developed a rating recommendation for each proposed RMBS or CDO tranche that would be used to issue securities, and presented the recommended ratings internally to a rating committee composed of other analysts and managers within the credit rating agency. The rating committee reviewed and then voted on the analyst's recommendations. Once the committee approved the ratings, a rating committee memorandum was prepared memorializing the actions taken, and the ratings were provided to the arranger. If the arranger indicated that the issuer accepted the ratings, the credit rating agency made the ratings available publicly. If dissatisfied, the arranger could appeal a ratings decision.[980] The entire

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[979] Synthetic CDOs, on the other hand, involved a different type of credit analysis. Unlike RMBS and cash CDOs, synthetic CDOs do not contain any cash producing assets, but simply reference them. The revenues paid into synthetic CDOs do not come from mortgages or other assets, but from counterparties betting that the referenced assets will lose value or suffer a specified credit event.

[980] 7/2008 "Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies," report prepared by the Securities and Exchange Commission, at 9.

rating process typically took several weeks, sometimes longer for novel or complex transactions.

RMBS and CDO Groups. Moody's and S&P had separate groups and analysts responsible for rating RMBS and CDOs. In 2007, Moody's RMBS ratings were issued by the RMBS Group, which had about 25 analysts, while it had about 50 derivatives analysts in its Derivatives Group, whose responsibilities included rating CDOs.[981] Each group responsible for rating these products was headed by a Team Managing Director who reported to a Group Managing Director. Both the RMBS Group and the Derivatives Group were housed in the Structured Finance Group. The setup was similar at S&P. At S&P, RMBS ratings were issued by the RMBS Group, which had about 90 analysts in 2007, while CDO ratings were issued by the Global CDO Group, with about 85 analysts.[982] Each group was headed by a Managing Director, and housed in the Structured Finance Ratings Group which was headed by a Senior Managing Director.

During the years reviewed by the Subcommittee, at Moody's, the CEO and Chairman of the Board was Raymond W. McDaniel, Jr.; the Senior Managing Director of the Structured Finance Group was Brian Clarkson; the head of the RMBS Group was Pramila Gupta; and the heads of the Derivatives CDO analysts were Gus Harris and Yuri Yoshizawa. At S&P, the President was Kathleen A. Corbet; the Senior Managing Director of the Structured Finance Ratings Group was Joanne Rose; the head of the RMBS Group was Frank Raiter and then Susan Barnes; and the head of the Global CDO Group was Richard Gugliada.

Surveillance. Following an initial credit rating, both Moody's and S&P conducted ongoing surveillance of all rated securities to evaluate a product's ongoing credit risk and to determine whether its credit rating should be affirmed, upgraded, or downgraded over the life of the security. Both used automated surveillance tools that, on a monthly basis, flagged securities whose performance indicated their rating might need to be adjusted to reflect the current risk of default or loss. Surveillance analysts investigated the flagged securities and presented recommendations for rating changes to a ratings committee.

Within both the RMBS and Derivatives Groups, in 2007, Moody's had 15 RMBS surveillance analysts and 24 derivatives surveillance

[981] 3/11/2008 compliance letter from Moody's to SEC, SEC_OCIE_CRA_011212; SEC_OCIE_CRA_011214; and SEC_OCIE_CRA_011217.
[982] 3/14/2008 compliance letter from S&P to SEC, SEC_OCIE_CRA_011218-59, at 32-34, and at 43-44.

analysts, respectively.[983] S&P maintained a Structured Finance Surveillance Group that included an RMBS Surveillance Group and a CDO Surveillance Group, with about 20 analysts in each group in 2007.[984] Each of these groups was headed by a Managing Director who reported to the head of the Structured Finance Group. The Managing Director for Moody's surveillance analysts was Nicolas Weill. At S&P, the Managing Director of the Structured Finance Surveillance Group was Peter D'Erchia.

Meaning of Ratings. The purpose of a credit rating, whether stated at first issuance or after surveillance, is to forecast a security's probability of default (S&P) or expected loss (Moody's). If the security has an extremely low likelihood of default, credit rating agencies grant it AAA status. For securities with a higher probability of default, they provide lower credit ratings.

When asked about the meaning of an AAA rating, Moody's CEO Raymond McDaniel explained that it represented the safest type of investment and had the same significance across various types of financial products.[985] While all credit rating agencies leave room for error by designing procedures to downgrade or upgrade ratings over time, Moody's and S&P told the Subcommittee that their ratings are designed to take into account future performance. Prior to the financial crisis, the numbers of downgrades and upgrades for structured finance ratings were substantially lower.[986]

(3) Record Revenues

From 2004 to 2007, Moody's and S&P produced a record number of ratings and a record amount of revenues in structured finance, primarily because of RMBS and CDO ratings. A 2008 S&P submission to the SEC indicates, for example, that from 2004 to 2007, S&P issued more than 5,500 RMBS ratings and more than 835 mortgage related CDO ratings.[987] The number of ratings it issued increased each year, going from approximately 700 RMBS ratings in 2002, to more than 1,600 in 2006. Its mortgage related CDO ratings increased tenfold,

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[983] 3/11/2008 compliance letter from Moody's to SEC, SEC_OCIE_CRA_011212; SEC_OCIE_CRA_011214; and SEC_OCIE_CRA_011217.
[984] 3/14/2008 compliance letter from S&P to SEC, SEC_OCIE_CRA_011218-59, at 48-49, and at 56-57.
[985] Subcommittee interview of Raymond McDaniel (4/6/2010).
[986] See, e.g., 3/26/2010 "Fitch Ratings Global Structured Finance 2009 Transition and Default Study," prepared by Fitch.
[987] 3/14/2008 compliance letter from S&P to SEC, SEC_OCIE_CRA_011218-59, at 20. These numbers represent the RMBS or CDO pools that were presented to S&P which then issued ratings for multiple tranches per RMBS or CDO pool.

going from 34 in 2002, to over 340 in 2006.[988] Moody's experienced similar growth. According to a 2008 Moody's submission to the SEC, from 2004 to 2007, it issued over 4,000 RMBS ratings and over 870 CDO ratings.[989] Moody's also increased the ratings it issued each year, going from approximately 540 RMBS and 45 CDO ratings in 2002, to more than 1,200 RMBS and 360 CDO ratings in 2006.[990]

Both companies charged substantial fees to rate a product. To obtain an RMBS or CDO rating during the height of the market, for example, S&P charged issuers generally from $40,000 to $135,000 to rate tranches of an RMBS and from $30,000 to $750,000 to rate the tranches of a CDO.[991] Surveillance fees, which may be imposed at the initial rating or annually, ranged generally from $5,000 to $50,000 for these mortgage backed securities.[992]

Revenues increased dramatically over time as well. Moody's gross revenues from RMBS and CDO ratings more than tripled in five years, from over $61 million in 2002, to over $260 million in 2006.[993] S&P's revenue increased even more. In 2002, S&P's gross revenue for RMBS and mortgage related CDO ratings was over $64 million and increased to over $265 million in 2006.[994] In that same period, revenues from S&P's structured finance group tripled from about $184 million in 2002 to over $561 million in 2007.[995] In 2002, structured finance ratings contributed 36% to S&P's bottom line; in 2007, they made up 49% of all S&P revenues from ratings.[996] In addition, from 2000 to 2007, operating margins at the CRAs averaged 53%.[997] Altogether, revenues from the

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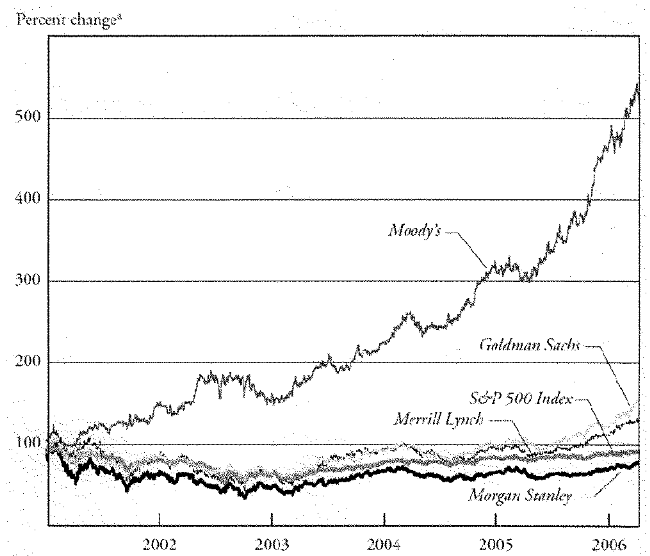
[988] Id.
[989] 3/11/2008 compliance letter from Moody's to SEC, SEC_OCIE_CRA_011212 and SEC_OCIE_CRA_011214. These numbers represent the RMBS or CDO pools that were presented to Moody's which then issued ratings for multiple tranches per RMBS or CDO pool. The data Moody's provided to the SEC on CDOs represented ABS CDOs, some of which may not be mortgage related. However, by 2004, most, but not all, CDOs relied primarily on mortgage related assets such as RMBS securities. Subcommittee interview of Gary Witt, former Managing Director of Moody's RMBS Group (10/29/2009).
[990] Id.
[991] See, e.g., "U.S. Structured Ratings Fee Schedule Residential Mortgage-Backed Financings and Residential Servicer Evaluations," prepared by S&P, S&P-PSI 0000028-35; and "U.S. Structured Ratings Fee Schedule Collateralized Debt Obligations Amended 3/7/2007," prepared by S&P, S&P-PSI 0000036-50.
[992] Id.
[993] 3/11/2008 compliance letter from Moody's to SEC, SEC_OCIE_CRA_011212 and SEC_OCIE_CRA_011214. The 2002 figure does not include gross revenue from CDO ratings as this figure was not readily available due to the transition of Moody's accounting systems.
[994] 3/14/2008 compliance letter from S&P to SEC, SEC_OCIE_CRA_011218-59, at 18-19.
[995] Id. at 19.
[996] Id.
[997] "Debt Watchdogs: Tamed or Caught Napping?" New York Times (12/7/2008). The operating margin is a ratio used to measure a company's operating efficiency and is calculated by dividing operating income by net sales.

three leading credit rating agencies more than doubled from nearly $3 billion in 2002 to over $6 billion in 2007.[998]

Both companies also saw their share prices shoot up. The chart below reflects the significant price increase that Moody's shares experienced as a result of increased revenues during the years of explosive growth in the ratings of both RMBS and CDOs.[999] Moody's percentage gain in share price far outpaced the major investment banks on Wall Street from 2002 to 2006.

HOW CREDIT RATING AGENCIES DIFFER FROM OTHER GATEKEEPERS 67

Figure 3-1. *Change in Moody's Share Price versus S&P 500 versus Major Investment Banks*



Source: http://finance.yahoo.com

Standard & Poor's is a division of The McGraw-Hill Companies (NYSE: MHP), whose share price also increased significantly during this time period.[1000]

[998] "Revenue of the Three Credit Rating Agencies: 2002-2007," chart prepared by Subcommittee using data from thismatter.com/money, Hearing Exhibit 4/23-1g.
[999] "How and Why Credit Rating Agencies Are Not Like Other Gatekeepers," Frank Partnoy, University of San Diego Law School Legal Studies Research Paper Series (5/2006), at 67.
[1000] See "The McGraw-Hill Companies, Inc.," Google Finance, http://www.google.com/finance?q=mcgraw+hill.

Top CRA executives received millions of dollars each year in compensation. Moody's CEO, Raymond McDaniel, for example, earned more than $8 million in total compensation in 2006.[1001] Brian Clarkson, the head of Moody's structured finance group, received $3.8 million in total compensation in the same year.[1002] Upper and middle managers also did well. Moody's managing directors made between $385,000 to about $460,000 in compensation in 2007, before stock options. Including stock options, their total compensation ranged from almost $700,000 to over $930,000.[1003] S&P managers received similar compensation.[1004]

C. Mass Credit Rating Downgrades

In the years leading up to the financial crisis, Moody's and S&P together issued investment grade ratings for tens of thousands of RMBS and CDO securities, earning substantial sums for issuing these ratings. In mid-2007, however, both credit rating agencies suddenly reversed course and began downgrading hundreds, then thousands of RMBS and CDO ratings. These mass downgrades shocked the financial markets, contributed to the collapse of the subprime RMBS and CDO secondary markets, triggered sales of assets that had lost investment grade status, and damaged holdings of financial firms worldwide. Perhaps more than any other single event, the sudden mass downgrades of RMBS and CDO ratings were the immediate trigger for the financial crisis.

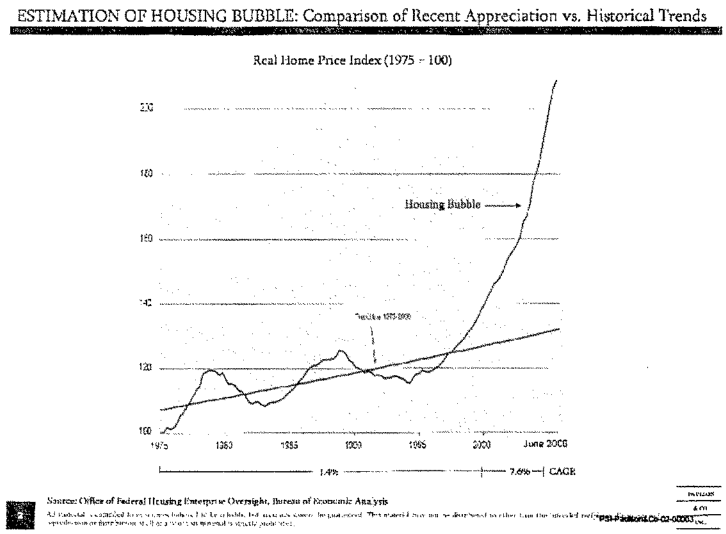
To understand why the credit rating agencies suddenly reversed course and how their RMBS and CDO ratings downgrades impacted the financial markets, it is useful to review trends in the housing and mortgage backed security markets in the years leading up to the crisis.

(1) Increasing High Risk Loans and Unaffordable Housing

The years prior to the financial crisis saw increasing numbers of borrowers buying not only more homes than usual, but higher priced homes, requiring larger and more frequent loans that were constantly refinanced. By 2005, about 69% of Americans had purchased homes, the largest percentage in American history.[1005] In the five-year period running up to 2006, the median home price, adjusted for inflation,

[1001] 3/19/2008 Moody's 2008 Proxy Statement, "Summary Compensation Table."
[1002] Id.
[1003] 4/27/2007 email from Yuri Yoshizawa to Noel Kirnon, PSI-MOODYS-RFN-000044 (Attachment, PSI-MOODYS-RFN-000045).
[1004] See S&P's "Global Compensation Guidelines 2007/2008," S&P-SEC 067708, 067733, 067740, and 067747.
[1005] See 3/1/2006 "Housing Vacancies and Homeownership Annual Statistics: 2005," U.S. Census Bureau.

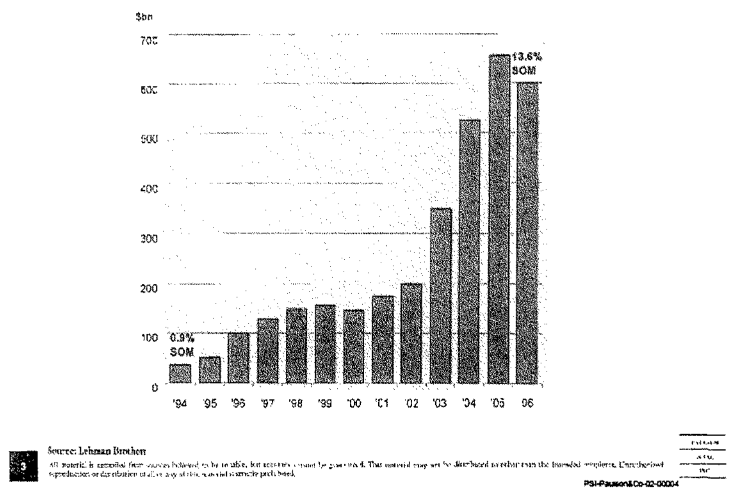
increased 50 percent.[1006] The pace of home price appreciation was on an unsustainable trajectory, as is illustrated by the chart below.[1007]



Subprime lending fueled the overall growth in housing demand and housing price increases that began in the late 1990s and ran through mid-2006.[1008] "Between 2000 and 2007, backers of subprime mortgage-backed securities – primarily Wall Street and European investment banks – underwrote $2.1 trillion worth of [subprime mortgage backed securities] business, according to data from trade publication *Inside Mortgage Finance*."[1009] By 2006, subprime lending made up 13.5% of mortgage lending in the United States, a fivefold increase from 2001.[1010] The graph below reflects the unprecedented growth in subprime mortgages between 2003 and 2006.[1011]

[1006] "Housing Bubble Trouble," The Weekly Standard (4/10/2006).
[1007] 1/25/2010, "Estimation of Housing Bubble: Comparison of Recent Appreciation vs. Historical Trends," chart prepared by Paulson & Co. Inc., Hearing Exhibit 4/23-1j.
[1008] See 3/2009 U.S. Department of Housing and Urban Development Interim Report to Congress, "Root Causes of the Foreclosure Crisis," at 36. See also "A Brief History of Credit Rating Agencies: How Financial Regulation Entrenched this Industry's Role in the Subprime Mortgage Debacle of 2007 – 2008," Mercatus on Policy (10/2009), at 2.
[1009] "The Roots of the Financial Crisis: Who is to Blame?" The Center for Public Integrity (5/6/2009), http://www.publicintegrity.org/investigations/economic_meltdown/articles/entry/1286.
[1010] 3/2009 U.S. Department of Housing and Urban Development Interim Report to Congress, "Root Causes of the Foreclosure Crisis," at 7.
[1011] 1/25/2010, "Mortgage Subprime Origination," chart prepared by Paulson & Co. Inc., PSI-Paulson&Co-02-0001-21, at 4.

MORTGAGE SUBPRIME ORIGINATION



To enable subprime borrowers to buy homes that they would not traditionally qualify for, lenders began using exotic mortgage products that reduced or eliminated the need for large down payments and allowed monthly mortgage payments that reflected less than the fully amortized cost of the loan. For example, some types of mortgages allowed borrowers to obtain loans for 100% of the cost of a house; make monthly payments that covered only the interest owed on the loan; or pay artificially low initial interest rates on loans that could be refinanced before higher interest rates took effect. In 2006, Barron's reported that first-time home buyers put no money down 43% of the time in 2005; interest only loans made up approximately 33% of new mortgages and home equity loans in 2005, up from 0.6% in 2000; by 2005, 15% of borrowers owed at least 10% more than their home was worth; and more than $2.5 trillion in adjustable rate mortgages were due to reset to higher interest rates in 2006 and 2007.[1012]

These new mortgage products were not confined to subprime borrowers; they were also offered to prime borrowers who used them to purchase expensive homes. Many borrowers also used them to refinance their homes and take out cash against their homes' increased value. Lenders also increased their issuance of home equity loans and lines of credit that offered low initial interest rates or interest-only features, often taking a second lien on an already mortgaged home.[1013]

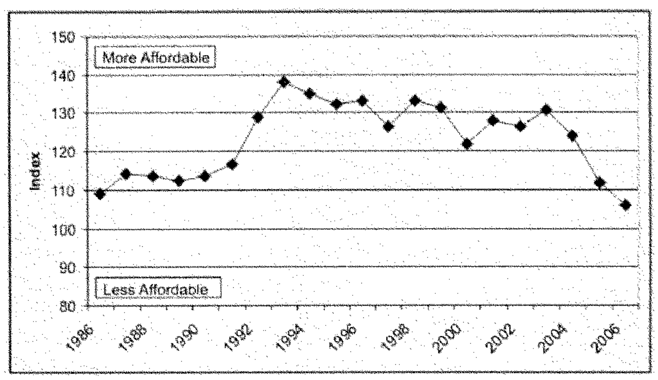
[1012] "The No-Money-Down Disaster," Barron's (8/21/2006).

[1013] 3/2009 U.S. Department of Housing and Urban Development Interim Report to Congress, "Root Causes of the Foreclosure Crisis," at 8.

Subprime loans, Alt A mortgages that required little or no documentation, and home equity loans all posed a greater risk of default than traditional 30-year, fixed rate mortgages. By 2006, the combined market share of these higher risk home loans totaled nearly 50% of all mortgage originations.[1014]

At the same time housing prices and high risk loans were increasing, the National Association of Realtors' housing affordability index showed that, by 2006, housing had become less affordable than at any point in the previous 20 years, as presented in the graph below.[1015] The "affordability index" measures how easy it is for a typical family to afford a typical mortgage. Higher numbers mean that homes are more affordable, while lower numbers mean that homes are generally less affordable.

Figure 2. Housing Affordability Index, 1986-2006



Source: National Association of Realtors.

Notes: Affordability index is based on median house prices, median family income, and mortgage rates, using a composite of fixed and adjustable mortgage rates. The index defines higher values as more affordable.

By the end of 2006, the concentration of higher risk loans for less affordable homes had set the stage for an unprecedented number of credit rating downgrades on mortgage related securities.

(2) Mass Downgrades

Although ratings downgrades for investment grade securities are supposed to be relatively infrequent, in 2007, they took place on a massive scale that was unprecedented in U.S. financial markets. Beginning in July 2007, Moody's and S&P downgraded hundreds and then thousands of RMBS and CDO ratings, causing the rated securities

[1014] Id.
[1015] 11/7/2007 "Would a Housing Crash Cause a Recession?" report prepared by the Congressional Research Service, at 3-4.

to lose value and become much more difficult to sell, and leading to the subsequent collapse of the RMBS and CDO secondary markets. The massive downgrades made it clear that the original ratings were not only deeply flawed, but the U.S. mortgage market was much riskier than previously portrayed.

Housing prices peaked in 2006. In late 2006, as the increase in housing prices slowed or leveled out, refinancing became more difficult, and delinquencies in subprime residential mortgages began to multiply. By January 2007, nearly 10% of all subprime loans were delinquent, a 68% increase from January 2006.[1016] Housing prices then began to decline, exposing more borrowers who had purchased homes that they could not afford and could no longer refinance. Subprime lenders also began to close their doors, which the U.S. Department of Housing and Urban Development marked as the beginning of economic trouble:

> "Arguably, the first tremors of the national mortgage crisis were felt in early December 2006 when two sizeable subprime lenders, Ownit Mortgage Solutions and Sebring Capital, failed. The Wall Street Journal described the closing of these firms as 'sending shock waves' through the mortgage-bond market. ... By late February 2007 when the number of subprime lenders shuttering their doors had reached 22, one of the first headlines announcing the onset of a 'mortgage crisis' appeared in the Daily Telegraph of London."[1017]

During the first half of 2007, despite the news of failing subprime lenders and increasing subprime mortgage defaults, Moody's and S&P continued to issue AAA credit ratings for a large number of RMBS and CDO securities. In the first week of July 2007 alone, S&P issued over 1,500 new RMBS ratings, a number that almost equaled the average number of RMBS ratings it issued in each of the preceding three months.[1018] From July 5 to July 11, 2007, Moody's issued approximately 675 new RMBS ratings, nearly double its weekly average in the prior month.[1019] The timing of this surge of new ratings on the eve of the mass downgrades is troubling, and raises serious questions

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[1016] 1/25/2010 "60 Day+Delinquency and Foreclosure," chart prepared by Paulson & Co. Inc., PSI-Paulson&Co-02-0001-21, at 15. Subcommittee interview of Sihan Shu (2/24/2010).
[1017] 3/2009 U.S. Department of Housing and Urban Development Interim Report to Congress, "Root Causes of the Foreclosure Crisis," at 2 [citations omitted].
[1018] 6/24/2010 supplemental response from S&P to the Subcommittee, at 12, Hearing Exhibit 4/23-108.
[1019] Data compiled by the Subcommittee using 6/14/2007 "Structured Finance New Ratings: May 28, 2007 through June 13, 2007," Moody's; 6/28/2007 "Structured Finance New Ratings: June 11, 2007 through June 27, 2007," Moody's; 7/5/2007 "Structured Finance New Ratings: June 18, 2007 through July 4, 2007," Moody's; and 7/12/2007 "Structured Finance New Ratings: June 25, 2007 through July 11, 2007," Moody's.

about whether S&P and Moody's quickly pushed these ratings through to avoid losing revenues before the mass downgrades began.

In the second week of July 2007, S&P and Moody's initiated the first of several mass rating downgrades, shocking the financial markets. On July 10, S&P placed on credit watch, the ratings of 612 subprime RMBS with an original value of $7.35 billion,[1020] and two days later downgraded 498 of these securities.[1021] On July 10, Moody's downgraded 399 subprime RMBS with an original value of $5.2 billion.[1022] By the end of July, S&P had downgraded more than 1,000 RMBS and almost 100 CDO securities.[1023] This volume of rating downgrades was unprecedented in U.S. financial markets.

The downgrades created significant turmoil in the securitization markets, as investors were required to sell off RMBS and CDO securities that had lost their investment grade status, RMBS and CDO securities in the investment portfolios of financial firms lost much of their value, and new securitizations were unable to find investors. The subprime RMBS secondary market initially froze and then collapsed, leaving financial firms around the world holding suddenly unmarketable subprime RMBS securities that were plummeting in value.[1024]

Neither Moody's nor S&P produced any meaningful contemporaneous documentation explaining their decisions to issue mass downgrades in July 2007, disclosing how the mass downgrades by the two companies happened to occur two days apart, or analyzing the possible impact of their actions on the financial markets. When

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[1020] 6/24/2010 supplemental response from S&P to the Subcommittee, Exhibit H, Hearing Exhibit 4/23-108 (7/11/2007 "S&PCORRECT: 612 U.S. Subprime RMBS Classes Put On Watch Neg; Methodology Revisions Announced," S&P RatingsDirect (correcting the original version issued on 7/10/2007)).

[1021] 6/24/2010 supplemental response from S&P to the Subcommittee, Exhibit I, Hearing Exhibit 4/23-108 (7/12/2007 "Various U.S. First-Lien Subprime RMBS Classes Downgraded," S&P's RatingsDirect).

[1022] 7/30/2010 supplemental response from Moody's to the Subcommittee, Hearing Exhibit 4/23-106 (7/12/2007 Moody's Structured Finance Teleconference and Web Cast, "RMBS and CDO Rating Actions," at MOODYS-PSI2010-0046899-900). The $5.2 billion also included the original value of 32 tranches that were put on review for possible downgrade that same day.

[1023] 6/24/2010 supplemental response from S&P to the Subcommittee, at 3, 6, Hearing Exhibit 4/23-108. According to this letter, the July downgrades were not the first to take place during 2007. The letter reports that, altogether in the first six months of 2007, S&P downgraded 739 RMBS and 25 CDOs. These downgrades, however, took place on multiple days over a six-month period. Prior to July, Moody's had downgraded approximately 480 RMBS during the first six months of 2007 (this figure was calculated by the Subcommittee based on information from Moody's "Structured Finance: Changes & Confirmations" reports for that time period).

[1024] See 3/19/2007 "Subprime Mortgages: Primer on Current Lending and Foreclosure Issues," report prepared by the Congressional Research Service, Report No. RL33930; 5/2008 "The Subprime Lending Crisis: Causes and Effects of the Mortgage Meltdown," report prepared by CCH, at 13.

Moody's CEO, Raymond McDaniel, was asked about the July downgrades, he indicated that he could not recall any aspect of the decision-making process.[1025] He told the Subcommittee that he was merely informed that the downgrades would occur, but was not personally involved in the decision.[1026]

Although neither Moody's nor S&P produced documentation on its internal decision-making process related to the mass downgrades, one bank, UBS, produced an email in connection with a court case indicating that Moody's was meeting with a series of investment banks to discuss the upcoming downgrades. In an email dated July 5, 2007, five days before the mass downgrades began, a UBS banker sent an email to a colleague about a meeting with Moody's:

> "I just got off the phone with David Oman .... Apparently they're meeting w/ Moodys to discuss impacts of ABS subprime downgrades, etc. Has he been in contact with the [UBS] Desk? It sounds like Moodys is trying to figure out when to start downgrading, and how much damage they're going to cause – they're meeting with various investment banks."[1027]

It is unclear how much notice Moody's or S&P provided to investment banks regarding their planned actions.

One senior executive at S&P, Ian Bell, the head of European structured finance ratings, provided his own views in a post-mortem analysis a few days after the initial downgrades. He expressed frustration and concern that S&P had mishandled its public explanation of the mass downgrades, writing:

> "[O]ne aspect of our handling of the subprime that really concerns me is what I see as our arrogance in our messaging. Maybe it is because I am away from the center of the action and so have more of an 'outsider's' point of view. ...
>
> I listened to the telecon TWICE. That guy [who asked a question about the timing of the mass downgrades] was not a

[1025] Subcommittee interview of Ray McDaniel (4/6/2010).
[1026] Id. At S&P, no emails were produced that explained the decision-making process, but a few indicated that, prior to the mass downgrades, the RMBS Group was required to make a presentation to the chief executive of its parent company about "how we rated the deals and are preparing to deal with the fallout (downgrades)." 3/18/2007 email from Michael Gutierrez to William LeRoy, Hearing Exhibit 4/23-52a; 3/2007 S&P internal email chain, "Pre-empting bad press on the subprime situation," Hearing Exhibit 4/23-52c.
[1027] 7/5/2007 email from David Goldsteen (UBS) to Dayna Corlito (UBS), "ABS Subprime & Moody's downgrades," UBS-CT 021485, Hearing Exhibit 4/23-94o.

'jerk'. He asked an entirely legitimate question that we should have anticipated. He then got upset when we totally fluffed our answer. We did sound like the Nixon White House. Instead of dismissing people like him or assuming some dark motive on their part, we should ask ourselves how we could have so mishandled the answer to such an obvious question.

I have thought for awhile now that if this company suffers from an Arthur Andersen event, we will not be brought down by a lack of ethics as I have never seen an organisation more ethical, nor will it be by greed as this plays so little role in our motivations; it will be arrogance."[1028]

In August 2007, Eric Kolchinsky, a managing director of Moody's CDO analysts, sent an urgent email to his superiors about the pressures to rate still more new CDOs in the midst of the mass downgrades:

"[E]ach of our current deals is in crisis mode. This is compounded by the fact that we have introduced new criteria for ABS CDOs. Our changes are a response to the fact that we are already putting deals closed in the spring on watch for downgrade. This is unacceptable and we cannot rate the new deals in the same away [sic] we have done before. ... [B]ankers are under enormous pressure to turn their warehouses into CDO notes."[1029]

Both Moody's and S&P continued to rate new CDO securities despite their companies' accelerating downgrades.

In October 2007, Moody's began downgrading CDOs on a daily basis, using the month to downgrade more than 270 CDO securities with an original value of $10 billion.[1030] In December 2007, Moody's downgraded another $14 billion in CDOs, and placed another $105 billion on credit watch. Moody's calculated that, overall in 2007, "8725 ratings from 2116 deals were downgraded and 1954 ratings from 732 deals were upgraded," which means it issued four times as many

[1028] 7/13/2007 internal S&P email from Ian Bell to Tom Gillis and Joanne Rose, Hearing Exhibit 4/23-54a.
[1029] 8/22/2007 email from Moody's Eric Kolchinsky, "Deal Management," Hearing Exhibit 4/23-42.
[1030] 7/30/2010 supplemental response from Moody's to the Subcommittee, at 9, Hearing Exhibit 4/23-106. In an email sent in the midst of these CDO downgrades, one Moody's analyst commented to a colleague: "You're right about CDOs as WMD – but it's only CDOs backed by subprime that are WMD." 11/27/2007 email from William May to Deepali Advani, Hearing Exhibit 4/23-58.

downgrades as upgrades.[1031] S&P calculated that, during the second half of 2007, it downgraded over 9,000 RMBS ratings.[1032]

The downgrades continued into 2008. On January 30, 2008, S&P took action on over 6,300 subprime RMBS securities and over 1,900 CDO securities – meaning it either downgraded their ratings or placed the securities on credit watch with negative implications. The affected RMBS and CDO securities represented issuance amounts of approximately $270.1 billion and $263.9 billion, respectively.[1033]

The rating downgrades affected a wide range of RMBS and CDO securities. Some of the downgraded securities had been rated years earlier; others had received AAA ratings less than 12 months before. For example, in April 2007, both Moody's and S&P gave AAA ratings to three tranches of approximately $1.5 billion in a cash CDO known as Vertical ABS CDO 2007-1. Six months later, the majority of the CDO's tranches were downgraded to junk status; in 2008, the CDO's ratings were withdrawn, it assets were liquidated, and the AAA rated securities became worthless. In another case, in February and March 2007, Moody's and S&P gave AAA ratings to 5 tranches of about a $1 billion RMBS securitization known as GSAMP Trust 2007-FM2. In late 2007, both credit rating agencies began downgrading the securities; by 2008, they began downgrading the AAA rated securities, and by August 2009 S&P had downgraded all its tranches to noninvestment grade or junk status.

One more striking example involved a $1.6 billion hybrid CDO known as Delphinus CDO 2007-1, Ltd., which was downgraded a few months after its rating was issued. Moody's gave AAA ratings to seven of its tranches and S&P to six tranches in July and August 2007, respectively, but began downgrading its securities by the end of the year, and by the end of 2008, had fully downgraded its AAA rated securities to junk status.[1034]

[1031] 2/2008 "Structured Finance Ratings Transitions, 1983-2007," Credit Policy Special Comment prepared by Moody's, at 4.
[1032] 6/24/2010 supplemental response from S&P to the Subcommittee, at 6, Hearing Exhibit 4/23-108.
[1033] 6/24/2010 supplemental response from S&P to the Subcommittee, Exhibit N, Hearing Exhibit 4/23-108 (1/30/2008 "S&P Takes Action on 6,389 U.S. Subprime RMBS Ratings and 1,953 CDO Ratings," S&P's RatingsDirect).
[1034] For more details about these three examples, see "Fact Sheet for Three Examples of Failed AAA Ratings," prepared by the Subcommittee based on information from S&P and Moody's websites.

Analysts have determined that, by 2010, over 90% of subprime RMBS securities issued in 2006 and 2007 and originally rated AAA had been downgraded to junk status by Moody's and S&P.[1035]

Percent of the Original AAA Universe
Currently Rated Below Investment Grade

Vintage	Prime Fixed	Prime ARM	Alt-A Fixed	Alt-A ARM	Option ARM	Subprime
2004	**3%**	**9%**	**10%**	**17%**	**50%**	**11%**
2005	**39%**	**58%**	**73%**	**81%**	**76%**	**53%**
2006	**81%**	**90%**	**96%**	**98%**	**97%**	**93%**
2007	**92%**	**90%**	**98%**	**96%**	**97%**	**91%**

Source: BlackRock Solutions as of February 8, 2010.
Prepared by the U.S. Senate Permanent Subcommittee on Investigations, April 2010.

D. Ratings Deficiencies

The Subcommittee's investigation uncovered a host of factors responsible for the inaccurate credit ratings assigned by Moody's and S&P to RMBS and CDO securities. Those factors include the drive for market share, pressure from investment banks to inflate ratings, inaccurate rating models, and inadequate rating and surveillance resources. In addition, federal regulations that limited certain financial institutions to the purchase of investment grade financial instruments encouraged investment banks and investors to pursue and credit rating agencies to provide those top ratings. All these factors played out against the backdrop of an ongoing conflict of interest that arose from how the credit rating agencies earned their income. If the credit rating agencies had issued ratings that accurately exposed the increasing risk in the RMBS and CDO markets, they may have discouraged investors from purchasing those securities, slowed the pace of securitizations, and as a result reduced their own profits. It was not in the short term economic self-interest of either Moody's or S&P to provide accurate credit risk ratings for high risk RMBS and CDO securities.

[1035] See "Percent of the Original AAA Universe Currently Rated Below Investment Grade," chart prepared by the Subcommittee using data from BlackRock Solutions, Hearing Exhibit 4/23-1i. See also 3/2008 "Understanding the Securitization of Subprime Mortgage Credit," report prepared by Federal Reserve Bank of New York staff, no. 318, at 58 and table 31 ("92 percent of 1st-lien subprime deals originated in 2006 as well as … 91.8 percent of 2nd-lien deals originated in 2006 have been downgraded."). See also "Regulatory Use of Credit Ratings: How it Impacts the Behavior of Market Constituents," University of Westminster - School of Law International Finance Review (2/2009), at 65-104 (citations omitted) ("As of February 2008, Moody's had downgraded at least one tranche of 94.2% of the subprime RMBS issues it rated in 2006, including 100% of the 2006 RMBS backed by second-lien loans, and 76.9% of the issues rated in 2007. In its rating transition report, S&P wrote that it had downgraded 44.3% of the subprime tranches it rated between the first quarter of 2005 and the third quarter of 2007.")

(1) Awareness of Increasing Credit Risks

The evidence shows that analysts within Moody's and S&P were aware of the increasing risks in the mortgage market in the years leading up to the financial crisis, including higher risk mortgage products, increasingly lax lending standards, poor quality loans, unsustainable housing prices, and increasing mortgage fraud. Yet for years, neither credit rating agency heeded warnings – even their own – about the need to adjust their processes to accurately reflect the increasing credit risk.

Moody's and S&P began issuing public warnings about problems in the mortgage market as early as 2003, yet continued to issue inflated ratings for RMBS and CDO securities before abruptly reversing course in July 2007. Moody's CEO testified before the House Committee on Oversight and Government Reform, for example, that Moody's had been warning the market continuously since 2003, about the deterioration in lending standards and inflated housing prices.

> "Beginning in July 2003, we published warnings about the increased risks we saw and took action to adjust our assumptions for the portions of the residential mortgage backed securities ("RMBS") market that we were asked to rate."[1036]

Both S&P and Moody's published a number of articles indicating the potential for deterioration in RMBS performance.[1037] For example, in September 2005, S&P published a report entitled, "Who Will Be Left Holding the Bag?" The report contained this strong warning:

> "It's a question that comes to mind whenever one price increase after another – say, for ridiculously expensive homes – leaves each succeeding buyer out on the end of a longer and longer limb:

[1036]Prepared statement of Raymond W. McDaniel, Moody's Chairman and Chief Executive Officer, "Credit Rating Agencies and the Financial Crisis," before the U.S. House of Representatives Committee on Oversight and Government Reform, Cong.Hrg. 110-155 (10/22/2008), at 1 (hereinafter "10/22/2008 McDaniel prepared statement").

[1037] See, e.g., 6/24/2010 supplemental response from S&P to the Subcommittee, Hearing Exhibit 4/23-108 (4/20/2005 Subprime Lenders: Basking in the Glow of A Still-Benign Economy, but Clouds Forming on the Horizon" S&P; 9/13/2005 "Simulated Housing Market Decline Reveals Defaults Only in Lowest-Rated U.S. RMBS Transactions," S&P; and 1/19/2006 "U.S. RMBS Market Still Robust, But Risks Are Increasing and Growth Drivers Are Softening" S&P). "Housing Market Downturn in Full Swing," Moody's Economy.com (10/4/2006); 1/18/2007 "Special Report: Early Defaults Rise in Mortgage Securitization," Moody's ; and 9/21/2007 "Special Report: Moody's Subprime Mortgage Servicer Survey on Loan Modifications," Moody's. See 10/22/2008 McDaniel prepared statement at 13-14. In addition, in March 2007 Moody's warned of the possible effect that downgrades of subprime mortgage backed securities might have on its structured finance CDOs. See 3/2007 "The Impact of Subprime Residential Mortgage-Backed Securities on Moody's-Rated Structured Finance CDOs: A Preliminary Review," Moody's.

When the limb finally breaks, who's going to get hurt? In the red-hot U.S. housing market, that's no longer a theoretical riddle. Investors are starting to ask which real estate vehicles carry the most risk – and if mortgage defaults surge, who will end up suffering the most."[1038]

Internal Moody's and S&P emails further demonstrate that senior management and ratings personnel were aware of the deteriorating mortgage market and increasing credit risk. In June 2005, for example, an outside mortgage broker who had seen the head of S&P's RMBS Group, Susan Barnes, on a television program sent her an email warning about the "seeds of destruction" in the financial markets. He noted that no one at the time seemed interested in fixing the looming problems:

"I have contacted the OTS, FDIC and others and my concerns are not addressed. I have been a mortgage broker for the past 13 years and I have never seen such a lack of attention to loan risk. I am confident our present housing bubble is not from supply and demand of housing, but from money supply. In my professional opinion the biggest perpetrator is Washington Mutual. 1) No income documentation loans. 2) Option ARMS (negative amortization) ... 5) 100% financing loans. I have seen instances where WAMU approved buyers for purchase loans; where the fully indexed interest only payments represented 100% of borrower's gross monthly income. We need to stop this madness!!!"[1039]

Several email chains among S&P employees in the Servicer Evaluation Group in Structured Finance demonstrate a clear awareness of mortgage market problems. One from September 2006, for example, with the subject line "Nightmare Mortgages," contains an exchange with startling frankness and foresight. One S&P employee circulated an article on mortgage problems, stating: "Interesting Business Week article on Option ARMs, quoting anecdotes involving some of our favorite servicers." Another responded: "This is frightening. It wreaks of greed, unregulated brokers, and 'not so prudent' lenders."[1040] Another employee commenting on the same article said: "I'm surprised the OCC and FDIC doesn't come downharder [sic] on these guys - this is like another banking crisis potentially looming!!"[1041]

[1038] "Economic Research: Who Will be Left Holding the Bag?" S&P's RatingsDirect (9/12/2005).
[1039] 7/22/2005 email from Michael Blomquist (Resource Realty) to Susan Barnes (S&P), "Washington Mutual," Hearing Exhibit 4/23-45.
[1040] 9/2/2006 email from Robert Mackey to Richard Koch, "Nightmare Mortgages," Hearing Exhibit 4/23-46a.
[1041] 9/5/2006 email from Michael Gutierrez to Richard Koch and Edward Highland, "RE: Nightmare Mortgages," Hearing Exhibit 4/23-46b.

Another email chain that same month shows that at least some employees understood the significance of problems within the mortgage market nine months before the mass downgrades began. One S&P employee wrote: "I think [a circulated article is] telling us that underwriting fraud; appraisal fraud and the general appetite for new product among originators is resulting in loans being made that shouldn't be made. … [I]f [Eliot] Spitzer [then-New York Attorney General] could prove coercion this could be a RICO offense!" A colleague responded that the head of the S&P Surveillance Group "told me that broken down to loan level what she is seeing in losses is as bad as high 40's – low 50% I'd love to be able to publish a commentary with this data but maybe too much of a powder keg."[1042]

In a third email chain from August 2006, commenting on an article about problems in the mortgage market, a director in the S&P Servicer Evaluation Group wrote: "I'm not surprised; there has been rampant appraisal and underwriting fraud in the industry for quite some time as pressure has mounted to feed the origination machine."[1043] Another S&P director in the same group wrote in an October 2006 internal email about a news article entitled, "More Home Loans Go Sour – Though New Data Show Rising Delinquencies, Lenders Continue to Loosen Mortgage Standards": "Pretty grim news as we suspected – note also the 'mailing in the keys and walking away' epidemic has begun – I think things are going to get mighty ugly next year!"[1044] Still another S&P email the same month circulated an article entitled, "Home Prices Keep Sliding; Buyers Sit Tight," and remarked: "[J]ust curious...are there ever any positive repo[r]ts on the housing market?"[1045]

An email among several S&P employees a few months later circulated an article entitled, "The Mortgage Mess Spreads" with one person noting ominously: "This is like watching a hurricane from FL [Florida] moving up the coast slowly towards us. Not sure if we will get hit in full or get trounced a bit or escape without severe damage …."[1046]

[1042] 9/29/2006 email from Michael Gutierrez, Director at S&P, PSI-S&P-RFN-000029.
[1043] 8/7/2006 email from Richard Koch, Director at S&P, Hearing Exhibit 4/23-1d.
[1044] 10/20/2006 email from Michael Gutierrez to Richard Koch and others, Hearing Exhibit 4/23-47.
[1045] 10/26/2006 email from Ernestine Warner to Robert Pollsen, Hearing Exhibit 4/23-48.
[1046] 3/9/2007 email from KP Rajan, Hearing Exhibit 4/23-51. See also 2/14/2006 email from Robert Pollsen, PSI-S&P-RFN-000038 (forwarding "Coming Home to Roost," Barron's (2/13/2006), which includes the sentences "The red-hot U.S. housing market may be fast approaching its date with destiny …. much anxiety is being focused on a looming 'reset problem.'"); see also 3/25/2007 S&P internal email chain, PSI-S&P-RFN-000006 (forwarding "Slow-Motion Train Wreck Picks Up Speed," Barron's (3/26/2007)). 3/26/2007 Moody's internal email, PSI-S&P-RFN-000003 (forwarding "Slow-Motion Train Wreck Picks Up Speed," Barron's (3/26/2007)); 10/19/2006 Moody's internal email, PSI-MOODYS-RFN-000009 (forwarding "More Home Loans Go Sour—Though New Data Show Rising Delinquencies,

Government Warnings. At the same time the credit rating agencies were publishing reports and circulating articles internally about the deteriorating mortgage market, several government agencies issued public warnings about lax lending standards and increasing mortgage fraud. A 2004 quarterly report by the FDIC, for example, sounded an alarm over the likelihood of more high risk loan delinquencies:

> "[I]t is unlikely that home prices are poised to plunge nationwide, even when mortgage rates rise .... The greater risk to insured institutions is the potential for increased credit delinquencies and losses among highly leveraged, subprime, and ARM borrowers. These high-risk segments of mortgage lending may drive overall mortgage loss rates higher if home prices decline or interest rates rise."[1047]

In 2005, in its 11th Annual Survey on Credit Underwriting Practices, the Office of the Comptroller of the Currency (OCC), which oversees nationally chartered banks, described a significant lowering of retail lending standards, noting it was the first time in the survey's history that a net lowering of retail lending practices had been observed. The OCC wrote:

> "Retail lending has undergone a dramatic transformation in recent years as banks have aggressively moved into the retail arena to solidify market positions and gain market share. Higher credit limits and loan-to-value ratios, lower credit scores, lower minimum payments, more revolving debt, less documentation and verification, and lengthening amortizations - have introduced more risk to retail portfolios."[1048]

Starting in 2004, federal law enforcement agencies also issued multiple warnings about fraud in the mortgage marketplace. For example, the Federal Bureau of Investigation (FBI) made national headlines when it warned that mortgage fraud had the potential to be a national epidemic,[1049] and issued a 2004 report describing how mortgage fraud was becoming more prevalent. The report noted: "Criminal activity has become more complex and loan frauds are expanding to

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Lenders Continue to Loosen Mortgage Standards," The Wall Street Journal (10/19/2006)); 9/6/2006 Moody's internal email, PSI-MOODYS-RFN-000001 (forwarding "The No-Money-Down Disaster." Barron's (8/21/2006)).

[1047] "Housing Bubble Concerns and the Outlook for Mortgage Credit Quality," FDIC Outlook (Spring 2004), available at http://www.fdic.gov/bank/analytical/regional/ro20041q/na/infocus.html.

[1048] 6/2005 "Survey of Credit Underwriting Practices," report prepared by the Office of the Comptroller of the Currency, at 6, available at http://www.occ.gov/publications/publications-by-type/survey-credit-underwriting/pub-survey-cred-under-2005.pdf.

[1049] "FBI: Mortgage Fraud Becoming an 'Epidemic,'" USA Today (9/17/2004).

multitransactional frauds involving groups of people from top management to industry professionals who assist in the loan application process."[1050] The FBI also testified about the problem before Congress:

> "The potential impact of mortgage fraud on financial institutions and the stock market is clear. If fraudulent practices become systemic within the mortgage industry and mortgage fraud is allowed to become unrestrained, it will ultimately place financial institutions at risk and have adverse effects on the stock market."[1051]

In 2006, the FBI reported that the number of Suspicious Activity Reports describing mortgage fraud had risen significantly since 2001.[1052]

The FBI's fraud warnings were repeated by industry analysts. The Mortgage Bankers Association's Mortgage Asset Research Institute (MARI), for example, had been reporting increasing fraud in mortgages for years. In April 2007, MARI reported a 30% increase in 2006 in loans with suspected mortgage fraud. The report also noted that while 55% of overall fraud incidents reported to MARI involved loan application fraud, the percentage of subprime loans with loan application fraud was even higher at 65%.[1053]

Press Reports. Warnings in the national press concerning the threat posed by deteriorating mortgages and unsustainable housing prices were also prevalent. A University of Florida website has collected dozens of these articles, many of which were published in 2005. The headlines include: "Fed Debates Pricking the U.S. Housing 'Bubble'," New York Times, May 31, 2005; "Yale Professor Predicts Housing 'Bubble' Will Burst," NPR, June 3, 2005; "Cover Story: Bubble Bath of Doom" [warning of overheated real estate market], Washington Post, July 4, 2005; "Housing Affordability Hits 14-Year Low," The Wall Street Journal, December 22, 2005; "Foreclosure Rates Rise Across the U.S.," NPR, May 30, 2006; "For Sale Signs Multiply

[1050] FY 2004 "Financial Institution Fraud and Failure Report," prepared by the Federal Bureau of Investigation, available at http://www.fbi.gov/stats-services/publications/fiff_04.
[1051] Prepared statement of Chris Swecker, Assistant Director of the Criminal Investigative Division, Federal Bureau of Investigation, "Mortgage Fraud and Its Impact on Mortgage Lenders," before the U.S. House of Representatives Financial Services Subcommittee on Housing and Community Opportunity, Cong.Hrg. 108-116 (10/7/2004), at 2.
[1052] "Financial Crimes Report to the Public: Fiscal Year 2006, October 1, 2005 – September 30, 2006," prepared by the Federal Bureau of Investigation, available at http://www.fbi.gov/stats-services/publications/fcs_report2006/financial-crimes-report-to-the-public-2006-pdf/view.
[1053] 4/2007 "Ninth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association," prepared by the Mortgage Asset Research Institute, LLC, at 10.

Across U.S.," The Wall Street Journal, July 20, 2006; and "Housing Gets Ugly," New York Times, August 25, 2006.[1054]

Had Moody's and S&P heeded their own warnings as well as the warnings in government reports and the national press, they might have issued more conservative, including fewer AAA, ratings for RMBS and CDO securities from 2005 to 2007; required additional credit enhancements earlier; and issued ratings downgrades earlier and with greater frequency, gradually letting the air out of the housing bubble instead of puncturing it with the mass downgrades that began in July 2007. The problem, however, was that neither company had a financial incentive to assign tougher credit ratings to the very securities that for a short while increased their revenues, boosted their stock prices, and expanded their executive compensation. Instead, ongoing conflicts of interest, inaccurate credit rating models, and inadequate rating and surveillance resources made it possible for Moody's and S&P to ignore their own warnings about the U.S. mortgage market. In the longer run, these decisions cost both companies dearly. Between January 2007 and January 2009, the stock price for both The McGraw-Hill Companies (S&P's parent company) and Moody's fell nearly 70%, and neither share price has fully recovered.

(2) CRA Conflicts of Interest

In transitioning from the *fact* that the rating agencies issued inaccurate ratings to the question of *why* they did, one of the primary issues is the conflicts of interest inherent in the "issuer-pays" model. Under this system, the firm interested in profiting from an RMBS or CDO security is required to pay for the credit rating needed to sell the security. Moreover, it requires the credit rating agencies to obtain business from the very companies paying for their rating judgment. The result is a system that creates strong incentives for the rating agencies to inflate their ratings to attract business, and for the issuers and arrangers of the securities to engage in "ratings shopping" to obtain the highest ratings for their financial products.

The conflict of interest inherent in an issuer-pay setup is clear: rating agencies are incentivized to offer the highest ratings, as opposed to offering the most accurate ratings, in order to attract business. It is much like a person trying to sell a home and hiring a third-party appraiser to make sure it is worth the price. Only, with the credit rating agencies, it is the seller who hires the appraiser on behalf of the buyer –

[1054] "Business Library – The Housing Bubble," University of Florida George A. Smathers Libraries, http://www.uflib.ufl.edu/cm/business/cases/housing_bubble.htm.

the result is a misalignment of interests. This system, currently permitted by the SEC, underlies the "issuers-pay" model.

The credit rating agencies assured Congress and the investing public that they could "manage" these conflicts, but the evidence indicates that the drive for market share and increasing revenues, ratings shopping, and investment bank pressures have undermined the ratings process and the quality of the ratings themselves. Multiple former Moody's and S&P employees told the Subcommittee that, in the years leading up to the financial crisis, gaining market share, increasing revenues, and pleasing investment bankers bringing business to the firm assumed a higher priority than issuing accurate RMBS and CDO credit ratings.

(a) Drive for Market Share

Prior to the explosive growth in revenues generated from the ratings of mortgage backed securities, the credit rating agencies had a reputation for exercising independent judgment and taking pride in requiring the information and performing the analysis needed to issue accurate credit ratings. A journalist captured the rating agency culture in a 1995 article when she wrote: "Ask a [company's] treasurer for his opinion of rating agencies, and he'll probably rank them somewhere between a trip to the dentist and an IRS audit. You can't control them, and you can't escape them."[1055]

But a number of analysts who worked for Moody's during the 1990s and into the new decade told the Subcommittee that a major cultural shift took place at the company around 2000. They told the Subcommittee that, prior to 2000, Moody's was academically oriented and conservative in its issuance of ratings. That changed, according to those interviewed, with the rise of Brian Clarkson who worked at Moody's from 1990 to 2008, and rose from Group Managing Director of the Global Asset Backed Finance Group to President and Chief Operating Officer of Moody's. These employees indicated that during Mr. Clarkson's tenure Moody's began to focus less on striving for accurate credit ratings, and more on increasing market share and "servicing the client," who was identified as the investment banks that brought business to the firm.

This testimonial evidence that increasing revenues gained importance is corroborated by documents obtained by the Subcommittee during the course of its investigation. For example, in a March 2000

[1055] "Rating the Rating Agencies," Treasury and Risk Management (7/1995).

email, the head of Moody's Structured Finance Group in Paris wrote that she was leaving the firm, because she was uncomfortable with "the lack of a strategy I can clearly understand, other than maximize the market share and the gross margin with insufficient resources."[1056] A 2002 Moody's survey of the Structured Finance Group (SFG) also documents the shift, finding that most employees who responded to the survey indicated that SFG business objectives included: generating increased revenue; increasing market share; fostering good relationships with issuers and investors; and delivering high quality ratings and research. According to the survey results: "When asked about how business objectives were translated into day-to-day work, most agreed that writing deals was paramount, while writing research and developing new products and services received less emphasis. Most agreed that there was a strong emphasis on relationships with issuers and investment bankers."[1057]

A 2003 email sent by Mr. Clarkson to one of his senior managers about the performance of the Structured Finance Real Estate and Derivatives Group further demonstrates the firm's emphasis on market share. Mr. Clarkson wrote:

> "Noel and his team handled the increase and met or exceeded almost every financial and market share objective and goal for his Group. ... Through November total revenue for Noel's Group has grown 16% compared with budgeted growth of 10% with CMBS [Commercial Mortgage Backed Securities] up 19% and Derivatives up 14%. This was achieved by taking advantage of increased CMBS issuance volumes and by meeting or slightly exceeding market share objectives for the Group. The Derivatives team has achieved a year to date 96% market share compared to a target share of 95%. This is down approximately 2% from 2002 primarily due to not rating Insurance TRUP CDO's and rating less subordinated tranches. Noel's team is considering whether we need to refine our approach to these securities. The CMBS team was able to meet their target share of 75%. However this was down from 84% market share in 2002 primarily due to competitor's [sic] easing their standards to capture share."[1058]

[1056] 3/19/2000 email from Catherine Gerst to Debra Perry, Moody's Chief Administrative Officer, PSI-MOODYS-RFN-000039.

[1057] 5/2/2002 Moody's SFG 2002 Associate Survey, prepared by Metrus Group, at 4, Hearing Exhibit 4/23-92a.

[1058] 12/1/2003 email from Brian Clarkson to Noel Kirnon, Managing Director of Real Estate and Derivatives Group, Hearing Exhibit 4/23-15.

This performance analysis notes that the team being reviewed put up a strong performance despite competitors "easing their standards to capture [market] share." It also notes that for certain CDOs and "less subordinated tranches," Moody's might "need to refine our approach." The clear emphasis of the analysis is increasing revenues and meeting "market share objectives," and appears silent with regard to issuing accurate ratings.

One former Moody's senior vice president, Mark Froeba, told the Subcommittee that Mr. Clarkson used fear and intimidation tactics to make analysts spend less time on the ratings process and work more cooperatively with investment bankers.[1059] At the Subcommittee hearing, another former Moody's senior analyst, Richard Michalek, described a meeting that he had with Mr. Clarkson shortly after he was promoted to head of the Structured Finance Group. Mr. Michalek stated:

> "In my 'discussion,' I was told that he [Mr. Clarkson] had met with the investment banks to learn how our Group was working with the various clients and whether there were any analysts who were either particularly difficult or particularly valuable. I was named … as two of the more 'difficult' analysts who had a reputation for making 'too many' comments on the deal documentation.
>
> The conversation was quite uncomfortable, and it didn't improve when he described how he had previously had to fire [another analyst], a former leader of the Asset-Backed group who he otherwise considered a 'good guy.' He described how, because of the numerous complaints he had received about [that analyst's] extreme conservatism, rigidity and insensitivity to client perspective, he was left with no choice. … He then asked me to convince him why he shouldn't fire me. … [T]he primary message of the conversation was plain: further complaints from the 'customers' would very likely abruptly end my career at Moody's."[1060]

Several former Moody's employees have testified that Moody's employees were fired when they challenged senior management with a more conservative approach to rating RMBS and CDO securities. According to Mr. Froeba:

[1059] Subcommittee interview of Mark Froeba (10/27/2010). See also 6/2/2010 statement of Mark Froeba submitted by request to the Financial Crisis Inquiry Commission.
[1060] Prepared statement of Richard Michalek at 13-14, April 23, 2010 Subcommittee hearing.

> "[T]he fear was real, not rare and not at all healthy. You began to hear of analysts, even whole groups of analysts, at Moody's who had lost their jobs because they were doing their jobs, identifying risks and describing them accurately."[1061]

A former Managing Director, Eric Kolchinsky, one of the senior managers in charge of the business line which rated subprime backed CDOs at Moody's stated:

> "Managers of rating groups were expected by their supervisors and ultimately the Board of Directors of Moody's to build, or at least maintain, market share. It was an unspoken understanding that loss of market share would cause a manager to lose his or her job."[1062]

He described how market share concerns were addressed:

> "Senior management would periodically distribute emails detailing their departments' market share. These emails were limited to Managing Directors only. Even if the market share dropped by a few percentage points, managers would be expected to justify 'missing' the deals which were not rated. Colleagues have described enormous pressure from their superiors when their market share dipped."[1063]

A Moody's email sent in early October 2007 to Managing Directors of the CDO Group illustrates the intense pressure placed on CDO analysts to retain or increase market share, even in the midst of the onset of the financial crisis.[1064] This email reported that for CDOs:

> "Market share by deal count [had] dropped to 94%, though by volume it's 97%. It's lower than the 98+% in prior quarters. Any reason for concern, are issuers being more selective to control costs (is Fitch cheaper?) or is it an aberration[?]"[1065]

This email was sent during the same period when Moody's began downgrading CDOs on a daily basis, eventually downgrading almost 1,500 CDO securities with an original value likely in the tens of billions

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[1061] 6/2/2010 statement of Mark Froeba, submitted by request to the Financial Crisis Inquiry Commission, at 4.
[1062] Prepared Statement of Eric Kolchinsky, Former Managing Director at Moody's Investor Service, April 23, 2010 Subcommittee Hearing, at 1.
[1063] Id. at 2.
[1064] 10/5/2007 email from Sunil Surana to Yuri Yoshizawa, and others, "RE: 3Q Market Coverage-CDO," Hearing Exhibit 4/23-24a.
[1065] Id.

in the last three months of 2007 alone. Despite the internal recognition at Moody's that previously rated CDOs were at substantial risk for downgrades, the email shows management pressing the CDO Managing Directors about losing a few points of market share in the middle of an accelerating ratings disaster.

The drive for market share was similarly emphasized at S&P. One former S&P Managing Director in charge of the RMBS Ratings Group described it as follows:

> "By 2004 the structured finance department at S&P was a major source of revenue and profit for the parent company, McGraw-Hill. Focus was directed at collecting market share and revenue data on a monthly basis from the various structured finance rating groups and forwarded to the finance staff at S&P."[1066]

Numerous internal emails illustrate not only S&P's drive to maintain or increase market share, but also how that pressure negatively impacted the ratings process, placing revenue concerns ahead of ratings quality. For example, in a 2004 email, S&P management discussed the possibility of changing its CDO ratings criteria in response to an "ongoing threat of losing deals":

> "We are meeting with your group this week **to discuss adjusting criteria for rating CDOs of real estate assets this week because of the ongoing threat of losing deals**."[1067]

On another occasion, in response to a 2005 email stating that S&P's ratings model needed to be adjusted to account for the higher risks associated with subprime loans, a director in RMBS research, Frank Parisi, wrote that S&P could have released a different ratings model, LEVELS 6.0, months ago "if we didn't have to massage the sub-prime and Alt-A numbers to preserve market share."[1068] This same director wrote in an email a month later: "Screwing with criteria to 'get the deal' is putting the entire S&P franchise at risk – it's a bad idea."[1069]

A 2004 email chain among members of the S&P Analytical Policy Board, which set standards to ensure integrity for the ratings process, provides additional evidence of how market share concerns affected the

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[1066] Prepared statement of Frank Raiter, Former Managing Director at S&P, April 23, 2010 Subcommittee Hearing, at 5.
[1067] 8/17/2004 email from S&P manager, "RE: SF CIA: CDO methodology invokes reactions," Hearing Exhibit 4/23-3 [emphasis in the original].
[1068] 3/23/2005 email from Frank Parisi to Thomas Warrack, and others, Hearing Exhibit 4/23-5.
[1069] 6/14/2005 email from Frank Parisi to Frank Bruzese, and others, Hearing Exhibit 4/23-6.

credit ratings process. In that chain of emails, a senior S&P manager, Gale Scott, openly expressed concern about how a criteria change could impact market share and cause S&P to lose business. Ms. Scott wrote: "I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision and if so, how much? We should have an effective way of measuring the impact of our decision over time."[1070] After a colleague reassured her that he did not believe it would cause a loss of business, she reiterated her concerns, noting, "I think the criteria process must include appropriate testing and feedback from the marketplace."

On another occasion, an August 2006 email reveals the frustration that at least one S&P employee in the Servicer Evaluation Group felt about the dependence of his employer on the issuers of structured finance products, going so far as to describe the rating agencies as having "a kind of Stockholm syndrome" – the phenomenon in which a captive begins to identify with the captor:

> "They've become so beholden to their top issuers for revenue they have all developed a kind of Stockholm syndrome which they mistakenly tag as Customer Value creation."[1071]

In October 2007, Moody's Chief Credit Officer explicitly raised concerns at the highest levels of the firm that it was losing market share "[w]ith the loosening of the traditional duopoly" between Moody's and S&P, noting that Fitch was becoming an "acceptable substitute."[1072] In a memorandum entitled, "Credit Policy issues at Moody's suggested by the subprime/liquidity crisis," the author set out to answer the question, "how do rating agencies compete?" [1073] The candid reflection noted that in an ideal situation "ratings quality" would be paramount, but the need to maintain, and even increase, market share, coupled with pressures exerted by the companies seeking credit ratings, were also affecting the quality of its ratings. Moody's Chief Credit Officer wrote the following lament:

> "Analysts and MDs [Managing Directors] are continually 'pitched' by bankers, issuers, investors – all with reasonable arguments – whose views can color credit judgment, sometimes improving it, other times degrading it (we 'drink the kool-aid'). Coupled with

[1070] 11/9/2004 email from Gale Scott to Perry Inglis, Hearing Exhibit 4/23-4.
[1071] 8/8/2006 email from Michael Gutierrez to Richard Koch, "RE: Loss Severity vs gross/net proceeds," Hearing Exhibit 4/23-14.
[1072] 10/21/2007 Moody's internal email, Hearing Exhibit 4/23-24b. Although this email is addressed to and from the CEO, the Chief Credit Officer told the Subcommittee that he wrote the memorandum attached to the email. Subcommittee interview of Andy Kimball (4/15/2010).
[1073] Id.

> strong internal emphasis on market share & margin focus, this does constitute a 'risk' to ratings quality."[1074]

By the time his memorandum was written, both Moody's and S&P were already issuing thousands of RMBS and CDO rating downgrades, admitting that their prior investment grade ratings had not accurately reflected the risk that these investments would fail.

(b) Investment Bank Pressure

At the same time Moody's and S&P were pressuring their RMBS and CDO analysts to increase market share and revenues, the investment banks responsible for bringing RMBS and CDO business to the firms were pressuring those same analysts to ease rating standards. Former Moody's and S&P analysts and managers interviewed by the Subcommittee described, for example, how investment bankers pressured them to get their deals done quickly, increase the size of the tranches that received AAA ratings, and reduce the credit enhancements protecting the AAA tranches from loss. They also pressed the CRA analysts and managers to ignore a host of factors that could be seen as increasing credit risk. Sometimes described as "ratings shopping," the analysts described how some investment bankers threatened to take their business to another credit rating agency if they did not get the favorable treatment they wanted. The evidence collected by the Subcommittee indicates that the pressure exerted by investment banks frequently impacted the ratings process, enabling the banks to obtain more favorable treatment than they otherwise would have received.

The type of blatant pressure exerted by some investment bankers is captured in a 2006 email in which a UBS banker warned an S&P senior manager not to use a new, more conservative rating model for CDOs. He wrote:

> "[H]eard you guys are revising your residential mbs [mortgage backed security] rating methodology - getting very punitive on silent seconds. [H]eard your ratings could be 5 notches back of [Moody's] equivalent. [G]onna kill your resi[dential] biz. [M]ay force us to do moodyfitch only cdos!"[1075]

When asked by his colleague about the change in the model, an S&P senior manager, Thomas Warrack, noted that the new model "took a more conservative approach" that would result in "raising our credit

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[1074] Id.

[1075] 5/3/2006 email from Robert Morelli (UBS) to Peter Kambeseles (S&P), Hearing Exhibit 4/23-11.

support requirements going forward," but Mr. Warrack was also quick to add: "We certainly did [not] intend to do anything to bump us off a significant amount of deals."[1076]

In another instance in May 2007, an S&P analyst reported to her colleagues about attempting to apply a default stress test to a CDO transaction proposed by Lehman Brothers. She wrote:

> "[T]hey claim that their competitor investment banks are currently doing loads of deals that are static in the US and where no such stress is applied. ... [W]e'd initially calculated some way of coming up with the stresses, by assuming the lowest rated assets default first .... [T]hey claim that once they have priced the whole thing, it is possible that the spreads would change .... We suggested that it was up to them to build up some cushion at the time they price, but they say this will always make their structures uneconomic and is basically unmanageable => I understand that to mean they would not take us on their deals."[1077]

Her supervisor responded in part: "I would recommend we do something. Unless we have too many deals in US where this could hurt."

On still another occasion in 2004, several S&P employees discussed the pressure to make their ratings profitable rather than just accurate, especially when their competitor employed lower rating standards:

> "We just lost a huge Mizuho RMBS deal to Moody's due to a huge difference in the required credit support level. It's a deal that six analysts worked through Golden Week so it especially hurts. What we found from the arranger was that our support level was at least 10% higher than Moody's. ... Losing one or even several deals due to criteria issues, but this is so significant that it could have an impact in the future deals. There's no way we can get back on this one but we need to address this now in preparation for the future deals."[1078]

Other emails illustrate the difficulty of upgrading the ratings models, because of the potential disruption to securitizations in the

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[1076] Id.

[1077] 5/23/2007 email from Claire Robert to Lapo Guadagnuolo, and others, Hearing Exhibit 4/23-31.

[1078] 5/25/2004 email from Yu-Tsung Chang to Joanne Rose and Pat Jordan, "Competition with Moody's," Hearing Exhibit 4/23-2.

process of being rated. Some investment banks applied various types of pressure to maintain the status quo, despite the fact that the newer models were considered more accurate. In a February 2006 email to an S&P analyst, for example, an investment banker from Citigroup wrote:

> "I am VERY concerned about this E3 [new CDO rating model]. If our current struc[ture], which we have been marketing to investors ... doesn't work under the new assumptions, this will not be good. Happy to comply, if we pass, but will ask for an exception if we fail."[1079]

In another instance from May 2005, an investment banker from Nomura in the middle of finalizing a securitization raised concerns that S&P was not only failing to provide the desired rating, but that a new model could make the situation worse. He wrote:

> "My desire is to keep S&P on all of my deals. I would rather not drop S&P from the upcoming deal, particularly if it ends up being for only a single deal until the new model is in place. Can you please review the approval process on this deal?"[1080]

Initially hesitant, S&P analysts ultimately decided to recommend approval of the deal in line with the banker's proposal.

The same pressure was applied to Moody's analysts. In an April 2007 email, for example, a SunTrust Bank employee told Moody's:

> "SunTrust is disconcerted by the dramatic increase in Moody's loss coverage levels given initial indications. ... Our entire team is extremely concerned. ... Each of the other agencies reduced their initial levels, and the material divergence between Moody's levels and the other agencies seems unreasonable and unwarranted given our superior collateral and minimal tail risk."[1081]

On another occasion in March 2007, a Moody's analyst emailed a colleague about problems she was having with someone at Deutsche Bank after Moody's suggested adjustments to the deal: "[The Deutsche Bank investment banker] is pushing back dearly saying that the deal has been marketed already and that we came back 'too late' with this

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[1079] 2/16/2006 email from Edward Tang (Citigroup) to Lina Kharnak (S&P), Hearing Exhibit 4/23-8.
[1080] 5/6/2005 email from Robert Gartner (Nomura) to Thomas Warrack (S&P), PSI-S&P-RFN-000024-28, at 28.
[1081] 4/12/2007 email from Patrick DellaValle (SunTrust) to David Teicher (Moody's), and others, PSI-MOODYS-RFN-000032.

discovery .... She claims it's hard for them to change the structure at this point."[1082]

Special Treatment. Documents obtained by the Subcommittee indicate that investment bankers who complained about rating methodologies, criteria, or decisions were often able to obtain exceptions or other favorable treatment. In many instances, the decisions made by the credit rating agencies appeared to cross over from the healthy give and take involved in complex analysis to concessions made to prevent the loss of business. While the former facilitates efficient transactions, the second distorts the market and hurts investors.

In a February 2007 email directed to Moody's, for example, a Chase investment banker complained that a transaction would receive a significantly lower rating than the same product was slated to receive from another rating agency: "There's going to be a three notch difference when we print the deal if it goes out as is. I'm already having agita about the investor calls I'm going to get." Upon conferring with a colleague, the Moody's manager informed the banker that Moody's was able to make some changes after all: "I spoke to Osmin earlier and confirmed that Jason is looking into some adjustments to his [Moody's] methodology that should be a benefit to you folks."[1083]

In another instance, a difference of opinion arose between Moody's and UBS over how to rate a UBS transaction known as Lancer II. One senior Moody's analyst wrote to her colleagues that, given the "time line for closing" the deal, they should side with the investment bank: "I agree that what the [Moody's rating] committee was asking is reasonable, but given the other modeling related issues and the time line for closing, I propose we let them go with the CDS Cp criteria for this deal."[1084]

S&P made similar concessions while rating three deals for Bear Stearns in 2006. An analyst wrote:

> "Bear Stearns is currently closing three deals this month which ha[ve] 40 year mortgages (negam) .... There was some discrepancy in that they were giving some more credit to

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[1082] 3/8/2007 email from Karen Ramallo to Yakov Krayn, Hearing Exhibit 4/23-22.
[1083] 2/20/2007 email from Mark DiRienz (Moody's) to Robert Miller (Chase), PSI-MOODYS-RFN-000031. See also 4/27/2006 email from Karen Ramallo to Wioletta Frankowicz and others, Hearing Exhibit 4/23-18 ("For previous synthetic deals this wasn't as much of an issue since the ARM % wasn't as high, and ... at this point, I would feel comfortable keeping the previously committed levels since such a large adjustment would be hard to explain to Bear .... So unless anybody objects, Joe and I will tell Bear that the levels stand where they were previously.").
[1084] 5/23/2007 email from Yvonne Fu to Arnaud Lasseron, PSI-MOODYS-RFN-000013.

recoveries than we would like to see. ... [I]t was agreed that for the deals this month we were OK and they would address this issue for deals going forward."[1085]

While the rating process involved some level of subjective discretion, these electronic communications make it clear that in many cases, close calls were made in favor of the customer.

An exception made one time often turned into further exceptions down the road. In August 2006, for example, an investment banker from Morgan Stanley tried to leverage past exceptions into a new one, couching his request in the context of prior deals:

> "When you went from [model] 2.4 to 3.0, there was a period of time where you would rate on either model. I am asking for a similar 'dual option' window for a short period. I do not think this is unreasonable."

A frustrated S&P manager resisted, saying: "You want this to be a commodity relationship and this is EXACTLY what you get." But even in the midst of his defense, the same S&P manager reminded the banker how often he had granted exceptions in other transactions: "How many times have I accommodated you on tight deals? Neer, Hill, Yoo, Garzia, Nager, May, Miteva, Benson, Erdman all think I am helpful, no?"[1086]

Some rating analysts who granted exceptions to firm policies, and then tried to limit those exceptions in future deals, found it difficult to do. In June 2007, for example, a Moody's analyst agreed to an exception, while warning that no exceptions would be made in future transactions:

> "This is an issue we feel strongly about and it is a published Moody's criteria. We are making an exception for this deal only. ... Going forward this has to be effective date level. I would urge you to let your colleagues know as well since we will not be in a position to give in on this issue in future deals."[1087]

[1085] 2/23/2006 email from Errol Arne to Martin Kennedy, and others, "Request for prioritization," PSI-S&P-RFN-000032.
[1086] 8/1/2006 email from Elwyn Wong (S&P) to Shawn Stoval (Morgan Stanley) and Belinda Ghetti (S&P), Hearing Exhibit 4/23-13.
[1087] 6/28/2007 email from Pooja Bharwani (Moody's) to Frank Li (Citigroup), and others, PSI-MOODYS-RFN-000019.

A similar scenario played out at S&P. A Goldman Sachs banker strongly objected to a rating decision on a CDO called Abacus 2006-12:

> "I would add that this scenario is very different from an optional redemption as you point out below since the optional redemption is at Goldman's option and a stated maturity is not. We therefore cannot settle for the most conservative alternative as I believe you are suggesting."

The S&P director pushed back, saying that what Goldman wanted was "a significant departure from our current criteria," but then suggested an exception could be made if it were limited to the CDO at hand and did not apply to future transactions:

> "As you point out, it is a conservative position for S&P to take, but it is one we've taken with all Dealers. Since time is of the essence, this may be another issue that we table for 2006-12 [the CDO under consideration], but would have to be addressed in future trades."[1088]

But a Moody's analyst showed how difficult it was to allow an exception once and demand different conduct in the future:

> "I am worried that we are not able to give these complicated deals the attention they really deserve, and that they [Credit Suisse] are taking advantage of the 'light' review and the growing sense of 'precedent'.
>
> As for the precedential effects, we had indicated that some of the 'fixes' we agreed to in Qian's deal were 'for this deal only'.... When I asked Roland if they had given further thought to a more robust approach, he said (unsurprisingly) that they had no success and could we please accept the same [stopgap] measure for this deal."[1089]

[1088] 4/23/2006 email from Chris Meyer (S&P) to Geoffrey Williams and David Gerst (Goldman Sachs), and others, PSI-S&P-RFN-000002. See also 5/1/2006 email from Matthew Bieber (Goldman Sachs) to Malik Rashid (S&P), and others, PSI-S&P-RFN-000008-11, at 9 ("GS has not agreed to this hold back provision in any of our previous transactions (including the ABACUS deal that just closed last week) - and we cannot agree to it in this deal.").

[1089] 5/1/2006 email from Richard Michalek to Yuri Yoshizawa, Hearing Exhibit 4/23-19; see also 5/23/2007 email from Eric Kolchinsky to Yuri Yoshizawa and Yvonne Fu, PSI-MOODYS-RFN-000011 ("In that case, should we exclude any mention of the one notch rule from the general communication? Instead, we should give comm[ittee] chairs the discretion to apply the rule as they see fit. In this way, there is less of a chance of it getting back to the bankers as a 'general rule'. They are more likely to know it as something that only applies, as a concession, on the deal that they are working on.").

Linking a Rating to a Fee. On at least one occasion, an investment bank seeking a credit rating attempted to link the ratings it would receive with the amount of fees it would pay. In June 2007, Merrill Lynch was seeking a rating from Moody's for a CDO known as Belden Point.[1090] Moody's agreed to rate the CDO, but only for a higher than usual fee using a "complex CDO fee schedule."[1091] Merrill Lynch responded: "[N]o one here has ever heard or seen this fee structure applied for any deal in the past. Could you point us to a precedent deal where we have approved this?"[1092] Moody's replied:

> "[W]e do not view this transaction as a standard CDO transaction and the rating process so far has already shown that the analysis for this deal is far more involved and will continue to be so. We have spent significant amount of resource[s] on this deal and it will be difficult for us to continue with this process if we do not have an agreement on the fee issue."[1093]

The next day, Merrill Lynch wrote:

> "We are okay with the revised fee schedule for this transaction. We are agreeing to this under the assumption that this will not be a precedent for any future deals and that you will work with us further on this transaction to try and get to some middle ground with respect to the ratings."[1094]

Moody's responded:

> "We agree that this will not be a precedent for future deals by default and we will discuss with you on a case by case basis if [the] Complex CDO rating application should be applied to future deals. We will certainly continue working with you on this transaction, but analytical discussions/outcomes should be independent of any fee discussions."[1095]

Vertical CDO. A transaction known as Vertical ABS CDO 2007-1 helps illustrate how imbalanced the relationship between investment bankers and rating analysts became. In connection with that CDO, an investment banker from UBS failed to cooperate with S&P rating analysts requesting information to analyze the transaction.

1090 See 6/11/2007 email exchange between Merrill Lynch and Moody's, Hearing Exhibit 4/23-23.
1091 Id.
1092 Id.
1093 Id.
1094 Id.
1095 6/12/2007 email from Moody's to Merrill Lynch, Hearing Exhibit 4/23-23 Addendum.

On March 30, 2007, an S&P analyst wrote that UBS wanted to close the deal in ten days, but was not providing the information S&P needed:

> "Sarah and I have been working with James Yao from UBS but we have not been getting cooperation from him. He has told me that I am jeopardizing the deal. ... This is the third time that he refuses to model the cashflow according to the Indenture and Criteria."[1096]

A few days later, in an April 5, 2007 instant message, one S&P analyst wrote: "[W]hat happened? ... [I] heard some fury." His colleague responded that it was Mr. Yao, the UBS banker.[1097] Later the same day, an S&P manager wrote that the three analysts:

> "[w]ould like to give us a heads-up with respect to the lack of responsiveness/cooperation from UBS ... on Vertical 2007-1. There seems to be a general lack of interest to work WITH us, incorporate our comments, or modeling to our criteria. Based on their collective difficult experience so far, our analysts estimate a smooth closing is unlikely. (The behavior is not limited to this deal either.)" [1098]

An S&P senior director responded:

> "Vertical is politically closely tied to B of A – and is mostly a marketing shop – helping to take risk off books of B o A. Don't see why we have to tolerate lack of cooperation. Deals likely not to perform."[1099]

Despite the uncooperative investment banker and prediction that the CDO was unlikely to perform, S&P analysts continued to work hard on the rating. One of the analysts sent an email to her colleagues describing their efforts to get the CDO to pass tests for issuing investment grade ratings:

> "Just wanted to let you know that this deal is closing and going Effective next Tuesday, but our rated Equity tranche (BBB) is failing in our cashflow modeling.

[1096] 3/30/2007 email from Lois Cheng, "Vertical ABS CDO 2007-1, Ltd. UBS," Hearing Exhibit 4/23-94c.

[1097] 4/5/2007 instant message exchange between Brian Trant and Shannon Mooney, Hearing Exhibit 4/23-94a.

[1098] 4/5/2007 email from Bujiang Hu to Peter Kambeseles, and others, Hearing Exhibit 4/23-94b [emphasis in the original].

[1099] 4/5/2007 email from James Halprin to Bujiang Hu and others, Hearing Exhibit 4/23-94b.

"Sarah tried a lot of ways to have the model passed. Unfortunately we are still failing by 1bp [basis point], without any stress runs and without modeling certain fees (anticipated to be minimal).

"In addition, we already incorporated the actual ramped up portfolio, and not a hypothetical one, for this exercise."[1100]

After another day of work, the analyst reported she had found a "mistake" that, when corrected, would allow Vertical to get the desired investment grade credit ratings:

"Just wanted to update you guys on Vertical. The model is passing now. We found a mistake in the waterfall modeling that was more punitive than necessary. James Yao [the UBS investment banker] has been notified and is probably having a chuckle at our expense. I still feel that his attitude toward our rating process and our team still needs to be addressed in some way."[1101]

These emails show S&P analysts expending great effort to provide favorable ratings to the UBS CDO, despite concerns about its creditworthiness.[1102]

On April 10, 2007, just three months before the July 2007 mass downgrades of subprime RMBS, S&P issued ratings for the Vertical securitization. All but one of the nine tranches were given investment grade ratings, with the top three receiving AAA. Moody's issued similar ratings.[1103]

Four months later in August 2007, all but the top three tranches were put on credit watch.[1104] Two months after that, in October, Moody's downgraded all but one of the Vertical securities to junk status.[1105] In 2008, the CDO was liquidated.[1106] The chart below shows

[1100] 4/5/2007 email from Lois Cheng to Brian O'Keefe and Peter Kambeseles, and others, Hearing Exhibit 4/23-94c.
[1101] 4/6/2007 email from Lois Cheng to Brian O'Keefe and Peter Kambeseles, and others, Hearing Exhibit 4/23-94c.
[1102] For a similar situation involving an RMBS, see 2/8/2006 email exchange among S&P analysts, "EMC Compares," PSI-SP-000362, Hearing Exhibit 4/23-7 (describing how an analyst worked to find a way to reduce the size of the cushion that an RMBS had to set aside to protect its investment grade tranches from loss, and found that changing the way first loan payment dates were reported in LEVELS would produce a slight reduction; a colleague responded: "I don't think this is enough to satisfy them. What's the next step?").
[1103] 4/2007 Moody's internal memorandum from Saiyid Islam and Peter Hallenbeck to the Derivatives Rating Committee, Hearing Exhibit 4/23-94d. Moody's gave investment grade ratings to seven of the eight tranches it rated, including AAA ratings to the top three tranches.
[1104] Moody's downgrade of Vertical ABS CDO 2007-1, Hearing Exhibit 4/23-94k.
[1105] Id.; 10/25/2007 "Moody's Downgrades Vertical ABS CDO 2007-1 Notes; Further Downgrades Possible," Moody's; 1/14/2008 and 6/23/2008 "Moody's downgrades ratings of

how the various tranches were originally rated by S&P, only to be downgraded to a D – the rating given to securities in default.

ISSUE ID	ISSUER NAME	SERIES	COLLATERAL TYPE	SALE DATE	RATING		
					ORIGINAL	11/1/2007	1/31/2010
829994	Vertical ABS CDO 2007-1, Ltd		CDO.HYB.MZ.CDO.OF.ABS	4/10/07	AAA	AAA	D
829994	Vertical ABS CDO 2007-1, Ltd		CDO.HYB.MZ.CDO.OF.ABS	4/10/07	AAA	AAA	D
829994	Vertical ABS CDO 2007-1, Ltd		CDO.HYB.MZ.CDO.OF.ABS	4/10/07	AAA	AAA	D
829994	Vertical ABS CDO 2007-1, Ltd		CDO.HYB.MZ.CDO.OF.ABS	4/10/07	AA	AA	D
829994	Vertical ABS CDO 2007-1, Ltd		CDO.HYB.MZ.CDO.OF.ABS	4/10/07	A	A	D
829994	Vertical ABS CDO 2007-1, Ltd		CDO.HYB.MZ.CDO.OF.ABS	4/10/07	BBB	BBB	D
829994	Vertical ABS CDO 2007-1, Ltd		CDO.HYB.MZ.CDO.OF.ABS	4/10/07	BBB-	BBB-	D
829994	Vertical ABS CDO 2007-1, Ltd		CDO.HYB.MZ.CDO.OF.ABS	4/10/07	BB	BB	D
829994	Vertical ABS CDO 2007-1, Ltd		CDO.HYB.MZ.CDO.OF.ABS	4/10/07	BBB-	BBB-	D

One of the purchasers of Vertical securities, a hedge fund called Pursuit Partners, sued UBS, S&P, and Moody's over the quick default. Both credit rating agencies filed successful motions to be dismissed from the lawsuit, but the court ordered UBS to set aside $35 million for a possible award to the investor. The investor had found internal UBS emails calling the investment grade Vertical securities "crap."[1107]

Barring Analysts. Rating analysts who insisted on obtaining detailed information about transactions sometimes became unpopular with investment bankers who pressured the analysts' directors to have them barred from rating their deals. One Moody's analyst, Richard Michalek, testified before the Subcommittee that he was prohibited from working on RMBS transactions for several banks because he scrutinized deals too closely. He stated:

> "During my tenure at Moody's, I was explicitly told that I was 'not welcome' on deals structured by certain banks. ... I was told by my then-current managing director in 2001 that I was 'asked to be replaced' on future deals by … CSFB [Credit Suisse First Boston], and then at Merrill Lynch. Years later, I was told by a different managing director that a CDO team leader at Goldman Sachs also asked, while praising the thoroughness of my work, that after four transactions he would prefer another lawyer be given an opportunity to work on his deals."[1108]

Notes issued by Vertical ABS CDO 2007-1, Ltd.," Moody's; 9/11/2008 "Moody's withdraws ratings of Notes issued by 34 ABS CDOs," Moody's. Moody's downgraded all but the super senior Vertical tranche to junk status in October 2007, just six months after giving investment grade ratings to seven of the eight tranches it rated. See 10/24/2007 email from Jonathan Polansky to Moody's colleagues, Hearing Exhibit 4/23-94f. S&P followed suit on November 14, 2007, downgrading all but two of Vertical's tranches, with five falling to junk status. 11/14/2007 "112 Ratings Lowered on 21 U.S. Cash Flow, Hybrid CDOs of ABS; $4.689B In Securities Affected," S&P.

[1106] 9/11/2008 "Moody's Withdraws Ratings of Notes Issued by 34 ABS CDOs," Moody's.

[1107] 8/28/2007 email from Evan Malik (UBS) to Hugh Corcoran (UBS) regarding Pursuit Partners' purchase of Vertical securities, Hearing Exhibit 4/23-94n.

[1108] Prepared statement of Richard Michalek at 16, April 23, 2010 Subcommittee hearing.

This analyst's claim was corroborated by the Moody's Managing Director who was his superior at the time.[1109]

At the Subcommittee's April 23 hearing, Yuri Yoshizawa, the Senior Managing Director of Moody's Derivatives Group testified that the relationship between CDO analysts and investment banks "could get very contentious and very abusive."[1110] She testified that she did get complaints from investment banks who wanted analysts removed from conducting their ratings, because they were unhappy with those analysts. She testified that "[t]here was always pressure from banks, including [removing analysts from transactions]."[1111] She stated that she did, in fact, remove analysts from rating certain banks' transactions, but claimed she did so to protect the analysts from abuse rather than to appease the complaining bank.[1112] When asked whether she ever protected her analysts by instead banning the abusive bank employee from Moody's interactions, she could not recall taking that action.

Ratings Shopping. It is not surprising that credit rating agencies at times gave into pressure from the investment banks and accorded them undue influence in the ratings process. The rating companies were directly dependent upon investment bankers to bring them business and were vulnerable to threats that the investment bankers would take their business elsewhere if they did not get the ratings they wanted. Moody's Chief Credit Officer told the Subcommittee staff that ratings shopping, the practice in which investment banks chose the credit rating agency offering the highest rating for a proposed transaction, was commonplace prior to 2008.[1113]

Ratings shopping inevitably weakens standards as each credit rating agency seeks to provide the most favorable rating to win business. It is a conflict of interest problem that results in a race to the bottom – with every credit rating agency competing to produce credit ratings to please its paying clients. Moody's CEO described the problem this way:

1109 Prepared statement of Gary Witt, Former Managing Director, Moody's Investors Service, submitted by request to the Financial Crisis Inquiry Commission (6/2/2010) at 6-7.
1110 April 23, 2010 Subcommittee Hearing at 64. Employees from both Moody's and S&P confirmed this abusive conduct in interviews with the Subcommittee, which was also corroborated in emails. Subcommittee interviews of Richard Michalek (1/18/2010) and Eric Kolchinsky (10/7/2009). See also, e.g., 4/6/2007 email from Lois Cheng to Brian O'Keefe and Peter Kambeseles, and others, Hearing Exhibit 4/23-94c.
1111 April 23, 2010 Subcommittee Hearing at 65.
1112 Id. at 64, 66.
1113 Subcommittee interview of Andy Kimball (4/15/2010). See also 2007 Moody's draft "2007 Operating Plan: Public Finance, Global Structured Finance and Investor Services," prepared by Brian Clarkson, MIS-OCIE-RMBS-0419014-53, at 25. In a draft presentation Clarkson wrote: "Challenges for 2007 … Competitive issues (ex. Rating inflation, successful rating shopping ….)." He also noted in the presentation "increased 'rating shopping' by market participants."

"What happened in '04 and '05 with respect to subordinated tranches is that our competition, Fitch and S&P, went nuts. Everything was investment grade. It didn't really matter."[1114]

All of the witnesses who were questioned about ratings shopping during the Subcommittee's hearing confirmed its existence:

> Senator Levin: Ms. Yoshizawa [Senior Managing Director, Moody's Derivatives Group], we were advised by Moody's Chief Credit Officer that it was common knowledge that ratings shopping occurred in structured finance. In other words, investment bankers sought ratings from credit rating agencies who would give them their highest ratings. Would you agree with that?
>
> Ms. Yoshizawa: I agree that credit shopping does exist, yes.
>
> Senator Levin: Ms. Barnes [Managing Director, S&P RMBS Group], would you agree that the same thing existed in your area?
>
> Ms. Barnes: Yes, Mr. Chairman.[1115]

Moody's CEO, Ray McDaniel echoed this concern during the hearing:

> Senator Levin: There are a lot of interesting things there that your Chief Credit Officer, Mr. Kimball, wrote in October of 2007 .... One of the things he wrote, and this is under market share, he says in paragraph five, 'Ideally, competition would be primarily on the basis of ratings quality' – that is ideally – 'with a second component of price and a third component of service. Unfortunately, of the three competitive factors, rating quality is proving the least powerful.' ... 'It turns out that ratings quality has surprisingly few friends; issuers want high ratings; investors don't want rating downgrades; short-sighted bankers labor short-sightedly to game the rating agencies for a few extra basis points on execution.' Would you agree with that?
>
> Mr. McDaniel: In this section, he is talking about the issue of rating shopping, and I agree that that existed then and exists now.[1116]

[1114] 9/10/2007 Transcript of Raymond McDaniel at Moody's MD Town Hall Meeting, at 63, Hearing Exhibit 4/23-98.
[1115] April 23, 2010 Subcommittee Hearing at 66-67.
[1116] April 23, 2010 Subcommittee Hearing at 100-101.

(3) Inaccurate Models

The conflict of interest problem was not the only reason that Moody's and S&P issued inaccurate RMBS and CDO credit ratings. Another problem was that the credit rating models they used were flawed. Over time, from 2004 to 2006, S&P and Moody's revised their rating models, but never enough to produce accurate forecasts of the coming wave of mortgage delinquencies and defaults. Key problems included inadequate performance data for the higher risk mortgages flooding the mortgage markets and inadequate correlation factors.

In addition, the companies failed to provide their ratings personnel with clear, consistent, and comprehensive criteria to evaluate complex structured finance deals. The absence of effective criteria was particularly problematic, because the ratings models did not conclusively determine the ratings for particular transactions. Instead, modeling results could be altered by the subjective judgment of analysts and their supervisors. This subjective factor, while unavoidable due to the complexity and novelty of the transactions being rated, rendered the process vulnerable to improper influence and inflated ratings.

(a) Inadequate Data

CRA analysts relied on their firm's quantitative rating models to calculate the probable default and loss rates for particular pools of assets. These models were handicapped, however, by a lack of relevant performance data for the high risk residential mortgages supporting most RMBS and CDO securities, by a lack of mortgage performance data in an era of stagnating or declining housing prices, by the credit rating agencies' unwillingness to devote sufficient resources to update their models, and by the failure of the models to incorporate accurate correlation assumptions predicting how defaulting mortgages might affect other mortgages.

Lack of High Risk Mortgage Performance Data. The CRA models failed, in part, because they relied on historical data to predict how RMBS securities would behave, and the models did not use adequate performance data in the development of criteria to rate subprime and other high risk mortgages that proliferated in the housing market in the years leading up to the financial crisis. From 2004 through 2007, many RMBS and CDO securities were comprised of residential mortgages that were not like those that had been modeled in the past. As one S&P email observed:

"[T]he assumptions and the historical data used [in the models] … never included the performance of these types of residential mortgage loans …. The data was gathered and computed during a time when loans with over 100% LTV or no stated income were rare."[1117]

In contrast to decades of actual performance data for 30-year mortgages with fixed interest rates, the new subprime, high risk products had little to no track record to predict their rates of default. In fact, Moody's RMBS rating model was not even used to rate subprime mortgages until December 2006; prior to that time, Moody's used a system of "benchmarking" in which it rated a subprime mortgage pool by comparing it to other subprime pools Moody's had already rated.[1118]

Lack of Data During Era of Stagnant or Falling Home Prices. In addition, the models operated with subprime data for mortgages that had not been exposed to stagnant or falling housing prices. As one February 2007 presentation from a Deutsche Bank investment banker explained, the models used to calculate "subprime mortgage lending criteria and bond subordination levels are based largely on performance experience that was mostly accumulated since the mid-1990s, when the nation's housing market has been booming."[1119] A former managing director in Moody's Structured Finance Group put it this way: "[I]t was 'like observing 100 years of weather in Antarctica to forecast the weather in Hawaii.'"[1120] In September 2007, after the crisis had begun, an S&P executive testified before Congress that:

"[W]e are fully aware that, for all our reliance on our analysis of historically rooted data that sometimes went as far back as the Great Depression, some of that data has proved no longer to be as useful or reliable as it has historically been."[1121]

1117 9/30/2007 email from Belinda Ghetti to David Tesher, and others, Hearing Exhibit 4/23-33.
1118 See 2008 SEC Examination Report for Moody's Investor Services Inc., PSI-SEC (Moodys Exam Report)-14-0001-16, at 3.
1119 2/2007 "Shorting Home Equity Mezzanine Tranches," Deutsche Bank Securities Inc., DBSI_PSI_EMAIL01988773-845, at 776. See also 6/4/2007 FDIC memorandum from Daniel Nuxoll to Stephen Funaro, "ALLL Modeling at Washington Mutual," FDIC_WAMU_000003743-52, at 47 ("Virtually none of the data is drawn from an episode of severe house price depreciation. Even introductory statistics textbooks caution against drawing conclusions about possibilities that are outside the data. A model based on data from a relatively benign period in the housing market cannot produce reliable inferences about the effects of a housing price collapse.").
1120 "Triple-A Failure," New York Times (4/27/2008).
1121 Prepared statement of Vickie Tillman, S&P Executive Vice President, "The Role of Credit Rating Agencies in the Structured Finance Market," before U.S. House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Cong.Hrg. 110-62 (9/27/2007), S&P SEN-PSI 0001945-71, at 46-47.

The absence of relevant data for use in RMBS modeling left the credit rating agencies unable to accurately predict mortgage default and loss rates when housing prices stopped climbing. The absence of relevant performance data for high risk mortgage products in an era of stagnant or declining housing prices impacted the rating of not only RMBS transactions, but also CDOs, which typically included RMBS securities and relied heavily on RMBS credit ratings.

Lack of Investment. One reason that Moody's and S&P lacked relevant loan performance data for their RMBS models was not simply that the data was difficult to obtain, but that both companies were reluctant to devote the resources needed to improve their modeling, despite soaring revenues.

Moody's senior managers even expressed skepticism about whether new loan data was needed and, in fact, generally did not purchase new loan data for a four-year period, from 2002 to 2006.[1122] In a 2000 internal email exchange, the head of Moody's Structured Finance Group at the time, Brian Clarkson, wrote the following regarding the purchasing of data for Moody's RMBS model:

> "I have a wild thought also – let[']s not even consider BUYING anymore data, programs, software or companies until we figure out what we have and what we intend to do with what we have. From what I have heard and read so far we have approaches (MBS, Tranching and Spread) few use or understand (let alone being able to explain it to the outside) and new data that we are unable to use. We want more data when most of the time we rate MBS deals using arbitrary rule of thumb?!! …
>
> "I suggest we spend less time asking for more data and software (I have not seen anything that sets forth the gains in revenue from such spending -- it is easy to ask for $$ -- much harder to justify it against competing projects) and more time figuring out how to utilize what we have by way of good analysis, a solid approach to this market a proper staffing model."[1123]

[1122] 2/24/2011 Response from Moody's to Subcommittee questions. The Subcommittee asked Moody's to provide information on any new data it had received or purchased for its models from 2002 to 2007.

[1123] 11/3/2000 email from Brian Clarkson to David Zhai and others, PSI-MOODYS-RFN-000007.

In response to Brian Clarkson's email, a managing director wrote:

> "As you know, I don't think we need to spend a lot of $ or resources to improve the model from an analytic perspective; but I'd need to defer to people more in the loop (looks like you're that person) on whether the marketing component mandates some announcement of model and data improvement. ...
>
> Make sure you talk to Noel and maybe Fons about the decision to buy the data; I was invited to the original meeting so that the powers that be (at the time) could understand the data originally used. I felt that the arguments for buying the data and re-inventing the model were not persuasive .... The most convincing argument for buying the data was that it would be a cornerstone for marketing, that S&P touted the size of their database as a competitive advantage and that this was why they had the market share advantage."[1124]

Moody's advised the Subcommittee that, in fact, it generally did not obtain any new loan data for its RMBS model development for four years, from 2002 until 2006, although it continued to improve its RMBS model in other ways.[1125] In 2005, a Moody's employee survey found that the company's employees felt that Moody's should have been spending more resources on improving its models.[1126] In 2006, Moody's obtained new loan level data for use in its new subprime model, M3 Subprime.[1127]

In contrast to Moody's, S&P did purchase new loan data on several occasions from 2002 to 2006, but told the Subcommittee that this data did not provide meaningful results that could be used in its RMBS model prior to 2006.[1128] In 2002, for example, S&P said that it purchased data on approximately 640,000 loans, including ARM and hybrid loans. S&P told the Subcommittee that it developed an equation from that data set which predicted a lower default rate for ARM and hybrid loans than for fixed rate loans. S&P considered this counter-

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[1124] 11/13/2000 email from Jay Siegel to Brian Clarkson, PSI-MOODYS-RFN-000007.
[1125] 2/17/2011 and 2/24/2011 Responses from Moody's to Subcommittee questions.
[1126] 4/7/2006 "Moody's Investor Service, BES-2005: Presentation to Derivatives Team," Hearing Exhibit 4/23-92b.
[1127] 2/24/2011 Response from Moody's to Subcommittee questions. Moody's also advised the Subcommittee that it "generally receives, as part of the surveillance process, updated loan performance statistics on a monthly basis for the collateral pools of the transactions it has rated." Moody's told the Subcommittee that its surveillance data tracked the deterioration in the RMBS market, and its rating committee members were able to incorporate that information into their rating considerations. 2/17/2011 Response from Moody's to Subcommittee questions.
[1128] 2/10/2011 Response from S&P to Subcommittee questions.

intuitive and chose not to incorporate it into its model.[1129] In 2005, S&P purchased data on another 2.9 million loans that included first and second liens for prime, subprime, Alt A, high LTV, and home equity loans.[1130] S&P claimed that it made "concerted efforts to analyze" this data, "both by employing external consultants and dedicating resources within Standard & Poor's to analyze the data for criteria development."[1131]

Contrary to S&P's claim, the former head of the S&P RMBS Ratings Group, Frank Raiter, who worked at S&P until 2005, told the Subcommittee that management did not provide him with sufficient resources to analyze the data and develop improved criteria for the RMBS model.[1132] Mr. Raiter told the Subcommittee that he personally informed S&P's senior management about the need to update S&P's model with better loan data several years before the crisis.[1133] Mr. Raiter also testified that the "analysts at S&P had developed better methods for determining default which did capture some of the variations among products that were to become evident at the advent of the crisis,"[1134] but those methods were not incorporated into the RMBS model before he left in 2005. Mr. Raiter said that "[i]t is my opinion that had these models been implemented we would have had an earlier warning about the performance of many of the new products that subsequently lead [sic] to such substantial losses."[1135]

According to Mr. Raiter, even though S&P revenues had increased dramatically and were generated in large part by the RMBS Group, senior management had no interest in committing the resources needed to update the RMBS model with improved criteria from the new loan data. Mr. Raiter said that S&P did not spend sufficient money on better analytics, because S&P already dominated the RMBS ratings market: "[T]he RMBS group enjoyed the largest ratings market share among the three major rating agencies (often 92% or better), and improving the model would not add to S&P's revenues."[1136]

1129 Id.
1130 Id.
1131 Id. S&P also told the Subcommittee that, between 2001 and 2008, it updated its RMBS model multiple times, using other types of data and analytical improvements. 2/2010 Standard & Poor's Presentation on LEVELS, PSI-Standard&Poor's-04-0001–0025, at 6.
1132 Subcommittee interviews of Frank Raiter (7/15/2009 and 4/8/2010).
1133 Id. See also prepared statement of Frank Raiter, "Credit Rating Agencies and the Financial Crisis," before the U.S. House of Representatives Committee on Oversight and Government Reform, Cong.Hrg. 110-155 (10/22/2008), at 5.
1134 Prepared statement of Frank Raiter, "Credit Rating Agencies and the Financial Crisis," before the U.S. House of Representatives Committee on Oversight and Government Reform, Cong.Hrg. 110-155 (10/22/2008), at 5-6.
1135 Id.
1136 Id. at 6.

Poor Correlation Risk Assumptions. In addition to using inadequate loan performance data, the S&P and Moody's credit rating models also incorporated inadequate assumptions about the correlative risk of mortgage backed securities. Correlative risk measures the likelihood of multiple negative events happening simultaneously, such as the likelihood of RMBS assets defaulting together. It examines the likelihood, for example, that two houses in the same neighborhood will default together compared to two houses in different states. If the neighborhood houses are more likely to default together, they would have a higher correlation risk than the houses in different states.

The former head of S&P's Global CDO Group, Richard Gugliada, told the Subcommittee that the inaccurate RMBS and CDO ratings issued by his company were due, in part, to wrong assumptions in the S&P models about correlative risk.[1137] Mr. Gugliada explained that, because CDOs held fewer assets than RMBS, statistical analysis was less helpful, and the modeling instead required use of significant performance assumptions, including on correlative risk. He explained that the primary S&P CDO model, the "CDO Evaluator," ran 100,000 simulations to determine how a pool would perform. These simulations ran on a set of assumptions that took the place of historical performance data, according to Mr. Gugliada, and included assumptions on the probability of default and the correlation between assets if one or more assets began to default. He said that S&P believed that RMBS assets were more likely to default together than, for example, corporate bonds held in a CDO. He said that S&P had set the probability of corporate correlated defaults at 30 out of 100, and set the probability of RMBS correlated defaults at 40 out of 100. He said that the financial crisis has now shown that the RMBS correlative assumptions were far too low and should have been set closer to 80 or 90 out of 100.[1138]

On one occasion in 2006, an outside party also highlighted a problem with the S&P model's consideration of correlative risk. On March 20, 2006, a senior managing director at Aladdin Capital Management, LLC sent an email to S&P expressing concern about a later version of its CDO model, Evaluator 3:

> "Thanks for a terrific presentation at the UBS conference. I mentioned to you a possible error in the new Evaluator 3.0 assumptions:

[1137] Subcommittee interview of Richard Gugliada, Former Head of S&P's CDO Ratings Group (10/9/2009).
[1138] Id.

> Two companies in the same Region belonging to two *different* local Sectors are assumed to be correlated (by 5%), while if they belong to the *same* local Sector then they are *un*correlated. I think you probably didn't mean that."[1139]

Apparently, this problem with the model had already been identified within S&P. Two S&P employees discussed the problem on the same email, with one saying:

> "I have already brought this issue up and it was decided that it would be changed in the future, the next time we update the criteria. … [T]he correlation matrix is inconsistent."

Despite this clear problem resulting in the understatement of correlative risk for assets in the same region, S&P in this instance did not immediately take the steps needed to repair its CDO model.

At Moody's, a former Managing Director of the CDO Group, Gary Witt, observed a different set of correlation problems with Moody's CDO model. Mr. Witt, who was responsible for managing Moody's CDO analysts as well as its CDO modeling, told the Subcommittee that he had become uncomfortable with the lack of correlation built into the company's methodology.[1140] According to Mr. Witt, Moody's model, which then used the "Binomial Expansion Technique (BET)," addressed correlation by having a diversity score at a time when CDOs had diverse assets such as credit cards or aircraft lease revenues, in addition to RMBS securities. By 2004, however, Mr. Witt said that most CDOs contained primarily RMBS assets, lacked diversity, and made little use of the diversity score.

Mr. Witt told the Subcommittee that, from 2004 to 2005, he worked on modifying the BET model to improve its consideration of correlation factors. According to Mr. Witt, modeling changes like the one he worked on had to be done on an employee's own time – late nights and weekends – because there was no time during the work week due to the volume of deals. Indeed, during his eighteen month tenure as a Managing Director in the CDO Group, Mr. Witt "spent a huge amount of time working on methodology because the ABS CDO market especially was in transition from multi-sector to single sector transactions [RMBS]" which he felt necessitated an update of Moody's

[1139] 3/20/2006 email from Isaac Efrat (Aladdin Capital Management LLC) to David Tesher (S&P), Hearing Exhibit 4/23-26 [emphasis in original].
[1140] Subcommittee interview of Gary Witt, Former Managing Director, Moody's Investors Service (10/29/2009).

model.[1141] Mr. Witt indicated that, in June 2005, Moody's CDO model was changed to incorporate part of his suggested improvements, but did not go as far as he had proposed. When asked about this 2005 decision, Mr. Witt indicated that he did not feel that Moody's was getting the ratings wrong for CDOs with RMBS assets, but he did "think that we [Moody's] were not allocating nearly enough resources to get the ratings right."[1142]

The lack of performance data for high risk residential mortgage products, the lack of mortgage performance data in an era of stagnating or declining housing prices, the failure to expend resources to improve their model analytics, and incorrect correlation assumptions meant that the RMBS and CDO models used by Moody's and S&P were out of date, technically deficient, and could not provide accurate default and loss predictions to support the credit ratings being issued. Yet Moody's and S&P analysts told the Subcommittee that their analysts relied heavily on their model outputs to project the default and loss rates for RMBS and CDO pools and rate RMBS and CDO securities.

(b) Unclear and Subjective Ratings Process

Obtaining expected default and loss analysis from the Moody's and S&P credit rating models was only one aspect of the work performed by RMBS and CDO analysts. Equally important was their effort to analyze a proposed transaction's legal structure, cash flow, allocation of revenues, the size and nature of its tranches, and its credit enhancements. Analyzing each of these elements involved often complex judgments about how a transaction would work and what impact various factors would have on credit risk. Although both Moody's and S&P published a number of criteria, methodologies, and guidance on how to handle a variety of credit risk factors, the novelty and complexity of the RMBS and CDO transactions, the volume and speed of the ratings process, and inconsistent applications of the various rules, meant that CRA analysts were continuously faced with issues that were difficult to resolve about how to analyze a transaction and apply the company's standards. Evidence obtained by the Subcommittee indicates that, at times, ratings personnel acted with limited guidance, unclear criteria, and a limited understanding of the complex deals they were asked to rate.

Many documents obtained by the Subcommittee disclosed confusion and a high level of frustration from RMBS and CDO analysts

[1141] 6/2/2010 Statement of Gary Witt, Former Managing Director, Moody's Investors Service, submitted by request to the Financial Crisis Inquiry Commission, at 11.
[1142] Id. at 21.

about how to handle ratings issues and how the ratings process actually worked. In May 2007, for example, one S&P employee wrote: "[N]o body gives a straight answer about anything around here …. [H]ow about we come out with new [criteria] or a new stress and ac[tu]ally have clear cut parameters on what the hell we are supposed to do."[1143] Two years earlier, in May 2005, an S&P analyst complaining about a rating decision wrote:

> "Chui told me that while the three of us voted 'no', in writing, that there were 4 other 'yes' votes. … [T]his is a great example of how the criteria process is NOT supposed to work. Being out-voted is one thing (and a good thing, in my view), but being out-voted by mystery voters with no 'logic trail' to refer to is another. ... Again, this is exactly the kind of backroom decision-making that leads to inconsistent criteria, confused analysts, and pissed-off clients."[1144]

When asked by the SEC to compile a list of its rating criteria in 2007, S&P was unable to identify all of its criteria for making rating decisions. The head of criteria for the structured finance department, for example, who was tasked with gathering information for the SEC, wrote in an email to colleagues:

> "[O]ur published criteria as it currently stands is a bit too unwieldy and all over the map in terms of being current or comprehensive. ... [O]ur SF [Structured Finance] rating approach is inherently flexible and subjective, while much of our written criteria is detailed and prescriptive. Doing a complete inventory of our criteria and documenting all of the areas where it is out of date or inaccurate would appear to be a huge job ...."[1145]

[1143] 5/8/2007 instant message exchange between Shannon Mooney and Andrew Loken, Hearing Exhibit 4/23-30b.

[1144] 5/12/2005 email from Michael Drexler to Kenneth Cheng and others, Hearing Exhibit 4/23-10c. In a similar email, S&P employees discuss questionable and inconsistent application of criteria. 8/7/2007 email from Andrew Loken to Shannon Mooney, Hearing Exhibit 4/23-96a ("Back in May, the deal had 2 assets default, which caused it to fail. We tried some things, and it never passed anything I ran. Next thing I know, I'm told that because it had gone effective already, it was surveillance's responsibility, and I never heard about it again. Anyway, because of that, I never created a new monitor.").

[1145] 3/14/2007 email from Calvin Wong to Tom Gillis, Hearing Exhibit 4/23-29. See also 2008 SEC Examination Report for Standard and Poor's Ratings Services, Inc., PSI-SEC (S&P Exam Report)-14-0001-24, at 6-7 ("[C]ertain significant aspects of the rating processes and the methodologies used to rate RMBS and CDOs were not always disclosed, or were not fully disclosed …. [S]everal communications by S&P employees to outside parties related to the application of unpublished criteria, such as 'not all our criteria is published. [F]or example, we have no published criteria on hybrid deals, which doesn't mean that we have no criteria,'" citing an 8/2006 email from the S&P Director of the Analytical Pool for the Global CDO Group.).

The confused and subjective state of S&P criteria, including when the criteria had to be applied, is also evident in a May 2007 email sent by an S&P senior director to colleagues discussing whether to apply a default stress test to certain CDOs:

> "[T]he cash-flow criteria from 2004 (see below), actually states [using a default stress test when additional concerns about the CDO are raised] ... in the usual vague S&P's way .... Still, consistency is key for me and if we decide we do not need that, fine but I would recommend we do something. Unless we have too many deals in [the] US where this could hurt."[1146]

Moody's ratings criteria were equally subjective, changeable, and inconsistent. In an October 2007 internal email, for example, Moody's Chief Risk Officer wrote:

> "Methodologies & criteria are published and thus put boundaries on rating committee discretion. (However, there is usually plenty of latitude within those boundaries to register market influence.)"[1147]

Another factor was that ratings analysts were also under constant pressure to quickly analyze and rate complex RMBS and CDO transactions. To enable RMBS or CDO transactions to meet projected closing dates, it was not uncommon, as shown above, for CRA analysts to grant exceptions to established methodologies and criteria, put off analysis of complex issues to later transactions, and create precedents that investment banks invoked in subsequent securitizations. CRA analysts were then compelled to decide whether to follow an earlier exception, revert to the published methodology and criteria, or devise still another compromise. The result was additional confusion over how to rate complex RMBS and CDO securities.

Publication of the CRAs' ratings methodologies and criteria was also inconsistent. According to an October 2006 email sent by an investment banker at Morgan Stanley to an analyst at Moody's, for example, key methodology changes had not been made public: "Our problem here is that nobody has told us about the changes that we are later expected to adhere to. Since there is no published criteria outlining the change in methodology how are we supposed to find out about

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[1146] 5/24/2007 email from Lapo Guadagnuolo to Belinda Ghetti, and others, Hearing Exhibit 4/23-31.

[1147] 10/21/2007 Moody's internal email, Hearing Exhibit 4/23-24b. Although this email is addressed to and from the CEO, the Chief Credit Officer told the Subcommittee that he wrote the memorandum attached to the email. Subcommittee interview of Andy Kimball (4/15/2010).

it?"[1148] On another occasion, a Moody's analyst sought guidance from senior managers because of the lack of consistency in applying certain criteria. He wrote: "Over time, different chairs have been giving different guidelines at different point[s] of time on how much over-enhancement we need for a bond to be notched up to Aaa."[1149] In a November 2007 email, another senior executive described the criteria problem this way: "It seems, though, that the more of the ad hoc rules we add, the further away from the data and models we move and the closer we move to building models that ape analysts expectations, no?"[1150]

The rating agency models were called by some a "black box," because they were difficult to understand and not always predictable. Issuers and investors alike vented frustrations toward the black box and basing their decisions on a computer program few understood or could replicate. This email from June 20, 2006, recounts the conversation one Moody's employee had with another over frustrations they had heard from an outside issuer.

> "**Managers are tired of large 'grids.'** They would rather prefer a model based test like what S&P and Fitch do. Pascale disagrees with these managers. As a wrapper, she hates that the credit quality of what she wraps is linked to a black box. Also, she hates the fact that the black box can change from time to time."[1151]

A January 2007 email from BlackRock to S&P (and other rating agencies) also complained about the "black box" problem:

> "What steps are you taking to better communicate and comfort investors about your ratings process? In other w[o]rds, how do we break the 'black box' that determines enhancement levels?"[1152]

At times, some CRA analysts openly questioned their ability to rate some complex securities. In a December 2006 email chain regarding a synthetic CDO squared, for example, S&P analysts appeared

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[1148] 10/19/2006 email from Graham Jones (Morgan Stanley) to Yuri Yoshizawa (Moody's) and others, Hearing Exhibit 4/23-37. See 2008 SEC Examination Report for Moody's Investor Services Inc., PSI-SEC (Moodys Exam Report)-14-0001-16, at 5 ("[C]ertain significant aspects of the rating processes and the methodologies used to rate RMBS and CDOs were not always disclosed, or were not fully disclosed ....").
[1149] 6/28/2007 email from Yi Zhang to Warren Kornfeld and others, Hearing Exhibit 4/23-39.
[1150] 11/28/2007 email from Roger Stein to Andrew Kimball and Michael Kanef, Hearing Exhibit 4/23-44.
[1151] 6/20/2006 email from Paul Mazataud to Noel Kirnon, MIS-OCIE-RMBS-0035460 [emphasis in original].
[1152] 1/16/2007 email from Kishore Yalamanchili (BlackRock) to Scott Mason (S&P), Glenn Costello (Fitch Ratings), and others, PSI-S&P-RFN-000044.

challenged by a modeling problem and questioned their ability to rate the product. One analyst wrote: "Rating agencies continue to create and [sic] even bigger monster – the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters."[1153] In an email written in a similar vein, an S&P manager preparing for a presentation wrote to her colleagues: "Can anyone give me a crash course on the 'hidden risks in CDO's of RMBS'?"[1154] In an April 2007 instant message, an S&P analyst offered this cynical comment: "[W]e rate every deal[.] [I]t could be structured by cows and we would rate it."[1155]

(4) Failure to Retest After Model Changes

Another key factor that contributed to inaccurate credit ratings was the failure of Moody's and S&P to retest outstanding RMBS and CDO securities after improvements were made to their credit rating models. These model improvements generally did not derive from data on new types of high risk mortgages, but were intended to improve the models' predictive capability,[1156] but even after they were made, CRA analysts failed to utilize them to downgrade artificially high RMBS and CDO credit ratings.

Key model adjustments were made in 2006 to both the RMBS and CDO models to improve their ability to predict expected default and loss rates for higher risk mortgages. Both Moody's and S&P decided to apply the revised models to rate new RMBS and CDO transactions, but not to retest outstanding subprime RMBS and CDO securities, even though many of those securities contained the same types of mortgages and risks that the models were recalibrated to evaluate. Had they retested the existing RMBS and CDO securities and issued appropriate rating downgrades starting in 2006, the CRAs could have signaled investors about the increasing risk in the mortgage market, possibly dampened the rate of securitizations, and possibly reduced the impact of the financial crisis.

Surveillance Obligations. Both Moody's and S&P were obligated by contract to conduct ongoing surveillance of the RMBS and

[1153] 12/15/2006 email from Chris Meyer to Belinda Ghetti and Nicole Billick, Hearing Exhibit 4/23-27.
[1154] 1/17/2007 email from Monica Perelmuter to Kyle Beauchamp, and others, Hearing Exhibit 4/23-28.
[1155] 4/5/2007 instant message exchange between Shannon Mooney and Rahul Dilip Shah, Hearing Exhibit 4/23-30a.
[1156] These model improvements still significantly underestimated subprime risk as is evidenced by the sheer number of downgrades that occurred after the model improvements for securities issued in 2006 and 2007.

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CDO securities they rated to ensure the ratings remained valid over the life of the rated securities. In fact, both companies charged annual surveillance fees to the issuers of the securities to pay for the surveillance costs, and each had established a separate division to carry out surveillance duties. Due to the huge numbers of RMBS and CDO securities issued in the years leading up to the financial crisis, those surveillance divisions were responsible for reviewing tens of thousands of securities. The issue of whether to retest the outstanding securities using the revised credit rating models was, thus, a significant issue affecting numerous securities and substantial company resources.

Increased Loss Protection. In July 2006, S&P made significant adjustments to its subprime RMBS model. S&P had determined that, to avoid an increasing risk of default, subprime RMBS securities required additional credit enhancements that would provide 40% more protection to keep the investment grade securities from experiencing losses.[1157] Moody's made similar adjustments to its RMBS model around the same time, settling on parameters that required 30% more loss protection. As Moody's explained to the Senate Banking Committee in September 2007:

> "In response to the increase in the riskiness of loans made during the last few years and the changing economic environment, Moody's steadily increased its loss expectations and subsequent levels of credit protection on pools of subprime loans. Our loss expectations and enhancement levels rose by about 30% over the 2003 to 2006 time period, and as a result, bonds issued in 2006 and rated by Moody's had more credit protection than bonds issued in earlier years."[1158]

The determination that RMBS pools required 30-40% more credit enhancements to protect higher rated tranches from loss reflected calculations by the updated CRA models that these asset pools were exposed to significantly more risk of delinquencies and defaults. Requiring increased loss protection meant that Moody's and S&P analysts had to require more revenues to be set aside in each pool to provide AAA ratings greater protection than before the model adjustments. Requiring increased loss protection also meant RMBS pools would have a smaller pool of AAA securities to sell to investors.

[1157] 3/19/2007 "Structured Finance Ratings - Overview and Impact of the Residential Subprime Market," S&P Monthly Review Meeting, at S&P SEC-PSI 0001473, Hearing Exhibit 4/23-52b.

[1158] Prepared statement of Michael Kanef, Group Managing Director of Moody's Asset Backed Finance Rating Group, "The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets," before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, S.Hrg. 110-931 (9/26/2007), at 17.

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That meant, in turn, that RMBS pools would produce fewer profits for issuers and arrangers. Requiring increased loss protection had a similar impact on CDOs that included RMBS assets.

Retesting RMBS Securities. Even though S&P and Moody's had independently revised their RMBS models and, by 2006, determined that additional credit enhancements of 30-40% were needed to protect investment grade tranches from loss, in 2006 and the first half of 2007, neither company used its revised models to evaluate existing rated subprime RMBS securities as part of its surveillance efforts.[1159] Instead S&P, for example, sent out a June 2006 email announcing that no retests would be done:

> "Simply put – although the RMBS Group does not 'grandfather' existing deals, there is not an absolute and direct link between changes to our new ratings models and subsequent rating actions taken by the RMBS Surveillance Group. As a result, there will not be wholesale rating actions taken in July or shortly thereafter on outstanding RMBS transactions, absent a deterioration in performance and projected credit support on any individual transaction."[1160]

Moody's and S&P each advised the Subcommittee that it had decided not to retest any existing rated RMBS securities, because it felt that actual performance data for the pools in question would provide a better indicator of future defaults and loss than application of its statistical model. But actual loan performance data for the subprime mortgages in the pools – the fact that, for example, timely loan payments had been made in the past on most of those loans – provided an incomplete picture regarding whether those payments would continue to be made after home prices stopped climbing, refinancings became

[1159] 6/2006 S&P internal email exchange, Hearing Exhibit 4/23-72; and 3/31/2008 Moody's Structured Finance Credit Committee Meeting Notes, Hearing Exhibit 4/23-80. See also 7/16/2007 Moody's email from Joseph Snailer to Qingyu Liu, and others, PSI-MOODYS-RFN-000029 (when an analyst sought guidance on whether to use the new or old methodology for testing unrated tranches of outstanding deals, she was advised: "The ratings you are generating should reflect what we would have rated the deals when they were issued knowing what we knew then and using the methodology in effect then (ie, using the OC model we built then."); 6/1/2007 email from Moody's Senior Director in Structured Finance, "RE: Financial Times inquiry on transparency of assumptions," MIS-OCIE-RMBS-0364942-46, at 43.

[1160] 6/23/2006 email from Thomas Warrack to Pat Jordan and Rosario Buendia, Hearing Exhibit 4/23-72 [emphasis in original]. Despite this 2006 email, the former head of S&P's RMBS Group, Frank Raiter, told a House Committee: "At S&P, there was an ongoing, often heated discussion that using the ratings model in surveillance would allow for re-rating every deal monthly and provide significantly improved measures of current and future performance." Prepared statement of Frank L. Raiter, "Credit Rating Agencies and the Financial Crisis," before the U.S. House of Representatives Committee on Oversight and Government Reform, Cong.Hrg. 110-155 (10/22/2008), at 7.

difficult, and higher interest rates took effect in many of the mortgages. By focusing only on actual past performance, the ratings ignored foreseeable problems and gave investors false assurances about the creditworthiness of the RMBS and CDO securities.

Some CRA employees expressed concern about the limitations placed on their ability to alter ratings to reflect expected performance of the rated securities. In a July 2007 email just before the mass ratings downgrades began, for example, an S&P senior executive raised concerns about these to the head of the RMBS Surveillance Group as follows:

> "Overall, our ratings should be based on our *expectations* of performance, not solely the *month to month* performance record, which will only be backward looking. ... Up to this point, Surveillance has been 'limited' in *when* we can downgrade a rating (only *after* it has experienced realized losses), how far we can adjust the rating (no more than 3 notches at a time is preferred), and how high up the capital structure we can go (not downgrading higher rated classes, if they 'pass' our stressed cash flow runs)."[1161]

In addition, many of the RMBS loans were less than a year old, making any performance data less significant and difficult to analyze. In others words, the loans were too unseasoned or new to offer any real predictive performance value.

Some internal S&P emails suggest alternative explanations for the decision not to retest. In October 2005, for example, an S&P analytic manager in the Structured Finance Ratings Group sent an email to his colleagues asking: "How do we handle existing deals especially if there are material changes [to a model] that can cause existing ratings to change?" His email then laid out what he believed was S&P's position at that time:

- "I think the history has been to only re-review a deal under new assumptions/criteria when the deal is flagged for some performance reason. I do not know of a situation where there were wholesale changes to existing ratings when the primary group changed assumptions or even instituted new criteria. The two major reasons why we have taken the approach is (i) lack of sufficient personnel resources and (ii) not having the same

[1161] 7/3/2007 S&P email from Cliff Griep to Ernestine Warner and Stephen Anderberg, Hearing Exhibit 4/23-32 [emphasis in original].

models/information available for surveillance to relook at an existing deal with the new assumptions (i.e. no cash flow models for a number of assets). The third reason is concerns of how disruptive wholesale rating changes, based on a criteria change, can be to the market.

- CDO is current[ly] debating the issue and appropriate approach as they change the methodology."[1162]

This email suggests the reason retesting did not occur was, not because S&P thought actual performance data would produce more accurate ratings for existing pools, but because S&P did not have the resources to retest, and lower ratings on existing deals might have disrupted the marketplace, upsetting investment banks and investors. Several S&P managers and analysts confirmed in Subcommittee interviews that these were the real reasons for the decision not to retest existing RMBS securities.[1163] Moody's documents also suggest that resource constraints may lay behind its decision not to retest.[1164]

The Subcommittee also found evidence suggesting that investment banks may have rushed to have deals rated before the CRAs implemented more stringent revised models. In an attempt to explain why one RMBS security from the same vintage and originator was pricing better than another, a CDO trader wrote:

> "Only reasons I can think for my guys showing you a tighter level is that we are very short this one and that the June 06 deals have a taint that earlier months don[']t due to the theory that late June deals were crammed with bad stuff in order to beat the S & P [model] revisions.[1165]

Retesting CDO Securities. The debate over retesting existing CDO securities followed a similar path to the debate over retesting RMBS securities. The CDO Group at S&P first faced the retest question in the summer of 2005, when it made a major change to its CDO model,

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[1162] 10/6/2005 email from Roy Chun, Hearing Exhibit 4/23-62.
[1163] Prepared statement of Frank Raiter, Former Managing Director at Standard & Poor's, April 23, 2010 Subcommittee Hearing, at 2; and Subcommittee interviews of S&P confidential sources (2/24/2010) and (4/9/2010).
[1164] See, e.g., 3/31/2008 Moody's Structured Finance Credit Committee Meeting Notes, Hearing Exhibit 4/23-80 ("Currently, following a methodology change, Moody's does not re-evaluate every outstanding, affected rating. Instead, it reviews only those obligations that it considers most prone to multi-notch rating changes, in light of the revised rating approach. This decision to selectively review certain ratings is made due to resource constraints.").
[1165] 10/20/2006 email from Greg Lippmann (Deutsche Bank) to Craig Carlozzi (Mast Capital), DBSI_PSI_EMAIL01774820.

then Evaluator 3 (E3).[1166] The S&P CDO Group appeared ready to announce and implement the improved model that summer, but then took more than a year to implement it as the group struggled to rationalize why it would not retest existing CDO securities with the improved assumptions.[1167] Internal S&P emails indicate that the primary considerations were, again, resource limitations and possible disruption to the CDO market, rather than concerns over accuracy. For instance, in a June 2005 email sent to an S&P senior executive, the head of the CDO Group wrote:

> "The overarching issue at this point is what to do with currently rated transactions if we do release a new version of Evaluator. Some of [us] believe for both logistical and market reasons that the existing deals should mainly be 'grand fathered'. Others believe that we should run all deals using the new Evaluator. The problem with running all deals using E3 is twofold: we don't have the model or resource capacity to do so, nor do we all believe that even if we did have the capability, it would be the responsible thing to do to the market."[1168]

Several months later the S&P CDO Ratings Group was still deliberating the issue. In November 2005, an investment banker at Morgan Stanley who had concerns about whether E3 would be used to retest existing deals and those in the pipeline expressed frustration at the delay:

> "We are in a bit of a pickle here. My legal staff is not letting me send anything out to any investor on anything with an S&P rating right now. We are waiting for you to tell us ... that you approve the disclaimer or are grandfathering [not retesting with E3] our existing and pipeline deals. My business is on 'pause' right now."[1169]

[1166] The CDO models were simulation models dependent upon past credit ratings for the assets they included plus various performance and correlation assumptions. See earlier discussion of these models.
[1167] 7/12/2005 S&P internal email, "Delay in Evaluator 3.0 incorporation in EOD/CDOi platform," PSI-S&P-RFN-000017.
[1168] 6/21/2005 email from Pat Jordan to Cliff Griep, "RE: new CDO criteria," Hearing Exhibit 4/23-60. See also 3/21/2006 email from an S&P senior official, Hearing Exhibit 4/23-71. ("FYI. Just sat on a panel with Frderic Drevon, my opposite number at Moody's who fielded a question on what happens to old transactions when there is a change to rating methodologie[s]. The official Moody's line is that there is no 'grandfathering' and that old transactions are reviewed using the new criteria. However, the 'truth is that we do not have the resources to review thousands of transactions, so we focus on those that we feel are more at risk.'").
[1169] 11/23/2005 email from Brian Neer (Morgan Stanley) to Elwyn Wong (S&P), Hearing Exhibit 4/23-64.

One S&P senior manager, frustrated by an inability to get an answer on the retesting issue, sent an email to a colleague complaining: "Lord help our f**king scam ... this has to be the stupidest place I have worked at."[1170]

In May 2006, S&P circulated a draft policy setting up what seemed to be an informal screening process "prior to transition date" to see how existing CDOs would be affected by the revised CDO model. The draft offered a convoluted approach in an apparent attempt to avoid retesting all existing CDOs, which included allowing the use of the prior "E2" model and review "by a special E3 committee." The draft policy read in part as follows:

> "***PRIVILEGED AND CONFIDENTIAL - S&P DISCUSSION PURPOSES ONLY***
> **Prior to Transition Date (in preparation for final implementation of E3 for cash CDOs):**
>
> - A large majority of the pre- E3 cash flow CDOs will be run through E3 in batch processes to see how the ratings look within the new model ...
> - Ratings falling ***more than*** 3 notches +/- from the current tranche rating in the batch process will be reviewed in detail for any modeling, data, performance or other issues
> - If any transactions are found to be passing/failing E3 by more than 3 notches due to performance reasons they will be handled through the regular surveillance process to see if the ratings are stable under current criteria (i.e., if they pass E2.4.3 using current cash flow assumptions the ratings will remain unchanged)
> - If any transactions are found to be passing/failing E3 by more than 3 notches due to a model gap between E2.4.3 and E3, they will be reviewed by a special E3 committee ...."[1171]

It is unclear whether this screening actually took place.

Questions continued to be raised internally at S&P about the retesting issue. In March 2007, almost a year after the change was made in the CDO model, an S&P senior executive wrote to the Chief Criteria Officer in the structured finance department:

[1170] 11/23/2005 email from Elwyn Wong to Andrea Bryan, Hearing Exhibit 4/23-64.
[1171] 5/19/2006 email from Stephen Anderberg to Pat Jordan, David Tesher, and others, PSI-S&P-RFN-000021 [emphasis in original].

"Why did the criteria change made in mid 2006 not impact any outstanding transactions at the time we changed it, especially given the magnitude of the change we are highlighting in the article? Should we apply the new criteria now, given what we now know? If we did, what would be the impact?"[1172]

In July 2007, the same senior executive raised the issue again in an email asking the S&P Analytic Policy Board to address the alignment of surveillance methodology and new model changes at a "special meeting."[1173] But by then, residential mortgages were already defaulting in record numbers, and the mass downgrades of RMBS and CDO ratings had begun.

Consequences for Investors. During the April 23 Subcommittee hearing, credit ratings expert, Professor Arturo Cifuentes, explained to the Subcommittee the importance of retesting existing rated deals when there is a model change.

> Senator Levin: If a ratings model changes its assumptions or criteria, for instance, if it becomes materially more conservative, how important is it that the credit rating agency use the new assumptions or criteria to re-test or re-evaluate securities that are under surveillance?
>
> Mr. Cifuentes: Well, it is very important for two reasons: Because if you do not do that, you are basically creating two classes of securities, a low class and an upper class, and that creates a discrepancy in the market. At the same time, you are not being fair because you are giving an inflated rating then to a security or you are not communicating to the market that the ratings given before were of a different class.[1174]

Moody's and S&P updated their RMBS and CDO models with more conservative criteria in 2006, but then used the revised models to evaluate only new RMBS and CDO transactions, bypassing the existing RMBS and CDO securities that could have benefited from the new credit analysis. Even with respect to the new RMBS and CDOs, investment banks sought to delay use of the revised models that required additional credit enhancements to protect investment grade tranches from loss. For example, in May 2007, Morgan Stanley sent an email to a Moody's Managing Director with the following:

[1172] 3/12/2007 email from Cliff Griep to Tom Gillis, and others, PSI-S&P-RFN-000015.
[1173] 7/15/2007 email from Tom Gillis to Valencia Daniels, "Special APB meeting," Hearing Exhibit 4/23-74.
[1174] April 23, 2010 Subcommittee Hearing at 35.

"Thanks again for your help (and Mark's) in getting Morgan Stanley up-to-speed with your new methodology. As we discussed last Friday, please find below a list of transactions with which Morgan Stanley is significantly engaged already (assets in warehouses, some liabilities placed). We appreciate your willingness to grandfather these transactions [under] Moody's old methodology."[1175]

When asked about the failure of Moody's and S&P to retest existing securities after their model updates in 2006, the global head trader for CDOs from Deutsche Bank told the Subcommittee that he believed the credit rating agencies did not retest them, because to do so would have meant significant downgrades and "they did not want to upset the apple cart."[1176] Instead, the credit rating agencies waited until 2007, when the high risk mortgages underlying the outstanding RMBS and CDO securities incurred record delinquencies and defaults and then, based upon the actual loan performance, instituted mass ratings downgrades. Those sudden mass downgrades caught many financial institutions and other investors by surprise, leaving them with billions of dollars of suddenly unmarketable securities. The RMBS secondary market collapsed soon after, and the CDO secondary market followed.

(5) Inadequate Resources

In addition to operating with conflicts of interest, models containing inadequate performance data, subjective and inconsistent rating criteria, and a policy against using improved models to retest outstanding RMBS and CDO securities, and despite the increasing numbers of ratings issued each year and record revenues as a result, neither Moody's nor S&P hired sufficient staff or devoted sufficient resources to ensure that the initial rating process and the subsequent surveillance process produced accurate credit ratings.

Instead, both Moody's and S&P forced their staffs to churn out new ratings and conduct required surveillance with limited resources. Over time, the credit rating agencies' profits became increasingly connected to issuing a high volume of ratings. By not devoting sufficient resources to handle the high volume of ratings, the strain on resources negatively impacted the quality of the ratings and their surveillance.

[1175] 5/2/2007 email from Zach Buchwald (Morgan Stanley Executive Director) to William May (Moody's Managing Director), and others, Hearing Exhibit 4/23-76. See also 4/11/2007 email from Moody's Managing Director to Calyon, PSI-MOODYS-RFN-000040.
[1176] Subcommittee interview of Greg Lippmann, Former Managing Director and Global Head of Trading of CDOs for Deutsche Bank (10/18/2010). Mr. Lippmann said he thought the agencies' decision not to retest existing securities was "ridiculous."

High Speed Ratings. From 2000 to 2007, Moody's and S&P issued record numbers of RMBS and CDO ratings. Each year the number of ratings issued by each firm increased. According to SEC examinations of the firms, from 2002 to 2006, "the volume of RMBS deals rated by Moody's increased by 137%, and the number of CDO deals … increased by 700%."[1177] At S&P, the SEC determined that over the same time period, "the volume of RMBS deals rated by S&P increased by 130%, and the number of CDO deals … increased by over 900%."[1178] In addition to the rapid growth in numbers, the transactions themselves grew in complexity, requiring more time and talent to analyze.

The former head of the S&P RMBS Group, Frank Raiter, described the tension between profits and resources this way: "Management wanted increased revenues and profit while analysts wanted more staff, data and IT support which increased expenses and obviously reduced profit."[1179]

Moody's CEO, Ray McDaniel, readily acknowledged during the Subcommittee's April 23 hearing that resources were stressed and that Moody's was short staffed.[1180] He testified: "People were working longer hours than we wanted them to, working more days of the week than we wanted them to." He continued: "It was not for lack of having open positions, but with the pace at which the market was growing, it was difficult to fill positions as quickly as we would have liked."[1181]

Moody's staff, however, had raised concerns about personnel shortages impacting their work quality as early as 2002. A 2002 survey of the Structured Finance Group staff reported, for example:

> "[T]here is some concern about workload and its impact on operating effectiveness. … Most acknowledge that Moody's intends to run lean, but there is some question of whether effectiveness is compromised by the current deployment of staff."[1182]

1177 2008 SEC Examination Report for Moody's Investor Services Inc., PSI-SEC (Moodys Exam Report)-14-0001-16, at 4.
1178 2008 SEC Examination Report for Standard and Poor's Ratings Services, Inc., PSI-SEC (S&P Exam Report)-14-0001-24, at 3.
1179 Prepared statement of Frank Raiter, Former Managing Director at Standard & Poor's, April 23, 2010 Subcommittee Hearing, at 1-2.
1180 April 23, 2010 Subcommittee Hearing at 96-97.
1181 Id. at 97.
1182 5/2/2002 "Moody's SFG 2002 Associate Survey: Highlights of Focus Groups and Interviews," Hearing Exhibit 4/23-92a at 6.

Similar concerns were expressed three years later in a 2005 employee survey:

> "We are over worked. Too many demands are placed on us for admin[istrative] tasks ... and are detracting from primary workflow .... We need better technology to meet the demand of running increasingly sophisticated models."[1183]

In 2006, Moody's analyst Richard Michalek worried that investment bankers were taking advantage of the fact that analysts did not have the time to understand complex deals. He wrote:

> "I am worried that we are not able to give these complicated deals the attention they really deserve, and that they (CS) [Credit Suisse] are taking advantage of the 'light' review and the growing sense of 'precedent'."[1184]

Moody's managers and analysts interviewed by the Subcommittee stated that staff shortages impacted how much time could be spent analyzing a transaction. One analyst responsible for rating CDOs told the Subcommittee that, during the height of the boom, Moody's analysts didn't have time to understand the complex deals being rated and had to set priorities on what issues would be examined:

> "When I joined the [CDO] Group in 1999 there were seven lawyers and the Group rated something on the order of 40 – 60 transactions annually. In 2006, the Group rated over 600 transactions, using the resources of approximately 12 lawyers. The hyper-growth years from the second half of 2004 through 2006 represented a steady and constant adjustment to the amount of time that could be allotted to any particular deal's analysis, and with that adjustment, a constant re-ordering of the priority assigned to the issues to be raised at rating Committees."[1185]

A Moody's managing director responsible for supervising CDO analysts put it this way in a 2007 email: "Unfortunately, our analysts are o[v]erwhelmed ...."[1186] Moody's CEO testified at the Subcommittee's hearing, "[w]e had stress on our resources in this period, absolutely."[1187]

[1183] 4/7/2006 "Moody's Investor Service, BES-2005: Presentation to Derivatives Team," Hearing Exhibit 4/23-92b.
[1184] 5/1/2006 email from Richard Michalek to Yuri Yoshizawa, Hearing Exhibit 4/23-19.
[1185] Prepared statement of Richard Michalek at 20, April 23, 2010 Subcommittee hearing.
[1186] 5/23/2007 email from Eric Kolchinsky to Yvonne Fu and Yuri Yoshizawa, Hearing Exhibit 4/23-91.
[1187] April 23, 2010 Subcommittee Hearing at 97.

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Senator Levin asked him if Moody's was profitable at the time, and he responded, "[w]e were profitable, yes."[1188]

S&P also experienced significant resource shortages. In 2004, for example, a managing director in the RMBS Group wrote a lengthy email about the resource problems impacting credit analysis:

> "I am trying to put my hat on not only for ABS/RMBS but for the department and be helpful but feel that it is necessary to re-iterate that there is a shortage in resources in RMBS. If I did not convey this to each of you I would be doing a disservice to each of you and the department. As an update, December is going to be our busiest month ever in RMBS. I am also concerned that there is a perception that we have been getting all the work done up until now and therefore can continue to do so.
>
> "We ran our Staffing model assuming the analysts are working 60 hours a week and we are short resources. We could talk about the assumptions and make modifications but the results would be similar. The analysts on average are working longer than this and we are burning them out. We have had a couple of resignations and expect more. It has come to my attention in the last couple of days that we have a number of staff members that are experiencing health issues."[1189]

A May 2006 internal email from an S&P senior manager in the Structured Finance Real Estate Ratings Group expressed similar concerns:

> "We spend most of our time keeping each other and our staff calm. Tensions are high. Just too much work, not enough people, pressure from company, quite a bit of turnover and no coordination of the non-deal 'stuff' they want us and our staff to do ...."[1190]

The head of the S&P CDO Ratings Group sent a 2006 email to the head of the Structured Finance Department to make a similar point. She wrote:

> "While I realize that our revenues and client service numbers don't indicate any ill [e]ffects from our severe understaffing situation, I

[1188] Id.
[1189] 12/3/2004 email from Gail McDermott to Abe Losice and Pat Jordan, PSI-S&P-RFN-000034.
[1190] 5/2/2006 email from Gale Scott to Diane Cory, "RE: Change in scheduling/Coaching sessions/Other stuff," PSI-S&P-RFN-000012.

am more concerned than ever that we are on a downward spiral of morale, analytical leadership/quality and client service."[1191]

Some of the groups came up with creative ways to address their staffing shortages. For example, the head of the S&P RMBS Ratings Group between 2005 and 2007, Susan Barnes, advised the Subcommittee that her group regularly borrowed staff from the S&P Surveillance Group to assist with new ratings. She said that almost half the surveillance staff provided assistance on issuing new ratings during her tenure, and estimated that each person in the surveillance group might have contributed up to 25% of his or her time to issuing new ratings.[1192]

The Subcommittee investigation discovered a cadre of professional RMBS and CDO rating analysts who were rushed, overworked, and demoralized. They were asked to evaluate increasing numbers of increasingly complex financial instruments at high speed, using out-of-date rating models and unclear ratings criteria, while acting under pressure from management to increase market share and revenues and pressure from investment banks to ignore credit risk. These analysts were short staffed even as their employers collected record revenues.

Resource-Starved Surveillance. Resource shortages also impacted the ability of the credit rating agencies to conduct surveillance on outstanding rated RMBS and CDO securities to evaluate their credit risk. The credit rating agencies were contractually obligated to monitor the accuracy of the ratings they issued over the life of the rated transactions. CRA surveillance analysts were supposed to evaluate each rating on an ongoing basis to determine whether the rating should be affirmed, upgraded, or downgraded. To support this analysis, both companies collected substantial annual surveillance fees from the issuers of the financial instruments they rated, and set up surveillance groups to review the ratings. In the case of RMBS and CDO securities, the Subcommittee investigation found evidence that these surveillance groups may have lacked the resources to properly monitor the thousands of rated products.

At Moody's, for example, a 2007 email disclosed that about 26 surveillance analysts were responsible for tracking over 13,000 rated CDO securities:

[1191] 10/31/2006 S&P internal email, "A CDO Director resignation," PSI-S&P-RFN-000001.
[1192] Subcommittee interview of Susan Barnes (3/18/2010).

"Thanks for sharing the draft of the CDO surveillance piece you're planning to publish later this week. ... In the section about your CDO surveillance infrastructure, we were struck by the data point about the 26 professionals who are dedicated to monitoring CDO ratings. While this is, no doubt, a strong team, we wanted to at least raise the question about whether the company's critics could twist that number – e.g., by comparing it to the 13,000+ CDOs you're monitoring – and once again question if you have adequate resources to do your job effectively. Given that potential risk, we thought you might consider removing any specific reference to the number of people on the CDO surveillance team."[1193]

The evidence of surveillance shortages at S&P was particularly telling. Although during an interview with the Subcommittee, the head of S&P's RMBS Surveillance Group from 2001 to 2008, Ernestine Warner, said she had adequate resources to conduct surveillance of rated RMBS securities during her tenure, her emails indicate otherwise.[1194] In emails sent over a two-year period, she repeatedly described and complained about a lack of resources that was impeding her group's ability to complete its work. In the spring of 2006, she emailed her colleague about her growing anxiety:

"RMBS has an all time high of 5900 transactions. Each time I consider what my group is faced with, I become more and more anxious. The situation with Lal [a surveillance analyst], being off line or out of the group, is having a huge impact."[1195]

In June 2006, she wrote that the problems were not getting better:

"It really feels like I am repeating myself when it comes to completing a very simple project and addressing some of the other surveillance needs. ... The inability to make a decision about how the project is going to be resourced is causing undue stress. I have talked to you and Peter [D'Erchia, head of global structured finance surveillance,] about each of the issues below and at this point I am not sure what else you need from me. ...

To rehash the points below:

[1193] 7/9/2007 email to Yuri Yoshizawa, "FW: CDO Surveillance Note 7_071.doc," PSI-MOODYS-RFN-000022.

[1194] During an interview, the head of RMBS surveillance advised that she believed she was adequately resourced and prioritized her review of outstanding securities by focusing on 2006 and 2007 vintages that had performance problems. Subcommittee interview of Ernestine Warner (3/11/2010).

[1195] 4/28/2006 email from Ernestine Warner to Roy Chun, and others, Hearing Exhibit 4/23-82.

In addition to the project above that involves some 863 deals, I have a back log of deals that are out of date with regard to ratings. … We recognize that I am still understaffed with these two additional bodies. … [W]e may be falling further behind at the rate the deals are closing. If we do not agree on the actual number, certainly we can agree that I need more recourse if I am ever going to be near compliance."[1196]

In December 2006, she wrote:

"In light of the current state of residential mortgage performance, especially sub-prime, I think it would be very beneficial for the RMBS surveillance team to have the work being done by the temps to continue. It is still very important that performance data is loaded on a timely basis as this has an impact on our exception reports. Currently, there are nearly 1,000 deals with data loads aged beyond one month."[1197]

In February 2007, she expressed concerns about having adequate resources to address potential downgrades in RMBS:

"I talked to Tommy yesterday and he thinks that the [RMBS] ratings are not going to hold through 2007. He asked me to begin discussing taking rating actions earlier on the poor performing deals. I have been thinking about this for much of the night. We do not have the resources to support what we are doing now. A new process, without the right support, would be overwhelming. ... My group is under serious pressure to respond to the burgeoning poor performance of sub-prime deals. … we are really falling behind. … I am seeing evidence that I really need to add staff to keep up with what is going on with sub prime and mortgage performance in general, NOW."[1198]

In April 2007, a managing director at S&P in the Structured Finance Group wrote an email confirming the staffing shortages in the RMBS Surveillance Group:

"We have worked together with Ernestine Warner (EW) to produce a staffing model for RMBS Surveillance (R-Surv). It is intended to measure the staffing needed for detailed surveillance of

[1196] 6/1/2006 emails from Ernestine Warner to Roy Chun, Hearing Exhibit 4/23-83.
[1197] 12/20/2006 email from Ernestine Warner to Gail Houston, Roy Chun, others, Hearing Exhibit 4/23-84.
[1198] 2/3/2007 email from Ernestine Warner to Peter D'Erchia, Hearing Exhibit 4/23-86 [emphasis in original].

the 2006 vintage and also everything issued prior to that. This model shows that the R-Surv staff is short by 7 FTE [Full Time Employees] - about 3 Directors, 2 AD's, and 2 Associates. The model suggests that the current staff may have been right sized if we excluded coverage of the 2006 vintage, but was under titled lacking sufficient seniority, skill, and experience."[1199]

The global head of the S&P Structured Finance Surveillance Group, Peter D'Erchia, told the Subcommittee that, in late 2006, he expressed concerns to senior management about surveillance resources and the need to downgrade subprime in more significant numbers in light of the deteriorating subprime market.[1200] According to Mr. D'Erchia, the executive managing director of the Global Structured Finance Ratings Group, Joanne Rose, disagreed with him about the need to issue significantly more downgrades in subprime RMBS and this disagreement continued into the next year. He also told the Subcommittee that after this disagreement with her, he received a disappointing 2007 performance evaluation. He wrote the following in the employee comment section of his evaluation:

> "Even more offensive – and flatly wrong – is the statement that I am not working for a good outcome for S&P. That is all I am working towards and have been for 26 years. It is hard to respond to such comments, which I think reflect Joanne's [Rose] personal feelings arising from our disagreement over subprime debt deterioration, not professional assessment. ... Such comments, and others like it, suggest to me that this year-end appraisal, in contrast to the mid-year appraisal, has more to do with our differences over subprime deterioration than an objective assessment of my overall performance."[1201]

In 2008, Mr. D'Erchia was removed from his surveillance position, where he oversaw more than 314 employees, as part of a reduction in force. He was subsequently rehired as a managing director in U.S. Public Finance at S&P, a position without staff to supervise. Similarly, Ernestine Warner, the head of RMBS Surveillance, lost her managerial position and was reassigned to investor relations in the Structured Finance Group.

[1199] 4/24/2007 email from Abe Losice to Susan Barnes, "Staffing for RMBS Surveillance," Hearing Exhibit 4/23-88.
[1200] Subcommittee interview of Peter D'Erchia (4/13/2010).
[1201] 2007 Performance Evaluation for Peter D'Erchia, S&P SEN-PSI 0007442; See also April 23, 2010 Subcommittee Hearing at 74-75.

On July 10, 2007, amid record mortgage defaults, S&P abruptly began downgrading its outstanding RMBS and CDO ratings. In July alone, it downgraded the ratings of more than 1,000 RMBS and 100 CDO securities. Both credit rating agencies continued to issue significant downgrades throughout the remainder of 2007. On January 30, 2008, S&P took action on over 8,200 RMBS and CDO ratings – meaning it either downgraded their ratings or placed the securities on credit watch with negative implications. These and other downgrades, matched by equally substantial numbers at Moody's, paint a picture of CRA surveillance teams acting at top speed in overwhelming circumstances to correct thousands of inaccurate RMBS and CDO ratings. When asked to produce contemporaneous decision-making documents indicating how and when the ratings were selected for downgrade, neither S&P nor Moody's produced meaningful documentation. The facts suggest that CRA surveillance analysts with already substantial responsibilities and limited resources were forced to go into overdrive to clean up ratings that could not "hold."

(6) Mortgage Fraud

A final factor that contributed to inaccurate credit ratings involves mortgage fraud. Although the credit rating agencies were clearly aware of increased levels of mortgage fraud, they did not factor that credit risk into their quantitative models or adequately factor it into their qualitative analyses. The absence of that credit risk meant that the credit enhancements they required were insufficient, the tranches bearing AAA ratings were too large, and the ratings they issued were too optimistic.

Reports of mortgage fraud were frequent and mounted yearly prior to the financial crisis. As noted above, as early as 2004, the FBI began issuing reports on increased mortgage fraud.[1202] The FBI was also quoted in Congressional testimony and in the popular press about the mortgage fraud problem. CNN reported that "[r]ampant fraud in the mortgage industry has increased so sharply that the FBI warned Friday of an 'epidemic' of financial crimes which, if not curtailed, could become 'the next S&L crisis.'"[1203] In 2006, the FBI reported that the number of Suspicious Activity Reports on mortgage fraud had increased sixfold, from about 6,800 in 2002, to about 36,800 in 2006, while pending mortgage fraud cases nearly doubled from 436 in FY 2003 to 818 in FY 2006.[1204] The Mortgage Asset Research Institute, LLC

[1202] FY 2004 "Financial Institution Fraud and Failure Report," prepared by the Federal Bureau of Investigation, available at http://www.fbi.gov/stats-services/publications/fiff_04.
[1203] "FBI warns of mortgage fraud 'epidemic'," CNN.com (9/17/2004), http://articles.cnn.com/2004-09-17/justice/mortgage.fraud_1_mortgage-fraud-mortgage-industry-s-1-crisis?_s=PM:LAW.
[1204] "Financial Crimes Report to the Public: Fiscal Year 2006, October 1, 2005 – September 30,

(MARI) also reported increasing mortgage fraud over several years, including a 30% increase in 2006 alone.[1205]

Published reports, as well as internal emails, demonstrate that analysts within both Moody's and S&P were aware of the serious mortgage fraud problem in the industry.[1206] Despite being on notice about the problem and despite assertions about the importance of loan data quality in the ratings process for structured finance securities,[1207] neither Moody's nor S&P established procedures to account for the possibility of fraud in its ratings process. For example, neither company took any steps to ensure that the loan data provided for specific RMBS loan pools had been reviewed for accuracy.[1208] The former head of S&P's RMBS Group, Frank Raiter, stated in his prepared testimony for the Subcommittee hearing that the S&P rating process did not include any "due diligence" review of the loan tape or any requirement for the provider of the loan tape to certify its accuracy. He stated: "We were discouraged from even using the term 'due diligence' as it was believed to expose S&P to liability."[1209] Fraud was also not factored into the RMBS or CDO quantitative models.[1210]

Yet when Moody's and S&P initiated the mass downgrades of RMBS and CDO securities in July 2007, they directed some of the blame for the rating errors on the volume of mortgage fraud. On July 10, 2007, when S&P announced that it was placing 612 U.S. subprime RMBS on negative credit watch, S&P noted the high incidence of fraud reported by MARI, "misrepresentations on credit reports," and that "[d]ata quality concerning some of the borrower and loan characteristics

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2006," prepared by the Federal Bureau of Investigation, available at http://www.fbi.gov/stats-services/publications/fcs_report2006/financial-crimes-report-to-the-public-2006-pdf/view.

[1205] 4/2007 "Ninth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association," prepared by Mortgage Asset Research Institute, LLC.

[1206] See, e.g., 9/2/2006 email chain between Richard Koch, Robert Mackey, and Michael Gutierrez, "Nightmare Mortgages," Hearing Exhibit 4/23-46a; 9/5/2006 email chain between Edward Highland, Michael Gutierrez, and Richard Koch, "Nightmare Mortgages," Hearing Exhibit 4/23-46b; and 9/29/2006 email from Michael Gutierrez, Director of S&P, PSI-S&P-RFN-000029.

[1207] See, e.g., 6/24/2010 supplemental response from S&P to the Subcommittee, Exhibit H, Hearing Exhibit 4/23-108 (7/11/2007 "S&PCORRECT: 612 U.S. Subprime RMBS Classes Put On Watch Neg; Methodology Revisions Announced," S&P's RatingsDirect (correcting the original version issued on 7/10/2007)).

[1208] See, e.g., 2008 SEC Examination Report for Moody's Investor Services Inc., PSI-SEC (Moodys Exam Report)-14-0001-16, at 7; and 2008 SEC Examination Report for Standard and Poor's Ratings Services, Inc., PSI-SEC (S&P Exam Report)-14-0001-24, at 11 (finding with respect to each credit rating agency that it "did not engage in any due diligence or otherwise seek to verify the accuracy and quality of the loan data underlying the RMBS pools it rated").

[1209] Prepared statement of Frank Raiter, Former Managing Director at Standard & Poor's, April 23, 2010 Subcommittee Hearing, at 3.

[1210] Subcommittee interviews of Susan Barnes (3/18/2010) and Richard Gugliada (10/9/2009).

provided during the rating process [had] also come under question." [1211] In October 2007, the CEO of Fitch Ratings, another ratings firm, said in an interview that "the blame may lie with fraudulent lending practices, not his industry."[1212] Moody's made similar observations. In 2008, Moody's CEO Ray McDaniel told a panel at the World Economic Forum:

> "In hindsight, it is pretty clear that there was a failure in some key assumptions that were supporting our analytics and our models. … [One reason for the failure was that the] 'information quality' [given to Moody's,] both the complete[ness] and veracity, was deteriorating."[1213]

In 2007, Fitch Ratings decided to conduct a review of some mortgage loan files to evaluate the impact of poor lending standards on loan quality. On November 28, 2007, Fitch issued a report entitled, "The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance." After reviewing a "sample of 45 subprime loans, targeting high CLTV [combined loan to value] [and] stated documentation loans, including many with early missed payments," Fitch reported that it decided to summarize information about the impact of fraud, as well as lax lending standards, on the mortgages. Fitch explained: "[t]he result of the analysis was disconcerting at best, as there was the appearance of fraud or misrepresentation in almost every file."[1214]

To address concerns about fraud and lax underwriting standards generally, S&P considered a potential policy change in November 2007 that would give an evaluation of the quality of services provided by third parties more influence in the ratings process. An S&P managing director wrote:

> "We believe our analytical process and rating opinions will be enhanced by an increased focus on the role third parties can play in influencing loan default and loss performance. … [W]e'd like to

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[1211] 6/24/2010 supplemental response from S&P to the Subcommittee, Exhibit H, Hearing Exhibit 4/23-108 (7/11/2007 "S&PCORRECT: 612 U.S. Subprime RMBS Classes Put On Watch Neg; Methodology Revisions Announced," S&P's RatingsDirect (correcting the original version issued on 7/10/2007)).

[1212] 10/12/2007 Moody's internal email, PSI-MOODYS-RFN-000035 (citing "Fitch CEO says fraudulent lending practices may have contributed to problems with ratings," Associated Press, and noting: "After S&P, Fitch is now blaming fraud for the impact on RMBS, at least partially.").

[1213] "Moody's: They Lied to Us," New York Times (1/25/2008), http://norris.blogs.nytimes.com/2008/01/25/moodys-they-lied-to-us/.

[1214] 11/28/2007 "The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance," report prepared by Fitch Ratings, at 4, Hearing Exhibit 4/23-100.

> set up meetings where specific mortgage originators, investment banks and mortgage servicers are discussed. We would like to use these meetings to share ideas with a goal of determining whether loss estimates should be altered based upon your collective input."[1215]

An S&P employee who received this announcement wrote to a colleague: "Should have been doing this all along." [1216]

S&P later decided that its analysts would also review specific loan originators that supplied loans for the pool. Loans issued by originators with a reputation for issuing poor quality loans, including loans marked by fraud, would be considered a greater credit risk and ratings for the pool containing the loans would reflect that risk. S&P finalized that policy in November 2008.[1217] As part of its ratings analysis, S&P now ranks mortgage originators based on the past historical performance of their loans and factors the assessment of the originator into credit enhancement levels for RMBS.[1218]

In September 2007, Moody's solicited industry feedback on proposed enhancements to its evaluation of nonprime RMBS securitizations, including the need for third-party due diligence reviews of the loans in a securitization. Moody's wrote: "To improve the accuracy of loan information upon which it relies, Moody's will look for additional oversight by a qualified third party."[1219] In November 2008, Moody's issued a report detailing its enhanced approach to RMBS originator assessments.[1220]

E. Preventing Inflated Credit Ratings

Weak credit rating agency performance has long been a source of concern to financial regulators. Many investors rely on credit ratings to identify "safe" investments. Many regulated financial institutions, including banks, broker-dealers, insurance companies, pension funds,

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[1215] 11/15/2007 email from Thomas Warrack to Michael Gutierrez, and others, Hearing Exhibit 4/23-34.
[1216] 11/15/2007 email from Robert Mackey to Michael Gutierrez, and others, Hearing Exhibit 4/23-34.
[1217] 6/24/2010 supplemental letter from S&P to the Subcommittee, Exhibit W, Hearing Exhibit 4/23-108 (11/25/2008 "Standard & Poor's Enhanced Mortgage Originator and Underwriting Review Criteria for U.S. RMBS," S&P's RatingsDirect).
[1218] Id.
[1219] "Moody's Proposes Enhancements to Non-Prime RMBS Securitization," Moody's (9/25/2007).
[1220] "Moody's Enhanced Approach to Originator Assessments for U.S. Residential Mortgage Backed Securities (RMBS)," Moody's, Hearing Exhibit 4/23-106 (originally issued 11/24/2008 but due to minor changes was republished on 10/5/2009).

mutual funds, money market funds, and others have been required to operate under restrictions related to their purchase of "investment grade" versus "noninvestment grade" financial instruments. When credit agencies issue inaccurate credit ratings, both retail investors and regulated financial institutions may mistakenly purchase financial instruments that are riskier than they intended or are permitted to buy. The recent financial crisis has demonstrated how the unintended purchase of high risk financial products by multiple investors and financial institutions can create systemic risk and endanger, not only U.S. financial markets, but the entire U.S. economy.

(1) Past Credit Rating Agency Oversight

Even before the recent financial crisis, the SEC and Congress had been reviewing the need for increased regulatory oversight of the credit rating industry. In 1994, for example, the SEC "issued a Concept Release soliciting public comment on the appropriate role of ratings in the federal securities laws, and the need to establish formal procedures for recognizing and monitoring the activities of [credit rating agencies]."[1221]

In 2002, the Senate Committee on Governmental Affairs examined the collapse of the Enron Corporation, focusing in part on how the credit rating agencies assigned investment grade credit ratings to the company "until a mere four days before Enron declared bankruptcy."[1222] The Committee issued a report finding, among other things, that the credit rating agencies:

> "failed to detect Enron's problems – or take sufficiently seriously the problems they were aware of – until it was too late because they did not exercise the proper diligence. ... [T]he agencies did not perform a thorough analysis of Enron's public filings; did not pay appropriate attention to allegations of financial fraud; and repeatedly took company officials at their word ... despite indications that the company had misled the rating agencies in the past."[1223]

[1221] 1/2003 "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," prepared by the SEC, at 5.

[1222] 10/8/2002 "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs," prepared by the U.S. Senate Committee on Governmental Affairs, at 6. See also "Rating the Raters: Enron and the Credit Rating Agencies," before the U.S. Senate Committee on Governmental Affairs, S.Hrg. 107-471 (3/20/2002). The Committee has since been renamed as the Committee on Homeland Security and Governmental Affairs.

[1223] 10/8/2002 "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs," prepared by the U.S. Senate Committee on Governmental Affairs, at 6, 108.

The report also found the credit rating "analysts [did] not view themselves as accountable for their actions," since the rating agencies were subject to little regulation or oversight, and their liability for poor quality ratings was limited by regulatory exemptions and First Amendment protections.[1224] The report recommended "increased oversight for these rating agencies in order to ensure that the public's trust in these firms is well-placed."[1225]

In 2002, the Sarbanes-Oxley Act required the SEC to conduct a study into the role of credit rating agencies in the securities markets, including any barriers to accurately evaluating the financial condition of the issuers of securities they rate.[1226] In response, the SEC initiated an in-depth study of the credit rating industry and released its findings in a 2003 report. The SEC's oversight efforts "included informal discussions with credit rating agencies and market participants, formal examinations of credit rating agencies, and public hearings, where market participants were given the opportunity to offer their views on credit rating agencies and their role in the capital markets."[1227] The report expressed a number of concerns about CRA operations, including "potential conflicts of interest caused by the [issuer-pays model]."[1228]

The Credit Rating Agency Reform Act, which was signed into law in September 2006, was designed to address some of the shortcomings identified by Congress and the SEC. The Act made it clear that the SEC had jurisdiction to conduct oversight of the credit rating industry, and formally charged the agency with designating companies as NRSROs.[1229] The statute also required NRSROs to meet certain criteria before registering with the SEC. In addition, the statute instructed the SEC to promulgate regulations requiring NRSROs to establish policies and procedures to prevent the misuse of nonpublic information and to disclose and manage conflicts of interest.[1230] Those regulations were designed to take effect in September 2007.

In the summer of 2007, after the mass downgrades of RMBS and CDO ratings had begun and as the financial crisis began to intensify, the SEC initiated its first examinations of the major credit rating agencies. According to the SEC, "[t]he purpose of the examinations was to

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[1224] Id. at 122.
[1225] Id. at 6.
[1226] Section 702 of the Sarbanes-Oxley Act of 2002.
[1227] 1/2003 "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," prepared by the SEC, at 4.
[1228] Id. at 19.
[1229] 9/3/2009 "Credit Rating Agencies and Their Regulation," report prepared by the Congressional Research Service, Report No. R40613 (revised report issued 4/9/2010).
[1230] Id.

develop an understanding of the practices of the rating agencies surrounding the rating of RMBS and CDOs."[1231] The examinations reviewed CRA practices from January 2004 to December 2007. In 2008, the SEC issued a report summarizing its findings. The report found that "there was a substantial increase in the number and in the complexity of RMBS and CDO deals," "significant aspects of the ratings process were not always disclosed," the ratings policies and procedures were not fully documented, "the surveillance processes used by the rating agencies appear to have been less robust than the processes used for initial ratings," and the "rating agencies' internal audit processes varied significantly."[1232] In addition, the report raised a number of conflict of interest issues that influenced the ratings process, noted that the rating agencies failed to verify the accuracy or quality of the loan data used to derive their ratings, and raised questions about the factors that were or were not used to derive the credit ratings.[1233]

(2) New Developments

Although the Credit Rating Agency Reform Act of 2006 strengthened oversight of the credit rating agencies, Congress passed further reforms in response to the financial crisis to address weaknesses in regulatory oversight of the credit rating industry. The Dodd-Frank Act dedicated an entire subtitle to those credit rating reforms which substantially broadened the powers of the SEC to oversee and regulate the credit rating industry and explicitly allowed investors, for the first time, to file civil suits against credit rating agencies.[1234] The major reforms include the following:

a. establishment of a new SEC Office of Credit Ratings charged with overseeing the credit rating industry, including by conducting at least annual NRSRO examinations whose reports must be made public;

b. SEC authority to discipline, fine, and deregister a credit rating agency and associated personnel for violating the law;

c. SEC authority to deregister a credit rating agency for issuing poor ratings;

[1231] 7/2008 "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies," prepared by the SEC, at 1. The CRAs examined by the SEC were not formally subject to the Credit Rating Agency Reform Act of 2006 or its implementing SEC regulations until September 2007.
[1232] Id. at 1-2.
[1233] Id. at 14, 17-18, 23-29, 31-37.
[1234] See Title IX, Subtitle C – Improvements to the Regulation of Credit Rating Agencies of the Dodd-Frank Act.

d. authority for investors to file private causes of action against credit rating agencies that knowingly or recklessly fail to conduct a reasonable investigation of a rated product;

e. requirements for credit rating agencies to establish internal controls to ensure high quality ratings and disclose information about their rating methodologies and about each issued rating;

f. amendments to federal statutes removing references to credit ratings and credit rating agencies in order to reduce reliance on ratings;

g. a GAO study to evaluate alternative compensation models for ratings that would create financial incentives to issue more accurate ratings; and

h. an SEC study of the conflicts of interest affecting ratings of structured finance products, followed by the mandatory development of a plan to reduce ratings shopping.[1235]

The Act stated that these reforms were needed, "[b]ecause of the systemic importance of credit ratings and the reliance placed on credit ratings by individual and institutional investors and financial regulators," and because "credit rating agencies are central to capital formation, investor confidence, and the efficient performance of the United States economy."[1236]

(3) Recommendations

To further strengthen the accuracy of credit ratings and reduce systemic risk, this Report makes the following recommendations.

1. **Rank Credit Rating Agencies by Accuracy.** The SEC should use its regulatory authority to rank the Nationally Recognized Statistical Rating Organizations in terms of performance, in particular the accuracy of their ratings.

2. **Help Investors Hold CRAs Accountable.** The SEC should use its regulatory authority to facilitate the ability of investors to hold credit rating agencies accountable in civil lawsuits for inflated credit ratings, when a credit rating agency knowingly or recklessly fails to conduct a reasonable investigation of the rated security.

[1235] See id. at §§ 931-939H; "Conference report to accompany H.R. 4173," Cong. Report No. 111-517 (June 29, 2010).
[1236] See Section 931 of the Dodd-Frank Act.

3. **Strengthen CRA Operations.** The SEC should use its inspection, examination, and regulatory authority to ensure credit rating agencies institute internal controls, credit rating methodologies, and employee conflict of interest safeguards that advance rating accuracy.

4. **Ensure CRAs Recognize Risk.** The SEC should use its inspection, examination, and regulatory authority to ensure credit rating agencies assign higher risk to financial instruments whose performance cannot be reliably predicted due to their novelty or complexity, or that rely on assets from parties with a record for issuing poor quality assets.

5. **Strengthen Disclosure.** The SEC should exercise its authority under the new Section 78o-7(s) of Title 15 to ensure that the credit rating agencies complete the required new ratings forms by the end of the year and that the new forms provide comprehensible, consistent, and useful ratings information to investors, including by testing the proposed forms with actual investors.

6. **Reduce Ratings Reliance.** Federal regulators should reduce the federal government's reliance on privately issued credit ratings.

VI. INVESTMENT BANK ABUSES: CASE STUDY OF GOLDMAN SACHS AND DEUTSCHE BANK

A key factor in the recent financial crisis was the role played by complex financial instruments, often referred to as structured finance products, such as residential mortgage backed securities (RMBS), collateralized debt obligations (CDOs), and credit default swaps (CDS), including CDS contracts linked to the ABX Index. These financial products were envisioned, engineered, sold, and traded by major U.S. investment banks.

From 2004 to 2008, U.S. financial institutions issued nearly $2.5 trillion in RMBS securities and over $1.4 trillion in CDOs securitizing primarily mortgage related products.[1237] Investment banks charged fees ranging from $1 to $8 million to act as the underwriter of an RMBS securitization,[1238] and from $5 to $10 million to act as the placement agent for a CDO securitization.[1239] Those fees contributed substantial revenues to the investment banks which set up structured finance groups, and a variety of RMBS and CDO origination and trading desks within those groups, to handle mortgage related securitizations. Investment banks placed these securities with investors around the world, and helped develop a secondary market where private RMBS and CDO securities could be bought and sold. The investment banks' trading desks participated in those secondary markets, buying and selling RMBS and CDO securities either for their customers or for themselves.

[1237] 3/4/2011 "U.S. Mortgage-Related Securities Issuance" and 1/1/2011 "Global CDO Issuance," charts prepared by Securities Industry and Financial Markets Association, www.sifma.org/research/statistics.aspx. The RMBS total does not include about $6.6 trillion in RMBS securities issued by government sponsored enterprises like Fannie Mae and Freddie Mac.
[1238] See, e.g., 2/2011 chart, "Goldman Sachs Expected Profit from RMBS Securitizations," prepared by the U.S. Senate Permanent Subcommittee on Investigations using Goldman-produced documents for securitizations from 2005-2007 (underlying documents retained in Subcommittee file); 3/21/2011 letter from Deutsche Bank counsel, PSI-Deutsche_Bank-32-0001.
[1239] See "Banks' Self-Dealing Super-Charged Financial Crisis," ProPublica (8/26/2010), http://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis ("A typical CDO could net the bank that created it between $5 million and $10 million – about half of which usually ended up as employee bonuses. Indeed, Wall Street awarded record bonuses in 2006, a hefty chunk of which came from the CDO business."). Fee information obtained by the Subcommittee is consistent with this range of CDO fees. For example, Deutsche Bank received nearly $5 million in fees for Gemstone 7, and the head of its CDO Group said that Deutsche Bank received typically between $5 and 10 million in fees, while Goldman Sachs charged a range of $5 to $30 million in fees for Camber 7, Fort Denison, and the Hudson Mezzanine 1 and 2 CDOs. 12/20/2006 Gemstone 7 Securitization Credit Report, DB_PSI_00237655-71 and 3/15/2007 Gemstone CDO VII Ltd. Closing Memorandum, DB_PSI_00133536-41; Subcommittee interview of Michael Lamont (9/29/2010); and Goldman Sachs response to Subcommittee QFRs at PSI-QFR-GS0249.

Some of these financial products allowed investors to profit, not only from the success of an RMBS or CDO securitization, but also from its failure. CDS contracts, for example, allowed counterparties to wager on the rise or fall in the value of a specific RMBS security or on a collection of RMBS and other assets contained or referenced in a CDO. Major investment banks also developed standardized CDS contracts that could be traded on a secondary market. In addition, they established the ABX Index which allowed counterparties to wager on the rise or fall in the value of a basket of subprime RMBS securities, and which could be used to reflect the state of the subprime mortgage market as a whole.

Investment banks sometimes matched up parties who wanted to take opposite sides in a structured finance transaction, and other times took one or the other side of a transaction to accommodate a client. At still other times, investment banks used these financial instruments to make their own proprietary wagers. In extreme cases, some investments banks set up structured finance transactions which enabled them to profit at the expense of their clients.

Two case studies, involving Goldman Sachs and Deutsche Bank, illustrate a variety of troubling and sometimes abusive practices involving the origination or use of RMBS, CDO, CDS, and ABX financial instruments. Those practices included at times constructing RMBS or CDOs with assets that senior employees within the investment banks knew were of poor quality; underwriting securitizations for lenders known within the industry for issuing high risk, poor quality mortgages or RMBS securities; selling RMBS or CDO securities without full disclosure of the investment bank's own adverse interests; and causing investors to whom they sold the securities to incur substantial losses.

In the case of Goldman Sachs, the practices included exploiting conflicts of interest with the firm's clients. For example, Goldman used CDS and ABX contracts to place billions of dollars of bets that specific RMBS securities, baskets of RMBS securities, or collections of assets in CDOs would fall in value, while at the same time convincing customers to invest in new RMBS and CDO securities. In one instance, Goldman took the entire short side of a $2 billion CDO known as Hudson 1, selected assets for the CDO to transfer risk from Goldman's own holdings, allowed investors to buy the CDO securities without fully disclosing its own short position, and when the CDO lost value, made a $1.7 billion gain at the expense of the clients to whom it had sold the securities. While Goldman sometimes told customers that it might take an adverse investment position to the RMBS or CDO securities it was selling them, Goldman did not disclose that, in fact, it already had significant proprietary investments that would pay off if the particular security it was selling or if RMBS and CDO securities in general fell in value. In another instance, Goldman marketed a CDO known as Abacus 2007-AC1 to clients without disclosing that it had allowed the sole short party in the CDO, a hedge fund, to play a major role in selecting the assets. The Abacus securities quickly lost value, and the three long investors together lost $1 billion, while the hedge fund profited by about the same amount. In still other instances, Goldman took on the role of a collateral put provider or liquidation agent in a CDO, and leveraged that role to obtain added financial benefits to the fiscal detriment of the clients to whom it sold the CDO securities.

In the case of Deutsche Bank, during 2006 and 2007, the bank's top CDO trader, Greg Lippmann, repeatedly warned and advised his Deutsche Bank colleagues and some of his clients seeking to buy short positions about the poor quality of the RMBS securities underlying many CDOs, describing some of those securities as "crap" and "pigs." At one point, Mr. Lippmann was asked to buy a specific CDO security and responded that it "rarely trades," but he "would take it and try to dupe someone" into buying it. He also disparaged RMBS securities that, at the same time, were being included in Gemstone 7, a CDO being assembled by the bank for sale to investors. Gemstone 7 included or referenced 115 RMBS securities, many of which carried BBB, BBB-, or even BB credit ratings, making them among the highest risk RMBS securities sold to the public, yet received AAA ratings for its top three tranches. Deutsche Bank sold $700 million in Gemstone securities to eight investors who saw their investments rapidly incur delinquencies, rating downgrades, and losses. Mr. Lippmann at times referred to the industry's ongoing CDO marketing efforts as a "CDO machine" or "ponzi scheme," and predicted that the U.S. mortgage market as a whole would eventually plummet in value. Deutsche Bank's senior management disagreed with his negative views, and used the bank's own funds to make large proprietary investments in mortgage related securities that, in 2007, had a notional or face value of $128 billion and a market value of more than $25 billion. At the same time, Deutsche Bank allowed Mr. Lippmann to develop for the bank a $5 billion proprietary short position in the RMBS market, which it later cashed in for a profit of approximately $1.5 billion. Despite that gain, in 2007, due to its substantial long investments, Deutsche Bank incurred an overall loss of about $4.5 billion from its mortgage related proprietary investments.

The two case studies illustrate how investment banks engaged in high intensity sales efforts to market new CDOs in 2007, even as U.S. mortgage delinquencies climbed, RMBS securities incurred losses, the U.S. mortgage market as a whole deteriorated, and investors lost confidence. They demonstrate how these investment banks benefitted from structured finance fees, and had little incentive to stop producing and selling high risk, poor quality structured finance products. They also illustrate how the development of complex structured finance products, such as synthetic CDOs and naked credit default swaps, amplified market risk by allowing investors with no ownership interest in the "reference obligations" to place unlimited side bets on their performance. Finally, the two case histories demonstrate how proprietary trading led to dramatic losses in the case of Deutsche Bank and to conflicts of interest in the case of Goldman Sachs.

Investment banks were a major driving force behind the structured finance products that provided a steady stream of funding for lenders to originate high risk, poor quality loans and that magnified risk throughout the U.S. financial system. The investment banks that engineered, sold, traded, and profited from mortgage related structured finance products were a major cause of the financial crisis.

A. Background

(1) Investment Banks In General

Historically, investment banks helped raise capital for business and other endeavors by helping to design, finance, and sell financial products like stocks or bonds. When a corporation needed capital to fund a large construction project, for example, it often hired an investment bank either to arrange a bank loan or to raise capital by designing, financing, and marketing an issue of shares or corporate bonds for sale to investors. Investment banks performed these services in exchange for fees.

Today, investment banks also participate in a wide range of other financial activities, including providing broker-dealer and investment advisory services, and trading commodities and derivatives. Investment banks also often engage in proprietary trading, meaning trading with their own money and not on behalf of a customer. Many investment banks are structured today as affiliates of one or more banks.

Under the Glass-Steagall Act of 1933, certain types of financial institutions had been prohibited from commingling their services. For example, with limited exceptions, only broker-dealers could provide brokerage services; only banks could offer banking; and only insurers could offer insurance. Each financial sector had its own primary regulator who was generally prohibited from regulating services outside of its jurisdiction.[1240] Glass-Steagall also contained prohibitions against proprietary trading.[1241] One reason for keeping the sectors separate was to ensure that banks with federally insured deposits did not engage in the type of high risk activities that might be the bread and butter of a broker-dealer or commodities trader. Another reason was to avoid the conflicts of interest that might arise, for example, from a financial institution pressuring its clients to obtain all of its financial services from the same firm. A third reason was to avoid the conflicts of interest that arise when a financial institution is allowed to act for its own benefit in a proprietary capacity, while at the same time acting on behalf of customers in an agency or fiduciary capacity.

Glass-Steagall was repealed in 1999, after which the barriers between banks, broker-dealers, and insurance firms fell. U.S. financial institutions not only began offering a mix of financial services, but also intensified their proprietary trading activities. The resulting changes in the way financial institutions were organized and operated made it more difficult for regulators to distinguish between activities intended to benefit customers versus the financial institution itself. The expanded set of financial services investment banks were allowed to offer also contributed to the multiple and significant conflicts of interest that arose between some investment banks and their clients during the financial crisis.

(2) Roles and Duties of an Investment Bank: Market Maker, Underwriter, Placement Agent, Broker-Dealer

Investment banks typically play a variety of significant roles when dealing with their clients, including that of market maker, underwriter, placement agent, and broker-dealer. Each role brings different legal obligations under federal securities law.

Market Maker. A "market maker" is typically a dealer in financial instruments that stands ready to buy and sell for its own

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[1240] Federal law has never established a "super-regulator" with jurisdiction to police compliance and conduct across banking, brokerage, investment advisory, and insurance sectors, and that remains the case today.

[1241] See Section 16 of the Banking Act of 1933, Pub. L. 73-66 (also known as the Glass-Steagall Act).

account a particular financial instrument on a regular and continuous basis at a publicly quoted price.[1242] A major responsibility of a market maker is filling orders on behalf of customers. Market markers do not solicit customers; instead they maintain, buy, and sell quotes in a public setting, demonstrating their readiness to either buy or sell the specified security, and customers come to them. For example, a market maker in a particular stock typically posts the prices at which it is willing to buy or sell that stock, attracting customers based on the competitiveness of its prices. This activity by market makers helps provide liquidity and efficiency in the trading market for the security.[1243] It is common for a particular security to have multiple market makers who competitively quote the security.

Market makers generally use the same inventory of assets to carry out both their market-making and proprietary trading activities. Market makers are allowed, in certain circumstances specified by the SEC, to sell securities short in situations to satisfy market demand when they do not have the securities in their inventory in order to provide liquidity. Market makers have among the most narrow disclosure obligations under federal securities law, since they do not actively solicit clients or make investment recommendations to them. Their disclosure obligations are generally limited to providing fair and accurate information related to the execution of a particular trade.[1244] Market makers are also subject to the securities laws' prohibitions against fraud and market manipulation. In addition, they are subject to legal requirements relating to the handling of customer orders, for example using best execution efforts when placing a client's buy or sell order.[1245]

Underwriter and Placement Agent. If an investment bank agrees to act as an "underwriter" for the issuance of a new security to the public, such as an RMBS, it typically purchases the securities from the issuer, holds them on its books, conducts the public offering, and bears the financial risk until the securities are sold to the public. By law, securities

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[1242] Section 3(a)(38) of the Securities Exchange Act of 1934 states: "The term "market maker" means any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis." See also SEC website, http://www.sec.gov/answers/mktmaker.htm; FINRA website, FAQs, "What Does a Market Maker Do?" http://finra.atgnow.com/finra/categoryBrowse.do.

[1243] See SEC website, http://www.sec.gov/answers/mktmaker.htm; FINRA website, FAQs, "What Does a Market Maker Do?" http://finra.atgnow.com/finra/categoryBrowse.do.

[1244] 1/2011 "Study on Investment Advisers and Broker-Dealers," study conducted by the U.S. Securities and Exchange Commission, at 55, http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[1245] See Responses to Questions for the Record from Goldman Sachs at PSI_QFR_GS0046.

sold to the public must be registered with the SEC. Underwriters help issuers prepare and file the registration statements filed with the SEC, which explain to potential investors the purpose of a proposed public offering, the issuer's operations and management, key financial data, and other important facts. Any offering document, or prospectus, given to the investing public in connection with a registered security must also be filed with the SEC.

If a security is not offered to the general public, it can still be offered to investors through a "private placement." Investment banks often act as the "placement agent," performing intermediary services between those seeking to raise money and investors. Placement agents often help issuers design the securities, produce the offering materials, and market the new securities to investors. Offering documents in connection with private placements are exempt from SEC registration and are not filed with the SEC.

In the years leading up to the financial crisis, RMBS securities were registered with the SEC, while CDOs were sold to investors through private placements. Both of these securities were also traded in a secondary market by market makers. Investment banks sold both types of securities primarily to large institutional investors, such as other banks, pension funds, insurance companies, municipalities, university endowments, and hedge funds.

Whether acting as an underwriter or placement agent, a major part of the investment bank's responsibility is to solicit customers to buy the new securities being offered. Under the securities laws, investment banks that act as an underwriter or placement agent for new securities are liable for any material misrepresentation or omission of a material fact made in connection with a solicitation or sale of those securities to investors.[1246]

[1246] See Sections 11 and 12 of Securities Act of 1933. See also Rule 10b-5 of the Securities Exchange Act of 1934. See also, e.g., SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 201 (1963) ("Experience has shown that disclosure in such situations, while not onerous to the advisor, is needed to preserve the climate of fair dealing which is so essential to maintain public confidence in the securities industry and to preserve the economic health of the country."). See also SEC Study on Investment Advisers and Broker-Dealers at 51 (citations omitted) ("Under the so-called 'shingle' theory ..., a broker-dealer makes an implicit representation to those persons with whom it transacts business that it will deal fairly with them, consistent with the standards of the profession. ... Actions taken by the broker-dealer that are not fair to the customer must be disclosed in order to make this implied representation of fairness not misleading.").

The obligation of an underwriter and placement agent to disclose material facts to every investor it solicits comes from two sources: the duties as an underwriter specifically, and the duties as a broker-dealer generally. With respect to duties relating to being an underwriter, the U.S. Court of Appeals for the First Circuit observed that underwriters have a "unique position" in the securities industry:

> "[T]he relationship between the underwriter and its customer implicitly involves a favorable recommendation of the issued security. ... Although the underwriter cannot be a guarantor of the soundness of any issue, he may not give it his implied stamp of approval without having a reasonable basis for concluding that the issue is sound."[1247]

In addition, Section 11 of the Securities Act of 1933 makes underwriters liable to any investor in any registered security if any part of the registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[1248]

Broker-Dealer. Broker-dealers also have affirmative disclosure obligations to their clients. With respect to the duties of a broker-dealer, the SEC has held:

> "[W]hen a securities dealer recommends a stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts to which it is aware. That includes disclosure of 'adverse interests' such as 'economic self interest' that could have influenced its recommendation."[1249]

To help broker-dealers understand when they are obligated to disclose material adverse facts to investors, the Financial Industry Regulatory Authority (FINRA) has further defined the term "recommendation":

> "[A] broad range of circumstances may cause a transaction to be considered recommended, and this determination does not depend on the classification of the transaction by a particular member as

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1247 SEC v. Tambone, 550 F.3d 106 (1st Cir. 2008) [citations omitted].

1248 Section 11 of the Securities Act of 1933, codified at 15 U.S.C. § 77a.

1249 In the Matter of Richmark Capital Corporation, Securities Exchange Act Rel. No. 48758 (Nov. 7, 2003) (citing Chasins v. Smith Barney & Co., Inc., 438 F.3d 1167, 1172 (2d Cir. 1970) ("The investor ... must be permitted to evaluate overlapping motivations through appropriate disclosures, especially where one motivation is economic self-interest")).

'solicited' or 'unsolicited.' In particular a transaction will be considered to be recommended when the member or its associated person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages."[1250]

There is no indication in any law or regulation that the obligation to disclose material adverse facts is diminished or waived in relation to the level of sophistication of the potential investor.[1251]

(3) Structured Finance Products

Over time, investment banks have devised, marketed, and sold increasingly complex financial instruments to investors, often referred to as "structured finance" products. These products include residential mortgage backed securities (RMBS), collateralized debt obligations (CDOs), and credit default swaps (CDS), including CDS contracts linked to the ABX Index, all of which played a central role in the financial crisis.

RMBS and CDO Securities. RMBS and CDO securities are two common types of structured finance products. RMBS securities contain pools of mortgage loans, while CDOs contain or reference pools of RMBS securities and other assets. RMBS concentrate risk by including thousands of subprime and other high risk home loans, with similar characteristics and risks, in a single financial instrument. Mortgage related CDOs concentrate risk even more by including hundreds or thousands of RMBS securities, with similar characteristics and risks, in a single financial instrument. In addition, while some CDOs included only AAA rated RMBS securities, others known as "mezzanine" CDOs contained RMBS securities that carried the riskier BBB, BBB-, and even BB credit ratings and were more susceptible to losses if the underlying mortgages began to incur delinquencies or defaults.

Some investment banks went a step farther and assembled CDO securities into pools and resecuritized them as so-called "CDO squared" instruments, which further concentrated the risk in the underlying

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[1250] FINRA Notice No. 96-60.

[1251] See FINRA Rules 2210(d)(1)(A) and 2211(a)(3) and (d)(1) (by rule all institutional sales material and correspondence may not "omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading."). See also FINRA Rule 2310 and IM-2310-3 (suitability obligation to institutional customers).

CDOs.[1252] Some investment banks also assembled "synthetic CDOs," which did not contain any actual RMBS securities or other assets, but merely referenced them. Some devised "hybrid CDOs," which contained a mix of cash and synthetic assets.

The securitization process generated billions of dollars in funds that allowed investment banks to supply financing to lenders to issue still more high risk mortgages and securities, which investment banks and others then sold or securitized in exchange for still more fees. This cycle was repeated again and again, introducing more and more risk to a wider and wider range of investors.

Credit Default Swaps. Some investment banks modified still another structured finance product, a derivative known as a credit default swap (CDS), for use in the mortgage market. Much like an insurance contract, a CDS is a contract between two parties in which one party guarantees payment to the other if the assets referenced in the contract lose value or experience a negative credit event. The party selling the insurance is referred to as the "long" party, since it profits if the referenced asset performs well. The party buying the insurance protection is referred to as the "short" party, because it profits if the referenced asset performs poorly.

The short party, or CDS buyer, typically pays periodic premiums, similar to insurance premiums, to the long party or CDS seller, who has guaranteed the referenced assets against a loss in value or a negative credit event such as a credit rating downgrade, default, or bankruptcy. If the loss or negative credit event occurs, the CDS seller is required to pay an agreed upon amount to the CDS buyer. Many CDS contracts also tracked the changing value of the referenced assets over time, and required the long and short parties to post cash collateral with each other to secure payment of their respective contractual obligations.

CDS contracts that reference a single, specific security or bond for protection against a loss in value or negative credit event have become known as "single name" CDS contracts. Other CDS contracts have been designed to protect a broader basket of securities, bonds, or other assets.

By 2005, investment banks had standardized CDS contracts that referred to a "single name" RMBS or CDO security. Some investment banks and investors, which held large inventories of RMBS and CDO

[1252] CDO squared transactions will generally be referred to in this Report as "CDO^2." Some Goldman materials also use the term "CDO^2."

securities, purchased those single name CDS contracts as a hedge against possible losses in the value of their holdings. Other investors, including investment banks, began to purchase single name CDS contracts, not as a hedge to offset losses from the RMBS or CDO securities they owned, but as a way to profit from particular RMBS or CDO securities they predicted would lose value or fail. CDS contracts that paid off on securities that were not owned by the CDS buyer became known as "naked credit default swaps." Naked CDS contracts enabled investors to bet against mortgage related assets, using the minimal capital needed to make the periodic premium payments and collateral calls required by a CDS contract.

The key significance of the CDS product for the mortgage market was that it offered an alternative to investing in RMBS and CDO securities that would perform well. Single name CDS contracts instead enabled investors to place their dollars in financial instruments that would pay off if specific RMBS or CDO securities lost value or failed.

ABX Index. In January 2006, a consortium of investment banks, led by Goldman Sachs and Deutsche Bank, launched still another type of structured finance product, linked to a newly created "ABX Index," to enable investors to bet on multiple subprime RMBS securities at once. The ABX Index was administered by a private company called the Markit Group and consisted of five separate indices, each of which tracked the performance of a different basket of 20 designated subprime RMBS securities.[1253] The values of the securities in each basket were aggregated into a single composite value that rose and fell over time. Investors could then arrange, through a broker-dealer, to enter into a CDS contract with another party using the ABX basket of subprime RMBS securities as the "reference obligation" and the relevant ABX Index value as the agreed upon value of that basket. For a fee, investors could take either the "long" position, betting on the rise of the index, or the "short" position, betting on the fall of the index, without having to physically purchase or hold any of the referenced securities or raise the capital needed to pay for the full face value of those referenced securities. The index also used standardized CDS contracts that remained in effect for a

[1253] Each of the five indices tracked a different basket of subprime RMBS securities. One index tracked a basket of 20 AAA rated RMBS securities; the second a basket of AA rated RMBS securities; and the remaining indices tracked baskets of A, BBB, and BBB- rated RMBS securities. Every six months, a new set of RMBS securities was selected for each index. See 3/2008 Federal Reserve Bank of New York Staff Report No. 318, "Understanding the Securitization of Subprime Mortgage Credit," at 26. Markit Group Ltd. administered the ABX Index which issued indices in 2006 and 2007, but has not issued any new indices since then.

standard period of time, making it easier for investors to participate in the market, and buy and sell ABX-linked CDS contracts.

The ABX Index allowed investors to place unlimited bets on the performance of one or more of the subprime RMBS baskets. It also made it easier and cheaper for investors, including some investment banks, to short the subprime mortgage market in bulk.[1254] Investment banks not only helped establish the ABX Index, they encouraged their clients to enter into CDS contracts based upon the ABX Index, and used it themselves to bet on the mortgage market as a whole. The ABX Index expanded the risks inherent in the subprime mortgage market by providing investors with a way to make unlimited investments in RMBS securities.

Synthetic CDOs. By mid-2006, there was a large demand for RMBS and CDO securities as well as a growing demand for CDS contracts to short the mortgage market. To meet this demand, investment banks and others began to make greater use of synthetic CDOs, which could be assembled more quickly, since they did not require the CDO arranger to find and purchase actual RMBS securities or other assets. The increasing use of synthetic CDOs injected even greater risk into the mortgage market by enabling investors to make unlimited wagers on various groups of mortgage related assets and, if those assets performed poorly, expanding the number of investors who would realize losses.

Synthetic CDOs did not depend upon actual RMBS securities or other assets to bring in cash to pay investors. Instead, the CDO simply developed a list of existing RMBS or CDO securities or other assets that would be used as its "reference obligations." The parties to the CDO were not required to possess an ownership interest in any of those reference obligations; the CDO simply tracked their performance over time. The performance of the underlying reference obligations, in the aggregate, determined the performance of the synthetic CDO.

The synthetic CDO made or lost money for its investors by establishing a contractual agreement that they would make payments to each other, based upon the aggregate performance of the underlying referenced assets, using CDS contracts. The "short" party essentially agreed to make periodic payments, similar to insurance premiums, to the other party in exchange for an agreement that the "long" party would pay the full face value of the synthetic CDO if the underlying assets lost

[1254] Subcommittee Interview of Joshua Birnbaum (4/22/2010); Subcommittee Interview of Rajiv Kamilla (10/12/2010).

value or experienced a defined credit event such as a ratings downgrade. In essence, then, the synthetic CDO set up a wager in which the short party bet that its underlying assets would perform poorly, while the long party bet that they would perform well.

Synthetic CDOs provided still another vehicle for investors looking to short the mortgage market in bulk. The synthetic CDO typically referenced a variety of RMBS securities. One or more investors could then take the "short" position and wager that the referenced securities as a whole would fall in value or otherwise perform poorly. Synthetic CDOs became a way for investors to short multiple specific RMBS securities that they expected to incur delinquencies, defaults, and losses.

Synthetic CDOs magnified the risk in the mortgage market because arrangers had no limit on the number of synthetic CDOs they could create. In addition, multiple synthetic CDOs could reference the same RMBS and CDO securities in various combinations, and sell financial instruments dependent upon the same sets of high risk, poor quality loans over and over again to various investors. Since every synthetic CDO had to have a "short" party betting on the failure of the referenced assets, at least some poor quality RMBS and CDO securities could be included in each transaction to attract those investors. When some of the high risk, poor quality loans later incurred delinquencies or defaults, they caused losses, not in a single RMBS, but in multiple cash, synthetic, and hybrid CDOs whose securities had been sold to a wide circle of investors.[1255]

Conflicts of Interest. Investment banks that designed, obtained credit ratings for, underwrote, sold, managed, and serviced CDO securities, made money from the fees they charged for these and other services. Investment banks reportedly netted from $5 to $10 million in fees per CDO.[1256] Some also constructed CDOs to transfer the financial

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[1255] See, e.g., "Senate's Goldman Probe Shows Toxic Magnification," Wall Street Journal (5/2/2010) (showing how a single $38 million subprime RMBS, created in June 2006, was included in 30 CDOs and, by 2008, had caused $280 million in losses to investors).

[1256] See "Banks' Self-Dealing Super-Charged Financial Crisis," ProPublica (8/26/2010), http://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis ("A typical CDO could net the bank that created it between $5 million and $10 million – about half of which usually ended up as employee bonuses. Indeed, Wall Street awarded record bonuses in 2006, a hefty chunk of which came from the CDO business."). Fee information obtained by the Subcommittee is consistent with this range of CDO fees. For example, Deutsche Bank received nearly $5 million in fees for Gemstone 7, and the head of its CDO group said that Deutsche Bank received typically between $5 and 10 million in fees, while Goldman Sachs charged a range of $5 to $30 million in fees for Camber 7, Fort Denison, and the Hudson Mezzanine 1 and 2 CDOs. 12/20/2006 Gemstone 7 Securitization Credit Report, DB_PSI_00237655-71 and 3/15/2007 Gemstone CDO VII Ltd. Closing Memorandum, DB_PSI_00133536-41; Subcommittee interview of Michael Lamont (9/29/2010); and Goldman Sachs response to Subcommittee QFRs at PSI-QFR-GS0249.

risk of poorly performing RMBS and CDO securities from their own holdings to the investors they were soliciting to buy the CDO securities.[1257] By selling the CDO securities to investors, the investment banks profited not only from the CDO sales, but also eliminated possible losses from the assets removed from their warehouse accounts. In some instances, unbeknownst to the customers and investors, the investment banks that sold them CDO securities bet against those instruments by taking short positions through single name CDS contracts. Some even took the short side of the CDO they constructed, and profited when the referenced assets lost value, and the investors to whom they had sold the long side of the CDO were required to make substantial payments to the CDO.

The following two case studies examine how two investment banks active in the U.S. mortgage market constructed, marketed, and sold RMBS and CDO securities; how their activities magnified risk in the mortgage market; and how conflicts of interest negatively impacted investors and contributed to the financial crisis. The Deutsche Bank case history provides an insider's view of what one senior CDO trader described as Wall Street's "CDO machine." It reveals the trader's negative view of the mortgage market in general, the poor quality RMBS assets placed in a CDO that Deutsche Bank marketed to clients, and the fees that made it difficult for investment banks like Deutsche Bank to stop selling CDOs. The Goldman Sachs case history shows how one investment bank was able to profit from the collapse of the mortgage market, and ignored substantial conflicts of interest to profit at the expense of its clients in the sale of RMBS and CDO securities.

[1257] See, e.g., discussion of the Hudson CDO, below; Subcommittee interview of Daniel Sparks (4/15/10) (Goldman tried selling subprime loans but could not; it was easier and more efficient to securitize them and then sell the securitized product to transfer loans in bulk; it was also easier to sell CDOs than individual underlying positions).

B. Running the CDO Machine: Case Study of Deutsche Bank

This case history examines the role of Deutsche Bank USA in the design, marketing, and sale of collateralized debt obligations (CDOs) that incorporated or referenced residential mortgage backed securities (RMBS).

From 2004 to 2008, U.S. financial institutions issued over $1.4 trillion worth of CDO securities. At first, this complex structured finance product proved highly profitable for investment banks which established CDO departments and trading desks to create and market the securities. By early 2007, however, due to declining housing prices, accelerating mortgage delinquencies, and RMBS losses, investor interest in CDOs began to drop off sharply. In July 2007, the major credit rating agencies began lowering credit ratings for many CDO securities, at times eliminating the investment grade ratings that had supported CDO sales. Despite waning investor interest, U.S. investment banks continued to issue new mortgage related CDOs throughout 2007, in an apparent effort to sustain their fees and CDO departments. Some investment banks supported the CDO market by purchasing existing CDO securities for inclusion in new, even more complex CDOs, seeking customers in Europe and Asia, or retaining risky CDO securities on their own books.

Deutsche Bank was a major player in the CDO market, both in creating new CDO issues and trading these securities in the secondary market. Deutsche Bank's top global CDO trader, Greg Lippmann, began to express concerns that the CDO market was unsustainable. By the middle of 2006, Mr. Lippmann repeatedly warned and advised his Deutsche Bank colleagues and some of his clients seeking to buy short positions about the poor quality of the assets underlying many CDOs. He described some of those assets as "crap" and "pigs," and predicted the assets and the CDO securities would lose value.

At one point, Mr. Lippmann was asked to buy a specific CDO security and responded that it "rarely trades," but he "would take it and try to dupe someone" into buying it. He also at times referred to the industry's ongoing CDO marketing efforts as a "CDO machine" or "ponzi scheme." Deutsche Bank's senior management disagreed with his negative views, and used the bank's own funds to make large proprietary investments in mortgage related securities that, in 2007, had a notional or face value of $128 billion and a market value of more than $25 billion.

Despite disagreeing with his negative views on the mortgage market, Deutsche Bank allowed Mr. Lippmann, in 2005, to develop a large proprietary short position for the bank in the RMBS market. Since carrying that short position required the bank to pay millions of dollars in premiums, senior management also required Mr. Lippmann to defray or eliminate those costs by convincing others to take short positions in the mortgage market, thereby generating fees for the bank from arranging those shorts. In 2006, Mr. Lippmann generated an estimated $200 million in fees by encouraging his clients, such as hedge funds, to buy short positions. Simultaneously, Mr. Lippmann increased the size of the bank's short position by taking the short side of credit default swaps (CDS) referencing individual RMBS securities, an investment strategy often referred to as investing in "single name CDS" contracts. Over a two-year period from 2005 to 2007, Mr. Lippmann built a massive short position in single name CDS contracts totaling $5 billion. From 2007 to 2008, at the direction of the bank's senior management, he cashed in that position, generating a profit for his trading desk of approximately $1.5 billion, which he claims made more money on a single position than any other trade had ever made for Deutsche Bank in its history. Despite that gain, due to its substantial long investments, Deutsche Bank incurred an overall loss of about $4.5 billion from its mortgage related proprietary investments.[1258]

To understand how Deutsche Bank continued to issue and market CDO securities even as the market for mortgage related securities began collapsing, the Subcommittee examined a specific CDO in detail, called Gemstone CDO VII Ltd. (Gemstone 7). In October 2006, Deutsche Bank began assisting in the gathering of assets for Gemstone 7, which issued its securities in March 2007. It was the last in a series of CDOs sponsored by HBK Capital Management (HBK), a large hedge fund which acted as the collateral manager for the CDO. Deutsche Bank made $4.7 million in fees from the deal, while HBK was slated to receive $3.3 million. It was not the last CDO issued by Deutsche Bank. Even after Gemstone 7 was issued in March of 2007, Deutsche Bank issued 9 additional CDOs.

Gemstone 7 was a hybrid CDO containing or referencing a variety of high risk, subprime RMBS securities initially valued at $1.1 billion when issued. Deutsche Bank's head global trader, Mr. Lippmann, recognized that these RMBS securities were high risk and likely to lose value, but did not object to their inclusion in Gemstone 7. Deutsche Bank, the sole placement agent, marketed the initial offering of

[1258] Subcommittee interview of Greg Lippmann (10/18/2010); Net Revenues from ABS Products Backed by U.S. Residential Mortgages, DB_PSI_C00000003.

Gemstone 7 in the first quarter of 2007. Its top tranches received AAA ratings from Standard & Poor's and Moody's, despite signs that the CDO market was failing and the CDO itself contained many poor quality assets.

Nearly a third of Gemstone's assets consisted of high risk subprime loans originated by Fremont, Long Beach, and New Century, three lenders known at the time within the financial industry for issuing poor quality loans and RMBS securities. Although HBK directed the selection of assets for Gemstone 7, Mr. Lippmann's CDO Trading Desk was involved in the process and did not object to including certain RMBS securities in Gemstone 7, even though Mr. Lippmann was simultaneously referring to them as "crap" or "pigs." Mr. Lippmann was also at the same time advising some of his clients to short some of those same RMBS securities. In addition, Deutsche Bank sold five RMBS securities directly from its inventory to Gemstone 7, several of which were also contemporaneously disparaged by Mr. Lippmann.

The Deutsche Bank sales force aggressively sought purchasers for the CDO securities, while certain executives expressed concerns about the financial risk of retaining Gemstone 7 assets as the market was deteriorating in early 2007. In its struggle to sell Gemstone 7, Deutsche Bank motivated its sales force with special financial incentives, and sought out buyers in Europe and Asia because the U.S. market had dried up. Deutsche Bank also talked of providing HBK's marks, instead of its own, to clients asking about the value of Gemstone 7's assets, since HBK's marks showed the CDO's assets performing better. Deutsche Bank was ultimately unable to sell $400 million, or 36%, of the Gemstone 7 securities, and agreed with HBK to split the unsold securities, each taking $200 million onto its own books. Deutsche Bank did not disclose to the eight investors whom it had solicited and convinced to buy Gemstone 7, that its global head trader of CDOs had an extremely negative view of a third of the assets in the CDO or that the bank's internal valuations showed that the assets had lost over $19 million in value since purchased.[1259]

Gemstone 7 also demonstrated how CDOs magnified risk by including or referencing within itself 115 different RMBS securities containing thousands of high risk, poor quality subprime loans. Many of those RMBS securities carried BB ratings, which are non-investment grade credit ratings and were among the highest risk securities in the

[1259] See Sections 11 and 12 of Securities Act of 1933. See also Rule 10b-5 of the Securities Exchange Act of 1934. For a more detailed discussion of the legal obligations of underwriters, placement agents, and broker-dealers, see Section C(6) on conflicts of interest analysis, below.

CDO. Gemstone 7 also included CDO securities that, in themselves, concentrated the risk of their underlying assets. Over 75% of Gemstone's assets consisted of RMBS securities with ratings of BBB or lower, including approximately 33% with non-investment grade ratings, yet Gemstone's top three tranches were given AAA ratings by the credit rating agencies. The next three tranches were given investment grade ratings as well. Those investment grade ratings enabled investors like pension funds, insurance companies, university endowments, and municipalities, some of which were required by law, regulation, or their investment plans to put their funds in safe investments, to consider buying Gemstone securities. Eight investors actually purchased them. Within eight months, the Gemstone securities began incurring rating downgrades. By July 2008, all seven tranches in the CDO had been downgraded to junk status, and the long investors were almost completely wiped out. Today, the Gemstone 7 securities are nearly worthless.

Deutsche Bank was, in Mr. Lippmann's words, part of a "CDO machine" run by investment banks that produced hundreds of billions of high risk CDO securities. Because the fees to design and market CDOs ranged from $5 to $10 million per CDO, investment bankers had a strong financial incentive to continue issuing them, even in the face of waning investor interest and poor quality assets, since reduced CDO activity would have led to less income for structured finance units, smaller bonuses for executives, and even the disappearance of CDO departments, which is eventually what occurred. The Deutsche Bank case history provides a cautionary tale for both market participants and regulators about how complex structured finance products gain advocates within an organization committed to pushing the products through the pipeline to maintain revenues and jobs, regardless of the financial risks or possible impact on the marketplace.

(1) Subcommittee Investigation and Findings of Fact

As part of its investigation into the CDO market and the Deutsche Bank case study, the Subcommittee collected and reviewed hundreds of thousands of Deutsche Bank documents including reports, analyses, memoranda, correspondence, transcripts, spreadsheets, and email. The Subcommittee also collected and reviewed documents from HBK Capital Management, several financial institutions that purchased Deutsche Bank CDO securities, and the Securities and Exchange Commission (SEC). In addition, the Subcommittee conducted 14 interviews, including interviews with current and former Deutsche Bank and HBK executives, managers, sales representatives, and traders; spoke with personnel from the financial institutions that invested in Gemstone

7; and consulted with a number of experts from the SEC, academia, and industry.

Based upon the Subcommittee's review, the Report makes the following findings of fact.

1. **CDO Machine.** From late 2006 through 2007, despite increasing mortgage delinquencies, RMBS losses, and investor flight from the U.S. mortgage market, U.S. investment banks continued to issue new CDOs, including Deutsche Bank which issued 15 new CDOs securitizing nearly $11.5 billion of primarily mortgage related assets from December 2006 to December 2007.

2. **Fee Incentives.** Because the fees charged to design and market CDOs were in the range of $5 to $10 million per CDO, investment banks had strong incentives to continue issuing CDOs despite increasing risks and waning investor interest, since reduced CDO activity meant less revenues for structured finance units and even the disappearance of CDO departments and trading desks, which is eventually what occurred.

3. **Deutsche Bank's $5 Billion Short.** Although Deutsche Bank as a whole and through an affiliated hedge fund, Winchester Capital, made proprietary investments in long mortgage related assets, the bank also permitted its head CDO trader to make a $5 billion short investment that bet against the mortgage market and produced bank profits totaling approximately $1.5 billion.

4. **Proprietary Loss.** By 2007, Deutsche Bank, through its mortgage department and an affiliated hedge fund, had substantial proprietary holdings in the mortgage market, including more than $25 billion in long investments and a $5 billion short position, which together resulted in 2007 losses to the bank of about $4.5 billion.

5. **Gemstone 7.** In the face of a deteriorating market, Deutsche Bank aggressively sold a $1.1 billion CDO, Gemstone 7, which included RMBS securities that the bank's top CDO trader had disparaged as "crap" and "pigs," and which produced $1.1 billion of high risk, poor quality securities that are now virtually worthless.

(2) Deutsche Bank Background

CDOs In General. According to the Securities Industry and Financial Markets Association, $1.4 trillion worth of CDOs were issued in the United States from 2004 through the end of 2007.[1260] The following chart depicts the dramatic rise and fall of the U.S. CDO market over the last ten years, with total CDO issuance reaching its peak in 2006 at $520 billion, and then falling to a low of $4 billion in 2009.[1261]

Total Annual CDO Issuance
2000-2009

Year	Total CDO Issuance ($ in billions)
2000	67.99
2001	78.45
2002	83.07
2003	86.63
2004	157.82
2005	251.27
2006	520.64
2007	481.60
2008	61.89
2009	4.34

In 2006 and 2007, investment banks created around half a trillion dollars in CDO securities each year, even as U.S. housing prices began to stagnate and decline, subprime mortgages began to default at record rates, and RMBS securities began to incur dramatic losses. By the middle of 2007, due to the increasing risks, U.S. institutional investors like pension funds, hedge funds, and others began to purchase fewer CDO securities, and investment banks turned their attention increasingly to European and Asian investors as well as the issuers of new CDOs who became the primary buyers of CDO securities.[1262] In 2007, U.S. investment banks kept issuing and selling CDOs despite slowed sales,

[1260] 10/15/2010 "Global CDO Issuance," Securities Industry and Financial Markets Association, http://www.sifma.org/research/statistics.aspx.
[1261] Chart prepared by the Subcommittee using data from 10/15/2010 "Global CDO Issuance," Securities Industry and Financial Markets Association, http://www.sifma.org/research/statistics.aspx. By 2004, most, but not all, CDOs relied primarily on mortgage related assets such as RMBS securities. Subcommittee interview of Gary Witt, former Managing Director of Moody's RMBS Group (10/29/2009).
[1262] See 7/12/2007 email from Michael Lamont to Boaz Weinstein at Deutsche Bank, DBSI_01201843; "Banks' Self-Dealing Super Charged Financial Crisis," ProPublica (8/26/2010), http://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis; and "Mortgage-Bond Pioneer Dislikes What He Sees," Wall Street Journal (2/24/2007).

which meant that investment banks had to retain an increasing portion of the unsold assets on their own balance sheets.[1263]

The credit rating agencies marked a "sea change" in the CDO market in 2007, in which investment banks issued CDOs at near record levels in the first half of the year, but then sharply reined in their efforts after the mass rating downgrades of RMBS and CDO securities began in July 2007:

> "[The CDO] market in the U.S. was very active in terms of issuance throughout the first half of 2007. ... The year 2007 saw a sea change for the CDO market. Moody's rated more than 100 SF [structured finance] CDO transactions in each of the first two quarters, but the number fell sharply to 40 in the third quarter and to just eight in the fourth quarter as the sheer speed and magnitude of the subprime mortgage fallout significantly weakened investors' confidence."[1264]

In the years leading up to the financial crisis, the typical size of a CDO deal was between $1 and $1.5 billion,[1265] and generated large fees for investment banks in the range of $5 to $10 million per CDO.[1266] To handle these transactions, a number of large investment banks established CDO departments and trading desks charged with designing, underwriting, selling, or trading CDO securities. The CDO origination desks typically worked with the investment banks' structured finance sales force to sell the resulting CDO securities. This structure meant that stopping the issuance of CDO securities would require the investment banks to lose out on the fees, prestige, and market share tied to CDO sales. In addition, whole CDO departments, with their dedicated

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1263 "Banks' Self-Dealing Super Charged Financial Crisis," ProPublica (8/26/2010).

1264 Moody's 2008 Global CDO Review (3/3/2008).

1265 "Wall Street's money machine breaks down," CNNMoney.com (11/12/2007), http://money.cnn.com/magazines/fortune/fortune_archive/2007/11/26/101232838/index.htm.

1266 See "Banks' Self-Dealing Super-Charged Financial Crisis," ProPublica (8/26/2010), http://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis ("A typical CDO could net the bank that created it between $5 million and $10 million – about half of which usually ended up as employee bonuses. Indeed, Wall Street awarded record bonuses in 2006, a hefty chunk of which came from the CDO business."). Fee information obtained by the Subcommittee is consistent with this range of CDO fees. For example, Deutsche Bank received nearly $5 million in fees for Gemstone 7, and the head of its CDO Group said that Deutsche Bank received typically between $5 and 10 million in fees per CDO, while Goldman Sachs charged a range of $5 to $30 million in fees for its Camber 7, Fort Denison, and Hudson Mezzanine 1 and 2 CDOs. 12/20/2006 Gemstone 7 Securitization Credit Report, DB_PSI_00237655-71; undated Gemstone 7 Securitization Credit Report, MTSS000011-13; 3/15/2007 Gemstone CDO VII Ltd. Closing Memorandum, DB_PSI_00133536-41; Subcommittee interview of Michael Lamont (Deutsche Bank) (9/29/2010); 3/21/2011 letter from Deutsche Bank's counsel to the Subcommittee, PSI-Deutsche_Bank-0001-04; Goldman Sachs response to Subcommittee QFRs at PSI-QFR-GS0249.

bankers, traders, and supervisors, would have to disappear, which is eventually what happened after the CDO market crashed.

CDOs at Deutsche Bank. From 2004 to 2008, Deutsche Bank issued 47 asset backed CDOs for a total securitization of $32.2 billion.[1267] According to analysts, in both 2006 and 2007, Deutsche Bank ranked fourth globally in issuing asset backed CDOs, behind Merrill Lynch, JPMorgan Chase, and Citigroup.[1268]

At Deutsche Bank, five different parts of the Securitized Product Group played key roles in its CDO business. They were the CDO Group (North America); the CDO sales force, formally called Securitized Products; the CDO Syndication Desk which helped promote and track CDO sales; the mortgage department; and the CDO Trading Desk, formally called ABS (Asset Backed Security) Trading, CDO Trading, and ABS Correlation Trading.

The CDO Group had two co-heads, Michael Lamont and Michael Herzig, and approximately 20 employees. The heads of the group reported to Richard D'Albert, Global Head of Deutsche Bank's Securitized Product Group. The CDO Group designed and structured the bank's CDOs, analyzed the assets that went into the CDOs, monitored the purchasing and warehousing of those assets, obtained CDO credit ratings, prepared CDO legal documentation, acted as the CDO underwriter or placement agent on behalf of Deutsche Bank, and oversaw the issuance of the CDO securities.[1269]

The CDO sales force sold the resulting CDO securities for Deutsche Bank. It received assistance from the CDO Syndication, sometimes called the "syndicate," which helped promote the deals with investors and tracked CDO sales. The CDO sales force was headed by Sean Whelan and Michael Jones. They reported to Munir D'auhajre, overall head of sales, who reported, in turn, to Fred Brettschneider, the head of the Institutional Client Group of Deutsche Bank Americas. The CDO sales force had approximately 20 employees. In the United States, the CDO Syndication had about seven employees, and was headed by

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[1267] Chart, ABS CDOs Issued by DBSI (between 2004 and 2008), PSI-Deutsche_Bank-02-0005-23.
[1268] See "Global ABS CDO Issuance" chart, Reuters (4/20/2010), http://graphics.thomsonreuters.com/10/04/GLB_GCDOV0410.gif: "Banks in Talks to End Bond Probe," Wall Street Journal (12/2/2010), http://online.wsj.com/article/SB10001424052748704594804575649170454587534.html?KEYWORDS=Banks+in+Talks+to+End+Bond+Probe. See also 10/2006, "CDO Primary Update Progress Report," prepared by Deutsche Bank, DBSI_PSI_EMAIL03970167-72, at 68 (ranking Deutsche Bank as third in CDO issuances as of October 2006).
[1269] Subcommittee interview of Michael Lamont (9/29/2010).

Anthony Pawlowski, who reported to Mr. Lamont and Mr. Herzig, who headed the CDO Group.

The Deutsche Bank mortgage department was responsible for purchasing residential mortgages from a variety of sources, warehousing those mortgages, and securitizing the mortgages into RMBS securities for which Deutsche Bank acted as the underwriter or placement agent. Some of those RMBS securities were later included or referenced in CDOs issued by the bank.

The CDO Trading Desk was headed by Greg Lippmann, who served as global head of Deutsche Bank's CDO, ABS, and ABS Correlation Trading Desks.[1270] Those desks were responsible for trading a variety of RMBS, CDO, and other asset backed securities on the secondary market. Mr. Lippmann had a staff of approximately 30 employees, 20 in the United States and 10 in London. Like the head of the CDO Group, Mr. Lippmann reported to Mr. D'Albert, the head of the bank's Securitized Product Group. Mr. Lippmann was also the head of risk management for all new issue CDOs and described himself as "involved in underwriting, structuring, marketing and hedging our warehouse risk for new issue cdos."[1271]

The CDO Trading Desk conducted trades for both clients and other Deutsche Bank entities. It was further divided into three trading desks, designated the CDO, ABS, and ABS Correlation Desks. Each traded certain structured finance products, tracked relevant market news and developed expertise in its assigned products, and served as a source of asset and market information for other branches of Deutsche Bank. The CDO Desk focused on buying and selling CDO securities; the ABS Desk concentrated on trading RMBS and other asset backed securities as well as short trading strategies involving credit default swap (CDS) contracts in single name RMBS; and the ABS Correlation Desk acted primarily in a market making capacity for Deutsche Bank clients, trading both long and short RMBS and CDO securities and CDS contracts with the objective of taking offsetting positions that minimized the bank's risk.[1272]

Mr. Lippmann was well known in the CDO marketplace as a trader. He had joined Deutsche Bank in 2000, after a stint at Credit Suisse trading bonds. One publication noted that Mr. Lippmann "made his name with big bets on a housing bust," continuing: "Mr. Lippmann

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[1270] Organizational Chart for Deutsche Bank Global CDO Group, DB_PSI_C00000001.
[1271] 7/14/2006 email from Greg Lippmann to Melissa Goldsmith at Deutsche Bank, DBSI_PSI_EMAIL01400135-37.
[1272] Subcommittee interview of Greg Lippmann (10/18/2010).

emerged as a Cassandra of the financial crisis, spotting cracks in the mortgage market as early as 2006. His warnings helped Deutsche brace for the crisis. He also helped investors – and himself – land huge profits as big bets that the housing market would collapse materialized."[1273]

(3) Deutsche Bank's $5 Billion Short

In 2006 and 2007, Deutsche Bank's top CDO trader, Greg Lippmann, repeatedly warned his Deutsche Bank colleagues and some clients outside of the bank about the poor quality of the assets underlying many RMBS and CDO securities. Although senior management within the bank did not agree with his views, they allowed Mr. Lippmann, in 2005, to establish a large short position on behalf of the bank, essentially betting that mortgage related securities would fall in value. From 2005 to 2007, Mr. Lippmann built that position into a $5 billion short.

(a) Lippmann's Negative Views of Mortgage Related Assets

Emails produced to the Subcommittee provide repeated examples of Mr. Lippmann's negative views of mortgage related assets, particularly those involving subprime mortgages. At times, he expressed his views to colleagues within the bank; at other times he expressed them in connection with advising a client to bet against an RMBS security by taking a short position. At times, Mr. Lippmann recommended that his clients short poor quality RMBS assets, even while his trading desk was participating in a selection process that included those same assets in Gemstone 7. The following emails by Mr. Lippmann, written during 2006 and 2007, provide examples of his negative views.

- Emails regarding LBMLT 2004-3 M8, a subprime RMBS security issued by Long Beach: "[T]his bond blows."[1274] (2/24/2006)

- Email providing Deutsche Bank trader his opinion regarding RMBS shelves: ["[Y]ikes didn't see that[.] … [H]alf of these

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[1273] "Lippmann, Deutsche Trader, Steps Down," New York Times (4/21/2010), http://dealbook.nytimes.com/2010/04/21/lippmann-deutsche-trader-steps-down/. See also Michael Lewis, The Big Short (2010), at 64.

[1274] 2/24/2006 emails between Greg Lippmann and Rocky Kurita at Deutsche Bank, DBSI_PSI_EMAIL00966290. Mr. Lippmann's negative comments did not begin in 2006; as early as May 2005, he wrote that the "real money flows are buying protection." 5/11/2005 email from Greg Lippmann to Rocky Kurita at Deutsche Bank, DBSI_PSI_EMAIL00048683.

are crap and rest are ok[.] ...[C]rap-heat pchlt sail tmts."[1275] (4/5/2006)

- Email advising an investment banker at JPMorgan Chase regarding subprime RMBS securities issued by Aegis Asset Backed Securities Trust ("aabst"), Bay View Financial Acquisition Trust ("bayv"), Home Equity Mortgage Loan Asset Based Trust ("inabs"), Park Place Securities Inc. ("ppsi"), and Structured Asset Investment Loan ("sail"): "This is a good pool for you because it has a fair number of weak names but not so many that investors should balk (I wouldn't add more of these) and also has only a few names that are very good."[1276] (6/23/2006)

- Email advising an investment banker at Oppenheimer Funds: "[Y]ou can certainly build a portfolio by picking only bad names and you have largely done that as Rasc ahl is considered bad as is Fremont (bsabs fr, fhlt, jpmac fre, sabr fr, nheli fm deals) ace, arsi and lbmlt."[1277] Mr. Lippmann listed ACE Securities Corp. as a "bad name" even though it was created by and associated with Deutsche Bank itself.[1278] (8/4/2006)

- Email to co-head of the Deutsche Bank CDO Group and to Global Head of Deutsche Bank's Securitized Product Group: "I was going to reject this [long purchase of a synthetic CDO] because it seems to be a pig cdo position dump 60^ but then I

[1275] 4/5/2006 email from Greg Lippmann to Deutsche Bank employee, DBSI_PSI_EMAIL01073270. The acronyms in the email refer to the following lenders: Home Equity Asset Trust ("heat"), People's Choice Home Loan Securities Trust ("pchlt"), Structured Asset Investment Loan ("sail"), and Terwin Mortgage Trust ("tmts").

[1276] 6/23/2006 email from Greg Lippmann to Derek Kaufman at JPMorgan, DBSI_PSI_EMAIL01344930-33.

[1277] 8/4/2006 email from Greg Lippmann to Michelle Borre at Oppenheimer Funds, DBSI_PSI_EMAIL01528941-43. The acronyms in the email refer to the following lenders: Residential Asset Securities Corp. ("Rasc"), American Home Loans ("ahl"), Fremont ("fr," "fre," "fm," and "fhlt"), Bear Stearns Asset Backed Securities (bsabs), JPMorgan Acquisition Trust ("jpmac"), Securitized Asset Backed Receivables Trust ("sabr"), Nomura Home Equity Loan, Inc. ("nheli"), ACE Securities Corp. ("ace"), Argent Securities Inc. ("arsi"), and Long Beach Mortgage Trust ("lbmlt").

[1278] Subcommittee interview of Greg Lippmann (10/18/2010); Subcommittee interview with Deutsche Bank's counsel (3/7/2011); 3/21/2011 letter from Deutsche Bank's counsel to the Subcommittee (ACE is one of "Deutsche Bank's own shelf offerings."), PSI-Deutsche_Bank-32-0001-04. See also 3/2/2011 letter from Deutsche Bank's counsel to the Subcommittee ("Deutsche Bank has no ownership interest in ACE Securities Corp. ('ACE'). All shares of ACE are held by Altamont Holdings Corp, a Delaware corporation. Deutsche Bank Securities, Inc. ('DBSI'), however, is an administrative agent for ACE and in that role has authority to act on behalf of ACE in connection with offerings of asset-backed securities, including RMBS offerings. ... Deutsche Bank hired the AMACAR Group, LLC ('AMACAR') to assist in the creation of ACE to act as a registrant and depositor in connection with RMBS offerings sponsored and/or underwritten by Deutsche Bank."), PSI-DeutscheBank-31-0004-06.

noticed winchester [Deutsche Bank affiliated hedge fund] is the portfolio selector……any idea???"[1279] (8/4/2006)

- Email responding to a hedge fund trader at Spinnaker Capital asking about a subprime RMBS security issued by Credit Based Asset Servicing and Securitization, LLC ("cbass"): "That said I can probably short this name to some CDO fool."[1280] (8/30/2006)

- Email responding to a hedge fund trader at Spinnaker Capital asking about MABS 2006-FRE1, a subprime RMBS security that contained Fremont loans and was issued by Mortgage Asset Securitization Transactions Asset-Backed Securities Trust: "This kind of stuff rarely trades in the synthetic market and will be tough for us to cover i.e. short to a CDO fool. That said if u gave us an order at 260 we would take it and try to dupe someone."[1281] (9/1/2006)

- Email describing MABS 2006-FRE1, a subprime RMBS security that contained Fremont loans and was issued by Mortgage Asset Securitization Transactions Asset-Backed Securities Trust, as a "crap bond."[1282] (9/01/2006)

- Email describing MSHEL 2006-1 B3, an RMBS security issued by Morgan Stanley as "crap we shorted"; referring to GSAMP 2006-HE3 M9, an RMBS security issued by Goldman Sachs, as "this bond sucks but we are short 20MM"; and noting with regard to ACE, which was created by and associated with Deutsche Bank, that "ace is generally horrible."[1283] (9/21/2006)

[1279] 8/23/2006 email from Greg Lippmann to Michael Lamont and Richard D'Albert, DBSI_PSI_EMAIL01605465.
[1280] 8/30/2006 email from Greg Lippmann to Bradley Wickens at Spinnaker Capital, DBSI_PSI_EMAIL01634802.
[1281] 9/1/2006 email from Greg Lippmann to Bradley Wickens at Spinnaker Capital, DBSI_PSI_EMAIL02228884.
[1282] 9/1/2006 email from Greg Lippmann to Bradley Wickens at Spinnaker Capital, DBSI_PSI_EMAIL01645016.
[1283] 9/21/2006 email from Greg Lippmann to Deutsche Bank employee, DBSI_PSI_EMAIL01689001-02. In an October 2006 email, a Deutsche Bank employee wrote to Mr. Lippmann and others that a number of RMBS such as LBMLT, HEAT, INABS, AMSI/ARSI, RAMP/RASC, and CWL "would be impossible to sell to the public" due to their poor quality. 10/2/2006 email from Axel Kunde at Deutsche Bank to Sean Whelan with copy to Mr. Lippmann, DBSI_PSI_EMAIL02255361.

- Email responding to a hedge fund trader at Mast Capital: "Long Beach is one of the weakest names in the market."[1284] (10/20/2006)

- Email to a client selecting bonds to short: "u have picked some crap right away so u have figured it out."[1285] (12/04/2006)

- Email regarding GSAMP 06-NC2 M8, an RMBS security that contained New Century loans and was issued by Goldman Sachs: "[T]his is an absolute pig."[1286] (12/8/2006)

- Email describing ABSHE 2006-HE1 M7, a subprime RMBS security issued by Asset Backed Securities Corporation Home Equity Loan Trust, as a "crap deal"; and describing ACE 2006 HE2 M7, a subprime RMBS securitization issued by ACE Securities Corp., as: "[D]eal is a pig!"[1287] (3/1/2007)

When asked about these emails, Mr. Lippmann told the Subcommittee that he generally thought all assets in CDOs were weak, and that his descriptions were often a form of posturing while negotiating prices with his clients. In a number of cases, however, Mr. Lippmann was assisting his clients in devising short strategies or communicating with Deutsche Bank colleagues, rather than negotiating with clients over prices. As will be seen later in this Report, some of the RMBS securities he criticized were, at virtually the same time, being included by his trading desk in Gemstone 7, which was later sold by Deutsche Bank's CDO Group.

In addition to disparaging individual RMBS securities, Mr. Lippmann expressed repeated negative views about the CDO market as a whole. At times during 2006 and 2007, he referred to CDO underwriting activity by investment banks as the workings of a "CDO machine" or "ponzi scheme."[1288] In June 2006, for example, a year

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[1284] 10/20/2006 email from Greg Lippmann to Craig Carlozzi at Mast Capital, DBSI_PSI_EMAIL01774820-21.
[1285] 12/4/2006 email from Greg Lippmann to Mark Lee at Contrarian Capital, DBSI_PSI_EMAIL01866336. The acronyms in the email refer to the following lenders: Bear Stearns Asset Backed Securities ("bsabs"), Option One Mortgage Loan Trust ("omlt"), and Ameriquest Mortgage Securities, Inc. ("amsi").
[1286] 12/8/2006 email from Greg Lippmann to Peter Faulkner at PSAM LLC, DBSI_PSI_EMAIL01882188.
[1287] 3/1/2007 email from Greg Lippmann to Joris Hoedemaekers at Oasis Capital UK, DBSI_PSI_EMAIL02033845.
[1288] In the 1920s, Charles Ponzi defrauded thousands of investors in a speculation scheme that "involves the payment of purported returns to existing investors from funds contributed by new investors." "Ponzi Schemes – Frequently Asked Questions," SEC, http://www.sec.gov/answers/ponzi.htm.

before CDO credit ratings began to be downgraded en masse, Mr. Lippmann sent an email to a hedge fund trader warning about the state of the CDO market: "[S]tuff is flat b/c [because] the cdo machine has not slowed but I am fielding 2-4 new guys a day that are kicking the tires so we probably don't go tighter." [1289] A few months later, in August 2006, Mr. Lippmann wrote about the coming market crash: "I don't care what some trained seal bull market research person says this stuff has a real chance of massively blowing up."[1290]

When asked about his comments, Mr. Lippmann told the Subcommittee that the CDO market was not really a ponzi scheme, because people did receive an investment return, and asserted that he had used the term because he was "grasping at things" to prove he was right in his short position.[1291] Mr. Lippmann also told the Subcommittee that while he knew that the major credit rating agencies had given AAA ratings to an unusually large number of RMBS and CDO securities and most people believed in the ratings, he did not. He also told the Subcommittee that he "told his views to anyone who would listen" but most CDO investors disagreed with him.[1292]

In March 2007, Mr. Lippmann again expressed his view that mortgage related assets were "blowing up":

> "I remain firm in my belief that these are blowing up whether people like it or not and that hpa [housing price appreciation] is far less relevant than these bulls think. Can't blame them because if this blows up lots of people lose their jobs so they must deny in hope that that will help prevent the collapse. At this price I'm nearly just as short as I've ever been."[1293]

(b) Building and Cashing in the $5 Billion Short

Mr. Lippmann did not just express negative views of RMBS and CDO securities to his colleagues and clients, he also acquired a significant short position on those assets on behalf of Deutsche Bank.

[1289] 6/8/2006 email from Greg Lippmann to Bradley Wickens at Spinnaker Capital, DBSI_PSI_EMAIL01282551.
[1290] 8/29/2006 email from Greg Lippmann to Bradley Wickens at Spinnaker Capital, DBSI_PSI_EMAIL01628496.
[1291] Subcommittee interview of Greg Lippmann (10/18/2010).
[1292] Subcommittee interview of Greg Lippmann (10/18/2010).
[1293] 3/4/2007 email from Greg Lippmann to Harvey Allon at Braddock Financial, DBSI_PSI_EMAIL02041351-53. On June 23, 2007, Mr. Lippmann wrote to a Deutsche Bank colleague, "Yup this is the beginning of phase 2 (the bulls still can't see it), sales by the longs and how do you think the foreign banks will feel when they see that the true mark for what they have is ... this could be the end of the cdo biz." 6/23/2007 email from Greg Lippmann to Michael George, DBSI_PSI_EMAIL02584591.

Despite the views of virtually all other senior executives at the bank that RMBS and CDO securities would gain in value over time, Mr. Lippmann convinced the bank to allow him to initiate and build a substantial proprietary short position that would pay off only if mortgage related securities lost value.

Initiating the Short Position. In 2005, Deutsche Bank was heavily invested in the U.S. mortgage market and, by 2007, had accumulated a long position in mortgage related assets that, according to Deutsche Bank, had a notional or face value of $128 billion and a market value of more than $25 billion.[1294] These positions had been accumulated and were held primarily by the Deutsche Bank mortgage department, the ABS Trading Desk, and a Deutsche Bank affiliated hedge fund, Winchester Capital, which was based in London.[1295]

Mr. Lippmann told the Subcommittee that, despite the bank's positive view of the mortgage market, in the fall of 2005, he requested permission to establish a proprietary trading position that would short RMBS securities.[1296] He explained that he made this request after reviewing data he received from a Deutsche Bank quantitative analyst, Eugene Xu. He said that this data showed that, in regions of the United States where housing prices had increased by 13%, the default rates for subprime mortgages had increased to 7%.[1297] At the same time, he said, in other regions where housing prices had increased only 4%, the subprime mortgage default rates had quadrupled to 28%.[1298] Mr. Lippmann explained that he had concluded that even a moderate slow down in rising housing prices would result in significant subprime mortgage defaults, that there was considerable correlation among these subprime mortgages, and that the defaults would affect BBB rated RMBS securities. Mr. Lippmann stressed that his negative view of

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[1294] According to Deutsche Bank, as of March 31, 2007, it held a total long position in mortgage related securities whose notional or face value totaled $127.8 billion, including $4.3 billion at "ABS Correlation London"; $5 billion at "CDO Primary Issue/New York"; $102 billion at "RMBS/New York"; $7.6 billion at "SPG-Asset Finance/New York"; and $8.9 billion at "Winchester Capital/London." 3/2/2011 letter from Deutsche Bank's counsel to the Subcommittee, PSI-DeutscheBank-31-0004-06. The market value of those positions was substantially lower. For example, according to Deutsche Bank, the $102 billion long investment held by its RMBS/New York office had a market value of about $24 billion. 3/21/2011 letter from Deutsche Bank's counsel to the Subcommittee, PSI-Deutsche_Bank-32-0001-04.
[1295] Id.
[1296] Subcommittee interview of Greg Lippmann (10/18/2010). When asked if the position was a proprietary investment by the bank, Mr. Lippmann told the Subcommittee that it was. Id. Deutsche Bank acknowledges in a 20-F filing with the U.S. Securities and Exchange Commission that it conducts proprietary trading, in addition to trading activity that facilitates customer business. Deutsche Bank stated that it trades for its own account (i.e., uses its capital) to exploit market opportunities. See Deutsche Bank Aktiengesellschaft's Form 20-F filed with the Securities and Exchange Commission on March 26, 2008, at 24.
[1297] Subcommittee interview of Greg Lippmann (10/18/2010).
[1298] Id.

RMBS securities was based primarily on his view that moderating home prices would cause subprime mortgage defaults and was not dependent upon the quality of the subprime loans.[1299]

In the fall of 2005, Mr. Lippmann said that he approached his supervisor Richard D'Albert, Global Head of the Structured Products Group, for permission to enter into CDS agreements to short RMBS securities totaling $1 billion.[1300] He said that he explained at the time that a cost benefit analysis favored a short RMBS position, because the bank would pay a relatively small amount of CDS premiums per year in exchange for a potentially huge payout. Mr. Lippmann said that he estimated at the time that, when the costs were compared to the potential payout if the BBB securities defaulted, the proposed short position offered a potential payout ratio of 8 to 1.

Mr. Lippmann also developed a presentation supporting his position entitled, "Shorting Home Equity Mezzanine Tranches." It made the following points:

- "Over 50% of outstanding subprime mortgages are located in MSAs [metropolitan statistical areas] with double digit 5 year average of annual home price growth rates.

- There is a strong negative correlation between home price appreciation and loss severity.

- Default of subprime mortgages are also strongly negatively correlated with home price growth rates.

- Nearly $440 billion subprime mortgages will experience payment shocks in the next 3 years.

- Products that may be riskier than traditional home equity/subprime mortgages have become popular." [1301]

Mr. Lippmann told the Subcommittee that Mr. D'Albert approved his taking the short position in or around November 2005, but said the trade was so big and controversial that Mr. Lippmann also had to get the approval of Rajeev Misra, Global Head of Credit Trading, Securitization and Commodities, who was based in London.[1302] Mr. Lippmann said

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[1299] Id.
[1300] Id.
[1301] 9/2005 "Shorting Home Equity Mezzanine Tranches, A Strategy to Cash in on a Slowing Housing Market," DBSI_PSI_EMAIL00502892-29.
[1302] Subcommittee interview of Greg Lippmann (10/18/2010).

that, in or around November 2005, Mr. Misra reluctantly gave his approval for the short position, even though Mr. Misra believed mortgage related securities would continue to increase in value over time.

Building the Short Position. Mr. Lippmann told the Subcommittee that he used some existing short positions that had been undertaken as hedges to begin building his position.[1303] He said that, throughout 2006, he gradually accumulated a larger short position, which eventually reached $2 billion. According to Mr. Lippmann, Deutsche Bank senior management reluctantly went along.[1304] He told the Subcommittee that, at one point in 2006, Boaz Weinstein, who reported to Mr. Misra, told him that the carrying costs of his position, which required the bank to pay insurance-like premiums to support the $2 billion short position, had become so large that he had to find a way to pay for them. According to Mr. Lippmann, the bank's senior management asked him to persuade them that he was right by demonstrating that others were willing to "short" the market as well. Mr. Lippmann told the Subcommittee he was then motivated to convince his clients that they ought to short the mortgage market, arrange the shorts for them, and make enough in fees from those transactions to pay for the costs of his multi-billion-dollar short.[1305]

Mr. Lippmann told the Subcommittee that he spent much of 2006 pitching his clients to short the mortgage market. He said that he often made presentations to prospective clients sharing with them his "strategy on how to cash in on a slowing housing market."[1306] He said that, in early 2006, he expended approximately 200 hours trying to convince AIG to short single name RMBS, but was unsuccessful. He told the Subcommittee that he also believed that his presentations helped convince AIG to stop buying RMBS and CDO securities and stop selling CDS protection for those deals. In an August 2006 email, Mr. Lippmann wrote: "In 05 for a time, we sold EVERY single one to AIG. They stepped out of the market in March of 06 after speaking with me and our research people (and I don't doubt other dealers)."[1307] Mr. Lippmann told the Subcommittee that Mr. Lamont, who co-led Deutsche Bank's CDO Group, was not pleased that Mr. Lippmann had convinced AIG, a very large purchaser of long interest in RMBS and CDO securities, to stop buying them.

[1303] Id.
[1304] Id.
[1305] Id.
[1306] Id.
[1307] 8/26/2006 email from Greg Lippmann to Richard Axilrod at Moore Capital, DBSI_PSI_EMAIL01618236.

The documents indicate that Mr. Lippmann and his trading team were aware at the time that the CDO Trading Desk was expected to promote rather than discourage client interest in purchasing Deutsche Bank's CDO securities. One of Mr. Lippmann's top traders, Rocky Kurita, put it this way in mid-2005: "[W]e have to make money. Customer happiness is a secondary goal but we cannot lose sight of the trading desk[']s other role of supporting new issue and the customer franchise."[1308] In a 2007 email to a client, Mr. Lippmann wrote: "[P]lease please do not forward these emails outside of your firm. ... I do not want to be blamed by the new issue people for destroying their business."[1309]

Although Mr. Lippmann was unsuccessful in convincing AIG to short RMBS and CDO securities, he did convince some of his other clients, usually hedge funds, to undertake such shorts, primarily by purchasing single name CDS contracts referencing specific RMBS securities. Those trades generated substantial sums for the ABS Correlation Trading Desk which acted as a market maker in the CDS market for those clients. Mr. Lippmann told the Subcommittee that the shorts executed by his clients ultimately generated about $200 million in revenues for his desk in 2006.[1310]

Defending the Short. According to Mr. Lippmann, in December 2006, he met in London with a senior bank official, Anshu Jain, Head of Global Markets at Deutsche Bank, and suggested that Deutsche Bank's long positions in mortgage related securities created too much exposure for the bank and should be reduced.[1311] Mr. Lippmann recommended that the bank hedge its risk using his short strategy. His suggestion was not acted upon, but as the market grew more volatile in late 2006 and early 2007, Mr. Lippmann's short position began to gain in value and caught the attention of senior management at the bank.

Mr. Lippmann told the Subcommittee that, in January 2007, he met with Mr. Jain, Mr. Misra, and Mr. D'Albert at a hotel in Lisbon, where all three again challenged him to defend his short position by noting that it had required him to pay out $20 million in CDS premiums during 2006.[1312] Mr. Lippmann told the Subcommittee that he countered by pointing out, while he had paid out $20 million, his desk made $200

1308 5/12/2005 email from Rocky Kurita to Greg Lippmann, DBSI_PSI_EMAIL00054826.
1309 2/1/2007 email from Greg Lippmann to Wyck Brown at Braddock Financial, DBSI_PSI_EMAIL01969867.
1310 Subcommittee interview of Greg Lippmann (10/18/2010).
1311 Id.
1312 Id.

million from trading in RMBS and CDO shorts for his clients. He said that the three concluded he could keep his short position.[1313] According to Mr. Lippmann, in February 2007, Mr. Jain met with him again to discuss whether or not to keep his short position, because it had gained in value and Deutsche Bank could cash in the position and take the profits at that time. Mr. Lippmann said that the result of the meeting was that, once again, his position was left in place.

While defending his position within the bank, Mr. Lippmann continued to speak with his outside clients about his negative views of the market, continued to make presentations to potential clients about shorting the market,[1314] and continued to execute shorts for them, while building his desk's proprietary short position.

According to Mr. Lippmann, in late February or early March 2007, as the ABX Index showed subprime RMBS securities losing value and subprime mortgages continued incurring delinquencies at record rates, an ad hoc meeting of Deutsche Bank's executive committee took place in London to discuss the bank's risk exposure in mortgage related securities. According to Mr. Lippmann, he happened to be in London at the time and was invited to attend. He estimated that ten to twelve persons were at the meeting in person, and another two to four persons participated by telephone. He said that, at the meeting, Deutsche Bank executives discussed whether the recent market volatility reflected short term or longer term trends and whether the bank should make any changes in its holdings.[1315] At that time, Mr. Lippmann held the only large short position on behalf of the bank, then about $4 to 5 billion in size.[1316] In contrast, the Deutsche Bank mortgage group held $102 billion in long RMBS and CDO securities, and Winchester Capital, Deutsche Bank's hedge fund affiliate, held a net long position of $8.9 billion.[1317] Mr. Lippmann told the Subcommittee that he was the only person at the meeting who argued for the bank to increase its short position.[1318]

At the time of the London meeting, Mr. Lippmann's position was showing a significant profit. Mr. Misra brought up the alternative of cashing in his position while RMBS prices were down, because he thought prices were in a short term dip and the profits might disappear

[1313] Id.
[1314] See, e.g., 2/2007 presentation, "Shorting Home Equity Mezzanine Tranches," prepared by Mr. Lippmann, DBSI_PSI_EMAIL01988773-845.
[1315] Subcommittee interview of Greg Lippmann (10/18/2010).
[1316] 2/23/2007 email from Greg Lippmann to Anshu Jain, DBSI_PSI_EMAIL02383117-18.
[1317] 3/2/2011 letter from Deutsche Bank's counsel to the Subcommittee, PSI-DeutscheBank-31-0004-06.
[1318] Subcommittee interview of Greg Lippmann (10/18/2010).

later on. Mr. Lippmann contended that the bank should not only keep his short position, but increase it, but more senior voices disagreed with him. He told the Subcommittee that the decision at the end of the meeting was for all parties to keep their positions unchanged, including Mr. Lippmann.[1319]

Cashing In the Short. In July 2007, the major credit rating agencies began issuing downgrades of RMBS and CDO securities, in particular those that incorporated or referenced subprime mortgages. The value of those securities began to plummet. By the end of the summer of 2007, Deutsche Bank initiated efforts to sell off the long positions held by Winchester Capital and other Deutsche Bank entities, reflecting a shift in the bank's strategy, but its sales force had difficulty due to the lack of customers willing to buy long.[1320] During 2007 and 2008, at the direction of senior management, Mr. Lippmann gradually cashed in his short position, obtaining a total return of about $1.5 billion, which Mr. Lippmann told the Subcommittee he believes was the largest profit obtained from a single position in Deutsche Bank history.[1321]

Despite the gain from Mr. Lippmann's short position, Deutsche Bank told the Subcommittee that, overall in 2007, it had a long position in mortgage related holdings, with a face value of about $128 billion and a market value of more than $25 billion. Deutsche Bank told the Subcommittee that, despite the size of these holdings and their declining value, it lost only about $4.5 billion on those mortgage related holdings for the year.[1322] Deutsche Bank also filed a 2007 annual report with the SEC claiming a 2007 profit of €7.2 billion.[1323] When asked why its large long position in mortgage holdings did not lose more value,

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[1319] Id.

[1320] Subcommittee interview of Jordan Milman (10/22/2010). Mr. Milman, one of Mr. Lippmann's top traders, stated that the market first weakened in February 2007, stabilized until June or July 2007, and then it was a "one way train" down from then through 2008. Id.

[1321] Subcommittee interview of Greg Lippmann (10/18/2010). See Net Revenues from ABS Products Backed by U.S. Residential Mortgages, DB_PSI_C00000003.

[1322] According to a chart prepared by Deutsche Bank for the Subcommittee, in 2007 and 2008, its RMBS holdings lost about $3.4 billion; the CDO Group lost about $1.0 billion; Winchester Capital lost about $1.1 billion; and two other trading desks lost nearly $650 million. These losses were offset by the $1.5 billion gain from the bank's short position, for total mortgage related losses of about $4.5 billion. Net Revenues from ABS Products Backed by U.S. Residential Mortgages, DB_PSI_C00000003.

[1323] Deutsche Bank stated in its annual report filed with the SEC that it ended 2007 in the black, due to gains in other areas of the bank, including its Corporate and Investment Bank which reported a pre-tax profit of €5.1 billion and its Private Clients and Asset Management division which reported a pre-tax profit of €2.1 billion. See Deutsche Bank's 2007 annual report filed with the SEC, in particular the Executive Summary of Deutsche Bank's Annual Report and the letter from the Chairman of the Board.

Deutsche Bank told the Subcommittee that it had placed large hedges, using U.S. Treasury bonds, which reduced its losses.[1324]

(4) The "CDO Machine"

From 2006 to 2007, Mr. Lippmann repeatedly cautioned his colleagues and clients that the mortgage market was headed for a downfall, convinced a number of his clients to short RMBS and CDO securities, and built his $5 billion short position on behalf of Deutsche Bank. Meanwhile, the "CDO machine," as he described it, continued issuing new CDO securities through the end of 2007. The reasons for this continuing CDO activity, despite a deteriorating mortgage market and waning investor interest, are key to understanding how these complex, high risk, structured finance products ended up in multiple financial portfolios throughout the U.S. financial system.

Mr. Lippmann was frequently asked why, given his negative views, the CDO market was continuing to operate. He pointed to investment bank fees, prestige, and pressure to preserve the CDO jobs involved. In August 2006, for example, Mr. Lippmann wrote:

> "Why have we done this? It is not without reluctance and we are looking for ways to get out of this risk, but for now the view has been, we like the fees and the league table credit (and dammit we have a budget to make)."[1325]

In January 2007, after a trader asked Mr. Lippmann why the CDO market hadn't imploded, Mr. Lippmann responded: "league table, fees, never has one blown up yet."[1326] The reference to "league table credit"

[1324] Subcommittee interview with Deutsche Bank's counsel (3/7/2011). See also 3/21/2011 letter and accompanying chart from Deutsche Bank's counsel to the Subcommittee, PSI-Deutsche_Bank-32-0001-04.

[1325] 8/26/2006 email from Greg Lippmann to Richard Axilrod at Moore Capital, DBSI_PSI_EMAIL01618236-42. On August 1, 2006, Mr. Lippmann wrote to Mr. Milman, "who has all this crap and let me know which ones to look at looks like a lot of crappy deals." 8/1/2006 email from Greg Lippmann to Jordan Milman, DBSI_PSI_EMAIL01510643. Mr. Lippmann's negative views were shared by his traders. In an email originally sent by one of the traders on his desk, Rocky Kurita, the CDO business is set to a song, "CDO Oh Baby," by Vanilla Ice with the following lyrics: "Yo vip let's kick it! CDO oh baby, CDO oh baby. All right, stop, collaborate and listen. Spreads are wide with a technical invasion. Home Eq Subs were trading so tightly. Until Hedge Funds Bot Protection daily and nightly. Will they stop? Yo I don't know. Turn up the Arb and let's go. To the extreme Macro Funds do damage like a vandal. Now, BBs are trading with a new handle. Print, even if the housing bubble looms. There are never ends to real estate booms. If there is a problem, yo, we'll solve it. Check out the spreads while my structurer revolves it. CDO oh baby, CDO oh baby." 11/8/2005 email from Jordan Milman to Greg Lippmann, DBSI_PSI_EMAIL00686597-601 (forwarding an 11/8/2005 email from Rocky Kurita at Deutsche Bank).

[1326] 1/5/2007 email from Greg Lippmann to Chris Madison at Mast Capital, DBSI_PSI_EMAIL02333467-68.

indicates that investment banks considered it prestigious to be listed as the leading producer of a complex structured finance product like CDOs, and used their standing in the tables that tracked total origination numbers as a way of burnishing their reputations, attracting top talent, and generating new business. An October 2006 "Progress Report" on its CDO business, for example, which was prepared internally by the bank, included a slide entitled, "CDO Primary Revenue Forecast and League Tables," in which a chart ranked Deutsche Bank third in CDO issuance, behind Merrill Lynch and Citigroup.[1327] The slide indicated that Deutsche Bank had completed 38 CDOs to date, had a 7% share of the CDO market, and "expected to close 50 deals by year end," with the "pipeline for Q1 and Q2 2007 building." The final page of the presentation, providing a chart listing the top 20 Deutsche Bank CDO salespersons by region, together with their individual sales credits, identifies some of the bank personnel invested in the continuation of the CDO business.

On the issue of fees, the head of Deutsche Bank's CDO Group Michael Lamont told the Subcommittee that he estimated the bank received 40-200 basis points for each CDO created, depending upon the complexity of the CDO.[1328] He indicated those fees translated into about $5 to $10 million per CDO.[1329] When asked what he meant by saying "we have a budget to make," Mr. Lippmann explained that new CDO deals had to be completed continuously to produce the revenues needed to support the budgets of the CDO desks and departments involved with their creation.[1330]

A similar view as to why the CDO business continued to operate despite increasing market risk was expressed by a former executive at the hedge fund Paulson & Co. in a January 2007 email exchange with another investor. The Paulson executive wrote:

> "It is true that the market is not pricing the subprime RMBS wipeout scenario. In my opinion this situation is due to the fact that rating agencies, CDO managers and underwriters have all the incentives to keep the game going, while 'real money' investors have neither the analytic tools nor the institutional framework to take action before the losses that one could anticipate based [on] the 'news' available everywhere are actually realized."[1331]

[1327] 10/2006, "CDO Primary Update Progress Report," DBSI_PSI_EMAIL03970167-72, at 68.
[1328] Subcommittee interview of Michael Lamont (9/29/2010).
[1329] Id.
[1330] Subcommittee interview of Greg Lippmann (10/18/2010).
[1331] 1/14/2007 email from Paolo Pellegrini at Paulson to Ananth Krishnamurthy at 3a Investors, PAULSON ABACUS 0234459.

At the end of September 2006, the head of Deutsche Bank's sales force, Sean Whelan, wrote to Mr. Lippmann expressing concern that some CDO tranches were getting increasingly difficult to sell: "[T]he equity and the AAA were the parts we found difficult to place."[1332] Mr. Lippmann told the Subcommittee that once firms could not sell an entire CDO to investors, it was a warning that the market was waning, and the investment banks should have stopped structuring new ones.[1333] Instead of getting out of the CDO business, however, he said, a new source of CDO demand was found – when new CDOs started buying old CDO securities to include in their assets. One media report explained how this worked:

> "As the housing boom began to slow in mid-2006, investors became skittish about the riskier parts of those investments. So the banks created – and ultimately provided most of the money for – new CDOs. Those new CDOs bought the hard-to-sell pieces of the original CDOs. The result was a daisy chain that solved one problem but created another: Each new CDO had its own risky pieces. Banks created yet other CDOs to buy those."[1334]

Research conducted by Thetica Systems, at the request of ProPublica, found that in the last years before the financial crisis, CDOs had become the dominant purchaser of high risk CDO securities, largely replacing real money investors like pension funds, insurance companies, and hedge funds. The CDO market analysis found that, by 2007, 67% of the high risk mezzanine CDO securities had been purchased by other CDOs, up from 36% in 2004.[1335]

Mr. Lippmann told the Subcommittee that he considered it a "shady" practice when, in 2006, difficult-to-sell BBB CDO tranches began to be placed in new CDOs.[1336] In a June 2007 email to Mr. Lippmann, Richard Kim, a Deutsche Bank Managing Director, described placing unsold CDO tranches into a new CDO to be sold to investors as a "CDO2 balance sheet dump."[1337]

[1332] 9/27/2006 email from Sean Whelan to Greg Lippmann, DBSI_PSI_EMAIL02255361-63.
[1333] Subcommittee interview of Greg Lippmann (10/18/2010). Mr. Lippmann told the Subcommittee that he thought Mr. Lamont's CDO Group at Deutsche Bank had too many CDOs in the pipeline in the spring of 2007, when it could not sell all of its CDO securities. He reported that he told Mr. Lamont that defaults would increase.
[1334] "Banks' Self-Dealing Super Charged Financial Crisis," ProPublica, (8/26/2010), http://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis.
[1335] Id. ProPublica even found that, from 2006 to 2007, nearly half of all the CDOs sponsored by Merrill Lynch bought significant portions of other Merrill CDOs.
[1336] Subcommittee interview of Greg Lippmann (10/18/2010).
[1337] 6/14/2007 email from Richard Kim at Deutsche Bank to Greg Lippmann, DBSI_PSI_EMAIL02202920.

In addition to placing unsold CDO securities in newly issued CDOs, investment banks turned increasingly to non-U.S. investors to keep the CDO machine going. In August 2006, Mr. Lippmann noted that European and Asian banks were being targeted to buy CDOs:

> "Hear what you are saying and in a normal market your logic would be inarguable, but the demand for this crap is virtually entirely technically driven, all cdos. And each person at the cdo table thinks someone else is the fool- cdo equity, ostensibly only two buyers one mutual fund in Australia, and one hedge fund in Chicago, who is actually putting on a bearish correlation trade: bbb sold mostly ponzi-like to other cdos with limited distribution in Europe. AA and Junior AAA sold mostly to high grade cdos and to a certain extent European and Asian banks and lastly the senior AAA, this may ultimately break the cdo market."[1338]

In a December 2006 email, Mr. Lippmann wrote to a client: "[W]ho owns the cdos...insurance company and german and asian banks...and high grade cdos (can you say ponzi scheme)[?]"[1339] In early 2007, he wrote:

> "[T]he other side is all cdos..so it is the cdo investors who r on the other side who buys cdos: aaa-reinsurance, ws [Wall Street] conduits, European and Asian banks, aa-high grade cdos, European and Asian banks and insurers..some US insurers, bbb other mezz [mezzanine] abs [asset-backed security] cdos (i.e. ponzi scheme), European banks and insurers, equity some US hedge funds, Asian insurance companies, Australian and Japanese retail investors through mutual funds." [1340]

In February 2007, when an investor wrote to Mr. Lippmann inquiring about the status of the "CDO machine," Mr. Lippmann responded: "[G]etting slower but not dead yet[.] ... 2-5 ramping a day instead of 10-15[.] ... [H]earing of many investors in [A]sia especially shutting down ... but the window is not completely shut yet."[1341]

[1338] 8/26/2006 email from Greg Lippmann to Richard Axilrod at Moore Capital, DBSI_PSI_EMAIL01618236.
[1339] 12/4/2006 email from Greg Lippmann to Deutsche Bank employee, DBSI_PSI_EMAIL01867147-49.
[1340] 2/27/2007 email from Greg Lippmann to Fabrizio Wittenburg at Deutsche Bank, DBSI_PSI_EMAIL02027053-55.
[1341] 2/20/2007 email from Greg Lippmann to David Homan at Moore Capital, DBSI_PSI_EMAIL02006853-54.

Deutsche Bank emails demonstrate that, in 2007, like other investment banks, it was actively trying to sell CDOs in Asia.[1342]

Mr. Lippmann had an unrelentingly negative view of the RMBS and CDO securities he traded. He believed the securities would ultimately lose value, but he also believed investment banks would do all they could to sustain the CDO market for as long as possible due to the CDO fees, prestige, market share, and jobs at stake.

(5) Gemstone

To understand how one investment bank, Deutsche Bank, continued to develop and aggressively solicit its clients to purchase CDO securities even as mortgage related securities lost value and the CDO market began collapsing, the Subcommittee examined in detail Gemstone 7, a $1.1 billion CDO. Gemstone 7 was assembled and marketed by Deutsche Bank, as sole placement agent, from October 2006 to March 2007.[1343] Gemstone 7 was the last in a series of CDOs sponsored by HBK Capital Management (HBK), a large hedge fund.[1344]

Deutsche Bank issued the Gemstone 7 securities in March 2007. Six out of Gemstone's seven tranches received investment grade ratings, including AAA ratings for the top three tranches. Two months later, in July 2007, the major credit rating agencies issued mass rating downgrades of RMBS and CDO securities, including 19 of the 115 RMBS securities included or referenced in Gemstone 7. In November 2007, the credit rating agencies began to downgrade the Gemstone 7 securities. Today, all seven tranches have been downgraded to junk status, and the Gemstone 7 securities are nearly worthless.

[1342] See, e.g., "I would like these guys to push Asia sales on this..., but also as Ilinca said, the question arises why weren't they working on this thus far?" 2/21/2007 email from Abhayad Kamat at Deutsche Bank to Michael Lamont and others at Deutsche Bank, DBSI_PSI_EMAIL04056326-36.

[1343] In the Gemstone 7 offering circular, Deutsche Bank is described as the placement agent: "The Notes purchased by the Initial Purchaser, if any, will be privately placed with eligible investors by the Initial Purchaser" where the Initial Purchaser was Deutsche Bank. Gemstone 7 Offering Circular, GEM7-00000427-816 at GEM7-00000640. In contrast, other documents produced by Deutsche Bank indicate that the bank was acting as an underwriter in the Gemstone 7 transaction. See, e.g., 12/20/2006 Gemstone 7 Securitization Credit Report, DB_PSI_00237655-71 and undated Gemstone 7 Securitization Credit Report, MTSS000011-13. For ease of reference but without making a judgment on the matter, this Report uses the term "placement agent" when describing Deutsche Bank's role in Gemstone 7.

[1344] Subcommittee interview of HBK Managing Director Jamiel Akhtar (9/15/2010).

(a) Background on Gemstone

Gemstone 7 was a $1.1 billion hybrid CDO whose assets consisted predominantly of high risk subprime RMBS securities. Nearly 90% of its assets were mid and subprime RMBS securities with 33% carrying non-investment grade ratings.[1345] Of the remaining assets, 4.5% were CDO securities; 3.3% were commercial mortgage backed securities; and 3.5% were securities backed by pools of student loans.[1346] When the deal closed in March 2007, Gemstone 7 had about $476 million in cash RMBS assets as well as $625 million in synthetic assets.[1347] Gemstone 7 was constructed as a "partially static" CDO, meaning that while some of its assets were set and could not change, others could be replaced by the collateral manager, HBK.

HBK is a Dallas based hedge fund that was founded in October 1991, and by 2007, managed approximately $12 billion in capital.[1348] According to HBK, its Structured Products Group, one of its 21 business units, was "one of the leading purchasers and long-term investors in credit sensitive mortgages ... including RMBS and ABS, a component in HBK's overall strategy since 2002."[1349] Deutsche Bank told the Subcommittee that HBK had a reputation as a competent manager of mortgage related assets.[1350] HBK had acted as the collateral manager for seven previous CDO deals (six named Gemstone), choosing to alternate the mandate for the deals between Lehman Brothers and Deutsche Bank.

In October 2006, HBK retained Deutsche Bank to act as the placement agent for Gemstone 7. Under the agreement, HBK was to receive 30 basis points, or 0.3%, per year of the notional amount of Gemstone 7 (approximately $3.3 million) in return for serving as the collateral manager. Deutsche Bank was slated to receive $6.79 million in "underwriting fees," but because the deal did not sell completely, Deutsche Bank ultimately received a lesser amount of $4.7 million.[1351]

[1345] The intended portfolio composition of Gemstone 7 was disclosed to investors in a Debt Investor Presentation. See 2/2007 Gemstone 7 Debt Investor Presentation, GEM7-00001687-1747 at 1695.
[1346] Id. at 1691.
[1347] 9/14/2010 Gemstone 7 Asset Chart, PSI-Deutsche Bank-17-Gemstone7-0001-03.
[1348] 1/2007 Gemstone 7 Debt Investor Presentation, at 17, DBSI_PSI_EMAIL01980000-60.
[1349] Id.
[1350] Subcommittee interview of Sean Whelan, co-head of Deutsche Bank sales force (9/22/2010).
[1351] See 12/20/2006 Gemstone 7 Securitization Credit Report, DB_PSI_00237655-71; undated Gemstone 7 Securitization Credit Report, MTSS000011-13; 3/15/2007 Gemstone CDO VII Ltd. Closing Memorandum, DB_PSI_00133536-41. According to the Gemstone Offering Circular, HBK was to receive "0.30% per annum on the Quarterly Amount payable in arrears on each distribution date." 3/15/2007 Offering Circular for Gemstone CDO VII, Ltd., GEM7-00000427-816, "The Management Agreement," at 168. As opposed to an upfront fee, which Deutsche Bank received, the fee to HBK was paid quarterly. Thus, 0.30% of $1.1 billion translates to a fee of approximately $3.3 million for HBK. See 7/11/2007 email from Chehao Lu at Deutsche Bank

On October 25, 2006, HBK and Deutsche Bank signed an agreement outlining the terms of Gemstone 7. HBK told the Subcommittee:

> "The collateral purchased under the warehouse arrangement was selected by HBK and subject to Deutsche Bank's right of approval. The warehouse documents originally contemplated a total collateral pool of $750 million, which was increased to $1.1 billion in late December 2006."[1352]

On October 24, 2006, Deutsche Bank opened a warehouse account to store the assets that would serve as the collateral for the CDO when it closed.[1353] Deutsche Bank and HBK shared the risk for any change in value of the warehoused assets if the deal failed to close. Pursuant to the risk sharing agreement, if the deal failed to close, HBK would incur the risk for the first $80 million in losses, and Deutsche Bank would bear the remaining risk.[1354]

Deutsche Bank CDO Group. Several departments and desks at Deutsche Bank were involved in designing, marketing, and selling the Gemstone 7 securities. The CDO Group, co-headed by Michael Lamont and Michael Herzig, was responsible for designing its structure, monitoring the purchasing and warehousing of its assets, obtaining its credit ratings, preparing the legal documentation, establishing its administrative structure, obtaining underwriting approval of the deal, designing the marketing materials, and overseeing the issuance of the CDO securities.[1355] Abhayad Kamat within the CDO Group was assigned lead responsibility for structuring Gemstone 7.[1356] The CDO Trading Desk, headed by Greg Lippmann, participated in the CDO approval process once HBK selected assets. The CDO sales force,

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to Marco Lukesch at HBK, GEM7-00003568. See also email noting HBK's quarterly collateral management fee of $826,067.88 as of September 11, 2007. 9/11/2007 email from Eric Martel at HBK to Jamiel Akhtar at HBK, GEM7-00006900.

1352 8/20/2010 letter from HBK's counsel to the Subcommittee, at 2.

1353 See chart, "Assets Purchased by Gemstone VII CDO during Warehouse Period," GEM7-00001831-33 (showing assets purchased during the warehouse period). According to Credit magazine, "The financial press will often make its first mention of a 'new' CDO on or around the time of its closing – with the closing date generally the day on which the CDO issues tranches of debt and equity to investors. Prior to that day, however, there will have been a so-called pre-closing or 'warehousing' period, typically lasting between three and six months. During that period the asset manager will have acquired (or 'warehoused') assets to act as collateral for the securities to be issued by the CDO ... on the closing day." See "CDO Guide: recovery rates," Credit magazine (May 2004), http://db.riskwaters.com/public/showPage.html?page=133193.

1354 12/20/2006 Gemstone 7 Securitization Credit Report, DB_PSI_00237655-71.

1355 Subcommittee interview of Michael Lamont (9/29/2010).

1356 Subcommittee interview of Abhayad Kamat (10/8/2010).

headed by Sean Whelan and Michael Jones, was responsible for selling the Gemstone 7 CDO securities.

To issue the CDO securities, Deutsche Bank established an offshore corporation in the Cayman Islands called Gemstone CDO VII, Ltd.[1357] To administer the corporation, Deutsche Bank appointed its Cayman Island affiliate, Deutsche Bank Cayman, which is a licensed trust company.[1358] As administrator, Deutsche Bank Cayman provided Gemstone 7 with the administrative services needed to operate the CDO securitization, including but not limited to, providing office facilities and secretarial staff, maintaining the books and records required by Cayman law, naming at least two Cayman directors, and acting as the Share Registrar for Gemstone shares.[1359]

HBK's Long Investment in Gemstone. HBK routinely purchased the equity tranche,[1360] also known as the residual interest, in all of its Gemstone deals, including Gemstone 7.[1361] HBK told investors in its sales presentation that "HBK has retained 100% of the equity from CDO transactions resulting in strong alignment of interests between HBK and investors."[1362] According to Kevin Jenks, HBK's collateral manager, HBK had a "buy and hold" approach to all of its Gemstone CDOs.[1363] HBK also told the Subcommittee that it participated in Gemstone 7 with "the objective of obtaining long exposure to the CDO's

[1357] Gemstone CDO VII Ltd. Certificate of Incorporation and Memorandum and Articles of Association of Gemstone CDO VII Ltd., DB_PSI_00236844.
[1358] Deutsche Bank International Limited is a wholly owned subsidiary of Deutsche Bank AG. It currently has several offices around the world, including one in the Cayman Islands, Deutsche Bank (Cayman) Limited ("DB Cayman"), that was opened in 1983. "Deutsche Bank International Ltd.," Bloomberg Businessweek, http://investing.businessweek.com/research/stocks/private/snapshot.asp?privcapId=884191; "Deutsche Bank in the Cayman Islands," Deutsche Bank, http://www.dboffshore.com/page.php?title=cayman_islands. DB Cayman is a licensed trust company incorporated in the Cayman Islands. Preference Share Paying Agency Agreement, GEM7-00001089-1030, at 1092.
[1359] Amended and Restated Administrative Agreement, GEM7-00001223-31; Preference Share Paying Agency Agreement, GEM7-00001089-1130 at 1095-96.
[1360] An equity tranche is the tranche in an RMBS or CDO structure that is designed to be the first to incur any losses from the securitization. Since it is expected to incur at least some level of losses, the equity tranche is usually not given a credit rating and is often retained by the originator of the securitization. See American Banker definition, http://www.americanbanker.com/glossary/e.html.
[1361] According to HBK, "HBK's investment process integrates expertise in capital markets, structural analysis, collateral and loan level analysis, due diligence, and in house surveillance. HBK is seen as not as a trader but as a vigilant investor that maximizes value through intensive analysis and surveillance." 1/2007 Gemstone 7 Debt Investor Presentation, DBSI_PSI_EMAIL01980000-60 at 23.
[1362] Id.
[1363] Subcommittee interview of Kevin Jenks (10/13/2010). Also see 1/2007 Gemstone 7 Debt Investor Presentation, DBSI_PSI_EMAIL01980000-60 at 25.

collateral, on a leveraged basis, through ownership of the Residual interest."[1364]

HBK deals were known for containing above average concentrations of BB or lower rated assets, but HBK prided itself on its ability to run in-depth analysis and accurate stress tests on assets it selected for its CDOs.[1365] HBK expected to receive a 15% return on its investment in the equity tranche.[1366] In its investor presentation, HBK stated: "The firm strives to provide superior risk-adjusted rates of return with relatively low volatility and relatively low correlation to most major market indices."[1367] HBK's presentation also claimed that, as of January 2007, it had only three downgrades in its asset backed security portfolio, and that its upgrade to downgrade ratio was 23 to 3.[1368] Investor M&T Bank, who later purchased Gemstone 7 securities, told the Subcommittee that it had relied on HBK's assertions when choosing what it thought was an investment with "minimal risk."[1369]

HBK informed the Subcommittee that it had never shorted any of the assets in its seven Gemstone CDOs, that its CDO trade book was evenly matched with long and short CDO assets during the 2006-2007 period,[1370] and that it lost over $700 million in its Structured Credit business unit during 2007.[1371]

(b) Gemstone Asset Selection

As the collateral manager, HBK selected the assets for Gemstone 7, subject to approval by Deutsche Bank's structuring and trading groups before each asset could be placed in the Deutsche Bank warehouse account for the CDO.[1372] According to HBK and Deutsche Bank personnel, the approval process worked in the following manner. First, HBK identified the RMBS, CDO, and other securities it wanted to include or reference in the CDO. HBK then sent an email to Mr.

[1364] 8/20/2010 letter from HBK's counsel to the Subcommittee.
[1365] Subcommittee interview of Abhayad Kamat (10/8/2010). Mr. Kamat was the individual at Deutsche Bank who was primarily responsible for structuring Gemstone 7.
[1366] Subcommittee interview of Jamiel Akhtar (9/15/2010).
[1367] 1/2007 Gemstone 7 Debt Investor Presentation, DBSI_PSI_EMAIL01980000-60 at 17.
[1368] Id. at 25.
[1369] Subcommittee interview of M&T (9/20/2010).
[1370] According to HBK, "HBK never had a short position in any securities issued by the Gemstone 7 CDO." HBK also told the Subcommittee staff that it had approximately $350 million of long exposure in Gemstone 7 and another $800 million of "additional long exposure to the same assets underlying collateral outside the CDO." 8/20/2010 letter from HBK's counsel to the Subcommittee. HBK told the Subcommittee that it did at times take short positions in certain mortgage backed securities unrelated to the Gemstone transactions.
[1371] 8/20/2010 letter from HBK's counsel to the Subcommittee, and exhibit to letter, HBK's exposure to Gemstone VII Notes, GEM7-00000001-10.
[1372] Subcommittee interview of Abhayad Kamat (10/8/2010).

Lippmann or his traders at Deutsche Bank requesting that the identified assets be placed in the warehouse account for Gemstone 7. Deutsche Bank traders, sometimes in consultation with Mr. Lamont's structuring group, would then either approve or voice concerns regarding the proposed assets. If they had concerns, the traders would work with HBK personnel to resolve them. For example, on January 9, 2007, HBK's Jason Lowry sent an email to Mr. Lippmann and his trader, Jordan Milman, with a list of RMBS securities proposed for inclusion in Gemstone 7, and asked: "This is the last BB list for approval. Could you take a look?" On the same day, Mr. Milman wrote back: "approved contingent upon first pay defaults getting bought back on the 2 heat bonds."[1373]

Although the Gemstone 7 offering circular did not describe Deutsche Bank's role in the asset selection process, the private engagement agreement between HBK and Deutsche Bank did.[1374] According to the terms of the engagement agreement, Deutsche Bank agreed to provide, among other items, the following service: "advising the Issuer [Gemstone 7] and the Company [HBK] on the selection and acquisition of the Underlying Assets" and "the scope of due diligence for the Underlying Assets."[1375] Under both the engagement agreement and a separate risk sharing agreement, Deutsche Bank also had the right to reject assets selected by HBK for the Gemstone warehouse account.[1376] When asked about Deutsche Bank's obligations under these agreements, Mr. Lippmann told the Subcommittee that he viewed Deutsche Bank as having an obligation to the entity, Gemstone 7, to price the assets accurately as they were purchased, which included comparing the price of each security or CDS contract on the date it went into the warehouse account to its market price and ensuring that the CDO did not overpay for the assets it purchased.[1377] Mr. Lippmann's trader, Mr. Milman, and Mr. Kamat, of Mr. Lamont's CDO Group, agreed with that assessment.[1378] All three also stated that the engagement agreement did not require Deutsche Bank to analyze the

[1373] See, e.g., 1/9/2007 email from Jason Lowry to Greg Lippmann, GEM7-00002154; and 12/11/2006 email from Greg Lippmann to Kevin Jenks, GEM7-00002805. The term "heat" refers to an RMBS security issued by Home Equity Asset Trust.
[1374] The Gemstone 7 offering circular states that with regard to the purchase of underlying assets: "The Issuer [Gemstone 7] will acquire Underlying Assets from a warehouse facility (the 'Warehouse Facility') provided by an affiliate of DBSI [Deutsche Bank Securities, Inc.], which provides for the purchase of Asset-Backed Securities at the direction of the Collateral Manager [HBK] on behalf of the Issuer prior to the Closing Date." Gemstone 7 Offering Circular, GEM7-00000427-816 at 494.
[1375] 10/25/2006 signed letter agreement between HBK and Deutsche Bank, GEM7-00000071-89 at 72.
[1376] Id.; 10/24/2006 Risk Sharing Agreement, GEM7-00000090-99 at 91.
[1377] Subcommittee interview of Greg Lippmann (10/18/2010).
[1378] Subcommittee interview of Jordan Milman (10/22/2010) and Abhayad Kamat (10/8/2010).

quality of the assets being purchased or how those assets were expected to perform.

On the other hand, documents reviewed by the Subcommittee indicate, in at least a few instances, that Deutsche Bank personnel voiced concerns about an RMBS security being placed in the deal due to performance concerns in addition to price. For example, Mr. Kamat, who also assisted Mr. Lippmann's trading desks, wrote to Mr. Jenks about the quality of an asset being considered for Gemstone 7. Mr. Kamat wrote: "MLMI 2005-HE1 B3 [is] on credit watch – do you want to move this out of the portfolio – investors might question/resist[.]" Mr. Jenks responded: "[N]o let's leave it in[.]"[1379]

On another occasion, Mr. Jenks from HBK exchanged several emails with Mr. Lippmann about several RMBS securities that Mr. Jenks wanted to include in the Gemstone 7 warehouse account. Mr. Jenks sent the list to Mr. Lippmann and wrote: "please approve." Mr. Lippmann responded: "ok approved but would like to lower these 2 pts each given recent press on fhlt and significant widening in the baa3 cds. Is that cool?" The term "fhlt" referred to RMBS securities issued by Fremont; by saying he wanted to "lower these 2 pts," Mr. Lippman indicated he wanted to assign them a lower value for warehouse purposes. Mr. Jenks replied: "Greg, Fremont overall is really not trading badly just the ones on downgrade watch," to which Mr. Lippmann responded: "we have seen the fhlt 05-d bbb-trade wide .... please work with me on this. ... I am trying to work with you." Mr. Jenks replied:

> "Greg, I have been trying to work with you. Doing trades just with you and not on bid lists. But we play in the higher quality part of the market, I really expected you to approve the list as is. We still have several hundred million of bonds to do in cds form to do [sic]."[1380]

This exchange shows that Mr. Lippmann was cognizant of the quality of the assets being included in the CDO, and pushed for lower prices when he thought the assets were of poor quality.

HBK told the Subcommittee that it selected good quality bonds using a very complex model to analyze them.[1381] It told investors that it

[1379] 1/5/2007 email from Abhayad Kamat to Kevin Jenks, GEM7-00001977.
[1380] 12/8/2006 and 12/11/2006 emails between Mr. Lippmann and Mr. Jenks, DBSI_PSI_EMAIL01886779-80.
[1381] See 1/2007 Gemstone 7 Debt Investor Presentation, DBSI_PSI_EMAIL01980000-60 ("HBK's investment model utilizes proprietary default, prepay and severity loan level models to

"analyze[d] every bond in the market, providing for a vast range of data .... [F]rom this data, trends can be observed early regarding the bonds themselves as well as the general economy and the implications on future issuance."[1382] HBK provided this description for the Subcommittee regarding the tools it used in the asset selection process:

> "HBK used a statistically driven mortgage behavior model to help make trading decisions and select assets for inclusion in the Gemstone VII CDO. Three separate database tools were utilized in this process. First, HBK licensed a commercial database called *LP Database,* which contained detailed information and performance history for millions of non-agency mortgages. The *LP Database* was a robust dataset comprising close to 80% of the market, back to the 1996 vintage. Utilizing the data acquired from the *LP Database,* HBK then developed a proprietary system called the *Loss Model* that forecasted the likelihood of default, prepayment, delinquency, or timely payment for an individual mortgage monthly over a ten-year time horizon. The *Loss Model* made these forecasts based on a series of 50 loan characteristics, including whether the mortgage was a first or second lien mortgage, the type of mortgage *(e.g.,* fixed or ARM), its geographic location, FICO score, loan-to-value ratio, and level of documentation, and projections of home price appreciation and unemployment rates.
>
> Finally, HBK merged the information from the *Loss Model* into a *Bond Evaluation Engine,* which was based on software licensed from Intex Solutions. The *Bond Evaluation Engine* provided information that assisted HBK traders in pricing mortgage bonds and evaluating how the bonds might perform under certain stresses. ... This portion of the analysis focused on the structure and enhancements of the RMBS and how those structures would contribute to bond performance."[1383]

Mr. Jenks of HBK told the Subcommittee that HBK "never had a bond that we thought was bad that was put in a CDO."[1384] Mr. Jenks also told the Subcommittee that he had frequent conversations with Mr. Lippmann, was aware of his "negative housing view," but disagreed

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make investments in the residential market. ... Transaction performance is tracked monthly via trustee surveillance reports and ongoing loan level information to monitor and analyze parameters such as collateral yields, delinquency and default trends, recoveries, prepayments, and available credit enhancement.").

1382 Id. at 42.

1383 10/12/2010 letter from HBK's counsel to the Subcommittee.

1384 Subcommittee interview of Kevin Jenks (10/13/2010).

with the magnitude of Mr. Lippmann's negative views.[1385] Mr. Lippmann told the Subcommittee that although he occasionally suggested bonds to Mr. Jenks for Gemstone 7, and Mr. Jenks at times purchased them, Mr. Jenks had strong views on the assets that should be included in the CDO and was not required to listen to him. HBK and Deutsche Bank emails confirm that Mr. Lippmann or his traders offered at times to sell certain bonds to HBK, which occasionally purchased them.[1386] Deutsche Bank sold five bonds from its inventory, with a value of more than $27 million, to HBK for inclusion in Gemstone 7.[1387] According to Mr. Lamont, his CDO Group was "agnostic" towards the quality of the assets that HBK purchased for Gemstone 7, and told the Subcommittee that investors had relied on HBK, the collateral manager, to analyze their quality.[1388] Mr. Lamont said that the role of the CDO Group was, not to select the CDO's assets, but to structure the deal and then use models to conduct stress tests on it.[1389]

(c) Gemstone Risks and Poor Quality Assets

Gemstone 7's assets were assembled in late 2006 and early 2007, when the mortgage market was deteriorating and subprime mortgages were experiencing record delinquency rates. The CDO posed a host of risks due to both the state of the market and the poor quality of many of its underlying assets.

Credit Report. In December 2006, Mr. Lamont's CDO Group prepared a Credit Report for Deutsche Bank's credit risk management group to obtain internal approval for the securitization of Gemstone 7.[1390] The Credit Report noted the following business risks for Deutsche Bank regarding Gemstone 7, including the possibility that the bank would be unable to sell $400 million of the Gemstone securities, which carried "significant" risk:

- "The portfolio is concentrated on RMBS obligations, with 67.6%, 20.2% and 1.9% of the RMBS exposure represented by

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[1385] Id.
[1386] See, e.g., 12/8/2006 email from Greg Lippmann to Kevin Jenks, DBSI_PSI_EMAIL01883072 (discussing trade they agreed to). See also 2/23/2007 email from Jordan Milman to Greg Lippmann, DBSI_PSI_EMAIL02022054 ("I'd rather just have Ilinca show hbk, he loves bonds like this.").
[1387] Assets Purchased by Gemstone VII CDO during Warehouse Period, GEM7-00001831-33.
[1388] Subcommittee interview of Michael Lamont (9/29/2010). Mr. Kamat also agreed that Deutsche Bank was agnostic with regard to the quality of the assets. Subcommittee interview of Abhayad Kamat (10/8/2010).
[1389] Subcommittee interview of Michael Lamont (9/29/2010).
[1390] Id. See undated Gemstone 7 Securitization Credit Report, MTSS000011-13 and 12/20/2006 Gemstone 7 Securitization Credit Report, DB_PSI_00237655-71. The 12/20/2006 Credit Report appears to be an earlier version of the document.

2005, 2006, and 2007 vintages, respectively, which results in significant vintage risk."

- "RMBS accounts for ~90.0% of the initial collateral portfolio."
- "All unsold tranches have been taken back by HBK except for the Class A-1B ($400mm). Currently, we are working with [redacted] to see if they will be interested in taking the tranche. The plan for distribution if [redacted] decides not to take the tranche, will be a senior sequential repack. The Class A-1B will be broken into two tranches. DB will take the senior part (Class A-1B(i) $200mm) and HBK will take the bottom part (Class A-1B(i) $200mm). Once the repack is setup, then DB will try to syndicate the Class A-1B(i)." [1391]

The business risks described in the internal Deutsche Bank credit report relating to "significant vintage risk" for the 2005, 2006, and 2007 vintage RMBS securities[1392]were not disclosed in the Gemstone 7 offering materials given to investors. Although the March 15, 2007 Offering Circular contained a "Risk Factor" section describing multiple risks associated with an investment in Gemstone 7, including those associated with residential asset backed securities, the Offering Circular was silent with respect to the above risks identified in the Credit Report, which were highlighted for Deutsche Bank management.

The Offering Circular did, however, describe in detail a number of significant risks associated with RMBS securities. For example, it stated:

- "The risk of losses on residential mortgage loans is particularly relevant now. While there is always a risk of defaults or delinquencies in payment, recently losses on residential mortgage loans have been increasing and may continue to increase in the future. The losses have been most significant in respect of subprime mortgage loans but all are affected.
- A number of factors are contributing to the increase in losses. Residential property values that increased for many years are now declining. ... Declining property values also exacerbate the losses due to a failure to apply adequate standards to potential borrowers. Failures to properly screen borrowers may include failures to do adequate due diligence on a borrower (including

[1391] Gemstone 7 Securitization Credit Report, MTSS000011-13.
[1392] Id.

employment and income history) or the relevant property (including valuation) or failures to follow predatory lending and the other borrower-protection statutes. Increases in interest rates may also contribute to higher rates of loss. ...

- The increase in delinquencies and defaults has contributed to a declining market for mortgage loans. The declining market has, in turn, seriously impacted mortgage originators and servicers. ... The financial difficulties of servicers in particular are likely to result in losses in respect of securities backed by residential mortgage loans. ... At any one time, the portfolio of Residential ABS Securities may be backed by residential loans with disproportionately large aggregate principal amounts secured by properties in only a few states or regions."[1393]

These disclosures demonstrate that both HBK and Deutsche Bank were well aware of the deteriorating mortgage market and increased risks associated with RMBS and CDO securities, even as they were marketing the Gemstone 7 securities and claiming HBK had applied careful analysis in the asset selection process to ensure good quality CDO securities.

Long Beach-Fremont-New Century Bonds. A substantial portion of the cash and synthetic assets included in Gemstone 7, 30% in all, involved subprime residential mortgages issued by three subprime lenders, Long Beach, Fremont, and New Century, all known for issuing poor quality loans and securities.[1394] Loans by these lenders were among the first to collapse. According to Moody's, these three originators, plus WMC Corporation, accounted for 31% of the subprime RMBS securities issued in 2006, but 63% of the rating downgrades issued in the second week of July 2007, when the mass rating downgrades began.[1395]

During the period when securities were being assembled for the Gemstone 7 warehouse in late 2006 and early 2007, Mr. Lippmann

[1393] 3/15/2007 Offering Circular for Gemstone CDO VII, Ltd., GEM7-00000427-816 at 483-84. While an earlier offering circular for Gemstone 7, dated February 14, 2007, identifies some risks associated with the CDO, the March offering circular contains additional language, quoted above, on the risks associated with the deteriorating mortgage market. 2/14/2007 Offering Circular for Gemstone CDO VII, Ltd., PSI-M&T_Bank-02-0001-370.

[1394] For more information on these three lenders, see sections D(3)(d) and E(2)(c)-(d) of Chapter IV. Mr. Jenks of HBK told the Subcommittee that he saw data showing that Long Beach and Fremont were poor performers, but he thought the performance varied depending upon the tranche, and he believed he could pick the better tranches. He thought he could buy low, structure the deal well, and make money. Subcommittee interview of Kevin Jenks (10/13/2010).

[1395] 7/12/2007 Moody's Structured Finance Teleconference and Web Cast: RMBS and CDO Rating Actions, at Moody's SI 2010-0046902, Hearing Exhibit 4/23-106.

frequently disparaged many of the same assets he and his traders allowed to be included in Gemstone 7. About $27 million of these assets came from Deutsche Bank's own inventory. In emails to colleagues and his clients, Mr. Lippmann used words like "crap" and "pig" to describe the assets. Mr. Lippmann brought some of the assets of Gemstone 7 to the attention of some of his clients that shorted these assets.[1396]

On October 20, 2006, for example, one of Mr. Lippmann's clients sent him an email seeking advice about certain subprime bonds issued by Long Beach Mortgage Loan and Trust (LBMLT) and other originators. Mr. Lippmann responded:

> "LBMLT-06-5 M9-375. Long Beach is one of the weakest names in the market. We shorted this bond to a CDO in the mid-300s on October 13[.] Deal was done before S&P changed their criteria on July 1. Lots of 40 year mortgages .... Less than half the loans have full documentation and 10% are investor properties. This is a real pig.
>
> LBMLT -06-2 M9 350. See above on Long Beach. This one is already performing poorly with substantial delinquencies .... Further the FICO is less than the 06-05 and there are fewer full doc loans. This seems a better short than the 06-5. Only reason I can think for my guys showing you a tighter level is that we are short this one and that the June 06 deals have a taint that earlier months don[']t due to the theory that late June deals were crammed with bad stuff in order to beat the S & P revisions."[1397]

Despite these negative views of Long Beach, Mr. Lippmann's group raised no concerns when $25 million in LBMLT 2006-5 M9 securities was purchased by HBK for Gemstone 7's warehouse account, $20 million of which was purchased on October 24, 2006, four days after Mr. Lippmann's email. Altogether, a total of $79.5 million in Long Beach bonds went into Gemstone 7.[1398]

Mr. Lippmann had similar negative views of RMBS securities containing subprime loans originated by Fremont, yet his group did not object to including Fremont securities in Gemstone 7. For instance, on December 6, 2006, Mr. Lippmann's traders did not object to including $20 million of an RMBS known as SABR 2005-FR4 B3, which

[1396] Subcommittee interview of counsel for Deutsche Bank (2/1/2011).
[1397] 10/20/2006 email from Greg Lippmann to Craig Carlozzi at Mast Capital, DBSI_PSI_EMAIL01774820-21.
[1398] 9/14/2010 Gemstone 7 Asset Chart, PSI-DeutscheBank-17-Gemstone7-0001-03.

contained Fremont loans, in Gemstone 7.[1399] One week earlier, on November 29, 2006, when asked by a bank colleague about the same RMBS security, Mr. Lippmann labeled it a "pig."[1400] Two days later, on December 1, 2006, Mr. Lippmann declared in an email to a client that the security was "blowing up."[1401]

In addition, on November 29, 2006, Mr. Lippmann called still another RMBS security with Fremont loans, FHLT 2005-A M9, a "pig."[1402] Yet a month earlier, on October 30, 2006, approximately $1 million of FHLT 2005-A M9 had been purchased for Gemstone 7, with no objection from Mr. Lippmann's trading desk.[1403]

Mr. Lippmann made similar negative remarks about RMBS securities containing subprime loans originated by New Century. On November 28, 2006, Mr. Lippmann wrote: "MABS 2005-NC2 M9 ... huge payment shock coming."[1404] Yet six weeks later, on January 17, 2007, $10 million of this exact asset, MABS 2005-NC2 M9, was purchased by Gemstone 7, without objection from Mr. Lippmann's traders.[1405] On December 8, 2006, Mr. Lippmann wrote about another New Century security underwritten by Goldman Sachs: "GSAMP 06-nc2 m8 this is an absolute pig."[1406] Although Gemstone 7 did not purchase the M8 securities, it did purchase a total of $30 million in GSAMP 2006-NC2 M9 securities – from a lower tranche in the same securitization with less subordination. It purchased those securities over a month-long period, with $10 million of the securities on November 13, 2006; another $10 million on December 8, 2006; and still another $10 million on December 21, 2006.[1407] In addition, on December 18, 2006, Gemstone 7 purchased $8.8 million worth of a similar security, GSAMP 2006-NC2 B2.[1408]

[1399] Id.
[1400] With regard to the asset, Mr. Lippmann wrote: "pig probably a 400-525 market." 11/29/2006 email from Greg Lippmann to Francis Blair at Deutsche Bank, DBSI_PSI_EMAIL01853153.
[1401] See 12/1/2006 email from Greg Lippmann to Tyler Duncan at Wayzata Investment Partners, DBSI_PSI_EMAIL01864446 (Mr. Lippmann wrote: "sabr 05-fr4 b3 another Fremont blowing up we traded in august at 260"). Later in January 2007, Greg Lippmann wrote: "SABR Fr [Fremont] blows." 1/25/2007 email from Greg Lippmann to Mark Lee at Contrarian Capital, DBSI_PSI_EMAIL01961580.
[1402] 11/29/2006 email from Greg Lippmann to Jashin Patel at Deutsche Bank, "Where is this pig marked?," DBSI_PSI_EMAIL01854608.
[1403] See 9/14/2010 Gemstone 7 Asset Chart, PSI-DeutscheBank-17-Gemstone7-0001-03.
[1404] 11/28/2006 email from Greg Lippmann to Rocky Kurita, DBSI_PSI_EMAIL01846000.
[1405] See 9/14/2010 Gemstone 7 Asset Chart, PSI-DeutscheBank-17-Gemstone7-0001-03.
[1406] 12/8/2006 email from Greg Lippmann to Peter Faulkner at PSAM, LLC, DBSI_PSI_EMAIL01882188.
[1407] See 9/14/2010 Gemstone 7 Asset Chart, PSI-DeutscheBank-17-Gemstone7-0001-03.
[1408] Id.

Mr. Lippmann was equally critical of New Century loans securitized by ACE, an entity created by and associated with Deutsche Bank. On September 21, 2006, for example, when asked by a Deutsche Bank salesperson for his opinion of ACE 2006-NC1 M9, an RMBS issued by ACE with New Century subprime loans, Mr. Lippmann responded that ACE was "generally horrible."[1409] On March 2, 2007, a client sent an email to Mr. Lippmann stating: "[T]hey are claiming that DB [Deutsche Bank] was one of the last ones to tighten standards on buying loans to securitize. [Y]ou were right - ACE is crap." Mr. Lippmann responded: "INDEED ... IT IS."[1410] Yet on December 19, 2006, Mr. Lippmann's traders did not object to the purchase of $10 million of ACE 2006-NC1 M9 for Gemstone 7.[1411]

Mr. Lippmann also had negative opinions about other securities purchased for Gemstone 7. On March 1, 2007, for example, Mr. Lippmann wrote that ABSHE 2006-HE1 M7 was "crap."[1412] But $5 million of this same security had been purchased three months earlier by Gemstone 7, on November 16, 2006, without objection from Mr. Lippmann's trading desk.[1413] In still another instance, on March 19, 2007, Mr. Milman described FFML 2006-FF13 as "a piece of crap."[1414] Yet over the prior five months, the Lippmann trading desk had approved the purchase of a total of $38.5 million of this exact bond, FFML 2006-FF13, for inclusion in Gemstone 7: $11.7 million of the class B1 securities on October 30, 2006; $16.2 million of the class B2 securities on November 17, 2006 and January 9, 2007; and $10.6 million of the class M9 securities on March 15, 2007.[1415]

Securities from Deutsche Bank's Inventory. Gemstone 7 purchased five securities totaling $27 million directly from Deutsche Bank's inventory.[1416] Mr. Lippmann, and his trader Jordan Milman,

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1409 9/21/2006 email from Greg Lippmann to Melissa Goldsmith at Deutsche Bank, DBSI_PSI_EMAIL01689001-02. Mr. Lippmann confirmed to the Subcommittee that he believed ACE was "horrible." Subcommittee interview of Greg Lippmann (10/18/2010). On May 19, 2006, Mr. Lippmann wrote to a Deutsche Bank colleague, "We traded that ACE piece of crap with Ike at 380." 5/19/2006 email from Greg Lippmann to Rocky Kurita at Deutsche Bank, DBSI_PSI_EMAIL0120552. On May 29, 2007, Mr. Lippmann wrote with regard to ACE 2006-ASP3 M7, "this stinks though I didn't mention it." 5/29/2007 email from Greg Lippmann to Danielle Pluthero at Deutsche Bank, DBSI_PSI_EMAIL02532365.

1410 3/2/2007 email from Greg Lippmann to Clark Baker at Harbinger Capital, DBSI_PSI_EMAIL02038599.

1411 9/14/2010 Gemstone 7 Asset Chart, PSI-DeutscheBank-17-Gemstone7-0001-03.

1412 3/1/2007 email from Greg Lippmann to Joris Hoedemaekers at Oasis Capital, DBSI_PSI_EMAIL02033845.

1413 9/14/2010 Gemstone 7 Asset Chart, PSI-DeutscheBank-17-Gemstone7-0001-03.

1414 3/19/2007 email from Jordan Milman to Greg Lippmann, DBSI_PSI_EMAIL02412084.

1415 9/14/2010 Gemstone 7 Asset Chart, PSI-Deutsche Bank-17-Gemstone7-0001-03.

1416 These five securities were: (1) ACE 2006-HE1 M10, (2) Securitized Asset Backed Receivables (SABR) 2005-OP1 B4, (3) Ameriquest Mortgage Securities Inc. (AMSI) 2005-R11 M10, (4) Deutsche Bank Alt-A Securities, Inc. (DBALT) 2006-AR6 M10, and (5) First Franklin shared negative views of one of the bonds, ACE 2006-HE1 M10, a security in which over 75% of the loans had been originated by Fremont.[1417] In an instant message conversation in December 2006, Mr. Lippmann asked Mr. Milman his thoughts on ACE 2006-HE1 M10. Mr. Lippmann asked: "DOESNT THIS DEAL BLOW," to which Mr. Milman replied: "yes it blows I am seeing 20-40% writedowns."[1418] Not only did HBK include $10 million of this asset in the Gemstone 7 warehouse account, HBK purchased it from Deutsche Bank that same month through one of Mr. Lippmann's traders.[1419] Thus, Deutsche Bank allowed Gemstone 7 to acquire a $10 million asset that its traders believed would perform poorly, and effectively removed the financial risk of this asset from its own inventory, shifting it to its customers.

Mr. Lippmann expressed a negative outlook for other assets as well, including SABR 2005-OP1, that was taken from Deutsche Bank's inventory and sold to Gemstone 7. On August 26, 2006, Mr. Lippmann wrote to a client about more securities "blowing up," including SABR 2005-OP1:

> "I am encouraged that in spite of the virility of the cdo bid, there are numerous examples of bonds blowing up ... the tripling of serious delinq [delinquencies] in sabr 05-opl to over 6.5% since feb even though the avg [average] mortgage age is now only 21 months i.e. hasn't reset yet .... What I'm saying is there is plenty of fundamental evidence that bonds are blowing up even as the new issue and index market are remaining buoyant."[1420]

On December 12, 2006, with no objection from Mr. Lippmann's desk, Gemstone 7 purchased $5.5 million of SABR 2005-OP1 B4 from Deutsche Bank, the same asset that he had described months earlier as incurring "serious delinquencies."[1421]

A third example involved securities issued by Ameriquest Mortgage Securities Inc. (AMSI), which Gemstone purchased from Deutsche Bank's inventory. On April 6, 2006, Mr. Lippmann called

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Mtg Loan Asset Backed Certificate (FFML) 2005-1 B4. See Assets Purchased by Gemstone VII CDO during Warehouse Period, GEM7-00001831-33. See also 9/14/2010 Gemstone 7 Asset Chart, PSI-Deutsche Bank-17-Gemstone7-0001-03.

1417 9/14/2010 Gemstone 7 Asset Chart, PSI-Deutsche Bank-17-Gemstone7-0001-03.

1418 12/1/2006 instant message conversation between Greg Lippmann and Jordan Milman, DBSI_PSI_EMAIL01863636.

1419 12/19/2006 email from Jason Lowry at HBK to Greg Lippmann and others at Deutsche Bank, DBSI_PSI_EMAIL01910568; 12/19/2006 email from Greg Lippmann to Jordan Milman and others at Deutsche Bank, DBSI_PSI_EMAIL01910580.

1420 8/26/2006 email from Greg Lippmann to Richard Axilrod, DBSI_PSI_EMAIL01618236.

1421 Assets Purchased by Gemstone VII CDO during Warehouse Period, GEM7-00001831-33.

AMSI 2005-R7 M8 a "crap name."[1422] In a June 16, 2006 email, Mr. Lippmann called AMSI generally a "weakish name."[1423] On December 12, 2006, Gemstone 7 purchased $5 million of another RMBS, AMSI 2005-R11 M10, with no objection from the Lippmann trading desk.[1424]

In still another instance, Deutsche Bank praised its sales force for placing a security it was having difficulty selling as the underwriter, Deutsche Alt-A Securities Inc. (DBALT) 2006-AR6, in Gemstone 7. On November 17, 2006, the Deutsche Bank Option Arms Desk sent the following email, "The Arms Desk would like to express its sincere appreciation to the sales force for an outstanding job in helping us place the bonds off DBALT 06-AR6. Thanks a lot!!"[1425] Less than two weeks later, on November 29, 2006, a member of the Deutsche Bank sales force wrote: "Some success in CMO [collateralized mortgage obligation] land today: Sold 9 mm [million] DBALT 06-AR6 M10 (Ba2/BBB-) to HBK. This class was never sold in the new issue marketing." [1426] HBK records indicate that, the next day, it agreed to purchase $8.8 million of DBALT 2006-AR6 M10.[1427]

Many investors would likely have found the negative views of Mr. Lippmann, Deutsche Bank's top CDO trader, important to their decision as to whether or not to buy Gemstone 7, but his views, as described above, were not disclosed to them. At the time, the traders on his desk as well as other Deutsche Bank CDO personnel knew that many clients valued and relied on Mr. Lippmann's opinion when making investment decisions, yet did not disclose his views of the specific assets included in Gemstone 7.[1428] M&T Bank told the Subcommittee that had it known about Mr. Lippmann's views, it might have "thought twice" before purchasing Gemstone 7 securities.[1429]

[1422] 4/6/2006 email from Greg Lippmann to himself, DBSI_PSI_EMAIL01075218.
[1423] 6/16/2006 email from Greg Lippmann to Rocky Kurita, DBSI_PSI_EMAIL01314036.
[1424] Assets Purchased by Gemstone VII CDO during Warehouse Period. GEM7-00001831-33.
[1425] 11/17/2006 email from Deutsche Arms to Deutsche Bank employees, DBSI_PSI_EMAIL01831021; 11/14/2006 email from Deutsche Arms to Deutsche Bank employees, DBSI_PSI_EMAIL01822045. DBALT was "one of Deutsche Bank's own shelf offerings." 3/21/2011 letter from Deutsche Bank's counsel to the Subcommittee, PSI-Deutsche_Bank-32-0001-04.
[1426] 11/29/2006 email from Larry Pike to Elcanny Pichardo and others, DB_PSI_01731794.
[1427] 11/30/2006 email from Jason Lowry at HBK to Abhayad Kamat and others, GEM7-00005480. See also Assets Purchased by Gemstone VII CDO during Warehouse Period, GEM7-00001831-33.
[1428] See 7/6/2006 email from Axel Kunde to Greg Lippmann, DBSI_PSI_EMAIL01374694 ("If you tell the sales guy the bond is really bad his investor will use that as an argument against us and demand we buy back his note, because he trusted DB [Deutsche Bank] to pick a good portfolio etc, etc.").
[1429] Subcommittee Interview of M&T (9/20/2010).

(d) Gemstone Sales Effort

Deutsche Bank began aggressively marketing Gemstone 7 to investors beginning in January 2007.[1430] The bank communicated with potential investors about Gemstone 7 in a variety of ways, including through emails, telephone calls, face to face meetings, and at conferences. Deutsche Bank personnel also went on what they called "road shows" to cities around the world, to meet investors and pitch the CDO to them.[1431] Sean Whelan, co-head of the Deutsche Bank CDO sales force, and Ilinca Bogza, a vice president in the Deutsche Bank syndicate group, worked to market Gemstone 7 to investors, including by scheduling road shows and personal meetings with potential investors.

Investors were typically shown a "Debt Investor Presentation" that had been prepared by HBK and Deutsche Bank.[1432] That presentation provided an overview of the transaction, a description of HBK's organization, and its investment strategy. The presentation highlighted investment considerations, including HBK's expertise in the capital markets, how its structured products exhibit relatively stable performance, and their low default history. The presentation also contained a description of HBK's analytical systems and surveillance capabilities, and included an appendix describing the risk factors for the deal. HBK told the Subcommittee that its employees attended investor meetings, and were at times called upon to answer questions, but did not always participate in the Gemstone 7 sales efforts which were led by Deutsche Bank.[1433]

One Gemstone investor, M&T Bank, told the Subcommittee that, after observing a presentation made by Mr. Jenks and receiving Deutsche Bank's assurances in connection with its solicitation efforts, it believed that Gemstone 7 securities posed minimal investment risk.[1434] According to the transcript of a telephone call on February 5, 2007, Sean Whelan of Deutsche Bank's sales force pitched the Gemstone 7 deal to M&T Bank and stated in part: "If you indicate early, like Gemstone deals go very well, and this deal will all go very well and it will get oversubscribed."[1435] The following day, February 6, 2007, Mr. Whelan again pitched the deal to M&T and stated that Gemstone 7 "was like a

[1430] See, e.g., 1/25/2007 Deutsche Bank internal email chain, DB_PSI_00346491-99, at 99.
[1431] Subcommittee interview of Sean Whelan (9/22/2010).
[1432] See, e.g., 1/2007 Gemstone 7 Debt Investor Presentation, DBSI_PSI_EMAIL01980000-60 and 2/8/2007 Gemstone 7 Debt Investor Presentation, GEM7-00001687-1747.
[1433] Subcommittee interview of Kevin Jenks (10/13/2010).
[1434] Subcommittee interview of M&T (9/20/2010).
[1435] 2/5/2007 telephone transcript between Sean Whelan and Alex Craig of M&T, MTSS000920-25, at 22.

lay up."[1436] When asked about these comments, Mr. Whelan told the Subcommittee that what he meant was that working with a quality hedge fund like HBK was a "lay up," not that the Gemstone 7 deal itself was a "lay up."[1437] With regards to his comment about oversubscription, he said he was referring to the tranches that M&T Bank was considering purchasing, which ultimately were fully subscribed.[1438]

In early 2007, as the closing date for Gemstone 7 neared, the Deutsche Bank sales force was having difficulty getting commitments from investors to buy Gemstone securities. Many investors who were solicited declined to invest because of concerns about the high concentration in subprime RMBS with BBB or BB ratings.[1439] In the beginning of 2007, there was a general lack of buyer interest in mortgage related securities in the United States, other than from new CDOs purchasing CDO securities from prior deals. It was not the first time, however, that a Gemstone deal involving Deutsche Bank and HBK could not be fully sold. HBK had conditioned Deutsche Bank's participation in Gemstone 7 on its purchasing unsold securities from Gemstone 4 and 5, BB rated securities that HBK still had on its books for $13.1 million. In an email sent to a colleague, an HBK Managing Director Jamiel Akhtar wrote:

> "As a condition for receiving the underwriting mandate, Kevin [Jenks] and I insisted that DB [Deutsche Bank] buy from us the $13.1mm of BB rated CDO liabilities HBK retained on its own books from Gemstone IV and V. This was a fairly sharp-elbowed tactic on our part, as the BB bonds are the worst part of the capital structure, but I felt like we should be sharp-elbowed with DB right now."[1440]

The head of Deutsche Bank's CDO Group, Michael Lamont, sent an email to the CDO Group banker assigned lead responsibility for structuring Gemstone 7, acknowledging the risk the bank took on by purchasing the earlier unsold securities, but also noting the "nice" fee being paid to the bank: "[T]hat is part of the risk we took when we were awarded the mandate and we are still making a nice all in fee."[1441] When Deutsche Bank told HBK that it intended to resell the Gemstone 4 and 5 securities, the HBK official indicated it was "ok with that as long

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[1436] 2/6/2007 telephone transcript between Sean Whelan, Alex Craig, and David Borchard of M&T, MTSS000929-31, at 31.
[1437] Subcommittee interview of Sean Whelan (9/22/2010).
[1438] Id.
[1439] See spreadsheet containing potential investor feedback regarding Gemstone 7, DBSI_PSI00117568.
[1440] 10/5/2006 email from Jamiel Akhtar at HBK to Jon Mosle at HBK, GEM7-00006353.
[1441] 2/8/2007 email from Michael Lamont to Abhayad Kamat, DBSI_PSI_EMAIL04045219-24.

as it is not blasted out to everyone so as not to affect his current deal [Gemstone 7] in the market."[1442] Deutsche Bank and HBK did not disclose in the Gemstone 7 offering materials both the bank's purchase of the Gemstone 4 and 5 securities as a precondition to the deal and the bank's plan to sell the Gemstone 4 and 5 securities contemporaneously with the Gemstone 7 securities.

Struggle to Sell Gemstone. Evidence obtained by the Subcommittee shows that both HBK and Deutsche Bank were concerned about their exposure should Gemstone 7 not be fully subscribed and worked hard to sell the deal in the face of U.S. investor disinterest.[1443] According to the terms of the Gemstone deal, if the securities were not fully sold, the risk of the first $80 million in losses would fall on HBK, while all remaining losses would fall on Deutsche Bank.[1444] On February 27, 2007, Mr. Kamat of Deutsche Bank wrote to Mr. Jenks of HBK about selling the Gemstone 4 and 5 securities and brought up the CDO Group's need to reduce risk: "[W]e are trying to reduce our exposure right now given internal very senior mgmt review of our business." Mr. Jenks responded: "We are also trying to reduce exposure."[1445]

In January 2007, Michael Lamont, head of Deutsche Bank's CDO Group, and Mr. Jenks, the HBK collateral manager, discussed the urgency of selling Gemstone 7 in the face of a deteriorating market. On January 9, 2007, Mr. Jenks wrote to Mr. Lamont: "[W]ith this market this way and probably going to get worse we would like to really move on the cdo. Please allocate the resources to expedite this." Four minutes later Mr. Lamont responded: "[W]e are focused on this as well. We don't have a deal in the market and you will be first."[1446]

Several developments in early 2007 signaled problems in the mortgage industry. On January 29, 2007, subprime lender Fremont Investment & Loan announced that it had "severed ties" with 8,000 brokers whose loans had high delinquency rates.[1447] The following week on February 7, 2007, New Century, another major subprime

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[1442] Id. at 24.

[1443] Subcommittee interview of Kevin Jenks (10/13/2010). Mr. Jenks recalled that there were more non U.S. investors in CDOs in 2007, but he believed that was because there was not much of a CDO market in Europe. Subcommittee interview of Kevin Jenks (10/13/2010). Mr. Whelan told the Subcommittee that in 2006 and 2007, CDO subscription was "spotty." Subcommittee interview of Sean Whelan (9/22/2010).

[1444] 12/20/2006 Gemstone 7 Securitization Credit Report, DB_PSI_00237655-71.

[1445] 2/27/2007 email between Abhayad Kamat and Kevin Jenks, DB_PSI_00421609 (discussing potential exposure due to purchase of earlier Gemstone 4 and 5 tranches in Gemstone 7).

[1446] 1/9/2007 email chain between Michael Lamont and Kevin Jenks, GEM7-00002156.

[1447] 2/1/2007 S&P internal email, "Defaults cause Fremont to end ties to 8,000 brokers," Hearing Exhibit 4/23-93d.

lender, disclosed in a conference call with investors that "the level of early-payment defaults and loan repurchases [had] led to tighter underwriting guidelines," that its nonprime loan production would be declining, and that it would be restating its earnings.[1448] An additional warning to the market that occurred as Gemstone was being marketed to investors was the plunge in the ABX Index that tracked the value of subprime RMBS securities. In February 2007, the ABX Index fell from a high of $0.90 early in the month to $0.69 by the end of the month, indicating a drop of more than 23% in the value of subprime RMBS securities.[1449] These and other events affected both the RMBS and CDO markets, since so many CDOs included or referenced subprime RMBS securities.

Emails reviewed by the Subcommittee show that CDO personnel at Deutsche Bank were well aware of the worsening CDO market and were rushing to sell Gemstone 7 before the market collapsed. On February 7, 2007, Mr. Lippmann, reacting to the New Century developments, raised concerns with Mr. Lamont about the ability of Deutsche Bank to continue to sell CDO securities: "I was calling about warehouse marks and distribution risk b/c [because] hearing rumors about other dealers having big trouble placing this stuff."[1450] The next day, February 8, 2007, Mr. Lamont told Abhayad Kamat, the CDO Group employee structuring Gemstone 7: "[R]egardless we need to sell it [Gemstone 7] now while we still can."[1451] The same day, Mr. Lamont wrote to Mr. Jenks at HBK: "Keep your fingers crossed but I think we will price this just before the market falls off a cliff."[1452] The next day, February 9, 2007, Ilinca Bogza, of the Deutsche Bank syndicate group, wrote to Mr. Lamont: "Jenks just called me. ... He is frightened that

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1448 "New Century plunges on loan production," MarketWatch (2/8/2007), http://www.marketwatch.com/story/new-centurys-shares-punished-over-loan-production-warning. On the day before the New Century conference call, Deutsche Bank received a request from HBK to approve a New Century asset purchase for the Gemstone 7 deal and approved this request on February 9. See 2/9/2007 email from Jordan Milman to Ashley Bonilla at HBK, DB_PSI_00845552.

1449 On Feb. 23, 2007, MarketWatch announced: "The ABX.HE index that tracks CDS on the riskiest subprime loans, rated BBB-, that were sold in the second half of 2006 fell to $0.69 on Friday, according to Markit.com, which administers the indexes. That's down from $0.72 on Thursday and $0.79 at the beginning of the week. In early February, this index was above 90." "Subprime mortgage derivatives index plunges; Bankruptcies, losses in subprime home loan industry spark drop," MarketWatch (2/23/2007), http://www.marketwatch.com/story/index-of-subprime-mortgage-derivatives-plunges-on-sector-woes.

1450 2/7/2007 email from Greg Lippmann to Michael Lamont, DBSI_PSI_EMAIL02366193-96, at 94. When Mr. Lamont heard about the New Century developments he wrote: "yikes. I think we will stay short a while." 2/7/2007 email from Michael Lamont to Greg Lippmann, DBSI_PSI_EMAIL02366194.

1451 2/8/2007 email from Michael Lamont to Abhayad Kamat, DBSI_PSI_EMAIL04045219-24.

1452 2/8/2007 email from Michael Lamont to Kevin Jenks, DBSI_PSI_EMAIL04045360.

accounts will pull their orders given the widening in abx today. … He mentioned he was going to give you a call. He is very nervous."[1453]

On February 13, 2007, the head of Deutsche Bank's syndicate group, Anthony Pawlowski, wrote to Mr. Lamont: "I am not sure how to push guys upstairs without having them crack. Everyone wants to price this deal asap (Sean Whelan [co-head of Deutsche Bank's CDO sales force] is pushing for Friday to lock up his guys on the AAA and AA)[.] Let me know."[1454] A week later, on February 20, 2007, Mr. Lamont wrote to Deutsche Bank syndicate to ask:

> "[O]n our managed mezz[anine] abs [asset backed security] CDOs last year what was the split by risk tranche across deals between real money and cdo warehouses. The street may be pulling back so this would be good info to have as we think about how we are going to place risk."[1455]

In one odd instance, Ms. Bogza, from the CDO syndicate, sent an email to the Deutsche Bank sales force suggesting that Gemstone 7 was experiencing greater investor interest than it really was. The February 20, 2007 email by Ms. Bogza stated that the bank had received an "indication of [investor] interest" in 75% of the BBB securities in Gemstone 7.[1456] After receiving this email, Mr. Lippmann wrote to Ms. Bogza: "[W]ow that much interest in the bbb? Is that real?? We would take as much as you can oversell."[1457] Ms. Bogza responded: "no. that is def[initely] not real .. it is at 50%.; cant oversell any tranche to be honest," to which Mr. Lippmann responded: "very sneaky."[1458]

In late February, as the market continued to deteriorate, Deutsche Bank attempted to motivate its employees to sell Gemstone 7 by providing special incentives to its sales force for selling the deal. On February 21, 2007, Mr. Kamat wrote to Ms. Bogza: "[W]e need help on selling the As and BBBs in the Gemstone CDO 7 transaction – we have nearly 50% unsold on both tranches in the transaction."[1459] In another

[1453] 2/9/2007 email from Ilinca Bogza to Michael Lamont, DBSI_PSI_EMAIL04047421-23.
[1454] 2/13/2007 email from Anthony Pawlowski at Deutsche Bank to Michael Lamont, DBSI_PSI_EMAIL04049521.
[1455] 2/20/2007 email from Michael Lamont to Ilinca Bogza, DBSI_PSI_EMAIL04054492. On February 20, 2007, a client of Mr. Lippmann's who was looking to short more RMBS commented in an email to him about the negative news concerning Novastar Financial Inc., which announced losses that day. His client described the situation in the market "like the plague." 2/20/2007 email from Steven Eisman at Frontpoint Partners to Greg Lippmann, DBSI_PSI_EMAIL02008182.
[1456] 2/20/2007 email from Ilinca Bogza to sales force, DBSI_PSI_EMAIL02007608.
[1457] 2/20/2007 email from Greg Lippmann to Ilinca Bogza, DBSI_PSI_EMAIL02007608.
[1458] 2/20/2007 email between Greg Lippmann and Ilinca Bogza, DBSI_PSI_EMAIL02007794.
[1459] 2/21/2007 email from Abhayad Kamat to Ilinca Bogza, DBSI_PSI_EMAIL04055827.

email the same day, he wrote: "[S]hould we offer more PCs for Gemstone 7 CDO given the market?"[1460] "PCs" refers to Production Credits, which were used to boost a salesperson's compensation including through an end-of-year bonus. Later the same night, Mr. Kamat sent an email to the co-head of the CDO Group seeking to increase the Production Credits that could be awarded for selling Gemstone 7: "[D]ouble digit PCs? I guess my original offer of 300 on single-As and 600 on triple-Bs is too low ... what can we offer?"[1461]

Showing Investors Higher Marks. As the value of mortgage related assets grew more volatile, some potential investors in Gemstone 7 inquired about the mark to market (MTM) value of the CDO's underlying assets. MTM is a valuation method by which the current value of an asset is recorded on a firm's books at the price it would sell in the marketplace on the day it is marked. Investors at times inquire about MTM values to determine if the underlying assets of a CDO have dropped in value since their inclusion in the warehouse account. Traders who closely follow buy and sell activity for a particular class of assets are generally best able to provide the most accurate current valuation. At Deutsche Bank, the CDO Trading Desk marked the value of assets monthly as a service to its clients and at times provided this service to HBK for the assets underlying Gemstone 7.[1462] HBK also prepared its own internal marks valuing Gemstone's assets. According to both Deutsche Bank and HBK, assigning a mark is a very complicated process that involves credit analysis of the securities at issue. Both explained it was not unusual for different entities to mark an asset differently.[1463]

During the marketing phase of Gemstone 7, documents indicate several potential investors asked Deutsche Bank to provide MTM values for the underlying assets in the CDO. In response, those potential investors were given HBK's marks, rather than the generally lower valuations assigned to the assets by Deutsche Bank's CDO Trading Desk. On January 23, 2007, Mr. Kamat sent an email to HBK explaining that some potential investors had requested marks for the Gemstone 7 assets:

> "Some investors are asking for current marks on the Gemstone 7 CDO portfolio. The attached file has the purchase price and the

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[1460] Id.

[1461] 2/21/2007 email from Abhayad Kamat at Deutsche Bank to Michael Lamont and others at Deutsche Bank, DBSI_PSI_EMAIL04056326-36.

[1462] 3/27/2007 email from Richard Leclezio at Deutsche Bank to Jordan Milman noting that HBK has requested marks from Deutsche Bank, DB_PSI_00423053-61.

[1463] Subcommittee interview of Jordan Milman (10/22/2010). Subcommittee interview of Kevin Jenks (10/13/2010).

current marks that we got from our desk. There are many bonds where the price difference between purchase price and current mark is more than 4% .... I have asked Jordan [Milman, a Deutsche Bank trader] to review the marks but it would be great if you could have someone at HBK review also to check if the current marks seem correct. It seems as if the entire portfolio price has dropped since purchase by 1.74% which does not show well to investors."[1464]

Before he heard back from HBK, Mr. Kamat sent a very similar request to Mr. Milman to review the marks to verify them. He wrote:

> "There are many [Gemstone 7] bonds where the price difference between purchase price and the current mark is more than 4% .... Before we send these over to CDO investors, pls could you review to check if the current marks are correct. It seems as if the entire portfolio price has dropped since purchase by 1.74% which does not show well to investors."[1465]

The next day, a Deutsche Bank trader verified the marks: "I checked the names that Abhayad [Kamat] highlighted [and] most are marked within the recent color[.] [T]here are 4 which should be tightened."[1466]

On January 23, 2007, Mr. Kamat learned that HBK's marks showed a loss of 0.9% or $9.4 million in the Gemstone 7 portfolio, while Deutsche Bank's marks showed a greater loss of 1.7% or $19 million.[1467] On January 24, 2007, Mr. Kamat directed Deutsche Bank's syndicate group to share HBK's marks with investors instead of Deutsche Bank's. He wrote: "[F]or investors who have asked for current marks on the Gemstone CDO 7 portfolio, tell them: HBK says that the overall current portfolio is down USD 9 million."[1468]

A couple weeks later, a question arose about using Deutsche Bank marks for Gemstone 7. On February 7, 2007, Ms. Bogza from the syndicate group wrote to Mr. Kamat: "Why can we not show a priced [marked] portfolio?? We need to show this [to investors]." Mr. Kamat

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[1464] 1/23/2007 email from Abhayad Kamat to HBK, GEM7-00003101. This document has HBK showing a loss of $9.4 million in the value of the Gemstone assets, whereas Deutsche Bank showed a loss of $19 million. In interviews with the Subcommittee, both Mr. Milman and Mr. Lippmann said that a 1.74% drop would not have concerned them because of the relative small dollars involved compared to the $1.1 billion deal.

[1465] 1/23/2007 email from Abhayad Kamat to Jordan Milman, DB_PSI_00465462.

[1466] 1/24/2007 email from Jashin Patel to Jordan Milman, DB_PSI_00843917.

[1467] 1/23/2007 email from Abhayad Kamat to HBK, GEM7-00003101.

[1468] 1/24/2007 email from Abhayad Kamat to Chehao Lu and others at Deutsche Bank, DB_PSI_00741750-52.

responded: "[T]he marks we got from Jordan are too low … and it will take quite some time if we try to take on an exercise where we try to get kevin and jordan to agree on the correct marks."[1469] Mr. Kamat wrote to another colleague later that day: "[U]se this for the current prices to be sent to investors, but please note to investors that this is from HBK."[1470] HBK also appeared to want to show higher marks to investors. When Mr. Kamat emailed Mr. Jenks seeking marks for the Gemstone 7 portfolio on February 7, Mr. Jenks sent an internal email to an HBK assistant trader. Mr. Jenks wrote: "Need line item marks for cdo portfolio[.] use dec or jan depending on which is better[.][1471]

When asked about these documents, Mr. Kamat stated that he advised using HBK's marks instead of Deutsche Bank's marks, because HBK's marks were better due to the collateral manager's familiarity with the assets.[1472] However, Deutsche Bank's trading desk was one of the biggest traders in RMBS and CDOs on Wall Street, making it unlikely that the desk could not adequately price the assets that it traded. Deutsche Bank also chose not to share both sets of marks with investors; it shared only the HBK marks showing higher asset values.

When HBK was asked about this matter, Mr. Jenks told the Subcommittee that he did not authorize Deutsche Bank to give out HBK's marks to investors and would be "surprised" if Deutsche Bank had given out HBK's marks.[1473] Mr. Jenks only recalled one time when an investor asked Deutsche Bank for Gemstone 7 marks. When the Subcommittee asked several of the investors who ultimately purchased Gemstone securities if they had asked for marks showing the current value of the underlying assets, M&T Bank told the Subcommittee that it did not know to ask for marks.[1474] Standard Chartered, Wachovia, and Commerzbank told the Subcommittee that they did not ask for the marks and it would have been unusual for them to do so. Eight days before the Gemstone CDO closed and its securities issued, HBK estimated that its portfolio marks were down approximately $30 million.[1475]

$400 Million of Unsold Securities. The mortgage market continued to worsen in March as Deutsche Bank continued to market the Gemstone securities. On March 8, 2007, one week before the Gemstone 7 deal closed, New Century – the subprime lender whose RMBS securities made up part of Gemstone – filed an 8-K with the SEC which

[1469] 2/7/2007 emails between Abhayad Kamat and Ilinca Bogza, DB_PSI_00434692-96.
[1470] 2/7/2007 email from Abhayad Kamat to Chehao Lu, DB_PSI_00711486.
[1471] 2/7/2007 email from Kevin Jenks to Jason Lowry, GEM7-00003084.
[1472] Subcommittee interview of Abhayad Kamat (10/8/2010).
[1473] Subcommittee interview of Kevin Jenks (10/13/2010).
[1474] Subcommittee interview of M&T (9/20/2010).
[1475] 3/7/2007 email from Kevin Jenks to Abhayad Kamat, GEM7-00001958.

said: "The Company has only been able to fund a portion of its loans this week. In addition, its capacity to fund new originations is substantially limited due to its lenders' restrictions or refusals to allow the Company to access their financing arrangements."[1476] New Century's financial troubles were prominently reported in the financial press on March 11, 2007.[1477] On March 15, 2007, the day Gemstone 7 closed, Bear Stearns said that "residential mortgage-related revenue decreased from the prior year period, reflecting weakness in the U.S. residential mortgage-backed securities market. … New Century Financial Corp., which had been a major provider of loans to people with risky credit, said it has lost support from its financial backers and is being delisted from the NYSE."[1478] New Century comprised 15% of Gemstone 7.

Ultimately $400 million of Gemstone 7 was unsold. Although not contractually obligated to do so, Deutsche Bank agreed to split the unsold $400 million of Gemstone 7 securities between itself and HBK.[1479] Meetings concerning taking back the $400 million were held

[1476] 3/8/2007 New Century Financial Corporation 8-K filing with the SEC. Even senior Deutsche Bank management was aware of the problems involving New Century and Fremont during this time period. On March 2, 2007, Mr. Lippmann sent an email to Mr. Misra, copying Mr. D'Albert, with a subject line: "Fremont Shut Down Sub-Prime business" that contained a number of negative news headlines concerning New Century including, "New Century says U.S. attorney conducting criminal probe … New Century says NYSE reviewing transactions in its securities … New Century says SEC requested meeting on restatement." The next day Mr. Misra replied to Mr. Lippmann, "Well, no regrets. Let's hold tight on our shorts now. It will be a bumpy market to market ride but we will prevail." 3/2/2007 and 3/3/2007 email chain between Mr. Lippmann and Mr. Misra, DBSI_PSI_EMAIL02392659-61.

[1477] See, e.g., "Crisis Looms In Market for Mortgages," The New York Times (3/11/2007), http://www.nytimes.com/ 2007/03/11/business/11mortgage.html. ("On March 1, a Wall Street analyst at Bear Stearns wrote an upbeat report on a company that specializes in making mortgages to cash-poor homebuyers. The company, New Century Financial, had already disclosed that a growing number of borrowers were defaulting, and its stock, at around $15, had lost half its value in three weeks. What happened next seems all too familiar to investors who bought technology stocks in 2000 at the breathless urging of Wall Street analysts. Last week, New Century said it would stop making loans and needed emergency financing to survive. The stock collapsed to $3.21.")

[1478] "Bear Stearns 1Q profit rises 8 percent on strong results in bonds, credit," Associated Press Financial Wire (3/15/2007). Also see "New Century Understated Debt; Faces SEC Probe, Stock Delisting," Associated Press (3/13/2007), http://www.cnbc.com/id/17590171/New_Century_Understated_Debt_Faces_SEC_Probe_Stock_Delisting; "New Century Subpoenaed, Faces Delisting," Washington Post (3/13/2007), http://www.washingtonpost.com/wp-dyn/content/article/2007/03/13/AR2007031300603.html.

[1479] On 3/14/2007, Fred Brettschneider, head of Deutsche Bank institutional sales, wrote: "We believe that we have reached an acceptable compromise with HBK. We will be restructuring the unsold mezz AAA and we will underwrite the senior portion leaving them [HBK] with the junior piece." 3/14/2007 email from Fred Brettschneider to Anshu Jain and others, DBSI_PSI_EMAIL02064810-12. On 3/27/2007, Larry Pike of Deutsche Bank wrote with regard to Gemstone 7, "400mm of the unsold bonds were a middle (mezz) AAA class that were expected to be purchased by an investor who backed out at a late stage due to a deteriorating market. HBK was upset about this and wanted DB to take these bonds down, threatening to curtail business globally with HBK if we didn't." 3/27/2007 email from Larry Pike to Sean Whelan and others, DB_PSI_00859611.

at the highest levels of both Deutsche Bank and HBK.[1480] As Mr. Lippmann put it: "[W]e don't have much choice … either we repo for them or we take it down."[1481]

Deutsche Bank and HBK were unable to sell 36% of the securities and instead kept those securities on their books. Mr. Jenks of HBK told the Subcommittee that he always wanted to know if unsold portions of a CDO he was interested in investing in would be bought back by the underwriter, but he did not know if everyone asked about this.[1482] M&T Bank told the Subcommittee that it would have been useful information, though it would have been more concerned if the tranches it was purchasing were not fully subscribed.[1483]

(e) Gemstone Losses

Gemstone 7 closed on March 15, 2007, and received credit ratings from S&P and Moody's on the same day.[1484] The top three tranches, representing 73% of the value of the CDO, received AAA ratings. The next three tranches received investment grade ratings of AA, A, and BBB.[1485] The CDO received these ratings even though one third of its underlying assets carried non-investment grade ratings.

Eight months later, in November 2007, five of its seven tranches were downgraded, including one of its AAA rated tranches. By July 2008, all seven tranches had been downgraded to junk status, and the Gemstone securities were nearly worthless. This chart, using S&P data, displays the downgrades.[1486]

[1480] Subcommittee interview of Michael Lamont (9/29/2010).
[1481] Apparently, Mr. Lippmann was explaining that either Deutsche Bank could "repo" or loan money to HBK in order for HBK to purchase the unsold Gemstone 7 securities or Deutsche Bank would have to "take it down" – either purchase the securities itself or liquidate the CDO. 2/20/2007 email from Greg Lippmann to Rich Rizzo at Deutsche Bank, DBSI_PSI_EMAIL02377303.
[1482] Subcommittee interview of Kevin Jenks (10/13/2010).
[1483] Subcommittee interview of M&T (9/20/2010). In addition, Standard Chartered reported that it didn't know that a portion of the CDO was unsold, and that it would have been information worth knowing but that it wouldn't have ultimately impacted its decision to invest in Gemstone 7. Subcommittee interview of counsel for Standard Chartered (10/14/2010).
[1484] 3/15/2007 letter from S&P to Gemstone CDO VII Ltd, GEM7-00001658-61; 3/15/2007 letter from Moody's to Gemstone CDO VII Ltd., GEM7-00001657.
[1485] Gemstone 7 ratings from S&P's RatingsDirect on the Global Credit Portal, https://www.globalcreditportal.com/ratingsdirect/Login.do, with subscription.
[1486] Chart prepared by the Subcommittee using data from S&P's RatingsDirect on the Global Credit Portal, https://www.globalcreditportal.com/ratingsdirect/Login.do, with subscription.

Gemstone VII Ratings by Tranche

Tranche	Initial Rating: Date	1st Downgrade: Date	2nd Downgrade: Date	3rd Downgrade: Date
Class A-1a	AAA March 15, 2007	A+ Feb. 5, 2008	BB+ July 11, 2008	CC August 19, 2009
Class A-1b	AAA March 15, 2007	B- Feb. 5, 2008	CC July 11, 2008	n/a
Class A-2	AAA March 15, 2007	AA- Nov. 21, 2007	CCC- Feb. 5, 2008	CC July 11, 2008
Class B	AA March 15, 2007	BBB Nov. 21, 2007	CC Feb. 5, 2008	n/a
Class C	A March 15, 2007	B- Nov. 21, 2007	CC Feb. 5, 2008	n/a
Class D	BBB March 15, 2007	CCC+ Nov. 21, 2007	CC Feb. 5, 2008	n/a
Class E	BB+ March 15, 2007	CCC Nov. 21, 2007	CC Feb. 5, 2008	n/a
Preference Shares	Not rated			

Source: S&P

Investors contacted by the Subcommittee reported that they had lost all or most of their investments. In June 2008, M&T Bank wrote down the value of its Gemstone 7 securities to about 2% of their original value – from $82 million to $1.87 million.[1487] Wachovia Bank told the Subcommittee that its $40 million investment in Gemstone paid out approximately $3 million from 2007-2010, but is currently worth nothing.[1488] Standard Chartered Bank told the Subcommittee that, in 2008, it liquidated its Gemstone investment and received approximately 25-30% of its initial $224 million investment.[1489] Commerzbank told the Subcommittee that its initial $16 million investment in Gemstone is currently worth nothing.[1490]

(6) Other Deutsche Bank CDOs

Gemstone 7 was only one of many CDOs that Deutsche Bank assembled and underwrote as the mortgage market deteriorated in 2007. From December 2006 through December 2007, Deutsche Bank issued 15 new CDOs with assets totaling $11.5 billion.[1491] The Subcommittee did not examine these CDOs, but a brief discussion of a few shows that

[1487] M&T Bank Corporation v. Gemstone CDO VII, (N.Y. Sup.), Complaint (June 16, 2008), DB_PSI_00000027-79, at ¶ 52. For a list of customers and their allocations of Gemstone 7, see Gemstone VII Summary, DB_PSI_00711305.
[1488] 11/19/2010, 11/23/2010 emails from counsel of Wachovia to Subcommittee staff.
[1489] Subcommittee interview of counsel of Standard Chartered (11/23/2010).
[1490] 12/7/2010 email from counsel of Commerzbank to Subcommittee staff.
[1491] ABS CDOs Issued by DBSI (between 2004 and 2008), PSI-Deutsche_Bank-02-0005-23.

the bank's issuance of high risk mortgage related assets was not confined to Gemstone 7.

Magnetar CDOs. Magnetar is a Chicago based hedge fund that, according to press reports, worked with several financial institutions to create CDOs with riskier assets and then bet on those CDOs to fail.[1492] Deutsche Bank underwrote one of those CDOs and served as trustee for two other Magnetar CDOs.

According to press reports, Magnetar's investment strategy was to purchase the riskiest portion of a CDO – the equity – and, at the same time, to purchase short positions on other tranches of the same CDO.[1493] Thus, Magnetar would receive a large return on the equity if the security did well, but would also receive a substantial payment from its short positions if the securities lost value. This strategy was dubbed by some as the "Magnetar Trade." It apparently generated large profits for Magnetar. By the end of 2007, when the market was in turmoil, Magnetar's Constellation Fund was up 76% and its Capital Fund was up 26%.[1494]

Mr. Lippmann disapproved of the Magnetar CDOs.[1495] In August 2006, when an investor asked Mr. Lippmann about Magnetar, he responded that it was a "Chicago based hedge fund that is buying tons of cdo equity and shorting the single names .... [T]hey are buying equity and shorting the single names ... a bit devious."[1496]

In May 2006, Magnetar created its first CDO, Orion 2006-1 Ltd., a $1.3 billion hybrid CDO with cash and synthetic assets.[1497] The CDO closed on May 26, 2006, and was underwritten by Calyon and managed

[1492] See, e.g., "The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going," ProPublica (4/9/2010), http://www.propublica.org/article/the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble-going.
[1493] Id.
[1494] "Magnetar's Exit: A Deal So Bad Even a Credit-Rating Agency Balked," ProPublica (4/9/2010), http://www.propublica.org/article/magnetars-exit-a-deal-so-bad-even-a-credit-rating-agency-balked.
[1495] Subcommittee interview of Greg Lippmann (10/18/2010).
[1496] 8/23/2006 email from Jeremy Coon at Passport Management to Greg Lippmann, DBSI_PSI_EMAIL01603121. In another email, when asked how Magnetar distorted the market, Mr. Lippmann responded, "easy but lengthy answer get him on the phone and call me." 8/31/2006 email from Warren Dowd at Deutsche Bank to Greg Lippmann, DBSI_PSI_EMAIL01641089.
[1497] See Loreley Financing v. Credit Agricole Corporate and Investment Bank, (N.Y. Sup.), (10/29/2010). Orion 2006-1 is one of two Magnetar CDOs that are the subjects of this lawsuit filed by Loreley Financing, a European-based investment fund, and Crédit Agricole, a French bank. See also "Magnetar Deals at Center of New Lawsuit," ProPublica (10/25/2010), http://www.propublica.org/article/magnetar-deals-at-center-of-new-lawsuit.

by NIBC Credit Management, Inc.[1498] Deutsche Bank's Special Situations Group purchased equity in Orion, and helped create the CDO.[1499] A Deutsche Bank employee, Michael Henriques, who worked on Orion as managing director of the Special Situations Group, left Deutsche Bank and ultimately went to work for Magnetar.[1500]

Although Orion received investment grade ratings from Fitch and Moody's in June 2006,[1501] a little over a year later, on August 21, 2007, Fitch issued the first of several rating downgrades.[1502] In November 2007, Moody's downgraded the Class A notes six notches and the Class B notes seven notches.[1503] By May 2008, every class of Orion's securities had been downgraded to junk status.[1504]

START CDOs. Deutsche Bank also underwrote six START CDOs with a combined value of $5.25 billion from June 2005 to December 2006.[1505] In one of the deals, Deutsche Bank worked with Elliot Advisors, a hedge fund that bought the equity tranche in the CDO and simultaneously bought CDS protection against the entire structure, essentially shorting the deal and betting that the value of its assets would fall.[1506] On four of the deals, Deutsche Bank worked with Paulson Advisors, a hedge fund that bought the equity tranche and apparently shorted the rest of the CDO, while Deutsche Bank sold the rest of the securities.[1507] An internal Deutsche Bank email explained one of the 2005 START CDOs as follows:

[1498] See Loreley Financing v. Credit Agricole Corporate and Investment Bank, (N.Y, Sup.), (10/29/2010) (alleging Calyon permitted Magnetar to select poor assets for the two Magnetar CDOs and fraudulently induced investors to purchase the securities).
[1499] "Magnetar Gets Started," ProPublica (4/9/2010), http://www.propublica.org/article/magnetar-gets-started; Loreley Financing v. Credit Agricole Corporate and Investment Bank, (N.Y. Sup.), (10/29/2010).
[1500] Loreley Financing v. Credit Agricole Corporate and Investment Bank, (N.Y. Sup.), (10/29/2010).
[1501] "Fitch Rates Orion 2006-1, Ltd./LLC.," BusinessWire (5/26/2006), http://www.thefreelibrary.com/Fitch+Rates+Orion+2006-1,+Ltd.%2FLLC.-a0146274727; 6/9/2006 "$292.5 Million of Debt Securities Rated, $936 Million of Senior Credit Swap Risk Rated," Moody's, http://v3.moodys.com/viewresearchdoc.aspx?docid=PR_109282.
[1502] Fitch downgraded the CDO's Class A notes from AAA to AA, the Class B notes from AA to A-, the Class C notes from A to BB, and the Class D notes from BBB to B+. "Fitch Downgrades $289MM of Orion 2006-1, Ltd.," BusinessWire (8/21/2007), http://www.highbeam.com/doc/1G1-167859601.html.
[1503] 11/1/2007 "Moody's takes neg action on Orion 2006-1," Moody's, http://v3.moodys.com/viewresearchdoc.aspx?docid=PR_143474.
[1504] 10/28/2010 "Moody's lowers ratings of 95 Notes issued by 56 structured finance CDO transactions," Moody's, http://v3.moodys.com/viewresearchdoc.aspx?docid=PR_208444.
[1505] They included Static Residential 2005-A for $1 billion; Static Residential 2005-B for $1 billion; Static Residential 2005-C for $500 million; Static Residential 2006-A for $1 billion; Static Residential 2006-B for $1 billion; and Static Residential 2006-C for $750 million. Chart, ABS CDOs Issued by DBSI (between 2004 and 2008), PSI-Deutsche_Bank-02-0005-23.
[1506] Subcommittee interview of Michael Lamont (9/29/2010).
[1507] Subcommittee interview of Greg Lippmann (10/18/2010).

"The $1 billion START 2005-B trade was backed by a static pool of CDS on mezzanine RMBS for Paulson Advisors ($4 bln risk arb hedge fund). Paulson retained the bottom 6% of the trade and we sold the rest of the capital structure. Paulson, who came to us with the strong desire to short the U.S. housing market, wrote CDS on underlying ABS (over 100 names) to DB [Deutsche Bank] and DB intermediated them into the deal."[1508]

Mr. Lamont told the Subcommittee that Mr. Paulson shorted the START deals, and he believed investors were aware of that fact. Mr. Lamont told the Subcommittee that Mr. Lippmann's ABS desk shorted the START CDOs only in its role as an intermediary for other clients, which was confirmed by Mr. Lippmann. In an email discussing START with a Deutsche Bank colleague, Mr. Lippmann advised him to buy protection for the bank against START. He wrote: "Start is crap you should short because I bet we'll have to ... buyback cash ones next year."[1509]

Mr. Lippmann told the Subcommittee that Deutsche Bank ended up losing a great deal of money on the START deals. One Deutsche Bank employee wrote to Mr. Lippmann regarding one of the deals in June 2007: "This along with our remaining held inventory if we can't sell away we repack into a CDO 2 balance sheet dump later this summer. Worst case we hold it but it is probably the lesser of two evils (the greater evil being our held START position)."[1510]

(7) Analysis

Deutsche Bank was the fourth largest issuer of CDOs in the United States. It continued to issue CDOs after mortgages began losing money at record rates, investor interest waned, and its most senior CDO trader concluded that the mortgage market in general and the specific RMBS securities being included in the bank's own CDOs were going to lose value. Mr. Lippmann derided specific RMBS securities and advised his clients to short them, at the same time his desk was allowing the very same securities to be included or referenced in Gemstone 7, a CDO that the bank was assembling for sale to its clients. In fact, the bank was selling some assets that Mr. Lippmann believed contained "crap."

[1508] 10/10/2005 email from Michael Raynes at Deutsche Bank to Greg Lippmann, DBSI_PSI_EMAIL00574452.

[1509] 12/14/2006 email from Greg Lippmann to Taranjit Sabharwal at Deutsche Bank, DBSI_PSI_EMAIL01895617.

[1510] 6/14/2007 email from Richard Kim at Deutsche Bank to Greg Lippmann, DBSI_PSI_EMAIL02202920.

While the Gemstone CDO was constructed and marketed by the bank's CDO Desk, which is separate from the trading desk controlled by Mr. Lippmann, both desks knew of Mr. Lippmann's negative views. The bank managed to sell $700 million in Gemstone 7 securities which then failed within months, leaving the bank's clients with worthless investments.

This case history raises several concerns. The first is that Deutsche Bank allowed the inclusion of Gemstone 7 assets which its most senior CDO trader was asked to review and saw as likely to lose value. Second, the bank sold poor quality assets from its own inventory to the CDO. Third, the bank aggressively marketed the CDO securities to clients despite the negative views of its most senior CDO trader, falling values, and the deteriorating market. Fourth, the bank failed to inform potential investors of Mr. Lippmann's negative views of the underlying assets and its inability to sell over a third of Gemstone's securities. Each of these issues focuses on the poor quality of the financial product that Deutsche Bank helped assemble and sell. Still another concern raised by this case history is the fact that the bank made large proprietary investments in the mortgage market that resulted in multi-billion-dollar losses – losses that, in this instance, did not require taxpayer relief but, due to their size, could have caused material damage to both U.S. investors and the U.S. economy.

C. Failing to Manage Conflicts of Interest: Case Study of Goldman Sachs

The Goldman Sachs case study shows how one investment bank profited from the collapse of the mortgage market and engaged in troubling and sometimes abusive practices that raise multiple conflict of interest concerns. The first part of this case study shows how Goldman used structured finance products, including CDO, CDS, and ABX instruments, to take a proprietary net short position against the subprime mortgage market. Reaching its peak at $13.9 billion, Goldman's net short investments realized record gains for the Structured Products Group in 2007 of over $3.7 billion which, when combined with other mortgage losses, resulted in overall net revenues for Goldman's Mortgage Department of $1.1 billion. The second half of the case study shows how Goldman engaged in securitization practices that magnified risk in the market by selling high risk, poor quality mortgage products to investors around the world. The Hudson, Anderson, Timberwolf, and Abacus CDOs show how Goldman used these financial instruments to transfer risk associated with its high risk assets, assist a favored client make a $1 billion gain, and profit at the direct expense of the clients that invested in the Goldman CDOs. In addition, the case study shows how conflicts of interest related to proprietary investments led Goldman to conceal its adverse financial interests from potential investors, sell investors poor quality investments, and place its financial interests before those of its clients.

(1) Subcommittee Investigation and Findings of Fact

During the course of its investigation into the Goldman Sachs case study, the Subcommittee issued 13 document subpoenas as well as multiple document request letters to financial institutions, government agencies, hedge funds, due diligence firms, insurance companies, individuals, and others. The Subcommittee obtained tens of millions of pages of documents, including internal reports, memoranda, correspondence, spreadsheets, and email. The Subcommittee conducted over 55 interviews and one deposition, including interviews with a variety of senior executives and Mortgage Department personnel at Goldman Sachs. The Subcommittee also spoke with agency officials, law enforcement, and industry and academic experts in financial products and securities law. On April 27, 2010, the Subcommittee held a hearing which took testimony from Goldman senior executives and current and former employees of its Mortgage Department, and released

173 hearing exhibits.[1511] After that hearing, the Subcommittee gathered additional information in post-hearing interviews and through post-hearing questions for the record.[1512]

In connection with the hearing, the Subcommittee released a joint memorandum from Chairman Levin and Ranking Member Coburn summarizing the investigation to date into the role of the investment banks in the financial crisis. The memorandum contained the following findings of fact, which this Report reaffirms, regarding the Goldman Sachs case study.

1. **Securitizing High Risk Mortgages.** From 2004 to 2007, in exchange for lucrative fees, Goldman Sachs helped lenders like Long Beach, Fremont, and New Century, securitize high risk, poor quality loans, obtain favorable credit ratings for the resulting residential mortgage backed securities (RMBS), and sell the RMBS securities to investors, pushing billions of dollars of risky mortgages into the financial system.

2. **Magnifying Risk.** Goldman Sachs magnified the impact of toxic mortgages on financial markets by re-securitizing RMBS securities in collateralized debt obligations (CDOs), referencing them in synthetic CDOs, selling the CDO securities to investors, and using credit default swaps and index trading to profit from the failure of the same RMBS and CDO securities it sold.

3. **Shorting the Mortgage Market.** As high risk mortgage delinquencies increased, and RMBS and CDO securities began to lose value, Goldman Sachs took a net short position on the mortgage market, remaining net short throughout 2007, and cashed in very large short positions, generating billions of dollars in gain.

[1511] "Wall Street and the Financial Crisis: The Role of Investment Banks," before the U.S. Senate Permanent Subcommittee on Investigations, S.Hrg. 111-674 (4/27/2010) (hereinafter "April 27, 2010 Subcommittee Hearing").

[1512] See, e.g., Responses to Questions for the Record from Goldman Sachs, including Lloyd C. Blankfein; David A. Viniar; Craig W. Broderick; Daniel L. Sparks; Michael J. Swenson; Joshua S. Birnbaum; and Fabrice P. Tourre, PSI_QFR_GS0001-548 [Redacted]. Unredacted version maintained in the files of the Subcommittee [Sealed Exhibit]. Hereinafter referred to as "Responses to Subcommittee QFR."

4. **Conflict Between Client Interests and Proprietary Trading.** In 2007, Goldman Sachs went beyond its role as market maker for clients seeking to buy or sell mortgage related securities, traded billions of dollars in mortgage related assets for the benefit of the firm without disclosing its proprietary positions to clients, and instructed its sales force to sell mortgage related assets, including high risk RMBS and CDO securities that Goldman Sachs wanted to get off its books, and utilizing key roles in CDO transactions to promote its own interests at the expense of investors, creating a conflict between the firm's proprietary interests and the interests of its clients.

5. **Abacus Transaction.** Goldman Sachs structured, underwrote, and sold a synthetic CDO called Abacus 2007-AC1, did not disclose to the Moody's analyst overseeing the rating of the CDO that a hedge fund client taking a short position in the CDO had helped to select the referenced assets, and also did not disclose that fact to other investors.

6. **Using Naked Credit Default Swaps.** Goldman Sachs used credit default swaps (CDS) on assets it did not own to bet against the mortgage market through single name and index CDS transactions, generating substantial revenues in the process.

(2) Goldman Sachs Background

Goldman Sachs was established in 1869 as an investment bank.[1513] Originally a private partnership, in 1999, it became a publicly traded corporation. In 2008, it converted to a bank holding company. Its headquarters are located in New York City, and the firm manages about \$870 billion in assets.[1514] Goldman employs about 14,000 employees in the United States and 32,500 worldwide. In 2007, it reported net revenues of \$11.6 billion, of which \$3.7 billion was generated by the Structured Products Group in the Mortgage Department, primarily as a result of its subprime investment activities.[1515]

[1513] The background information about Goldman in this section was taken from several sources. See "Profile, Goldman Sachs," Reuters.com; "Profile, The Goldman Sachs Group, Inc.," Hoovers.com; 4/19/2010, "A Brief History of Goldman Sachs – Timeline," Wall Street Journal; 1/2010, "The Bank Job," Vanity Fair (written with cooperation of Goldman Sachs).

[1514] During 2006 and 2007, Goldman's headquarters were at 85 Broad Street in Manhattan. In 2010, the firm moved its headquarters to 200 West Street in Manhattan. See "Morgan Stanley May Lease Old Goldman Sachs Building," Bloomberg (10/18/2010).

[1515] See Goldman Sachs Form 10-K for the fiscal year ending Nov. 30, 2007, filed with the SEC on 1/28/2008, at 64; 11/30/2007 "SPG Trading Mortgages Weekly Metrics 30-November-2007," Unlike other Wall Street banks, Goldman has no retail banking operations. It does not accept deposits from, nor lend to, retail customers, nor does its broker-dealer provide advice to or execute trades on behalf of retail customers. Goldman provides services only to so-called "sophisticated" institutional investors, generally large corporations, financial services firms, pension funds, hedge funds, and a few very wealthy individuals.[1516]

For most of its history, Goldman operated exclusively as an investment bank, providing investment advice to corporate clients, arranging and executing mergers and acquisitions, and arranging financing for customers through stock and bond offerings. After the 1999 repeal of the Glass-Steagall Act, which had restricted the activities that could be engaged in by investment banks, Goldman expanded its operations.[1517]

Over the last ten years, traditional investment banking activities have become a small percentage of Goldman's business. Goldman has instead become primarily a Wall Street trading house, providing broker-dealer services to institutional customers, acting as a prime broker to hedge funds,[1518] structuring and financing deals for customers from its own capital, and conducting proprietary trading activities for its own benefit. In the years leading up to the financial crisis, Goldman became an active investor and participant in the deals and transactions that it was handling for clients as well as selling to investors.[1519]

Goldman Sachs Mortgage Department. In 2006 and 2007, the time period reviewed by the Subcommittee, the most senior Goldman executives were the Chairman of the Board and Chief Executive Officer Lloyd Blankfein; Chief Operating Officer and Co-President Gary Cohn; Co-President Jon Winkelried; and Chief Financial Officer David Viniar. Goldman's Chief Risk Officer, Craig Broderick, was head of the Market Risk Management & Analysis area of the firm, which monitored and measured risk for the firm as a whole and for each business unit. Goldman's Treasurer, Sarah Smith, was in charge of the Controllers area of the firm, which was responsible for financial accounting, profit and

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GS MBS-E-015646485.

[1516] See supra note 1513.

[1517] Id.

[1518] "Prime brokers" are generally large broker-dealers that provide a special set of services to special clients, including securities lending, leveraged trade execution, and cash management. See definition of "prime brokerage" at Investopedia.com.

[1519] See supra note 1513.

loss statements, customer credit, collateral/margin matters, and position valuation verification.[1520]

In 2006 and 2007, Goldman Sachs' operating activities were divided into three segments: Investment Banking, Trading and Principal Investments, and Asset Management and Securities Services.[1521] The Trading and Principal Investments Segment was divided into three businesses: Fixed Income, Currency and Commodities (FICC); Equities; and Principal Investments.[1522] FICC had five principal businesses: commodities; credit products; currencies; interest rate products; and mortgage related securities and loan products and other asset backed instruments.[1523]

In its mortgage business, Goldman Sachs acted as a market maker, underwriter, placement agent, and proprietary trader in residential and commercial mortgage related securities, loan products, and other asset backed and derivative products.[1524] The Mortgage Department was responsible for buying and selling virtually all of the firm's mortgage related assets. It originated and invested in residential and commercial mortgage backed securities; developed, traded, and marketed structured products and derivatives backed by mortgages; and traded mortgage market products on exchanges.[1525]

In 2006 and 2007, the head of the Mortgage Department was Daniel Sparks. Goldman Co-Presidents Gary Cohn and Jon Winkelried, as well as CFO David Viniar, had been involved in Mr. Sparks' earlier career at Goldman, and he maintained frequent, direct contact with them regarding the Mortgage Department.[1526] In 2006, Mr. Sparks formally reported first to Jonathan Sobel, who had run the Mortgage Department prior to Mr. Sparks.[1527] He next reported to Richard Ruzika, who was then co-head of Commodities.[1528] In late 2006, Mr. Sparks began reporting directly to Thomas Montag, who was co-head of Global Securities for the Americas, which included both the FICC Division and the Equities Division.[1529] In mid-2007, Mr. Sparks began reporting to

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1520 Subcommittee interviews of David Viniar (4/13/2010), Craig Broderick (4/9/2010), and Daniel Sparks (4/15/2010).
1521 2/6/2007 Goldman Sachs Form 10-K filing with the SEC.
1522 Id.
1523 Id.
1524 Id.
1525 Id.
1526 Subcommittee interview of Daniel Sparks (4/15/10).
1527 Id.
1528 Id.
1529 Id.

Donald Mullen, who was head of U.S. Credit Sales & Trading, and Mr. Mullen in turn reported to Mr. Montag.[1530]

The Mortgage Department was divided into seven different desks: (1) the Residential Whole Loan Trading Desk; (2) the Structured Product Group (SPG) Trading Desk; (3) the CDO Origination Desk, which also handled collateralized loan obligations (CLOs); (4) the Structured Product Syndicate and Asset Backed Security (ABS) Finance Desk; (5) the Collateralized Mortgage Obligations (CMO) and Derivatives Desk; (6) the Advisory Group Desk; and (7) the Commercial Real Estate Loan Trading Desk.[1531]

The Residential Whole Loan Trading Desk was headed by Kevin Gasvoda.[1532] It bought packages of residential whole loans; issued RMBS securities in the subprime, Alt A and prime categories; originated residential and commercial mortgages; and gave lines of credit to certain selected mortgage lenders in exchange for direct access to pools of mortgages they originated, in so-called "conduit" arrangements.[1533]

The SPG Trading Desk was headed by Michael Swenson.[1534] It was further subdivided into three different desks: the ABS Desk, the Correlation Trading Desk, and the Commercial Mortgage Backed Securities (CMBS) Desk. The ABS Desk was also headed by Michael Swenson and traded mainly synthetic asset backed securities, particularly RMBS and CDO securities and single name CDS contracts related to RMBS and CDOs. The ABS Desk also had an important sub-desk called the ABX Trading Desk, which was headed by Joshua Birnbaum, and traded synthetic mortgage backed securities based on the ABX Index. The Correlation Trading Desk was headed by Jonathan Egol. It structured, marketed, and traded complex synthetic structured finance products, including a series of 23 CDOs known as Abacus.[1535] The CMBS Desk was headed by David Lehman and traded commercial mortgage backed securities. With the exception of the Correlation Desk, the SPG Trading Desk was primarily devoted to "secondary trading," meaning the buying and selling of pre-existing asset backed securities.

1530 Id.
1531 "North America Mortgages," chart prepared by Goldman Sachs, GS MBS-E-007818849 (showing organization of Mortgage Department).
1532 Id.
1533 See, e.g., 6/27/2006 email from Brian O'Brien to John Cassidy, "Conduit Sellers and u'writing guides," GS MBS-E-004060914.
1534 Subcommittee interview of Michael Swenson (4/16/2010).
1535 4/22/2010 Goldman Sachs Form 8-K filing with the SEC. Of the 23 Abacus CDOs, 16 contained primarily mortgage related assets.

The SPG Trading Desk was also sometimes referred to as the "Mortgage Secondary Trading Desk."

The CDO Origination Desk was headed by Peter Ostrem.[1536] This desk structured and originated most of Goldman's CDOs and CLOs, excluding Abacus. The CDO Desk was primarily an underwriting desk that arranged for the issuance of new securities which had not yet been sold in the marketplace. Because of its underwriting focus, the CDO Desk's activities required a higher level of disclosure to customers regarding newly issued securities than was ordinarily required of a secondary trading desk, which buys and sells only pre-existing securities.[1537] Goldman maintained an inventory of RMBS and CDO securities to carry out activities for its clients and proprietary trading for the firm.

The Structured Product (SP) Syndicate and ABS Finance Desk was headed by Bunty Bohra and Curtis Probst.[1538] This desk was often referred to simply as the "Syndicate." It coordinated Goldman's sales efforts and the issuance of different securities across different desks.

In the middle of 2007, the Mortgage Department was restructured. One key change was that the CDO Origination Desk was moved into the secondary trading area under the SPG Trading Desk. Mr. Lehman was designated as head of the CDO Origination Desk, with assistance from Mr. Swenson.[1539] As a result, the SPG Trading Desk had responsibility for selling new Goldman-originated CDO securities as well as engaging in secondary trading of pre-existing CDOs and RMBS securities, related credit default swaps (CDS), ABX trading, correlation trading, property derivatives, CMBS, and other asset backed securities.[1540]

[1536] "North America Mortgages," chart prepared by Goldman, GS MBS-E-007818849 (showing organization of Mortgage Department). In 2006, Mr. Ostrem co-headed the CDO Origination Desk with David Rosenblum, who was primarily involved in the CLO aspects of the desk's activities. Mr. Rosenblum was in the process of leaving the Mortgage Department for a position in the Credit business in late 2006, though he continued to have some responsibilities with respect to the CDO Origination Desk.

[1537] See discussion of the disclosure obligations of broker-dealers, underwriters, and placement agents, above. The Correlation Trading Desk, which also arranged for the issuance of new CDOs had the same obligations as the CDO desk when issuing a new CDO.

[1538] "North America Mortgages," chart prepared by Goldman, GS MBS-E-007818849 (showing organization of Mortgage Department).

[1539] "Mortgages Organizational Structure," chart prepared by Goldman Sachs, GS MBS-E-010872812.

[1540] Id.

In 2006 and 2007, the Residential Whole Loan Trading Desk underwrote 93 RMBS worth $72 billion.[1541] The CDO Origination Desk acted as a placement agent and underwrote approximately 27 mortgage based CDOs worth $28 billion.[1542] Of the 27 CDOs, 84% were hybrid CDOs, 15% were synthetic, and only about 1% were cash CDOs with physical assets.[1543] The mortgage-based CDOs included 8 CDOs on the Abacus platform, with $5 billion in issued securities;[1544] a $2 billion synthetic CDO known as Hudson Mezzanine 2006-1; a $300 million synthetic CDO known as Anderson Mezzanine 2007-1; and $1 billion hybrid CDO known as Timberwolf I.

(3) Overview of Goldman Sachs Case Study

This Report looks at two activities undertaken by Goldman in 2006 and 2007. The first is Goldman's intensive effort, beginning in December 2006 and continuing through 2007, to profit from the subprime mortgage market collapse, particularly by shorting subprime mortgage assets. The second is how, in 2006 and 2007, Goldman used mortgage related CDOs to unload the risk associated with its faltering high risk mortgage assets onto clients, help a favored client make a $1 billion gain, and profit from the failure of the very CDO securities it sold to its clients.

These activities raise questions related to Goldman's compliance with its obligations to provide suitable investment recommendations to its clients and disclose its material adverse interests to potential investors. They also raise questions about whether some of Goldman's incomplete disclosures were deceptive, and whether some of its activities generated conflicts of interest in which Goldman placed its financial interests before those of its clients. They also raise questions about the high risk nature of some structured finance products and their role in U.S. financial markets.

(a) Overview of How Goldman Shorted the Subprime Mortgage Market

Beginning in December 2006 and continuing through 2007, Goldman twice built and profited from large net short positions in mortgage related securities, generating billions of dollars in gross

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[1541] Undated chart prepared by Goldman for the Subcommittee, GS-PSI-00172.
[1542] Undated chart prepared by Goldman for the Subcommittee, GS MBS 0000021129 and GS MBS 0000004276.
[1543] Id.
[1544] Id.

revenues for the Mortgage Department. Its first net short peaked at about $10 billion in February 2007, and the Mortgage Department as a whole generated first quarter revenues of about $368 million, after deducting losses and writedowns on subprime loan and warehouse inventory.[1545] The second net short, referred to by Goldman Chief Financial Officer David Viniar as "the big short,"[1546] peaked in June at $13.9 billion. As a result of this net short, the SPG Trading Desk generated third quarter revenues of about $2.8 billion, which were offset by losses on other mortgage desks, but still left the Mortgage Department with more than $741 million in profits.[1547] Altogether in 2007, Goldman's net short positions from derivatives generated net revenues of $3.7 billion.[1548] These positions were so large and risky that the Mortgage Department repeatedly breached its risk limits, and Goldman's senior management responded by repeatedly giving the Mortgage Department new and higher temporary risk limits to accommodate its trading.[1549] At one point in 2007, Goldman's Value-at-Risk measure indicated that the Mortgage Department was contributing 54% of the firm's total market risk, even though it ordinarily contributed only about 2% of its total net revenues.[1550]

To build its net short positions, Goldman's Mortgage Department personnel used structured finance products to engage in multiple, complex transactions. Its efforts included selling high risk loans, RMBS, CDO, ABX, and other mortgage related assets from its inventory and warehouse accounts; shorting RMBS and CDO securities, either by shorting the assets themselves or by taking the short side of CDS contracts that referenced them, in order to profit from their fall in value; and shorting multiple other mortgage backed assets simultaneously, including different tranches of the ABX Index, tranches of CDOs, and CDS contracts on such assets. To lock in its profits after the short assets fell in value, Goldman often entered into offsetting CDS contracts to

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[1545] See net short chart prepared by the Subcommittee, below; 9/17/2007 Presentation to GS Board of Directors, Residential Mortgage Business at 5, GS MBS-E-001793845, Hearing Exhibit 4/27-41; 3/10/2007 email to Daniel Sparks, "Mortgage Presentation to the board," GS MBS-E-013323395, Hearing Exhibit 4/27-17.
[1546] 7/25/2007 email from Mr. Viniar to Mr. Cohn, "Private & Confidential: FICC Financial Package 07/25/07," GS MBS-E-009861799, Hearing Exhibit 4/27-26.
[1547] 10/2007 Global Mortgages, Business Unit Townhall at 4-5, GS MBS-E-013703463, Hearing Exhibit 4/27-47.
[1548] 4Q07 Fact Sheet prepared for David Viniar, GS MBS-E-009724276, Hearing Exhibit 4/27-159.
[1549] See discussion of risk limits, VAR measurements, and risk reports, below.
[1550] Id. "Value-at-Risk" or VAR is a key risk measurement system used by Goldman. At a 95% confidence level, VAR represents the dollar amount a business unit could expect to lose once every 20 trading days or about once per month. Subcommittee interview of Craig Broderick (4/9/2010). See also Philippe Jorion, "Value at Risk: The New Benchmark for Managing Financial Risk," at 20 (3d ed. 2007).

"cover its shorts," as explained below. Senior Goldman executives directed and monitored these activities.

The evidence reviewed by the Subcommittee shows that some of the transactions leading to Goldman's short positions were undertaken to advance Goldman's own proprietary financial interests and not as a function of its market making role to assist clients in buying or selling assets. In the end, Goldman profited from the failure of many of the RMBS and CDO securities it had underwritten and sold. As Goldman CEO Lloyd Blankfein explained in an internal email to his colleagues in November 2007: "Of course we didn't dodge the mortgage mess. We lost money, then made more than we lost because of shorts."[1551]

Covering Shorts to Lock In Profits. To understand how Goldman profited from its short positions, it is important to understand references in its internal documents to "covering" or "monetizing" its shorts. When Goldman built its short positions, it generally used CDS contracts to short a variety of mortgage related securities, including individual RMBS and CDO securities and baskets of 20 RMBS securities identified in the ABX indices. Goldman's shorts then gained or lost value over time, depending upon how the underlying referenced assets performed during the same period.

Most CDS contracts expire after a specified number of years. As explained earlier, during the covered period, the short party makes periodic premium payments to the opposing long party in the CDO. The short party is essentially betting that a "credit event" will take place during the covered period that will result in the long party having to provide it with a large payment that outweighs the cost of the short party's premium payments.[1552] However, the short party does not have to wait for a credit event in order to realize a gain on its CDS contract.

One possible alternative is for the short party simply to sell its short position to another party for a profit. If, however, the short party does not want to sell or has no ready buyer, the short party can still lock in a gain by entering into a second, offsetting CDS contract in which it

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[1551] 11/18/2007 email from Lloyd Blankfein, "RE: NYT," GS MBS-E-009696333, Hearing Exhibit 4/27-52.

[1552] Under standard CDS contracts designed by the International Swaps and Derivatives Association (ISDA), a credit event is defined as a (1) bankruptcy; (2) failure to pay; (3) restructuring; (4) repudiation of or moratorium on payment in the event of an authorized government intervention; or (5) an acceleration of an obligation. Another common credit event is incurring a credit rating loss.

takes the long position on an offsetting asset, an action often referred to as "covering the short."

In practice, there were several different, technical methods for a party to cover its short positions. The simplest example is if the short party bought a $100,000 CDS contract whose reference asset is a single RMBS security. Suppose after one month the RMBS security performs so poorly that the market value of the short position increases to $150,000. If the short party wanted to lock in the $50,000 gain, it could do so simply by entering into a new offsetting CDS contract, referencing the same RMBS security, in which it takes the long position with a new party who takes the short position at the new higher market value of $150,000. The result would be that the original short party would own a short position and a long position that offset each other, and would lock in the $50,000 difference in value as profit.

During 2007, Goldman executives repeatedly directed the Mortgage Department to "cover its shorts" and lock in the gains from the increased value of its short positions. When it covered its short positions by entering into offsetting contracts, the Mortgage Department simultaneously "monetized" its short positions – recorded the locked in profit. That is because, when it covered a short by entering into an offsetting contract, the Mortgage Department's general practice was to record a profit on its books equal to the gain on the original short position. Because the original purchase price of the CDS was known and fixed, and the new higher price obtained in the offsetting transaction was known and fixed, the Mortgage Department was able to capture the difference between the two prices as profit.

Going Past Home: The First Net Short. Because Goldman's activities were so varied and complex during the period reviewed, this overview provides a brief summary of the key events detailed in the following sections. The review begins in mid to late 2006, when Goldman realized that the market for subprime mortgage backed securities was beginning to decline, and the large long positions it held in ABX assets, loans, RMBS and CDO securities, and other mortgage related assets began to pose a disproportionate risk to both the Mortgage Department and the firm.[1553] In October 2006, the Mortgage Department

[1553] See, e.g., 10/17/2006-10/18/2006 email from Tom Montag to Daniel Sparks, "3 things," GS MBS-E-010917469 (acquisition of a large net long position described as "slipp[ing] up a bit"). In an email to Goldman Co-President Gary Cohn, Richard Ruzika criticized the accumulation of the large net long position: "You know and I know this position was allowed to get too big – for the liquidity in the market, our infrastructure, and the ability of our traders. That statement would be the same even if we had gotten the market direction correct – although the vultures designed a synthetic CDO called Hudson Mezzanine 2006-1, which included over $1.2 billion of long positions on CDS contracts to offset risk associated with ABX assets in Goldman's own inventory and another $800 million in single name CDS contracts referencing subprime RMBS securities that Goldman wanted to short; the Mortgage Department then sold the Hudson securities to its clients.[1554] While this CDO transferred $1.2 billion of subprime risk from Goldman's inventory to its clients and gave Goldman an opportunity to short another $800 million in RMBS securities it thought would perform poorly, the Mortgage Department still held billions of dollars of long positions in subprime mortgage related assets, primarily in ABX index assets.[1555]

On December 14, 2006, as Goldman's mortgage related assets continued to lose value, Goldman's Chief Financial Officer, David Viniar, held a meeting with key Mortgage Department personnel and issued instructions for the Department to "get closer to home."[1556] By "closer to home," Mr. Viniar meant for the Mortgage Department to assume a more neutral risk position, one that was neither substantially long nor short, but actions taken by the Mortgage Department in response to his instructions quickly shot past "home," resulting in Goldman's first large net short position in February 2007.[1557]

The actions taken by the Mortgage Department included selling outright from its inventory large numbers of subprime RMBS, CDO, and ABX assets, even at a loss, while simultaneously buying CDS contracts to hedge the long assets remaining in its inventory. The Mortgage Department also halted new RMBS securitizations, began emptying its RMBS warehouse accounts, and generally stopped purchasing new assets for its CDO warehouse accounts. It also purchased the short side of CDS contracts referencing the ABX index for a basket of AAA rated subprime residential loans, as a kind of "disaster insurance" in the event that even AAA rated mortgages started defaulting.

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wouldn't be circling. You also know that we probably would have gotten the position correct had I been involved a year ago – I probably would have gotten short to protect our warehouse and general hedge against the business given our outlook in the space." 2/5/2007 email from Richard Ruzika to Gary Cohn, "Are you living Morgatages? [sic]," GS MBS-E-016165784.

[1554] For more information about the Hudson CDO, see below.

[1555] See, e.g., 12/7/2006 email from Tom Montag, GS MBS-E-009756572 ("I don't think we should panic regarding ABX holdings").

[1556] 12/14/2006 email from Daniel Sparks, "Subprime risk meeting with Viniar/McMahon Summary," GS MBS-E-009726498, Hearing Exhibit 4/27-3.

[1557] Subcommittee interview of David Viniar (4/13/2010).

Within about a month of the "closer to home" meeting, in January 2007, the Mortgage Department had largely eliminated or offset Goldman's long positions on subprime mortgage related assets. The Mortgage Department then started to build a multi-billion-dollar short position to enable the firm to profit from the subprime RMBS and CDO securities starting to lose value. By the end of the first quarter of 2007, the Mortgage Department had swung from a $6 billion net long position in December 2006, to a $10 billion net short position in late February 2007, a $16 billion reversal.[1558] A senior Goldman executive later described a net short position of $3 billion in subprime mortgage backed securities as "huge and outsized."[1559] But Goldman's net short position in February 2007 was $10 billion – more than triple that size.

In late February, Goldman's Operating Committee, a subcommittee of its Firmwide Risk Committee, became concerned about the size of the $10 billion net short position. The Firmwide Risk Committee was co-chaired by Mr. Viniar, and Messrs. Cohn and Blankfein regularly attended its meetings.[1560] The concern arose, in part, because the $10 billion net short position had dramatically increased the Mortgage Department's Value-at-Risk or "VAR," the primary measure Goldman used to compute its risk. The Committee ordered the Department to lock in its profits by "covering its shorts," as explained above. The Mortgage Department complied by covering most, but not all, of the $10 billion net short and brought down its VAR. It then maintained a relatively lower risk profile from March through May 2007.

Attempted Short Squeeze. In May 2007, the Mortgage Department's Asset Backed Security (ABS) Trading Desk attempted a "short squeeze" of the CDS market that was intended to compel other market participants to sell their short positions at artificially low prices.[1561] Goldman's ABS Desk was still in the process of covering the Mortgage Department's shorts by offering CDS contracts in which Goldman took the long side. The ABS Desk devised a plan in which it would offer those CDS contracts to short parties at lower and lower prices, in an effort to drive down the overall market price of the shorts. As prices fell, Goldman's expectation was that other short parties would

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1558 3/10/2007 email to Daniel Sparks, "Mortgage Presentation to the board," GS MBS-E-013323395, Hearing Exhibit 4/27-17. 12/13/2006 Goldman email, "Subprime Mortgage Risk," Hearing Exhibit 4/27-2.

1559 8/23/2007 email from Tom Montag, "Current Outstanding Notional SN ames," GS MBS-E-010621231.

1560 11/13/2007 Goldman email, GS MBS-E-010023525 (attachment, 11/14/2007 "Tri-Lateral Combined Comments," GS MBS-E-010135693-715 at 695).

1561 9/7/2007 Fixed Income, Currency and Commodities Annual Individual Review Book, Self-Review of Deeb Salem, GS-PSI-03157-80 at 72 (hereinafter "Salem 2007 Self-Review").

begin to sell their short positions, in order to avoid having to sell at still lower prices. The ABS Desk planned to buy up those short positions at the artificially low prices it had caused, thereby rebuilding its own net short position at a lower cost.[1562] The ABS Desk initiated its plan, and during the same period Goldman customers protested the lower values assigned by Goldman to their short positions as out of line with the market. Despite the lower prices, the parties who already held short positions generally kept them and did not try to sell them. In June, after learning that two Bear Stearns hedge funds specializing in subprime mortgage assets might collapse, the ABS Desk abandoned its short squeeze effort and recommenced buying short positions at the prevailing market prices.

The Big Short. In mid-June 2007, the two Bear Stearns hedge funds did collapse, triggering another steep decline in the value of subprime mortgage assets. In response, Goldman immediately went short again, to profit from the falling prices. Within two weeks, Goldman had massed a large number of CDS contracts shorting a variety of subprime mortgage assets. On June 22, 2007, Goldman's net short position reached its peak of approximately $13.9 billion, as calculated by the Subcommittee.[1563] That total included the $9 billion in AAA ABX assets that Goldman had earlier acquired as "disaster protection," in case the subprime market as a whole lost value. The resulting net short, referred to by Mr. Viniar as the "big short," was nearly 40% larger than its first net short which had peaked at $10 billion in February 2007.

To lock in its profits on the $13.9 billion short, the Mortgage Department began working to cover its shorts, buying long assets and entering into offsetting CDS contracts in which it took the long position. On July 10, 2007, the credit rating agencies issued the first of many mass rating downgrades that affected hundreds and then thousands of RMBS and CDO securities, whose values began to fall even more rapidly.[1564] The Mortgage Department was able to purchase long assets at a low cost, managed to cover most of its short positions, and locked in its profits. At the same time, the Mortgage Department maintained a net short position in higher risk subprime RMBS securities carrying credit ratings of BBB

[1562] Id.
[1563] See chart entitled, "Goldman Sachs Mortgage Department Total Net Short Position, February-December 2007 in $ Billions," prepared by the Permanent Subcommittee on Investigations, Hearing Exhibit 4/27-162 (April 2010 version), updated January 2011 (updated version), derived from Goldman Sachs Mortgage Strategies, Mortgage Dept Top Sheets provided by Goldman Sachs (hereinafter "PSI Net Short Chart"), See Section C(4)(g).
[1564] For more information about the mass rating downgrades, see Chapter V, above. See also 7/10/2007 Goldman email, "GS Cashflow/Abacus CDOs Mentioned in S&P Report on CDO Exposure to Subprime RMBS," GS MBS-E-001837256.

or BBB-, betting that those securities would lose still more value and produce still more profits for the firm. In August, however, Goldman senior management again became concerned about the size of the Department's net short position and its VAR levels, which had reached record levels. On August 21, 2007, Goldman's Chief Operating Officer Gary Cohn ordered the Mortgage Department to "get down now."

Big Short Profits. In response, the Mortgage Department began another round of covering its shorts and locking in its profits, including the shorts referencing BBB and BBB- rated RMBS securities. In the third quarter of 2007, the SPG Trading Desk reported record revenues from its short positions totaling $2.8 billion.[1565] By the end of 2007, the SPG Trading Desk in the Mortgage Department recorded year-end net revenues totaling $3.7 billion, which were used to offset losses on other desks, leaving the Mortgage Department as a whole with record net revenues of over $1.1 billion for the year.[1566] The head of the SPG Desk, Michael Swenson, later wrote that 2007 was "the [year] I am most proud of to date," because of the "extraordinary profits" from the short positions he had advocated.[1567] His colleague, Joshua Birnbaum who headed the ABX Desk within SPG, also reviewed the year in terms of the profitable short positions it built. He wrote: "The prevailing opinion within the department was that we should just 'get close to home' and pare down our long," but he decided his ABS Desk should "not only ... get flat, but get VERY short."[1568] He wrote: "[W]e implemented the plan by hitting on almost every single name CDO protection buying opportunity in a 2-month period. Much of the plan began working by February as the market dropped 25 points and our very profitable year was under way." When the subprime mortgage market fell further in July after the credit rating mass downgrades, he wrote: "We had a blow-out [profit and loss] month, making over $1Bln that month."[1569]

The $3.7 billion in net revenues from the SPG's short positions helped to offset other mortgage related losses, and, at year's end, at a time when mortgage departments at other large financial institutions were

[1565] 10/2007 Global Mortgages, Business Unit Townhall at 4-5, GS MBS-E-013703463, Hearing Exhibit 4/27-47.
[1566] Quarterly Breakdown of Mortgage P/L, GS MBS-E-009713204 at 205. Goldman's gross revenues from all derivative products, without deduction of related losses, were apparently $5.9 billion. 4Q07 Fact Sheet prepared for David Viniar (FY07 P&L [profit and loss]: . . . derivatives +5.9B), GS MBS-E-009724276, Hearing Exhibit 4/27-159.
[1567] Swenson self evaluation, Hearing Exhibit 4/27-55b.
[1568] Birnbaum self evaluation, Hearing Exhibit 4/27-55c.
[1569] Id.

reporting record losses, Goldman's Mortgage Department reported overall net revenues of $1.1 billion.[1570]

(b) Overview of Goldman's CDO Activities

This Report also examines four CDOs that Goldman originated, underwrote, and marketed in the years leading up to the financial crisis: Hudson Mezzanine 2006-1, Anderson Mezzanine 2007-1, Timberwolf I, and Abacus 2007-AC1. Hudson was conceived in 2006, and issued its securities in December 2006, as Goldman began its concerted effort to sell its mortgage holdings. Anderson, Timberwolf, and Abacus issued their securities in 2007, as RMBS and CDO securities were losing value, and Goldman was shorting the subprime mortgage market.

During 2007, as Goldman built and profited from its net short positions in the first and third quarters of the year, it continued to design, underwrite, and sell CDO securities. Due to waning investor interest, in February 2007, Goldman conducted a review of the CDOs in its pipeline. The Mortgage Department decided to cancel four pending CDOs, downsize another two, and bring all of its remaining CDOs to market as quickly as possible. Also in February 2007, the Mortgage Department limited its CDO Origination Desk to carrying out only the CDO transactions already underway.

"Gameplan" for CDO Valuation Project. In the first quarter of 2007, Goldman's Mortgage Department worked to sell the warehouse assets from the discontinued CDOs, the securities issued by past Goldman-originated CDOs, and the new securities from CDOs being originated by Goldman in 2006 and 2007. In May 2007, as CDO sales slowed dramatically, Goldman became concerned about the lack of sales prices to establish the value of its CDO holdings. Goldman needed accurate values, not just to establish its CDO sales prices, but also to value the CDO securities for collateral purposes and in compliance with Goldman's policy of using up-to-date market values for all of its holdings.[1571] On May 11, 2007, Goldman senior executives, including Mr. Cohn and Mr. Viniar, Mortgage Department personnel, controllers, and others held a meeting and developed a "Gameplan" for a CDO valuation project.[1572] The Gameplan called for the Mortgage Department, over the course of about a week, to use three different valuation methods to price all of its CDO warehouse assets, unsold securities from past

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[1570] Quarterly Breakdown of Mortgage P/L, GS MBS-E-009713204 at 205.
[1571] 5/11/2007 email from Daniel Sparks, "You okay?," GS MBS-E-019659221.
[1572] Id.; 5/14/2007 email from David Lehman, "Gameplan – asset model analysis," GS MBS-E-001865782 (last email in a longer email chain).

CDOs, and new securities from the CDOs currently being marketed to clients.[1573]

While the CDO valuation project was underway, Goldman senior executive Thomas Montag asked Daniel Sparks for an estimate of how much the firm would need to write down the value of its CDO assets. Mr. Sparks responded that "the base case from traders is down [$]382 [million]." He also wrote: "I think we should take the write-down, but market [the CDO securities] at much higher levels."[1574] Another Goldman senior executive, Harvey Schwartz, expressed concern about selling clients CDO securities at one price and then immediately devaluing them: "[D]on't think we can trade this with our clients andf [sic] then mark them down dramatically the next day."[1575] At the same time, Goldman's Chief Credit Risk Officer Craig Broderick told his staff to anticipate deep markdowns and highlighted the need to identify clients that might suffer financial difficulty if Goldman devalued their CDO securities and demanded they post more cash collateral.

On May 20, 2007, the Gameplan results were summarized in an internal presentation.[1576] It projected that Goldman would have to take from $248 to $440 million in writedowns on unsold CDO securities and warehouse assets, making it clear to Goldman executives that its CDO assets were losing value rapidly.[1577] In several drafts of the presentation, the Mortgage Department had also written that Goldman's CDOs were expected "to underperform," but that statement was removed from the final presentation given to senior executives.[1578]

Targeted Sales. The Gameplan also recommended a two-pronged approach to selling the firm's remaining CDO assets. First, it recommended transfer of the CDO warehouse assets to the Mortgage Department's SPG Trading Desk for further valuation and sale. Second, it recommended that the Mortgage Department use a "targeted" approach to

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[1573] Id.; 5/14/2007 email from Elisha Weisel, "Modelling Approaches for Cash ABS CDO/CDO^2," GS MBS-E-001863618.
[1574] 5/14/2007 email from Tom Montag to Daniel Sparks, GS MBS-E-019642797.
[1575] 5/11/2007 email from Harvey Schwartz to Daniel Sparks, Tom Montag, and others, GS MBS-E-010780864.
[1576] 5/20/2007 email, "Viniar Presentation - Updated," GS MBS-E-010965211 (attached file, "Mortgages Department, May 2007," Goldman presentation, GS MBS-E-010965212); see also 5/19/2007 "Mortgages CDO Origination – Retained Positions & Warehouse Collateral, May 2007," Goldman presentation, GS MBS-E-010951926.
[1577] 5/19/2007 "Mortgages CDO Origination – Retained Positions & Warehouse Collateral, May 2007," Goldman presentation, GS MBS-E-010951926.
[1578] Compare 5/19/2007 "Mortgages CDO Origination – Retained Positions & Warehouse Collateral, May 2007," Goldman presentation, GS MBS-E-010951926, with 5/20/2007 "Mortgages Department, May 2007," Goldman presentation, GS MBS-E-010965212.

sell off the existing and new securities from Goldman-originated CDOs, naming four hedge funds as the primary targets and providing a list of another 35 clients as secondary targets.[1579]

At the same time, Mr. Sparks named David Lehman, a commercial mortgage backed securities trader, as the new head of the CDO Origination Desk. Shortly thereafter, Goldman dismantled the CDO Origination Desk and moved all remaining CDO securities to the SPG Trading Desk, where he was based. The SPG Trading Desk, which was a secondary trading desk and had little experience with underwriting, assumed responsibility for marketing the remaining unsold Goldman-originated CDO securities. The SPG Trading Desk's lack of underwriting experience meant that it was less familiar with the obligations of underwriters and placement agents to disclose all material adverse interests to potential investors.

The SPG Trading Desk worked with Goldman's sales force to market the CDO securities. Goldman employed "hard sell" tactics, repeatedly urging its sales force to sell the CDO securities and target clients with limited CDO familiarity.[1580] After trying the Gameplan's "targeted" client approach during May, June, and July 2007, the Mortgage Department switched back to issuing sales directives or "axes" to its entire sales force, including sales offices abroad. Axes on CDOs generally went out at weekly or monthly intervals, identified specific CDO securities as top sales priorities, and offered additional financial incentives for selling them. Despite the CDOs' declining value, the sales force succeeded in selling some of the CDO securities, primarily to clients in Europe, Asia, Australia, and the Middle East, but was unable to sell all of them.

The four CDOs that the Subcommittee examined illustrate a variety of conflict of interest issues related to how Goldman designed, marketed, and administered them.

Hudson Mezzanine 2006-1. Hudson Mezzanine 2006-1 (Hudson 1) was a $2 billion synthetic CDO comprised of $1.2 billion in ABX assets from Goldman's own inventory, and $800 million in single name CDS contracts on subprime RMBS and CDO securities that Goldman wanted to short. It was called a "mezzanine" CDO, because the

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[1579] 5/19/2007 "Mortgages CDO Origination – Retained Positions & Warehouse Collateral, May 2007," Goldman presentation, GS MBS-E-010951926; 5/20/2007 email from Lee Alexander to Daniel Sparks, Donald Mullen, Lester Brafman, Michael Kaprelian, "Viniar Presentation - Updated," GS MBS-E-010965211 (attached file "Mortgages V4.ppt," "Mortgages Department, May 2007," GS MBS-E-010965212).

[1580] See discussions of Hudson, Anderson, Timberwolf, and Abacus sales efforts, below.

referenced RMBS securities carried the riskier credit ratings of BBB or BBB-. Goldman used the CDO to transfer the risk associated with its ABX assets to investors that bought Hudson 1 securities. Goldman also took 100% of the short side of the CDO, which meant that it would profit if any of the Hudson securities lost value. In addition, Goldman exercised complete control over the CDO by playing virtually every key role in its establishment and administration, including the roles of underwriter, initial purchaser of the issued securities, senior swap counterparty, credit protection buyer, collateral put provider, and liquidation agent.

Goldman began marketing Hudson 1 securities in October 2006, soliciting clients to buy Hudson securities. It did not fully disclose to potential investors material facts related to Goldman's investment interests, the source of the CDO's assets, and their pricing. The Hudson 1 marketing materials stated prominently, for example, that Goldman's interests were "aligned" with investors, because Goldman was buying a portion of the Hudson 1 equity tranche.[1581] In its marketing materials, Goldman did not mention that it was also shorting all $2 billion of Hudson's assets – an investment that far outweighed its $6 million equity share and which was directly adverse to the interests of prospective investors. In addition, the marketing materials stated that Hudson 1's assets were "sourced from the Street" and that it was "not a balance sheet CDO."[1582] However, $1.2 billion of the Hudson assets had been selected solely to transfer risk from ABX assets in Goldman's own inventory.

Goldman also did not disclose in the materials that it had priced the assets without using any actual third party sales. The absence of arm's length pricing was significant, because the Hudson CDO was designed to short the ABX Index using single name RMBS securities, and there was a pricing mismatch between the two types of assets.[1583] Goldman not only determined the pricing for the RMBS securities purchased by Hudson 1, but retained the profit from the pricing differential. The marketing materials did not inform investors of Goldman's role in the pricing, the pricing methodology used, or the gain it afforded to Goldman. In addition, the marketing materials stated Hudson 1 was "not a balance sheet" CDO, without disclosing that Hudson had been designed from its inception to remove substantial risk from Goldman's balance sheet.

[1581] 10/2006 Goldman Sachs report, "Hudson Mezzanine Funding, 2006-1, LTD.," at 4, GS MBS-E-009546963, Hearing Exhibit 4/27-87.
[1582] Id.
[1583] For more information on this pricing mismatch, see the Hudson discussion, below.

The Hudson 1 Offering Circular contained language that may have also misled investors about Goldman's true investment interest in the CDO. The Offering Circular stated:

> "[Goldman Sachs International] and/or any of its affiliates may invest and/or deal, for their own respective accounts for which they have investment discretion, in securities or in other interests in the Reference Entities, in obligations of the Reference Entities or in the obligors in respect of any Reference Obligations or Collateral Securities ... , or in credit default swaps ... , total return swaps or other instruments enabling credit and/or other risks to be traded that are linked to one or more Investments."[1584]

This provision seems to inform investors that Goldman "may invest" for its own account in the CDO's securities, reference obligations, or CDS contracts, while withholding the fact that, by the time the Offering Circular had been drafted, Goldman had already determined to take 100% of the short position in the CDO, an investment which was directly adverse to the interests of Hudson securities investors.

Once Hudson issued its securities, Goldman placed a priority on selling them, and delayed the issuance of a CDO on behalf of another client in order to facilitate Hudson sales. Goldman sales representatives reported that clients expressed skepticism regarding the quality of the Hudson assets, but Goldman continued to promote the sale of the CDO.

In 2008, as Hudson's assets lost value and received rating downgrades from the credit rating agencies, Goldman, in its role as liquidation agent, was tasked with selling those assets to limit losses to the long investors. The major Hudson investor, Morgan Stanley, pressed Goldman to do just that. Goldman, however, delayed selling the assets for months. As the assets dropped in value, Goldman's short position increased in value. Morgan Stanley's representative reported to a colleague that when Goldman rejected the firm's request to sell the poorly performing Hudson assets, "I broke my phone." [1585] He also sent an email to the head of Goldman's CDO Desk saying: "[O]ne day I hope I get the real reason why you are doing this to me."[1586] Morgan Stanley lost nearly $960 million on its Hudson investment.

[1584] 12/3/2006 Hudson Mezzanine 2006-1, LTD. Offering Circular, GS MBS- E-021821196 at 251 (emphasis added).

[1585] 2/6/2008 email from John Pearce to Michael Petrick, HUD-CDO-00005146.

[1586] 2/7/2008 email from John Pearce to David Lehman, HUD-CDO-00005147.

Anderson Mezzanine 2007-1. Anderson Mezzanine 2007-1 (Anderson) was another synthetic CDO referencing BBB and BBB- rated subprime RMBS securities. It was issued in March 2007. Among other roles, Goldman served as the CDO's placement agent, initial purchaser, collateral put provider, and liquidation agent. Goldman hired another firm, a New York hedge fund founded by former Goldman employees, GSC Partners, to act as the collateral manager. Goldman took a short position on approximately 40% of the $305 million in assets underlying Anderson.

Anderson referenced a number of poor quality assets. Those assets had been selected by GSC Partners, with the approval of Goldman. Over 45% of the referenced subprime RMBS securities contained mortgages originated by New Century, a subprime lender known within the industry, including Goldman, for issuing poor quality loans and which was experiencing financial problems while Anderson was being structured and marketed.[1587] Inside Goldman, staff were aware of New Century's problems and were taking action to return substantial numbers of substandard loans purchased from New Century and demand repayment for them.[1588] Other assets in the Anderson CDO were also performing poorly, and at one point, Goldman personnel estimated its warehouse assets had fallen in value by $22 million.[1589] Due to the asset quality problems, the Mortgage Department head, Daniel Sparks, initially decided to cancel Anderson, but later changed his mind and decided to market the CDO as quickly as possible, using the $305 million in assets already in its warehouse account, rather than wait to accumulate all of the $500 million in assets initially planned.

When Anderson issued its securities in March 2007, Goldman placed a high priority on selling them, even delaying another CDO – Abacus 2007-AC1 which was being organized at the request of the Paulson hedge fund – to allow its sales force to concentrate on promoting Anderson. Potential investors raised questions about the quality of its underlying assets, especially the New Century loans, and Goldman

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1587 In April 2007, the month after Anderson issued its securities, New Century announced it would have to restate its earnings. It declared bankruptcy soon after. For more information about New Century, see Chapter IV, section E(2)(c).

1588 See, e.g., 3/2007 Goldman internal email, GS MBS-E-002146861, Hearing Exhibit 4/27-77 ("I recommend putting back 26% of the pool....if possible."). See also 2/2/2007 email from Matthew Nichols to Kevin Gasvoda, GS MBS-E-005556331 ("NC is running a 10% drop rate [due diligence drop] at ~6 points / drop and 4% EPD rate at close to 20 points."). 2/8/2007 email from John Cassidy to Joseph Ozment, others, GS MBS-E-002045021 ("Given the current state of the company I am no longer comfortable with the practice of taking loans with trailing docs . . . that we need in order to conduct compliance testing. . .").

1589 3/16/2007 GSI Risk Committee Memo, "GSI Warehousing for Structured Product CDOs," GS MBS-E-001806010.

provided its sales representatives with talking points to dispel concerns about the New Century assets. When one client asked how Goldman had gotten "comfortable" with the New Century loans, Goldman did not disclose to the client its own negative views of New Century loans or that it had 40% of the short side of the CDO.

Goldman marketed Anderson securities to a number of its clients, including pension funds, and recommended using Anderson securities as collateral security in other CDOs.[1590] In the end, Goldman sold only $102 million or about one third of the Anderson securities.[1591] Seven months after the securities were issued, they suffered their first credit rating downgrade. Currently, all of the Anderson securities have been reduced to junk status, and the Anderson investors have lost virtually their entire investments.

Timberwolf I CDO. Timberwolf I was a $1 billion hybrid CDO^2 transaction that referenced single-A rated securities from other CDOs. Those CDO securities referenced, in turn, RMBS securities carrying lower credit ratings, primarily BBB. Altogether, Timberwolf referenced 56 unique CDO securities that had over 4,500 unique underlying assets. Goldman served as the CDO's placement agent, initial purchaser, collateral put provider, and liquidation agent. It also hired a hedge fund with former Goldman employees, Greywolf Capital Management, to act as the collateral manager. Greywolf selected the CDO's assets, with Goldman's approval. Goldman took a short position on approximately 36% of the $1 billion in assets underlying Timberwolf.[1592]

Timberwolf's securities began losing value almost as soon as they were purchased. In February 2007, Goldman's Mortgage Department head told a senior executive that Timberwolf was one of two deals "to worry about." He also wrote that the assets in the Timberwolf warehouse account had declined so much in value that they had already exhausted Greywolf's responsibility to pay a portion of any warehouse losses, and any additional losses would be Goldman's exclusive obligation.[1593] Goldman rushed Timberwolf to market, and it closed on March 27, 2007, approximately six weeks ahead of schedule.[1594] Almost as soon as the Timberwolf securities were issued, they too began to lose value.

[1590] 3/12/2007 email from Robert Black to Matthew Bieber and others, GS MBS-E-000898037.
[1591] See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.
[1592] Among other assets, Goldman sold $15 million in certain Abacus securities to the Timberwolf CDO. Goldman held 100% of the short side of the relevant Abacus CDO. Its sale of the Abacus securities meant that Goldman held the short side of those assets, while Timberwolf investors took the long side.
[1593] 2/26/2007 email between Tom Montag and Daniel Sparks, GS MBS-E-019164806.
[1594] 3/2007 Goldman internal email chain, GS MBS-E-001800634.

Despite doubts about its performance and asset quality, Goldman engaged in an aggressive campaign to sell the Timberwolf securities. As part of its tactics, Mr. Lehman instructed Goldman personnel not to provide written information to investors about how Goldman was valuing or pricing the Timberwolf securities, and its sales force offered no additional assistance to potential investors trying to evaluate the 4,500 underlying assets. Mr. Sparks and Mr. Lehman sent out numerous sales directives or "axes" to the Goldman sales force, stressing that Timberwolf was a priority for the firm.[1595] In April, Mr. Sparks suggested issuing "ginormous" sales credits to any salesperson who sold Timberwolf securities, only to find out that large sales credits had already been offered.[1596] In May, while Goldman was internally lowering the value of Timberwolf, it continued to sell the securities at a much higher price than the company knew it was worth. At one point, a member of the SPG Trading Desk issued an email to clients and investors, advising them that the market was rebounding and the downturn was "already a distant memory."[1597] Goldman also began targeting Timberwolf sales to "non-traditional" buyers and those with little CDO familiarity, such as increasing its marketing efforts in Europe and Asia.

On June 18, 2007, Goldman sold $100 million worth of Timberwolf securities to an Australian hedge fund, Basis Capital. Just 16 days later, on July 4, Goldman informed Basis Capital that the securities had lost value, and it had to post additional cash collateral to secure its CDS contract. On July 12, Goldman told Basis Capital that the value had dropped again, and still more collateral needed to be posted. In less than a month, the value of Timberwolf had fallen by $37.5 million. Basis Capital posted the additional capital, but soon after declared bankruptcy.

On June 1, 2007, Goldman Sachs sold $36 million in Timberwolf securities to a Korean life insurance company, Hungkuk Life, that had little familiarity with the product. The head of the Korean sales office said his office was willing to sell the company additional securities, if assured the office would receive a 7% sales credit. Goldman agreed, and said "get 'er done." The sales office sold another $56 million in Timberwolf securities to the life insurance company which paid $76 per share when Goldman's internal value for the security was $65.

[1595] See, e.g., 6/2007-8/2007 Goldman internal emails, "Timberwolf Sales Efforts," Hearing Exhibit 4/27-166; 3/2007 Goldman internal email, "GS Syndicate Structured Product CDO Axes," Hearing Exhibit 4/27-100.

[1596] 4/19/2007 email chain between Daniel Sparks and Bunty Bohra, GS MBS-E-010539324, Hearing Exhibit 4/27-102 (Mr. Bohra responds, "[w]e have done that with Timberwolf already.").

[1597] 5/14/2007 email from Edwin Chin, GS MBS-E-012553986.

Within ten days of that sale, Thomas Montag, a senior Goldman executive, sent an email to the Mortgage Department head, Daniel Sparks, stating: "boy that timeberwof [Timberwolf] was one shitty deal."[1598] Despite that comment, Goldman continued to market Timberwolf securities to its clients.

Goldman had also arranged for its subsidiary, Goldman Sachs International (GSI), to act as both the primary CDS counterparty and the collateral put provider in Timberwolf.[1599] Although GSI received a fee for serving as the collateral put provider, GSI began to refuse to approve Timberwolf's purchase of new collateral securities whose values might decline below par value and put Goldman at risk of having to make up the difference. Instead, GSI pressured Timberwolf to keep its collateral in cash, even though an internal Goldman analysis had confirmed that cash collateral produced lower returns for Timberwolf investors than collateral securities. When Greywolf objected to this practice, Goldman backed down and allowed the purchase of a narrow range of very safe, short term asset backed securities as collateral.

In the fall of 2007, a Goldman analyst provided executives with a price history for Timberwolf A2 securities. It showed that, in five months, Timberwolf securities had lost 80% of their value, falling from $94 in March to $15 in September. Upon receiving the pricing history, the Timberwolf deal captain, Matthew Bieber, wrote that March 27 – the day Timberwolf issued its securities – was "a day that will live in infamy."[1600] Timberwolf was liquidated in 2008.

Abacus 2007-AC1. Abacus 2007-AC1 was a $2 billion synthetic CDO that referenced BBB rated mid and subprime RMBS securities issued in 2006 and early 2007. It was a static CDO, meaning once selected, its reference obligations did not change. It was the last in a series of 16 Abacus CDOs that referenced primarily mortgage backed assets and were designed by Goldman. Those Abacus CDOs were known as single tranche CDOs, structures pioneered by Goldman to provide customized CDOs for clients interested in assuming a specific type and

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[1598] 6/2007 Goldman internal email to Daniel Sparks, Hearing Exhibit 4/27-105.

[1599] In synthetic CDOs, the cash proceeds from the sales of the CDO securities were used to purchase "collateral debt securities." Later, when cash was needed to make payments to a long or short party, those collateral securities were sold, and the cash was used to make the payments. In the event the collateral securities used to pay the short party (called "default swap collateral") could not be sold for face (par) value, Goldman, the short party, absorbed the loss, effectively serving as the default swap collateral put provider. For more information, see discussion of Goldman's actions taken while the collateral put provider of Timberwolf, below.

[1600] 9/17/2007 email from Matthew Bieber to Christopher Creed, GS MBS-E-000766370, Hearing Exhibit 4/27-106.

amount of investment risk. They enabled the client to select the assets, the size of the investment, the amount of subordination or cushion before the securities would be exposed to loss, and could be issued with a single tranche.[1601] The Abacus CDOs also enabled investors to short a selected group of RMBS or CDO securities at the same time. Goldman used the Abacus CDOs not only to sell short positions to investors, but also as a way for Goldman itself to short mortgage assets in bulk.[1602]

Abacus 2007-AC1 was the first and only Abacus transaction in which Goldman allowed a third party client to essentially "rent" its CDO structure and play a direct, principal role in the selection of the assets. Goldman did not itself intend to invest in the CDO.[1603] Instead, it functioned primarily as an agent, earning fees for its roles in structuring, underwriting, and administering the CDO. Those roles included Goldman's acting as the placement agent, collateral securities selection agent, and collateral put provider. Unlike previous Abacus CDOs, Goldman employed a third party to serve as the portfolio selection agent, essentially using that agent to promote sales and mask the role of its client in the asset selection process.

Goldman originated Abacus 2007-AC1 in response to a request by Paulson & Co. Inc. (Paulson), a hedge fund that was among Goldman's largest customers for subprime mortgage related assets. Paulson had a very negative view of the mortgage market, which was publicly known, and wanted Goldman's assistance in structuring a transaction that would allow it to take a short position on a portfolio of subprime mortgage assets that it believed were likely to perform poorly or fail. Goldman allowed Paulson to use the Abacus CDO for that purpose. In entering into that arrangement with Paulson and simultaneously acting as the placement agent responsible for marketing the Abacus securities to long investors, Goldman created a conflict of interest between itself and the investors it would be soliciting to buy the Abacus securities.

[1601] 6/2007 Goldman document, "CDO Platform Overview," at 31, GS MBS-E-001918722 ("ABACUS is the Goldman brand name for single-tranche CLN [credit linked note] issuances referencing portfolios comprised entirely of structured products."); 4/2006 Goldman presentation "Overview of Structured Products," GS MBS-E-016067482.

[1602] 3/12/2007 Goldman internal memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," GS MBS-E-002406025, Hearing Exhibit 4/27-118.

[1603] As collateral put provider, which it performed for a fee, Goldman did carry risk in the Abacus 2007-AC1 transaction. In addition, shortly before the Abacus 2007-AC1 transaction closed, Goldman agreed to take the long side of a CDS contract on the performance of a small portion of the underlying assets when Paulson wanted to increase its short position at the last minute. Goldman tried to find an investor to assume its small long position, but was unable to do so.

Paulson established a set of criteria to select the reference assets for the Abacus CDO to achieve its investment objective.[1604] After establishing those parameters, Paulson worked with the actual portfolio section agent to select the assets. Documents show that Paulson proposed, substituted, rejected, and approved assets for the reference portfolio. Goldman was aware of Paulson's investment objective, the role it played in the selection of the reference assets, and the fact that the selection process yielded a set of poor quality assets. Of the final set of 90 assets referenced in the Abacus CDO portfolio, 49 had been initially proposed by Paulson. Yet Goldman did not publicly disclose the central role played by Paulson in the asset selection process or the fact that the economic interest held by an entity actively involved in the asset selection process was adverse to the interest of investors who would be taking the long position.

ACA Management LLC, the company hired by Goldman to serve as the portfolio selection agent, told the Subcommittee that, while it knew Paulson was involved, it was unaware of Paulson's true economic interest in the CDO. The ACA Managing Director who worked on the Abacus transaction stated that ACA believed that Paulson was going to invest in the equity tranche of the CDO, thus aligning its interests with those of ACA and other investors.[1605] ACA and its parent company both acquired long positions in the Abacus CDO as did a third investor. The Abacus securities lost value soon after purchase. The three long investors together lost more than $1 billion, while Paulson, the sole short investor, recorded a corresponding profit of about $1 billion. Today, the Abacus securities are worthless.

In addition to not disclosing the asset selection role and investment objective of the Paulson hedge fund, Goldman did not disclose to investors how its own economic interest was aligned with Paulson. In addition to accepting a sizable placement fee paid by Paulson for marketing the CDO securities, Goldman had entered into a side arrangement with the hedge fund in which it would receive additional fees from Paulson for arranging CDS contracts tied to the Abacus CDO that included low premium payments falling within a specified range.[1606] While those lower premium payments would benefit Paulson by lowering its costs, and benefit Goldman by providing it with additional fees, they

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[1604] April 27, 2010 Subcommittee Hearing at 82.
[1605] Subcommittee interview of Laura Schwartz (ACA) (4/23/2010). See also In the Matter of Abacus 2007-AC1 CDO, File No. HO-10911 (SEC), Statement of Laura Schwartz (January 21, 2010), ACA ABACUS 00004406 at 408. (hereinafter "Statement of Laura Schwartz").
[1606] 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," GS MBS-E-002406025-28, Hearing Exhibit 4/27-118.

would also reduce the amount of cash being paid into the CDO, disadvantaging the very investors to whom Goldman was marketing the Abacus securities. Goldman nevertheless entered into the arrangement, contrary to the interests of the long investors in Abacus, and failed to disclose the existence of the fee arrangement in the Abacus marketing materials.

On April 16, 2010, the SEC filed a complaint against Goldman and one of the lead salesmen for the Abacus CDO, Fabrice Tourre, alleging they had failed to disclose material adverse information to potential investors and committed securities fraud in violation of Section 17(a) of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. On July 14, 2010, Goldman reached a settlement with the SEC, admitting:

> "[T]he marketing materials for the ABACUS 2007-AC1 transaction contained incomplete information. In particular, it was a mistake for the Goldman marketing materials to state that the reference portfolio was 'selected by' ACA Management LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors."[1607]

Goldman agreed to pay a $550 million fine.

The Hudson, Anderson, Timberwolf, and Abacus CDOs provide concrete details about how Goldman designed, marketed, and administered mortgage related CDOs in 2006 and 2007. The four CDOs also raise questions about whether Goldman complied with its obligations to offer suitable investments that it believed would succeed, and provide full disclosure to investors of material adverse interests. They also illustrate a variety of conflicts of interest in the CDO transactions that Goldman resolved by placing its financial interests and favored clients before those of its other clients.

Each of the four CDOs examined by the Subcommittee presents conflict of interest concerns and elements of deception related to how information about the CDO was presented to investors, including disclosures related to the relevant CDO's asset selection process, the quality and value of the CDO's assets and securities, and the nature and size of Goldman's proprietary financial interests. The Subcommittee's investigation raises questions regarding whether Goldman complied with

[1607] Securities and Exchange Commission v. Goldman, Sachs & Co. and Fabrice Tourre, Case No. 10-CV-3229, (S.D.N.Y.), Consent of Goldman Sachs, (July 14, 2010), at 2.

its obligations to disclose material information to investors, including its material adverse interests, and to refrain from making investment recommendations that are unsuitable for any investor by recommending financial instruments designed to lose value and perform poorly. A key issue underlying much of this analysis is the structuring of and disclosures related to financial instruments that enable an investment bank to bet against the very financial products it is selling to clients.

(4) How Goldman Shorted the Subprime Mortgage Market

Having provided an overview of Goldman's shorting activities and CDO activities in the years leading up to the financial crisis, this next section of the Report provides detailed information about how Goldman shorted the subprime mortgage market.

(a) Starting $6 Billion Net Long

By mid-2006, Goldman's Mortgage Department had a predominantly pessimistic view of the U.S. subprime mortgage market. According to Michael Swenson, head of the Mortgage Department's Structured Products Group: "[D]uring the early summer of 2006 it was clear that the market fundamentals in subprime and the highly levered nature of CDOs [were] going to have a very unhappy ending."[1608]

$6 Billion Long. In mid-2006, Goldman held billions of dollars in long subprime mortgage related securities, in particular the long side of CDS contracts referencing the ABX Index. In September 2006, Mortgage Department head Daniel Sparks and his superior, Jonathan Sobel, initiated a series of meetings with Mr. Swenson, head of the Structured Products Group (SPG), and Mr. Birnbaum, the Mortgage Department's top trader in ABX assets, to discuss the Department's long holdings.[1609] In those meetings, they discussed whether the Asset Backed Security (ABS) Trading Desk within SPG should get out of its existing positions or "double-down." After the first meeting, Mr. Birnbaum emailed Mr. Swenson:

[1608] 9/26/2007 Michael J. Swenson Self-Review, GS-PSI-02396-401 at 398, Hearing Exhibit 4/27-55b. See also 12/14/2006 email from Daniel Sparks to Messrs. Montag and Ruzika, "Subprime risk meeting with Viniar/McMahon Summary," GS MBS-E-009726498, Hearing Exhibit 4/27-3 ("there will be very good opportunities as the market[] goes into what is likely to be even greater distress"); 7/13/2006 email from Stuart Bernstein copied to Mr. Cohn, GS MBS-E-016209254 ("he believes the REIT market is dead. We agreed . . . that as the market got worse, his 'distressed' expertise would be more (not less) interesting to investors"). See also Section 5(a)(iii) below regarding Goldman executives' negative views of the market for subprime mortgages and subprime mortgage backed securities.

[1609] 9/19/2006 email chain between Joshua Birnbaum and Daniel Sparks, "ABX," GS MBS-E-012683946.

> "Sobel and Sparks want to know if we should exit or double down. We double down if we have a structured place to go with the risk. ... [W]e are going to sit down with the CDO guys and talk about a deal."[1610]

If the Department's existing long positions could be transferred off SPG's books by finding a "structured place to go with the risk," the ABS Trading Desk would then be free to "double down" by taking on new positions and risk.

That same month, September 2006, the ABS and CDO Desks reached agreement on constructing a new CDO to provide the ABS Desk with a "structured exit" from some of its existing investments. The result was Hudson Mezzanine 2007-1, a CDO designed by Goldman to transfer to Hudson investors the risk associated with $1.2 billion in net long ABX assets then in Goldman's inventory. The Hudson CDO was also designed to allow Goldman to short $800 million in RMBS securities to offset a portion of its long ABX assets.[1611]

In December 2006, even after the $2 billion Hudson CDO was constructed, the Mortgage Department calculated that it still had a $6 billion net long position in subprime mortgage related assets.[1612] Goldman's ABX holdings continued to be a major source of its long assets.

Goldman's Long ABX Assets. In January 2006, Goldman, Deutsche Bank, and several other Wall Street firms launched the ABX Index which, for the first time, allowed investors to use standardized CDS contracts to invest in baskets of subprime RMBS securities. The ABX Index measured the aggregate performance of a selected basket of 20 RMBS securitizations, producing a single value that rose or fell over time in line with the performance of the underlying RMBS securities.[1613] Investors could enter into CDS contracts that used a particular ABX Index as the "reference obligation," without physically purchasing or holding

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[1610] Id.

[1611] Goldman responses to Subcommittee QFRs at PSI_QFR_GS0239. For more information on Hudson, see section C(5)(b)(ii)AA., below.

[1612] 3/10/2007 email to Daniel Sparks, "Mortgage presentation to the Board," GS MBS-E-013323395, Hearing Exhibit 4/27-17 (Mortgage Department was $6 billion net long at start of the quarter). 12/13/2006 Goldman email, "Subprime Mortgage Risk," Hearing Exhibit 4/27-2.

[1613] The ABX Index actually consisted of five separate indices. Each index tracked a different set of RMBS securities pulled from the 20 RMBS securitizations in the ABX basket. The sets varied according to their assigned credit ratings. One index tracked the 20 RMBS securities with AAA ratings, another tracked the 20 RMBS securities with AA ratings, and so on.

any of the RMBS securities in the underlying basket. Because the ABX Index itself was synthetic, and did not depend upon the acquisition of large blocks of RMBS securities, it enabled an unlimited number of investors to make unlimited bets on the performance of a group of subprime RMBS securities, using standardized contracts that could be bought and sold. The ABX Index also made it economical for investors to short subprime RMBS securities in bulk.[1614]

In internal documents, Goldman described itself as "the leader and principal driver in the creation of" the ABX Index.[1615] In July 2006, Joshua Birnbaum, Rajiv Kamilla, David Lehman, and Michael Swenson from the Mortgage Department nominated Goldman's role in the creation of both the ABX and CMBX – a similar index based on Commercial Mortgage Backed Securities – for an internal Goldman award, called the "Mike Mortara Award for Innovation."[1616] That award "recognize[d] the creative, forward-looking, and entrepreneurial contributions of an individual or team" within the equities or fixed income divisions.[1617] The Mortgage Department personnel wrote that the new indices "enable[d] market participants to trade risk without ownership of the underlying SP [structured product] security – thereby permitting market participants to efficiently go short the risk of these securities."[1618] They also wrote that "Goldman Dominates Client Trading Volume" with "an estimated 40% market share," and also "dominates the inter-dealer market."[1619] In 2007, Rajiv Kamilla, the ABS trader who spearheaded Goldman's efforts to launch the ABX Index, wrote that he "[c]ontinued to enhance our trading dominance in ... ABX indices."[1620]

While Mr. Kamilla led Goldman's efforts to develop the ABX Index, the firm's day-to-day ABX trading was conducted primarily by Joshua Birnbaum on the Mortgage Department's Structured Products

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1614 Subcommittee interview of Joshua Birnbaum (10/1/2010); Subcommittee interview of Rajiv Kamilla (10/12/2010).
1615 6/20/2006 email from David Lehman, "Mortara Nomination – ABX/CMBX Indices," GS MBS-E-014038810 (attached file, "2006 Mike Mortara Award for Innovation Nomination Template for ABX & CMBX Indices," GS MBS-E-014038811 at 6 (hereinafter "Mortara Award Submission")).
1616 Id. at 8.
1617 6/20/2006 email from "Equities and FICC Communications" to "All Equities and FICC," Mike Mortara Award for Innovation," GS MBS-E-010879020 [original email].
1618 Mortara Award Submission at 2.
1619 Id. at 3-4. See also 8/30/2006 Fixed Income, Currency and Commodities Individual Review Book for Rajiv K. Kamilla, at 20, GS-PSI-04064 (hereinafter "Kamilla 2006 Review"); 9/6/2007 Fixed Income, Currency and Commodities Individual Review Book for Rajiv K. Kamilla, at 19, GS-PSI-04100 (hereinafter "Kamilla 2007 Review").
1620 Kamilla 2007 Review at 19. In 2007, Mr. Kamilla was named a Managing Partner at Goldman.

Group (SPG) Trading Desk.[1621] Mr. Birnbaum had a negative view of the subprime mortgage market, and favored the firm's building a net short position.[1622] However, during 2006, Goldman's overall ABX position was net long, not net short.

Goldman was net long because, as a market maker that helped launch the ABX Index in 2006, it facilitated ABX trades for a number of clients, and many of those clients – primarily hedge funds – went almost exclusively short, requiring Goldman to take the opposing long side of the CDS contracts referencing the ABX indices.[1623] These transactions enabled Goldman to amass a 30-40% market share in ABX trading during its first year of existence. But by mid-2006, they had also contributed to the Mortgage Department's net long position in subprime mortgage related assets. When the mortgage market began showing signs of strain in the second half of 2006, the risks associated with the firm's net long

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[1621] Daniel Sparks, the Mortgage Department head, viewed Mr. Birnbaum as a talented trader, writing in October 2006: "Josh for EMD [Extended Managing Director] – he is an extraordinary commercial talent and a key franchise driver. ... He will make us a lot of money." 10/17/2006-10/18/2006 emails from Daniel Sparks, "3 things," GS MBS-E-010917469. Other Goldman senior executives also relied on his trading skills. See, e.g., 2/21/2007 email from David Lehman, "ACA/Paulson Post," GS MBS-E-003813259 (before approving the Abacus CDO, Mr. Lehman asked Mr. Tourre to "[w]alk josh through the $, if that makes sense, let's go"); 6/29/2007 email from David Lehman, "ABS Update," GS MBS-E-011187909 (during exceptionally bad trading day, Mr. Lehman asked Mr. Swenson, "Is Josh in? Mr. Swenson replied "No he is in Spain – don't worry I am fine.").

[1622] Subcommittee interview of Joshua Birnbaum (4/22/2010). Throughout 2006, Mr. Birnbaum was also working to develop a new product for Goldman, a suite of home price derivatives that would track the Case/Schiller Home Price Indices. Like the ABX Index, a derivative product tracking the Case/Schiller Indices would enable investors to bet on the rise or fall in home prices in various U.S. markets, and provide another vehicle to short the mortgage market. See 12/18/2006 New Product Memorandum, "Launch of US Property Derivatives Trading," GS MBS-E-013492538. In May 2006, Mr. Swenson forwarded an email to Mr. Birnbaum about another financial firm seeking to develop the same type of home price derivatives as Mr. Birnbaum. A note with the email said: "FYI–The cat is crawling out of the bag," meaning that other firms were thinking about launching similar products. See 5/16/2006 email from Michael Swenson to Joshua Birnbaum, "Housing Futures and Options," GS MBS-E-016087363. Goldman offered the new U.S. property derivatives briefly in 2007, but they did not develop significant trading volumes. Subcommittee interview of Joshua Birnbaum (10/1/2010).

[1623] The ABX Index began trading in January 2006. Goldman's position in the ABX Index was flat when the Index debuted, but became long and grew considerably longer in the fall of 2006. See, e.g., 10/17/2006-10/18/2006 email exchange between Daniel Sparks and Tom Montag, "3 things," GS MBS-E-010917469; 3/1/2007 email from Daniel Sparks, "Dinner," GS MBS-E-002356757, Hearing Exhibit 4/27-143 ("Most of the synthetic flows were hedge funds getting short and CDO vehicles getting long."). Goldman executives also told the Subcommittee that the firm often took the long side of ABX transactions in which hedge funds were going short. Subcommittee interview of Daniel Sparks (4/15/2010); Subcommittee interview of David Viniar (4/13/2010). See also, e.g., 8/10/2006 email from Goldman salesperson, "Paulson bookings," GS MBS-E-012395893 ("GS sold 550mm protection on ABX.HE.A 06-2 to Paulson"); 12/7/2006 email chain between Daniel Sparks and Tom Montag, "More thorough response," GS MBS-E-010931324 (Goldman had previously handled approximately $9 billion in transactions for Paulson); Subcommittee interview of Michael Swenson (4/16/2010) ("Paulson [hedge fund] was the biggest counterparty on day 1 [of the ABX Index] and throughout 2006").

ABX position became more of a concern.[1624] Senior Goldman executives expressed the view that the subprime mortgage related market was likely to get much worse, and the firm should prepare for it.[1625]

In December 2006, Goldman used the Hudson CDO to transfer the risk associated with $1.2 billion of its ABX long holdings to Hudson investors. But even after this transfer, Goldman still had billions of dollars in long ABX holdings on its books.

Goldman's Long Mortgage Holdings. In addition to its long ABX holdings, the Mortgage Department's $6 billion net long position in December 2006 was due to a large inventory of RMBS, CDO, and other mortgage related assets in Goldman's investment and sale inventories and in its CDO warehouses. In 2006, the Mortgage Department conducted numerous RMBS and CDO securitizations that required it to acquire and repackage whole loans, RMBS and CDO securities, and other mortgage related assets. When assembling CDOs, Goldman often worked with third party partners. These strategic partners bought a portion of the equity and bore some of the risk of loss in the CDO. The partners were generally smaller financial firms, such as hedge funds or asset managers with expertise in CDOs or a particular asset class. For a fee, the partners

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[1624] Mr. Birnbaum's acquisition of a large net long position in the ABX was viewed negatively by Goldman senior executives. When Mr. Sparks recommended Mr. Birnbaum for a promotion to managing director in October 2006, Mr. Montag responded: "Josh slipped a bit with the abx position etc. Is that appropriate." Mr. Sparks replied: "Josh ... has had a rough couple of months. But he has handled it very well and is a key person for our franchise. I don't think those 2 months should confuse his value to the firm." 10/17/2006 email exchange between Daniel Sparks and Tom Montag, "3 things," GS MBS-E-010917469. Mr. Birnbaum was named a managing director later that month, but Mr. Montag again raised the issue of his net long ABX position when Mr. Sparks sought to allow Mr. Birnbaum to continue buying equity put options on companies with subprime exposure. Mr. Montag wrote: "Unfortunately trader josh has not demonstrated a track record of controlling his position. ... Instead of these lousy hedges he should just be selling his position." 3/21/2007 email chain between Tom Montag and Daniel Sparks, GS MBS-E-010629379, Hearing Exhibit 4/27-21. See also 2/5/2007 email from Richard Ruzika to Gary Cohn, "Are you living Morgatages [sic]," GS MBS-E-016165784 (Mr. Ruzika: "You know and I know this position was allowed to get too big – for the liquidity in the market, our infrastructure, and the ability of our traders. That statement would be the same even if we had gotten the market direction correct –although the vultures would not be circling.").

[1625] See, e.g., 12/15/2006 email from David Viniar to Tom Montag, "Subprime Risk Meeting with Viniar/McMahon Summary," GS MBS-E-009726498, Hearing Exhibit 4/27-3 ("there will be very good opportunities as the markets goes into what is likely to be even greater distress"); 2/8/2007 email from Daniel Sparks, "Post," GS MBS-E-002201668, Hearing Exhibit 4/27-7 ("Subprime environment going from bad to worse (think whack a mole)."); 1/9/2007 Goldman Presentation, "Mortgage Department Update," GS MBS-E-002320968 ("Risks, Challenges and Structural Issues: –Very tough going in Resi Credit world – p&l [profit and loss] will be challenging; –Housing price and loan volume declines; –Investing in business in very difficult environment"); cf. 11/1/2006 Goldman Structured Products Strategist memorandum, "Q3 Mortgage Investor Survey," GS MBS-E-006576068-76 ("Clients expect a downturn in housing in 2007, investors worried about high LTV [loan-to-value], low/no doc loans, pay option ARMs, origination volumes to be down 10% in 2007").

also sometimes served as a CDO's collateral manager, helping to select the assets.[1626]

Peter Ostrem, who was head of the CDO Origination Desk from 2006 until May 2007, was aware of substantial problems in the subprime mortgage market, but believed that the market distress was temporary and the market would stabilize.[1627] Mr. Ostrem wanted to continue to increase the CDO Desk's business by producing as many marketable CDOs as possible.[1628] Darryl Herrick, who worked for Mr. Ostrem on the CDO Origination Desk expressed the view that hedge funds were shorting only the worst CDOs: "[CDO] shelves people are shorting are enhanced garbage."[1629]

The CDO Origination Desk was a primary contributor to the Mortgage Department's net long position, as Goldman often had to hold or "warehouse" subprime assets until they were packaged into a CDO.[1630] Each CDO was designed to include or reference hundreds of millions or billions of dollars in assets, which the CDO Origination Desk and its partners had to locate and acquire, a process called "ramping" that averaged six to nine months per CDO.[1631] Goldman and its partners acquired these assets from other large Wall Street broker-dealers, often called "the Street," or took them from their own inventory of assets.

When assembling a CDO, Goldman generally opened an internal "warehouse account" for the CDO in which it stored the acquired assets until a target amount was achieved, and the CDO was brought to market. While the assets were in the warehouse account, they were included in Goldman's warehouse balance sheet and contributed to its long or short positions. When the bulk of the target assets were acquired for a particular CDO, perhaps 75% to 95% of the total, in some cases Goldman priced the CDO securities and began selling them to clients who were told what the remaining assets would likely be.[1632] When a CDO transaction

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[1626] Subcommittee interview of Peter Ostrem (10/5/2010); Subcommittee interview of Darryl Herrick (10/13/2010).
[1627] Subcommittee interview of Peter Ostrem (10/5/2010). See also, e.g., 8/10/2006 email from Peter Ostrem to Daniel Sparks, "Leh CDO Fund," GS MBS-E-010898470 (urging Goldman to "do our own fund. SP CDO desk. Big time.").
[1628] Subcommittee interview of Peter Ostrem (10/5/2010).
[1629] 6/8/2006 email from Darryl Herrick to Peter Ostrem, "**GS ABS** RMBS CDS Lineup," GS MBS-E-016445770.
[1630] Subcommittee interview of Daniel Sparks (4/15/2010); Subcommittee interview of Peter Ostrem (10/5/2010).
[1631] See 5/19/2007 Goldman presentation, "Mortgages CDO Origination – Retained Positions & Warehouse Collateral, May 2007," GS MBS-E-010951926 ("average ramp period 6-9 months").
[1632] See, e.g. 3/7/2007 and 3/13/2007 internal emails, "Timberwolf I, Ltd. Preliminary Offering Circular," GS MBS-E-001800634 (Collateral manager Greywolf wrote: "We will not be fully ramped and I want to use the remaining bucket strategically. Is it OK if we have 5% ramp post-

"closed" and its securities were issued, Goldman transferred the relevant assets from its warehouse account to the corporation or trust established for the CDO.[1633] The CDO entity then housed the long assets that had been on Goldman's warehouse books, and Goldman was left with a corresponding short position which it could keep or sell to the CDO's short parties.

In 2006 and early 2007, since it was often acquiring assets for several CDOs at once, the CDO Desk generally had a substantial net long position in subprime assets in its CDO warehouse accounts.[1634] For example, as of March 16, 2007, Goldman calculated that its CDO warehouses contained $4.7 billion in mortgage related assets.[1635] After deducting potential liabilities assumed by Goldman's partners and making other adjustments, Goldman calculated that it had $2.3 billion in net long warehouse risk.[1636] In early 2007, Goldman executives began to express concern about the risks posed by the subprime mortgage related assets in the CDO warehouse accounts.[1637]

On December 7, 2006, Daniel Sparks, the Mortgage Department head, exchanged emails with Goldman senior executive Thomas Montag about why Goldman was not doing more to reduce the firm's risk associated with its net long positions.[1638] On the same day, Mr. Montag

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close?" Goldman responded: "We represented to BSAM [Bear Stearns Asset Management] that deal would be fully ramped upon closing. As long as they're ok (or get veto rights), I don't have any issue.").

[1633] Subcommittee interview of Daniel Sparks (4/15/2010); Subcommittee interview of David Lehman (4/12/2010).

[1634] See, e.g., 3/16/2007 Goldman memorandum from Mitch Resnick and Peter Ostrem to GSI Risk Committee, "GSI Warehousing for Structured Product CDOs," GS MBS-E-001806010; 2/8/2007 email from Daniel Sparks to Messrs. Cohn, Montag, Viniar et al., "Post," GS MBS-E-002201668, Hearing Exhibit 4/27-7 ("Loan business is long by nature and goal is to mitigate."); Subcommittee interview of Peter Ostrem (10/15/2010).

[1635] 3/16/2007 Goldman memorandum from Mitch Resnick and Peter Ostrem to GSI Risk Committee, "GSI Warehousing for Structured Product CDOs," GS MBS-E-001806010.

[1636] Id.

[1637] 2/28/2007 email from David Rosenblum to Peter Ostrem, "Pete– pls send me cob 2/28 MTM for SP CDO WH's first thing in the morning," GS MBS-E-001800707; 2/28/2007 email from David Rosenblum, "Hedges Status Report," GS MBS-E-002640538 (new ABX hedges added and other hedges allocated to ensure that CDO warehouse risk was fully hedged); 2/22/2007 email from Peter Ostrem to David Rosenblum, "League Tables," GS MBS-E-001800683 ("FYI Liquidating 3 warehouses tomorrow."); 2/22/2007 email from Daniel Sparks to Tom Montag, GS MBS-E-010989710 ("There are a few deals that look tough now, including a A-rated CDO of CDOs with Greywolf [Timberwolf]").

[1638] 12/7/2006 email chain between Daniel Sparks and Tom Montag, "More thorough response," GS MBS-E-010931324. Mr. Montag also raised the possibility of hiring a trader from the Paulson hedge fund to help Goldman short the mortgage market. In addition, the email exchange indicates that Goldman had previously done $7 billion in transactions with the Paulson hedge fund, but had not done much with the hedge fund recently. Mr. Sparks wrote: "They had asked us to do another tranched protection trade for them, and seem fine with it being pushed to January." Id. The tranched protection trade for Paulson that Mr. Sparks mentioned later became complained to CFO David Viniar about the Mortgage Department's lack of aggressiveness in trying to reduce its net long ABX position:

> "[O]n ABX having numerous conversations–I don't think we should panic out but we certainly didn't do a good job of keeping pressure on ... makes me mad because they should have kept doing it ugh."[1639]

The next week, Mr. Viniar called a meeting with the Mortgage Department to discuss its holdings.

(b) Going Past Home: Goldman's First Net Short

CFO David Viniar told the Subcommittee that, in early December 2006, he received reports showing that the Mortgage Department had lost money on ten-successive days.[1640]

Viniar Meeting. On December 14, 2006, Mr. Viniar convened a meeting in the conference room next to his office on the 30th floor, in which he and other senior Goldman executives met for several hours with Mortgage Department managers, as well as representatives from Market Risk Management & Analysis and from the Controllers group.[1641] At the meeting, Mr. Viniar and other Goldman executives conducted an in-depth review of the Mortgage Department's holdings. Mr. Viniar concluded the Mortgage Department's position in subprime mortgage related assets was too long, and its risk exposure was too great.[1642]

Mr. Viniar and others told the Subcommittee that Mr. Viniar's basic message to the Mortgage Department at the December meeting was not necessarily to go short, but instead to "get closer to home."[1643] In trading parlance, "home" means a net neutral trading position – a position that is neither significantly short nor long.[1644] Mr. Viniar told the Subcommittee that, by telling the Mortgage Department to "get closer to home," he meant that it should assume a more neutral risk position.[1645] One way to "get closer to home" was for the Department to sell its long assets.

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the Abacus 2007-AC1 CDO discussed in this Report.

1639 12/7/2006 email chain between Tom Montag and David Viniar, GS MBS-E-009756572.

1640 Subcommittee interview of David Viniar (4/13/2010).

1641 12/14/2006 email from Daniel Sparks, "Subprime risk meeting with Viniar/McMahon Summary," GS MBS-E-009726498, Hearing Exhibit 4/27-3.

1642 Id. See also 12/15/2006 email from David Viniar to Tom Montag, GS MBS-E-009726498, Hearing Exhibit 4/27-3.

1643 Subcommittee interview of David Viniar (4/13/2010), Daniel Sparks (4/15/2010), and David Lehman (4/12/2010).

1644 Subcommittee interview of David Viniar (4/13/2010).

1645 Id.

Another way to achieve a more neutral risk position was for the Department to take new short positions to offset its existing long positions.[1646]

Internal documents indicate that the directions given to the Mortgage Department in the December meeting were more detailed than the general instruction to "get closer to home." In an email sent on the same day by Mr. Sparks to Goldman executives Messrs. Montag and Ruzika entitled, "Subprime risk meeting with Viniar/McMahon Summary," Mr. Sparks wrote:

> "Followups:
> 1. Reduce exposure, sell more ABX index outright, basis trade of index vs. CDS too large.
> 2. Distribute as much as possible on bonds created from new loan securitizations and clean previous positions.
> 3. Sell some more resid[ual]s
> 4. Mark [the value of assets in] the CDO warehouse more regularly ...
> 5. Stay focused on the credit of the originators we buy loans from and lend to
> 6. Stay focused and aggressive on MLN [Mortgage Lending Network] (warehouse customer and originator we have EPDs [early payment defaults] to that is likely to fail)
> 7. Be ready for the good opportunities that are coming (keep powder dry and look around the market hard)."[1647]

The next day, December 15, 2006, Mr. Montag forwarded Mr. Sparks' email to Mr. Viniar asking: "is this a fair summary?"[1648] Mr. Viniar replied: "Yes." Mr. Viniar noted:

[1646] Id. In terms of risk reduction, taking on offsetting short positions to reduce long positions does not necessarily offer the same degree of certainty of risk protection as simply selling off the long assets. In many cases, the offsets may not perfectly match, leaving some degree of risk exposure known as "basis risk." See, e.g., 2/12/2007 email from Mr. Sobel to Mr. Cohn, "Post today," GS MBS-E-009763506 ("Risk that concerns me is basis between ABX and single names."); 2/11/2007 email from Tom Montag, GS MBS-E-009688192 (discussing ABX offsets: "There is no est[imated] loss in the basis risk. Big wildcard. They [the traders] think they have correlation right and moves either way should be ok but obviously index assumptions have been wrong starting last may or june when positions were being put on and the gains seduced us to do more.").

[1647] 12/14/2006 email from Daniel Sparks, "Subprime risk meeting with Viniar/McMahon Summary," GS MBS-E-009726498, Hearing Exhibit 4/27-3. "Residuals" refers to the equity positions that Goldman had retained from the RMBS and CDO securitizations it originated.

[1648] 12/14/2006 email from Tom Montag to David Viniar, GS MBS-E-009726498, Hearing Exhibit 4/27-3.

"On ABX, the position is reasonably sensible but is just too big. Might have to spend a little to size it appropriately. On everything else my basic message was let's be aggressive distributing things because there will be very good opportunities as the markets [go] into what is likely to be even greater distress and we want to be in a position to take advantage of them."[1649]

In response to the Viniar meeting, the Mortgage Department took immediate action. It began selling its long ABX positions outright when possible and entering into large single name CDS shorts to offset its remaining long assets. Goldman personnel developed a chart depicting the long positions the Mortgage Department had taken on BBB and BBB-rated ABX assets.[1650] This chart also showed how quickly the Mortgage Department moved after the Viniar meeting to offset those long positions by amassing single name RMBS and CDS short positions.

[SEE CHART NEXT PAGE: *Notionals (ABX convention)*, prepared by Goldman Sachs, reformatted by the Permanent Subcommittee on Investigations to be readable in black and white print, GS MBS-E-010214410.]

Within about a month, in January 2007, the Mortgage Department had largely eliminated or offset its long subprime mortgage assets, but it didn't stop there. In January and February, the Mortgage Department began building a multi-billion-dollar short position as part of a plan by the SPG Trading Desk to profit from the subprime RMBS and CDO securities starting to lose value. The plan was discussed with Mr. Sparks and Mr. Ruzika before it was set in motion. By the end of February 2007, the Department had swung from a $6 billion net long position to a $10 billion net short position, a $16 billion reversal in the span of two months.

[1649] 12/15/2006 email from David Viniar to Tom Montag, GS MBS-E-009726498, Hearing Exhibit 4/27-3.

[1650] See 1/5/2007 "Notionals (ABX convention)" chart, taken from "Index and Single Name Position History 2006 as of 05Jan07.xls," attachment to 1/8/2007 email from Joshua Birnbaum to Daniel Sparks, "ABX Subprime Risk by vintages," GS MBS-E-010214409. The SPG Desk also periodically updated that chart. See, e.g., chart attachments to 2/6/2007 email from Kevin Kao to Joshua Birnbaum, "Index and Single Name Position History 2006 as of 05Feb07.xls," GS MBS-E-012744553; chart attachments to 2/23/2007 email from Tom Barrett to Kevin Kao, Michael Swenson and Justin Gmelich, "Index and Single Name Position History 2006 As of 22Feb07.xls," GS MBS-E-012411673; chart attachments to 3/2/2007 email from Kevin Kao to Joshua Birnbaum, "Index and Single Name Position History 2006 As of 01Mar07.xls," GS MBS-E-012776557.

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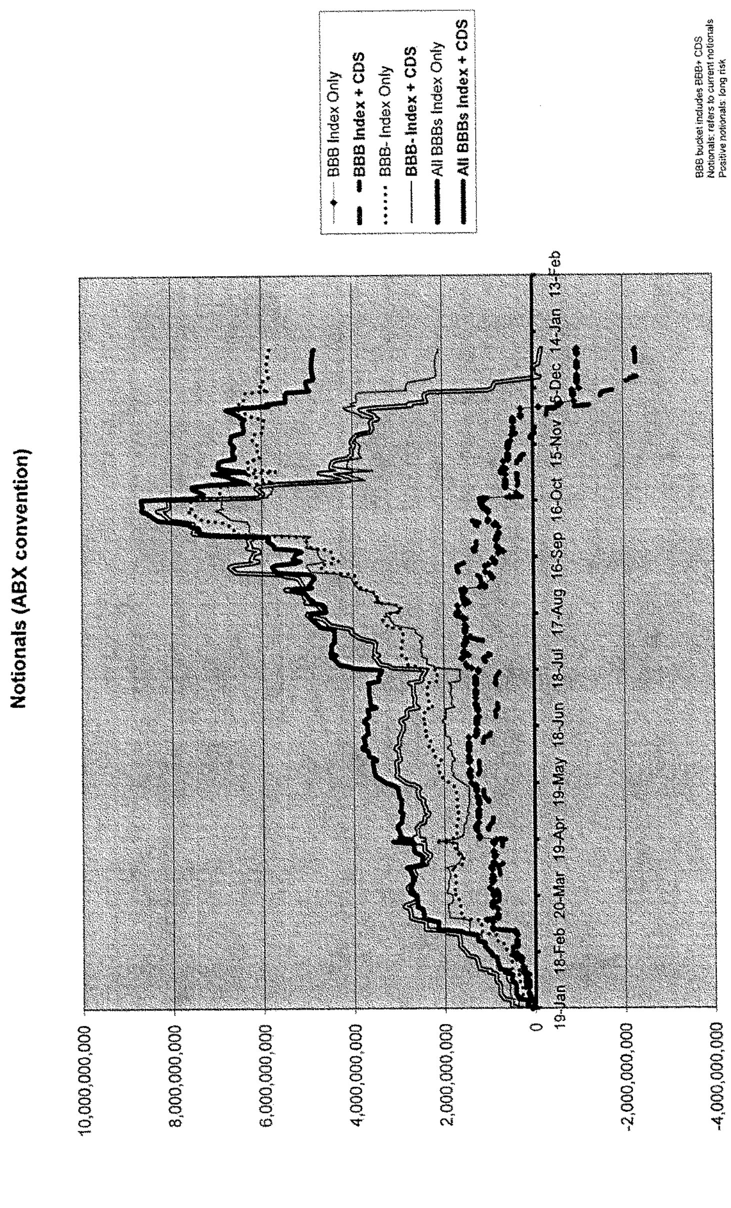

Prepared by the U.S. Senate Permanent Subcommittee on Investigations, February 2011.
Derived from Goldman Sachs document, GS MBS-E-010214410.

Selling Assets Outright. On December 14, 2006, the same day as the Viniar meeting, Kevin Gasvoda, head of the Residential Whole Loan Trading group, instructed his staff to begin selling the RMBS securities in Goldman's inventory, focusing on RMBS securities issued from Goldman-originated securitizations. He urged them to "move stuff out" even at a loss:

> "[P]ls refocus on retained new issue bond positions and move them out. ... [W]e don't want to be hamstrung based on old inventory. Refocus efforts and move stuff out even if you have to take a small loss."[1651]

In February 2007, to further encourage sales, Mr. Gasvoda issued a sales directive or "axe" to the Goldman sales force to sell the remaining RMBS securities from Goldman-originated RMBS securitizations. On February 9, 2007, the sales force reported a substantial number of sales, and Mr. Gasvoda replied: "Great job syndicate and sales, appreciate the focus."[1652]

In February 2007, Goldman CEO Lloyd Blankfein personally reviewed the Mortgage Department's efforts to reduce its subprime RMBS whole loan, securities, and residual equity positions, asking Mr. Montag: "[W]hat is the short summary of our risk and the further writedowns that are likely[?]"[1653] After a short report from Mr. Montag, Mr. Blankfein replied:

> "[Y]ou refer to losses stemming from residual positions in old deals. Could/should we have cleaned up these books before and are we doing enough right now to sell off cats and dogs in other books throughout the division?"[1654]

At the end of February, Goldman's controllers prepared a summary of the changes in Goldman's RMBS and whole loan inventory since December 2006, and reported:

> "Residential Credit Loans: The overall loans inventory decreased from $11bn to $7bn. ... subprime loans decreased from $6.3bn to

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[1651] 12/14/2007 email from Mr. Gasvoda, "Retained bonds," GS MBS-E-010935323, Hearing Exhibit 4/27-72.
[1652] 2/9/2007 email exchange between Kevin Gasvoda and sales syndicate, "GS Syndicate RMBS Axes (INTERNAL)," GS MBS-E-010370495, Hearing Exhibit 4/27-73.
[1653] 2/11/2007 email exchange between Lloyd Blankfein and Tom Montag, "Mortgage Risk – Credit residential," GS MBS-E-009686838, Hearing Exhibit 4/27-130.
[1654] Id.

$1.5bn, Second Liens decreased from $1.5bn to $0.7bn and S&D [scratch and dent] Loans remained unchanged at $0.8bn."[1655]

This analysis indicates that, in less than three months, Goldman had reduced its subprime loan inventory by over two-thirds, and its second lien inventory by half.

The Mortgage Department reduced its inventory, not only by selling assets outright, but also by reducing its purchase of whole loans and securitization efforts. In March 2007, Goldman informed its Board of Directors and the SEC that it had stopped purchasing subprime loans and RMBS securities through, in its words, the use of "conservative bids."[1656] While those presentations did not explain the phrase "conservative bids," an email to Goldman's Chief Credit Officer, Craig Broderick, discussing a March 2007 presentation to Goldman's Audit Committee about the subprime mortgage business, was much more explicit: "Just fyi not for the memo, my understanding is that the desk is no longer buying subprime. (We are low balling on bids)."[1657] Still another method to reduce its loan inventory was an ongoing effort by the Mortgage Department to return defaulted or fraudulent loans to the lenders from which it had purchased them.

On April 23, 2007, Mr. Gasvoda reported to Messrs. Montag and Sparks a dramatic reduction in Goldman's inventory of subprime loans and RMBS securities:

> "[W]e have $180mm in loans (unsecuritized) and $255mm of residuals off old deals. The $180mm of loans is the smallest we've been since we started the business in 2002. We had been running at an average loan position balance in subprime of around $4B . ... The $255mm we have retained is from deals dating back to 2002 and while we've developed some buying partners, it is not a deep

[1655] 2/23/2007 "Significant Cash Inventory Change (Q1'07 vs. Q4'06)," prepared by Goldman, GS MBS-E-010037310, Hearing Exhibit 4/27-12. "Scratch and dent" loans are loans that are not performing.
[1656] 3/26/2007 Goldman presentation to Board of Directors, "Subprime Mortgage Business," GS MBS-E-005565527, Hearing Exhibit 4/27-22 ; 3/14/2007 Goldman Presentation to SEC, "Subprime Mortgage Business 14-Mar-2007," at 7, GS MBS-E-010022328.
[1657] 3/2/2007 email from Patrick Welch to Craig Broderick, "Audit Committee Package_Feb 21_Draft_Mortgage_Page.ppt," GS MBS-E-009986805, Hearing Exhibit 4/27-63. In the context of assets offered by a customer to the Correlation Desk, it appears that Mr. Egol also may have returned an unappealing bid: "Many of these assets are garbage. I told her should would not like the level [the price bid by Goldman] ...." 2/26/2007 email from Jon Egol, "Portfolio for Proposed Transaction 070226 (2).xls," GS MBS-E-002631719.

market. These have been intentional principal retained positions."[1658]

The subprime loan balance of $180 million was just over one-tenth of the $1.5 billion total Goldman had held at the end of February 2007, reflecting a reduction in its subprime inventory over a two-month span by nearly 90%. Overall, the $180 million loan balance was down from an average subprime loan position balance of $4 billion, which was a 95% reduction in overall subprime loan inventory levels.

Building the First Short Position. At the same time the Residential Whole Loan Trading Desk was selling loans and RMBS securities, the Structured Product Group (SPG) Trading Desk was working to sell its inventory of long CDS contracts linked to the ABX indices.[1659] At first, in December and January, because so many market participants were going short, the SPG's ABX Trading Desk found its long ABX positions difficult to sell.[1660] The ABS Desk then decided to offset the long ABX assets in part by purchasing the short side of single name CDS contracts on certain RMBS and CDO securities.[1661] Within

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[1658] 4/22/2007 email from Kevin Gasvoda, "Resi credit QTD/YTD P&L and positions," GS MBS-E-010474983.

[1659] The Mortgage Department also worked to sell assets from its CDO warehouse accounts, an issue discussed in part below and in part in connection with the Report's section on Goldman's CDO activity.

[1660] Subcommittee interview of Michael Swenson (4/16/2010).

[1661] Id. By adopting the strategy of offsetting the long positions with similar, but not necessarily identical short positions, the SPG Desk was incurring a very large amount of basis risk – the risk of a mismatch between the offsetting assets. Mr. Sparks and other senior Goldman executives wanted to reduce that basis risk by paring the positions down on both sides – selling the long assets and covering the short assets. The SPG Desk was not, however, making the progress Mr. Sparks wanted to see in reducing the basis risk. On January 23, 2007, Mr. Sparks wrote to Messrs. Swenson, Birnbaum, and Lehman:

> "It does not look like you made any progress on the things we discussed – I want a plan and daily reports on progress. Not to be difficult, but if you 3 are too busy I can add someone who can focus on the issue. My other concern is I want to stay nimble, and not get too wedded to one way positions – getting massively short could be more painful than what we have experienced."

1/23/2007 email from Daniel Sparks, GS MBS-E-010267341. A week later, Mr. Swenson requested a meeting with Mr. Sparks and Mr. Ruzika to discuss the difficulties the traders were encountering in reducing the basis risk. He wrote: "I want to go over the facts of what we are up against." 1/30/2007 email from Michael Swenson to David Lehman, GS MBS-E-011375519. Mr. Swenson and Mr. Birnbaum met with Mr. Ruzika and Mr. Sparks around February 1, 2007. The group apparently discussed the SPG Desk's net short position and the difficulties of reducing the basis risk. On February 5, 2007, Mr. Ruzika wrote to Mr. Cohn about how the short position was "allowed to get too big" and stated: "I don't want to be short – I want to neutralize the risk and shed our basis risk." 2/5/2007 email from Richard Ruzika to Gary Cohn, "Are you living Morgatages [sic]?," GS MBS-E- 016165784. About a week later, when the large net short positions began producing large profits, Mr. Ruzika apparently changed his mind and became supportive of the large net short, though he still wanted to reduce basis risk "whenever possible."

about six weeks, by February 2007, the ABS Desk had acquired a huge net short position in single name CDS contracts referencing RMBS and CDO securities that totaled more than $5 billion. By then, the ABX market had stabilized somewhat, and the ABS Desk was able to sell outright more of its long ABX positions. Rather than slow down once its $6 billion long position was offset, however, the ABS Desk used CDS contracts to short RMBS and CDO securities "at every opportunity," in the words of one trader, going increasingly net short.[1662]

On February 12, 2007, Mr. Sparks reported to senior management on the Mortgage Department's progress and the substantial profits that its new net short position was already showing:

> "(1) +20mm [million] P&L [profit and loss] today.
> Secondary trading desk is net short risk in the form of single names and structured index vs index longs (some index shorts also). Large move down again today ....
>
> (2) Possible significant upside in book.
> The desk has been moving [marking down] single names about 1/3 of what they feel the correct correlation [to ABX Index] is (around 70%) .... As the market has moved so much one way, there is the potential for the book to currently have significant upside embedded in it.[1663]

2/13/2007 email from Richard Ruzika to Gary Cohn, "Catch up," GS MBS-E-019794071.
1662 Salem 2007 Self-Review, GS-PSI-03157 at 71-72.
1663 The reference to 70% in the email involves correlation assumptions. Correlation trading depends upon assumptions about the relative values between one asset (such as a CDS contract referencing the ABX Index) and another (such as a CDS contract referencing a single RMBS security). A correlation value of 100% means that the values of both assets move together in the same amounts. With 100% correlation, a 10% decline in the value of one asset implies a 10% decline in the value of the other. The correlation ratios between different assets are a matter of the trading desk's informed judgment. As one Goldman mortgage trader noted: "We should discuss base correlations live . . . there is no market standard for calculating them." 3/26/2007 email from SPG Trading to Goldman London, "ABX – TABX : Request from [customer]," GS MBS-E-021893369. Once a correlation ratio was set, however, the general practice at Goldman was to change correlation ratios only upon a showing of observable market trade prices supporting the change. Traders, thus, engaged in frequent discussions of "observability." A change in correlation ratios could result in an immediate markdown or markup of particular positions, which could effect Goldman's profit and loss calculations, collateral calls, and the value of individual customer positions.

In his February 12 email, Mr. Sparks wrote that the SPG Desk had been marking down the value of single name long CDS contracts by only one-third of the amount that would apply if the desk's true calculation of the correlation between single name and ABX CDS contracts was correct – that the two products were more closely correlated than the market recognized. Mr. Swenson told the Subcommittee that, in late 2006 and early 2007, single name long CDS contracts were trading at higher prices than similar ABX CDS contracts, and the observable market prices of single name CDS contracts were not falling as quickly as market professionals

(3) Loan & resid[ual] books flat [i.e., already hedged]."[1664]

On February 14, 2007, Mr. Sparks again reported to senior management on the Department's progress, describing how it was neutralizing its net long position:

> "[O]ur risk reduction program consisted of: (1) selling index outright (2) buying single name protection and (3) buying protection on super-senior portions of the BBB/BBB- index. ... That is good for us position-wise, bad for accounts who wrote that protection ... but could hurt our CDO pipeline position as CDOs will be harder to do."[1665]

"Overall," Mr. Sparks wrote, "as a business we are selling our longs and covering our shorts."[1666]

With respect to market conditions, Mr. Sparks reported:

> "Subprime environment – bad and getting worse. Everyday is a major fight for some aspect of the business (think whack-a-mole). Trading position has basically squared ... plan to play from short side. Loan business is long by nature and goal is to mitigate. Credit issues are worsening on deals and pain is broad (including investors

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thought they should. Subcommittee interview of Michael Swenson (4/16/2010). Nonetheless, in a steeply declining market, Goldman's Mortgage Department assumed that the single name long CDS contracts would eventually fall to the same low values as the long ABX contracts. If that happened, since the SPG Desk was net short single name CDS contracts, the anticipated drop in value would result in an equivalent amount of profit for the desk's short position – hence, Mr. Sparks' reference to the "upside embedded in" the book.

On February 14, 2007, the Mortgage Department actually captured that upside by changing its correlation assumptions to recognize a higher correlation between single name CDS and ABX CDS contracts. Using the new assumptions, Goldman then marked down the value of its customers' single name CDS contracts to levels closer to the ABX Index assets. As the short party to those same CDS contracts, Goldman also realized a profit of $100 million in a single day. See 2/14/2007 email from Arbind Jha to Michael Swenson, "Mortgages Estimate REVISED," GS MBS-E-012474685.

1664 2/12/2007 email from Daniel Sparks, "Post today," GS MBS-E-009763506.

1665 2/14/2007 email from Daniel Sparks, "Post," GS MBS-E-009635410, Hearing Exhibit 4/27-8.

1666 3/21/2007 email from Daniel Sparks to Tom Montag, GS MBS-E-010629379, Hearing Exhibit 4/27-21. See also 2/19/2007 email from Mr. Sparks to Mr. Montag, "2 things," GS MBS-E-010378492 ("Please send a short note to Josh Birnbaum, Mike Swenson and David Lehman telling them great week – short singles and short CDOs."); 2/28/2007 email from Michael Sherwood to Messrs. Sparks, Swenson, Birnbaum and Lehman, "ABX/Single name notional/risk history," GS MBS-E-010389296 (Mr. Sherwood, a London managing director and member of the Firmwide Risk Committee, wrote: "Many congrats on last few weeks trading ... keep it up!").

in certain GS-issued deals). Distressed opportunities will be real, but we aren't close to that time yet."[1667]

In order to "play from the short side," the Mortgage Department continued building a net short position, employing aggressive strategies.[1668] Mr. Birnbaum, Goldman's ABX trader, later wrote: "I concluded that we should not only get flat, but get VERY short."[1669] He wrote that he then "socialized," or discussed, his proposal with others in the Mortgage Department, and "we all agreed the plan made sense."[1670] The ABS Desk began implementing the plan by taking a very large short position in single name CDS contracts referencing RMBS and CDO securities to offset the Department's remaining ABX long position:

> "After socializing the plan with [Daniel] Sparks and ultimately [Richard] Ruzika, we implemented the plan by hitting on almost [every] single name CDO protection buying opportunity in a 2-month period. Much of the plan began working by February when the market dropped 25 points and our profitable year was underway."[1671]

By clearing the plan with Mr. Sparks and Mr. Ruzika first, SPG Trading Desk informed senior management of its intent to use the firm's capital to build the net short position. Mr. Birnbaum also wrote:

> "When we were socializing our plan to get short in the beginning of the year, I put together a tool . . . quantifying our position risk and the p&l [profit and loss] under various market level scenarios. I

[1667] 2/8/2007 email from Daniel Sparks, "Post," GS MBS-E-002201668, Hearing Exhibit 4/27-7.
[1668] Id.; see also 3/10/2007 email from Mr. Dinias to Daniel Sparks, "Mortgage Presentation to the board," GS MBS-E-013323395, Hearing Exhibit 4/27-17; 3/11/2007 email from Daniel Sparks, "Risk Changes Over Quarter," GS MBS-E-010400546, Hearing Exhibit 4/27-18; cf. 3/27/2007 Presentation to GS Board of Directors, "Subprime Mortgage Business," GS MBS-E-005565527, Hearing Exhibit 4/27-22.
[1669] 9/26/2007 2007 EMD Reviews, Joshua Birnbaum Self-Review, Hearing Exhibit 4/27-55c. In his self-review, Mr. Birnbaum provided a detailed explanation of his reasons for recommending that the SPG Desk go "VERY short": "(1) Given how much ABX we had purchased through the broker market in 2006, the world would think GS was very long for the foreseeable future. We could use that fear to our advantage if we could flip our risk, (2) After unsuccessfully trying to sell our long to some of [a Goldman salesperson's] accounts, I realized traditional distressed buyers were no more likely to buy ABX at 85, 75, 65, etc. than at 95. The cash flow was just too binary, so there would be little support if negative momentum began, (3) The fundamentals for mortgage credit were undeniably deteriorating, (4) CDO managers were in denial ... [their positive market] sentiments would allow us to amass large amounts of cheap single name protection if we desired, and (5) If the market truly tanked, the already large CDO warehouses would have to liquidate, further exacerbating the move and ultimately allowing us to cover." Id.
[1670] Id.
[1671] Id.

believe this was key for senior management to gain confidence that we were taking controlled and quantifiable risk that was well understood."[1672]

The Mortgage Department's lead trader in single name CDS contracts referencing RMBS securities, Deeb Salem, also described the plan in his 2007 performance self-evaluation:

> "Mike [Swenson], Josh [Birnbaum] and I were able to learn from our bad long position at the end of 2006 and layout the game plan to put on an enormous directional short. The results of that are obvious."[1673]

In an interview, Mr. Salem told the Subcommittee that the "obvious" results he was referring to were the desk's resulting profits.[1674]

The ABS Desk within the Structured Product Group (SPG) used CDS contracts to short RMBS and CDO securities as well as the ABX Index. The Correlation Desk within SPG used a different technique, obtaining approval to use a Goldman-designed CDO platform, Abacus, "to short structured product CDOs in bulk. The ABACUS transactions are currently one of the unique formats available to . . . [short] in large size on this type of structured product risk."[1675]

From January to late February, the Mortgage Department continued to pile on short positions in the subprime mortgage market.[1676] By the end of the first quarter in 2007, it had built a $10 billion net short position. In a later performance self-evaluation, Mr. Salem described the aggregate $10 billion net short position as "HUGE" and "enormous."[1677] A Goldman senior executive, Thomas Montag, later referred to a net short position of $3 billion in subprime mortgage backed securities as "huge and outsized."[1678] Goldman's net short position in February 2007 was more than three times that size.

1672 Id.
1673 Salem 2007 Self-Review at GS-PSI-03157 at 71-72.
1674 Subcommittee interview of Deeb Salem (10/6/2010).
1675 3/12/2007 Mortgage Capital Committee memo, "ABACUS Transaction to be Lightly-Managed by Lion Capital," at 2, GS MBS-E-002665382, Hearing Exhibit 4/27-150.
1676 See 3/10/2007 email from Mr. Dinias to Daniel Sparks, "Mortgage Presentation to the board," GS MBS-E-013323395, Hearing Exhibit 4/27-17; 3/11/2007 email from Daniel Sparks, "Risk Changes Over Quarter," GS MBS-E-010400546, Hearing Exhibit 4/27-18; 3/27/2007 presentation to GS Board of Directors, "Subprime Mortgage Business," at 8, GS MBS-E-005565527, Hearing Exhibit 4/27-22 [footnote omitted].
1677 Salem 2007 Self-Evaluation [emphasis in original].
1678 8/23/2007 email from Tom Montag, "Current Outstanding Notional SN ames," GS MBS-E-010621231.

Profiting from the First Net Short. In February 2007, Goldman's senior management decided that the $10 billion net short position had become too risky, and ordered the Mortgage Department to cover a portion of the short. Covering some of the short not only reduced the risk, but also locked in some of the profit associated with the position.

In late February 2007, the Mortgage Department's net short position, coupled with added volatility in the subprime mortgage market, caused a sharp increase in the Department's risk profile, as measured by Value at Risk or "VAR." Goldman had assigned a VAR limit of $35 million to the Mortgage Department.[1679] In November 2006, the Department's reported VAR was $13 million, well below its limit.[1680] By late February 2007, however, its VAR had reached $85 million – an increase of over 550%.[1681]

Goldman senior management closely monitored the Department's increasing VAR. On February 23, 2007, Goldman risk controllers told senior executives that the Mortgage Department's increasing VAR was "primarily driven by a combination of increased volatility in ABX market and the [SPG] desk increasing their net short risk in RMBS subprime sector."[1682] On February 14, 2007, Justin Gmelich, a managing director asked to help Mr. Sparks with the Mortgage Department on a short term basis, sent an email to Mr. Montag expressing unease with the Department's increasing risk profile:

> "Abx risk should be working to get closer to home. My opinion, singles v. short index is too big (no news here). Abx correlation trade is good. I think we should be covering a bit of our short. There is a lot to do."[1683]

Mr. Montag forwarded Mr. Gmelich's email to Goldman's Co-Presidents, Gary Cohn and Jon Winkelried, as well as to Mr. Ruzika, commenting: "clearly need to opportunistically take position down."[1684]

On February 21, 2007, senior management told Mr. Sparks to reduce the size of the Mortgage Department's $10 billion net short position by

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[1679] 2/8/2007 email from Bill McMahon, "VaR limit for Mtg SPG," GS MBS-E-009980807.
[1680] 2/23/2007 Goldman internal document, "Mortgage VaR Change (Q1'07 vs. Q4'06)," GS MBS-E-010037310, Hearing Exhibit 4/27-12; 3/8/2007 email from Jha Arbind, "Risk changes over the quarter," GS MBS-E-010400546, Hearing Exhibit 4/27-18.
[1681] Id.
[1682] 2/23/2007 Goldman internal document, "Mortgage VaR Change (Q1'07 vs. Q4'06)," GS MBS-E-010037310, Hearing Exhibit 4/27-12.
[1683] 2/14/2007 email from Mr. Gmelich to Tom Montag, GS MBS-E-016165580.
[1684] Id.

covering $3 billion.[1685] Mr. Sparks communicated the decision to personnel on the SPG Desk:

> "We need to buy back $1 billion single names and $2 billion of the stuff below [CDO securities] – today. I know that sounds huge, but you can do it – spend bid/offer, pay through the market, whatever to get it done.
>
> It is a great time to do it – bad news on HPA [housing price appreciation], originators pulling out, recent upticks in unemployment, originator pain. . . .
>
> This is a time to just do it, show respect for risk, and show the ability to listen and execute firm directives.
>
> You called the trade right, now monetize a lot of it.
>
> You guys are doing very well."[1686]

Although some SPG traders disagreed with the decision,[1687] the Mortgage Department took immediate action in response to the order. By the end of the day, February 21, 2007, Mr. Sparks reported to senior management that the ABS Desk had covered $400 million in single name CDS contracts, but had not been able to reach the $3 billion goal:

> "Market sold off significantly (BBB and BBB- indices over 100 bps wider) We covered over $400mm single names – still significant work to do. ...
>
> "We are net short, but mostly in single name CDS and some tranched index vs the some [sic] index longs. We are working to cover more, but liquidity makes it tough. Volatility is causing our VAR numbers to grow dramatically."[1688]

[1685] 2/22/2007 email from Daniel Sparks to Messrs. Birnbaum, Swenson and Lehman, "Block size tranche protection offers for Paulson or others," GS MBS-E-010381411.
[1686] Id.
[1687] Subcommittee interview of Joshua Birnbaum (4/22/2010) (Mr. Birnbaum wanted to continue to hold the short position, rather than cover it, since he thought it would earn additional profit); see also 2007 Birnbaum Self-Review, Hearing Exhibit 4/27-55c (Mr. Birnbaum wrote that he should have argued more forcefully against covering the shorts in February 2007).
[1688] 2/21/2007 email chain from Daniel Sparks, "Mortgages today," GS MBS-E-010381094, Hearing Exhibit 4/27-10. In response, Mr. Viniar wrote to Mr. Sparks: "Good start. Keep covering." 2/21/2007 email from David Viniar to Daniel Sparks, "Mortgages today," GS MBS-E-009757841. In another email, Mr. Montag wrote: "How hard are we pushing covering some of singlename. Let's not be bidoffer foolish. The downside isn't worth the upside imo." 2/21/2007 email from Tom Montag to Daniel Sparks, GS MBS-E-017237596. Mr. Sparks

Mr. Ruzika sent an email to Mr. Montag and Mr. Sparks commenting on the covering efforts:

> "I think Dan's guys are being practical. I know Bill [McMahon] was upset but covering the single name bbb and bbb- is prudent as it cuts vol and var the most. ... Guys didn't give up bid ask but they also didn't stand on the bid."[1689]

The Mortgage Department found that its single name CDS contracts were difficult to cover, in part because many of the referenced RMBS and CDO securities had already been acquired by securitizers for inclusion in CDOs and so were not for sale.[1690] That meant the SPG Trading Desk could not cover its single name short positions simply by buying the offsetting long asset – the RMBS and CDO securities were no longer available for purchase.[1691] Instead, the SPG Desk had to use offsetting CDS contracts, ones which referenced the same RMBS or CDO securities, but in which Goldman took the long side.[1692] The problem with those contracts, however, was that many market participants had already acquired short positions on RMBS and CDO securities and weren't in the market to buy more. In addition, their purchases had driven up the price of short contracts. Between market saturation and high price levels, Goldman found few buyers when it wanted to cover its shorts.[1693] The Mortgage Department's inability to cover its single name shorts concerned Messrs. Montag and Ruzika, who continued to press for quick progress.

On February 25, 2007, Mr. Sparks reported to Messrs. Montag and Ruzika on the Mortgage Department's progress after a week of effort:

> "Cover[ed] around [$]1.55 billion single name subprime BBB- CDS and about $700mm single name subprime BBB CDS. The desk also net sold over $400mm BBB- ABX index. Desk is net short, but less

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replied: "Pushing hard, but need to be realistic with respect to expectation on liquidity. Very hard to force it. Trade has been right, and should continue to run (though there will be bumps). Entire team knows we have to reduce and is focused on it." Id. Mr. Montag responded: "If you sold it in a bad market u ough[t] to be able to buy it." Id.

1689 2/22/2007 email from Richard Ruzika to Tom Montag and Daniel Sparks, GS MBS-E-010381967.

1690 Subcommittee interview of Michael Swenson (4/16/2010).

1691 Id.

1692 Id.

1693 A similar situation existed at the time in the market for commercial mortgage backed securities (CMBS). In a February email to Mr. Lehman, a CMBS trader remarked: "It's amazing that everyone was lifting [accepting bids on] cmbs 1 and 2 [CMBX indices], but NOBODY will bid single names." 2/23/2007 email from [CMBS trader] to David Lehman, "CT CDO w/ [Bank]," GS MBS-E-011270138-39 [emphasis in original].

> than before. Shorts are in senior tranches of indexes sold and in single names. Plan is to continue to trade from short side, cover more single names and sell BBB- index outright."[1694]

On February 27, 2007, Mr. Ruzika sent an email to Messrs. Montag, Gmelich, and Sparks indicating that the Mortgage Department needed to reduce its net short position by covering even more than $3 billion in shorts: "There are two issues – first is the size of the short – I want to see us getting the short down to 4.5 bil[lion] net. ... Second – the basis in the book needs to be reduced as well."[1695] Less than an hour later, Mr. Ruzika sent Mr. Sparks another email at the conclusion of a meeting of Goldman's Operating Committee (OpCom), comprised of Goldman's senior executives. In an email entitled, "OpCom Directive," Mr. Ruzika wrote:

> "Dan. Directly from the opcom we have to pick up the pace of buying back single names even if it costs us some money. I know your guys are trying but we can pay away some if it helps to get size done."[1696]

In response, Mr. Sparks immediately sent an email to Messrs. Swenson, Lehman, and Birnbaum regarding the "Opcom directive." He wrote: "Buyback single names in size today."[1697] He also sent the SPG and CDO Desk managers a set of "Goals":

> "Reduce risk. That means:
> (1) get m[o]re super-seniors done on CDOs or take other steps to reduce CDO pipeline risk;
> (2) cover more single name shorts BBB- and BBB
> (3) reduce the basis trade between BBB- index and BBB- single names
> (4) reduce the index/index trades in A and AAA."[1698]

Mr. Sparks' list of goals showed that he was closely tracking the SPG Desk's activities and directed them to reduce rather than eliminate its basis and index trades.

[1694] 2/25/2007 email from Daniel Sparks to Tom Montag, "Questions you had asked," GS MBS-E-010987763.
[1695] 2/27/2007 email from Richard Ruzika to Tom Montag, Justin Gmelich, and Daniel Sparks, GS MBS-E-002204942.
[1696] Id.
[1697] 2/27/2007 email from Daniel Sparks, "Opcom Directive," GS MBS-E-017250218.
[1698] 2/27/2007 email from Daniel Sparks, "Goals," GS MBS-E-010387086, Hearing Exhibit 4/27-11.

At the end of February, the Mortgage Department's efforts got a substantial boost when a new hedge fund client, Harbinger, purchased the short side of $4 billion in single name CDS contracts referencing RMBS securities.[1699] By taking the long side in those contracts, the Mortgage Department was able to cover its shorts by the same amount.

On February 28, 2007, Mr. Sparks reported at a Firmwide Risk Committee meeting on the Mortgage Department's progress in reducing its VAR.[1700] The committee minutes reflect that Mr. Sparks' report stated the following:

> "–VaR up due to vols. Business working to reduce exposures; a lot of shorts already covered.
> –ABX widened 500bp on the week. Business covered $4BN in single names.
> –Noted a lot of negative news in the subprime market with rumors on everyone.
> –CDS on CDOs started to widen significantly over the week. ...
> –Business continuing to clear out loans."[1701]

Five days later, on March 5, 2007, Mr. Montag requested another update: "Do we think the business is net short, long or flat right now?" Mr. Sparks responded: "We think the overall business is net short." Mr. Gmelich added: "I think we have a very modest short across all the businesses at current market levels. I concur with Dan."[1702]

[1699] See, e.g., 2/22/2007 Goldman internal emails, GS MBS-E-018938493, GS MBS-E-018940734; 2/27/2007 email from Michael Swenson to Bill McMahon, GS MBS-E-012502371 ("Bought 1.5bb of sn baa3 risk from harbinger."); 3/1/2007 email from Daniel Sparks, "SN Protection Offers for Harbinger (50 names)," GS MBS-E-019460848 ("Trade was executed at +725 "); 3/3/2007 email to Michael Swenson and Daniel Sparks, "Harbinger Update," GS MBS-E-010707216. As a result, Harbinger became Goldman's largest hedge fund counterparty credit risk: "Harbinger is our #1 hedge fund exposure globally. We had to explain this to the SEC this month." 4/20/2007 Goldman internal email, "Harbinger didn't add the last piece we had spoke of, but are now thinking of adding ~50mm," GS MBS-E-012523933. Harbinger was also instrumental in Goldman's second round of short covering efforts in August 2007. See, e.g., 7/30/2007 email to Michael Swenson, "Harbinger Single-A Offerings.xls," GS MBS-E-012374026; 8/23/2007 email from Michael Swenson, "Harbinger Post," GS MBS-E-009739009.

[1700] 2/28/2006 Goldman internal memorandum, "Firmwide Risk Committee: February 28th FWR Minutes, "GS MBS-E-009687468, Hearing Exhibit 4/27-13 [sic - correct year is 2007].

[1701] Id. See also 2007 Swenson Self-Review ("we prudently covered $5bb of single-name shorts at the all time lows at the time back in February"), Hearing Exhibit 4/27-55b.

[1702] 3/5/2007 email from Tom Montag, GS MBS-E-010393092. Goldman COO Gary Cohn expressed concern that a positive move in the markets would cause the Mortgage Department to incur large losses due to its net short: "A big plus would hurt the Mortgage business but Justin [Gmelich] thinks he has a big trade lined up for the morning to get us out of a bunch of our short risk." 3/5/2007 email from Gary Cohn, GS MBS-E-009656525, Hearing Exhibit 4/27-15. The big trade referred to by Mr. Cohn was one of the Harbinger trades that enabled Goldman to cover $4 billion of its single name CDS short positions.

The Mortgage Department's efforts to cover its $10 billion net short position reduced its VAR; it also allowed the Department to lock in and record large profits from its net shorts. In March 2007, in connection with Goldman's quarterly earnings call with analysts, "Mortgage Talking Points" prepared for Mr. Viniar stated that the Department's revenues were primarily the result of its short positions:

> "The Mortgage business' revenues were primarily driven by synthetic short positions concentrated in BBB/BBB- sub prime exposure and single A CDO exposure which benefitted from spread widening."[1703]

At the end of the first quarter of 2007, the Mortgage Department reported total net revenues of $368 million.[1704]

The Mortgage Department continued its efforts to cover the rest of its short position. On March 14, 2007, Mr. Sparks reported to Messrs. Cohn and Montag that a Goldman salesperson "did a fantastic job for the desk by bringing in $1.2BB [billion] in A-rated single names today."[1705] Mr. Montag in turn reported to Goldman CEO Lloyd Blankfein: "Covered another 1.2 billion in shorts in mortgages–almost flat–now need to reduce risk."[1706]

That same day, March 14, 2007, in response to his request, the Mortgage Department sent Mr. Ruzika a detailed breakdown of its subprime mortgage holdings.[1707] It disclosed that, despite offsetting short and long positions in a number of areas, the SPG Desk still held three sizeable net short positions involving about $2.6 billion in ABX assets, $2.2 billion in single name CDS contracts, and $2 billion in mezzanine CDOs.[1708]

[1703] 3/9/2007 email to David Viniar, "Mortgage Talking Points for Earnings Call," GS MBS-E-009762678, Hearing Exhibit 4/27-16.
[1704] 9/17/2007 Presentation to GS Board of Directors, Residential Mortgage Business at 5, GS MBS-E-001793840, Hearing Exhibit 4/27-41.
[1705] 3/17/2007 email from Daniel Sparks and Tom Montag, "Cactus Delivers," GS MBS-E-009632839.
[1706] Id. Mr. Montag's comment suggests that he may have wanted the Mortgage Department to reduce the size of both its longs and shorts to reduce its overall risk, or to reduce its basis risk, the risk that arises when two different types of assets are used to offset one another, and the assets are imperfectly matched.
[1707] 3/14/2007 email from David Lehman, "ABS Trading - Subprime risk," GS MBS-E-010397102.
[1708] Id.

Goldman personnel prepared the following chart tracking the SPG Trading Desk's efforts to cover its BBB and BBB- net short position from February through mid-May 2007.[1709]

> [SEE CHART NEXT PAGE: *Notionals (ABX convention)*, prepared by Goldman Sachs, reformatted by the Permanent Subcommittee on Investigations to be readable in black and white print, GS MBS-E-012890600.]

AAA Disaster Insurance. Despite all the attention paid to the Mortgage Department's subprime mortgage holdings beginning in December 2006, one large short position seemed to have escaped the directives of senior management in the first quarter of 2007 to cover the Department's shorts. It consisted of a massive $9 billion net short position made up of CDS contracts referencing an ABX index that tracked a basket of 20 AAA rated subprime RMBS securities.[1710] Goldman representatives could not recall when that short position was acquired, who acquired it, or whether proprietary funds were used,[1711] but the CDS contracts appear to have been held at a relatively constant level of $9 billion from some time in 2006 until July 2007.[1712] Mr. Sparks told the Subcommittee that the net short position served as a form of low cost "disaster insurance" that would pay off only in a "worst case" scenario – when even the top tier AAA rated RMBS securities, among the safest of all subprime mortgage investments, lost value.[1713]

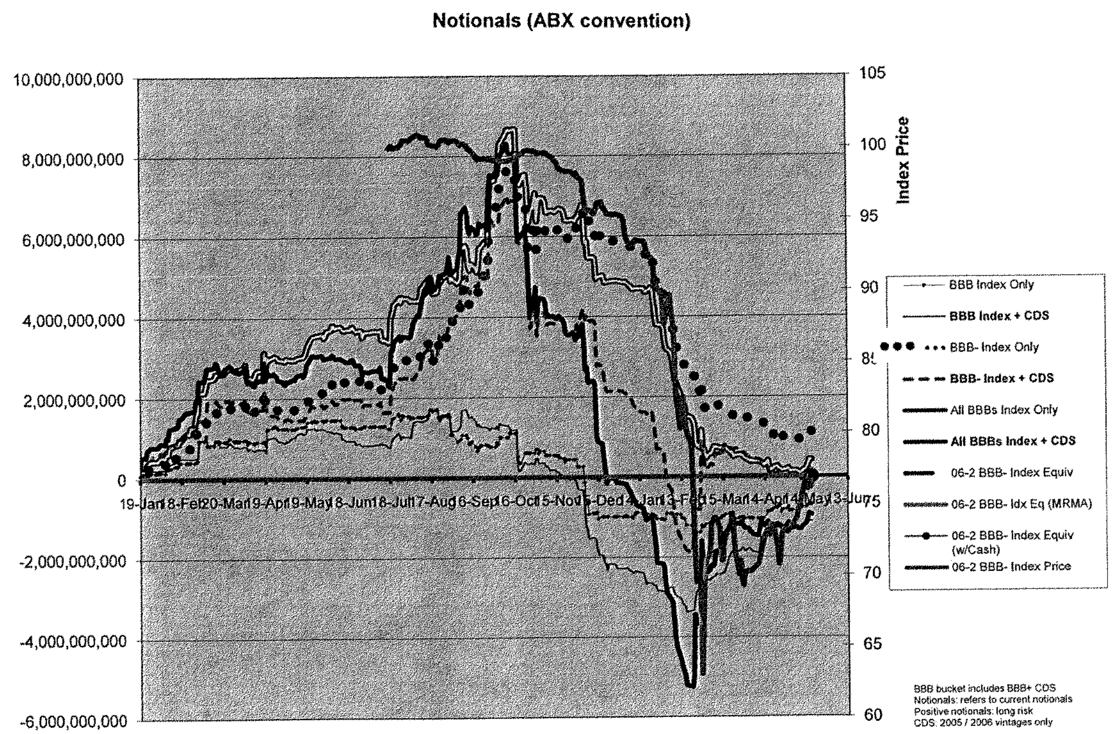
[1709] See "Notionals (ABX convention)," chart attached to 5/23/2007 email from Kevin Kao to Joshua Birnbaum, "RMBS Subprime risk history as of 18May07," GS MBS-E-012890599.

[1710] See, e.g., 3/8/2007 email from Mr. Sparks, "Mortgage Risk," GS MBS-E-002206279, Hearing Exhibit 4/27-75 (noting Mortgage Department's $9 billion short position on the AAA ABX index).

[1711] Subcommittee interview of Daniel Sparks (4/15/2010), David Lehman (4/12/2010), Joshua Birnbaum (4/22/2010), and Michael Swenson (4/16/2010).

[1712] See chart entitled "Goldman Sachs Mortgage Department Total Net Short Position, February-December 2007 in $ Billions," prepared by the Subcommittee, April 2010, updated January 2011, derived from Goldman Mortgage Strategies and Mortgage Department Top Sheets.

[1713] Subcommittee interview of Daniel Sparks (10/3/2010).



Prepared by the U.S. Senate Permanent Subcommittee on Investigations, February 2011.
Derived from Goldman Sachs document, GS MBS-E-012890600.

The most comprehensive description of the AAA ABX short position located by the Subcommittee was a chart prepared by a Mortgage Department analyst in August 2007. The analyst sent the chart to Mr. Birnbaum at his request, to show the Mortgage Department's overall position in synthetic products, including CDS contracts referencing ABX, RMBS, and CDO assets.[1714] The chart includes the AAA ABX short position as a long, nearly flat line showing an approximately $9 billion net short until early July 2007, when the value turned sharply upward.[1715] The analyst wrote in an August email, after much of the AAA ABX net short position had been covered: "M[ortgage] department is short ABX AAA [$]8.7b[illion], splitting among ABS/Alt A/prime/conduit in the beginning of fiscal year 2007, and is now long [$]410m[illion]." While this chart and the covering email do not reveal the origin of the AAA short, they indicate that, by early 2007, it was split between the ABS Trading Desk in the Structured Product Group and three desks in Mr. Gasvoda's Residential Whole Loan Trading area – the Alt A Trading Desk under Genevieve Nestor, the Prime Trading Desk under Clay DeJacinto, and the Conduit for conducting subprime loan pool securitizations under Matt Nichols.

Goldman emails provide additional information about the AAA ABX short. One series of emails, from March 2007, indicates that about $8 billion of the $9 billion AAA short was then held by the three desks in Mr. Gasvoda's Residential Whole Loan Trading area, and that he favored maintaining the short, because it provided billions of dollars in coverage and cost only $5 million per quarter in premiums to maintain. On March 4, 2007, Mr. Gasvoda emailed Mr. Sparks with "Quick Thoughts on ABX AAA risk":

> "I talked to [Matt] Nichols and Clay [DeJacinto] about the AAA ABX short. Think it offers a good amount downside protection w/ relatively light pain if we're wrong. Below is a $8B ABX AAA short #s. It costs us $5mm/quarter to carry. On the downside, if the

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[1714] 8/17/2007 Goldman internal chart, "RMBS Subprime Notional History (Mtg Dept.)," GS MBS-E-012928391, Hearing Exhibit 4/27-56a. The analyst's cover email stated: "The attached spreadsheet covers the single name and ABX positions of the entire mortgage department for the fiscal year 2007. I spot checked the numbers with risk reports they tie out well." See also 8/17/2007 email from Joshua Birnbaum, GS MBS-012928388, Hearing Exhibit 4/27-56b.
[1715] When shown the chart during his interview, Mr. Sparks told the Subcommittee he was unfamiliar with it and pointed what he believed to be an anomaly related to its depiction of the Mortgage Department's short position involving BBB rated RMBS securities. He also indicated that he could not confirm its depiction of the AAA ABX short position. Since multiple Goldman email messages confirm the existence of the AAA ABX short position during most of Goldman's fiscal year 2007, however, the chart's depiction of that position as a nearly flat line at about $9 billion short until July 2007 appears consistent with the other evidence.

market rallies to par ... we drop $50mm. Taking it to 0 spread we lose $80mm.

"On the upside front, we get good jump risk. If AAA's widen to current AA levels ... we gain $70mm and if spreads move up to super senior risk pricing in CDOs ... we're up $190mm.

"Net, think this is a good position to have on given downside protection and relatively light upside pain. If we get an opportunity to buy some back next week, think we should but I'm thinking buy back $1-2B, not $8B."[1716]

Mr. Sparks replied to Mr. Gasvoda: "Good trading response and thought process. We need to consider daily."[1717]

The next day, March 5, 2007, the Residential Whole Loan Trading Desk under Mr. Gasvoda and the CDO Origination Desk under Peter Ostrem exchanged information about the "ABX hedges" that each business was carrying to reduce the risk associated with its respective long assets.[1718] The Residential Whole Loan Trading Desk reported: "[b]elow are all our ABX hedges across our Resi Credit + Prime books," which included approximately $7 billion in AAA ABX holdings.[1719] The CDO Origination Desk, in turn, reported holding another $2.25 billion in AAA ABX "hedges."[1720] A few days earlier, with respect to the CDO Origination Desk's holdings, Mr. Egol had remarked: "Love that huge AAA abx short."[1721]

Although the $7 billion figure reported by Mr. Gasvoda's group on March 5 was $1 billion less than the $8 billion reported the day before,[1722]

[1716] 3/4/2007 email from Kevin Gasvoda to Daniel Sparks, "Quick thoughts on ABX AAA risk," GS MBS-E-010398072.
[1717] Id. Despite Mr. Gasvoda's suggestion that he might try to cover a portion of the $8 billion net short, the AAA ABX short position in Mr. Gasvoda's area appears to have remained unchanged until around July 2007. 8/17/2007 Goldman internal chart, "RMBS Subprime Notional History (Mtg Dept.)," GS MBS-E-012928391, Hearing Exhibit 4/27-56a.
[1718] Goldman's hedging practice was that each desk was responsible for its own hedges. Accordingly, different desks would not necessarily share information about their respective hedges, even if both were hedging with the same product, such as an ABX short.
[1719] 3/5/2007 email from Cyrus Pouraghabagher, "ABX hedges for Resi businesses," GS MBS-E-012085546.
[1720] Id.
[1721] 2/28/2007 email from Jonathan Egol to Fabrice Tourre, "Hedges Status Report," GS MBS-E-002628642.
[1722] The report from Mr. Gasvoda's group may have inadvertently omitted a particular loan book that was holding the additional $1 billion in hedges, the figure may be a typographical error, or the group may have chosen not to disclose some of its hedges. The Goldman personnel interviewed by the Subcommittee were unable to explain the discrepancy.

and the $2.25 billion reported by the CDO Origination Desk was larger than the $1 billion that the August 2007 email later ascribed to the Structured Product Group, all of the evidence indicates that Goldman had a massive AAA ABX short position in 2007. A few days later, on March 8, 2007, in an email to senior management entitled, "Mortgage Risk," Mr. Sparks described the AAA ABX short as a hedge against long positions in the Department's loan books and CDO warehouse accounts:

> "[O]verall the department has significant shorts against loan books and the CDO warehouse. The bulk of these shorts ($9BB) are on the AAA index, so the downside is limited as the index trades at 99."[1723]

In this email to senior executives, Mr. Sparks put the size of the AAA ABX short at $9 billion, which seems to have been the amount most commonly cited for the short.[1724]

When asked about the Gasvoda email which described the AAA ABX short as an inexpensive "jump risk,"[1725] Mr. Sparks told the Subcommittee that the email was referring to acquiring "jump insurance" against a sudden, huge loss arising from the total default of an asset.[1726] In this context, the short was acquired as insurance against the unlikely event that a significant portion of the AAA rated RMBS securities identified in the ABX Index defaulted simultaneously.[1727] Since AAA rated RMBS securities were typically the safest of the RMBS securities offered for sale, it was widely believed in 2006 and 2007, that they would remain untouched even if defaulting mortgages harmed riskier RMBS securities. By shorting AAA rated RMBS securities, Goldman was insuring against a "tail risk" – the risk of an event that appeared to have a very small probability of ever actually occurring, but which was likely to cause catastrophic losses if it did occur. Mr. Sparks also explained that, since the subprime mortgage industry considered losses in AAA rated RMBS

1723 3/8/2007 email from Daniel Sparks, "Mortgage Risk," GS MBS-E-002206279, Hearing Exhibit 4/27-75.

1724 Id. See also 8/23/2007 email from Tom Montag to Lloyd Blankfein, GS MBS-E-009585951, Hearing Exhibit 4/27-37 (Mortgage Department "bought back 9 billion of AAA abx index over last two weeks."); 8/23/2007 email from Tom Montag to Gary Cohn and David Viniar, "Harbinger Post," GS MBS-E-009739009.

1725 3/4/2007 email Kevin Gasvoda to Daniel Sparks, "Quick thoughts on ABX AAA risk," GS MBS-E-010398072 (" we get good jump risk . . . Net, think this is a good position to have on given downside protection and relatively light upside pain.").

1726 Subcommittee interview of Daniel Sparks (4/15/2010).

1727 Id.

securities to be exceedingly unlikely, the price of acquiring and holding such a short position was relatively inexpensive.[1728]

From the time the $9 billion AAA ABX short was acquired in 2006 until July 2007, it was not included in Goldman senior management's directives to cover shorts, and it does not appear to have been part of the Mortgage Department's efforts to get "closer to home," build a net short position in early 2007, or cover that net short in February and March.[1729] The $9 billion AAA ABX short may have been left out of management's directives on the first net short, because it was serving as a hedge for long subprime mortgage assets held by several Mortgage Department desks.[1730] As those long assets were sold or written down, however, no apparent steps were taken to unwind or remove the $9 billion AAA ABX hedge.[1731] By June 2007, it remained almost entirely intact as a net short. The value, cost, and risk associated with the AAA ABX short had been monitored, but not acted upon, until the short suddenly began approaching profitability and began contributing to high VAR levels for the Mortgage Department. It then drew the attention of Goldman senior management which included the AAA ABX short in its directive to cover the firm's second big net short. Covering the AAA ABX net short contributed to the multi-billion-dollar profits realized by Goldman in the third and fourth quarters of 2007.

Report To Board. On March 26, 2007, Mr. Sparks and Goldman senior executives gave a presentation to Goldman's Board of Directors regarding the firm's subprime mortgage business.[1732] The presentation recapped for the Board the various steps the Mortgage Department had

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[1728] Id.

[1729] See 8/17/2007 Goldman internal chart, "RMBS Subprime Notional History (Mtg Dept.)," GS MBS-E-012928391, Hearing Exhibit 4/27-56a.

[1730] The AAA ABX short appears to have served as a hedge for long assets in the Whole Loan and CDO Origination areas in March 2007. Many of those assets were sold during the spring and summer of 2007. If a hedged asset is sold, the hedge is ordinarily unwound commensurately. See, e.g., 5/30/2007 email from David Lehman, "ABX hedges – Buy order," GS MBS-E-011106690 (directing the unwinding of certain short ABX hedges held against the CDO Origination Desk when the CDO positions were transferred to another desk).

[1731] See 8/17/2007 Goldman internal chart, "RMBS Subprime Notional History (Mtg Dept.)," GS MBS-E-012928391, Hearing Exhibit 4/27-56a.

[1732] 3/26/2007 Goldman presentation to Board of Directors, "Subprime Mortgage Business," GS MBS-E-005565527, Hearing Exhibit 4/27-22. While the final version of the presentation indicated Goldman had an overall net long position in subprime assets by about $900 million, a near-final draft of the presentation indicated that Goldman had an overall net short position of $2.8 billion. 3/16/2007 draft presentation to Board of Directors by Daniel Sparks, "Subprime Mortgage Business," GS MBS-E-002207710. The primary difference between the two figures appears to be the inclusion in the final version of Goldman's net long holdings of Alt A mortgages, even though Alt A assets are not usually considered to be subprime mortgages. Subcommittee interview of David Viniar (4/13/2010).

taken since December 2006, in response to the deterioration of the subprime mortgage market.[1733] The presentation noted, among other measures, the following steps:

"• GS reduces CDO activity
• Residual assets marked down to reflect market deterioration
• GS reverses long market position through purchases of single name CDS and reductions of ABX
• GS effectively halts new purchases of sub-prime loan pools through conservative bids
• Warehouse lending business reduced
• EPD [early payment default] claims continue to increase as market environment continues to soften."[1734]

By the time this presentation was given to the Board of Directors, Goldman's Mortgage Department had swung from a $6 billion net long position in December 2006, to a $10 billion net short position in February 2007, and then acted to cover much of that net short. Despite having to sell billions of dollars in RMBS and CDO securities and whole loans at low prices, and enter into billions of dollars of offsetting long CDS contracts, Goldman's mortgage business managed to book net revenues for the first quarter totaling $368 million.[1735]

In a section entitled, "Lessons Learned," the presentation stated: "Capital markets and financial innovation spread and increase risk,"[1736] an acknowledgment by Goldman that "financial innovation," which in this context included ABX, CDO, and CDS instruments, had magnified the risk in the U.S. mortgage market.

(c) Attempted Short Squeeze

In May 2007, Goldman's Structured Product Group (SPG) continued to work to cover the Mortgage Department's short position by offering to take the long side of CDS contracts referencing RMBS and CDO securities, but found few buyers. Many market participants had already shorted subprime mortgage assets, driving the price relatively high, and few wanted to buy additional short positions at the prevailing price. In order to turn the situation to its benefit, SPG's traders attempted

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[1733] Id. at 4.
[1734] Id. at 8 [footnotes defining CDO and CDS omitted].
[1735] 9/17/2007 Presentation to Goldman Sachs Board of Directors, Residential Mortgage Business, at 5, GS MBS-E-001793840, Hearing Exhibit 4/27-41.
[1736] 3/26/2007 Goldman Sachs presentation to Board of Directors, "Subprime Mortgage Business," GS MBS-E-005565527, Hearing Exhibit 4/27-22.

to carry out a "short squeeze" of the subprime CDS market in May 2007.[1737]

The ABS Desk's traders were already offering single name CDS contracts in which Goldman would take the long position, in order to cover the Mortgage Department's short position.[1738] To effectuate a short squeeze, they appear to have decided to offer the short positions on those contracts at lower and lower prices, in order to drive down the market price of subprime CDS shorts to artificially low levels. Once prices fell below what the existing CDS holders had paid for their short positions, the CDS holders would have to record a loss on their holdings and might have to post additional cash collateral with their opposing long parties. Goldman hoped the CDS holders would react by selling their short positions at the lower market price. When the sell off was large enough and the price low enough, Goldman planned to move in and buy more shorts for itself at the artificially low price.

This short-squeeze strategy was later laid out in a 2007 performance self-evaluation by one of the traders on Goldman's ABS Desk who participated in the activity, Deeb Salem. In the self-evaluation he provided to senior management, Mr. Salem wrote:

> "In May, while we were remain[ing] as negative as ever on the fundamentals in sub-prime, the market was trading VERY SHORT, and susceptible to a squeeze. We began to encourage this squeeze, with plans of getting very short again, after the short squeezed [sic] cause[d] capitulation of these shorts. This strategy seemed do-able and brilliant, but once the negative fundamental news kept coming in at a tremendous rate, we stopped waiting for the shorts to capitulate, and instead just reinitiated shorts ourselves immediately."[1739]

When interviewed by the Subcommittee, Mr. Salem denied that the ABS Desk ever intended to squeeze the market, and claimed that he had wrongly worded his self-evaluation.[1740] He said that reading his self-evaluation as a description of an intended short squeeze put too much emphasis on "words."[1741]

[1737] See, e.g., Salem 2007 Self-Review.
[1738] See, e.g. 4/5/2007 email from Deeb Salem, "let's sell ~200mm in Baa2 protection . . .," GS MBS-E-004516519 (Mr. Swenson's reply: "Make that 500mm").
[1739] Deeb Salem 2007 Self-Review [emphasis in original].
[1740] Subcommittee interview of Deeb Salem (10/6/2010).
[1741] Id.

Mr. Salem's description of an attempted short squeeze by Goldman's Structured Product Group is supported by other evidence. In May 2007, Michael Swenson, the head of both SPG and ABS Desks and Mr. Salem's supervisor, wrote emails that appear to confirm the attempted short squeeze. In the first email, dated May 25, 2007, Mr. Swenson wrote:

> "We should be offering sn [single name] protection down on the offer side to the street on tier one stuff to cause maximum pain."[1742]

Four days later, on May 29, 2007, Mr. Swenson followed up with another email:

> "We should start killing the sn [single name] shorts in the street – let's pick some high quality stuff that guys are hoping is wider today and offer protection tight – this will have people totally demoralized."[1743]

When asked about these emails, Mr. Swenson also denied that Goldman had attempted to squeeze the CDS short market. He claimed that the cost of single name CDS shorts had gone too high, and the purpose behind Goldman's actions was to restore balance to the market.[1744] Mr. Swenson could not explain, however, why in an effort to restore balance to the market, he used the phrases "cause maximum pain," and "this will have people totally demoralized."

Goldman documents show there was a plan and an attempt to conduct a short squeeze, despite the harm that might be caused to Goldman's clients. Contemporaneous emails further show that clients were complaining about a sudden markdown by Goldman in the value of their short positions, especially compared to prevailing market prices and the worsening of the subprime market itself.[1745]

On May 18, 2007, a Friday, the ABS Desk marked down the value of many of its clients' CDS short positions. On Monday, May 21, Mr.

[1742] 5/25/2007 email from Michael Swenson to Edwin Chin and Deeb Salem, GS MBS-E-012443115.
[1743] 5/29/2007 email from Michael Swenson to Deeb Salem, "they want to think about doing this again," GS MBS-E-012561798.
[1744] Subcommittee interview of Michael Swenson (10/8/2010).
[1745] Goldman's CDS collateral agreements were usually bilateral, meaning collateral could flow either way, to the short or long party, depending upon price movements in the underlying assets. Subcommittee interview of Michael Swenson (10/18/2010). Clients wrote emails to Goldman questioning how they could owe collateral on CDS contracts they had only recently purchased from Goldman.

Salem sent an email to Mr. Swenson and Edwin Chin entitled, "A few things . . . pain-related."[1746]

> "Guys r gonna complain about their marks [hedge fund] already emailed me. I would talk about the recent flow of OWICS [offers] and the levels ... they have been trading as the reason we moved marks on Friday. ... [Another customer] lost 6 pct based on fridays moves."[1747]

That same day, a Goldman sales representative sent Mr. Chin a complaint from a hedge fund customer named Stanfield Capital regarding the lower values assigned to its CDS short positions. The sales representative wrote:

> "Stanfield feels we are marking them tighter than other dealers with whom they have similar protection. ...
>
> In addition, 14 of the 25 names below were marked over 100 bps [basis points] tighter week-on-week. That is a massive move and is creating major stress at the clients, as we can't see a similar move in the broader market. ...
>
> Finally, be aware that Stanfield may look for you to offer protection very close to your mark. ... I'm hoping your attention to the marks below will defuse a situation in which they think we're messing with them via our marks on their protection."[1748]

Mr. Chin forwarded the email to Mr. Swenson and Mr. Salem. Mr. Swenson replied: "We are ok with that they do not have much more gun powder."[1749] Mr. Swenson's response suggested that Goldman did not have to be concerned about Stanfield's threat to buy CDS shorts at the same low price Goldman had applied to his CDS holdings, since Stanfield did not have the financial resources – the "gun powder" – to make a large purchase.

On May 24, 2007, the Stanfield trader wrote to Goldman that he had thought the purchase of the CDS contract signaled the beginning of a partnership between Stanfield and Goldman, but he had lost credibility

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[1746] 5/21/2007 email from Deeb Salem to Michael Swenson and Edwin Chin, "A few things pain-related," GS MBS-E-021887795 [ellipses in original].
[1747] Id.
[1748] 5/21/2007 email to Edwin Chin, "Edwin–Important–Stanfield levels," GS MBS-E-012570169.
[1749] Id.

with his company because of the CDS contracts and expressed concern that he may have been "naive to trust the pitch" from Goldman:

> "When we put on the Single A protection trade the underlying names were suppose[d] to have a large similarity to the index. ... The indexes are up only a couple of points since we did the trade. Looking at the mid's on our Single A trades we have tightened roughly 33%. ... I'm just trying to figure out how we can reverse some of the losses we have incurred.
>
> Also, from where our BBB trade was marked last Friday ... [t]his trade is tighter by 35% as well. ...
>
> I had always thought that these trades were meant to be the start of a partnership building of future business between Stanfield and Goldman Sachs. I know we are big boys and we did the trade there is no doubt of that. What I am attempting to do is either cut our losses and get out or determine what I can say to keep this trade on .... I've lost a lot of credi[b]ility on the desk with this trade. Maybe I was naive to trust the pitch on the trade. It has cost me a lot."[1750]

A week later, on May 31, 2007, Stark Investments indicated interest in buying a short on certain RMBS securities backed by home equity loans. The Goldman sales representative trying to close the sale emailed SPG personnel that the client was hesitating due to Goldman's valuations which were "drastically different" from other dealers:

> "Stark has an interest in looking at this trade; but there is an obstacle we need to address: They feel Goldman is very inconsistent in the single name HEL [Home Equity Loan] CDS marks that we provide them. We are drastically different in marking positions versus other dealers. It is an annoyance that would potentially limit their interest in putting on incremental CDS trades. I can name specific examples if you would like. Please advise."[1751]

[1750] 5/24/2007 email from Stanfield, "Our thoughts on single-name RMBS CDS," GS MBS-E-012891722.
[1751] 5/31/2007 email from sales to Edwin Chin and Deeb Salem, "Stark CDO CDS potential trade 5/31," GS MBS-E-012443662.

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Mr. Salem replied: "you couldn't be more wrong," while Mr. Swenson replied:

> "Frankly, we believe we are best in class and have numerous data from controllers, collateral posting and markit (the company, not market) that reflect upon this. This process is thoroughly reviewed by all levels of senior management at GS. ...
>
> "Unlike other dealers we stand by our marks and are willing to transact in the context of our marks. ...
>
> We also don't mark our book wide if we are long protection and tight if we are short. [W]e mark to market."[1752]

When the salesman replied: "I am trying to work with you guys," Mr. Swenson chided him: "You need to manage their opinions on marks – that has been fully vetted over here."[1753]

On June 7, 2007, Mortgage Department personnel learned that two Bear Stearns hedge funds specializing in subprime mortgage assets were in financial distress.[1754] In response, the ABS Desk immediately decided to buy more shorts at the prevailing market price to take advantage of the possible collapse of the Bear Stearns hedge funds, which would send subprime mortgage prices still lower. To do so meant the ABS Desk had to sacrifice its "short squeeze" play. On June 7, 2007, Mr. Salem emailed Messrs. Swenson and Chin:

> "We need to go to magnetar [a hedge fund] and see if we can buy a bunch of the cdo protection. ... Can tell them we have a protection buyer, who is looking to get into this trade now that spreads have tightened back in."[1755]

[1752] Id.; see also, e.g., "Valuation & Pricing Related to Transactions with AIG," prepared by Goldman in response to inquiry by the Financial Crisis Inquiry Commission, GS MBS 0000039096.

[1753] 5/31/2007 Goldman email chain, "Stark CDO CDS potential trade 5/31," GS MBS-E-012443675. Mr. Swenson made no mention of his email from two days earlier in which he recommended lowering CDS values to "have people totally demoralized." 5/29/2007 email from Michael Swenson to Deeb Salem, GS MBS-E-012561798.

[1754] 6/7/2007 Goldman internal email chain, "BSAM Post," GS MBS-E-011184213.

[1755] 6/7/2007 email from Deeb Salem to Michael Swenson and Edwin Chin, GS MBS-E-012444252.

Raising no concerns about the proposed deception, Mr. Swenson replied "Great idea."[1756] Mr. Salem continued:

> "Should we also send an email to select sales people in the mtg [mortgage] sales force saying that we r looking to buy a block of single name protection vs a cdo OUT OF COMP [in a private, off-market transaction]? It's a no lose situation . . . either we get some sn [single name] protection that we want or we gave these guys a chance and nobody can say we aren't working with them."[1757]

Mr. Swenson responded: "We need to be careful." Mr. Chin wrote that he knew of another CDO collateral manager that might also be willing to sell some shorts: "I mentioned there was a hedge fund on the side and he was very axed to do something."[1758]

Having decided to start buying shorts outright, the ABS Desk also stopped offering to sell CDS short positions to Goldman customers, effectively abandoning the attempted short squeeze. On June 8, 2007, Mr. Swenson told his traders: "[w]ant to slow down on protection offers."[1759] On June 10, 2007, in response to a customer inquiry about a CDS short, Mr. Salem wrote: "Not sure if we have any to offer any more."[1760] Mr. Swenson was less equivocal: "Really don't want to offer any."[1761] On June 13, 2007, a Goldman salesman emailed SPG personnel: "[Customer] is looking to buy protection on cdos."[1762] Mr. Salem replied: "too late!"

Once it began buying CDS shorts, the SPG Desk immediately changed its CDS short valuations and began increasing their value. Clients with long positions began to complain that the marks were too high, and internal Goldman business units also raised questions. For example, on June 11, 2007, a Goldman valuation specialist sent an email to Mr. Swenson, with copies to Compliance and the Controller's Office noting that "Client challenging marks," followed by "Trading has agreed to change ... marks."[1763] The next day, June 12, 2007, a Goldman representative from the Controller's Office sent an email to Mr. Salem,

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1756 Id.
1757 Id.
1758 Id.
1759 6/8/2007 email from Michael Swenson to Benjamin Case, Edwin Chin, and Deeb Salem, "CDO CDS protection offers," GS MBS-E-012551726.
1760 6/10/2007 email from Michael Swenson to Deeb Salem, Edwin Chin, and salesman, "CDSs on CDOs," GS MBS-E-012551460.
1761 Id.
1762 6/13/2007 email from sales, "CDO protection," GS MBS-E-012445931.
1763 6/11/2007 Goldman email chain, "Please advise – Client challenging marks," GS MBS-E-018947548.

asking: "Given recent gyrations in the ABX and CDS markets, when can I come by to discuss how you are marking the book tonight?"[1764] The following week, on June 19, 2007, the Controller's office sent an email to Mr. Swenson raising questions about values assigned to certain CDS contracts: "These levels look quite wide. Do you have any specific market color that points this direction?"[1765]

The May 2007 attempted short squeeze described in Mr. Salem's performance self-evaluation did not succeed in compelling existing CDS holders to sell their short positions. In Subcommittee interviews, Mr. Salem and Mr. Swenson denied that an attempted short squeeze even took place. Any attempt that did take place was apparently abandoned in June 2007, when Goldman stopped offering to sell CDS short positions. Trading with the intent to manipulate market prices, even if unsuccessful, is a violation of the federal securities laws.[1766] Given the novelty of credit default swaps and their use in the mortgage field, however, the Subcommittee is unaware of any enforcement action or case applying an anti-manipulate prohibition to the CDS market. Because Goldman is a registered broker-dealer subject to the supervision of the Financial Industry Regulatory Authority (FINRA), the conduct of its ABS traders raises questions about their compliance with FINRA's Rule 2010, which provides: "A member, in the conduct of his or her business, must observe high standards of commercial honor and just and equitable principles of trade."

(d) Building the Big Short

In the months of June and July 2007, Goldman's Mortgage Department went short again. This time, it built an even larger net short position than earlier in the year, reaching a peak of $13.9 billion in late

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[1764] 6/12/2007 email from controllers, "CDS," GS MBS-E-012445404.

[1765] 6/19/2007 email from controllers, "A3 subprime bonds in transition account," GS MBS-E-012458169. Mr. Swenson replied: "Tier 4 bonds talk to Deeb [Salem]."

[1766] See Markowski v. SEC, 274 F.3d 525, 527-28 (D.C. Cir. 2001) (Congress determined that "'manipulation' may be illegal solely because of the actor's purpose"); In re IPO Litigation, 241 F. Supp. 2d 281, 391 (S.D.N.Y. 2003) (no additional requirements aside from manipulative intent); H.R. Rep. No. 1383, 73rd Cong., 2d Sess. 20 (1934) (under Securities Exchange Act, "if a person is merely trying to acquire a large block of stock for investment, or desires to dispose of his holdings, his knowledge that in doing so he will affect the market price does not make his actions unlawful. His transactions become unlawful only when they are made for the purpose of raising or depressing the market price."); but see GLF Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 205 (3d Cir. 2001) (requiring, in addition to manipulative intent, "that the alleged manipulator injected inaccurate information into the market or created a false impression of market activity"). Single name CDS contracts referencing RMBS and CDO securities appear to qualify as "security-based swap agreements" subject to anti-manipulation and anti-fraud prohibitions under the federal securities laws.

June,[1767] which Mr. Viniar later referred to as "the big short."[1768] This net short position included the $9 billion AAA ABX short which had suddenly begun gaining value as the subprime market worsened. In June, two Bear Stearns hedge funds specializing in subprime mortgage assets collapsed. In July 2007, the credit rating agencies began downgrading ratings for hundreds and then thousands of RMBS and CDO securities. Soon after, the subprime mortgage backed securities market froze and then collapsed. Each of these events increased the value of Goldman's net short position.

Bear Stearns Hedge Fund Collapse. The collapse of the Bear Stearns hedge funds in mid-June triggered Goldman's effort to rebuild its net short position. On June 7, 2007, the Mortgage Department learned that the Bear Stearns hedge funds were seeking quietly to sell some of their subprime portfolio to meet client redemption requests, which Goldman interpreted as a signal of serious financial distress.[1769] After reviewing the hedge funds' assets, one Goldman employee remarked:

> "In total these two portfolios add up to roughly $17bil in total exposure after leverage. It goes without saying that if this portfolio were to be released into the market the implications would be pretty severe."[1770]

[1767] PSI Net Short Position Chart; 8/17/2007 Goldman chart, "RMBS Subprime Notional History (Mtg Dept.)," GS MBS-E-012928391, Hearing Exhibit 4/27-56a.
[1768] 7/25/2007 email from Mr. Viniar to Mr. Cohn, "Private & Confidential: FICC Financial Package 07/25/07," GS MBS-E-009861799, Hearing Exhibit 4/27-26.
[1769] See 6/7/2007 Goldman email chain, "BSAM Post," GS MBS-E-011184213.
[1770] Id. Some have suggested that the financial problems experienced by the Bear Stearns hedge funds were caused in part by severe markdowns taken by Goldman on assets held in the funds' portfolios, and that Goldman caused the funds to collapse. In its final report, the Financial Crisis Inquiry Commission (FCIC) briefly addressed these allegations. See The Financial Crisis Inquiry Report 2010 at 237-40, 244 (hereinafter "Final Report"). Goldman denied the allegations with respect to its April and May 2007 marks in filings with the FCIC. See 11/1/2010 letter from Goldman counsel Janet Broecke to FCIC, "FCIC Requests for Documents and Information" and Appendices A-G, available at www2.goldmansachs.com. The FCIC's Final Report was critical of Goldman's marks in general as being significantly lower than those of other banks and noted in particular its collateral dispute with AIG. See Final Report at 243-44, 265-71. With respect to the Bear Stearns hedge funds, however, the Final Report merely noted that Bear Stearns had disputed marks from Goldman and three other banks and cited the testimony of the funds' portfolio manager, Ralph Cioffi, that "a number of factors contributed to the April revision [in the hedge funds' values, which ultimately led to the funds' collapse], and Goldman's marks were one factor." Final Report at 240.

In addition to the markdowns in April and May, Goldman also marked down certain CDO securities held by the Bear Stearns funds in June 2007, but it appears those June markdowns did not play a significant role in the hedge funds' collapse. That month, Goldman marked down their positions in four Goldman CDOs by two points each. See, e.g., 6/8/2007 email from Jonathan Egol to Daniel Sparks, "BSAM mark recap," GS MBS-E-001920339 (Mr. Egol emailed Mr. Sparks a recap of the Bear Stearns markdowns and stated: "We lowered the marks on 4 bonds

On June 8, 2007, Mr. Sparks received an urgent early morning email from Goldman's Japan office regarding "unprecedented overnight [rates] market volatility," suggesting that he call in the ABX traders early.[1771] "Given the recent correlation of risk assume this is not a good sign for RMBS/ABS spreads."[1772] Later that day, when another trader complained

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down 2 pts each.").

Mr. Swenson had urged larger markdowns, but his advice was not followed. On June 7, 2007, Mr. Egol had first marked down the funds' holdings in a single Abacus CDO by 2 points, from 89 to 87. Mr. Egol emailed Mr. Sparks a spreadsheet with a cover note: "GS exposure to BSAM [Bear Stearns Asset Management] as of today. ABACUS mark corrected to 87 to handle." 6/7/2007 email from Mr. Egol to Mr. Sparks GS MBS-E-003375593. Since Abacus was only one of four Goldman CDOs in which the Bear Stearns funds held positions, Mr. Swenson emailed Mr. Lehman recommending further markdowns:

> Mr. Swenson: I am on the same page [as] egol we n[e]ed to mark him [Ralph Cioffi, Portfolio Manager of the Bear Stearns funds]
> Mr. Lehman: Told Egol I'm comfortable w/ the prices, especially when u include the 5 pt [percent] HC [haircut.] Don't think mar[k]ing him down 1 or 2 pts makes sense or sends the right message .... I wud run it by Dan [Sparks] and get his take .... [M]y opinion is that the Firm is appropriately protected w/ current HC [haircut] and mark.
> Mr. Swenson: We need to mark him he is the biggest elephant by far and it has an impact on the m$arket[.]
> Mr. Lehman: How much do u [sic] want to mark him by?
> Mr. Swenson: A lot[.]
> Mr. Lehman: I disagree on this one ... Let's talk tomorrow[.]
> Mr. Swenson: He is done[.]

6/7/2007 email exchange between Mr. Swenson and Mr. Lehman, "BSAM Post," GS MBS-E-011184213.

The next day, Friday, June 8, 2007, Mr. Egol reported he had marked down all four CDO positions by two points. 6/8/2007 email from Jon Egol to Daniel Sparks, "BSAM mark recap," GS MBS-E-001920339. Upon reviewing the marks the following Monday, Mr. Sparks wrote: "The marks look stale." 6/11/2007 email from Daniel Sparks, "BSAM Exposure Summary," GS MBS-E-010798675. A Mortgage Department employee replied: "Marks for everything but the correlation positions are taken from work egol did last thurs. Correlation marks are as of friday's cob [close of business]." Id.

On June 12, Bear Stearns announced that it would be changing the hedge funds' Net Asset Valuations (NAVs). 6/12/2007 email to Craig Broderick, "BSAM Bullet Points," GS MBS-E-009967117 ("BSAM is currently in the process of restating their performance figures for April, from down 5% to down 10%. This was due to many dealers changing the way they are marking their Repo positions"). The Mortgage Department later marked down two Timberwolf tranches owned by the Bear Stearns hedge funds by another 2 points and 5 points, respectively, to 95 and 89, before it bought them back from Bear Stearns at 96 and 90 on June 19, 2007, in a negotiated unwind of the Bear funds' positions with Goldman. See 6/22/2007 emails from Mr. Lehman, "BSAM Repo Summary," GS MBS-E-001916435. See also 6/18/2007 email from Mr. Lehman, "Today's Bear Stearns Prices," GS MBS-E-001919600; 6/27/2007 email from Mr. Sparks to Mr. Viniar, "CDO^2s," GS MBS-E-009747489.

[1771] 6/8/2007 email to Daniel Sparks, "Heads Up – rates market volatile," GS MBS-E-010796702.

[1772] Id.

about "getting crushed" in the ABX market, Mr. Birnbaum replied: "Patience, patience. The CDO unwind has only begun."[1773]

Around June 12, 2007, public news accounts indicated that the two Bear Stearns funds were unable to meet collateral calls on their subprime mortgage backed securities holdings.[1774] The funds also devalued their Net Asset Valuations (NAVs) to significantly lower levels, which effectively triggered the funds' total collapse.[1775]

The failure of the Bear Stearns hedge funds triggered another decline in the value of subprime mortgage related assets. The ABX Index, which was already falling, began a steep, sharp decline. The collapse had further negative effects when the hedge funds' massive subprime holdings were suddenly dumped on the market for sale, further depressing prices of subprime RMBS and CDO assets.

The creditors of the Bear Stearns hedge funds met with Bear Stearns management in an attempt to organize a "workout" solution to stabilize the funds.[1776] While those efforts were underway, Goldman and Bear Stearns agreed to an unwind in which Goldman bought back $300 million of two AAA CDO tranches of Goldman's Timberwolf CDO, which the hedge funds had purchased two months earlier in April 2007. Goldman paid Bear Stearns 96 and 90 cents on the dollar, respectively, for the two Timberwolf tranches.[1777] Goldman also bought a few other

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[1773] 6/8/2007 email from Joshua Birnbaum, "* ABX Markets 07-1, 06-2, 06-1: 11:00 a.m.," GS MBS-E-012900708.

[1774] 6/12/2007 email to Craig Broderick, "BSAM Bullet Points," GS MBS-E-009967117.

[1775] Id. A month later, on July 17, 2007, Mr. Sparks reported to Mr. Mullen and Mr. Montag that the Bear Stearns funds were "returning 9 cents and 0 cents on the dollar in the less-levered and more-levered funds." 7/17/2007 email from Daniel Sparks, "Mortgages Estimate," GS MBS-E-010857498.

[1776] 6/12/2007 email to Craig Broderick, "BSAM Bullet Points," GS MBS-E-009967117.

[1777] See 6/22/2007 emails from David Lehman, "BSAM Repo Summary," GS MBS-E-001916435. See also 6/18/2007 email from David Lehman, "Today's Bear Stearns Prices," GS MBS-E-001919600; 6/27/2007 email from Daniel Sparks to David Viniar, "CDO^2s," GS MBS-E-009747489. The prices Goldman paid to Bear Stearns on the A1B and A1C tranches of Timberwolf were approximately one cent (or 100 basis points) above its own internal marks on the Timberwolf tranches in the week of June 18, which were then at 95 and 89 points, respectively. Id. In May 2007, Goldman had completed a re-evaluation of its CDO assets, which suggested on a preliminary basis that the AAA Timberwolf securities should be marked down dramatically in value. Accordingly, Goldman may have been generous toward Bear Stearns in buying back the Timberwolf positions at 96 and 90. On the other hand, repurchasing the Timberwolf securities near its own low internal marks might have reduced the price Goldman could obtain in reselling the tranches, which it identified in a June 22 sales directive to its sales force and recommended selling at 98.5 and 95, respectively. When asked about the buyback of the Timberwolf tranches, Mr. Viniar told the Subcommittee that Goldman had financed the purchase of both tranches and may have been legally entitled to seize them, but there are circumstances in which Goldman voluntarily settles a dispute on agreed terms, rather than going through the legal process entailed in seizing and selling collateral. Subcommittee interview of

RMBS and CDO assets, which it immediately sold.[1778] The attempt to organize a workout solution for the funds was ultimately unsuccessful. Large blocks of subprime assets from the Bear Stearns hedge funds' inventory began flooding the market, further depressing subprime asset values.[1779]

Goldman's Structured Product Group (SPG) took the collapse of the Bear Stearns hedge funds as the signal to begin rebuilding its net short position. As Joshua Birnbaum, the head ABX trader on the SPG Desk, later wrote:

> "[T]he Bear Stearns Asset Management (BSAM) situation changed everything. I felt that this mark-to-market event for CDO risk would begin a further unraveling in mortgage credit. Again, when the prevailing opinion in the department was to remain close to home, I pushed everyone on the [SPG] desk to sell risk aggressively and quickly. We sold billions of index and single name risk."[1780]

In a later internal presentation for Goldman senior executives which Mr. Birnbaum drafted for another purpose,[1781] Mr. Birnbaum wrote that, after the Bear Stearns funds collapsed, SPG's Trading Desks went net short outright and that the shorts were not a hedge for long positions:

David Viniar. (4/13/2010).

[1778] 6/22/2007 email from Tom Montag to Daniel Sparks, "Few Trade Posts," GS MBS-E-010849103 (Mr. Montag: "Can I get a complete rundown on everything we bought from BSAM and what's left?" Mr. Sparks: "Yes – main thing left is 300mm timberwolfs Other large positions were tmts - gone, octan - gone, abacus - we will collapse against short There were some small rmbs positions.").

[1779] At the time, a trader from another bank stated in a market update: "[T]he BSAM [Bear Stearns Asset Managment] story will dictate the tone in the market in the short term, as a continued liquidation of their holdings will put further downward price pressure on ... ABX trading." 6/18/2007 email to Edwin Chin, "ABX Open," GS MBS-E-021890868.

[1780] 9/26/2007 2007 MD Reviews, Joshua Birnbaum Self-Review, GS-PSI-01956, Hearing Exhibit 4/27-55c. The SPG Desk's ABX shorting efforts caught the attention of another Goldman trader who was apparently unaware of Mr. Birnbaum's strategy. The trader emailed: "yo-who the F- is getting short the ABX at these levels." 6/21/2007 email to Deeb Salem, GS MBS-E-021905440.

[1781] This presentation was drafted to support a proposal that the SPG traders be compensated in a manner similar to hedge fund managers. 10/3/2007 "SPG Trading – 2007," presentation by Joshua Birnbaum, GS MBS-E-015654036. Mr. Birnbaum had drafted the presentation on behalf of the SPG Trading Desk as a whole. Mr. Swenson and Mr. Lehman reviewed and commented upon the presentation, and Mr. Birnbaum revised it to make the changes they suggested. See, e.g., 10/2/2007 email from David Lehman to Joshua Birnbaum, "SPG Trading - 2007.ppt," GS MBS-E-015653681 (providing comments and suggesting text for presentation). Mr. Birnbaum replied and copied Mr. Swenson on the email chain as well: "I added your bullet and one more." Id. See also 10/4/2007 email from Joshua Birnbaum to Michael Swenson and David Lehman, "How's this?," GS MBS-E-015712249 (forwarding another revised bullet point for presentation). Mr. Birnbaum told the Subcommittee, however, that the SPG Trading Desk ultimately did not use the presentation. See Birnbaum responses to Subcommittee QFRs at PSI_QFR_GS0509.

"By June, all retained CDO and RMBS positions were identified already hedged. ... SPG trading reinitiated shorts post BSAM [Bear Stearns Asset Management] unwind on an outright basis with no accompanying CDO or RMBS retained position longs. In other words, the shorts *were not a hedge.*"[1782]

On June 29, 2007, the ABX Index and the value of single name CDS contracts referencing RMBS and CDO securities plummeted in value and continued dropping until mid-July. Mr. Swenson, head of the SPG Trading Desk, exchanged emails with Mr. Lehman and other Goldman executives about that day's trading: "There is absolutely no support at the lower levels from the street. CDOs are wider by 50 bps or more." Mr. Lehman responded: "[W]e r in the middle of a mkt meltdown."[1783]

On July 10, 2007, the two primary ratings agencies, Standard & Poor's and Moody's, began the first of many mass ratings downgrades for subprime RMBS and CDO securities.[1784] The downgrades sent another negative shockwave through the subprime mortgage market as investors scrambled to assess the impact of the downgrades on their RMBS and CDO holdings.[1785] On July 12, 2007, when still more RMBS and CDO ratings downgrades were announced, Mr. Birnbaum wrote to his colleagues: "Seen massive flows recently. Many accounts 'throwing in the towel'. Anybody who tried to call the bottom left in bodybags."[1786]

On July 27, 2007, a Goldman senior sales executive summarized the state of the market:

"Whether you remember '94, '98, or '03, the general themes/patterns are consistent. An initial dislocation to the market (in this instance a credit deterioration in sub prime mortgages) acts as a tipping point and leads to spread widening in other sectors. This in turn quickly becomes a liquidity crunch/crisis. It appears this is where the structured product market is now – searching for liquidity. This has produced numerous capitulation/liquidation situations and forced customers to trade. . . . The impact of this week

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[1782] 10/3/2007 "SPG Trading – 2007," presentation by Joshua Birnbaum, GS MBS-E-015654036 [emphasis in original]. See also Birnbaum responses to Subcommittee QFRs at PSI_QFR_GS0509.
[1783] 6/29/2007 emails between Michael Swenson and David Lehman, "ABS Update," GS MBS-E-011154528.
[1784] 7/10/2007 Goldman internal email, "GS Cashflow/Abacus CDOs Mentioned in S&P Report on CDO Exposure to Subprime RMBS," GS MBS-E-001837256.
[1785] See id.
[1786] 7/12/2007 email from Joshua Birnbaum, "ABX Markets 07-1, 06-2, 06-1: 12:00 p.m.," GS MBS-E-012944742, Hearing Exhibit 4/27-146.

leaves the account base in three camps: The Paralyzed . . . The Wounded (some fatally) . . . The Opportunistic."[1787]

Although the July subprime market meltdown was a disaster for many investors, the value of Goldman's net short positions climbed rapidly. Senior management at all levels were aware of the Mortgage Department's net short and the profits it was generating. On July 20, 2007, CEO Lloyd Blankfein and COO Gary Cohn received a profit and loss report showing that the Mortgage Department was up $72.7 million for the day, across almost every mortgage trading desk. Mr. Cohn wrote to Mr. Blankfein: "There is a net short."[1788] On July 24, 2007, the Mortgage Department posted a profit of $83 million for the day, while the firm's overall net revenue for the day was only $74 million.[1789] Mr. Viniar forwarded the report to Mr. Blankfein with a note saying: "Mergers, overnight asia and especially short mortgages saved the day." On July 29, 2007, Mr. Sparks reported to Messrs. Montag and Mullen:

> "Department-wide P&L [Profit & Loss] for the week was $375mm (this is after adjusting for the $100mm [error] discussed today). Correlation P&L on the week was $234mm, with CMBS, CDOs, and RMBS/ABX shorts all contributing."[1790]

Mr. Birnbaum later recapped the SPG Trading Desk's profits during this period: "[W]hen the [ABX] index dropped 25 pts in July, we had a blow-out p&l month, making over $1Bln that month."[1791]

Covering the Big Short to Lock in Profits. Starting in July and throughout August 2007, Goldman undertook an intensive effort to cover its $13.9 billion net short and lock in its profits. To do so, the Mortgage Department bought long assets, offered CDS contracts in which it took the long side, and even sold some short positions.

The Mortgage Department was particularly focused on purchasing long AAA assets to cover Goldman's $9 billion AAA ABX short, to lock in the unexpected profits on that position. In August 2007, Mr. Lehman,

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[1787] 7/27/2007 email to Tom Montag, Daniel Sparks, and Donald Mullen, "Structured Products Weekly Update – 7/27/07," GS MBS-E-010876357.
[1788] 7/20/2007 email from Gary Cohn to Lloyd Blankfein, "Private & Confidential: FICC Financial Package 07/20/07," GS MBS-E-009648405, Hearing Exhibit 4/27-24.
[1789] 7/24/2007 email from David Viniar to Lloyd Blankfein, "Daily Estimate 07-24-07 – Net Revenues $74M," GS MBS-E-009690033, Hearing Exhibit 4/27-25.
[1790] 7/29/2007 email from Daniel Sparks to Tom Montag, "Correlation information you asked for," GS MBS-E-010876594, Hearing Exhibit 4/27-27.
[1791] 9/26/2007 2007 EMD Reviews, Joshua Birnbaum Self-Review, GS-PSI-01975, Hearing Exhibit 4/27-55c.

co-head of the SPG Desk, wrote: "[A]s swenny/deeb/josh have done an awesome job sourcing risk, the CDO transition book AAA ABX short decreased from 1.55bb to 250m over the past two weeks – we love covering that trade."[1792] On August 23, 2007, Mr. Montag reported to Messrs. Cohn and Viniar: "We ... bought back almost 9 billion of aaa abx over last two weeks."[1793]

From mid-July through the end of August, the Mortgage Department also covered a range of other shorts.[1794] On August 5, 2007, Mr. Swenson reported a "phenomenal week":

> "In summary, a phenomenal week for covering our Index shorts on the week. The ABS Desk bought $3.3bb of ABX Index across various vintages and ratings over the past week. $1.5 billion was retained by the ABS desk to cover shorts in ABX ($900mm in ABX 06-1 As being the most significant) and $1.0 billion was sold to internal desks across the mortgage department ($925mm in triple-As)."[1795]

Mr. Swenson also reported that the Mortgage Department was still $8.3 billion net short across all subprime asset classes, including $4 billion of AAA ABX assets.[1796]

On August 8, the market rallied for a short period, and the Mortgage Department's net short position suffered a $100 million loss. Mr. Swenson explained: "Market rallied especially at the top end of the capital structure – AAA (up 2 pts), AA (up 3 pts), and A (up 2 pt.)." He reported that the Department still held a $3.1 billion net short in AAA rated subprime mortgage assets.[1797] Mr. Montag replied: "now on to the 3 billion short."[1798] The next day, August 9, 2007, Mr. Montag reported to his colleagues: "mortgages bought back 1 billion of 3 billion short in AAA indices at ½ to 1 point better than yesterday."[1799]

[1792] 8/11/2007 email from David Lehman, "Japan exposure to CDOs," GS MBS-E-001929202.
[1793] 8/23/2007 email from Tom Montag to Gary Cohn and David Viniar, "Harbinger Post," GS MBS-E-009739009. See also 8/21/2007 email from Michael Swenson, "Mortgage Commentary for Firmwide Risk Committee," GS MBS-E-010619375 ("Current SPG Trading Desk Position Summary: – RMBS AAA – long $2.2bb").
[1794] The one short position the Mortgage Department did not attempt to cover was its $3 billion net short in BBB and BBB- rated RMBS securities, as discussed below.
[1795] 8/5/2007 email from Michael Swenson, "great week," GS MBS-E-012376888, Hearing Exhibit 4/27-28.
[1796] Id.
[1797] Id.
[1798] 8/8/2007 email from Tom Montag to Michael Swenson and David Lehman, GS MBS-E-011088957.
[1799] 8/9/2007 email from Tom Montag, GS MBS-E-009640293.

On August 11, 2007, reports of firms having to sell CDO securities in Asia prompted Mr. Mullen to ask: "Did we cover to[o] soon? Looks like more selling at the higher end of cap stack"[1800] Mr. Lehman replied: "Don't th[in]k so – we haven't covered any CDO risk (we have gone the other way by 1.44bb since June 1st) and that is where the market still has bad longs – th[in]k AAA rmbs is a very different trade."[1801]

On August 20, 2007, Mr. Sparks reported on the Mortgage Department's progress in covering its net short, telling Mr. Montag: "[L]oan books had been heavily net short (still are some – especially ... in alt a) and I have been forcing them to cover over the past 2 weeks." Mr. Montag responded: "[H]eavily isn't the half of it – we have bought back 4 - 5 billion and still short."[1802]

Buying More AAA RMBS Securities. In August 2007, the Mortgage Department proposed buying $10 billion in AAA rated RMBS securities, but did not receive permission to initiate the investment.

By August 2007, AAA rated RMBS and CDO securities were available from many financial firms at a very low price. On August 14, 2007, in summarizing the prior week's trading Mr. Swenson wrote: "Top of the capital structure is where all the action is. AAAs are extremely cheap .... [W]ant to scale into a large long."[1803] Mr. Sparks agreed: "[T]he AAA ABX index is a great opportunity and we continue to like it."[1804] On August 19, 2007, Mr. Lehman reported that the Mortgage Department had purchased $1.6 billion of the long side of CDS contracts referencing the ABX Index for AAA RMBS securities, and that its value had increased 1.5 percent over the prior week. Given Goldman's dominant market share and recent large purchases, however, Mr. Montag was skeptical: "How much of the aaa outperforming was us buying?"[1805] Mr. Birnbaum responded: "On the AAA outperformance question, I think AAAs would have performed similarly without our adding."[1806] He also

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1800 8/11/2007 emails between Donald Mullen and David Lehman, "Japan exposure to CDOs," GS MBS-E-001929202.
1801 Id. See also 8/11/2007 email from Daniel Sparks to Tom Montag and Donald Mullen, "GSC ms prop/Paulson swap," GS MBS-E-010673306 ("We need to keep buying AAA ABX, and now we can start looking to cover some CDO CDS").
1802 8/20/2007 email exchange between Daniel Sparks and Tim Montag, "Hsbc loans," GS MBS-E-010681855.
1803 8/14/2007 email from Michael Swenson, "ABS Summary for Week Ended August 10th," GS MBS-E-010678428.
1804 Id.
1805 8/19/2007 email from Tom Montag, "Mtg Department Weekly Update," GS MBS-E-010681647.
1806 Id.

wrote that the "likelihood of loss on 'real' RMBS AAAs (i.e., not AAA CDOs)," was "remote."[1807]

According to Mr. Birnbaum, a key reason for buying the AAA rated assets was that Mr. Birnbaum and others in the Mortgage Department wanted to maintain a large short position in ABX assets referencing BBB and BBB- rated RMBS securities, because they believed the ABX Index for those securities would fall even further.[1808] Mr. Birnbaum told the Subcommittee that covering the BBB/BBB- net short position in August would have amounted to leaving money on the table.[1809] He explained that the Mortgage Department thought that buying a proportionate amount of AAA ABX long positions could be used to offset the risks of continuing to hold the BBB/BBB- short until the ABX Index bottomed out.[1810]

On August 14, 2007, Mr. Sparks updated Goldman senior executives on the success of the Mortgage Department's efforts to cover its shorts and added that the Department was interested in increasing its purchase of AAA rated RMBS securities: "we will likely come to you soon and say we'd like to get long billions[.]"[1811] Senior executives reacted with skepticism.[1812] Mr. Sparks responded: "We're continuing to cover some shorts and we may cover some BBB with AAA, but I got the message clearly that we shouldn't get long without Gary [Cohn]/Tom [Montag]/Don [Mullen] all saying OK."[1813]

1807 Id. Not everyone at Goldman agreed that the risk of loss on AAA was "remote." On July 29, 2007, Mr. Rosenblum circulated an email to Mortgage Department managers and research analysts with a series of questions about how AAA subprime RMBS securities would be affected by other market developments. 6/29/2007 email from David Rosenblum, GS MBS-E-010060183. The head of Goldman's Structured Product Strategies area, Alan Brazil, responded: "Well, as is becoming clearer to the market is [sic] that the subprime issue is really a triple-a issue, either directly as a aaa subprime or indirectly in a aaa cdo. As a rough guide, over 90% of a subprime deal are in aaas. ... And once you start downgrading bbb/bbb- you will ultimately be start [sic] downgrading aaas. And, in my view, that is a significant escalation of the subprime meltdown. ... At its heart, the main shoe to fall will be when the rating agencies downgrade to the aaa level. I don't see as they have much of a choice. Mez[zanine] aaa cdo trade in the 20 and 30s cannot be overlooked even by the agencies." Id.

1808 Subcommittee interview of Joshua Birnbaum (4/22/2010).

1809 Id.

1810 Id.

1811 8/14/2007 email from Daniel Sparks, "Fw: Post," GS MBS-E-010678053, Hearing Exhibit 4/27-30.

1812 See 8/14/2007 email from Gary Cohn to Daniel Sparks, "Fw: Post," GS MBS-E-010678053, Hearing Exhibit 4/27-30 ("Talk to me before you go long."); 8/14/2007 email from Tom Montag, "Post," GS MBS-E-009741145 ("We will not be going long billions. Lots of risk to clean up first imo").

1813 8/15/2007 email from Daniel Sparks, "Post," GS MBS-E-009740784, Hearing Exhibit 4/27-32.

On August 20, 2007, Mr. Sparks pitched the idea again to Mr. Montag and other senior executives in an email entitled, "Big Opportunity":

> "We are seeing large liquidations – we bought $350mm AAA subprime RMBS from ... SIV unwinds today. ... We think it is now time to start using balance sheet and it is a unique opportunity with real upside – specifically for AAA RMBS. We've sold over $100mm of what we bought today – most up 1-2 points.
>
> That's a great trade – buy and flip up 1-2 points, however, we're not always going to be able to do that – and there's the opportunity for us to make 5-10 points if we have a longer term hold."[1814]

On August 21, 2007, Mr. Birnbaum presented the Mortgage Department's plan to buy up to $10 billion in AAA rated RMBS securities.[1815] The plan had dual objectives, to profit from the intrinsic financial value of the proposed assets and to use those assets to preserve, rather than cover, the Department's existing $3.5 billion BBB/BBB- net short:

> "– The mortgage department thinks there is currently an extraordinary opportunity for those with dry powder to add AAA subprime risk in either cash or synthetic form.
>
> – We would like to be opportunistic buyers of up to $10Bln subprime AAAs in either cash or synthetic (ABX) form and run that long against our $3.5Bln in mezzanine subprime shorts.
>
> – Mortgage dept VAR would be reduced by $75mm and Firmwide VAR would be reduced by $25mm.

[1814] 8/20/2007 email from Daniel Sparks to Gary Cohn, David Viniar, Jon Winkelried, Tom Montag, and Donald Mullen, "Big Opportunity," GS MBS-E-009739836. See also 8/20/2007 email exchange between Daniel Sparks and Tom Montag, "Hsbc loans," GS MBS-E-010681855 (Mr. Sparks pitched the plan again to Mr. Montag separately: "As a overall business, we're not short AAA's anymore. We are putting on the long index (mostly AAA)/short single name mezz trade on .... We are planning to continue to play offense. . . . Discussions on the up the quality trade (top cap stack and top quality collateral) were had in various times with don [Mullen], gary [Cohn] and bill [McMahon]. We aren't going crazy with it, just being opportunistic. Before we get large, we are going to lay out a strategy for the four of you.").

[1815] 8/21/2007 email from Joshua Birnbaum, "Potential large subprime trade and impact on firmwide VAR," GS MBS-E-016359332, Hearing Exhibit 4/27-34; 8/21/2007 email from Joshua Birnbaum, "For 2 p.m. meeting," GS MBS-E-010608145 (graphs in support of plan to go long up to $10 billion in AAA ABX index).

– At current dollar prices, the implied losses at the AAA level are 2.5x higher than the implied losses at the BBB level where we have our shorts (the ratio is even cheaper for cash due to technicals). If AAAs were priced consistent with BBB implied loss levels, they would be trading 5-10pts higher in synthetics and 10-15 points higher in cash. ...

– On the demand side, we plan to share this trade quietly with selected risk partners. We began doing so yesterday when we sold 1/3 of the AAAs purchased off the [seller] list to [customer] and 100% of the AAAs from [seller] to [customer] and [customer]."[1816]

Mr. Montag responded that he wanted to discuss the concept further.[1817] Mr. McMahon wrote: "What are we holding against the 3.5b mezz shorts right now? Why don't we just cover the shorts?"[1818] Co-President Gary Cohn emailed Messrs. Mullen, Winkelried, and Montag: "I do like the idea but you[r] call."[1819] Before any further discussion took place, however, events overtook the debate.

(e) "Get Down Now"

Despite direction from senior management to cover its $13.9 billion net short position, the Mortgage Department continued to maintain several large net shorts, including at least $3 billion in single name CDS contracts referencing BBB and BBB- rated RMBS securities that it expected to gain in profits. In August 2007, Co-President Gary Cohn finally issued an order to "get down now."[1820]

Excessive VAR. By late August, a combination of the large net short and volatility in the subprime mortgage market had driven the Mortgage Department's VAR to an all-time high. When the AAA ABX short position was far out-of-the-money, it entailed little market risk, as it was not actively traded and had little likelihood of ever paying off. Once the AAA ABX short became profitable, however, the $9 billion position was so large that it had a major impact on the firm's risk measurements.

[1816] Id.

[1817] See 8/21/2007 email from Mr. Montag to Mr. Birnbaum, GS MBS-E-010682736 ("FYI. I think it would be much better for all concerned that we all discuss this and any strategy and have agreem[e]nt before we go to the presidents and cfo .... Secondly, I think we should be reducing our basis trades to reduce var as is .... Let's sit down").

[1818] 8/21/2007 email from Bill McMahon, "Potential large subprime trade and impact on Firmwide VAR," GS MBS-E-012606879.

[1819] 8/21/2007 email from Joshua Birnbaum, "Potential large subprime trade and impact on firmwide VAR," GS MBS-E-016359332, Hearing Exhibit 4/27-34

[1820] 8/15/2007 email from Gary Cohn, "Trading VaR $165mm," GS MBS-E-009778573.

Even a small percentage change in $9 billion can cause substantial changes in a profit and loss statement. As Mr. Sparks explained: "The combination of our large AAA ABX index shorts and the relatively new volatility in the AAA part of the index will result in much larger daily swings in P&L [profit and loss] both ways."[1821]

As predicted, due to the $9 billion short, the Mortgage Department's daily profit and loss reports began to show much larger swings.[1822] For example, while the Mortgage Department showed a profit of $71 million on July 21, 2007,[1823] it showed a loss of $100 million on August 8.[1824] Upon hearing of that loss, Mr. Montag asked "so who lost the hundy?"[1825] Mr. Birnbaum wrote to a colleague: "I'm sure the AAA ABX is being blamed as the reason the dept was down 100 yest[erday]."[1826] While some in the Mortgage Department disagreed with the use of VAR as a measure of risk,[1827] the gyrations in daily profit and loss figures demonstrated that the $9 billion net short posed real risk to Goldman.

VAR depends primarily on the aggregate size of net asset positions and the volatility of the relevant market. Goldman was holding several large net short positions, the subprime market had become extremely volatile, and the Department's efforts to cover its shorts further complicated matters. Although Goldman's covering of its $9 billion net short AAA position would ordinarily be expected to reduce risk, the massive size of the position, combined with unprecedented levels of

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[1821] 7/21/2007 email from Daniel Sparks to Donald Mullen, Tom Montag, and others, "Mortgages Estimate," GS MBS-E-009640287.
[1822] See id. (noting $50 million down trading day, followed by a day in which the AAA index accounted for half of the day's profit).
[1823] Id.
[1824] 8/9/2007 email from Joshua Birnbaum to Deeb Salem, GS MBS-E-012927140.
[1825] 8/8/2007 email from Tom Montag to Michael Swenson and David Lehman, GS MBS-E-011311633. Mr. Swenson explained that the approximately $100 million loss was split between the Residential Whole Loan Trading Desk, the SPG Trading Desk, and the CDO Origination Desk. Id.
[1826] 8/9/2007 email from Joshua Birnbaum to Deeb Salem, GS MBS-E-012927140.
[1827] 8/9/2007 email from Joshua Birnbaum to Deeb Salem, "MarketRisk: Mortgage Risk Report (cob 08/08/2007)," GS MBS-E-012927200 ("These VAR numbers are ludicrous, btw. Completely overestimated for SPG trading, underestimated for other mortgage desks."). See also 8/21/2007 email from Joshua Birnbaum to Bill McMahon, "Potential large subprime trade and impact on Firmwide VAR," GS MBS-E-012606879 ("We have the 13.5Bln IO which makes us less short by $1-1.5 Bln ....") (IO is an asset arising from differences in the duration and timing of CDS premium payment streams); 8/21/2007 email from Michael Dinias, "Trading VaR Analysis," GS MBS-E-009993267 ("the mortgage desk has questioned the size of the implied short exposure (i.e. desk believes they are less short than implied by the VaR model). We are reviewing the current VaR methodology with the mortgage traders/strategists and assessing the impact of various potential enhancements."); Subcommittee interview of Joshua Birnbaum (10/1/2010).

volatility in the market, the speed of Goldman's covering, and the size of the trades involved, resulted in steep increases in the Department's VAR.

The Mortgage Department's VAR had increased from around $13 million in mid-2006, well under the Department's permanent limit of $35 million, to $85 million in February 2007, to a high of around $113 million in August 2007.[1828] The $113 million figure exceeded the Department's $35 million permanent VAR limit by more than 350%. Moreover, the Mortgage Department, which had never contributed more than about 2% of firmwide net revenue prior to 2007, was generating some 54% of all the risk incurred by the firm in August 2007. The Mortgage Department's risk level, however profitable, was of increasing concern from a firmwide perspective.[1829]

In an effort to maximize the profit potential from its net short positions, SPG personnel in the Mortgage Department argued against indiscriminately covering all of the Department's shorts.[1830] But the Mortgage Department's VAR level proved to be both intractable and highly unpredictable.[1831] It also contributed to record high levels of firmwide VAR, a figure carefully monitored by the firm's most senior management. The Mortgage Department and its risk controllers tried unsuccessfully to reduce the Department's VAR, and were discussing new alternatives,[1832] when Goldman's Co-President Gary Cohn intervened. On August 15, 2007, the same day that Goldman's firmwide VAR hit a then-

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[1828] For more information on the Mortgage Department's VAR levels, see below.

[1829] On August 7, 2007, a senior risk executive wrote to Messrs. Cohn, Viniar, and McMahon: "We are doing a detailed analysis of mortgage and credit trading var contributors to see where we might get the most efficient var reduction." 8/7/2007 email from Bruce Petersen, "VaR," GS MBS-E-009775575.

[1830] See, e.g., 8/21/2007 email from Joshua Birnbaum, "Potential large subprime trade and impact on firmwide VAR," GS MBS-E-016359332, Hearing Exhibit 4/27-34 (favoring preservation of the $3.5 billion BBB/BBB- short).

[1831] Risk controller Robert Berry explained to Messrs. Viniar, McMahon, and Broderick that VAR was becoming acutely sensitive to estimates of correlation implicit in the data used in the VAR computation: "[T]here will be days where 'nothing happened' – positions didn't change, markets were quiet, but small changes in correlation will mean the difference between 140 and 160. It will really be difficult to explain to you and to the desks why we were under [VAR limits] yesterday but over today." 8/15/2007 email from Robert Berry, "MarketRisk: End of Day Summary – cob 8/10/07," GS MBS-E-009779885. Mr. McMahon responded: "var can swing between 140 and 160 without any changes in the complexion of our trading books – essentially it is just noise." 8/15/2007 email from Bill McMahon to Gary Cohn and David Viniar, "Trading VaR $165mm," GS MBS-E-009778573.

[1832] See, e.g., 8/15/2007 email from Michael Dinias, "Hedge Analysis cob 8/13/07," GS MBS-E-010678553 (analyzing 6 potential VAR-reducing trading scenarios featuring different proposed transactions); 8/21/2007 email from Michael Dinias, "Trading VaR Analysis," GS MBS-E-009993267 (analyzing the VAR-reducing impact of going long in various classes of assets); 8/22/2007 email from Daniel Sparks to Tom Montag and Donald Mullen, "VAR reduction possibilities," GS MBS-E-010619824 (proposed transactions in single name CDS protection to reduce VAR).

record high of $165 million, Mr. Cohn emailed the Mortgage Department's senior managers, risk analysts and controllers: "There is no room for debate – we must get down now."[1833]

The Mortgage Department took immediate action. To reduce its VAR, the Department had to sell at least some of its BBB/BBB- net short position.[1834] On August 23, 2007, Mr. Swenson reported that Harbinger had bought a large block of single name CDS contracts shorting BBB/BBB- rated RMBS securities which allowed Goldman to take the long side: "We just printed $400mm of Singles with Harbinger. 130mm of BBB and 270mm BBB-." Mr. Montag passed the message on to Messrs. Cohn and Viniar: "Finally actuall[y] covering singles." Mr. Cohn responded: "Great."[1835]

But even after that $400 million sale, Mr. Sparks reported to Mr. Montag: "[W]e are short ... about $3BB single names."[1836] Mr. Montag responded that the $3 billion net short position was "huge and outsized" and $800 million had to be sold: "[I]f I make you sell a whopping 800 [million] out of 3 billion which is less than 30% how can anyone complain–the position is huge and outsized."[1837] At the end of the trading day on August 23, Mr. Montag asked Mr. Sparks: "How much did we cover–shooting for $1 billion." Mr. Sparks responded: "Not much more today – trying."[1838]

[1833] 8/15/2007 email from Gary Cohn, "Trading VaR $165mm," GS MBS-E-009778573. Mr. Viniar agreed. Two days earlier, after seeing a daily risk report showing Firmwide VAR at $159 million, Mr. Viniar emailed senior risk executives: "No comment necessary. Get it down." 8/13/2007 email from David Viniar to Bill McMahon, Craig Broderick, and Robert Berry, "MarketRisk: End of Day Summary – cob 8/10/2007," GS MBS-E-009779885. Even after Mr. Cohn's order to "get down now," Firmwide VAR continued to increase. On August 16, Firmwide VAR rose from $165 million to $171 million. 8/16/2007 email from Michael Dinias, "Trading VAR $171mm," GS MBS-E-099775568. On August 17, it rose to $174 million. 8/17/2007 email to David Viniar, Gary Cohn, Jon Winkelried, Tom Montag, Bill McMahon, Craig Broderick et al., "Weekly Market Risk Summary as of 8/17/07," GS MBS-E-009756424.

[1834] On August 22, 2007, Mr. Montag emailed Mr. Blankfein: "[W]e are covering a number of shorts in mortgages today and tomorrow–probably $1.5 billion worth–will reduce mortgages [VAR] hopefully to below 80." 8/22/2007 email from Tom Montag to Lloyd Blankfein, "Trading VaR $144mm," GS MBS-E-009605812, Hearing Exhibit 4/27-36. The next morning Mr. Montag emailed Mr. Blankfein that the Department "covered about 700 million in shorts in mtgs last night–500 million in single names . . . . lots more to go–but they fortunately had bought back 9 billion of AAA abx index over last two weeks." 8/23/2007 email from Tom Montag to Lloyd Blankfein, GS MBS-E-009585951, Hearing Exhibit 4/27-37.

[1835] 8/23/2007 email from Michael Swenson, "Harbinger Post," GS MBS-E-009739009.

[1836] 8/23/2007 email from Daniel Sparks, "Current Outstanding Notional SN ames," GS MBS-E-010621231.

[1837] Id.

[1838] 8/23/2007 email exchange between Tom Montag and Daniel Sparks, "Current Outstanding Notional SN ames," GS MBS-E-010621324.

Although the Mortgage Department did not cover its shorts as quickly as Mr. Montag wanted, within days of Mr. Cohn's August 15 order to "get down," Goldman's firmwide trading VAR had dropped by $40 million and the Mortgage Department's VAR had dropped below $100 million.[1839] On August 23, 2007, Mr. Cohn forwarded a VAR report to CEO Lloyd Blankfein: "The message got through." Mr. Blankfein responded: "Good job." Mr. Cohn wrote: "Down 40 in 2 days."[1840]

Although the Mortgage Department's VAR measure fell substantially, it remained well above its permanent risk limit of $35 million throughout the rest of 2007.[1841] In addition, although Goldman senior executives rejected the Mortgage Department's plan to buy $10 billion in AAA rated RMBS securities,[1842] the Department ultimately purchased over $2.2 billion in AAA rated RMBS securities[1843] and continued to hold and strategically sell off its BBB and other short positions through the end of 2007.[1844]

[1839] 8/23/2007 email exchange between Gary Cohn and Lloyd Blankfein, "Trading VaR $133mm," GS MBS-E-009643469.

[1840] Id. Goldman senior executives continued to monitor the Mortgage Department's actions. For example, on August 31, 2007, Mr. Montag emailed Mr. Lehman: "abx hurting us today? Mkt over reacting?" 8/31/2007 email from Tom Montag, "Structured Products Weekly Update – 08/30/07 (Internal Use only)," GS MBS-E-009589083. Mr. Birnbaum responded: "Based on the markets we are making, we would be ok in this move. We are +50mm in AAAs alone right now." Mr. Montag forwarded the emails to Mr. Blankfein who wrote: "Thanks. Appreciate the posts, I'm watching the financial news."

[1841] 12/2007 Quarterly Market Risk Review, GS MBS-E-009586222, Hearing Exhibit 4/27-54f (third quarter mortgages average VAR was $68 million; fourth quarter mortgages average VAR was $75 million).

[1842] Subcommittee interview of David Viniar (4/13/2010); Subcommittee interview of Daniel Sparks (4/15/2010); Subcommittee interview of Joshua Birnbaum (4/22/2010).

[1843] 8/21/2007 email from Michael Swenson, "Mortgage Commentary for Firmwide Risk Committee," GS MBS-E-010619375 ("Current SPG Trading Desk Position Summary: – RMBS AAA – long $2.2bb"); Michael J. Swenson, responses to Subcommittee QFRs at PSI_QFR_GS0474.

[1844] In the week of December 6, 2007, the Mortgage Department's risk managers noted "an increase in net short position in the residential sector." 12/7/2007 email to David Viniar, "Weekly Market Risk Summary as of 12/06/07," GS MBS-E-009708911, Hearing Exhibit 4/27-53. See also 9/5/2007 email from Michael Swenson to Tom Montag, "ABS Update," GS MBS-E-012386239, Hearing Exhibit 4/27-39; 9/23/2007 email to David Viniar, "Mortgage P&L for the Week Ended 9/21," GS MBS-E-009732431, Hearing Exhibit 4/27-43 (Finance division reported that, in week of September 21, the Mortgage Department reported $63 million from "short synthetic positions including SPG Trading (+$40M), CDO (+22M) and Residential Credit (+12M).").

(f) Profiting from the Big Short: Making "Serious Money"

Goldman's short positions continued to produce profits for the firm, as mortgage related assets continued to lose value. In September 2007, one of the key traders in the Mortgage Department, Deeb Salem, summarized four key short-side trading strategies that enabled the Mortgage Department to profit from the collapse of the subprime mortgage market:[1845]

(a) a "dispersion trade," in which Goldman took advantage of "mispriced" single name CDS contracts that referenced very poorly performing RMBS securities, but were not priced much lower than better performing RMBS securities, resulting in profits of $750 million "so far";

(b) a massive purchase of single name CDS contracts referencing a variety of RMBS securities, taking advantage of Goldman's estimated 33% "dominant" market share in single name CDS to make a "HUGE directional bet" against the subprime mortgage market, resulting in profits of $1.7 billion;[1846]

(c) the purchase "at a discount" of single name CDS contracts referencing Alt A and A rated RMBS securities, which "others don't want/know where to price," resulting in profits of $400 million "so far"; and

(d) the purchase of single name CDS contracts on A, AA and AAA rated CDO securities "in size," amassing an "enormous" market share whose profits had "exceeded all of our high expectations" at $900 million "so far."[1847]

[1845] Salem 2007 Self-Review.
[1846] Id. [emphasis in original].
[1847] Id. Mr. Salem described the trading strategies as follows:

"a. The Dispersion Trade
More than a year ago, Edwin [Chin] and I realized that the dispersion amongst single-name subprime CDS was grossly mispriced. Bad names (tier 4), that the market almost universally disliked traded only 50 bps wider than securities that we all agreed were superior. ... So for the past year, we bought protection on tier 4 names at every chance possible . . . When we wanted to flatten out the book, we just wrote protection on the tier 1 names. Amazingly we did this for most of the year without a usable model to value different single names. ... We were very aggressive with pricing and only shared risk with smart guys if they gave us insight on names to go short or go long in return. Even when the dispersion widened out ... by the end of February, Edwin and I refused to monetize the trade .... With 3-4bb of notional in this dispersion trade, we have recognized $750mm of P&L so far on this trade.

In October 2007, after the credit rating agencies downgraded hundreds of CDO securities,[1848] Mr. Swenson wrote to Mr. Mullen that the downgrades would eventually cause defaults in many CDO securities that Goldman had shorted, meaning that Goldman's "CDS protection premiums paid out will go to zero,"[1849] and Goldman would receive substantial CDS payments on those CDOs from the long parties. Mr. Mullen responded: "Looks like we're going to make some serious money." Mr. Swenson replied: "Yes, we are well-positioned."[1850]

Indeed, the Mortgage Department made $110 million the very next day.[1851] Mr. Swenson explained: "65mm was from yesterday's downgrades which lead to the selloff." Mr. Mullen replied: "Great

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"b. Our single name market share:
Having traded over $200bb of notional in SN [single name] CDS, GS is the dominant market-maker in single name CDS. We approximate our market share to be greater than 33%. ... This market share and willingness to trade size proved invaluable in November, December and January when we decided to make the HUGE directional bet of being long SN CDS protection [or "short risk," i.e., taking the short side of a CDS transaction]. ... If we did not have such presence in the SN CDS market, it is unlikely that we would have achieved the size short that we desired and eventually put on. We're up $1.7bb in RMBS SN CDS!

"c. Willingness to put on trades that others don't want/know where to price
The 2 most successful trades in this regard have been our $70mm long Alt-A protection and our $1-2bb long sub-prime Single-A protection [i.e., being "short risk" or taking short side in a CDS transaction]. When CDOs wanted to sell Alt-A and single-A protection ... the rest of the street was tentative. ... We viewed this as a tremendous opportunity to buy cheap out-of-the-money options at a significant discount to fair-value. Our exit strategy was always that if sub-prime fundamentals got bad enough, and they did, that the contagion would have to spread up the capital structure because cum loss vol/uncertainty has to go up thus. . . .$400mm so far for the desk ....

"d. CDO CDS trade:
This trade has made $900mm so far, which exceeded all of our high expectations for the trade. I had the confidence and desire for the desk to buy A, AA, and AAA CDO CDS protection in size during the fall of 2006 for several reasons: ... [T]he rating agencies' correlation assumptions were out of whack with the growing concern about the housing market and the remarkable similarity between the bonds in a CDO, the difficulty that GS was having in placing such mezzanine liabilities and the complexity of such securities scared hedge funds from buying the protection themselves. Edwin and I used the same aggressive strategies in purchasing protection that we used to dominate the SN CDS market. Our market share was enormous ... and we did every ... trade possible." Id.

1848 See, e.g., 10/11/2007 email from Michael Swenson to Donald Mullen, "Early post on P and L," GS MBS-E-016031234, Hearing Exhibit 4/27-69. For more information about this downgrade, see Chapter V.

1849 Id.

1850 Id.

1851 10/12/2007 email exchange between Michael Swenson and Donald Mullen, "P and L," GS MBS-E-018936577, Hearing Exhibit 4/27-68.

day!"[1852] By the end of 2007, the Mortgage Department had brought in approximately $3.7 billion in net revenues from its SPG Trading Desk.[1853]

(g) Goldman's Records Confirm Large Short Position

In addition to contemporaneous emails, presentations, and reports, Goldman's large net short position is reflected in its own financial records, including its Mortgage Department Top Sheets.[1854] Goldman's Mortgage Department kept records of its overall net short positions across various subprime asset classes on a daily basis throughout most of 2007.[1855] Those records indicate that the Mortgage Department had large net short positions in the subprime mortgage market throughout most of 2007. Goldman's documents reveal that it had a $10 billion net short position at the end of February 2007, and a $13.9 billion net short position in mid-June 2007.[1856]

(i) Top Sheets

Daniel Sparks told the Subcommittee that, in 2006 and earlier, he was frustrated because he felt Goldman had inadequate systems to track and aggregate the daily positions of the various desks in the Mortgage Department.[1857] At the end of each trading day, he had to review up to a dozen separate reports from the desks to develop a composite mental picture of the Mortgage Department's overall positions. To remedy this shortcoming, in February 2007, Mr. Sparks and the Department's strategic analysts, sometimes called "strats," developed a single-page report called the Mortgage Department Top Sheet.[1858]

The Mortgage Department Top Sheet became the primary report through which the Mortgage Department tracked its daily positions in various classes of mortgage related assets. It provided a comprehensive listing of the Mortgage Department's long and short positions in different

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1852 Id.

1853 See 10/3/2007 Goldman presentation, "SPG Trading – 2007," GS MBS-E-015654036. See also 11/16/2007 Goldman chart, "Mortgages Weekly Metrics 16-November-2007," GS MBS-E-015863620 ("P&L YTD Annl 3,742,461").

1854 See, e.g., 4/2010 "Goldman Sachs Mortgage Department Total Net Short Position, February - December 2007 in $ Billions," chart prepared by the Subcommittee, Hearing Exhibit 4/27-162 (compiled from Top Sheets); examples of Top Sheets include GS MBS-E-010369585 and GS MBS-E-010850895, Hearing Exhibit 4/27-162.

1855 Id.

1856 See 2/26/2007 Mortgage Department Top Sheet, GS MBS-E-010388545, and 6/25/2007 Mortgage Department Top Sheet, GS MBS-E-010850895, Hearing Exhibit 4/27-162.

1857 Subcommittee interview of Daniel Sparks (4/15/2010).

1858 Id.; 2/26/2007 email to Daniel Sparks, Michael Swenson, and others, "New cross desk Top Sheet risk report," GS MBS-E-010386051.

asset classes across all desks at the end of each trading day. The Top Sheet drew data from up to a dozen separate reports generated by Goldman's electronic systems. Mr. Sparks told the Subcommittee that the Top Sheet evolved over time to become a good tool that provided a comprehensive record of the Department's positions.[1859] The Goldman Controller's office told the Subcommittee that Goldman did not maintain any other type of comprehensive daily report regarding the Mortgage Department's net positions in various asset classes.[1860]

The Top Sheet was literally the top sheet, or cover page, to a comprehensive report distributed daily to Mr. Sparks and other Mortgage Department managers.[1861] The top line of the Top Sheet listed the aggregate total amounts held by the Mortgage Department in various asset classes, including AAA, AA, BBB, and BBB- rated assets.[1862] During most of 2007, the Top Sheet also provided an overall net short or long figure that summed across the top line totals for each of the respective asset classes, providing an overall figure by which the Mortgage Department was net long or net short across all asset classes each day. By plotting this overall net figure for each daily Top Sheet, the Subcommittee

[1859] Subcommittee interview of Daniel Sparks (4/15/2010).

[1860] Subcommittee discussions with Goldman Controller staff on Responses to Questions for the Record and related documents. Despite the fact that the Mortgage Department Top Sheet was the primary comprehensive position report available to Mortgage Department managers, some more senior Goldman executives appeared to be unaware of its existence. Chief Risk Officer Craig Broderick, for example, testified that he was unaware of a Mortgage Department Top Sheet and he thought the "top sheet" concept might not be suitable for the Mortgage Department. Subcommittee interview of Craig Broderick (4/9/2010). His risk office produced its own daily risk reports that translated the Mortgage Department's electronic trading data directly into risk measures, such as "VAR." Id.; see also, e.g., 8/9/2007 email from risk manager, "MarketRisk: Mortgage Risk Report (cob 08/08/2007)," GS MBS-E-010674894 (attached Goldman report, "Mortgage Risk Report – 8/9/07," GS MBS-E-010674895). The Controller's office also produced its own reports based on the Mortgage Department's electronic trading data, such as the daily profit and loss report for the Mortgage Department. Subcommittee discussions with Goldman Controller staff on responses to Subcommittee QFRs and related documents. See also 7/20/2007 email from controllers, "Mortgages Estimate," GS MBS-E-009640287.

[1861] 2/26/2007 email to Daniel Sparks, Michael Swenson, and others, "New cross desk Top Sheet risk report," GS MBS-E-010386051. The Mortgage Department shared its Top Sheet and several sub-reports for September 25, 2007, with Mr. Viniar around October 1, 2007, in a presentation that summarized the changes in the Mortgage Department's long/short positions across all desks and all assets since the initiation of the Gameplan in May 2007. 10/1/2007 Goldman internal document, "September Risk Pack Viniar," GS MBS-E-013693128 (attached to 10/1/2007 email, "Viniar Risk Pack - Sept," GS MBS-E-013693127).

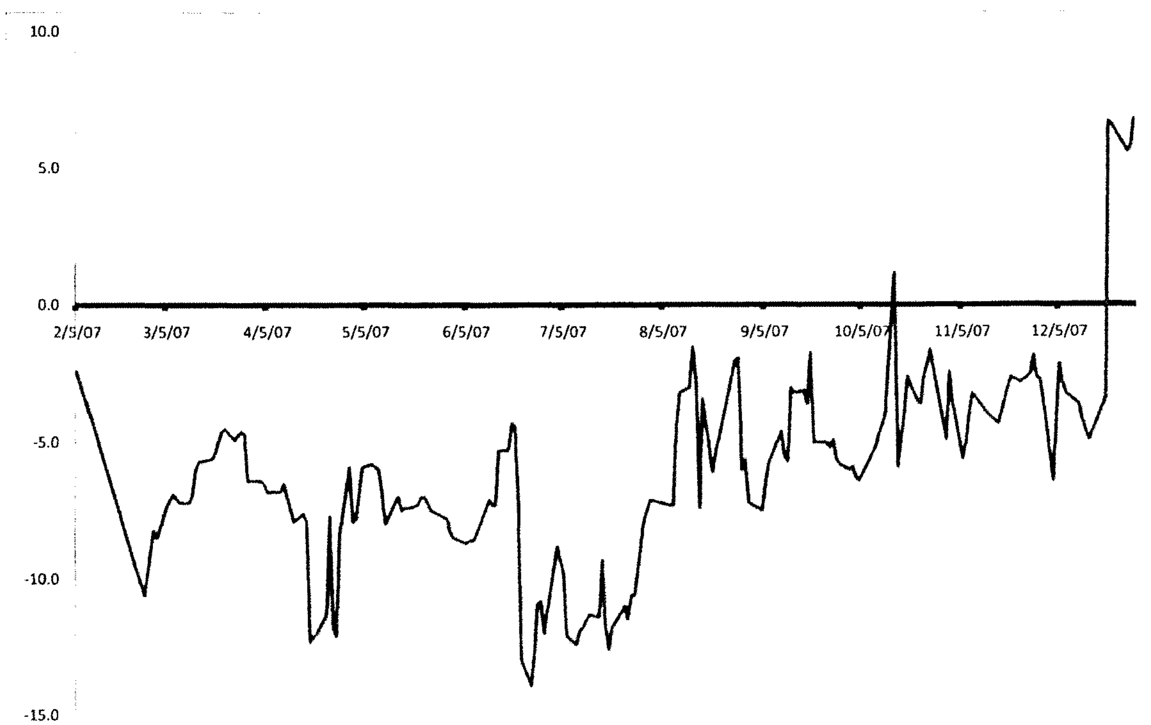
[1862] The balance of the page provided detail regarding the amount of each asset class held by each of the Mortgage Department's desks or business units. Behind the top sheet, the report provided detailed data regarding the various desks and provided different data analyses, such as changes in position from week to week. The last page of each report listed all of the electronic data sources and separate reports from which the Top Sheet was compiled. See, e.g., 2/5/2007 Mortgage Department Top Sheet, GS MBS-E-010369585, Hearing Exhibit 4/27-162.

developed a graph of the Mortgage Department's net position during 2007, as indicated on the chart on the following page.[1863]

[SEE CHART NEXT PAGE: *Goldman Sachs Mortgage Department Total Net Short Position*, prepared by the Permanent Subcommittee on Investigations.]

[1863] See chart entitled, "Goldman Sachs Mortgage Department Total Net Short Position, February-December 2007 in $ Billions," prepared by the Permanent Subcommittee on Investigations, Hearing Exhibit 4/27-162 (April 2010 version), updated January 2011 (updated version), derived from Goldman Sachs Mortgage Strategies, Mortgage Dept Top Sheets provided by Goldman Sachs (hereinafter "PSI Net Short Chart").

Goldman Sachs Mortgage Department Total Net Short Position, February - December 2007 in $ Billions
(Market Value, Including All Synthetic and Cash Positions in Mortgage Related Products)



Prepared by the U.S. Senate Permanent Subcommittee on Investigations, April 2010. Updated January, 2011.
Derived from Goldman Sachs Mortgage Strategies, Mortgage Dept Top Sheets provided by Goldman Sachs.

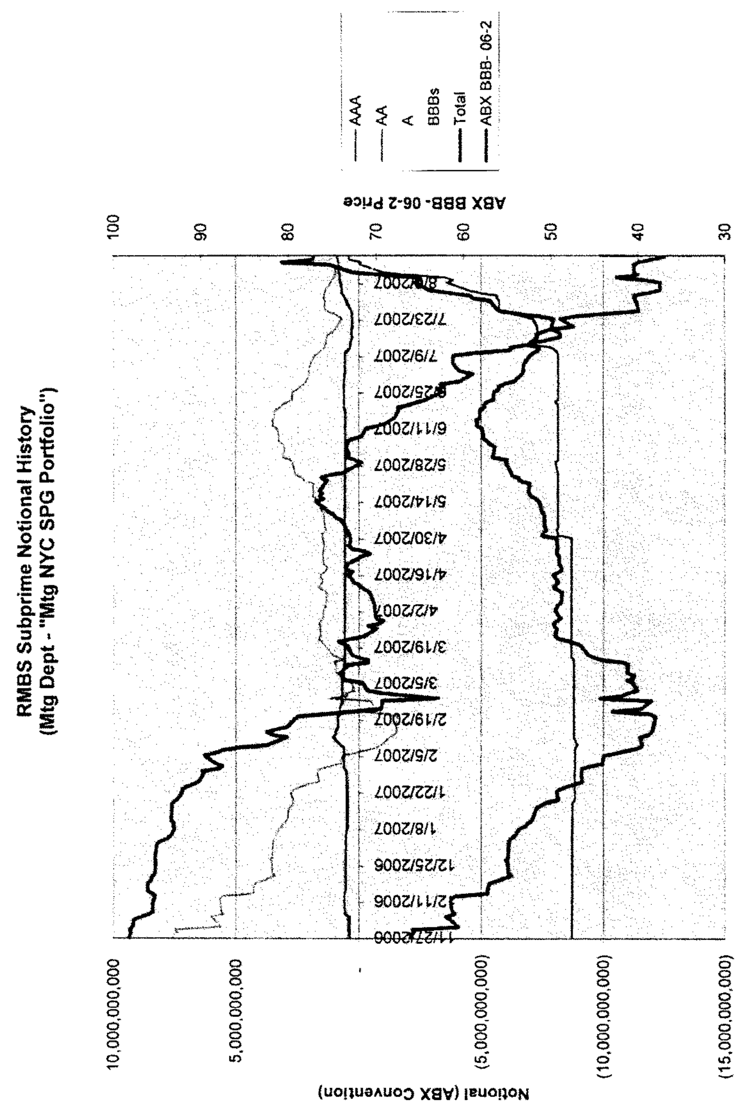
The Subcommittee's net short chart is generally consistent with a Goldman chart that Mr. Birnbaum asked one of the Mortgage Department's analysts to prepare for him in August 2007, which can be seen on the following page.

[SEE CHART NEXT PAGE: *RMBS Subprime Notional History*, prepared by Goldman Sachs.][1864]

The "zero" line in the middle of the chart represents a neutral trading position that is neither net long nor net short. To use Mr. Viniar's description, the zero line represents "home." The area below the zero line represents net short positions; the area above the line represents net long positions. The chart shows that the Goldman Mortgage Department was net short throughout 2007, with a total net short position that reached $13.9 billion in July.

[1864] 8/17/2007 Goldman internal chart, "RMBS Subprime Notional History (Mtg Dept - 'Mtg NYC SPG Portfolio')," GS MBS-E-012928391, Hearing Exhibit 4/27-56a. The title of the Goldman chart, "NYC SPG Trading" is confusing, as Mr. Birnbaum asked the analyst, Kevin Kao, for a chart of all synthetic positions across the entire Mortgage Department (including areas other than SPG Trading). In an email to Mr. Birnbaum, Mr. Kao confirmed that despite the title, the chart actually included all synthetic positions across the entire Mortgage Department, and not just the SPG Trading Desk positions. 8/17/2007 email from Mr. Kao to Mr. Birnbaum, GS MBS-E-012929469. Mr. Kao explained that his chart did not include cash positions, meaning long positions in mortgage loans or RMBS from any remaining warehouse inventory. Id. That omission was not significant, however, since Goldman had rapidly sold off the vast bulk of its cash inventory starting in November 2006. 4/2010 "Goldman Sachs Long Cash Subprime Mortgage Exposure, Investments in Subprime Mortgage Loans, and Investments in Subprime Mortgage Backed Securities November 24, 2006 vs. August 31, 2007 - in $ Billions," chart prepared by the Subcommittee, Hearing Exhibit 4/27-163. In any event, the Subcommittee's net short chart includes the Department's cash positions and demonstrates that any long cash positions were insufficient to offset the shorts, as the Mortgage Department was massively net short throughout most of 2007. See PSI Net Short Chart.

In his Supplemental Responses to Questions for the Record from the Subcommittee, Mr. Birnbaum conceded that the Subcommittee's net short chart includes cash positions and therefore fixed the problem of being limited to synthetics as was the case with Goldman's own net short chart. See 8/17/2007 Goldman internal chart, "RMBS Subprime Notional History (Mtg Dept - Mtg NYC SPG Portfolio)," GS MBS-E-012928391, Hearing Exhibit 4/27-56a; Birnbaum responses to Subcommittee QFRs at PSI_QFR_GS0509. Mr. Birnbaum maintained his objection that the Subcommittee's net short chart improperly summed the notional amounts of different asset classes. Id. However, as noted in the text, the Mortgage Department's Top Sheet actually converted the notional amounts of each asset class into their market values, making it fair to sum across all asset classes.



Gsmbs-E-012928391

Some Goldman representatives told the Subcommittee that they objected to both the Subcommittee's net short chart, and Goldman's own similar chart, on the grounds that the charts are too simplistic and fail to account for the relative "weight" or value of short positions in differing asset classes.[1865] For example, in a 2010 interview with the Subcommittee, Mr. Birnbaum said that because of their differing "weights" or values relative to one another, the notional amounts in each asset class could not simply be summed up together. For example, he said the notional amount of AAA assets cannot be added to the notional amount of BBB assets, because the market assigns each of those positions different weights or values relative to each other.[1866] He said that these relative weights or values are often expressed as specific "hedge ratios" which Goldman traders can call up on their computer screens in real time to tell them, for example, the amount of AAA assets they should buy long to hedge a given net short position in BBB assets.[1867] Each class also poses a different level of risk than the others. For example, short positions in AAA assets were relatively inexpensive, as the risk of loss in that tier was considered relatively low, while short positions in BBB assets would have higher prices, because the risk of loss was considered high. Mr. Birnbaum said the only chart of Goldman's net short position that he would accept as fairly representative would be one that was "Beta-adjusted" to account for differences in the relative weights, but he admitted that he was unaware of any such charts or reports created by Goldman during 2007.[1868] Without considering these relative weights (which continually change based on market price movements in various asset tiers), Mr. Birnbaum said it would be impossible to say that Goldman was ever "net short" at all or in what amount.[1869]

Goldman's own documents provide a different picture, however. The Top Sheet was the primary comprehensive record used by the Mortgage Department to track all net positions across the Mortgage Department. Goldman did not keep any other records that identified the

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[1865] See Birnbaum responses to Subcommittee QFRs at PSI_QFR_GS0509. Subcommittee interview of Joshua Birnbaum (10/1/2010).

[1866] Subcommittee interview of Joshua Birnbaum (10/1/2010); Subcommittee interview of Michael Swenson (10/8/2010).

[1867] Subcommittee interview of Joshua Birnbaum (10/1/2010).

[1868] Id.

[1869] Id. Mr. Swenson made similar statements in his second Subcommittee interview. "Were we ever net short? It's hard to say what 'net short' means really." Subcommittee interview of Michael Swenson (10/8/2010). Mr. Swenson had no such difficulty, however, in his first Subcommittee interview. When asked the greatest amount by which he remembered his desk being net short, Mr. Swenson replied: "$9 billion." Subcommittee interview of Michael Swenson (4/16/2010).

Mortgage Department's net positions in various asset classes,[1870] and did not keep any records that used the "Beta-adjustment" method advocated by Mr. Birnbaum. By early March 2007, the Top Sheet generally expressed the market values of positions in different asset classes, rather than the notional amount of the positions.[1871] By using the market values of positions in each asset class on a given day, the Mortgage Department did, in fact, create a reasonable method for summing across all asset classes in a single common denominator – the amount of cash the assets would bring in the market that day. Since the Subcommittee's net short chart relies on the Department's daily Top Sheet figures as expressed in market values rather than notional amounts, it does not suffer from the incompatibility defect pointed out by Mr. Birnbaum.

Mr. Birnbaum's position that the notional amounts of each asset class cannot be summed up together is also inconsistent with what Goldman's Mortgage Department did on a day-to-day basis in 2007. Mr. Sparks, the Mortgage Department head who helped design the Top Sheet, used it to measure the Department's daily position. Mortgage Department personnel and other Goldman executives also discussed the Department's being "net short"– either overall or in specific asset classes – on a daily basis.[1872]

Indeed, the phrase "net short" appears more than 3,400 times in the documents produced to the Subcommittee by Goldman.[1873] Since Mr. Birnbaum claimed that one could never really say whether Goldman was truly "net short," the Subcommittee asked him why the phrase "net short" appeared so many times in Goldman's documents. Mr. Birnbaum said

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[1870] As noted above, the risk management and controller areas at Goldman kept their own daily reports based on the Mortgage Department's electronic trading data, but they did not track Goldman's aggregate positions in each asset class on either a notional or market value basis. Rather, the risk area converted the Mortgage Department data into risk measures, while the controllers' area converted the data into profit and loss reports. Though based on the Mortgage Department's reported daily trading, these reports did not directly reflect specific net positions in subprime mortgage assets.

[1871] In general, positions were expressed in market values for all liquid assets and in "hedge equivalents" of illiquid assets, meaning the market value of a position that could be used to hedge that asset. See e.g., 3/5/2007 Mortgage Department Top Sheet, GS MBS-E-010630691 (Legend: "Market Value (MM$)(Hedge Equiv MV for CDS)"); 9/11/2007 email, GS MBS-E-010690522, attaching 9/10/2007 Mortgage Department Top Sheet, GS MBS-E-010690523 ("Market value of bonds/loans, bond equiv mkt val for synthetics.").

[1872] See e.g., 3/5/2007 email from Daniel Sparks to Tom Montag and others, GS MBS-E-010646842 ("We think the overall business is net short"); 3/8/2007 email from Daniel Sparks to Jon Winkelried and others, "Mortgage Risk," GS MBS-E-002211242 ("We are still net short"); 7/21/2007 email from Daniel Sparks to Donald Mullen and others, "Mortgages Estimate," GS MBS-E-009640287 ("There is also a large net short that we are chipping away to cover").

[1873] 1/10/2011 Concordance search of all documents produced to the Subcommittee by Goldman for the phrase "net short."

that the use of the phrase "net short" was a "shorthand" that was used internally in the Mortgage Department.[1874] In fact, neither Mr. Birnbaum, Goldman, nor the Subcommittee could identify any specific document or instance from 2007 in which the weighting exercise advocated by Mr. Birnbaum in his September 2010 interview was ever used or suggested.

Aside from the Top Sheet that summed up totals across different asset classes to obtain an aggregate total, there are also many documents in which Goldman personnel described the total amounts by which Goldman was net short in respective asset classes. For example, Mr. Swenson, and later Mr. Lehman, compiled an email summary each week that described each Mortgage Department desk's net position in different asset classes. A typical format was as follows:

> "Current [SPG Trading] Desk Position Summary:
>
> - RMBS Single-As - net short 900mm 100% in single-name CDS
> - RMBS BBB/BBB- - net short 3,000mm (80% in single-name CDS - 50% 2005 vintage
> - Correlation Desk - net short $400mm of ABX 06-1 BBB and BBB-
> - Mortgage Department short approx $4bb AAA ABX"[1875]

Mr. Swenson's email summaries were forwarded to Mr. Montag and other senior executives to keep them apprised of the Department's positions.[1876] While these documents did not provide an aggregate overall net short position for the Mortgage Department, they did establish net short positions in each of the various specific asset classes described, and they were apparently acceptable to and relied upon by various Goldman executives. Throughout most of 2007, these weekly reports clearly show very large net short positions in mortgage related assets.[1877]

Email correspondence among Goldman's senior executives also routinely referred to the Mortgage Department's net short positions in "billions."[1878] CFO David Viniar told the Subcommittee that a loss (or

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[1874] Subcommittee interview of Joshua Birnbaum (10/1/2010).
[1875] 8/5/2007 email from David Lehman to Tom Montag, "Mtg Department Weekly Update," GS MBS-E-010671564.
[1876] Id.
[1877] Id.
[1878] See, e.g., 8/23/2007 email from Tom Montag to Daniel Sparks, "Current Outstanding Notional in SN ames," GS MBS-E-010621231 (Mr. Montag said, "so if I make you sell a whopping 800 out of 3 billion which is less than 30% how can anyone complain- -the position is huge and outsized."); 3/14/2007 email from Tom Montag to Lloyd Blankfein, "Cactus Delivers," GS MBS-E-009632839 ("Covered another 1.2 billion in shorts in mortgages"); 8/23/2007 email

gain) in the amount of even $25 million was considered "large" and would immediately be brought to his attention.[1879] By that standard, net revenues of $2 billion from the Mortgage Department's net short positions in the third quarter of 2007 would have been considered significant and monitored by senior management, as indeed they were.

In testimony before the Subcommittee and other public statements, Goldman attempted to minimize the size of its net short position by suggesting to the Subcommittee that the short positions held by the Mortgage Department were hedges for other, unidentified long assets.[1880] Mr. Blankfein even made that argument to his colleagues in September 2007: "The short position wasn't a bet. It was a hedge."[1881] But Mr. Birnbaum contradicted that position just a few days later. On October 4, 2007, Mr. Birnbaum prepared on behalf of the SPG Trading Desk a presentation entitled, "SPG Trading – 2007," in which he advocated that SPG Trading Desk personnel should be compensated like hedge fund managers and not as ordinary participants in Goldman's traditional bonus pool system.[1882] The presentation, which Mr. Birnbaum prepared to anticipate and refute counter-arguments that might be made by Goldman senior executives, explicitly addressed and rejected the contention that the profitable net short positions managed by the SPG Trading Desk were

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from Tom Montag to Gary Cohn and David Viniar, "Harbinger post," GS MBS-E-009739009 ("We had bought back almost 9 billion of aaa abx over last two weeks though"); 2/27/2007 email from Richard Ruzika to Tom Montag, GS MBS-E-002204942 ("I want to see us getting the short down to 4.5 bil[lion] net").

[1879] Subcommittee interview of David Viniar (4/13/2010).

[1880] See, e.g., Testimony of David Viniar, April 27, 2010, Subcommittee Hearing at 98, 99-100; 4/7/2010 Blankfein & Cohn Letter to Shareholders (quoted in 4/2010 Goldman report, "Risk Management and the Residential Mortgage Market," at 12, Hearing Exhibit 4/27-161).

[1881] 9/26/2007 email from Lloyd Blankfein, "Fortune: How Goldman Sachs Defies Gravity," GS MBS-E-009592726. Mr. Blankfein went on to explain what he meant by "hedge": "Ie, the avoidance of a bet. Which is why for a part it subtracted from var, not added to var." Mr. Blankfein did not explain the "part" in which the big short subtracted from VAR. In February and August 2007, most of Goldman's senior management expressed concern that the large net short positions added to VAR, rather than subtracted from it, and indeed, pushed the firmwide VAR to record levels.

[1882] 10/3/2007 Goldman presentation, "SPG Trading – 2007," GS MBS-E-015654036. Mr. Swenson and Mr. Lehman reviewed and commented upon the "SPG Trading – 2007" presentation. Mr. Birnbaum revised the presentation to make the changes Mr. Swenson and Mr. Lehman suggested. See, e.g., 10/2/2007 email from David Lehman to Joshua Birnbaum, "SPG Trading - 2007.ppt," GS MBS-E-015653681 (providing comments and suggesting text for presentation). Mr. Birnbaum replied and copied Mr. Swenson on the email chain as well: "I added your bullet and one more." Id. See also 10/4/2007 email from Joshua Birnbaum to Michael Swenson and David Lehman, "How's this?," GS MBS-E-015712249 (forwarding revised bullet point for presentation). This collaboration indicates the presentation was made on behalf of the SPG Trading Desk as a whole. Mr. Birnbaum, however, told the Subcommittee that the SPG Trading Desk ultimately did not use the presentation in connection with its proposal for 2007 compensation. See Birnbaum responses to Subcommittee QFRs at PSI_QFR_GS0509.

hedges for long assets held by other desks. Mr. Birnbaum, one of the chief architects of Goldman's big short, stated:

> "By June [2007], all retained CDO and RMBS positions were identified as already hedged. ... SPG trading re-initiated shorts post BSAM [Bear Stearns Asset Management] unwind on an outright basis with no accompanying CDO or RMBS retained position longs. In other words, the shorts *were not a hedge.*"[1883] (Emphasis in original).

In response to Questions for the Record from the Subcommittee, Mr. Birnbaum once again stated that SPG Trading initiated the "shorts on an outright basis with no accompanying CDO or RMBS retained position longs following the Bear Stearns Asset Management unwind in 2007, and that these positions were not a hedge."[1884]

Mr. Birnbaum's statement that "all retained CDO and RMBS positions were identified as already hedged" by June 2007 is also supported by other documents provided by Goldman's Mortgage Department. On February 28, 2007, for example, David Rosenblum, Co-Head of the CDO/CLO Origination Desk, initiated a project to ensure that all of the CDO Origination Desk's warehouse accounts were "fully hedged."[1885] As a result, the CDO Origination Desk initiated new hedges and specifically allocated others to cover all the desk's warehouse risk. Learning of these actions, Mr. Rosenblum responded: "Great. Getting pretty nailed down."[1886] In addition, in a February 12, 2007 email, Mr. Sparks reported to senior management: "Loan and residual books flat," and indicated that the Department's long positions were fully hedged with the short ABX positions.[1887] In a third example, after conclusion of the CDO valuation project, all of the remaining CDO assets were transferred from the CDO Origination Desk to the SPG Trading Desk in May 2007. Even after the transfer of those long assets, the SPG Trading Desk remained short, suggesting again that the CDO assets may have already been hedged.[1888] These Goldman documents all support Mr. Birnbaum's statement that all retained CDO and RMBS positions were identified as

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[1883] 10/3/2007 Goldman presentation, "SPG Trading – 2007," GS MBS-E-015654036 [emphasis in original].

[1884] See Birnbaum responses to Subcommittee QFRs at PSI_QFR_GS0509.

[1885] 2/28/2007 email from David Rosenblum to Peter Ostrem, "Pete– pls send me cob 2/28 MTM for SP CDO WH's first thing in the morning," GS MBS-E-001800707; 2/28/2007 email from David Rosenblum,"Hedges Status Report," GS MBS-E-002640538 (new ABX hedges added and other hedges allocated to ensure that CDO warehouse risk was fully hedged).

[1886] Id.

[1887] 2/12/2007 email from Daniel Sparks, "Post today," GS MBS-E-002202310.

[1888] Id.; PSI Net Short Chart.

already hedged when the SPG desk started rebuilding its net short position in June 2007.

(ii) Risk Reports

The Mortgage Department's large net short positions were also demonstrated by the periodic risk reports that recorded Goldman's key risk measure, "Value at Risk" or "VAR," throughout 2007. At a 95% confidence level, VAR represents the dollar amount a business unit, here the Mortgage Department, could expect to make or lose once every 20 trading days – or about once a month.[1889]

The Mortgage Department's VAR skyrocketed during 2007, climbing far beyond the Mortgage Department's permanent VAR limit of $35 million and hitting a record high of $113 million in mid-August 2007.[1890] In 2007, with notable exceptions discussed below, whenever the Mortgage Department's trading exceeded its risk limits, Goldman's risk managers simply assigned the department a new, higher "temporary" risk limit to accommodate the Department's trading.[1891]

At the same time, the higher VAR did signal the presence of a large net short position and functioned to limit the size of that position. Twice during 2007, in late February and again in late August, Goldman's senior executives ordered the Mortgage Department to reduce its large short positions in order to bring the firm's overall VAR measure down.[1892] The senior executives were aware of the Mortgage Department's large net short positions, in part, because those positions had contributed to increases in Goldman's firmwide or trading VAR.

The firm tolerated the exceptionally high levels of VAR generated by the Mortgage Department, despite the risks reflected in those high VAR levels.[1893] On the few days when the market rallied, the Mortgage

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[1889] Subcommittee interview of Craig Broderick (4/9/2010). See also Philippe Jorion, "Value at Risk: The New Benchmark for Managing Financial Risk," at 20, (3d ed. 2007).
[1890] See Mortgage Department Quarterly Average VAR. (Third Quarter 2006 - $13 million; Fourth Quarter 2006 - $14 million; Second Quarter 2007 - $63 million; Third Quarter 2007 - $68 million; Fourth Quarter 2007 - $75 million). See 9/2007 Quarterly Market Risk Review, "Market Risk Management and Analysis," GS MBS-E-009590673, Hearing Exhibit 4/27-54e; see also 12/2007 Quarterly Market Risk Review, "Market Risk Management and Analysis," GS MBS-E-009586222, Hearing Exhibit 4/27-54f.
[1891] 8/9/2007 email from Joshua Birnbaum to Deeb Salem, "MarketRisk: Mortgage Risk Report (cob 08/08/2007)," GS MBS-E-012927202.
[1892] 2/27/2007 email from Richard Ruzika to Tom Montag and others, GS MBS-E-002204942; 8/15/2007 email from Gary Cohn, "Trading VaR $165mm," GS MBS-E-016344758; Subcommittee interview of Joshua Birnbaum (10/1/2010).
[1893] Subcommittee interview of Craig Broderick (4/9/2010).

Department incurred huge losses from its net short position that were immediately reported up the chain to senior management. For example, upon hearing of a $100 million loss in a single day, Mr. Montag asked: "Okay, who lost the hundy?"[1894] Mr. Viniar told the Subcommittee that he was notified of even a $25 million loss in a single day.[1895] Allowing the Mortgage Department to maintain high VAR levels meant that Goldman's large net short positions left the firm exposed to large losses, which in some instances did occur, though not as often as its VAR predicted they might.[1896]

Risk Management at Goldman. Every business unit and trading desk at Goldman had a counterpart in the firm's risk management area.[1897] Risk managers were assigned to "shadow" the relevant business unit and trading desk operations to ensure that their respective trading activities did not exceed pre-determined risk limits.[1898] Separate VAR limits were set

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[1894] 8/8/2007 email from Tom Montag to David Lehman and Michael Swenson, GS MBS-E-011311633.
[1895] Subcommittee interview of David Viniar (4/13/2010).
[1896] Mr. Birnbaum frequently argued that VAR, or at least Goldman's then-current model of VAR, was an inappropriate risk measure for the Mortgage Department's shorting activities. 8/9/2007 email from Joshua Birnbaum to Deeb Salem, "MarketRisk: Mortgage Risk Report (cob 08/08/2007)," GS MBS-E-012927200 ("These VAR numbers are ludicrous, btw. Completely overestimated for SPG trading, underestimated for other mortgage desks."). He contended that for various reasons, the Mortgage Department was not actually as short as the VAR measure reflected. See, e.g., 9/26/2007 2007 MD Reviews, Joshua Birnbaum Self-Review, GS-PSI-01956, Hearing Exhibit 4/27-55c. In arguing for a special compensation model for the SPG Trading Desk, Mr. Birnbaum pointed out that the desk never lost as much money as the firm's VAR measure predicted it would. 10/3/2007 Goldman presentation, "SPG Trading – 2007," GS MBS-E-015654036. Accordingly, Mr. Birnbaum may have been correct that the firm's VAR measure did not accurately measure risk to the firm. Id. On the other hand, since VAR rests on probability theory which is based on a "normal" distribution of profits and losses (the typical "bell curve"), the Mortgage Department may have benefitted from the extraordinary and continual one-way movement downward in the subprime mortgage markets.

One risk management expert testified before Congress: "It is well known that VaR cannot measure crisis risk. During periods of crisis the relationship between securities changes in strange and seemingly unpredictable ways. VaR, which depends critically on a set structure for volatility and correlation, cannot provide useful information in this situation. It contains no mechanism for predicting the type of crisis that might occur, and does not consider the dynamics of market crises. This is not to say that VaR has no value or is hopelessly flawed. Most of the time it will provide a reasonable measure of risk – indeed the vast majority of the time this will be the case. If one were forced to pick a single number for the risk of a portfolio in the near future, VaR would be a good choice for the job." Prepared statement of Richard Bookstaber, "The Risks of Financial Modeling: VaR and the Economic Meltdown," before the U.S. House of Representatives Committee on Science and Technology, Subcommittee on Investigations and Oversight, Serial No. 111-48 (9/10/2009), at 4.
[1897] Subcommittee interview of Craig Broderick (4/9/2010).
[1898] The Mortgage Department had other risk limits aside from VAR, including Credit Spread Widening or "CSW," which seeks to measure what would happen if credit spreads suddenly widened by large amounts (called "shocks"); "dv01," which measures the dollar amount by which a security's value would change based on a 1 basis point change in the relevant index or interest rate; and balance sheet limits, meaning the amount of Goldman's balance sheet the

for the firm as a whole and for each division. The division then allocated its VAR limit among each department or business area within a division. Some trading desks within a department also had assigned risk limits.

At the end of a typical trading day, Goldman's Risk Department prepared risk reports containing some or all of the risk measures used for the Mortgage Department. The Risk Department prepared daily, weekly, and quarterly risk reports, as well as reports for the Board of Directors and various management committees.[1899] Goldman's Firmwide Risk Committee (FWRC) was co-chaired by David Viniar and its weekly meetings were often attended by Co-President Gary Cohn and CEO Lloyd Blankfein.[1900] In preparation for a meeting with regulators, Goldman senior executives noted that the Mortgage Department was discussed at every meeting of the FWRC throughout 2007.[1901] Goldman also noted that risk "[l]imits are set by the FWRC. Decisions regarding, e.g., short positions in mortgages taken by business units but with full knowledge of the 30th floor."[1902]

Goldman executives told the Subcommittee that, in general, risk limits were firm and compliance was mandatory.[1903] At the end of each day, department and divisional personnel, their respective risk managers, and other executives were provided with risk reports from which they could readily see whether a trading desk had breached its limits. In the event of a violation, the desk would be directed to curtail its activities or to take whatever steps were necessary to bring its trading within the applicable limits. Once a desk was notified of its breach of a limit, it was

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relevant business unit would be permitted to consume. Subcommittee interview of Craig Broderick (4/9/2010).

1899 9/2006-12/2007 Goldman Sachs Quarterly Market Risk Review, "Market Risk Management & Analysis." Hearing Exhibits 4/27-54a-f and GS MBS-E-010674895.

1900 11/13/2007 Goldman email, GS MBS-E-010023525 (attachment, 11/14/2007 "Tri-Lateral Combined Comments," GS MBS-E-010135693-715). In November 2007, Goldman's Chief Risk Officer, Craig Broderick, Controller Sarah Smith, and senior members of their staffs met with the Tri-Lateral Review Group, which included representatives of the Federal Reserve Bank, the SEC, and the United Kingdom's Financial Services Authority, to discuss risk management during the financial crisis. The "Trilateral Combined Comments" are the talking points prepared by Goldman senior executives for that meeting, in order to respond to specific written questions Goldman and other firms had received from the Trilateral Review Group.

1901 Id.

1902 Id. The reference to the 30th floor was to the floor on which Goldman's senior executives then had their offices in Goldman's New York headquarters. Goldman also noted that "sr mgmt participated actively in all of the significant exposure management including when / how to reduce positions."11/13/2007 Goldman email, GS MBS-E-010023525 (attachment, 11/14/2007 "Tri-Lateral Combined Comments," GS MBS-E-010135693-715 at 695).

1903 Subcommittee interview of Joshua Birnbaum (10/1/2010); Subcommittee interview of Craig Broderick (4/9/2010).

generally required to act immediately to comply with the existing limits.[1904]

At times, the Mortgage Department proposed various modifications or alternatives to its existing risk measures. Some of these proposals were adopted and some were not.[1905] But from the perspective of the firm's most senior executives, VAR appeared to have been the predominant risk measure by which the Department's activities were judged.[1906]

VAR Levels Show Net Short. The primary factors that influence VAR are: (1) the relative size and correlation of positions, and (2) the volatility of trading.[1907] While VAR is computed by applying a complex algorithm to trading data, the VAR measure directly reflects position size and correlation, and volatility – or a combination of both factors.[1908] Changes in VAR levels over time can also provide information about the general magnitude and direction of trading positions.

In the fourth quarter of 2006, the Mortgage Department's permanent VAR limit was $20 million, of which it consumed only $13 million.[1909]

1904 Subcommittee interview of Joshua Birnbaum (10/1/2010).

1905 See, e.g., 2/8/2007 email from Michael Dinias to Robert Berry, and Craig Broderick, GS MBS-E-009980807; 2/24/2007 email from Robert Berry to David Viniar, Craig Broderick and Bill McMahon, "Mortgage VaR," GS MBS-E-009778897 (recommending model parameters for VAR calculations); 4/18/2007 email from Jeremy Primer to Joshua Birnbaum, "Resolution from MRMA meeting?," GS MBS-E-012868698 (discussing further adjustment to VaR calculation); 4/23/2007 email from Robert Berry to Daniel Sparks and SPG Trading Desk, "Mortgage VaR," GS MBS-E-009708690 (adjustments to VAR calculations).

1906 See, e.g., 8/21/2007 email from Tom Montag to Gary Cohn, GS MBS-E-016344758; 8/21/2007 email from Michael Dinias, "Trading VaR Analysis," GS MBS-E-009742070; Subcommittee interview of David Viniar (4/13/2010) and Joshua Birnbaum (10/1/2010); 2/24/2007 email from Robert Berry to David Viniar and others, "FW: Mortgage VaR," GS MBS-E-009778897.

1907 See generally "The Risks of Financial Modeling: VaR and the Economic Meltdown," before the U.S. House of Representatives Committee on Science and Technology, Subcommittee on Investigations and Oversight, H.R. Hrg. 111-48 (9/10/2009), at 4 (Written Testimony of Richard Bookstaber); Philippe Jorion, "Value at Risk: The New Benchmark for Managing Financial Risk (3d ed. 2007) at 64.

1908 See id. Based on these factors, VAR is generally lower if a desk has many small and non correlated (well diversified) positions that are trading at steady and predictable price levels. By contrast, VAR is higher if a desk is holding a small number of very large and highly correlated positions that are trading at volatile and unpredictable price levels. The position size/correlation and volatility factors may also operate independently. Thus, even if the desk has a large number of relatively small and non correlated positions, VAR tends to rise as the volatility of trading rises. Similarly, even if there is little volatility in trading, VAR tends to rise as the desk's position sizes become larger and increasingly correlated. The two factors also reinforce one another – large position sizes combined with high volatility tend to increase VAR dramatically.

1909 Market Risk Management & Analysis, Quarterly Market Risk Review, December 2006, GS MBS-E-009583144, Hearing Exhibit 4/27-54; see also 2/6/2007 email from MarketRisk,"MarketRisk: Mortgage Risk Report (cob 02/06/07)," GS MBS-E-009980807 (Mortgage SPG VaR Limit 20).

Early the next year, on February 5, 2007, the Mortgage Department exceeded its limit with a VAR of $20.5 million.[1910] On February 8, 2007, a senior risk manager recommended that the Mortgage Department's permanent VAR limit be increased to $30 million to accommodate anticipated increased price volatility in the mortgage markets that year.[1911] A senior manager concurred and increased the Mortgage Department's permanent VAR limit to $35 million, which remained the Mortgage Department's "permanent" limit throughout 2007.[1912]

Almost immediately, however, the Mortgage Department breached its new limit, and its VAR continued to climb. Over the course of a single quarter, the Mortgage Department's VAR jumped from $13 million at the end of 2006, to $85 million in the first quarter of 2007 – a 550% increase. Goldman's Chief Risk Officer, Craig Broderick, told the Subcommittee that he would be concerned about any breach of a VAR limit, and would certainly investigate the doubling of a business unit's VAR, but he admittedly took no action when the Mortgage Department's VAR more than quintupled over the course of a single quarter. Mr. Broderick attributed the steep rise in VAR almost exclusively to unprecedented market volatility,[1913] although other Goldman officials stated that the VAR levels were being driven by Goldman's large net short positions.[1914]

For the most part, Goldman's risk managers ignored the Mortgage Department's VAR violations and did not demand immediate compliance with the last applicable limit, as would ordinarily be the case.[1915] With notable exceptions in late February and late August 2007, Goldman's risk managers continually assigned the Mortgage Department new "temporary" VAR limits large enough to accommodate whatever risk levels resulted from the Department's trading. Mr. Birnbaum later

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[1910] 2/8/2007 email from Michael Dinias, "VaR limit for Mtg SPG," GS MBS-E-009980807.
[1911] Id.
[1912] Id.
[1913] Subcommittee interview of Craig Broderick (4/9/2010).
[1914] 2/27/2007 email from Richard Ruzika to Tom Montag, others, GS MBS-E-002204942; Subcommittee interview of Joshua Birnbaum (4/22/2010); Subcommittee interview of Daniel Sparks (4/15/2010); 8/9/2007 email from Joshua Birnbaum to Deeb Salem, "MarketRisk: Mortgage Risk Report (cob 08/08/2007)," GS MBS-E-012927202; 8/16/2007 email from Michael Dinias, "mortgage var contribution," GS MBS-E-011247689 ("Mortgage Trading has 53.8% marginal contribution to Firmwide VaR and removing the entire mortgage business reduces Firmwide VaR by $53mm (from $165mm to $112mm). ... As expected SPG Trading desk dominates this risk with 56% contribution and adds $49mm to Firmwide VaR. This is primarily driven by ABS Synthetics and Correlation book which have the bulk of the mortgage shorts."); 8/21/2007 email from Michael Dinias, "Trading VaR Analysis," GS MBS-E-009742070 (Mortgage VAR "primarily driven by mortgage shorts on the ABS Synthetics and Correlation desks."); 8/22/2007 email from Tom Montag to Lloyd Blankfein, "Trading VaR $144mm," GS MBS-E-009605812, Hearing Exhibit 4/27-36 ("we are covering a number of shorts in mortgages today and tomorrow–probably 1.5 billion worth–will reduce mortgages [VAR] hopefully to below [$]80 [million]").
[1915] Subcommittee interview of Joshua Birnbaum (10/1/2010).

described this pattern as the risk area's "policy to just keep increasing ou[r] limit."[1916]

The first quarter of 2007 is illustrative of the pattern. During that quarter, the Mortgage Department's trading activities exceeded three new VAR limits in as many weeks. The Mortgage Department received its new permanent VAR limit of $35 million on February 8, 2007.[1917] Four days later, on February 12, the Department's VAR hit $49 million.[1918] On February 14, the Department was assigned a new "temporary" limit of $50 million that would expire on February 20.[1919] By February 20, however, the Department's VAR was $63 million, well in excess of its temporary limit of $50 million.[1920] So the Department was assigned a new temporary limit of $60 million – a level it was already exceeding – until February 27.[1921] Instead of dropping below the new temporary limit of $60 million, the Mortgage Department's VAR continued to rise until it hit a quarter-high level of $85 million on February 23 and February 26.[1922] In response, on February 27, the Department was given yet another temporary limit of $90 million through the end of the month.[1923] But the precipitous rise in VAR apparently alarmed Goldman's Operating Committee, which ordered the Department to reduce the size of its net

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1916 8/9/2007 email from Joshua Birnbaum to Deeb Salem, "MarketRisk: Mortgage Risk Report (cob 08/08/2007)," GS MBS-E-012927198. It is unclear the extent to which Goldman's regulators were aware of the Mortgage Department's VAR levels. In November 2007, Goldman met with the Tri-Lateral Review Group, which included the Federal Reserve Bank, the SEC, and the United Kingdom's Financial Services Authority, regarding its risk management during the financial crisis. Talking points prepared by Goldman personnel for that meeting stated that with respect to VAR: "Exposures were managed responsibly by the business units within agreed limits. Highs were set in Mortgages .... Benign P&L allowed for a disciplined but measured response."11/13/2007 Goldman email, GS MBS-E-010023525 (attachment, 11/14/2007 "Tri-Lateral Combined Comments," GS MBS-E-010135693-715 at 707). This description did not disclose that the Mortgage Department, for nearly the entire year, had routinely exceeded its $35 million VAR limit by significant amounts for months on end.

1917 2/8/2007 email from Michael Dinias, "FW: VaR limit for Mtg SPG," GS MBS-E-009980807.

1918 2/13/2007 email, "MarketRisk: End of Day Summary - cob 02/12/2007," GS MBS-E-009716432; see also 2/14/2007 Goldman internal email, "Increase in Mortgage VaR," GS MBS-E-010374687 ("MTG SPG Desk VaR increase from $21 mm to $48mm from cob Feb 6 to cob Feb 13, driven primarily by SPG Trading desk").

1919 2/14/2007 email, "MarketRisk: End of Day Summary - cob 02/13/2007," GS MBS-E-009763394 ("Mortgages VAR is over its $35mm limit. Temporary $50mm limit was granted until cob 02/20/2007.").

1920 2/20/2007 email, "MarketRisk: End of Day Summary - cob 02/16/2007," GS MBS-E-009724779. 2/22/2007 email, "MarketRisk: End of Day Summary - cob 02/21/2007," GS MBS-E-009762741 (Mortgages VAR on 2/20 was 63 million).

1921 Id. ("Mortgages VAR has a temporary $60mm limit until cob 2/27/2007.").

1922 2/26/2007 email, "MarketRisk: End of Day Summary - cob 2/23/2007," GS MBS-E-009720057; 2/27/2007 email, "MarketRisk: End of Day Summary - cob 2/26/2007," GS MBS-E-009764685.

1923 2/27/2007 email, "MarketRisk: End of Day Summary - cob 2/26/2007," GS MBS-E-009764685 ("Mortgages VAR has a temporary $90mm limit until cob 03/06/07."). 2/28/2007 email, "MarketRisk" End of Day Summary - cob 2/27/2007," GS MBS-E-009762239.

short position to $4.5 billion.[1924] The Department responded immediately and, by February 28, had reduced its VAR to $81 million.[1925]

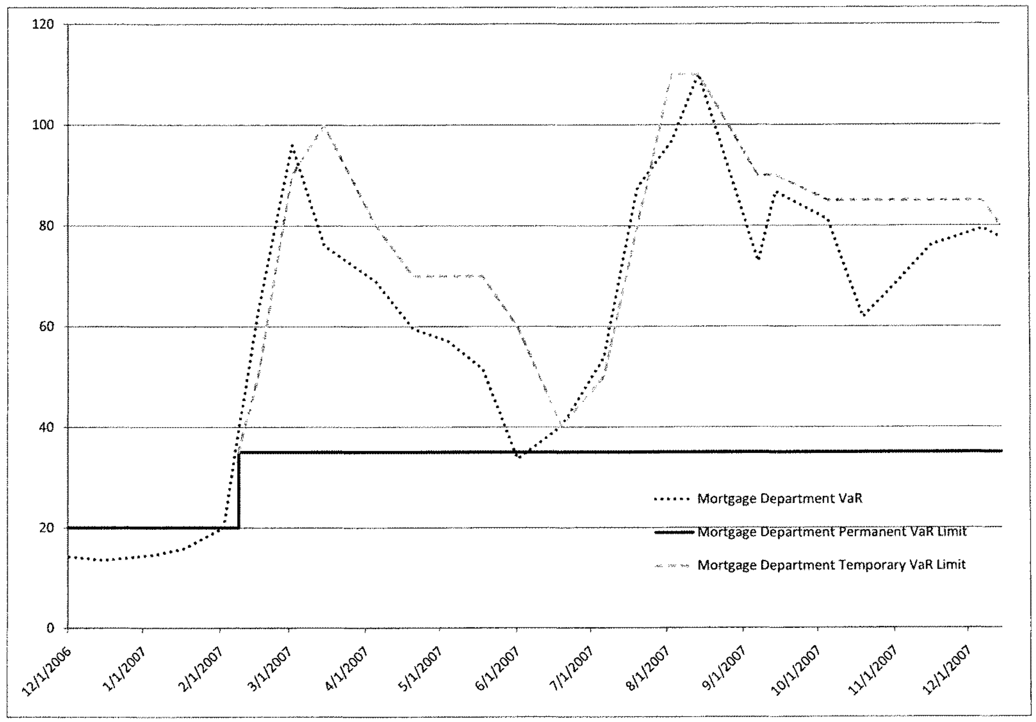
The pattern created by the Mortgage Department's increasing VAR levels, and the lagged reaction of Goldman's risk managers in setting new "temporary" limits over the course of 2007 is shown in the chart on the next page.

> [SEE CHART NEXT PAGE: *Goldman Sachs Mortgage Department Value at Risk (VaR)*, prepared by Permanent Subcommittee on Investigations.]

The continual increases in the Mortgage Department's VAR also had an impact on VAR for all of Goldman's trading activities, called "Trading VAR" or "Firmwide VAR." Goldman carefully tracked the amount of its trading VAR that was attributable to the activities of each of its trading desks or units. During the first quarter of 2007, its records show that the firm's Trading VAR rose from $119 million in the prior quarter to $154 million.[1926] Goldman has stated that its Mortgage Department's activities have historically resulted in only about 2% of the firm's net revenues.[1927] At the end of 2006, the Mortgage Department's VAR of $14 million contributed only about 3% of the Firmwide Trading VAR of $119 million, which is roughly consistent with or proportionate to the 2% contribution to firmwide net revenues that Goldman has reported.[1928]

[1924] 2/27/2007 email from Richard Ruzika to Tom Montag, others, GS MBS-E-002204942.
[1925] 3/1/2007 email, "MarketRisk: End of Day Summary - cob 02/28/2007," GS MBS-E-009757430.
[1926] 3/2007 Goldman "Quarterly Market Risk Review, Market Risk Management & Analysis," GS MBS-E-009685934, Hearing Exhibit 4/27-54c.
[1927] 4/2010 Goldman report, "Risk Management and the Residential Mortgage Market," Hearing Exhibit 4/27-161.
[1928] 12/2006 Goldman "Quarterly Market Risk Review, Market Risk Management & Analysis," GS MBS-E-009583144, Hearing Exhibit 4/27-54b.

Goldman Sachs Mortgage Department Value at Risk (VaR)
December 2006 - December 2007 (in $ Millions)



Derived from Goldman Sachs Firmwide Risk Committee Appendices and Market Risk End of Day Summaries provided by Goldman Sachs.
Prepared by the U.S. Senate Permanent Subcommittee on Investigations, April 2010.

At the end of the first quarter in 2007, however, the Mortgage Department's VAR of $85 million was contributing a total of 23% to the Firmwide VAR.[1929] During the rest of 2007, the Mortgage Department's percentage contribution to Firmwide VAR continued to rise until it hit an all-time high of 54% on August 14, 2007, when the Mortgage Department's VAR reached $110 million on a Firmwide VAR of $165 million.[1930]

The 54% contribution rate to Firmwide VAR means that the Mortgage Department's trading alone accounted for a 54% of total firmwide risk, while all of Goldman's other trading activities combined – including all equities, commodities, foreign exchange, and interest rate instruments – accounted for the rest. Given the serious financial ramifications of such a large and highly concentrated position, the decision to allow the Mortgage Department to incur such a high level of firmwide risk would have required approval at the highest levels of firm management. Indeed, it was Goldman's Operating Committee and its Co-President, Mr. Cohn, who decided in February and August 2007, respectively, that the Mortgage Department's VAR had risen too high and had to be brought down.[1931]

Because of the net short's impact on the Mortgage Department and Firmwide VAR levels, Goldman's senior executives not only knew about the "big short," but made frequent inquiries and exercised frequent control over the Mortgage Department's activities.[1932] On August 16, 2007, for example, Jon Winkelried, who served as Co-President with Mr. Cohn, asked Mr. Sparks: "Do you still feel we are being conservative with our marks .... Good time to make sure we're conservative." Mr. Sparks replied:

> "I try, but it is much harder than you think with all the things we are dealing with – completely dislocated markets with little price transparency, systems/tools that are not where they should be,

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[1929] 3/2007 Goldman Quarterly Risk Review, "Market Risk Management and Analysis," GS MBS-E-009685958, Hearing Exhibit 4/27-54.
[1930] 8/14/2007 Market Risk Report, Mortgage Portfolio Summary, GS MBS-E-012380294, Hearing Exhibit 4/27-35 (Mortgage Structured Products, VAR 110.1 on 8/14/07, Percentage Contribution to Firmwide VaR 53.8%).
[1931] 2/27/2007 email from Richard Ruzika to Tom Montag and Daniel Sparks, GS MBS-E-002204942; 8/15/2007 email from Gary Cohn, "Trading VaR $165mm," GS MBS-E-016344758.

[1932] 8/16/2007 email from Jon Winkelried to Daniel Sparks, "Mort P&L Explanation," GS MBS-E-010680327-330; 7/25/2007 email from David Viniar to Gary Cohn, "Private & Confidential: FICC Financial Package 07/25/07," GS MBS-E-009861799, Hearing Exhibit 4/27-26; 2/27/2007 email from Richard Ruzika to Tom Montag, others, GS MBS-E-002204942; 8/15/2007 email from Gary Cohn, "Trading VaR $165mm," GS MBS-E-016344758.

> focused controllers (who I think are doing a very good job in a tough market) and many cooks in the kitchen who like to micro-manage. ... But I hear your message."

Mr. Winkelried replied: "I think you should drop the micro manage theme in this environment."[1933]

Mr. Mullen also expressed concern that the Mortgage Department's practice of skirting the normal decisionmaking channels and communicating directly with the Co-Presidents Gary Cohn and Jon Winkelried, among other very senior officers, could create problems. When Mr. Birnbaum drafted the Mortgage Department's proposal to buy $10 billion in AAA RMBS securities, he sent it directly to Mr. Cohn and Mr. Winkelried, as well as to his more immediate superiors, Messrs. Mullen, Montag, and Sparks, among others. Mr. Mullen wrote to Messrs. Cohn and Winkelried, the Co-Presidents of Goldman: "It would help to manage these guys if u would not answer these guys and keep bouncing them back to Tom and I." Mr. Cohn replied: "Got that and am not answering," but then added: "I do like the idea but you[r] call."[1934]

For his part, Mr. Montag was also aware that he and Mr. Mullen were taking a more active role in the management of the Mortgage Department than they normally would. Mr. Montag, for example, was Global Co-Head of Securities for the Americas, which encompassed both the FICC Division and the Equities Division, and was responsible for numerous departments. Nonetheless, he was involved in management decisions regarding the Mortgage Department on a near-daily basis in 2007. In August of that year, Mr. Lehman reported to Mr. Sparks that Mr. Montag had asked:

> "how the desk thought about him and mullen being very involved. I told him we understood the scrutiny on the business given the overall pressure on our market, large P+L [profit and loss] and risk swings, etc."[1935]

Given the scrutiny by senior executives, the fact that the Mortgage Department's VAR was permitted to reach over $113 million in mid-August 2007 – more than three times its permanent limit – suggests that senior management knew and approved of the magnitude of the risk the

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[1933] 8/16/2007 email from Jon Winkelried to Daniel Sparks, "Mort P&L Explanation," GS MBS-E-010680327-330.

[1934] 8/21/2007 email from Joshua Birnbaum, "Potential large subprime trade and impact on firmwide VAR," GS MBS-E-016359332, Hearing Exhibit 4/27-34

[1935] 6/28/2007 email from David Lehman to Daniel Sparks, GS MBS-E-010623720.

Department incurred. It also suggests that the net short positions the Mortgage Department took were proprietary.[1936] Goldman's senior executives would have no reason to take such large risks if they were seeking only the small spread arbitrage available from market-making activities for customers.

On February 26, 2007, the Mortgage Department's VAR reached a quarterly high of $85.4 million.[1937] On February 22, Mr. Sparks had told Messrs. Swenson, Lehman, and Birnbaum that they would have to cover $2 billion in subprime mortgage related net short positions that same day.[1938] On February 27, 2007, Mr. Ruzika wrote Mr. Sparks and others: "I want to see us getting the short down to 4.5 bil[lion] net."[1939] Later that day, Mr. Ruzika forwarded the "OpCom Directive" to Mr. Sparks: "Dan. Directly from the opcom we need to step up the pace of buying back single names even if it costs us some money."[1940] Mr. Birnbaum told the Subcommittee that the SPG Trading Desk's actions in February were taken to reduce the level of VAR.[1941]

On August 9, 2007, Mr. Birnbaum received a note from the Department's risk managers indicating that the Department's temporary VAR limit might not be extended, which would reverse the prior policy of continually extending temporary limits:

> "– Temporary MTG [Mortgage Department] SPG VaR limit of $110mm expired on 8/7/2007[.]
> – MTG SPG is over its permanent VaR limit of $35mm."[1942]

Mr. Birnbaum told the Subcommittee that he read the note as an indication that the temporary trading limit would not be renewed, and he was being directed to reduce his net short positions to bring VAR under

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1936 See 8/16/2007 email from Jon Winkelried to Daniel Sparks, "Mort P&L Explanation," GS MBS-E-010680327-330; 7/25/2007 email from David Viniar to Gary Cohn, "Private & Confidential: FICC Financial Package 07/25/07," GS MBS-E-009861799, Hearing Exhibit 4/27-26. 2/27/2007 email from Richard Ruzika to Tom Montag, others, GS MBS-E-002204942; 8/15/2007 email from Gary Cohn, "Trading VaR $165mm," GS MBS-E-016344758.
1937 2/26/2007 Market Risk Report, Mortgage Risk Portfolio Summary, GS MBS-E-010388177.
1938 2/22/2007 email from Daniel Sparks, "FW: Block size tranche protection offers for [redacted] or others," GS MBS-E-010381411.
1939 2/27/2007 email from Richard Ruzika to Tom Montag, Justin Gmelich, and Daniel Sparks, GS MBS-E-002204942.
1940 Id.
1941 Subcommittee interview of Joshua Birnbaum (10/1/2010); see also 2/22/2007 email from Mr. Ruzika to Mr. Montag and Mr. Sparks, GS MBS-E-010381967 (Mr. Ruzika: "covering the single name bbb and bbb- is prudent because it cuts vol and var the most").
1942 8/9/2007 email from Deeb Salem to Joshua Birnbaum, "MarketRisk: Mortgage Risk Report (cob 08/08/2007)," GS MBS-E-012927200.

the permanent limit of $35 million.[1943] On the same day, August 9, Mr. Birnbaum sent an email to the ABS Desk trader, Mr. Salem:

> "Are you getting any more heat to cut/cover risk? These VAR numbers are ludicrous, btw. Completely overestimated for SPG trading, underestimated for other mortgage desks."[1944]

Mr. Salem replied that he had "waved in ~120mm in bbb and bbb- protection in the last 2 days," which covered shorts, so he felt no heat about covering.[1945] Mr. Birnbaum said:

> "I just asked b/c I saw the note about mortgages dropping back down to a permanent limit of 35mm (which we are way over). This would mark a change of their recent policy to just keep increasing ou[r] limit. Makes me a little nervous that we may be told to do something stupid."[1946]

Mr. Birnbaum continued: "I do think it is a real concern. How quickly can you work with strats to get them to revise our VAR to a more realistic number?"[1947]

Mr. Birnbaum explained to the Subcommittee that by the phrase, "be told to do something stupid," he meant being ordered by senior Goldman leadership to cover all of the desk's lucrative BBB and BBB- short positions immediately.[1948] Mr. Birnbaum and others were reluctant to cover all of SPG Trading's BBB/BBB- shorts, because they believed the ABX Index for BBB and BBB- rated RMBS securities would fall further in coming months, so covering the entire short immediately would amount to leaving significant money on the table.[1949] The Department's traders, analysts, and risk managers designed and executed specific transactions over the month of August to lower VAR, but they were unsuccessful.[1950]

[1943] Id.; Subcommittee interview of Joshua Birnbaum (10/1/2010).
[1944] 8/9/2007 email from Joshua Birnbaum to Deeb Salem, "MarketRisk: Mortgage Risk Report (cob 08/08/2007)," GS MBS-E-012927200.
[1945] Id.
[1946] Id.
[1947] Id.
[1948] Subcommittee interview of Joshua Birnbaum (10/1/2007).
[1949] Id.
[1950] 8/15/2007 email from Daniel Sparks, "Trading VaR $165mm," GS MBS-E-016344758; See, e.g., 8/15/2007 email from Michael Dinias, "Hedge Analysis cob 8/13/07," GS MBS-E-010678553 (analyzing 6 potential VAR-reducing trading scenarios featuring different proposed transactions); 8/21/2007 email from Mr. Dinias, "Trading VaR Analysis," GS MBS-E-009993267 (analyzing the VAR-reducing impact of going long in various classes of assets); 8/22/2007 email from Daniel Sparks to Tom Montag and Donald Mullen, "VAR reduction possibilities," GS MBS-E-010619824 (proposed transactions in single name CDS protection to reduce VAR).

For a week between August 14 and August 21, 2007, the Mortgage Department's VAR hovered around $100 million.[1951] The Department's record-high VAR contributed to a record Firmwide VAR of $167 million on August 17, 20, and 21, all of which exceeded the Firmwide VAR limit of $150 million.[1952] On August 15, 2007, Goldman's Co-President Gary Cohn issued his order: "[G]et down now."[1953] In response, the Mortgage Department began selling and covering a portion of its BBB/BBB- net short position, and its VAR quickly dropped to $68 million by August 31. The Mortgage Department was allowed to keep a substantial net short in certain assets, and was granted renewed "temporary" VAR limits at levels between $80 and $110 million through the end of Goldman's fiscal year 2007.[1954] The Risk Reports recording these VAR levels throughout 2007 further demonstrate Goldman's net short position. By 2010, the Mortgage Department's permanent VAR limit had increased from $35 million to only $40 million.[1955]

The dates on which Goldman senior executives ordered the Mortgage Department to reduce its VAR – on February 21 and August 21 – were within two weeks before the end of Goldman's fiscal quarters. In each case, the result was an immediate drop in VAR through the end of the quarter. In February 2007, the Department's VAR dropped from $92 million to $81 million by the end of the quarter. In August 2007, the Department's VAR dropped even more sharply, from a record high of over $110 million to $79.7 million by the end of the quarter.[1956] The lower Firmwide VAR figures that resulted from the Mortgage Department's VAR reductions were publicly reported in Goldman's quarterly financial reports.[1957]

[1951] See, e.g., 8/14/2007 Goldman Market Risk Report, GS MBS-E-010679220; 8/21/2007 email from MarketRisk,"MarketRisk: End of Day Summary - cob 8/20/07," GS MBS-E-009740158.
[1952] 8/21/2007 email from MarketRisk, "MarketRisk: End of Day Summary - cob 8/20/07," GS MBS-E-009740158.
[1953] 8/15/2007 email from Gary Cohn, "Trading VaR $165mm," GS MBS-E-016344758.
[1954] See, e.g, 8/28/2007 email from MarketRisk, "MarketRisk: End of Day Summary - cob 8/28/07," GS MBS-E-009716460 (Mortgages temporary VAR limit was $110 million); 9/14/2007 email from MarketRisk, "MarketRisk: End of Day Summary - cob 9/13/07," GS MBS-E-009714807 (Mortgages temporary VAR limit was $90 million); 9/27/2007 email from MarketRisk, "MarketRisk: End of Day Summary - cob 9/27/07," GS MBS-E-009708872 (Mortgages temporary VAR limit was $90 million); 10/3/2007 email from MarketRisk, "MarketRisk: End of Day Summary - cob 10/2/07," GS MBS-E-009717721 (Mortgages temporary VAR limit was $85 million); 10/19/2007 email from MarketRisk, "MarketRisk: End of Day Summary - cob 10/18/07," GS MBS-E-009724040 (Mortgages temporary VAR limit was $85 million); 12/13/2007 email from MarketRisk, "MarketRisk: End of Day Summary - cob 12/12/07," GS MBS-E-009707379 (Mortgages temporary VAR limit was $80 million).
[1955] Subcommittee interview of Craig Broderick (4/9/2010).
[1956] 9/28/2007 Goldman Market Risk Report, GS MBS-E-009926240.
[1957] See 4/3/2007 Goldman Sachs Group Inc. Form 10-Q at 79 (first quarter 2007 Average Daily VAR reported as $127 million); 10/9/2007 Goldman Sachs Group, Inc. Form 10-Q at 86 (third quarter 2007 Average Daily VAR reported as $139 million).

(h) Profiting From the Big Short

In the third quarter of 2007, Goldman posted financial results showing that it had shorted the subprime mortgage market and profited from its net short position. After posting those third quarter financial results, Goldman continued to trumpet its success, both inside and outside the firm.

Third Quarter Financials. On September 20, 2007, Goldman announced record net revenues of $12.3 billion for its third quarter.[1958] On September 19, 2007, in a conference call with financial analysts on Goldman's third quarter results, Goldman's CFO, David Viniar, highlighted the performance of the Mortgage Department:

> "Let me also address Mortgages specifically. The mortgage sector continues to be challenged and there was a broad decline in the value of mortgage inventory during the third quarter. As a result, we took significant markdowns on our long inventory positions during the quarter, as we had in the previous two quarters. However, our risk bias in that market was to be short and that net short position was profitable."[1959]

Goldman also issued a press release about its third quarter earnings that mentioned mortgages:

> "Net revenues in mortgages were also significantly higher, despite continued deterioration in the market environment. Significant losses on non-prime loans and securities were more than offset by gains on short mortgage positions."[1960]

Internal Statements. In September 2007, Goldman summarized its third quarter results for its Board of Directors, highlighting the Mortgage Department's record profits: "[W]e were overall net short the mortgage market and thus had very strong results."[1961]

[1958] See 10/9/2007 Goldman Sachs Group Inc. Form 10-Q at 66. See also, e.g., "How Goldman Sachs Defies Gravity," Fortune (9/20/2007).
[1959] 9/19/2007 Goldman internal document, "Third Quarter 2007 Earnings Call Script for David Viniar," GS MBS-E-009779213, Hearing Exhibit 4/27-45.
[1960] 9/17/2009 email to Daniel Sparks, "Mortgage commentary on Q3 earnings call," GS MBS-E-009853301, Hearing Exhibit 4/27-44.
[1961] 9/17/2007-9/18/2007 Goldman Sachs Board of Directors Meeting, "Financial Summary, Quarter Ended August 31, 2007," GS MBS-E-009776900, Hearing Exhibit 4/27-42.

In early October, the Mortgage Department held an internal Global Townhall to discuss its third quarter profits in detail. In a draft of the presentation he prepared for the Townhall, Mortgage Department head Daniel Sparks reported that global mortgages generated aggregate net revenues of $741 million, a 152% increase over the same quarter in the prior year, while benefitting from a "proprietary short."[1962] Under the heading of "Performance Drivers (Net Revenues)," Mr. Sparks wrote:

> "SPG Trading: +2.04bn [up] $1.92bn vs. Q3 2006
> - The desk benefited from a proprietary short in CDO and RMBS single names
> - Additionally, we captured P&L [profit & loss] on spread widening [price declines] in various indices"[1963]

To put the SPG Trading Desk's performance in perspective, it had generated $80 million in the third quarter of 2006, a big year for mortgage related products, but in the third quarter of 2007, an exceptionally poor year for mortgage related products, Goldman's SPG Trading Desk generated $2.04 billion in net revenues – nearly 25 times more. SPG Trading's $2.04 billion in net revenues was offset by other mortgage related losses, including losses from the CDO Origination, Residential Credit, and Residential Prime Desks, but left an aggregate net profit of $741 million for the Mortgage Department as a whole – more than twice the comparable quarter net profit of $294 million in the prior year.[1964] The $2.04 billion in net revenues from the SPG Desk accounted for over 16% of Goldman's overall net revenues of $12.3 billion in the third quarter of 2007. The $741 million in net revenues for the Mortgage Department as a whole contributed about 6% of the firm's total net revenues of $12.3 billion for the third quarter, which was three times the department's historical average contribution of about 2% to net revenue.[1965]

In his draft presentation, Mr. Sparks wrote that the "desk benefited from a proprietary short in CDO and RMBS single names."[1966] In industry parlance, a "proprietary" position is one acquired with the firm's own capital, solely for the benefit of the firm and not related to customer orders or the firm's role as a market maker. In a later version of the

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[1962] 10/5/2007 Goldman presentation, "Global Mortgages Business Unit Townhall Q3 2007," GS MBS-E-013703463, Hearing Exhibit 4/27-47.
[1963] Id.
[1964] Id.
[1965] 4/2010 "Goldman Sachs: Risk Management and the Residential Mortgage Market," report prepared by Goldman Sachs, Hearing Exhibit 4/27-161.
[1966] 10/5/2007 Goldman presentation, "Global Mortgages Business Unit Townhall Q3 2007," GS MBS-E-013703463, Hearing Exhibit 4/27-47.

presentation, Mr. Sparks revised the line to read that the desk benefitted from "strong results from trading long correlation and net short bias."[1967] When asked why he had originally written that "the desk benefitted from a proprietary short," Mr. Sparks told the Subcommittee that the language was inaccurate.[1968]

Later in October 2007, Goldman's Chief Risk Officer, Craig Broderick, discussed the Mortgage Department's performance before an internal Goldman audience:

> "So what happened to us? A quick word on our own market and credit risk performance in this regard. In market risk – you saw in our 2nd and 3rd qtr results that we made money despite our inherently long positions. – because starting early in '07 our mortgage trading desk started putting on big short positions, mostly using the ABX index, which is a family of indices designed to replicate cash bonds. And did so in enough quantity that we were net short, and made money (substantial money in the 3rd quarter) as the subprime market weakened. (This remains our position today)."[1969]

Goldman's net short positions were also featured in the internal self-evaluations that Mortgage Department personnel were required to prepare and which they expected to be read by their supervisors. In these self-evaluations, which were completed in September 2007, two months before Goldman's fiscal year end on November 30, 2007, several Mortgage Department traders who were active in its shorting activities described the profits produced by the Department's net shorts. Mr. Birnbaum, the senior ABX trader, wrote:

> "As a co-head of ABS and SPG trading, my performance in 2007 has been my best ever by any objective measure: 1. P&L. YTD: ABS synthetics: $2.5Bln, ABS: $2.0Bln, SPG Trading: $3.0Bln, all #1 on

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[1967] "Global Mortgages Business Unit Townhall Q3 2007," Final version, GS MBS-E-013668603.

[1968] Subcommittee interview of Daniel Sparks (10/4/2010). In his subsequent responses to the Subcommittee's Questions for the Record, Mr. Sparks said: "The presentation should have used the words 'net short position,' not 'proprietary position.'" Daniel L. Sparks responses to Subcommittee QFRs, PSI_QFR_GS0452 at 470 (Question 6). Mr. Sparks' response did not resolve the question of whether the position was proprietary or undertaken on behalf of customers, as a "net short position" could be either.

[1969] 10/29/2007 "Contagion and Crowded Trades," Goldman Sachs Tax Department Presentation, GS MBS-E-010018511, Hearing Exhibit 4/27-48 [emphasis in original].

> the street by a wide margin, #2 in the world trading subprime risk (behind Paulson Partners)."[1970]

His self-evaluation showed that the SPG Trading Desk alone generated profits of $3 billion.[1971]

Mr. Swenson, the head of the SPG and ABS trading desks, wrote:

> "It should not be a surprise to anyone that the 2007 year is the one that I am most proud of to date. ... I ... [built] a number one franchise that was able to achieve extraordinary profits (nearly $3bb to date). ... The contributions to the $3bb of SPG Trading profits and $2bb of ABS trading p & l are spread out across various trades and strategies."[1972]

Mr. Salem, one of the ABS traders, wrote:

> "Obviously the most important aspect of my 2007 and my contribution to the firm has been the desk's P&L. Mike, Josh, and I were able to learn from our bad long position at the end of 2006 and layout the game plan to put on an enormous directional short. The results of that are obvious."[1973]

Mr. Salem went on to outline estimated profits from four specific trading strategies pursued by the ABS Desk that generated profits totaling $3.75 billion.[1974]

In these three internal documents, key Mortgage Department personnel involved in constructing the Department's net short positions describe the profits generated by those net shorts as "#1 on the street by a wide margin," "extraordinary," and "an enormous directional short" that produced $3.7 billion in profits for the firm.

[1970] Joshua Birnbaum Self-Review, Hearing Exhibit 4/27-55c. The figures cited for ABS synthetics and ABS (both cash and synthetics) are apparently both included within the total of $3 billion profit cited for the SPG Trading Desk as a whole.

[1971] Id. Mr. Birnbaum also wrote: "During this period, I would also add that the ABS team contributed significantly to the Correlation desk[']s $800+mm in YTD p&l by dissuading that desk from externalizing their shorting opportunities to the likes of Paulson Partners, even when significant risk-free p&l was available at the time." Id.

[1972] Michael Swenson Self-Review, Hearing Exhibit 4/27-55b. The $2 billion profit figure attributed to ABS trading is apparently included within the $3 billion figure cited as the year-to-date profit for the SPG Trading Desk.

[1973] Salem 2007 Self-Review.

[1974] See description of Mr. Salem's single name trading strategies, above.

Statements to Regulators. Goldman also described its short positions and the profits they produced to its regulators. In October 2007, Goldman sent a letter to the Securities and Exchange Commission answering questions about its trading activities and reporting that it had been "net short" during "most of 2007":

> "[W]e are active traders of mortgage securities and loans and . . . we may choose to take a directional view of the market .... For example, during most of 2007, we maintained a net short sub-prime position and therefore stood to benefit from declining prices in the mortgage market."[1975]

In November 2007, in another letter to the SEC, Goldman explained further:

> "During most of 2007, we maintained a net short subprime position with the use of derivatives, including ABX index contracts and single name CDS which hedged [our] long cash exposure."[1976]

Also in November 2007, in talking points prepared for a meeting with the Tri-Lateral Review Group, which included the Federal Reserve Bank, the SEC, and the United Kingdom's Financial Services Authority, Goldman wrote: "[W]e were able to maintain a short throughout the year."[1977] Goldman also wrote:

> "The press and others have discussed an anticipated Q4 [2007 fourth quarter] write-down for GS. Our remaining long subprime exposure totals $695 million, inclusive of whole loans and CDO positions. However, we're net short – as we have been throughout 2007. Accordingly, we have nothing to write down."[1978]

Public Statements. Goldman also discussed its net short and related profits in public settings. In November 2007, the Bloomberg news service reported that Goldman's CEO, Lloyd Blankfein, told a public audience at a securities industry conference that Goldman was, and would continue to be, net short the subprime markets:

[1975] 10/4/2007 letter from Goldman Sachs to the SEC, GS MB S-E-009758287, Hearing Exhibit 4/27-46 [emphasis added].
[1976] 11/7/2007 letter from Goldman Sachs to the SEC, GS MBS-E-015713460, Hearing Exhibit 4/27-50.
[1977] 11/13/2007 Goldman email, GS MBS-E-010023525 (attachment, 11/14/2007 "Tri-Lateral Combined Comments," GS MBS-E-010135693-715 at 694).
[1978] Id.

"[Mr. Blankfein] said the firm is still betting that mortgage-backed assets and collateralized debt obligations will drop. ... 'Given that point of view, we continue to be net short in these markets.'"[1979]

In reaction to another November 2007 news report on how Goldman "dodged the mortgage mess,"[1980] Mr. Blankfein sent an email to his colleagues stating: "Of course we didn't dodge the mortgage mess. We lost money, then made more than we lost because of shorts."[1981]

Goldman also prepared for public use a corporate statement entitled, "How Did GS Avoid the Mortgage Crisis? Our Response."[1982] The statement was prepared for Mr. Viniar's use in responding to questions about the Mortgage Department's performance in a fourth quarter conference call with analysts. Goldman's public statement outlined the steps it took to reduce its subprime mortgage inventory and related subprime risks in late 2006 and early 2007, characterizing these "proactive" steps as part of its ordinary risk management efforts. Goldman went on to state: "[O]ne should not be led to believe that we went through this period unscathed and somehow significantly profited from a 'bet' on the downturn in mortgage markets."[1983] After noting that significant writedowns in the value of its long mortgage inventory had resulted in a "weak" second quarter for mortgages, Goldman wrote:

"[D]uring the third quarter we were able to make money on mortgages as a result of our net short position. As a consequence, we believe that we are well-positioned to opportunistically participate in the inevitable restructuring of the mortgage market."[1984]

Despite denying earlier in its statement that it significantly profited from a "bet" against a downturn in mortgage markets, Goldman wrote that, in the third quarter of 2007, it had profited from a "net short position" on mortgages. A "net short position" is, in essence, a bet on a downturn in the relevant market, and Goldman's bet was "able to make money."

[1979] "Goldman Doesn't Plan Significant Mortgage Writedown," Bloomberg (11/13/2007); see also 11/13/2007 email to Lloyd Blankfein, GS MBS-E-009601759 (forwarding Bloomberg article regarding Mr. Blankfein's remarks at conference sponsored by Merrill Lynch & Co. in New York City on Nov. 13, 2007).

[1980] "Goldman Sachs Rakes in Profit in Credit Crisis," New York Times (11/19/2007).

[1981] 11/18/2007 email from Lloyd Blankfein, "RE: NYT," GS MBS-E-009696333, Hearing Exhibit 4/27-52. Goldman's Co-President, Gary Cohn, replied to Mr. Blankfein's message, adding, "We were just smaller in the toxic products" Id.

[1982] 11/7/2007 Goldman document, "How Did GS Avoid the Mortgage Crisis?," GS MBS-E-009713204, Hearing Exhibit 4/27-51.

[1983] Id.

[1984] Id.

2007 Year-End Results. The SPG Trading Desk's net revenues for the full fiscal year 2007 were approximately $3.7 billion.[1985] In fiscal year 2007, Goldman's total net revenues were approximately $46 billion, and its net earnings (after tax) were approximately $11.6 billion.[1986]

At the Subcommittee hearing, Goldman's Chief Financial Officer, David Viniar, stated that the Mortgage Department's net revenue for 2007 was "less than $500 million, approximately 1 percent of Goldman Sachs's overall net revenues."[1987] He insisted that its 2007 net short position in the mortgage market "was not a large short,"[1988] and was largely offset by its long positions, omitting that, in 2007, the Mortgage Department's SPG Trading Desk generated a record $3.7 billion in net revenues for the Department as a whole from its net shorts.[1989] Those profits sustained the Mortgage Department and Goldman through the harsh financial environment of the subprime mortgage market meltdown and the global credit crisis in 2007. While much of those revenues were offset by other losses, they were a bulwark of profitability in what would otherwise have been a disastrous year for Goldman's mortgage business.

In contrast, other major Wall Street banks reported losses in the third quarter of 2007, primarily due to multi-billion-dollar writedowns in the value of their subprime mortgage related assets.[1990] Goldman had not only profited from its net shorts, but had also sold off the bulk of its subprime mortgage assets earlier and at higher prices than many other banks. After observing the losses and writedowns suffered by other Wall Street banks, Mr. Viniar wrote: "Tells you what might be happening to people without the big short."[1991]

1985 See 11/30/2007 "SPG Trading Mortgages Weekly Metrics 30-November-2007," GS MBS-E-015646485.

1986 See Goldman Sachs Form 10-K for the fiscal year ending Nov. 30, 2007, filed on 1/28/2008, at 64; see also Goldman presentation, "Overview of Goldman Sachs," at 5, available at http://www2.goldmansachs.com/our-firm/investors/creditor-information/creditor-presentation-3-1-11.pdf.

1987 April 27, 2010 Subcommittee Hearing at 96. See also 235, 252, 345.

1988 Id. at 98.

1989 11/30/2007 "SPG Trading Mortgages Weekly Metrics 30-November-2007," GS MBS-E-015646485.

1990 In the third quarter of 2007, for example, Lehman Brothers had $700 million in loan and mortgage writedowns. 9/23/2007 email to Lloyd Blankfein and others, "Weekly Competitor, EM and Regulatory News – Week Ending 9/21/07," GS MBS-E-009653853. Morgan Stanley had $940 million in loan writedowns. Id. Bear Stearns had $250 million in loan writedowns and $450 million in mortgage writedowns. Id. Citibank had approximately $1.6 billion in mortgage writedowns and a $636 million loss in credit trading. 10/21/2007 email to Lloyd Blankfein and others, "Weekly Competitor, EM and Regulatory News – Week Ending 10/19/07," GS MBS-E-009631348. JPMorgan Chase had $1.3 billion in loan writedowns and $339 million in mortgage writedowns. Id.

1991 7/25/2007 email from David Viniar to Gary Cohn, "Private & Confidential: FICC Financial Package 07/25/07," GS MBS-E-009861799, Hearing Exhibit 4/27-26.

At one point, Mr. Birnbaum also contrasted Goldman's performance with its competitors:

> "Results out of DB, Citi, UBS, Bear, Lehman etc. all bear evidence that we were far ahead of our competition in marking down positions and moving CDO risk before the market cratered and came to a standstill post-BSAM [Bear Stearns Asset Management]."[1992]

All of these explanations point to actions taken by Goldman to transfer the risks of its own subprime mortgage inventory to others, including many of its own customers, before they became fully aware of the risks entailed in the products Goldman was marketing to them.

Goldman Denials. In late 2007, Goldman spoke openly of shorting the subprime mortgage market and that its net short position was profitable. Afterward, as mortgage losses erupted into a full blown financial crisis in the United States and abroad, Goldman began to downplay and even deny the size of its short position, its proprietary nature, and the profits it generated for the firm.[1993]

Goldman had not been the only market participant to profit from a large net short position in mortgage related products. Other investors also aggressively shorted the mortgage market and profited from their short positions. A particularly large short position taken by one hedge fund – Goldman's customer, the Paulson Credit Opportunity Fund of Paulson & Co. Inc. – netted billions of dollars in what was later characterized as "the greatest trade ever."[1994] Mr. Birnbaum, however, had described Goldman's own massive net short position as the "greatest trade ever" as early as July 2007.[1995] Earlier in the year, Mr. Birnbaum had also described Goldman as the market leader in shorting the housing market, but by July 2007, Mr. Birnbaum conceded that Paulson was "definitely the man in this space, up 2-3 bil on this trade. We were giving him a run for his money for a while but now are a definitive #2."[1996] When preparing his case for SPG traders to be paid additional compensation for their 2007 efforts, Mr. Birnbaum

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[1992] 10/3/2007 Goldman presentation, "SPG Trading – 2007," GS MBS-E-015654036.
[1993] Goldman also highlighted losses it suffered in 2008, related to its mortgage business, particularly mortgage related products associated with prime and Alt A residential loans. The Subcommittee did not investigate Goldman's use of short positions in 2008, nor its involvement with prime and Alt A loan products.
[1994] Gregory Zuckerman, The Greatest Trade Ever (2009); Michael Lewis, The Big Short (2010).
[1995] 7/20/2007 email from Joshua Birnbaum, "ABX Markets 07-02, 07-01, 06-2, 06-1: 3:00 p.m.," GS MBS-E-012962076 (Mr. Birnbaum: "greatest trade ever . . . I have a huge short . . .").
[1996] 7/12/2007 email from Joshua Birnbaum, "ABX Markets 07-1, 06-2, 06-1: 12:00 p.m.," GS MBS-E-012944742, Hearing Exhibit 4/27-146.

again made a comparison to Paulson: "RMBS-related revenues: #1 on the street by a wide margin. #2 in the world behind Paulson Partners."[1997]

In the aftermath of the financial crisis, however, Goldman no longer claimed credit for its market-leading performance during the subprime meltdown. After many of its customers suffered major losses, and several had declared bankruptcy during the financial crisis,[1998] Goldman began to downplay the size of its short position and the impact on its profits.[1999] In particular, Goldman attempted to dispel the perception that it sold its own customers CDOs it knew were destined to fail, and then profited by betting against them, as discussed in the next section.[2000]

In April 2010, Goldman posted a statement on its website entitled, "Goldman Sachs: Risk Management and the Residential Mortgage Market."[2001] In the statement's Executive Summary, Goldman made the following assertions, among others:

"• Goldman Sachs did not take a large directional 'bet' against the U.S. housing market, and the firm was not consistently or significantly net 'short the market' in residential mortgage-related products in 2007 and 2008, as the performance of our residential mortgage-related products business demonstrates.

• Goldman Sachs did not engage in some type of massive 'bet' against our clients. The risk management of the firm's exposures and the activities of our clients dictated the firm's overall action, not any view of what might or might not happen to any security or market."[2002]

[1997] 10/3/2007 Goldman presentation, "SPG Trading – 2007," GS MBS-E-015654036; Birnbaum Self-Review, Hearing Exhibit 4/27-55c.
[1998] See 9/17/2007 Goldman presentation to Board of Directors, "Residential Mortgage Business, Global Impact of the Mortgage Crisis," at 2, GS MBS-E-001793840, Hearing Exhibit 4/27-41 (noting bankruptcies of Goldman clients IKB and Basis Capital). See also 8/10/2007 Goldman internal memorandum, "Summary of German Bank US Sub Prime Exposure," GS MBS-E-009994305; 11/27/2007 email from Mr. Lehman to Mr. Sparks, "ACA" (discussing "what would happen upon an ACA bankruptcy (which is the most likely scenario in our opinion)."), GS MBS-E-013746511.
[1999] See, e.g., April 27, 2010 Subcommittee Hearing, testimony of Lloyd Blankfein at 132 and David Viniar at 98.
[2000] 4/7/2010 Blankfein & Cohn, Letter to Shareholders (quoted in Hearing Exhibit 4/27-161 at 12).
[2001] 4/2010 Goldman report, "Risk Management and the Residential Mortgage Market," Hearing Exhibit 4/27-161.
[2002] Id.

On April 7, 2010, Goldman CEO Lloyd Blankfein and Co-President Gary Cohn made similar assertions in a letter to shareholders contained in Goldman's Annual Report:

> "• The firm did not generate enormous net revenues or profits by betting against residential mortgage-related products, as some have speculated; rather our relatively early risk reduction resulted in our losing less money that we otherwise would have when the residential housing market began to deteriorate rapidly ....
>
> • Although Goldman Sachs held various positions in residential mortgage-related products in 2007, our short positions were not a 'bet against our clients.' Rather, they served to offset our long positions."[2003]

At the Subcommittee hearing, Mr. Blankfein repeated the same claims. He testified:

> "Much has been said about the supposedly massive short Goldman Sachs had on the U.S. housing market. The fact is, we were not consistently or significantly net short the market in residential mortgage-related products in 2007 and 2008. Our performance in our residential market-related business confirms this. During the 2 years of the financial crisis, while profitable overall, Goldman Sachs lost approximately $1.2 billion from our activities in the residential housing market. We didn't have a massive short against the housing market and we certainly did not bet against our clients. Rather, we believe that we managed our risk as our shareholders and our regulators would expect."[2004]

Mr. Viniar, Goldman's Chief Financial Officer, testified:

> "[A]cross 2007, we were primarily, although not consistently short, and it was not a large short. ... The short positions themselves made a lot of money in 2007, but they offset long positions that lost a lot of money in 2007."[2005]

Goldman's denials of its net short positions in the subprime mortgage market, and the large profits produced by those net short positions, are

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[2003] 4/7/2010 Blankfein & Cohn, Letter to Shareholders (quoted in 4/2010 Goldman report, "Risk Management and the Residential Mortgage Market," at 12, Hearing Exhibit 4/27-161).
[2004] April 27, 2010 Subcommittee Hearing at 132.
[2005] Id. at 98.

directly contradicted by its own financial records and internal communications, as well as its own public statements in 2007, and are not credible.

(5) How Goldman Created and Failed to Manage Conflicts of Interest in its Securitization Activities

In the years leading up to the financial crisis, Goldman was an active trader in the mortgage market, buying and selling a variety of mortgage related assets, including RMBS, CDO, ABX, and CDS instruments, as described in the prior section. In addition, Goldman was one of the leaders in mortgage related securitizations, helping to originate both CDO and RMBS securities. Goldman's 2006 and 2007 securitization activities are the focus of this section.

In 2006 and 2007, Goldman originated 27 CDOs and 93 RMBS securitizations with a total value of about $100 billion.[2006] Goldman designed the structure of each securitization, including the number of tranches, how the payments would be allocated, and the projected rate of return or "coupon rate" that would be paid to investors. In some, Goldman selected the assets to be securitized; in others, it hired a portfolio selection agent or collateral manager to help select the assets and manage the portfolio. For each securitization, Goldman typically housed all of the assets to be securitized in a "warehouse" account until the transaction was ready to go to market. The assets in the warehouse accounts were then included in Goldman's balance sheet. Goldman also typically worked with one or more credit rating agencies to obtain favorable credit ratings for the proposed securities.

In addition, Goldman typically established a domestic and an offshore corporation to act as the nominal owners of the securitization's incoming cash, assets, and collateral securities; to serve as the actual issuers of the securities; and to perform certain administrative services. Goldman also established arrangements for the servicing of any underlying mortgages. In some CDOs, Goldman or its affiliate provided additional services as well, acting in such roles as the collateral securities selection agent, the collateral put provider, or the liquidation agent charged with selling impaired assets. Goldman also used its global sales force to market its securities to investors around the world, typically selling Goldman-

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[2006] The 27 CDOs securitized about $28 billion in assets. See undated chart prepared for Subcommittee by Goldman Sachs, GS MBS 0000004276. The 93 RMBS securitized about $72 billion in home loans. See undated chart prepared for Subcommittee by Goldman Sachs, GS-PSI-00172.

issued CDO securities through a private placement and RMBS securities through a public offering.

In late 2006, when subprime residential mortgages began to incur higher than expected rates of delinquency, fraud, and default, and its inventory of mortgage related assets began to lose value, Goldman took a number of actions. It sold the mortgage related assets in its inventory; returned poor quality loans to the lenders from which they were purchased and demanded repayment; limited new RMBS securitizations; sold or securitized the assets in its RMBS warehouse accounts; limited new CDO securitizations to transactions already in the pipeline; and sold assets from discontinued CDOs.

Throughout this process, Goldman made a concerted effort to sell securities from the CDO and RMBS securitizations it had originated, even when those securities included or referenced poor quality assets and began losing value. Many of the CDO and RMBS securities that Goldman sold to its clients incurred substantial losses. The widespread losses caused by CDO and RMBS securities originated by investment banks are a key cause of the financial crisis that affected the global financial system in 2007 and 2008.

This section of the Report examines how Goldman originated, marketed, and sold its mortgage related securities, in particular CDO securities, during late 2006 and in 2007, as the mortgage market deteriorated and as Goldman was profiting from its own net short positions. The section begins with general information about Goldman's securitization activities, followed by detailed case studies of four Goldman-originated CDOs: Hudson 1, Anderson, Timberwolf I, and Abacus 2007-AC1.

The evidence discloses troubling and sometimes abusive practices which show, first, that Goldman knowingly sold high risk, poor quality mortgage products to clients around the world, saturating financial markets with complex, financially engineered instruments that magnified risk and losses when their underlying assets began to fail. Second, it shows multiple conflicts of interest surrounding Goldman's securitization activities, including its use of CDOs to transfer billions of dollars of risk to investors, assist a favored client make a $1 billion gain at the expense of other clients, and produce its own proprietary gains at the expense of the clients to whom Goldman sold its CDO securities.

Under Goldman's sales policies and procedures, an affirmative action by Goldman personnel to sell a specific investment to a specific customer constituted a recommendation of that investment.[2007] Under federal securities law, when acting as an underwriter, placement agent, or broker-dealer recommending an investment to a customer, Goldman had an obligation to sell investments that were suitable for any investor and were not designed to fail. When acting in those roles and affirmatively soliciting clients to buy securities, Goldman also had an obligation to disclose material information that a reasonable investor would want to know, including material conflicts of interest or adverse interests in connection with its sale of a security.[2008]

In 2006 and 2007, when selling subprime CDO securities to customers, Goldman did not always disclose that the securities contained or referenced assets Goldman believed would perform poorly, and that the securities themselves were rapidly losing value. Goldman also did not disclose that the firm had built a large net short position betting that CDO and RMBS securities similar to the ones it was selling would lose value. In the case of the Hudson, Anderson, and Timberwolf CDOs, Goldman failed to disclose to potential investors that it was shorting the very securities Goldman was selling to them. In the case of the Abacus CDO, Goldman failed to disclose to potential investors that it had allowed an interested party to help select the CDO assets and act as the sole short party, with the expectation that the selected assets would lose value and that party would make money at the expense of the long investors to whom Goldman had sold the securities.-Goldman created these and other conflicts of interest with its clients in connection with its CDO activities.

(a) Background

To understand Goldman's securitization activities, this section provides general background about its CDO and RMBS business and how Goldman changed its securitization activities when the mortgage market began to deteriorate in late 2006.

(i) Goldman's Securitization Business

The Goldman Mortgage Department originated CDOs through two different desks within the Department. Approximately half of Goldman's CDOs were originated by its CDO Origination Desk, which assembled the assets, structured the CDOs, and worked with the Goldman sales force to market the resulting securities to a broad range of investors. The CDO

2007 See Goldman Sachs response to Subcommittee QFR at PSI_QFR_GS0252, at 0262.
2008 For a detailed discussion of these obligations under federal securities laws, see Section (6)(a), below.

Origination Desk was headed by Peter Ostrem from 2006 until May 2007, after which all remaining Goldman-originated CDOs were transferred to the Structured Product Group (SPG) Trading Desk and were overseen by David Lehman.

Goldman's other CDOs, which were part of a series issued under the name of Abacus, were originated by the Correlation Trading Desk, which was a sub-desk of the SPG Trading Desk. The Correlation Trading Desk specialized in arranging customized trades for investors and used the Abacus series of CDOs as one of its investment alternatives. The Correlation Trading Desk was headed by Jonathan Egol. The CDO Origination and Correlation Trading Desks were located on the same floor as the other SPG Trading Desks.

RMBS securitizations were handled by the Residential Whole Loan Trading Desk, headed by Kevin Gasvoda. Sub-desks within the Residential Whole Loan Trading area oversaw the purchase of residential loan pools, constructed the RMBS securitizations, and worked with the Goldman sales force to sell the resulting securities to investors.

After a desk originated a CDO or RMBS securitization and sold the Goldman-originated securities for the first time, all secondary trading of the securities was handled by the Structured Products Group's Asset-Backed Security (ABS) Desk. In mid-2007, Goldman shut down its CDO Origination Desk and directed the ABS Desk to sell all remaining Goldman-originated CDO securities, in addition to conducting the secondary trading it normally handled.

Daniel Sparks, as head of the Mortgage Department, oversaw all of Goldman's CDO and RMBS origination activities. Mr. Sparks reported at times to Jonathan Sobel, the prior department head, and Richard Ruzika, then head of Commodities Trading. He also worked with Justin Gmelich, a managing director asked to help him run the Department on a short term basis. Mr. Sparks also had frequent contact with more senior Goldman executives, including Thomas Montag, then global co-head of Securities Trading, and Donald Mullen, then head of Credit Trading. On occasion, he also received directives from Chief Financial Officer David Viniar and Co-Presidents Gary Cohn and Jon Winkelried.

(ii) Goldman's Negative Market View

As established earlier in the Report, all of Goldman's securitization activities from 2006 to 2007 took place against the backdrop of a subprime mortgage market that, in Goldman's view, was in distress and worsening.

On December 7, 2006, for example, Mr. Sparks sent this gloomy assessment to senior executive Thomas Montag:

> "Generally, originators are struggling with EPDs [early payment defaults] which require them to buy back loans and take losses – thinly capitalized firms can't take much of it. Lower margins and volumes are also causing pain. Ownit [a mortgage originator] ... closed Monday. Premiums for these originators – all of whom are for sale – are rapidly falling. ... Likely fall-out – more originators close and spreads in related sectors widen."[2009]

A week later, on December 13, 2006, Mr. Sparks repeated his negative view of the subprime mortgage market before senior Goldman executives on the Firmwide Risk Committee. The committee minutes described his report as follows:

> "Dan Sparks: Noted the stress in the subprime market; Concern around '06 originators, as two more failed last week; Concern around early payment defaults, $5BN in loans to subprime borrowers, warehouse lines to 6 subprime lenders, and $16MM in '06 residual positions and alt-a and subprime residual positions from '04-'05; Street aggressively putting back early payment defaults to originators thereby affecting the originator's business. Rumors around more failures are in the market."[2010]

On December 14, 2006, CFO David Viniar held a meeting with senior Mortgage Department executives, reviewed their mortgage related holdings, and directed them to offset the risk posed by declining values.[2011] The Mortgage Department then initiated its first multi-billion-dollar net short positions in 2007, essentially betting that subprime mortgage related assets would fall in value.

In early 2007, Mr. Sparks made increasingly dire predictions about the decline in the subprime mortgage market and issued emphatic instructions to his staff about the need to get rid of subprime loans and other assets. On February 8, 2007, for example, Mr. Sparks wrote:

[2009] See 12/7/2006 email from Daniel Sparks to Tom Montag, "Subprime Volatility," GS MBS-E-010931233.
[2010] 12/13/2006 Firmwide Risk Committee December 13 Minutes, GS MBS-E-009582963-64.
[2011] For more information about this December 14 meeting, see discussion in Section C(4)(b), above.

"Subprime environment – bad and getting worse. Everyday is a major fight for some aspect of the business (think whack-a-mole). . . . [P]ain is broad (including investors in certain GS-issued deals)."[2012]

On February 14, 2007, Mr. Sparks wrote some notes to himself:

"Bad week in subprime

collateral performance on loans was poor – we took a write-down on second lien deals and on the scratch and dent book last week ...

Synthetics market got hammered – around 150 [basis points] wider ...

Originators are really in a bad spot. Thinly capitalized, highly levered, dealing with significant loan putbacks, some with retained credit risk positions, now having trouble selling loans above par when it cost them 2 points to produce.

What is the next area of contagion."[2013]

That same day, February 14, 2007, Mr. Sparks exchanged emails with Goldman's Co-President Jon Winkelried about the deterioration in the subprime market:

Mr. Winkelried: "Another downdraft?"

Mr. Sparks: "Very large – it's getting messy. ... Bad news everywhere. Novastar bad earnings and 1/3 of market cap gone immediately. Wells [Fargo] laying off 300 subprime staff and home price appreciation data showed for first time lower prices on homes over year broad based."[2014]

On February 26, 2007, when Mr. Montag asked him about two CDO^2 transactions being assembled by the CDO Origination Desk, Timberwolf and Point Pleasant, Mr. Sparks expressed his concern about both:

Mr. Montag: "cdo squared–how big and how dangerous"

[2012] 2/8/2007 email from Daniel Sparks, "Post," Hearing Exhibit 4/27-7.
[2013] 2/14/2007 email from Daniel Sparks to himself, "Risk," GS MBS-E-002203268.
[2014] 2/21/2007 email exchange between Daniel Sparks and Jon Winkelried, "Mortgages today," GS MBS-E-010381094, Hearing Exhibit 4/27-10.

Mr. Sparks: "Roughly 2bb, and they are the deals to worry about."[2015]

On March 3, 2007, Mr. Sparks made notes after a telephone call: "Things we need to do .... Get out of everything."[2016] On March 7, 2007, Mr. Sparks again reported to Goldman's Firmwide Risk Committee on accelerating problems in the subprime mortgage market:

"• 'Game Over' – accelerating meltdown for subprime lenders such as Fremont and New Century.
• The Street is highly vulnerable . ... Current strategies are to 'put back' inventory and liquidate positions.
• The Mortgage business is currently closing down every subprime exposure possible."[2017]

On March 8, 2007, Mr. Sparks emailed several senior executives, including Mr. Viniar and Mr. Cohn about "Mortgage Risk": "[W]e are trying to close everything down, but stay on the short side."[2018]

Other Mortgage Department personnel gave similarly bleak assessments of the subprime mortgage market. As early as January 2007, Jonathan Egol, head of the Correlation Trading Desk, wrote to a colleague expressing his clients' views: "The mkt is dead."[2019] In February 2007, when discussing plans to issue an Abacus CDO with a Correlation Desk Trader, Fabrice Tourre, Mr. Egol repeated that assessment as his own:

> Mr. Egol: "[T]he paulson trade may already be dead (although given it is baa2 it may still have a decent shot)."
>
> Mr. Tourre: "Don't think the Paulson trade is dead. Supersenior pretty much done with ACA, AAAs could be placed in 2 shots, this is sufficient. Remember we make $$$ per tranche placed. ..."

[2015] 2/26/2007 emails between Tom Montag and Daniel Sparks, "Questions you had asked," GS MBS-E-019164799.
[2016] 3/3/2007 email from Daniel Sparks, "Call," Hearing Exhibit 4/27-14.
[2017] 3/12/2007 Goldman Firmwide Risk Committee, "March 7th FWR Minutes," GS MBS-E-00221171, Hearing Exhibit 4/27-19; see also 3/7/2007 email from Daniel Sparks to himself, "Risk Comm," GS MBS-E-002212223.
[2018] 3/8/2007 email from Daniel Sparks, "Mortgage risk," Hearing Exhibit 4/27-75.
[2019] 1/29/2007 email from Jon Egol to Fabrice Tourre, GS MBS-E-002620292. Mr. Tourre responded: "'The market is dead'??? Ouahhh, what do you mean by that? Do you have any insight I don't?" Mr. Egol replied: "LDL [let's discuss live] tomorrow." Id. Mr. Egol later wrote: "This is not my personal opinion – just a synopsis of the views of the customers we have seen today." 1/29/2007 email from Jon Egol to Daniel Sparks, GS MBS-E-003249991.

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Mr. Egol: "You know I love it all I'm saying is the cdo biz is dead we don't have a lot of time left."[2020]

On March 8, 2007, in an email to senior management, Mr. Sparks listed a number of "large risks I worry about."[2021] At the top of the list was "CDO and Residential loan securitization stoppage – either via buyer strike or dramatic rating agency change." Mr. Sparks was referring to the possibility that Goldman would be unable to securitize and sell its remaining subprime mortgage related inventory by repackaging it into RMBS and CDOs for sale to customers. His concern was either that buyers would refuse to purchase such products ("buyer strike"), or that the ratings agencies might realize the poor quality and high risks associated with these products and downgrade them so they could not be sold with AAA ratings ("dramatic rating agency change"). In essence, Mr. Sparks was worried about Goldman's being left with a large inventory of unsold and unsaleable subprime mortgage related assets when the market finally collapsed.[2022]

At the same time Goldman personnel were expressing these negative views of the securitization business, the Mortgage Department was building its large net short positions in the first and third quarters of the year.

(iii) Goldman's Securitization Sell Off

In response to the December 14, 2006 meeting at which CFO David Viniar ordered the Mortgage Department to offset the risk associated with its mortgage related holdings, the Department initiated an intensive effort

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2020 2/11/2007 email from Jon Egol, "Index Tranche Pricing Study - 08Feb07.xls," GS MBS-E-002640951. See also 2/20/2007 email from Fabrice Tourre to Jon Egol, GS MBS-E-009332408 (Mr. Tourre: "By the way, quote from an ABS correlation trader (non-GS): "the mezz ABS CDO business is dead." Mr. Egol responded: "who." Mr. Tourre replied: "LDL." "LDL," which means "let's discuss live," is an abbreviation that appears throughout the Goldman documents produced to the Subcommittee.); 3/27/2007 email from a Goldman analyst, GS MBS-E-009685430 ("The housing slowdown has the risk now not be[ing] offsetting [sic] by stronger capital spending. Both growth and the market are DEAD if that's the case.") [emphasis in original].

2021 3/8/2007 email from Daniel Sparks, "Mortgage risk," Hearing Exhibit 4/27-75.

2022 See also emails expressing concerns about the CDO market in particular. 6/27/2007 email from Jonathan Sobel, "Citi feedback on debt mkts," GS MBS-E-010807091 (reporting a conversation with the head of the mortgage desk at Citibank: "He is very nervous. ... Some Citi people think the CDO market is dead - a potential result of [subprime] contagion."); 8/30/2007 email from Daniel Sparks, "RAIT," GS MBS-E-010626401 ("the business model pursued by these guys (taking junior parts of the . . . capital structure and obtaining further leverage via the CDO market) is dead for the foreseeable future.").

to sell off the subprime RMBS and CDO securities and other assets in its inventory and warehouse accounts.[2023]

AA. RMBS Sell Off

As described earlier, on the same day as the Viniar meeting, December 14, 2006, Kevin Gasvoda, head of the Mortgage Department's Residential Whole Loan Trading Desk, instructed his staff to undertake an immediate, concerted effort to sell the whole loans and RMBS securities in Goldman's inventory and warehouse accounts, focusing on RMBS securities from Goldman-originated securitizations.[2024] By February 9, 2007, the Goldman sales force reported a substantial number of sales,[2025] and by the end of February, Goldman's controllers reported that Goldman's inventory of whole loans had "decreased from $11bn to $7bn" with "subprime loans decreased from $6.3bn to $1.5bn," a reduction of more than two-thirds.[2026]

In addition, during the first quarter of 2007, the Mortgage Department drastically slowed its RMBS origination business and its purchase of whole loans and RMBS securities.[2027] Those actions meant that Goldman was not only reducing its inventory, but also reducing its intake of what had previously been a constant inflow of billions of dollars in whole loans and RMBS securities purchased as part of its securitization business.

In addition to selling whole loans and RMBS securities, the Mortgage Department wrote down the value of its remaining subprime mortgage portfolio. On February 8, 2007, for example, Mr. Gasvoda

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[2023] See also Section C(4)(b) of this chapter, above.
[2024] 12/14/2007 email from Kevin Gasvoda, "Retained bonds," GS MBS-E-010935323, Hearing Exhibit 4/27-72. See also 2/8/2007 email from Kevin Gasvoda to Tom Montag, "Mortgage risk – credit residential," at 2, GS MBS-E-010372233, Hearing Exhibit 4/27-74 (seven weeks later, Mr. Gasvoda reported transferring the remaining Goldman-originated RMBS securities to the mortgage trading desk to sell: "moving retained bonds out of primary desk hands and into 2ndry desk.").
[2025] 2/9/2007 email exchange between Kevin Gasvoda and sales syndicate, "GS Syndicate RMBS Axes (INTERNAL)," GS MBS-E-010370495, Hearing Exhibit 4/27-73.
[2026] 2/23/2007 "Significant Cash Inventory Change (Q1'07 vs. Q4'06)," datasheet prepared by Goldman, GS MBS-E-010037311, Hearing Exhibit 4/27-12.
[2027] See, e.g., 3/8/2007 email from Daniel Sparks, "Mortgage risk," GS MBS-E-002206279, Hearing Exhibit 4/27-75 ("[f]or residential loans, we have not bought much lately"); 3/26/2007 Goldman presentation to Board of Directors, "Subprime Mortgage Business," GS MBS-E-005565527, Hearing Exhibit 4/27-22 (reporting that Mortgage Department is using "conservative bids" on loans); 3/14/2007 Goldman Presentation to SEC, "Subprime Mortgage Business 14-Mar-2007," at 7, GS MBS-E-010022328; 3/2/2007 email to Craig Broderick, "Audit Committee Package_Feb 21_Draft_Mortgage_Page.ppt," GS MBS-E-009986805, Hearing Exhibit 4/27-63 (we are "lowballing" bids on loans).

recommended that certain whole loan pools and RMBS securities be marked down by $22 million.[2028] On February 9, 2007, Mr. Sparks reported a $30 million writedown on non performing loans.[2029] Mr. Ruzika responded: "Ok, you've been communicating the write down was coming. Let's go through the residual risk and make sure we get to the correct number for the quarter."[2030] Residual risk referred to the non rated equity tranches that underwriters like Goldman often retained from the RMBS securitizations they originated; those tranches were also written down in value. Those writedowns not only implemented Goldman's policy of using current market values for its assets, but also effectively reduced the size of Goldman's "long" position in subprime mortgage related assets. As Mr. Ruzika wrote to Mr. Cohn: "working with Dan to uncover exactly what else needs to be written down so that we can pnl [profit and loss] it this quarter and be clean going into next quarter."[2031]

Loan Repurchase Campaign. In addition to its sales and writedowns, the Mortgage Department intensified its efforts to identify and return defaulted or otherwise deficient loans to the originating lender from which they had been purchased in exchange for a refund of the purchase price. Altogether in 2006 and 2007, Goldman made about $475 million in repurchase claims for securitized loans, and recovered about $82

[2028] 2/8/2007 email from Kevin Gasvoda to Daniel Sparks, "Post," GS MBS-E-002201668, Hearing Exhibit 4/27-7 ("monthly performance analysis completed this morning on what can be securitized vs will be foreclosed tells us we should mark down around $22mm"). See also 2/2/2007 email from Daniel Sparks, "Second lien deal performance and write-down," GS MBS-E-002201050, Hearing Exhibit 4/27-92 ("Gasvoda alerted me last night that we will take a write-down to some retained positions next week as the loan performance data from a few second lien sub-prime deals just came in (comes in monthly) and it is horrible."); 2/8/2007 email from Kevin Gasvoda to Tom Montag, "Mortgage risk – credit residential," at 2, GS MBS-E-010372233, Hearing Exhibit 4/27-74. Mr. Gasvoda summarized the other write-downs as follows:

> "– 2nd lien residual – took $20-25mm write-downs over last 3 months (could lose $5-15 mm more)
> – 2nd lien retained bonds–took $18mm write-down this week (could lose $5-15 more)
> – Subperforming loan book – taking $28mm write-down this week (could lose $20-40mm more)
> What do all these areas have in common? – most HPA [housing price appreciation] sensitive sectors. They've crumbled under HPA slowdown as these are the most levered borrowers.
> What have we done to mitigate?
> – we stopped buying subprime 2nd liens in the summer of '06 and have focused on alt-a and prime."

[2029] 2/9/2007 email from Daniel Sparks, "Scratch & dent loan write down $30mm," GS MBS-E-009760380.

[2030] Id.

[2031] 2/13/2007 email from Richard Ruzika to Gary Cohn, "Catch Up," GS MBS-E-019794071. Mr. Cohn forwarded Mr. Ruzika's report to Messrs. Blankfein and Winkelried. Id. See also 6/8/2007 email from Kevin Gasvoda, "Project Omega - Mortgages MTM of Resids," GS MBS-E-013411815 (working on potential deal to sell marked-down mortgage residuals).

million.[2032] It also made about $40 million in repurchase claims for unsecuritized loans, and recovered about $17 million.[2033]

In the years leading up to the financial crisis, most subprime loan purchase agreements provided that if a loan experienced an early payment default (EPD), meaning the borrower failed to make a payment within three months of the loan's purchase, or if the loan breached certain representations or warranties, such as representations related to the loan's characteristics or documentation, the loan could be returned or "put back" to the seller which was then obligated to repurchase it. In late 2006, as subprime loans began to experience accelerated rates of EPDs and fraud,[2034] Wall Street firms began to intensify their efforts to return those loans for refunds. Some subprime lenders began to experience financial distress due to unprecedented waves of repurchase requests that drained their cashflows.[2035]

Although Goldman, either directly or through a third party due diligence firm, routinely conducted due diligence reviews of the mortgage loan pools it bought from lenders or third party brokers for use in its securitizations, those reviews generally examined only a sample of the loans and did not attempt to identify and weed out all deficient mortgages.[2036] Instead, Goldman purchased loan pools with the expectation that they would incur a certain rate of defaults. In late 2006, however, like other Wall Street firms, Goldman began to see much higher than anticipated delinquency and default rates in the loan pools in its inventory and warehouse accounts, and in the subprime RMBS and CDO

[2032] See Goldman Sachs response to Subcommittee QFR at PSI_QFR_GS0039.
[2033] Id.
[2034] Using loan data, the U.S. mortgage industry had developed anticipated default rates, including EPDs, for different mortgage classes, such as subprime, Alt A, and prime loans. These default rates, however, were based in large part on past loan underwriting practices and loan types that bore little resemblance to the loans issued in the years leading up to the financial crisis, as explained in Chapter V of this Report. In 2006, subprime loans began to experience higher than anticipated EPD rates, and lenders were hit by unanticipated repurchase demands they could not afford to pay. The first EPD-related mortgage lender failures occurred in late 2006, and bankruptcies continued throughout 2007.
[2035] See, e.g., 3/26/2007 "Subprime Mortgage Business," Goldman presentation to Board of Directors, at 3-5, GS MBS-E-005565527 at 532, Hearing Exhibit 4/27-22 (timeline showing Ownit, a subprime lender, filed for bankruptcy on December 28, 2006, and list of subprime related businesses bankrupted, suspended, closed, sold, or put up for sale).
[2036] Goldman or a third party due diligence firm it hired typically examined a sample of the loans. Based on the number of problem loans found in the sample, Goldman or the due diligence firm extrapolated the total percentage of problem loans likely to be contained in the pool. This information was then factored into the price Goldman paid for the pool. Any specific loans identified in the sampling process as deficient were generally returned to the lender for repurchase, but it was rare for an investment bank to review 100% of a pool to identify all of the deficient loans and return them. Subcommittee interview of Clayton Holdings (11/9/2010).

securitizations it originated.[2037] Defaulted loans generally could not be sold or securitized, and had to be terminated through foreclosure proceedings or sold in so-called "scratch and dent" pools that generally produced less money than the loans cost to buy. In addition, defaulted loans meant that the borrowers who took out those loans stopped making loan payments to the securitized loan pool, reducing the cashflow into the related securities. RMBS and CDO securities whose underlying assets incurred high rates of loan delinquencies and defaults experienced reduced cashflows, lost value, and sometimes failed altogether, resulting in substantial losses for investors.

In early 2007, Goldman's Mortgage Department initiated an intensive review of the loans in its inventory, warehouse accounts, and RMBS and CDO securitizations, to identify deficient loans and return them for refunds. On February 2, 2007, Mr. Sparks reported to senior Goldman executives Messrs. Viniar, Montag, and Ruzika that obtaining refunds from the loan originators would be "a battle":

> "The team is working on putting loans in the deals back to the originators (New Century, WAMU, and Fremont – all real counterparties), as there seem to be issues potentially including some fraud at origination, but resolution will take months and be contentious. ... The put backs will be a battle."[2038]

To manage its loan repurchase campaign, Goldman expanded an operations center in St. Petersburg, Florida,[2039] and made extensive use of third party due diligence firms hired to review its securitized loan pools.[2040]

[2037] See, e.g., 1/8/2007 email from Daniel Sparks, "Color on the Sub Prime Market," GS MBS-E-002195434 (after receiving a report on potential EPD problems, Mr. Sparks wrote: "I just can't see how any originator in the industry is worth a premium. I'm also a bit scared of accredited and new century, and I'm not sure about taking on a bunch of new exposures."); 2/8/2007 email from FICC analyst to Mr. Sparks, Mr. Gasvoda, and others, "2006 Subprime 2nds Deals Continue to Underperform," GS MBS-E-003775340, Hearing Exhibit 4/27-167d ("2006 vintage Subprime closed-end seconds (CES) issuance has continued to deteriorate. ... [N]on-GS Subprime CES deals are categorically experiencing similar negative behavior across shelves, originators, and servicers. ... Outlook: 2006 vintage ... could eventually reach 4-5+ times that of 2004/early 2005 vintages (more than double that of RA expected losses).").

[2038] 2/2/2007 email from Daniel Sparks to Messrs. Montag, Ruzika, and Viniar, GS MBS-E-002201050, Hearing Exhibit 4/27-92. See also 2/2/2007 email from Michelle Gill, "Warehouse policy," GS MBS-E-005556331 (discussing proposal to charge higher warehouse fees to mortgage originators with higher EPD and "drop-out" rates, including Fremont and New Century).

[2039] 2/27/2007 email from Christopher Gething, "Our Expansion," GS MBS-E-010387242 (expansion of St. Petersburg office to accommodate staff for loan repurchase effort).

[2040] See, e.g. 3/2007 Goldman email chain, "RE: NC Visit," GS MBS-E-002048050 (mentioning four different third party "vendors" conducting loan reviews for the loan repurchase effort and stating: "We're off to other vendors at this point.").

Goldman instructed the firms to "re-underwrite" every loan in pools of mortgages purchased from specific lenders, including New Century, Fremont, Long Beach, and later Countrywide.[2041]

By March 2007, the average EPD rate for subprime loans in Goldman's inventory had climbed from 1% of aggregate volume to 5%, a dramatic increase.[2042] On March 7, 2007, Mr. Sparks described Goldman's exposure as follows:

> "As for the big 3 originators – Accredited, New Century and Fremont, our real exposure is in the form of put-back claims. Basically, if we get nothing back we would lose around $60mm vs loans on our books (we have a reserve of $30mm) and the loans in the [CDO and RMBS] trusts could lose around $60mm (we probably suffer about 1/3 of this in ongoing exposures). ... Rumor today is that the FBI is in Accredited."[2043]

Five days later, on March 12, 2007, Mr. Sparks wrote: "The street is aggressively putting things back, like a run on the bank before there is no money left to fulfill the obligations."[2044]

One of the lenders that was an initial focus of Goldman's loan repurchase effort was New Century, a subprime lender whose loans Goldman had used in many Goldman-originated RMBS securitizations. After completing a review of one New Century loan pool, an analyst recommended "putting back 26% of the pool ... if possible."[2045] A putback

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[2041] See 3/9/2007 email from Kevin Gasvoda, "priorities," GS MBS-E-002211055 (listing priority mortgage originators as Accredited, Fremont, New Century, and Novastar); 3/14/2007 Goldman email, "NC Visit," GS MBS-E-002048050 (identifying New Century, Fremont and Long Beach); 6/29/2007 email from Ed Chavez, "Countrywide Investigation Review Update," GS MBS-E-002134411.

[2042] 3/2/2007 email to Craig Broderick, "Audit Committee Package_Feb 21_Draft_Page.ppt," GS MBS-E-009986805, Hearing Exhibit 4/27-63.

[2043] 3/7/2007 email from Daniel Sparks, "Originator exposures," GS MBS-E-002206279, Hearing Exhibit 4/27-75.

[2044] 3/12/2007 email from Daniel Sparks, "Subprime Opportunities," GS MBS-E-004641002. See also 4/15/2007 email, "March 2007 Counterparty Surveillance," GS MBS-E-002135667 (forwarding report to loan repurchase team, "Please find attached the March counterparty surveillance report (and boy, is it a doozy)."); 3/26/2007 "Subprime Mortgage Business," Goldman presentation to Board of Directors, at 5, GS MBS-E-005565527, Hearing Exhibit 4/27-22 (list of subprime related businesses bankrupted, suspended, closed, sold, or put up for sale).

[2045] 3/13/2007 email from Manisha Nanik, "New Century EPDs," GS MBS-E-002146861, Hearing Exhibit 4/27-77. The review of the New Century loan pool found:

> "– approx 7% of the pool has material occupancy misrepresentation where borrowers took out anywhere from 4 to 14 loans at a time and defaulted on all. ...
>
> – approx 20% of the pool has material compliance issues. These are mainly missing HUDs. ...
>
> – approx 10% of the pool is flagged as potential REO [Real Estate Owned by lender] or

rate of 26% meant that about one in four of the loans in the New Century pool had EPDs, were fraudulent, or otherwise breached New Century's contractual warranties. It also implied that about 25% of the expected mortgage payments might not be made to the relevant RMBS securitization. Unless the problem loans could be successfully "put back" to New Century in exchange for a refund, a fail rate of that magnitude would likely impair the performance of all of the securities dependent upon that pool of mortgages.

Goldman made a total of about $67 million in repurchase requests to New Century, which was among the five mortgage originators to whom Goldman directed the most repurchase requests in 2006 and 2007.[2046] In March 2007, however, New Century stopped paying Goldman's claims due to insufficient cash, and the loan repurchase team sought advice from Mr. Gasvoda:

> "As you know, we have an extensive re-underwrite review underway on 06 NC2 [New Century second lien loans] and also other NC loans in the 2nds deals that are in the pipeline for scrubs. Should we change course at all here given the fact NC can't pay?"[2047]

Mr. Gasvoda responded:

> "Yes .... I think priority s/b [should be] on Fremont and Long Beach on 2nd lien deals. Fremont first since they still have cash but may not for long. ... [O]n NC2 we need not halt that entirely but should pull back resources there. We should also move 06FM2 [Fremont second lien loans] up the priority list."

Goldman made a total of about $46 million in repurchase requests to Fremont, another subprime lender for whom Goldman had underwritten multiple securities and which was also among the five mortgage originators to whom Goldman made the most repurchase requests in 2006

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potential unsecured (if 2nd liens). ...
– approx 5% of the pool was possibly originated fraudulently based on the dd [due diligence] results. Main findings: possible ID theft, broker misrepresentations, straw buyer, and falsification of information in origination docs. ...
"approx 62% of the pool has not made any payments (4% were reversed pymts/nsf [non-sufficient funds]) ...
"approx 38% of the loans are out of [loan to value] tolerance."

[2046] See Goldman Sachs response to Subcommittee QFR at PSI_QFR_GS0040.

[2047] 3/14/2007 Goldman email, "NC Visit," GS-MBS-E-002048050. See also 3/21/2007 email from Daniel Sparks to Tom Montag, GS MBS-E-002207114 (noting progress in cutting down funding commitments to mortgage originators to $300 million, including closeout of all funding to New Century in exchange for loans).

and 2007.[2048] When Goldman personnel reviewed a loan pool purchased from Fremont, the results were even worse than for the New Century loans. Goldman concluded that "on average, about 50% of about 200 files look to be repurchase obligations."[2049] Later, Goldman came to a similar conclusion after reviewing certain loans purchased from Countrywide, again finding that about 50% of the loans reviewed were candidates for return to the lender.[2050]

Goldman made a total of about $34 million in repurchase requests to Long Beach, a subprime lender for whom Goldman had underwritten billions of dollars in RMBS securities and which was also among the five mortgage originators to whom Goldman made the most repurchase requests in 2006 and 2007.[2051] Goldman pressed both Long Beach and its parent Washington Mutual for repayment of millions of dollars in refunds. At one point, a Goldman executive involved in the repurchase effort sent an email to the head of Washington Mutual Home Loans Division, David Schneider. After noting that Long Beach second lien loans were "performing dramatically worse" than other 2006 RMBS securities, the Goldman executive wrote: "As you can imagine, this creates extreme pressure, both economic and reputational, on both organizations."[2052]

Goldman's loan repurchase campaign recovered substantial funds from some lenders,[2053] but little or none from others.[2054] Non performing loans that were not repurchased by the lender generally remained in Goldman's inventory or the relevant securitized loan pool. Many other

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[2048] See Goldman Sachs response to Subcommittee QFR at PSI_QFR_GS0040.
[2049] 3/14/2007 Goldman email, "NC Visit," GS-MBS-E-002048050. See also 8/10/2007 email from Michelle Gill, "Fremont - Incremental Information," GS MBS-E-009860358 (Goldman's repurchase claims against Fremont would have amounted to a 9% ownership stake in Fremont after a proposed buyout by investor group; Goldman was not the largest purchaser of Fremont loans but its repurchase claims were 3-4 times larger than the claims of the nearest counterparty).
[2050] 6/29/2007 email from Ed Chavez, "Countrywide Investigation Review Update," GS MBS-E-002134411.
[2051] See Goldman Sachs response to Subcommittee QFR at PSI_QFR_GS0040. The five mortgage originators to which Goldman directed the most repurchase requests were First Franklin, New Century, Fremont, Greenpoint, and Long Beach. Id.
[2052] 2/15/2007 email from Loren Morris of Goldman Sachs to David Schneider of WaMu and others, GS MBS-E-002142424, Hearing Exhibit 4/13-69b.
[2053] See, e.g., Goldman response to Subcommittee QFR at PSI_QFR_GS0040; 3/8/2007 email from Daniel Sparks to Jon Winkelried and others, "Mortgage risk," GS_MBS-E-002206279, Hearing Exhibit 4/27-75 ("Accredited ... plan to send us $21mm"); 6/25/2007 email from Deana Knox, "Option One," GS MBS-E-019645932 ("Option One has agreed to settle the entire claim, paying $2.5M (repurchase and monitor) and $3M will be rescinded.").
[2054] New Century, for example, declared bankruptcy in April 2007. In re New Century TRS Holdings, Inc., Case No. 07-10416 (KJC) (US Bankruptcy Court, District of Delaware). See also 6/7/2007 email from Loren Morris, "WFALT 05-2 Repurchase demand," GS MBS-E-002131857.

securitizers engaged in similar loan repurchase efforts which continued in 2011.[2055]

Poor Quality RMBS Securities. As a result of its loan repurchase and writedown efforts, the Mortgage Department was keenly aware of the poor quality of many of the loan pools in its warehouse accounts. Nevertheless, during this time period, Goldman continued securitizing many of those loans and selling the resulting RMBS securities to clients.

In March 2007, for example, Goldman securitized over $1 billion in subprime loans that it had purchased from Fremont, originating an RMBS securitization called GSAMP Trust 2007-FM2.[2056] Goldman underwrote the security in the same month that it was attempting to return millions of dollars in deficient loans to the lender,[2057] and regulators ordered Fremont to stop issuing subprime loans.[2058] Goldman marketed and sold the RMBS securities to clients. Within seven months, by October 2007, the rating downgrades began; by August 2009, every tranche of the GSAMP securities had been downgraded to junk status.[2059]

On March 26, 2007, the Mortgage Department sought permission from Goldman's Mortgage Capital Committee to securitize and underwrite a new RMBS called GSAMP Trust 2007-HE2, which contained nearly $1 billion in subprime mortgage loans in a Goldman warehouse account, over 70% of which had been purchased from New Century.[2060] Goldman approved this securitization even though it knew at the time that New Century's subprime loans were performing poorly, many

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[2055] See, e.g., 1/3/2011 Bank of America press release, "Bank of America Announces Fourth-Quarter Actions," bankofamerica.com (announcing agreements to pay $3 billion to Freddie Mac and Fannie Mae to resolve residential mortgage repurchase claims related to loans originated by Countrywide).

[2056] See 2/2/2007 Goldman memorandum to the Mortgage Capital Committee, "Agenda for Monday, February 5, 2007," GS MBS-E-002201064; 2/5/2007 Mortgage Capital Committee Memorandum regarding GSAMP Trust 2007-FM2, GS MBS-E-002201055-58.

[2057] See discussion of Goldman's loan repurchase effort, above. In addition, in the prior month, a Goldman employee in the mortgage credit trading department sent senior Mortgage Department officials a lengthy email on the deteriorating subprime mortgage market and observed: "Subprime originators, large and small, ha[ve] exhibited a notable increase in delinquencies and defaults, however, deals backed by Fremont and Long Beach collateral have generally underperformed the most." 2/8/2007 email from Fabrice Tourre, "FW: 2006 Subprime 2nds Deals Continue to Underperform **INTERNAL ONLY**," at GS MBS-E-003775340, Hearing Exhibit 4/27-167d.

[2058] In re Fremont Investment & Loan, Docket No. FDIC-07-035b, Order to Cease and Desist (March 7, 2007).

[2059] See Standard & Poor's www.globalcreditportal.com.

[2060] 3/23/2007 Goldman memorandum to members of the Mortgage Capital Committee, "Agenda for Monday, March 26, 2007," Hearing Exhibit 4/27-79 ("GSAMP 2007-HE2 – Goldman to securitize $960 million of subprime mortgage loans purchased by Goldman Sachs from New Century (71.9%)" and other mortgage originators. "The securitization is scheduled to be completed by April 12, 2007.").

of the New Century loans in Goldman's inventory were problematic, and New Century was in financial difficulty.[2061] The securitization was approved for issuance in April 2007, the same month New Century declared bankruptcy.[2062] Goldman marketed and sold the RMBS securities to its clients. The securities first began to be downgraded in October 2007, and all of the securities have since been downgraded to junk status.[2063]

Had Goldman not securitized the $2 billion in Fremont and New Century loans, the Mortgage Department would likely have had to liquidate the warehouse accounts containing them and either sell the loan pools or keep the high risk loans on its own books.

On April 11, 2007, a Goldman salesman forwarded to Mr. Egol a scathing letter from a customer, a Wachovia affiliate, which had purchased $10 million in RMBS securities backed by Fremont loans and underwritten by Goldman. The client wrote that it was "shocked" by the poor performance of the securities "right out of the gate," and concerned about Goldman's failure to have disclosed information about the poor quality of the underlying loans in the deal termsheet:

> " As you know, we own $10mm of the GSAMP 06-S3 M2 bond. ... We are shocked by how poorly this bond has performed right 'out of the gate' and had asked [Goldman] to send us the attached ProSupp [Prospectus Supplement]. After having read the ProSupp and compared it to the termsheet we have several concerns:
>
> * According to the Prosupp, approximately $2.2mm ... of loans were delinquent when they were transferred to the trust. However, there is no mention of delinquent loans anywhere in the termsheet that was sent to investors when the deal was priced.
>
> * According to the Prosupp, approximately $3.3mm ... are re-performing loans. However, there is no mention of reperforming loans anywhere in the termsheet.

[2061] See discussion of Goldman's loan repurchase effort, above. Earlier in March, a Goldman review of a different New Century loan pool had found that 26% of the loans were deficient and ought to be returned to New Century for a refund. 3/13/2007 email from Manisha Nanik, "New Century EPDs," GS MBS-E-002146861, Hearing Exhibit 4/27-77. In addition, New Century had already informed Goldman that it had insufficient cash to pay any loan repurchase requests. 3/14/2007 Goldman email, "NC Visit," GS-MBS-E-002048050.

[2062] In re New Century TRS Holdings, Inc., Case No. 07-10416 (KJC) (US Bankruptcy Court, District of Delaware).

[2063] See Standard & Poor's www.globalcreditportal.com.

* Approx. 53.14% of the loans in the deal allow for a Prepayment Premium and that all Prepayment Premiums collected from borrowers are paid to the Class P certificateholders. None of this was disclosed in the termsheet and my concerns are two-fold: (1) The presence of Prepayment Premiums effects prepayment speeds which affects ... [the deal's performance]; (2) Prepayment Premiums are not staying inside the deal for the benefit of all investors but are being earmarked for the Class P holder (which is not mentioned in the termsheet). Note that ... $1.2mm in Prepayment Premiums has already been paid out to the Class P holder.

* ... [T]he servicer must charge off any loan that becomes 180 days delinquent, giving rise to a Realized Loss inside the deal. Currently losses are at 9.71% of the original deal balance, or approximately $48mm despite the fact that the deal is only 11 months old (note that this figure already exceeds Moody's expec[ta]tion for cumulative losses for the deal over the ENTIRE LIFE of the deal). I will also note that there are an additional $57.5mm of loans in the delinquency pipeline. This seems to indicate significant fraud at either the borrower or lender level ....

* ... [A]ny subsequent recoveries on the charged-off loans do not inure to the benefit of all investors in the deal but ONLY to the Class X1 certificateholder. This is not mentioned anywhere in the termsheet. Who owns the Class X1 notes? Is that Goldman or an affiliate? How much has been recovered so far? This is a material fact to me especially considering that loss severities are coming in at around 105% on the charged-off loans."[2064]

Reduced RMBS Business. By the end of 2007, Goldman had substantially reduced its RMBS securitization business. In November 2007, in response to a request, Goldman provided specific data to the SEC about the decrease in its inventory of subprime mortgage loans and RMBS securities. Goldman informed the SEC that the value of its subprime loan inventory had dropped from $7.8 billion on November 24, 2006, to $462 million on August 31, 2007. Over the same time period, the value of its inventory of subprime RMBS securities had dropped from $7.2 billion to $2.4 billion, a two-thirds reduction.[2065] The graph below, which was

[2064] 4/11/2007 email to Jon Egol, "GSAMP 2006-S3 – Computational Materials for Wachovia (external)," GS MBS-E-003322028 [emphasis in original].
[2065] 11/7/2007 letter from Sarah Smith, Controller and Chief Accounting Officer to SEC, at 5, GS MBS-E-015713460, Hearing Exhibit 4/27-50. Goldman issued its final RMBS securitization for the year in August 2007.

prepared by the Subcommittee using the data provided by Goldman to the SEC, illustrates the rapid decline in Goldman's subprime holdings.[2066]

> [SEE CHART NEXT PAGE: *Goldman Sachs Long Cash Subprime Mortgage Exposure*, prepared by the Permanent Subcommittee on Investigations, Hearing Exhibit 163.]

BB. CDO Sell Off

Goldman reduced its inventory of subprime loan pools and RMBS securities through outright sales, writedowns, and its loan repurchase campaign. It was equally aggressive in reducing its subprime CDO warehouse inventory.

In January 2007, after the CDO Origination Desk worked to sell securities from a CDO called Camber 7, Mr. Sparks wrote to Mr. Montag: "Need you to send message to peter ostrem and darryl herrick telling them what a great job they did. They structured like mad and traveled the world, and worked their tails off to make some lemonade out of some big old lemons."[2067]

In February 2007, the Mortgage Department conducted a review of the CDOs in its origination pipeline.[2068] As part of that review, Mr. Sparks cancelled four pending CDOs that had acquired some but not all of the assets needed for the CDOs to go to market.[2069] On February 25, 2007, Mr. Sparks reported to Mr. Montag and Mr. Ruzika:

> "The CDO business liquidated 3 warehouses for deals of $530mm (about half risk was subprime related). Business also began liquidation of $820mm [redacted] warehouse – all synthetics done, cash bonds will be sold in the next few days."[2070]

[2066] 4/2010 "Goldman Sachs Long Cash Subprime Mortgage Exposure, Investments in Subprime Mortgage Loans, and Investments in Subprime Mortgage Backed Securities November 24, 2006 vs. August 31, 2007 in $ Billions," chart prepared by the Subcommittee, Hearing Exhibit 4/27-163.

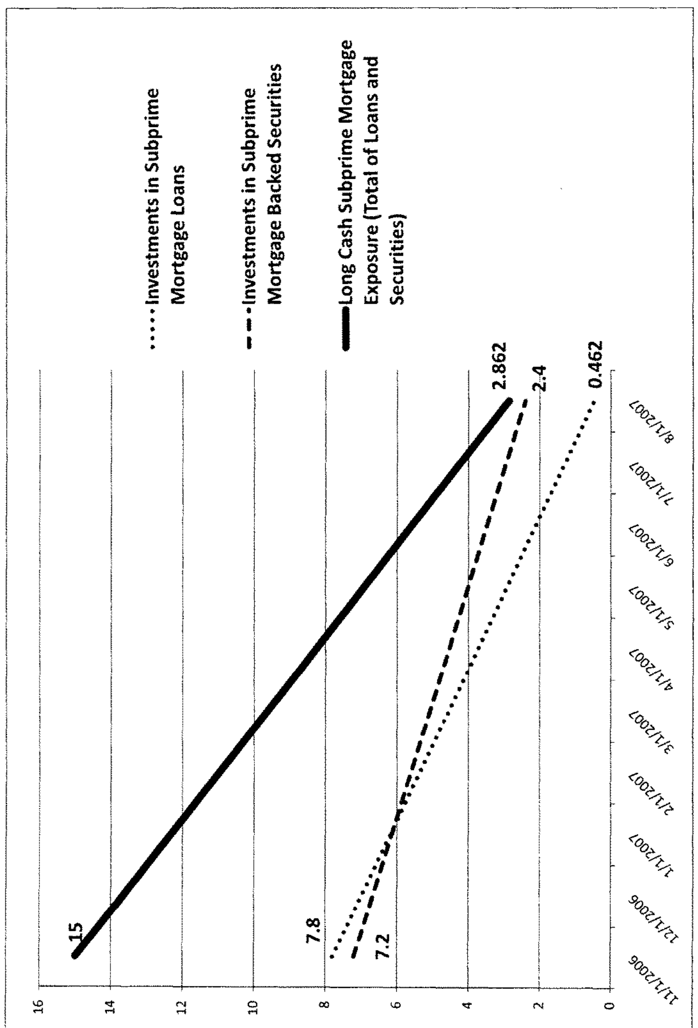
[2067] 1/31/2007 email from Daniel Sparks to Tom Montag, "MTModel," Hearing Exhibit 4/27-91.

[2068] See, e.g., 2/25/2007 emails between Daniel Sparks and Tom Montag, "Questions you had asked," GS MBS-E-019164799.

[2069] See 2/23/2007 email from Daniel Sparks, "Mortgages today," GS MBS-E-009759477 ("We liquidated 3 CDO warehouses today and started the liquidation of another."); 2/26/2007 emails between Daniel Sparks and Tom Montag, "Questions you had asked," GS MBS-E-019164799; 2/22/2007 email from Peter Ostrem to David Rosenblum, "League Tables," GS MBS-E-001800683 ("FYI Liquidating 3 warehouses tomorrow. And Dan [Sparks] wants to liquidate Greywolf.").

[2070] 2/25/2007 emails between Daniel Sparks and Tom Montag, "Questions you had asked," GS MBS-E-019164799.

Goldman Sachs Long Cash Subprime Mortgage Exposure,
Investments in Subprime Mortgage Loans, and
Investments in Subprime Mortgage Backed Securities
November 24, 2006 vs. August 31, 2007 - in $ Billions



Prepared by the U.S. Senate Permanent Subcommittee on Investigations, April 2010.
Data from Nov. 7, 2007, letter from Goldman Sachs to the Securities and Exchange Commission, GS MBS-E-015713460, at 5 (Exhibit 50).

The Mortgage Department rushed several remaining CDOs to market, including Anderson, Timberwolf, and Point Pleasant, which issued their securities in March and April 2007.[2071] In May and June 2007, the Mortgage Department began closing all of its remaining CDO warehouse accounts and transferring the assets to the SPG Trading Desk for sale.[2072] On June 22, 2007, Mr. Lehman reported that the ABS Desk had just sold another $50 million in RMBS securities from the CDO warehouse accounts for a profit of $1 million, and that: "[o]nly 40mm RMBS A3/A- remain in the WH [warehouse] accounts, ½ of which is Long Beach paper - continue to work."[2073] Throughout 2007, Goldman sought to sell all of its remaining subprime assets from the CDO warehouse accounts as well as the new securities issued by Goldman-originated CDOs.[2074]

Aggressive Sales Efforts. On March 9, 2007, Mr. Sparks emailed a call for "help" to Goldman's top sales managers around the world to "sell our new issues – CDOs and RMBS – and to sell our other cash trading positions."[2075] In response, Mr. Sparks and key sales managers had a dialogue about "reaching the next wave of players here and abroad."[2076]

The Goldman sales manager for Europe and the Middle East suggested that Mr. Sparks focus the CDO sales efforts abroad, because the clients there were not involved in the U.S. housing market and therefore were "not feeling pain":

> "The key to success in the correlation melt-down 2 years ago was getting new clients/capital into the opportunity quickly. Saved/made us a lot of money. Lots of banks and real money clients in Europe and middle east and lots of macro hedge funds are not involved and not feeling pain. In Europe we need a summary of key

[2071] See, e.g., 3/8/2007 email from Daniel Sparks to Mr. Winkelried and others, GS MBS-E-002206279, Hearing Exhibit 4/27-75 (Mortgage Department is "rushing to get deals rated"). See also discussions of Anderson and Timberwolf CDOs, below.
[2072] See 6/1/2007 email from David Lehman, "CDO Update," GS MBS-E-001866889 (referring to "liquidated warehouses"); 5/30/2007 email from David Lehman, "ABX hedges – Buy order," GS MBS-E-011106690 (directing trading desk to unwind hedges for CDO warehouse accounts). Some of the assets were accounted for in a separate "CDO Transition book," but the sale of the assets became the responsibility of the SPG trading desk.
[2073] 6/22/2007 email from David Lehman, "Few trade posts," GS MBS-E-010848985.
[2074] Between the fall of 2006 and mid-2007, Goldman originated 14 CDOs, which included or referenced many assets that were from or similar to Goldman's own inventory. The Subcommittee examined seven of those CDOs, and found that 57% of the CDO assets had come from Goldman, including over $3 billion in synthetic assets in which Goldman was the short party, and therefore stood to profit from a decline in the value of the underlying assets. Goldman had unsold securities from a number of these CDOs on its books.
[2075] 3/9/2007 email exchange between Daniel Sparks and sales managers, "help," GS MBS-E-010643213, Hearing Exhibit 4/27-76.
[2076] Id.

opportunities/axes and I will get the team to focus on. 2-3 most important things plus sales talking points rather than laundry list."[2077]

Mr. Ostrem, head of the CDO Origination Desk, agreed with expanding Goldman's CDO sales efforts in Europe and the Middle East: "I agree with [sales manager's] comments on new clients. Middle east, french banks, macro hedge funds could and are making these deals 'work' currently."[2078] The following week, Mr. Lehman issued three new sales directives or "axes" to the Goldman sales force placing a priority on selling securities from the Anderson, Timberwolf, and Hudson CDOs:[2079]

> "As per [European/Middle East sales manager's] suggestion last Friday, below are the three main focus areas for SP CDOs/SPG Trading, including Anderson Mezzanine, Timberwolf CDO^2 and secondary CDO positions (Hudson Mezzanine and high grade BBBs)."

Goldman's New York sales office forwarded the axe sheet to the European/Middle East sales office saying: "London – this is for you."[2080]

In an additional effort to expand Goldman's sales effort, the Mortgage Department's sales syndicate provided a list of "non-traditional buyers" to the CDO and SPG Trading Desks:

> "We have pushed credit sales to identify accounts in the credit space that would follow yield into the ABS [asset-backed security] CDO market, and tried to uncover some non-traditional buyers. ... Below is a list of higher delta accounts uncovered so far; and we continue to push for leads. We are working with sales on these accounts to push our axes."[2081]

Goldman personnel worked diligently to pitch CDO securities to various clients, internal documents show. On March 30, 2007, for example, Fabrice Tourre reported to senior Mortgage Department executives about his efforts and plans to sell the CDO securities:

> "This transaction [Abacus 2007-AC1] has been showed to selected accounts for the past few weeks. Those selected accounts had

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2077 Id.
2078 Id.
2079 3/12/2007 email from David Lehman, "**Internal** Three focus axes for SP CDOs/SPG Trading," GS MBS-E-021895601.
2080 Id.
2081 3/21/2007 email from syndicate, "Non-traditional Buyer Base for CDO AXES," GS MBS-E-003296460, Hearing Exhibit 4/27-78.

previously declined participating in Anderson mezz, Point Pleasant and Timberwolfe. ... Plan would still be to ask sales people to focus on Anderson mezz, Point Pleasant and Timberwolfe, but if accounts pass on these trades, steer them towards available tranches in ABACUS 07-AC1 since we make $$$ proportionately with the notional amount of these tranches sold. Wanted to make sure everyone is comfortable with this plan."[2082]

In April 2007, the Mortgage Department issued a new directive to its sales force with a list of new and old CDO securities in its inventory that it wanted sold, including Timberwolf and Anderson as well as CDOs known as Point Pleasant and Altius.[2083] Dissatisfied with the pace of sales, Mr. Sparks suggested issuing a separate axe for each CDO and offering additional sales credits: "Why don't we go one at at a time with some ginormous credits - for example, let's double the current offering of credit for timberwolf."[2084] A sales manager responded: "We have done that with timberwolf already. Don't want to roll out any more focus axes until we get some traction there but at the same time, don't want to stop showing inventory."

"Gameplan" for CDO Valuation Project. By May 2007, CDO sales had slowed significantly. Goldman executives became concerned about the lack of sales prices to establish the value of its CDO holdings.[2085] Goldman needed accurate values, not just to establish its CDO sales prices, but also to value the CDO securities for collateral purposes and to comply with Goldman's policy of using up-to-date market values for all of its holdings. Mr. Sparks expressed concern that the value of the remaining CDO assets were rapidly declining, warning one senior executive: "We are going to have a very large mark down – multiple hundreds. Not good."[2086]

[2082] 3/30/2007 email from Fabrice Tourre to Daniel Sparks, David Lehman, and others, GS MBS-E-002678071, Hearing Exhibit 4/27-80.

[2083] 4/11/2007 email from syndicate, "GS Syndicate Structured Product CDO Axes (INTERNAL)," GS MBS-E-010533482, Hearing Exhibit 4/27-101. Mr. Sparks forwarded the directive to global senior sales executives with a note: "Your focus on this ax would be very helpful – we are trying to clean up deals and this is our priority."

[2084] 4/19/2007 email from Daniel Sparks to Bunty Bohra, GS MBS-E-010539324, Hearing Exhibit 4/27-102. Mr. Sparks authorized large sales credits on at least one other occasion as well – for sales to cover the Department's $9 million AAA ABX net short position in September 2007. See 9/27/2007 email from Tom Montag to Daniel Sparks, GS MBS-E-010703744 (Mr. Montag asked: "Did we really pay sixty million in gcs [gross credits] on the aaa short covering? Why so high?" Mr. Sparks responded: "It was a very big ax, but sales credits have become such a contentious point that trading team doesn't debate it anymore. The politics around sales credits had become unbelievable and were a hinderance [sic] to business." Mr. Montag replied: "so you overpay?").

[2085] See, e.g., 5/11/2007 email from Tom Montag to Daniel Sparks, GS MBS-E-019648100.

[2086] 5/11/2007 email from Daniel Sparks to Richard Ruzika, "You okay?," GS MBS-E-019659221.

On May 11, 2007, Goldman senior executives, including Mr. Cohn and Mr. Viniar, held a lengthy meeting with Mortgage Department personnel, their risk controllers, and others to develop a "Gameplan" for a CDO valuation project.[2087] The Gameplan called for the Mortgage Department, over the course of about a week, to use three different valuation methods to price all of its remaining CDO warehouse assets and unsold securities from the Goldman-originated CDOs then being marketed to clients.[2088]

A few days later, on May 14, 2007, while the CDO valuation project was underway, Mr. Montag asked Mr. Sparks for an estimate of how much the firm would need to write down the value of its CDO assets. Mr. Sparks responded that the "base case from traders is down [$]382 [million]." He also wrote:

> "I think we should take the write-down, but market [the CDO securities] at much higher levels. I'm a little concerned we are overly negative and ahead of the market, and that we could end up leaving some money on the table."[2089]

The valuation project's results were summarized in a presentation dated Sunday, May 20, 2007, prepared for a 9:00 p.m. conference call that night with Mr. Viniar, in which Mr. Mullen, Mr. Sparks, Mr. Lehman, and others also participated.[2090] Using the three valuation methods, the

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[2087] Id. ("We had a meeting today with viniar, don [Mullen], mcmahon, my team, controllers, gary [Cohn] on the phone to walk through situation. The market has seized up so much that levels are very hard to determine for the complex products – which also are difficult to model for value due to market changes."); 5/14/2007 email from David Lehman, "Gameplan – asset model analysis," GS MBS-E-001865782 (last email in a longer email chain).

[2088] 5/14/2007 email from David Lehman, "Gameplan – asset model analysis," GS MBS-E-001865782 (last email in a longer email chain) ("Following up from this afternoon's meeting. We are going to better evaluate the CDO^2 risk using three distinct frameworks: 1) Blended scenario analysis using HPA [housing price appreciation;] ... 2) Risk neutral/correlation framework, consistent with our current synthetic ABS CDOs[;] 3) Simplistic loss assumptions on the underlyings / Market Value Coverage"); 5/14/2007 email from Elisha Weisel, "Modelling Approaches for Cash ABS CDO/CDO^2," GS MBS-E-001863618. See also 3/6/2007 email from Elisha Weisel to Daniel Sparks, "Property Derivs," GS MBS-E-010649734 (discussing lack of model or models to consistently value subprime assets).

[2089] 5/14/2007 email from Tom Montag to Daniel Sparks, GS MBS-E-019642797.

[2090] 5/20/2007 email from Lee Alexander to Daniel Sparks, Donald Mullen, Lester Brafman, and Michael Kaprelian, "Viniar Presentation - Updated," GS MBS-E-010965211 (attached file "Mortgages V4.ppt," "Mortgages Department, May 2007," GS MBS-E-010965212). This document is identified in the relevant correspondence as "v.4," and appears to be the final version of a draft presentation prepared earlier that day, "Mortgages Department, May 2007," GS MBS-E-001863651, which bears a time and date stamp of May 20, 2007, 2:58 p.m. See also 5/20/2007 Goldman document, "Mortgage Presentation to David Viniar – Dial In Information," GS MBS-E-010787603. The final document, "Mortgages V4.ppt" was emailed to Mr. Sparks and Mr. Mullen, and also messengered to Mr. Mullen's home, at 8:31 p.m. on May 20, immediately before the scheduled call. 5/20/2007 email to Daniel Sparks and Donald Mullen, "Viniar Presentation – Updated," GS MBS-E-010971156.

presentation estimated that the loss in value and the total writedowns required for the firm's CDO assets were between $237 and $448 million.[2091] The executive summary of the presentation also expressed concern about Goldman-originated CDO securities, especially its two CDO^2 transactions, Timberwolf and Point Pleasant, since "[t]he complex structure of these positions makes them difficult to value and distribute."[2092] The presentation estimated that the market value of those CDO securities, plus the equity and super senior tranches that had been retained by Goldman, was $4.3 billion. The executive summary also estimated the market value of the remaining assets from the CDO warehouse accounts at $1.5 billion, and expressed particular concern about selling $742 million in CDO securities from non Goldman originated CDOs due to "limited liquidity and price transparency in this space." The executive summary stated that since "securitization is no longer a viable exit, the warehouse collateral will be marked to market on an individual basis."[2093]

The presentation also presented "Next Steps." It recommended that Goldman "unwind the warehouses" and use "[i]ndependent teams to continue to value" the CDO securities, equity tranches, and super senior tranches from the Goldman-originated securitizations. It also recommended that sales of the Goldman-originated CDO securities be targeted, first, at four hedge fund customers, Basis Capital, Fortress, Polygon, and Winchester Capital.[2094] The presentation also attached a list

Goldman also produced a similar document prepared the day before, which may have been an earlier draft of the final presentation. 5/19/2007 Goldman presentation, "Mortgages CDO Origination – Retained Positions & Warehouse Collateral, May 2007," GS MBS-E-010951926. This document is identified in the relevant correspondence as "Mortgages CDO Origination," and the file name is "Mortgages V3.ppt." This presentation was forwarded to Mr. Sparks for comment on May 19, 2007 at 12:32 a.m., and Mr. Sparks replied with comments at 5:57 p.m. Mr. Sparks forwarded the file "Mortgages V3.ppt" to himself at home on Sunday, May 20, 2007 at 8:07 a.m.

[2091] The writedowns were required, in part, because the assets in the CDO warehouses had generally been marked at cost when purchased or at a value related to the final securitized structure, called "mark-to-securitization-exit." Those valuation methods generally resulted in values well above what the assets would bring if sold individually in a declining mortgage market.

[2092] Id.

[2093] 5/20/2007 email from Lee Alexander to Daniel Sparks, Donald Mullen, Lester Brafman, Michael Kaprelian, "Viniar Presentation - Updated," GS MBS-E-010965211 (attached file "Mortgages V4.ppt," "Mortgages Department, May 2007," GS MBS-E-010965212). By May 2007, Goldman had ceased originating any new CDO securitizations.

[2094] Id. The four identified customers appear to be ones which the sales force felt it had the greatest likelihood of success in selling the CDO assets. Two of the customers, Basis Capital and Polygon, had already made recent purchases of Point Pleasant and Timberwolf securities, respectively, from Goldman. See Goldman Sachs response to Subcommittee QFR at PSI_QFR_GS0226.

of 35 other target customers with notes regarding the status of efforts to sell them CDO securities in the past.[2095]

The CDO valuation project undertaken in May provided clear notice to Goldman senior management at the highest levels that its CDO assets had fallen sharply in value, and that despite their lower value, the Mortgage Department planned to aggressively market them to customers. In an earlier draft of the presentation, the Mortgage Department had also

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[2095] The client list drawn up pursuant to the Gameplan was a stark example of actions taken by Goldman to target specific clients for CDO sales, but different Mortgage Department desks maintained their own "target lists" that focused on specific types of products, specific transactions, and specific types of cross-selling opportunities with other Goldman departments. See, e.g., 3/1/2007 email from Michael Swenson, "names," GS MBS-E-012504595 (SPG Trading target list tiered according to likelihood of purchasing); 2/14/2007 email to Matthew Bieber, "Timberwolf I, Ltd. – Target Account List," GS MBS-E-001996121 (list of U.S. accounts "we should be directly targeting" for Timberwolf sales); 3/2/2007 email from David Lehman, "ABX/Mtg Credit Accts," GS MBS-E-011057632 (mortgage credit business shared with SPG Trading Desk "a fairly lengthy list of accounts that are considered to be 'key'"). In December 2006, the Correlation Trading Desk drew up a list of target customers for 2007: the "proposed top 20 correlation customer list." 12/29/2006 email from Fabrice Tourre, "Last call–any other comments on the proposed top 20 correlation customer list," GS MBS-E-002527843, Hearing Exhibit 4/27-61. Mr. Tourre issued a "last call" for comments on the list and suggested focusing on "buy-and-hold rating-base buyers" who might be more profitable for the desk than more sophisticated and demanding hedge fund customers:

> "[T]his list might be a little skewed towards sophisticated hedge funds with which we should not expect to make too much money since (a) most of the time they will be on the same side of the trade as we will, and (b) they know exactly how things work and will not let us work for too much $$$, vs. buy-and-hold rating-based buyers who we should be focused on a lot more to make incremental $$$ next year."

The proposed top 20 list identified a number of European accounts, as well as customers who had purchased asset backed security products from Goldman in the past.

The reference to "buy and hold, ratings-based buyers" was to conservative financial institutions, often insurance companies or pension funds, that tended to hold their investments indefinitely or until maturity, some of which were limited to holding investments with AAA or other investment grade credit ratings. Many of these buyers tended to rely on the AAA rating as a "seal of approval" signaling that the rated instrument offered predictable, safe returns. Many viewed the AAA rating as, in effect, all these buyers thought they needed to know about the CDO securities they were purchasing. See, e.g.,11/13/2007 Goldman email, GS MBS-E-010023525 (attachment, 11/14/2007 "Tri-Lateral Combined Comments," GS MBS-E-010135693-715 at 713) ("Investors in subprime related securities, especially higher rated bonds, have historically relied significantly on bond ratings particularly when securities are purchased by structured investing vehicles."). But as one press article explained: "CDO ratings may mislead investors because they can obscure the risk of default, especially compared with similar ratings for bonds, says Darrell Duffie, a professor of finance at Stanford Graduate School of Business in California, who's paid by Moody's to advise the company on credit risk. 'You can't compare these CDO ratings with corporate bond ratings,' Duffie says. 'These ratings mean something else – entirely.'" See 5/31/2007 email to David Lehman and others, "CDO Boom Masks Subprime Losses," GS MBS-E-001865723 at 733. The article pointed out that the lowest grade of corporate bonds rated by Moody's had a default rate of 2.2%, while the default rate for CDOs with the same rating was 24%. Id.

stated that it expected Goldman's CDO and CDO^2 securities "to underperform":

> "The complexity of the CDO^2 product and the poor demand for CDOs in general has made this risk difficult to sell and the desk expects it to underperform."[2096]

Mr. Sparks reviewed that draft language and made comments about other items on the same page, but did not change the phrase, "the desk expects it to underperform."[2097] The same phrase appeared in several earlier versions of the presentation as well, but was removed from the final version sent to Mr. Viniar.[2098]

CDO Desk Shutdown. In May 2007, Goldman decided to stop issuing new CDOs, and the head of its CDO Origination Desk, Peter Ostrem, left the firm.[2099] Mr. Sparks named as his replacement David Lehman, who was a senior member of the Structured Product Group (SPG) and head of its CMBS Trading Desk, but had little experience in either underwriting or CDOs.[2100] On May 19, 2007, Mr. Lehman received an email from a former Goldman managing director who wrote: "Congratulations, but seems like you have a lot ofwork [sic] ahead of you."[2101] Mr. Lehman asked Mr. Egol: "What do u th[in]k he means by 'lot of work to do?'"[2102] Mr. Egol responded:

> "I know what he means. If you talk to people knowledgeable about cdos, you will find that external perception of GS franchise in this space is much lower than Sparks and Sobel believed. Over the last 2 years, GS [Goldman Sachs] is perceived to be a bottom quartile abs

2096 5/19/2007 Goldman presentation, "Mortgages CDO Origination – Retained Positions & Warehouse Collateral, May 2007," GS MBS-E-010951926.
2097 5/19/2007 email from Daniel Sparks, "Mortgages CDO Origination Presentation," GS MBS-E-010973174 (Mr. Sparks: "p. 5 again 'marked to securitization exit' [re marked to model language] ... some A and BBB were sold on the deals [re demand only for the supersenior tranche language]").
2098 See 5/19/2007 email from Dan Sparks to Lee Alexander, others, GS MBS-E-010973174 (attached file "Mortgages V3.ppt," GS MBS-E-010973175); and 5/20/2007 9:52 a.m. draft "Mortgages V4.ppt," GS MBS-E-010952331; compared to final version, 5/20/2007 email from Lee Alexander to Daniel Sparks, Donald Mullen, Lester Brafman, and Michael Kaprelian, "Viniar Presentation - Updated," GS MBS-E-010965211 (attached file "Mortgages V4.ppt," "Mortgages Department, May 2007," GS MBS-E-010965212).
2099 5/17/2007 email from Daniel Sparks to Tom Montag, "Ostrem is resigning," GS MBS-E-019654926.
2100 5/11/2007 email from Daniel Sparks, "You okay?," GS MBS-E-019659221 ("I'm going to make a change in the responsibility of the business away from Ostrem to david lehman (with Swenson helping).").
2101 5/19/2007 email to David Lehman, "congratulations, but seems like you have a lot of work ahead of you," GS MBS-E-018921924.
2102 Id.

[asset-backed security] cdo underwriter and to have done several poor deals. There is a reason [the CDO desk] didn't sell much paper. The fact that [the CDO desk] was basically giving money away in these no-fee principal deals and could still only get TCW, GSC (both street wh—e managers) and some start up managers to work with GS is a stain that will take time to remove. The HG [high-grade] deals in particular are very poor. I thought the alladin deals had some potential but fortius 2 is going to be a real mess.

"These are not just my views – they are from customers whose views resonate in the market. Sales people have just been too timid internally or not engaged enough with their accounts to provide accurate feedback. It pains me to say it but citi, ubs, db [Deutsche Bank], lehman and ms [Morgan Stanley] have much stronger franchises – among large dealers only ML [Merrill Lynch] is more reviled than [Goldman's] business. ...

"I should add altius 3 is a doozy as well. I'll spare you the detailed list."[2103]

That May 19, 2007 email provided Mr. Lehman with additional notice of the poor quality of the CDO securities he was charged with selling.

The CDO valuation project presentation given the next day, May 20, 2007, recommended that all assets from the CDO warehouse accounts be transferred to the SPG Trading Desk for sale. A CDO "transition book" was created to account for profits and losses from some of the assets, and the transfer took place the following week.[2104] In addition, by June 1, 2007, Goldman eliminated the CDO Origination Desk as a separate entity, and moved all of the remaining Goldman-originated CDO securities to the SPG Trading Desk, where Mr. Lehman was based.[2105] As a result, the SPG Trading Desk, which was a secondary trading desk and had little experience with the greater disclosure obligations involved with selling newly minted securities, became solely responsible for selling all Goldman-originated CDO securities.

Renewed Sales Efforts. After the transfer of the CDO assets, the SPG Trading Desk began to work with the Goldman sales force to identify potential customers and sell the CDO products. On May 24, 2007, a

[2103] 5/19/2007 email from Jon Egol to Daniel Sparks, GS MBS-E-018921924.
[2104] 5/20/2007 email from David Lehman, "ABX hedges – Buy order," GS MBS-E-011106690 ("begin unwinding certain ABX hedges vs. the CDO WH [warehouse] and transition book"); 6/1/2007 email from Mr. Lehman, "CDO Update," GS MBS-E-001866889 ("liquidated warehouses and the trading books").
[2105] Subcommittee interview of David Lehman (9/27/2010).

Goldman salesperson contacted Messrs. Sparks and Lehman regarding two potential customers interested in Timberwolf and Point Pleasant securities.[2106] With respect to one customer, the salesman wrote that it was "[n]ot experts in this space at all but [I] made them a lot of money in correlation dislocation and will do as I suggest." With respect to the second customer, the Goldman salesperson wrote that the customer had "just raised another $1bln for their ABS [asset backed security] fund and they are very short the ABX so are natural buyers of our axe."[2107]

A couple of weeks before the CDO valuation project, Goldman's Australia sales representative, George Maltezos, announced he had found a potential Australian buyer for a Goldman CDO being constructed by the Correlation Desk: "I think I found white elephant, flying pig and unicorn all at once."[2108] On the same day the project identified Basis Capital as a primary target for CDO sales, May 20, 2007, Mr. Maltezos sent Mr. Lehman an email saying he would contact the Basis principals as soon as they returned from a business trip the following day.[2109]

On May 24, 2007, the CDO sales dry spell ended, when Paramax Capital Group, a U.S. investment adviser, purchased $40 million in AA Timberwolf securities.[2110] On May 30, Mr. Lehman announced the sale of $20 million in AAA Timberwolf securities to Tokyo Star Bank in Japan.[2111]

CDO Sales in Asia. On June 11, 2007, Mr. Lehman received a note from the Mortgage Department's sales syndicate desk asking whether the directive listing high priority CDO sales could be sent to the Japan sales office, which oversaw sales throughout Asia:

> "Know there was sensitivity w/ sending this out, but asia sales management is asking again. Do you want to consider sending more broadly for asia sales or do you want to stick with the more targeted approach?"[2112]

2106 5/24/2007 email from Yusuf Aliredha to Mr. Sparks, Mr. Lehman, and others, "Priority Axes," GS MBS-E-001934732.
2107 Id.
2108 4/27/2007 email from George Maltezos, Goldman Australia sales, to Jon Egol, "utopia," GS MBS-E-003305101.
2109 5/20/2007 email from George Maltezos to David Lehman, "T/wolf and Basis," GS MBS-E-001863555.
2110 See Goldman Sachs response to Subcommittee QFR at PSI_QFR_GS0226.
2111 5/30/2007 email from David Lehman, "Timberwolf – Order from Tokyo Star Bank," GS MBS-E-001934058. Tokyo Star Bank was not on the list of "targeted" customers, but had been solicited previously by the Japan sales team pursuant to an earlier sales directive listing Timberwolf as a priority.
2112 6/11/2007 email from syndicate, "GS Syndicate Structured Product CDO Axes (INTERNAL USE ONLY)," GS MBS-E-001914921-24.

The Japan sales group wrote that the head of the Japan office "is saying that we need it to go more broadly to all Sales at least in Japan. Given her request twice now and her help in getting focus, think we should at least push this in Japan."[2113] Mr. Lehman responded: "Fine – let's send to all Japan sales then."[2114]

The Japan sales office responded to the new directive with several quick sales. On June 13, 2007, the Japan sales office sent out this celebratory note:

> "**We have moved over $250mm of SP CDO axes to account in Japan, Australia and Korea over the past 2+ weeks.** These are HUGE orders for the firm as they have helped reduce balance sheet risk and further exhibits the importance of the Asia franchise to the global Structured Products Group business. **Note that in line with these trades we have paid out over $14mm of gross credits** – this is clearly the top focus for us now in SP [Structured Product] CDO space. ... Call the SPG Asia desk in Tokyo for updated axes and offer levels. We hope to trade another $20mm of CDO^2 risk with a Japanese account in the coming week+. Thanks."[2115]

Mr. Lehman replied: "Thx for sending this out."[2116]

A few days later, Mr. Lehman reported to senior management that the Japan sales office had been successful in selling another $20 million in CDO securities. Mr. Lehman wrote:

> "Great job by [Japan sales] (again) on our CDO^2 axes. Tonight we will trade $20mm Point Pleasant A1s @90.7 to Tokyo Star Bank .... We hope to trade another $20mm of these bonds next week w/ this account."[2117]

Mr. Lehman sent an email to the head of the Japan sales office letting him know that Goldman's senior management was aware of the sales effort: "Montag ve[r]y involved in this fyi." The Japan sales manager

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[2113] Id.
[2114] Id. See also "New Investors Board the Asian CDO Train," Creditflux (6/1/2007) (noting that while non bank investors had previously been barred from buying CDO assets in most Asian countries, regulators increasingly allowed life insurance companies and other financial firms to buy them within prescribed limits).
[2115] 6/13/2007 email from Goldman Sachs Japan sales, "**GS SP CDO Axes** – Asia Trade Update (INTERNAL USE ONLY)," GS MBS-E-010803888 [emphasis in original].
[2116] 6/13/2007 email from Goldman Sachs Japan sales, "**GS SP CDO Axes** – Asia Trade Update (INTERNAL USE ONLY)," GS MBS-E-011212260.
[2117] 6/18/2007 email from David Lehman, "$20mm Point Pleasant trade w/ TK Star Bank," GS MBS-E-011136832.

responded: "Yes – he made that clear when he spent almost 20 minutes on the desk with me in TKO [Tokyo] last week going through every potential lead."[2118] That same day, the Japan sales manager sent out a new email urging the trading team to bring in another $20 million from Tokyo Star Bank and promising them additional sales incentives:

> "To reward your strong effort and in hopes of the follow on 20mm order from the client on this deal, we plan on paying you a **total bonus GC payment of $40 / bond** (double our $20/bond for AAA's on our axes that are not lower mezz AAA). We look forward to additional trades from Tokyo Star Bank on our CDO axes."[2119]

During June and July, additional sales took place in Japan, Korea, Taiwan, and Australia.[2120] Goldman also made sales to customers in Europe and the Middle East.[2121]

Despite the sales in June and July, Goldman continued to have a significant inventory of unsold CDO securities. On August 15, 2007, Mr. Mullen even made a casual reference to "our cdo business which remains unsaleable."[2122] If Goldman's CDOs remained unsaleable, however, it was not for lack of trying. In August and September 2007, Goldman switched from its targeted customer approach to issuing broad directives to its entire sales force in the United States and abroad urging them to concentrate on its CDO securities. On August 17, 2007, for example, the SPG Trading Desk issued a new directive to certain salespersons asking them to place a priority on selling interests in two Timberwolf super senior tranches.[2123] These tranches were first in line to receive payments within the CDO and so had the lowest risk. Super senior CDO positions were often sold through CDS contracts, sometimes called super senior swaps, in which the customer took the long side and the CDO originator took the short side, and that's what Goldman wanted the sales force to market. But the following week, on August 23, 2007, Goldman sent a new directive to the sales force urging them to find customers willing to take the short side of the super senior tranches, so the Mortgage Department could take the long

[2118] Id.
[2119] 6/18/2007 email from Goldman Sachs Japan sales, "Point Pleasant 07-A1 // Tokyo Star Bank (internal use only)," GS MBS-E-001920459 [emphasis in original].
[2120] See Goldman Sachs response to Subcommittee QFR at PSI_QFR_GS0226; 7/24/2007 email from [Taiwan], "7/23 CDO/RMBS requests from Taiwan," GS MBS-E-011198375, Hearing Exhibit 4/27-67.
[2121] Id.
[2122] 8/15/2007 email from Donald Mullen, "Post," GS MBS-E-009740784, Hearing Exhibit 4/27-32.
[2123] 8/17/2007 email from Michael Swenson, "Twolf super seniors," GS MBS-E-001927791.

side and cover some of its shorts.[2124] When asked his opinion of the directive, the head of Japan sales office expressed skepticism about sales to Asian customers:

> "The only question in my mind is that we have not seen many accounts pushing hard to find ways to get short (typically they are long only). That being said, the reality of the current market may have finally sunk in and investors may be able to convince their boards [n]ow to put on this sort of trade."[2125]

On September 5, 2007, notwithstanding "the reality of the current market," the SPG Trading Desk issued a "Refresh of Axe Priorities" to its entire sales force.[2126] The directive placed a priority on selling Goldman's residual CDO equity tranches as well as a variety of other assets to help Goldman cover and lock in the profits from its big short. Mr. Sparks emailed senior sales executives:

> "Please let me know how these are going. I am personally going to work to do a better job making sure you understand the things we are trying to achieve as a business. In addition to this, the super-senior ABX trade [Jonathan] egol sent around and general securities financing trades are priorities for us."[2127]

Mr. Sparks forwarded this email to Mr. Cohn, who responded "Great to see."[2128] On September 6, Mr. Sparks emailed the syndicate desk about the "Refresh of Axe Priorities": "Want to get you to send out daily 1-3 priority axes for department – let's discuss."[2129]

2124 8/23/2007 email from Jon Egol, "*** SP CDO/Correlation Desk Super Senior Axes *** (INTERNAL USE ONLY), GS MBS-E-011310717.

2125 Id. Around the same time, a Goldman managing director who ran Corporate / PWM [Private Wealth Management] Sales in Japan and sold investments to wealthy individuals, inquired: "Do you have any cdo secondary inventory." 8/21/2007 email from PWM Managing Director, GS MBS-E-010619382. He was advised by the SPG Trading Desk that Goldman was "prohibited from offering cdo paper to all pw [private wealth] clients, even [qualified institutional] pw clients. ... To change this, we would have to petition the committee that oversees such things [the Structured Investment Product Committee]." Id. Mr. Lehman added: "Spoke with Sparks about this. Given the complexity of the product, we would like to handle this on a client by client basis." Id. After receiving information that potential clients had previously purchased ABS CDOs from other firms, Mr. Lehman asked Goldman compliance: "What do we need to do on our end to get this approved." 8/28/2007 email from David Lehman, "Japan PWM Client Interest in ABS CDO (internal use only)," GS MBS-E-011090928. One of Mr. Lehman's team members in the Mortgage Department replied: "Ldl [let's discuss live]. Have info on this." Id. Mr. Lehman replied "xoxo." Id.

2126 9/5/2007 email from Michael Swenson, "Refresh of Axe Priorities," GS MBS-E-010684858.

2127 Id.

2128 Id.

2129 9/6/2007 email from Daniel Sparks to syndicate desk, "Refresh of Axes Priorities," GS MBS-E-010685200.

Goldman has at times suggested that many of its CDO sales were not the result of affirmative client solicitations and recommendations made by the firm, but were in response to client requests–generally known as "reverse inquiries." In a letter to the Financial Crisis Inquiry Commission, for example, Goldman's General Counsel, Gregory Palm, made the following statement about Goldman's role as an underwriter of synthetic CDOs:

> "Goldman Sachs' CDOs containing primarily residential mortgage-related synthetic assets were initially created in response to the request of a sophisticated institutional investor that approached the firm specifically seeking that particular exposure. Reverse inquiries from clients were a common feature of this market. ... These transactions often are initiated by our clients, and when proposed by us are often in response to previously expressed investment interests of the client. We are responding to our clients' desires either to establish, or to increase or decrease, their exposure to a position based on their own investment views."[2130]

Mr. Palm's characterization of Goldman as playing only a passive, responsive role is at odds with the firm's documented and concerted efforts to market its CDO securities in the face of investor disinterest and falling values. Throughout 2007, Goldman issued directives to its sales force to sell specific CDO securities on a "first priority" basis. It expanded its selling efforts to "nontraditional buyers" as well as to banks, hedge funds, and other clients in Asia, Europe, and the Middle East. It offered its sales force substantial incentives, such as "ginormous" sales credits, to push the sales to clients.[2131] Under its CDO Gameplan, Goldman "targeted" four primary and 35 secondary clients for CDO sales, and celebrated selling CDO securities to several of them. The weight of this evidence demonstrates that Goldman was soliciting sales rather than responding solely to client inquiries.

CC. CDO Marks

One issue that gained intensity as the mortgage market continued its decline was Goldman's practice of selling CDO securities to customers at one price only to mark down the value substantially within days or weeks of the sale, where Goldman had an ongoing client relationship.

[2130] 3/1/2010 letter from Goldman Sachs to the Financial Crisis Inquiry Commission, GS-PSI-01310 at 16.
[2131] 4/19/2007 email from Daniel Sparks, "*UPDATE* GS Syndicate Structured Product CDO Axes," GS MBS-E- 010539324, Hearing Exhibit 4/27-102.

Goldman used a mark-to-market process to manage its risk, which required valuing its holdings on a daily basis to reflect their current market value.[2132] In practice, many of its mortgage related assets were marked on a monthly rather than daily basis, including many of its CDO securities.[2133] Nonetheless, Goldman appears to have been more active in re-marking the value of its mortgage related assets than other Wall Street firms and to have used lower marks than many of its competitors.[2134] Goldman also had a process for automatically marking down its internal value of any asset held longer than a specified period of time, in order to encourage its trading desks to sell their aged assets.[2135]

During 2007, Goldman's markdowns of the value of its CDO securities became a source of dispute with its customers.[2136] Some clients

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[2132] Subcommittee interview of David Viniar (4/13/2010) and Craig Broderick (4/9/2010).

[2133] See, e.g., 2/2007 Goldman email chain, "FYIs," GS MBS-E-002339552 (regarding residential credit scratch & dent loan book: "Has the biz agreed with controllers about how frequently each book is to be marked? Daily? Weekly? Monthly?"; Mr. Sparks' response: "For this book I think monthly is the right way as the data comes monthly on performance. Dramatic mkt moves could change things."). CDOs were often marked monthly, as hedge fund clients generally needed month-end valuations of CDOs in their portfolios to enable them to report hedge fund Net Asset Values (NAVs) to clients. See, e.g., 6/28/2007 email from Bear Stearns, "Missing Marks (15).xls," GS MBS-E-001965860 (portfolio manager requesting month-end marks: "I need the 4 bonds marked for 5/31/07 we still need to report an NAV."); 6/19/2007 email from Lester Brafman to Jon Egol, GS MBS-E-003373736 (regarding Abacus CDO securities, Mr. Egol wrote: "We mark them monthly").

[2134] See, e.g., 2/12/2007 email from Daniel Sparks, "Post today," GS MBS-E-009763506 (New Century "claim[s] we are the only ones being harsh. C-Bass claims we are the only one margin calling. Our marks are appropriate for moves in the market. More margin calls going out today.").

[2135] Subcommittee interview of David Lehman (4/12/2010).

[2136] Mr. Broderick explained in his interview with the Subcommittee that because of the volatility in the subprime market, Goldman had an unusually large number of disputes with customers over marks or collateral valuation during 2007. Subcommittee interview of Craig Broderick (4/9/2010). See also 8/2/2007 email from Stacy Bash-Polley, "Marks Summary," GS MBS-E-013349723 (transmitting complaints from eight clients that Goldman's marks were far lower than those of other dealers); 2/12/2007 email from Daniel Sparks, "Post today," GS MBS-E-009763506 (New Century "claim[s] we are the only ones being harsh. C-Bass claims we are the only one margin calling."); 8/10/2007 Goldman memorandum, "Summary of German Bank US Sub Prime Exposure," GS MBS-E-009994305. This memorandum was generated by Goldman's European Investment Banking Division, FICC Sales and Credit. It highlighted losses incurred by many German banks due to markdowns in the value of U.S. subprime assets, necessitating several European Central Bank bailouts. The memorandum stated: "We understand from clients that valuation marks provided by Goldman Sachs on ABS are substantially lower than the competition's valuations. As a result, clients are irritated by the valuation difference."

Goldman's dispute with AIG FP is another example. The two companies disagreed over both the marks and the amount of collateral and margin that AIG had to post with Goldman in connection with various mortgage products. At one point in the dispute, Co-President Jon Winkelried wrote to his colleagues: "[O]ne thing we're not going to do is compromise on what we think the right marks are and our margin process." 8/2/2007 email from Jon Winkelried, "Aig collateral call," GS MBS-E-010055302. Goldman's dispute with AIG continued for over a year until the Federal Reserve, through the Maiden Lane III transaction, ultimately ensured that Goldman and its customers received 100 cents on the dollar on the bulk of their disputed claims were negatively affected in a variety of ways when lower values were assigned to Goldman's CDO securities. Some had purchased their CDO securities through "repo" financing arrangements with Goldman; under those arrangements, a decline in the value of the CDO securities being financed required the client to post more cash margin with Goldman. In a few other instances, clients had invested in CDO securities through a CDS contract with Goldman. If the CDO securities declined in value, the CDS contracts required those clients to post more cash collateral with Goldman. In other cases, clients did not have to post additional cash collateral, they simply incurred losses from the lower values.[2137]

Lower marks also had significance for Goldman internally, since a CDO security with a marked down value might reduce the firm's profits and reduce its long position. Alternatively, if Goldman held the short side of an investment, a lower mark might increase the firm's profits, increase the value of its short position, and bring in more cash from the long parties. When the firm held a proprietary position in opposition to the position held by a client, the fact that Goldman was marking the value of its own position created a conflict of interest, since Goldman would benefit as the client lost money.

Gameplan Markdowns. When, on May 11, 2007, Goldman executives and the Mortgage Department decided to embark upon a CDO valuation project, Goldman's Chief Risk Officer, Craig Broderick, sent an email to his team to discuss the consequences of lower CDO values for Goldman's clients. He wrote:

> "Sparks and the Mtg [Mortgage] group are in the process of considering making significant downward adjustment to the marks on their mortgage portfolios esp[ecially] CDOs and CDO squared. This will potentially have a big P&L [profit and loss] impact on us, but also on our clients due to the marks and associated margin calls on repos, derivatives and other products. We need to survey our

against AIG. Subcommittee interview of David Viniar (4/13/2010). Goldman later told regulators that it had more collateral disputes than anticipated during the financial crisis. 11/13/2007 Goldman email, GS MBS-E-010023525 (attachment, 11/14/2007 "Tri-Lateral Combined Comments," GS MBS-E-010135693-715 at 695). According to Goldman documents, as late as October 30, 2007, its Mortgage Department generated approximately 66% of all derivative collateral disputes by Goldman customers. 10/30/2007 Goldman presentation, "Derivative Collateral Dispute Summary," GS MBS-E-009882064.

[2137] See, e.g., 8/10/2007 Goldman memorandum, "Summary of German Bank US Sub Prime Exposure," GS MBS-E-009994305 (highlighting losses incurred by many German banks due to markdowns in the value of U.S. subprime assets, necessitating several European Central Bank bailouts).

clients and take a shot at determining the most vulnerable clients, knock on implications, etc."[2138]

Mr. Broderick called for a client survey to identify which clients were "most vulnerable" to financial difficulty if Goldman's CDO securities were marked down in value, and they either incurred losses or were required to post more cash margin or collateral. He also wrote: "This is getting lots of 30th floor attention right now."[2139]

Some Goldman managing directors also raised the issue of selling CDO securities to clients at a price that would be marked down almost immediately. In a May 11 email to colleagues, for example, Goldman senior executive, Harvey Schwartz, wrote: "[D]on't think we can trade this with our clients andf [sic] then mark them down dramatically the next day."[2140] Later that day, in an exchange of emails with Mr. Schwartz, Mr. Montag, and Mr. Sparks, Don Mullen acknowledged Mr. Schwartz's concern "about the representations we may be making to clients as well as how we will price assets once we sell them to clients."[2141] The Goldman executives also agreed, however, not to "slow or delay" efforts to sell the CDO securities, if the sales force received "strong bids."[2142]

The May 2007 CDO valuation project resulted in lower values for many of Goldman's CDO assets. While those internal markdowns were taken at month's end, around May 25, 2007, Goldman continued to price the CDO securities it was selling at much higher levels, creating the potential for a rapid markdown after an asset was sold.[2143]

"Monster CDO Re-Mark." Six weeks later, in mid-June, the Mortgage Department learned that two Bear Stearns hedge funds with a $17 billion portfolio of subprime assets were in financial distress. The Mortgage Department immediately initiated an effort to build a new, large short position to take advantage of the expected drop in the value of subprime mortgage assets.[2144]

[2138] 5/11/2007 email from Craig Broderick, "CDOs - Mortgages," Hearing Exhibit 4/27-84.
[2139] Id. The reference to the "30th floor" was the floor on which Goldman's most senior executives had office space in its New York headquarters.
[2140] 5/11/2007 email from Harvey Schwartz to Daniel Sparks, Tom Montag, and others, GS MBS-E-010780864. As explained earlier, some clients were affected by Goldman's marks even after completing purchase of CDO securities, due to repo financing margin requirements, CDS collateral requirements, or other arrangements.
[2141] 5/11/2007 chain of email exchanges among Messrs. Mullen, Schwartz, Montag, and Sparks, GS-MBS-E-010780849, Hearing Exhibit 4/27-103.
[2142] Id.
[2143] See, e.g., discussion of Timberwolf CDO, below.
[2144] See Section (3)(a), above.

Within two weeks, Goldman had amassed a large number of CDS contracts shorting a variety of subprime mortgage assets. By June 22, 2007, Goldman's short position reached its peak size of approximately $13.9 billion.[2145]

The Bear Stearns hedge funds failed in mid-June, subprime assets plummeted in value, and Goldman established its big short by the end of the month. After its new net short was in place, the Mortgage Department implemented a series of large markdowns in the value of its RMBS and CDO assets. The markdowns had the dual effect of increasing the value of Goldman's net short position, while reducing the value of many of its customers' holdings. Due to their financing arrangements or CDS contracts, the lower values meant that some of the affected clients also had to post more margin or cash collateral with the firm. Goldman issued broad and deep markdowns of its clients' positions at month's end in June, July and August 2007, as well as on intermittent dates in response to mass ratings downgrades of specific RMBS securities in July and August or to individual customer credit issues.

One of the markdowns took effect on July 25, 2007,[2146] which Mr. Sparks called "the CDO monster remark."[2147] In an email to Mr. Mullen, Mr. Sparks wrote: "We made massive mark adjustments this week, pushed them through because of basis and counterparty exposure."[2148] In a separate email to Mr. Montag, Mr. Sparks made clear that by "basis," he meant Basis Capital, an Australian hedge fund that had financed the purchase of Timberwolf and other CDO securities using Goldman funds and defaulted on its margin and collateral obligations. Goldman then repurchased those securities at a low price and adjusted its marks for other clients.[2149]

The CDO markdown drew an immediate negative reaction from Goldman's customers. On July 31, 2007, an internal report was sent to a dozen Goldman senior executives and Mortgage Department personnel

2145 4/2010 "Goldman Sachs Mortgage Department Total Net Short Position, February - December 2007 in $ Billions (including All Synthetic and Cash Positions in Mortgage Related Products)," Hearing Exhibit 4/27-162.
2146 See 7/25/2007 email from Arbind Jha to Kevin Kao, "Cash bonds," GS MBS-E-011128623 ("huge changes in marks today").
2147 7/29/2007 email from Daniel Sparks to Tom Montag, "Problem," GS MBS-E-010876595 ("[w]e probably should have taken more time to put through the CDO monster remark").
2148 7/29/2007 email from Daniel Sparks to Mr. Mullen, "Problem," GS MBS-E-010876565.
2149 7/29/2007 email from Daniel Sparks to Tom Montag, "Problem," GS MBS-E-010876595 ("we rushed it because of Basis and a desire to protect ourselves against counter-parties"). See also 7/13/2007 email from John McHugh to Michael Swenson and David Lehman, "Talking Points Needed for Gary Cohn," GS MBS-E-010853931 ("BSAM [Bear Stearns Asset Management] & other hedge fund managers (most recently Basis Capital) announced they were halting fund redemptions and/or liquidating holdings, with some likely to fail.").

regarding pending "mortgage derivative collateral disputes," meaning customers who were disputing the lower valuations and resulting cash margin and collateral calls.[2150] The email identified the "10 largest disputes," naming AIG Financial Products, Morgan Stanley, and Deutsche Bank, among others. It stated: "The overall derivative collateral dispute amount is now $7.0 billion."[2151] The email also noted that the total in dispute from the prior week had been $3 billion, which suggests that the July 25 markdowns had caused the amount in dispute to more than double in a week. Mr. Montag immediately forwarded the report to Mr. Blankfein: "7 billion of collateral disputes!!!"[2152]

Mr. Blankfein responded: "Make sure they prioritize weaker credits where our risk is threatening."[2153] In other words, Mr. Blankfein directed Goldman personnel to focus on disputes with clients that had the weakest credit, and might have fewer resources to pay the amounts owed to Goldman as a result of the downward marks. The same markdowns causing losses for those clients were simultaneously increasing the profitability of Goldman's net short.

Two weeks later, the Mortgage Department implemented another large markdown, this time related to Goldman's Abacus CDOs. This markdown took place on August 16, 2007, after the Correlation Trading Desk adjusted its correlation assumptions in a way that resulted in steep markdowns for Abacus CDO customers and a corresponding $94 million increase in the value of the Correlation Trading Desk's net short positions on the same CDOs.[2154] The Mortgage Department as a whole reported a $121 million profit that same day. Mr. Sparks reported to senior management: "94mm ... is from correlation adjustment in ABX (from 50 to 70%) as market observability better recently, rest is from outright shorts."[2155] Also on August 16, 2007, Mr. Egol listed the Correlation Trading Desk's Top Ten Winners and Losers due to Goldman's markdowns and calculated that "[t]he aggregate P&L in the book is

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2150 See 7/31/2007 email chain between Tom Montag and Lloyd Blankfein, "Mortgage Derivative Collateral Disputes – 7/31 Update (COB 7/27 marks)," GS MBS-E-009691545.

2151 Id.

2152 Id. By late August, Goldman had instituted a system that required senior management pre-approval for large markdowns. On August 28, 2007, Mr. Lehman sent Mr. Sparks a list of "Mark changes which are greater than 5% / greater than 10%" for his approval. 8/28/2007 email from David Lehman to Daniel Sparks, GS MBS-E-010623779. Mr. Lehman asked whether he should ask Mr. Mullen for approval of the changes greater than 10%, and Mr. Sparks told him to do so. Id.

2153 Id.

2154 8/16/2007 email from Daniel Sparks, "Mort P&L explanation," GS MBS-E-010680327. Since Goldman took the entire net short side in many of its Abacus CDOs, the customers' losses translated directly into gains for Goldman.

2155 Id. The Correlation Trading Desk reported $145 million in total profits, which were then offset by losses on other mortgage desks.

$405mm (ie net markdown to customers), much of this is scattered across a bunch of cashflow CDOs."[2156]

DD. Customer Losses

Goldman's internal marks demonstrate that, at the time it sold its CDO securities, Goldman's senior management knew its sales force was selling CDO securities at inflated prices and that the CDO securities were also rapidly losing value. In addition, soon after selling the CDO securities, Goldman marked down their value, causing some customers to incur substantial losses within days or weeks of a purchase and undergo substantial margin and collateral calls that caused additional financial distress.[2157]

One Goldman salesperson expressed remorse over the impact on their customers of CDO sales followed by large markdowns within days or weeks of the client's purchase:

> "Real bad feeling across European sales about some of the trades we did with clients. The damage this has done to our franchise is significant. Aggregate loss for our clients on just ... 5 trades alone is 1bln+."[2158]

At the same time, the salesperson thought the sales force deserved a bigger share of the profits generated for the firm:

> "In addition team feels that recognition (sales credits and otherwise) they received for getting this business done was not consistent with the money it ended up making/saving the firm."[2159]

A Goldman salesperson in Taiwan sought help in explaining Goldman's markdowns to a bank whose CDO investment had been marked down from about 97 to about 45 cents on the dollar in a matter of weeks:

> "[B]ank just bought the altius deal from gs [Goldman Sachs] 5 weeks ago and the mtm [mark-to-market] dropped over 50%. We

[2156] 8/16/2007 email from Jon Egol to Michael Swenson, "Projected Corr Customers winners/losers from single-name mark changes," GS MBS-E-011092473, Hearing Exhibit 4/27-33.

[2157] See, e.g., 5/11/2007 email from Craig Broderick, "CDOs - Mortgages," GS MBS-E-009976918, Hearing Exhibit 4/27-84; see also 8/10/2007 Goldman internal memorandum, "Summary of German Bank US Sub Prime Exposure," GS MBS-E-009994305.

[2158] 10/12/2007 email to Daniel Sparks, "US ABS SS Intermediation Trades," GS MBS-E-013706095, Hearing Exhibit 4/27-70.

[2159] Id.

understand the liquidity is thin, but I really need some info to support this price. ... This is very important as this transaction has a lot to do with our reputation in taiwan market. I understand all deals are down and spread is trading wider now. Unless the principal is at risk now, the mtm is not supposed to drop so quickly during such short period of time."[2160]

On August 2, 2007, Stacy Bash-Polley, a Goldman senior sales executive, sent an email to Messrs. Montag, Mullen, Schwartz, and Sparks outlining eight specific instances in which clients had complained that Goldman's marks were significantly lower that those of other dealers.[2161] Her summary of client concerns included the following:

> "–They have not agreed with our process and recently asked other dealers to analyze – say that we are off significantly from where other dealers are modeling this ....
>
> –We took their mark on Fort Denison from 93.16 to 40.00[.] They admit the AAA CDO mkt is off substantially but feel that this particular bond [has objective characteristics that should make it] ... perform better than the junior AAA market as a whole. Meanwhile, we took Hudson Mezz ... AAA from 80.4 to 65. They would like our thoughts as to why Fort Den[ison] was marked down so much more. ...
>
> –The Alt-A marks were particularly punitive. ... Our offerings are still 10-20 points higher than the marks. Look at GSAMP 2007-7. On financing, [customer] said our HC [haircuts] ... were by far the most onerous of all dealers. ...
>
> –They bought AAA cdos .... They have communicated to sales that GS is by far an outlier and they will never be able to buy another cdo from us based on their lack of confidence in understanding how we are coming up with marks. ...
>
> –Issues with their CDO marks. Said we were many many points behind where other dealers were marking similar positions."[2162]

[2160] 7/24/2007 email from [Taiwan], "7/23 CDO/RMBS requests from Taiwan," GS MBS-E-011198375, Hearing Exhibit 4/27-67.
[2161] 8/2/2007 email from Stacy Bash-Polley to Messrs. Montag, Mullen, Schwartz, and Sparks, "Marks Summary," GS MBS-E-013349723.
[2162] Id.

Even before this email, Goldman's sales force had been vocal in its criticism of Goldman's low marks which were making their sales job more difficult. On June 21, 2007, Mr. Sparks stated in an email: "sales is making significant noise about gs notable conservatism in marking and haircuts."[2163] Mortgage Department personnel dismissed such criticisms out of hand. One managing director responded: "Would have tho[ugh]t that bsam event [failure of Bear Stearns Asset Management hedge funds] would provide reasonable explanation as to why our marking and haircuts r ok." Mr. Sparks replied: "Kind of stunning – but we are hearing it."

Goldman generally declined to offer any written explanations of its marks to clients, and rarely offered any financial accommodation or compromise regarding the marks or related collateral calls.[2164] On one occasion, when a sales representative asked about providing information about the firm's CDO marks to a customer, Mr. Lehman wrote: "We cannot put this on paper - It concerns me they want something specifically in writing."[2165] When told that other dealers had provided the customer with marks and a written description of their CDO pricing methodologies, Mr. Lehman responded: "Our marking policy is a market price (bid and/or offer) – We do not have a written methodology for pricing and we should tell them that."[2166] In another instance, when a client asked for marks for the two prior months related to a CDO it was considering buying, Mr. Lehman wrote: "Verbal only .... Want to give them our tho[ugh]ts on

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[2163] 6/21/2007 email from Mr. Sparks to Lester Brafman, "Repo," GS MBS-E-010847490.

[2164] The Subcommittee did identify at least one instance of a mark change. Goldman's China sales representative contacted the ABS Desk to request an increase in a mark on an RMBS security:

> "[C]an we try our best to show 'better' indicative prices for [client]? ... [C]lient is under pressure of being questioned that they bought something looks really bad. ... [W]e showed a price of LBMLT 06 A A1 as of 95-00 . . . this is something hard for client to believe .... [W]e need them to think of GS as the best firm, and we need them to be our best client when next biz boom comes. ... We would highly appreciate if a slightly aggressive price can be showed from trading desk."

5/21/2007 email from China sales representative to Edwin Chin and others, "Mark to market prices," GS MBS-E-011068490. Mr. Chin moved the mark in question from 95 to 98, and wrote:

> "After much discussion internally, we will improve our bid to 98-00 given the market color we have observed in the past two days. The markdown was mostly a reaction to rating agency downgrade and partly reflected the illiquidity of the position, but upon further analysis we have gotten more comfortable with the risk position and agree it should be marked at a higher price."

Id.

[2165] 8/6/2007 email from David Lehman to Japan sales, "RE: Tokyo Star," GS MBS-E-001927891.

[2166] Id.

market levels, not 'marks.'"[2167] In his 2007 performance self-evaluation, the head of the SPG Trading Desk, Michael Swenson, wrote:

> "I spent numerous hours on conference calls with clients discussing valuation methodologies for GS issued transactions in the subprime and second lien space .... I said 'no' to clients who demanded that GS should 'support the GSAMP' program [Goldman RMBS securities] as clients tried to gain leverage over us. Those were unpopular decisions but they saved the firm hundreds of millions of dollars."[2168]

In November 2007, Goldman analysts issued a research report to clients about the crisis in the mortgage market.[2169] Goldman predicted that the mortgage market crisis was likely to continue and would have serious implications for a significant number of financial institutions: "Write-downs and losses will continue to mount .... [M]anagements will need to repair some seriously damaged balance sheets."[2170] Goldman estimated that industry-wide losses reflecting markdowns in subprime mortgage CDOs would approach $150 billion, of which about $40 billion would be taken in the third and fourth quarters of 2007.[2171]

Customers who purchased CDO assets from Goldman in 2007 generally suffered substantial losses from those investments, and several went bankrupt, including IKB, a German bank, and Basis Capital, the Australian hedge fund.[2172] Goldman was not only aware of its clients' predicaments, but in some cases, Goldman purchased CDS protection or equity puts on its clients' stock, essentially betting that the stock price would fall or the company would lose value. For example, after ACA Financial Guaranty Corp., the parent company of ACA Management which acted as the collateral manager of Abacus 2007-AC1, purchased Abacus securities, Goldman purchased the short side of a CDS contract

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2167 6/6/2007 email from David Lehman to Japan sales, "Point Pleasant Marks – request from Tokyo Star Bank," GS MBS-E-001912408-10 at 9.
2168 9/26/2007 Goldman Sachs 2007 Performance Review for Michael Swenson, "Reviewee's Feedback," GS-PSI-02399, Hearing Exhibit 4/27-55b.
2169 11/20/2007 email from Thomson IFR - ABS, "ABS: Market Tense as Goldman Predicts RMBS CDO Problems to Drag On," GS MBS-E-013782989.
2170 Id.
2171 Id.
2172 See 9/17/2007 Goldman presentation to Board of Directors, "Residential Mortgage Business, Global Impact of the Mortgage Crisis," at 2, GS MBS-E-001793840, Hearing Exhibit 4/27-41 (noting bankruptcies of Goldman clients IKB and Basis Capital). See also 8/10/2007 Goldman internal memorandum, "Summary of German Bank US Sub Prime Exposure," GS MBS-E-009994305; 11/27/2007 email from David Lehman to Daniel Sparks, "ACA," GS MBS-E-013746511 (discussing "what would happen upon an ACA bankruptcy (which is the most likely scenario in our opinion).").

that referenced ACA Financial Guaranty. ACA Financial Guaranty encountered extreme financial distress in late 2007.[2173]

At the Subcommittee hearing, Goldman executives were asked about the four Goldman-originated CDOs highlighted in this Report, Hudson 1, Anderson, Timberwolf, and Abacus 2007-AC1.[2174] Senator John Tester noted Mr. Birnbaum's testimony that, in 2007, Goldman could "see some things happening,"[2175] and that Goldman itself was betting against the mortgage market. Senator Tester asked Mr. Sparks, in light of those developments, "how [he] got comfortable with sales," and how he "in good faith" sold the CDO securities to Goldman's customers – how he could "sell them out and collect the fees and make the dough?"[2176] Senator Tester and Mr. Sparks then had the following exchange:

> Senator Tester: Every one of these [CDOs] were – it looks like a wreck waiting to happen because they were all downgraded to junk in very short order.
>
> Mr. Sparks: Well, Senator, at the time we did those deals, we expected those deals to perform.
>
> Senator Tester: Perform in what way?
>
> Mr. Sparks: To not be downgraded–
>
> Senator Tester: Perform to go to junk, so that the shorts made out?
>
> Mr. Sparks: To not be downgraded to junk in that short a time frame. In fact, to not be downgraded to junk. ...
>
> Senator Tester: Do you feel confident that the information about each one of these [CDOs] ... was given to the investors, all of the information that was out there, and the credit rating agencies too?
>
> Mr. Sparks: Well, I generally feel that the disclosure for the new issues that Goldman Sachs brought was good.[2177]

[2173] See 6/21/2007 email from Fabrice Tourre, "Post on ACA," GS MBS-E-002562148. See also ACA Financial Guaranty Corp. v. Goldman, Sachs & Co., Complaint (filed 1/6/2011, Sup. Ct. N.Y) at ¶ 7 (ACA now "operates as a run-off insurance company."), available at http://www.aca.com/press/pdfs/2011/20110106-GoldmanComplaint.pdf.
[2174] April 27, 2010 Subcommittee Hearing at 66.
[2175] Id.
[2176] Id.
[2177] Id. Mr. Sparks went on to say: "I mentioned we made some bad business decisions. These deals performed horribly. That is bad. ... [T]hat said, just because one person in my business unit or a few people might have had one view, I can tell you there were a lot of people in my business

While Mr. Sparks testified that, in 2007, the Mortgage Department expected its CDOs "to perform," a contemporaneous draft presentation that he helped prepare in May 2007 stated that the "desk expects [the CDOs] to underperform."[2178] Many other emails provide his negative views of the CDO market at the time, including emails in which Mr. Sparks described the subprime market as "bad and getting worse,"[2179] and directed Goldman's mortgage traders to "get out of everything,"[2180] and "stay on the short side."[2181] He wrote, among other things: "Game over,"[2182] "bad news everywhere," and "the business is totally dead."[2183] As Senator Tester noted, many of Mr. Sparks's dire predictions were made before three of the four CDOs discussed at the hearing were even offered to customers.[2184]

Mr. Sparks also testified that the Mortgage Department did not expect the Goldman-issued CDOs to be downgraded, but all were within a year of issuance. In April 2007, for example, six of the 20 RMBS deals that comprised the ABX Index were downgraded,[2185] and the Hudson CDO that referenced them followed soon after. Many of the RMBS securities referenced in the other three CDOs were downgraded within three months of the issuance of the last CDO in April 2007, making the downgrade of the CDOs themselves all but inevitable.[2186] For example, when Moody's and S&P announced their first mass downgrades of RMBS securities on July 10, 2007, the S&P downgrade affected 35% of the assets in Timberwolf.[2187] Ultimately, all of the CDOs discussed at the Subcommittee's hearing were downgraded to junk status. On October 26, 2007, a Goldman employee sent an email about Abacus 2007-AC1, even noting this dubious distinction:

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unit that had a very different view, and there were a lot of investors that had a very different view." Id.

2178 See 5/19/2007 draft Goldman presentation, "Mortgages CDO Origination – Retained Positions & Warehouse Collateral, May 2007," GS MBS-E-010951926.

2179 2/8/2007 email from Mr. Sparks, "Post," Hearing Exhibit 4/27-7.

2180 3/3/2007 email from Mr. Sparks, "Call," Hearing Exhibit 4/27-14.

2181 3/8/2007 email from Mr. Sparks, "Mortgage risk," Hearing Exhibit 4/27-75.

2182 3/12/2007 Goldman memorandum to Firmwide Risk Committee, "March 7th FWR Minutes," GS MBS-E-00221171, Hearing Exhibit 4/27-19.

2183 2/21/2007 email from Daniel Sparks to Jon Winkelried, "Mortgages today," GS MBS-E-010381094, Hearing Exhibit 4/27-10.

2184 April 27, 2010 Subcommittee Hearing at 66. The Anderson, Timberwolf, and Abacus 2007-AC1 CDOs were issued in March and April 2007.

2185 4/27/2007 email from Deeb Salem to Michael Swenson, GS MBS-E-012432706 (6 of 20 deals in ABX Index put on watch or downgraded).

2186 7/10/2007 email to George Maltezos, "GS Cashflow/ABACUS CDOs Mentioned in S&P Report on CDO Exposure to Subprime RMBS," GS MBS-E-001837256; 7/10/2007 email from Goldman Sachs analyst to Goldman Sachs Japan salesman, "GS Cashflow/ABACUS CDOs Mentioned in S&P Report on CDO Exposure to Subprime RMBS," GS MBS-E-001990255 (updating percentage exposure from 25% to 35%).

2187 Id.

"This deal was number 1 in the universe of CDO's that were downgraded by Moody's and S&P. 99.89% of the underlying assets were downgraded."[2188]

(b) Goldman's Conflicts of Interest

In late 2006 and 2007, Goldman's securitization business was marked, not just by its hard sell tactics, but also by multiple conflicts of interest in which Goldman's financial interests were opposed to those of its clients. The following examples illustrate the problem.

(i) Conflicts of Interest Involving RMBS Securities

In 2006 and 2007, Goldman originated 27 CDO and 93 RMBS securitizations. Beginning in December 2006, Goldman originated and aggressively marketed some of these securities at the same time that subprime and other high risk loans were defaulting at alarming rates, the subprime and CDO markets were deteriorating, and Goldman was shorting subprime mortgage assets. At times, Goldman originated and sold RMBS securities that it knew had poor quality loans that were likely to incur abnormally high rates of default. At times, Goldman went further and sold RMBS securities to customers at the same time it was shorting the securities and essentially betting that they would lose value. Two examples illustrate how Goldman constructed and sold poor quality RMBS securities and profited from the decline of the very securities it had sold to its clients.

Long Beach RMBS. The first example involves Washington Mutual Bank (WaMu) and its subprime lender, Long Beach Mortgage Corporation. WaMu, Long Beach, and Goldman had collaborated on at least $14 billion in loan sales and securitizations.[2189] In February 2006, Long Beach had a $2 billion warehouse account with Goldman, which was the largest of Goldman's warehouse accounts at that time.[2190]

Long Beach was known within the industry for originating some of the worst performing subprime mortgages in the country. As explained in Chapter III, in 2005, a surge of early payment defaults in its subprime loans required Long Beach to repurchase over $837 million of nonperforming loans from investors, as well as book a $107 million

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[2188] 10/26/2007 email from Goldman salesman to Michael Swenson, "ABACUS 2007-AC1 – Marketing Points (INTERNAL ONLY) [T-Mail]," GS MBS-E-016034495.
[2189] See "List of WaMu-Goldman Loans Sales and Securitizations," Hearing Exhibit 4/13-47b.
[2190] 2/13/2006 Goldman chart, "Current Warehouse Facilities and Funded Balances," GS MBS-E-001157934.

loss.[2191] Similar EPD problems affected its loans in 2006 and 2007. WaMu reviews and audits of Long Beach, as well as examinations by the Office of Thrift Supervision, repeatedly identified serious deficiencies in its lending practices, including lax underwriting standards, unacceptable loan error and exception rates, weak risk management, appraisal problems, inadequate oversight of third party brokers selling loans to the firm, and loan fraud. While these reviews were not available to the public, the performance of Long Beach paper was. Long Beach securitizations had among the worst credit losses in the industry from 1999-2003; in 2005 and 2006, Long Beach securities were among the worst performing in the market.[2192]

Nevertheless, in May 2006, Goldman acted as co-lead underwriter with WaMu to securitize about $532 million in subprime second lien mortgages originated by Long Beach. Long Beach Mortgage Loan Trust 2006-A (LBMLT 2006-A) issued approximately $495 million in RMBS securities backed by those Long Beach mortgages. The top three tranches, representing about 66% of the principal loan balance, received AAA ratings from S&P, even though the pool contained subprime second lien mortgages – loans which could recover funds in the event of a default only after the primary loan was repaid — and even though the loans were issued by one of the nation's worst performing mortgage lenders. Yet Goldman was able to use two-thirds of that extremely risky debt to issue AAA rated securities which Goldman then sold to its customers.

In less than a year, the Long Beach loans began incurring delinquencies. In February 2007, a Goldman analyst reported internally that all of Goldman's 2006 subprime second lien RMBS securities were deteriorating in performance, but "deals backed by Fremont and Long Beach collateral have generally underperformed the most."[2193] The analyst predicted "lifetime losses in the teens, and over 20% in some deals." By May 2007, the cumulative net loss on the LBMLT 2006-A mortgage pool had climbed to over 12%, eliminating most of the financial cushion protecting the investment grade securities from loss. That month, S&P downgraded six out of the seven credit ratings for the mezzanine tranches of the securitization. The Long Beach securities plummeted in value.

Goldman held some of the unsold Long Beach mezzanine securities on its books, meaning LBMLT 2006-A securities that carried credit ratings

2191 See Chapters III and IV, above.
2192 See, e.g., 4/14/2005 OTS email, "Fitch," OTSWME05-012 0000806, Hearing Exhibit 4/13-8a.
2193 2/8/2007 email from Goldman analyst to Mr. Sparks, Mr. Gasvoda, and others, "2006 Subprime 2nds Deals Continue to Underperform **INTERNAL ONLY**," GS MBS-E-003775340, Hearing Exhibit 4/27-167d.

of BBB or BBB-. Goldman had also purchased the short side of a CDS contract that would pay off if those same securities lost value. On May 17, 2007, Deeb Salem, a trader on the Mortgage Department's ABS Desk, learned of additional losses in the Long Beach securitization and wrote to his supervisor Michael Swenson with the news:

> "[B]ad news ... [The loss] wipes out the m6s [mezzanine tranches] and makes a wipeout of the m5 imminent. ... [C]osts us about 2.5 [million dollars]. ... [G]ood news ... [W]e own 10 [million dollars] protection at the m6 ... [W]e make $5 [million]."[2194]

In other words, Goldman lost $2.5 million from the unsold Long Beach securities still on its books, but gained $5 million from the CDS contract shorting those same securities. Overall, Goldman profited from the decline of the same type of securities it had earlier sold to its customers.

By May 2008, even the AAA securities in LBMLT 2006-A had been downgraded to default status. By March 2010, the securities recorded a cumulative net loss of over 66%.[2195]

Fremont RMBS. The second example involves Fremont Loan & Investment, another subprime lender notorious for issuing poor quality loans.[2196] In March 2007, Fremont reported in an 8-K filing with the SEC that the FDIC filed a cease and desist order to which the company consented. Among other matters, it order Fremont to stop "[m]arketing and extending adjustable–rate mortgage products to subprime borrowers in an unsafe and unsound manner that greatly increases the risk that borrowers will default on the loans or otherwise causes losses."[2197]

Even before the actions taken by regulators in March 2007, Goldman was aware of the poor quality of at least some of Fremont's loans. In a November 2006 exchange of emails, for example, two Goldman sales representatives were discussing trying to sell Fremont RMBS securities to a client. One salesperson forwarded to the other the client's explanation of why it did not want to buy the securities and its low opinion of Fremont's loan pools: "Fremont refused to make any forward looking statements so we really got nothing from them on the crap pools that are out there now."[2198] In March 2007, Goldman initiated a detailed review of its

[2194] 5/17/2007 email from Deeb Salem to Michael Swenson, "FW: LBML 06A," GS MBS-E-012550973, Hearing Exhibit 4/27-65.
[2195] See wamusecurities.com.
[2196] For more information about Fremont, see Chapter IV, Section D(2)(d).
[2197] 3/7/2007 Fremont General Corporation 8-K filing with the SEC.
[2198] 11/16/2006 Goldman internal email, "ACA and Freemont [sic] deal," Hearing Exhibit 4/27-173.

Fremont loan inventory to identify deficient loans that it could return to the lender for a refund. Mr. Gasvoda placed a priority on reviewing Fremont loans "since they still have cash but may not for long."[2199] One loan pool review conducted on March 14, 2007, found that "on average, about 50% of about 200 files look to be repurchase obligations," meaning that fully half of the reviewed loans should be returned to the lender.[2200] Goldman eventually made about $46 million in repurchase requests to Fremont, which was one of the top five mortgage originators from whom Goldman made repurchase requests in 2006 and 2007.[2201]

Despite these and other indications of Fremont's poor quality loans, Goldman continued to underwrite and market securities backed by Fremont loans. In an internal February 2007 memorandum to its Mortgage Capital Committee, Goldman wrote that it had a "significant relationship with Fremont," based upon past securitizations, whole loan purchases, and warehouse fees.[2202] In March 2007, at the same time it was sending millions of dollars in loan repurchase requests to Fremont, Goldman securitized over $1 billion in Fremont subprime loans in one of its warehouse accounts, originating GSAMP Trust 2007-FM2.[2203] At Goldman's request, Moody's and S&P rated the securities, even though analysts at both rating firms expressed concern about the quality of Fremont loans. At S&P, for example, in a January 2007 email to his supervisor, a credit ratings analyst wrote: "I have a Goldman deal with subprime Fremont collateral. Since Fremont collateral has been performing not so good, is there anything special I should be aware of?"[2204] One supervisor told him: "No, we don't treat their collateral any differently," while another wrote that, as long as the analyst had current

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2199 3/14/2007 Goldman email, "NC Visit," GS-MBS-E-002048050.

2200 Id.; see also 8/10/2007 email from Michelle Gill, "Fremont - Incremental Information," GS MBS-E-009860358 (Goldman's repurchase claims against Fremont would have amounted to a 9% ownership stake in Fremont after a proposed buyout by investor group; Goldman was not the largest purchaser of Fremont loans but its repurchase claims were 3-4 times larger than the claims of the nearest counterparty).

2201 See Goldman Sachs response to Subcommittee QFR at PSI_QFR_GS0040.

2202 2/20/2007 Goldman memorandum to Mortgage Capital Committee, "Request for renewal of the existing $1 billion ... 1-year revolving warehouse facility," GS MBS-E-001157942. Goldman wrote that Fremont produced "revenues totaling $13.38 million in 2006 of which $620,000 came in the form of warehouse usage and commitment fees."

2203 See 2/2/2007 Goldman memorandum to the Mortgage Capital Committee, "Agenda for Monday, February 5, 2007," GS MBS-E-002201064; 2/5/2007 Mortgage Capital Committee Memorandum regarding GSAMP Trust 2007-FM2, GS MBS-E-002201055 - 58.

2204 1/24/2007 S&P internal email, "Quick Question: Fremont," Hearing Exhibit 4/23-93b. See also 2/1/2007 S&P internal email, "Defaults cause Fremont to end ties to 8,000 brokers," Hearing Exhibit 4/23-93d (S&P analysts circulated an article about how Fremont had stopped using 8,000 brokers due to loans with some of the highest delinquency rates in the country).

FICO scores for the borrowers, he was "good to go."[2205] Both agencies gave AAA ratings to the top five tranches of the securitization.[2206]

Goldman marketed and sold the Fremont securities to its customers, while at the same time purchasing $15 million in CDS contracts referencing some of the Fremont securities it underwrote.[2207] Seven months later, by October 2007, the ratings downgrades had begun; by August 2009, every tranche in the GSAMP securitization had been downgraded to junk status.[2208]

In both examples involving Long Beach and Fremont RMBS securities, Goldman obtained CDS protection and essentially bet against the very securities it was selling to clients. In each case, Goldman profited from the fall in value of the same securities it sold to its clients and which caused those clients to suffer substantial losses.

(ii) Conflicts of Interest Involving Sales of CDO Securities

As with some of its RMBS securities, Goldman at times originated CDO securities using assets that it believed were of poor quality and would lose value, and sold the securities at higher prices than it believed they were worth.[2209] In addition, Goldman took steps that created multiple conflicts of interest with the clients to whom it sold the CDO securities, and placed its financial interests ahead of those of its clients. Four examples involving the Hudson 1, Anderson, Timberwolf, and Abacus 2007-AC1 CDOs illustrate the problems. Those problems include troubling and sometimes abusive practices related to how Goldman designed the CDOs and selected their assets; marketed and sold the CDO securities; designated the value of the CDO securities pre- and post-sale; and executed its duties as liquidation agent and collateral put provider.

[2205] 1/24/2007 S&P internal email, "RE: Quick Question: Fremont," Hearing Exhibit 4/23-93c.
[2206] 4/17/2010 S&P downgrade of GSAMP Trust 2007-FM2 containing Fremont mortgages, Hearing Exhibit 4/23-93f.
[2207] See 3/21/2007 Goldman spreadsheet, "RMBS CDS Trade History 19Jan06 - 19Mar07 v3," GS MBS-E-013648130.
[2208] See Standard & Poor's www.globalcreditportal.com.
[2209] In some cases, Goldman used assets from its own inventory or warehouse accounts, so that it could transfer assets with falling value to the CDO and the investors who purchased the CDO securities. The Subcommittee examined seven CDOs issued by Goldman, and of those, 57% of the CDOs' assets were sourced from Goldman, including over $3 billion in synthetic assets in which Goldman was the short party, and therefore stood to profit from a decline in the value of the underlying assets.

AA. Hudson Mezzanine Funding 2006-1

Hudson Mezzanine Funding 2006-1 (Hudson 1) was a $2 billion synthetic CDO that referenced mezzanine subprime RMBS assets[2210] and assets linked to the ABX Index.[2211] This CDO was the second in a series of three "Hudson" branded CDOs, which according to Goldman marketing materials were intended "to create a consistent, programmatic approach to invest in attractive relative value opportunities in the RMBS and structured product market."[2212] One key feature of the three Hudson CDOs was that Goldman itself, without any third party participation, selected the CDO's assets, which were supposed to remain with the CDO until they reached maturity or were deemed "credit risk assets," at which point Goldman, acting as the liquidation agent for the CDO, was responsible for selling them.[2213] In each of the Hudson CDOs, Goldman played multiple roles in its formation and administration, including selecting assets and serving as the underwriter, initial purchaser of the CDO securities, collateral put provider,[2214] senior swap counterparty, and credit protection buyer.[2215] In Hudson 1, Goldman took 100% of the short side of the CDO, and when the Hudson 1 securities declined in value, Goldman made a $1.35 billion

[2210] Mezzanine subprime RMBS assets are RMBS securities that carry a credit rating of BBB or BBB- or CDS contracts that reference those types of RMBS securities. Mezzanine RMBS assets are riskier than AAA, AA, and A rated RMBS securities, but less risky than those that carry, for example, BB, B, or CCC ratings.

[2211] The ABX Index tracks the performance of a designated basket of 20 subprime RMBS securitizations. It consists of five separate indices, each of which tracks a different subset of the RMBS basket, divided according to credit ratings. The indices that track the mezzanine RMBS securities, for example, track the 20 RMBS securities that carry BBB and BBB- credit ratings. In ABX assets, investors enter into CDS contracts in which one party takes the long side, essentially betting that the ABX indices tracking the mezzanine RMBS securities will increase in value, while the other party takes the short side, essentially betting that the indices will fall in value. Prior to establishing the Hudson CDO, Goldman had taken the long side in a number of CDS contracts linked to the ABX indices tracking mezzanine RMBS securities.

[2212] 10/2006 Goldman document, "Hudson Mezzanine Funding 2006-1, Ltd.," Hearing Exhibit 4/27-87. The first Hudson CDO, Hudson High Grade, was issued in September 2006. The second, discussed here, was Hudson Mezzanine 2006-1, issued in October 2006. The third was Hudson Mezzanine 2006-2, issued in February 2007.

[2213] Id. For more information about Goldman's role as the liquidation agent in Hudson, see Section C(5)(b)(iii)AA, below.

[2214] In synthetic CDOs, the cash proceeds from the sales of the CDO securities were used to purchase "collateral debt securities." Later, when cash was needed to make payments to a long or short party, those collateral securities were sold, and the cash was used to make the payments. In the event the collateral securities could not be sold for face (par) value, the collateral put provider paid the difference to the CDO. For more information about the role of collateral put providers, see Section C(5)(b)(iii)BB, below.

[2215] See 2/18/2008 Goldman document, "CDO Transactions (July 1, 2006 - December 31, 2007) in which Goldman Sachs acted as underwriter," GS MBS 0000004337 at 4338. Acting as the "senior swap counterparty" meant that Goldman served as an intermediary between the Hudson CDO and the super senior investor. Acting as "credit protection buyer" meant that Goldman initially took the short side of the CDO and, in the case of Hudson 1, kept 100% of the short side during the life of the CDO.

profit at the expense of the clients to whom it had sold the Hudson 1 securities.

Transferring Risk. Hudson 1 was conceived and designed by Goldman to transfer the risk associated with a large collection of ABX assets in its inventory, in which Goldman held the long side of CDS contracts referencing mezzanine subprime RMBS securities that were tracked by the ABX Index and that might go down in value. The objective of the CDO was to transfer the risk of unwanted financial assets off of Goldman's books. In response to questions from the Subcommittee, Goldman explained that Hudson 1 was "initiated by the firm as the most efficient method to reduce long ABX exposures."[2216] Contemporaneous notes from Goldman's Firmwide Risk Committee meetings also stated that Hudson 1 was an "exit for our long ABX risk."[2217] Goldman records show that the firm used Hudson 1 to short $1.2 billion worth of the ABX assets in the firm's inventory as well as $800 million in single name CDS contracts referencing subprime RMBS securities carrying mostly BBB or BBB- credit ratings. Hudson 1 was one of several methods Goldman used to transfer its risk associated with its subprime mortgage holdings during the fall of 2006.[2218]

Conceiving Hudson 1. In the months leading up to the creation of Hudson 1, Goldman had accumulated billions of dollars in ABX assets referencing mezzanine subprime RMBS securities.[2219] By August 2006, Goldman management had decided that this ABX trade had "run its course," and directed the Mortgage Department's ABS Desk to sell off its ABX holdings.[2220] After several weeks of effort, however, the ABS Desk was unable to find many buyers, and its ABX mezzanine assets, which were dropping in value, were losing millions of dollars for the firm.[2221]

[2216] See Goldman response to Subcommittee QFR at PSI_QFR_GS0239.

[2217] 9/20/2006 email from Arbind Jha to Josh Birnbaum, GS MBS-E-012685289. See also 9/20/2006 Firmwide Risk Committee Minutes, GS MBS 0000004472.

[2218] See 10/24/2006 email from Jonathan Sobel to Tom Montag, Dan Sparks, and others, GS MBS-E-010919930 ("CDO should price tomorrow and is in good shape. ... We also are starting to see some short covering, which we will sell into to further reduce our risk toward your 50% goal.").

[2219] Subcommittee interview of Michael Swenson (4/16/2010). Mr. Swenson told the Subcommittee that Goldman had been long "several billion" in ABX in September 2006.

[2220] 8/9/2006 Firmwide Risk Committee Minutes, GS MBS-E-009682590; Subcommittee interview of Joshua Birnbaum (10/1/2010). Mr. Birnbaum recalled a "directive" to reduce ABX exposure in the summer of 2006.

[2221] See, e.g., 9/21/2006 email from Jonathan Sobel to Tom Montag, "ABX wider again today," GS MBS-E-009739145 ("Down about $10mm."); 9/12/2006 email from Jonathan Sobel to Michael Swenson and Daniel Sparks, "ABX," GS MBS-E-012681410 ("The last post you gave me was this morning when you thought things were 'firm'. Now I find out that we're down $6mm on the day. I understand things move, but you need to post me. Also, I want to reduce this position."); 9/9/2006 Firmwide Risk Committee Minutes, GS MBS 0000004468 ("Business continuing to reduce volatile ABX position."); 8/23/2006 Firmwide Risk Committee Minutes, On September 19, 2006, Jonathan Sobel and Daniel Sparks called an 8:00 a.m. meeting to discuss the ABX problem with Joshua Birnbaum, head of ABX trading, and Michael Swenson, head of both the Structured Product Group (SPG) Trading Desk and ABS Trading Desk.[2222] Mr. Swenson was unable to attend, and in a later email from Mr. Birnbaum who recounted the meeting to him, Mr. Sobel and Mr. Sparks wanted to know whether the Mortgage Department should sell all of its ABX mezzanine holdings or "double down" the ABX holdings, which could happen only if it found a "structured place to go with the risk."[2223]

Later that day, Mr. Sparks approached Peter Ostrem, who headed the desk that originated CDOs for Goldman, and asked "if there was something [the CDO Desk] could do with ABX."[2224] Mr. Ostrem spoke with Darryl Herrick, who worked for him on the CDO Desk and who eventually became the Hudson 1 deal captain, about crafting a CDO to reduce the firm's ABX risk. The two brainstormed a structure that became the foundation of Hudson 1.[2225]

That same evening, September 19, 2006, Mr. Swenson scheduled a meeting with several traders on the ABS Desk he oversaw, Joshua Birnbaum from the ABX Desk, and Mr. Ostrem and other personnel from the CDO Origination Desk to discuss "ABX and Single-Name Opportunities."[2226] After the meeting, around 8:00 p.m., Mr. Ostrem sent his CDO team an email announcing "Hudson Mezz - new":

> "We have been asked to do a CDO of $2bln [billion] for the ABS desk. Approx. $1.2bln will be CDS off single-names referenced from the AB[X] index 06-1 and 06-2. This is a trade we need to execute for the desk over the next 4-6 weeks and involves selling half the equity (at least 30mm to sell) and the seniors and the mezz (at least half of the BBBs to get true sale). I would like everyone to work together on this one. We expect to charge ongoing 10bp [basis point] liquidation agent fees and 1-1.5pts upfront. ... Obviously

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GS MBS-E-009615593 ("Mortgages sold down another net 15% of their large ABX position.").

[2222] 9/19/2006 email from Jonathan Sobel to Daniel Sparks, Michael Swenson, and Josh Birnbaum, GS MBS-E-012683946.

[2223] 9/19/2006 email from Josh Birnbaum to Michael Swenson, GS MBS-E-012683946. Mr. Sobel also informed Mr. Swenson later that day: "We need to reach a conclusion on the viability of a structured exit." 9/19/2006 email from Jonathan Sobel to Michael Swenson, GS MBS-E-012328199.

[2224] Subcommittee interview of Peter Ostrem (10/5/2010).

[2225] Id.; Subcommittee interview of Darryl Herrick (10/13/2010).

[2226] 9/19/2006 calendar invite from Michael Swenson, GS MBS-E-012328194.

important to overall SP [Structured Product] floor and Sobel and Sparks are focused on this happening."[2227]

Also that evening, Mr. Swenson emailed Mr. Sobel to inform him they were "proceeding with the CDO solution, the CDO team has 60 single-names that they will be able to begin to build a deal around."[2228]

The next day, Mr. Sobel reported to senior executives at Goldman's Firmwide Risk Committee that the CDO Desk was working on the first ever ABX CDO, which would function as an exit for the firm's long ABX position.[2229] Later that same afternoon Mr. Sobel sent an email to Goldman senior executive Thomas Montag, discussing the Mortgage Department's ABX losses and stating: "I think most hedge funds have been right on this (i.e. they've been short). ... The synthetic CDO seems like a viable takeout here."[2230]

A Goldman risk officer, Arbind Jha, began contacting Goldman mortgage traders and CDO personnel for regular Hudson updates.[2231] In fact, the day after the ABS and CDO teams came up with the Hudson 1 concept, Mr. Jha emailed Mr. Birnbaum asking about the CDO: "Sobel this morning mentioned in the Firmwide Risk Committee meeting that we are looking at CDO exit for our long ABX risk. Wanted to get some color on this."[2232] On another occasion, Mr. Jha asked Darryl Herrick:

> "Do we really have scenario risk on $2bn [billion] not'l [notional]? $1.2bn of not'l is being sourced from ABX desk - this risk is already being captured in our risk number for SPG Trading desk. ... The remaining $0.8bn will be composed of single name CDS. Since we do not have any pre-existing long (credit), we will be going short after we price this CDO and therefore will have a risk mitigating impact on our risk. Please correct me if I am getting this wrong."[2233]

[2227] 9/19/2006 email from Peter Ostrem, GS MBS-E-01818608, Hearing Exhibit 4/27-86. Goldman later told the Subcommittee that Hudson actually offset $1.39 billion in ABX assets on its books. Goldman response to Subcommittee QFR, PSI_QFR_GS0239.
[2228] 9/20/2006 email from Michael Swenson to Jonathan Sobel, GS MBS-E-012328203. See discussion of selection of 60 single names by Mr. Herrick and Mr. Salem, below.
[2229] 9/20/2006 Firmwide Risk Committee Minutes, GS MBS 0000004472; 9/20/2006 email from Arbind Jha to Josh Birnbaum, GS MBS-E-012685289.
[2230] 9/21/2006 email from Jonathan Sobel to Tom Montag, GS MBS-E-009739145.
[2231] See, e.g., 10/16/2006 email from John Li to Darryl Herrick, "Call Arbind Jha," GS MBS-E-018209595 ("Regarding Hudson Mezz Risk issue").
[2232] 9/20/2006 email from Arbind Jha to Josh Birnbaum, GS MBS-E-012685289. When asked about this email and Hudson 1 in general, Mr. Birnbaum told the Subcommittee that he had no specific recollection of any involvement with the Hudson 1 CDO. Subcommittee interview of Joshua Birnbaum (10/1/2010).
[2233] 10/12/2006 email from Arbind Jha, "Re: Risk Issue," Hearing Exhibit 4/27-88.

Designing Hudson 1. At the time Hudson 1 was conceived, no other investment bank had issued a CDO in which the majority of assets referenced ABX assets.[2234] Prior to that, the major credit rating agencies refused to rate any CDO with more than a 5% exposure to credit default swaps (CDS) using an ABX index as the reference obligation.[2235] CDS that used an ABX index as the reference obligation allowed the parties to the CDS to make a pure bet on the composite performance of a basket of 20 RMBS securities. Credit rating agencies were concerned that the inclusion of ABX assets in CDOs would increase market-wide correlation and make CDO performance more volatile.

In order to get around that limitation and create a CDO that the credit rating agencies would be willing to rate, Goldman took several steps. First, it decided Hudson 1 would reference the two ABX 06-1 indices and the two ABX 06-2 indices that referenced RMBS securities with BBB and BBB- ratings. Since each of those four indices tracked 20 subprime mezzanine RMBS securities, altogether they tracked 80 RMBS securities.[2236] Next, Goldman created 80 single name CDS contracts, each of which used as its reference obligation one of the subprime mezzanine RMBS securities tracked by the ABX indices.[2237] Goldman's ABS Desk took the short position in each of those 80 contracts, while Goldman's CDO Origination Desk took the long position.[2238] By taking the short position in the 80 single name CDS contracts, the ABS Desk essentially offset its long position in the corresponding ABX contracts. Next, the CDO Origination Desk entered into a CDS contract with Hudson 1, taking the short side while the Hudson CDO assumed the long side of the 80 single name CDS contracts. The end result was that Hudson 1 took the long side and assumed the risk associated with the long position for $1.2 billion worth of CDS single name contracts referencing the RMBS

[2234] 9/20/2006 Firmwide Risk Committee Minutes, GS MBS 0000004472.
[2235] See, e.g., 3/23/2007 "CDO Rating Factors: Inclusion of Tranched ABX Indices in ABS CDOs," Moody's, Document No. SF95049.
[2236] The ABX 06-1 Index and the ABX 06-2 Index each tracked a completely different set of 20 RMBS securitizations. Each Index also had its own subset of five indices tracking individual securities issued by those 20 securitizations, divided by credit rating. For example, one of the RMBS securitizations tracked by the ABX 06-2 Index was called CWL 2006-8. One of the sub-indices within the ABX 06-2 Index tracked BBB rated securities that were issued as part of the 20 securitizations, including the M8 tranche of CWL 2006-8 which carried a BBB rating. Another of the five indices tracked the securities carrying a BBB- rating, including the M9 tranche of CWL 2006-8 which carried that credit rating. The CWL 2006-8 M8 and CWL 2006-M9 securities were just two of the 40 BBB and BBB- rated securities issued by the 20 RMBS securitizations in the ABX 06-2 Index. The ABX 06-1 Index functioned the same way; its sub-indices tracked another 40 mezzanine RMBS securities from the 20 RMBS securitizations that composed that Index.
[2237] A "single name CDS" contract uses a single security as its reference obligation, such as a specific RMBS security.
[2238] For simplicity, all 20 assets in each of the ABX baskets were given the same weighted price in Hudson 1.

securities comprising the ABX 06-1 and 06-2 BBB and BBB- indices.[2239] By transferring the long CDS position to Hudson, Goldman effectively transferred the risk associated with its ABX long assets to any investors who bought the Hudson securities.

In order to attract investors and convince them to buy the Hudson securities, Goldman decided to make use of a pricing difference between CDS contracts referencing the ABX Index versus single name RMBS securities.[2240] In 2006, at the time Hudson was being constructed, the price of CDS contracts that used an ABX index as the reference obligation was lower than the price of CDS contracts that used an individual RMBS security as its reference obligation. Because Goldman exercised complete control over the CDO and created CDS contracts referencing assets from its own inventory, Goldman also exercised complete control over the pricing of those contracts. When Goldman set up the 80 single name CDS contracts, and sold the long side of those contracts to Hudson 1, Goldman decided internally what it would charge the CDO to acquire the long side of those contracts. Goldman decided to price the contracts, not according to the cost of a single name CDS contract on the market, but instead according to the cost of a CDS contract for the long side of the relevant ABX index that day.[2241] By using this pricing method, Goldman enabled Hudson to purchase the single name CDS contracts at the lower ABX prices, which meant it could tell investors that, by purchasing Hudson securities, they would be purchasing the single name CDS contracts at the discount price at which Hudson acquired them.[2242]

[2239] See, e.g., 4/27/2007 email from Fabrice Tourre to Michael Swenson, Deeb Salem, and Edwin Chin, GS MBS-E-012432742.

[2240] Mr. Swenson described this situation in his testimony before the Subcommittee: "Throughout 2006, numerous clients wanted to sell the ABX in order to express a negative view on the U.S. residential housing market. As a result of these trades, we took on long positions. In order to hedge those positions, we began to increase our short position in single-names. By November 2006, volatility in the ABX increased, pushing prices down. Because our positions in single names did not match identically the basket of securities that comprised the ABX, the positions moved at different rates and even different directions, resulting in losses for the ABS desk." Prepared statement of Michael Swenson, April 27, 2010 Subcommittee Hearing, at 208-09.

[2241] Goldman decided to price the single name assets at one point below the median ABX trading price. See 9/21/2006 email from Darryl Herrick to Deeb Salem, Michael Swenson, Joshua Birnbaum, Peter Ostrem, and Edwin Chin, GS MBS-E-012685645.

[2242] See 10/2/2006 email from Darryl Herrick to Michael Swenson, Joshua Birnbaum, Deeb Salem, Peter Ostrem, and Daniel Sparks, GS MBS-E-010913416 ("We plan to announce Hudson Mezzanine Funding tomorrow in the am for Europe, Asia and the US[.] I'm circulating around to everyone the CDO portfolio and spreads we will be showing investors and agencies, based on our agreed upon amounts and levels from last week."). Mr. Swenson responded: "Darryl we should use the 265 and 245 spread for the ABX2 and ABX1 triple-B minus spreads and 145 and 130 for triple-B ABX2 and ABX1 triple-B spreads." Id.

The pricing differential also benefitted Goldman's ABS Desk in two ways. First, it created a modest incentive for investors to buy Hudson securities and take the long position needed to offset Goldman's ABX risk. Second, it left Goldman with a short position in the form of CDS single name contracts, which Goldman expected to become more valuable than a short position in CDS contracts that referenced ABX indices. The ABS Desk kept both its long ABX positions and its short single name CDS positions in the same dedicated account. Over time, the short position in single name CDS did gain in value and boosted the overall value of the portfolio of assets held by the ABS Desk by more than $1 million, producing additional profits for Goldman.[2243]

In addition to the $1.2 billion in single name CDS contracts to offset Goldman's ABX risk, Mr. Herrick from the CDO Origination Desk and Deeb Salem from the ABS Desk worked together to select $800 million in additional single name CDS contracts to include in the Hudson CDO.[2244] Mr. Herrick told the Subcommittee that he gave Mr. Salem a specific set of criteria for selecting these CDS contracts, including a list of RMBS names that he wanted to be included, a list of RMBS names that he did not want to be included, and an acceptable price range for each CDS contract. Since Goldman planned to take 100% of the short side of Hudson 1, these lists were presumably used to identify RMBS contracts that Goldman expected to offset Goldman's long positions. Mr. Herrick told the Subcommittee that Mr. Salem responded with an initial list of 60 possible RMBS reference obligations, 52 of which were ultimately included in Hudson 1.[2245]

[2243] The gain generated by the CDS single name contracts was retained on the books of the ABS Desk, and created a favorable "basis" compared to the cost of the ABX long position held by the desk. See 4/27/2007 email from Fabrice Tourre to Michael Swenson, Deeb Salem, and Edwin Chin, GS MBS-E-012432742; Goldman response to Subcommittee QFR at PSI_QFR_GS0239. See also 9/19/2006 email from Michael Swenson to Thomas Cornacchia and Joshua Birnbaum, GS MBS-E-012684557 ("[ABX] Index to single-name basis is at the wides[t] (ie 40 bp at BBB-level). Index to cash is even more extreme at 70bp. Bids for cash deals remain strong and have barely widened."); Performance Review for Michael Swenson, GS-PSI-02396, Hearing Exhibit 4/27-55b (describing the mortgage trading desk's strategy of shorting single-name RMBS to offset long ABX positions: "[D]uring the early summer of 2006 it was clear that the market fundamentals in subprime and the highly levered nature of CDOs was going to have a very unhappy ending. The beauty of the CDO short was that it allowed for a very efficient method for capturing the value in the ABX to single-name basis from the short side.").

[2244] Subcommittee interview of Darryl Herrick (10/13/2010). See also 10/8/2006 email from Darryl Herrick to a Goldman salesperson, GS MBS-E-017502983 (discussing Hudson 1: "Omar, I realize lack of manager may be tough hurdle for them [investors]. May be helpful to let Deeb and I get on a call with the investor and discuss our asset selection criteria and I can go through asset sale criteria.").

[2245] See 9/19/2006 email from Darryl Herrick to Deeb Salem, Peter Osterm, others, GS MBS-E-011402123, with attachment GS MBS-E-011403442 (Mr. Salem wrote to Mr. Herrick: "Attached are 60 RMBS Ref Obs ... for the CDO we're discussing. On the RMBS side, we chose 30 Baa2 and 30 Baa3 CUSIPs evenly split btw 2005 and 2006 vintage. We can add a few alt-a names as well. How many of those would you like?"). When interviewed by the

According to Goldman's contemporaneous records and its responses to Subcommittee questions, 100% of the CDS contracts included in Hudson 1 were supplied by Goldman's Mortgage Department.[2246] Because Hudson 1 contained only CDS contracts, it was entirely "synthetic"; it contained no loan pools or RMBS securities that directed actual cash payments to the CDO. Instead, the only cash payments made to Hudson 1 consisted of the cash paid by investors making initial purchases of the Hudson securities and the premiums that Goldman paid into Hudson 1 as the sole short party.[2247]

Marketing Hudson. After establishing its basic characteristics and selecting the CDS assets to be included in Hudson 1, Goldman began to look for investors. A key development took place early on, when near the end of September 2006, Morgan Stanley's proprietary trading desk committed to entering into a CDS agreement with Goldman referencing the "super senior" portion of Hudson 1, meaning the CDO's lowest risk tranche that would be the first to receive payments to the CDO.[2248] Morgan Stanley agreed to take the long side of a CDS that represented $1.2 billion of the $2 billion CDO, while Goldman took the short side.[2249] As part of its agreement to invest in Hudson 1, Morgan Stanley was permitted to review the $800 million in single name CDS contracts to be included in the CDO and, in fact, vetoed the proposed inclusion of certain CDS contracts referencing commercial mortgage backed securities.[2250]

After getting the commitment from Morgan Stanley, Goldman turned its focus to selling the remaining Hudson securities. On September 27, 2007, Mr. Swenson, the SPG Trading Desk and ABS Desk head, sent an email to set up a meeting, which later became a conference call, on "Marketing Strategy for the ABX CDO Trade."[2251] The invitees included

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Subcommittee, Mr. Salem had no specific recollection of how assets were selected for Hudson 1 and little specific recollection about Hudson 1 as a whole. Subcommittee interview of Deeb Salem (10/6/10).

[2246] See, e.g., Goldman response to Subcommittee QFR, PSI_QFR_GS0192.

[2247] Goldman used the cash paid into Hudson 1 to purchase "collateral securities," as discussed further below.

[2248] See 10/30/2006 email from Peter Ostrem, GS MBS-E-0000057886, Hearing Exhibit 4/27-90 ("Super senior note ($1.2bln in size) was executed in the first week of the transaction and was a key driver of this deal[']s success.").

[2249] The $1.2 billion investment made by Morgan Stanley did not correspond to the CDO's $1.2 billion in CDS contracts referencing RMBS securities in the two ABX indices. Rather, Morgan Stanley was investing in the top tier of the CDO as a whole, which included CDS contracts referencing both the ABX and other RMBS securities.

[2250] Subcommittee interview of Darryl Herrick (10/13/2010). See further discussion of Morgan Stanley investment in Section C(5)(b)(iii)AA, below.

[2251] 9/27/2006 email from Michael Swenson to Crystal Young, GS MBS-E-012328848. Mr. Swenson told the Subcommittee that he had no recollection of this conference call, and that it would have been unusual for him to be involved in the marketing efforts of a CDO. Subcommittee interview of Michael Swenson (10/8/2010).

Daniel Sparks, Jon Sobel, Peter Ostrem, Darryl Herrick, and others. Mr. Herrick circulated a draft copy of the Hudson 1 termsheet and transaction overview for review in advance of the call.[2252]

Goldman's CDO marketing strategy typically involved its sales personnel sending clients a marketing booklet outlining different features of a particular CDO. Mr. Herrick drafted the marketing booklet for Hudson 1, and circulated it for review to Mr. Ostrem and other members of the CDO Origination Desk including Benjamin Case and Matthew Bieber.[2253] The executive summary of the marketing booklet described Goldman's Hudson CDO program generally and Hudson 1 in particular:

> "• Goldman Sachs developed the Hudson CDO program in 2006 to create a consistent, programmatic approach to invest in attractive relative value opportunities in the RMBS and structured product market[.]
>   - We successfully launched Hudson High Grade in September. This is a continuation of the program using mezzanine Baa2/Baa3 quality RMBS[.]
>
> • Hudson CDOs are non-managed and static in nature and provide term non-recourse funding where Goldman Sachs acts as Liquidation Agent on an ongoing basis. The Liquidation Agent will be responsible for efficiently selling credit risk assets ...
>
> • Goldman Sachs has aligned incentives with the Hudson program by investing in a portion of equity and playing the ongoing role of Liquidation Agent."[2254]

The marketing booklet also described the Hudson 1 assets, and the selection process for those assets:

> "• The portfolio composition of Hudson Mezzanine Funding 2006-1 will consist of 100% CDS on RMBS.
>   - 60% of the RMBS will be single name CDS on all 40 obligors in ABX 2006-1 and ABX 2006-2

[2252] 9/28/2006 email from Darryl Herrick, GS MBS-E-014042217, with attachments GS MBS-E-014042218 and GS MBS-E-014042220.

[2253] 9/30/2006 email from Darryl Herrick to Peter Ostrem, Benjamin Case, and Matthew Bieber, GS MBS-E-014367160, with attachment GS MBS-E-014367161; 9/30/2006 Goldman internal email chain among Darryl Herrick, Peter Ostrem, Benjamin Case, and Matthew Bieber, GS MBS-E-017504075.

[2254] 10/2006 Hudson Mezzanine Funding 2006-1, LTD., GS MBS-E-009546963, at 966, Hearing Exhibit 4/27-87.

- 40% of the RMBS will consist of single name CDS on 2005 and 2006 vintage RMBS ...

Goldman Sachs' portfolio selection process:

- Assets sourced from the Street. Hudson Mezzanine Funding is not a Balance Sheet CDO
- Goldman Sachs CDO desk pre-screens and evaluates assets for portfolio suitability
- Goldman Sachs CDO desk reviews individual assets in conjunction with respective mortgage trading desks (Subprime, Midprime, Prime, etc.) and makes decision to add or decline[.]"[2255]

The marketing booklet statement that "Goldman Sachs had aligned incentives with the Hudson program by investing in a portion of equity," was misleading. Goldman did, in fact, purchase approximately $6 million in Hudson equity.[2256] However, that $6 million equity investment was outweighed many times over by Goldman's $2 billion short position, which made Goldman's interest adverse to, rather than aligned with, the Hudson investors. Neither the marketing booklet nor other offering materials disclosed to investors the size or nature of Goldman's short position in Hudson 1.

The marketing booklet also stated that Hudson's assets were "sourced from the Street," and that it was "not a Balance Sheet CDO," even though all of the CDS contracts had been produced and priced internally by Goldman and $1.2 billion of the contracts offset Goldman ABX holdings. The plain meaning of the phrase, "sourced from the Street," is that the Hudson 1 assets were purchased from several broker-dealers on Wall Street.[2257] Indeed, a former Goldman salesperson who sold Hudson 1 securities to investors told the Subcommittee that he thought "sourced from the Street" referred to assets being acquired from a variety of different broker-dealers at the best prices, and was surprised to learn that all of the Hudson assets had been provided by Goldman's ABS Desk.[2258] A Hudson 1 investor told the Subcommittee that it had also interpreted the phrase "sourced from the Street" to mean assets acquired from a variety of different broker-dealers.[2259]

[2255] Id. at 966, 978.
[2256] See Goldman response to Subcommittee QFR, at PSI_QFR_GS0223.
[2257] Barron's Dictionary of Finance and Investment Terms defines "the Street" as "referring to the financial community in New York City and elsewhere. It is common to hear 'The Street likes XYZ.' This means there is a national consensus among securities analysts that XYZ's prospects are favorable."
[2258] Subcommittee interview of Andrew Davilman (9/30/2010).
[2259] Subcommittee interview of Morgan Stanley (6/24/2010).

The Subcommittee asked several Goldman traders involved in Hudson 1 to explain their understanding of the phrase, and received inconsistent answers. Darryl Herrick, who drafted the Hudson marketing booklet, stated that "sourced from the Street" meant the assets were "sourced from a street dealer at street prices." His supervisor, CDO Managing Director Peter Ostrem, stated that "sourced from the Street" referred to the fact the underlying RMBS securities were not originated or underwritten by Goldman.[2260] Deeb Salem, a Goldman mortgage trader who selected 40% of the assets in Hudson 1, described "the Street" as simply "short hand for all broker-dealers."[2261] David Lehman, who became the head of the CDO Origination Desk after Mr. Ostrem, and Matthew Bieber, who worked for Mr. Ostrem and later Mr. Lehman, claimed that it was accurate to say the Hudson assets were "sourced from the Street," even though all the assets were acquired from the Goldman ABS Desk, because Goldman was part of "the Street."[2262]

By using the phrase, "sourced from the Street," Goldman may have misled investors into thinking that the referenced assets had been purchased from several broker-dealers and obtained at arms-length prices, rather than simply taken directly from Goldman's inventory and priced by its own personnel. Moreover, this phrase also appears to hide the fact that Goldman had an adverse interest to investors and was seeking to transfer unwanted risk from its own inventory to the clients it was soliciting. By claiming it was "not a Balance Sheet CDO," Goldman may have misled investors into believing that Goldman had little interest in the performance of the referenced assets in Hudson, rather than having selected the assets to offset risks on its own books.

In addition to the Hudson marketing booklet, in December 2006, Goldman issued an Offering Circular which it distributed to potential investors.[2263] The Offering Circular contained the statement that no independent third party had reviewed the prices at which the CDS contracts were sold to Hudson 1.[2264] In addition to lacking third party

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2260 The Subcommittee asked Mr. Ostrem whether he considered the Hudson 1 assets to be the RMBS securities or the credit default swaps referencing those securities, and Mr. Ostrem responded that the assets in the CDO were the RMBS securities which had been originated by a variety of financial institutions on Wall Street. When asked why it would be important to indicate to investors that not all the underlying RMBS securities were underwritten by Goldman, given that this information would be clear to a professional reviewing the names of the reference assets in Hudson 1, Mr. Ostrem replied that he didn't know. Subcommittee interview of Peter Ostrem (10/5/2010).

2261 Subcommittee interview of Deeb Salem (10/6/2010).

2262 Subcommittee interview of David Lehman (9/27/2010); Subcommittee interview of Matthew Bieber (10/21/2010).

2263 12/3/2006 Hudson Mezzanine 2006-1, LTD. Offering Circular, GS MBS-E-021821196.

2264 Id. at 021821241.

verification, no external counterparty had participated in any aspect of the CDS contracts – all of the CDS contracts had been produced, signed, and priced internally by two Goldman trading desks which exercised complete control over the Hudson CDO.

Internally, while Hudson 1 was being constructed, Goldman personnel acknowledged that they were using a novel pricing approach.[2265] At one point, Mr. Swenson sent an email to Mr. Birnbaum, raising questions about how they could explain some of the pricing decisions. Mr. Swenson wrote that he was: "concerned that the levels we put on the abx cdo for single-a and triple-bs do not compare favorably with the single-a off of a abx 1 + abx 2 trade," telling Mr. Birnbaum "[w]e need a goo[d] story as to why we think the risk is different."[2266] The prices that Goldman established for the CDS contracts that Hudson "bought" affected the value of the CDO and the Hudson 1 securities Goldman sold to investors, but the Offering Circular failed to disclose the extent to which Goldman had single-handedly controlled the pricing of 100% of the CDO's assets.

Perhaps the most serious omission from the marketing booklet and other offering materials was Goldman's failure to disclose the fact that it would be the sole short party in the entire $2 billion CDO. The Goldman materials told investors that an affiliate, Goldman Sachs International (GSI), would be the "credit protection buyer" or initial short party for the Hudson 1 CDO.[2267] It was common practice for underwriters to act as the initial short party in a CDO, acting as an intermediary between the CDO vehicle and broker-dealers offering competitive bids in order to short the assets referenced in the CDO.[2268] The disclosure provided by Goldman

[2265] See, e.g., 9/19/2006 email from Michael Swenson to Thomas Cornacchia and Joshua Birnbaum, GS MBS-E-012684557 ("we are going to price an innovative full capital structure $1+bb CDO deal with 60% of the risk in ABX (no one has done this before)."); 9/21/2006 email from Darryl Herrick to Deeb Salem, Michael Swenson, Joshua Birnbaum, Peter Ostrem, and Edwin Chin, GS MBS-E-012685645.
[2266] 9/27/2006 email from Michael Swenson to Joshua Birnbaum, GS MBS-E-012689798.
[2267] 12/3/2006 Hudson Mezzanine 2006-1, LTD. Offering Circular, GS MBS-E-021821196, at 021821229. This disclosure related to the master credit default swap, where Goldman Sachs International served as the credit protection buyer facing the Hudson Mezzanine 2006-1, Ltd., the legal entity that issued the Hudson 1 securities. See 12/1/2006 ISDA Master Agreement, GS MBS-E-021822056. In this role, Goldman was serving as an intermediary, and was protecting the CDO from credit risk by placing the Goldman Sachs name on the transaction and assuring investors that a single credit-worthy entity would be making all required payments to the Hudson 1 trust. Having one broker-dealer intermediate between the market and a CDO vehicle was desirable to credit rating agencies in order to minimize risk in the CDO, and Goldman clearly disclosed this role to investors.
[2268] Goldman intermediated between other broker-dealers and the CDO vehicle in Anderson Mezzanine Funding 2007-1, Camber 7, Hudson Mezzanine 2006-1, Hudson Mezzanine 2006-2, and Timberwolf I, among several other CDOs. See Goldman response to Subcommittee QFR, at PSI_QFR_GS0192.

contained boiler plate language suggesting that would be the role played by GSI in the Hudson transaction. Goldman never disclosed that it had provided all of Hudson's assets internally, GSI was not acting as an intermediary, and GSI would not be passing on any portion of the short interest in Hudson to any other party, but would be keeping 100% of the short position. The Hudson disclosures failed to state that, rather than serving as an intermediary, Goldman was making a proprietary investment in the CDO which placed it in a direct, adverse position to the investors to whom it was selling the Hudson securities.

The Offering Circular contained a section entitled, "Certain Conflicts of Interest," which included a subsection entitled, "The Credit Protection Buyer and Senior Swap Counterparty," in which Goldman could have disclosed its short position. Rather than disclose that short position, however, Goldman stated in part:

> "GSI and/or any of its affiliates may invest and/or deal, for their own respective accounts for which they have investment discretion, in securities or in other interests in the Reference Entities, in obligations of the Reference Entities or in the obligors in respect of any Reference Obligations or Collateral Securities (the "Investments"), or in credit default swaps (whether as protection buyer or seller), total return swaps or other instruments enabling credit and/or other risks to be traded that are linked to one or more Investments."[2269]

This disclosure indicates that GSI or an affiliate "may invest and/or deal" in securities or other "interests" in the assets underlying the Hudson CDO, and "may invest and/or deal" in CDS contracts that are "linked to" the Hudson "investments." The Offering Circular, however, misrepresented Goldman's investment plans. At the time it was created in December 2006, Goldman had already determined to keep 100% of the short side of the Hudson CDO and act as the sole counterparty to the investors buying Hudson securities, thereby acquiring a $2 billion financial interest that was directly adverse to theirs.

Tracking Hudson. Once it constructed the Hudson CDO, Goldman personnel were focused on completing and selling the Hudson 1 securities as quickly as possible. At least one other CDO was pushed back to facilitate the execution of Hudson 1.[2270]

[2269] 12/3/2006 Hudson Mezzanine 2006-1, LTD. Offering Circular, GS MBS- E-021821196, at 021821251.

[2270] 10/16/2006 email exchange between Daniel Sparks and Peter Ostrem, GS MBS-E-010916991 ("Cambridge is upset that we are delaying their deal. They know that Hudson Mezz (GS prop deal) is pushing their deal back.").

Goldman senior executives closely followed Hudson's development and sale. Hudson was discussed, for example, at five different Firmwide Risk Committee meetings attended by senior Goldman executives.[2271] Mortgage Department executives also sent progress reports to the senior executives on Hudson 1. On October 25, 2006, for example, Mr. Sobel sent an email to COO Gary Cohn and CFO David Viniar alerting them to Hudson sales efforts and the pricing of its securities.[2272] During discussions over the best price at which to market the CDO's equity tranche, a senior executive emailed Peter Ostrem and others: "keep in mind the overall objective - this is not about one trade - having said that, I agree that [the proposed price] may be too low."[2273] On October 26, 2006, Mr. Jha, a Goldman risk officer, circulated a Mortgage Department Risk Report to a number of Goldman executives, including CEO Lloyd Blankfein and COO Gary Cohn, noting in the forwarding email: "Risk reduction [in the Mortgage Department] is primarily due to pricing of $2bn Hudson Mez synthetic CDO."[2274]

Selling Hudson. Once the Hudson CDO was ready for sale, the Goldman sales force had difficulty selling Hudson securities to investors due to its reliance on BBB and BBB- rated subprime RMBS securities. Allied Irish Bank (AIB), for example, apparently referred to the Hudson securities as "junk."[2275] One Goldman employee emailed the CDO team and asked:

> "[D]o we have anything talking about how great the BBB sector of RMBS is at this point in time ... a common response I am hearing on

[2271] Firmwide Risk Committee meetings were often chaired by David Viniar and frequently attended by Lloyd Blankfein and Gary Cohn. See 9/20/2006 Firmwide Risk Committee Minutes, GS MBS 0000004472; 9/27/2006 Firmwide Risk Committee Minutes, GS MBS 0000004474; 10/4/2006 Firmwide Risk Committee Minutes, GS MBS 0000004476; 10/11/2006 Firmwide Risk Committee Minutes, GS MBS 0000004478; 11/1/2010 Firmwide Risk Committee Minutes, GS MBS 0000004484. See also 10/11/2006 email from Arbind Jha to Joshua Birnbaum, GS MBS-E-012695030 ("Sobel this morning in the firmwide risk committee mentioned that we have circled up the junior and some of the equity tranches").
[2272] 10/25/2006 email from Jonathan Sobel to David Viniar and Gary Cohn, GS MBS-E-009757821.
[2273] 10/12/2006 email from Thomas Cornacchia to Peter Ostrem and others, GS MBS-E-0000066413.
[2274] 10/26/2006 email from Arbind Jha, "MarketRisk: Mortgage Risk Report (cob 10/25/2006)," GS MBS-E-0000056041, Hearing Exhibit 4/27-89. That same day, October 26, 2006, Mr. Swenson also described the risk transfer to Goldman executive Bill McMahon when updating him on the trading desk's ABX position: "In addition to $2bb of risk that was placed into the CDO, we have sold to retail since 4pm yesterday $2bb of BBB- risk." 10/26/2006 email from Michael Swenson to Bill McMahon, others, GS MBS-E-0000054856.
[2275] 10/11/2006 Goldman internal email, "FW: Hudson Mezz," GS MBS-E-017502610, Hearing Exhibit 4/27-170c. (A Goldman employee asked a sales associate: "what specifically did AIB say was 'junk' about the hudson mezz deal?" The employee then forwarded the email to Mr. Herrick saying: "You may want to ask [the sales associate] about this when she's there tomorrow and Friday. ... She said 'AIB are too smart to buy this kind of junk.'").

> both Hudson & HGS1 is a concern about the housing market and BBB in particular? We need to arm sales with a bit more."[2276]

Another Goldman salesman emailed Mr. Herrick on the CDO Desk, telling him:

> "The guy at Schroders looking at this deal has one main issue h[e] has to get over: He is worried about how he is going to convince his boss to invest in a pool of sub prime mortgages with probably their greatest exposures in California and Florida. He is nervous on US house prices. ... Anything else we could offer? He is not a big believer in the Moody's data and rating system. **I WANT THIS GUY THERE AND IN SIZE! Please help if you can - just three bullet points would help."**[2277]

Mr. Herrick kept the SPG Trading Desk posted on the progress of sales. On October 11, 2006, Mr. Herrick informed the group: "This [sale] clears the team of majority the senior risk Equity and BBs we are hammering away on and hope to get traction tomorrow/Friday."[2278] Mr. Swenson responded: "you are doing an awesome job, keep it up." Mr. Swenson emailed the sales team manager: "I am extremely impressed by darryl [a]nd the rest of your team."[2279]

On October 25, 2006, Mr. Sobel sent a Hudson update to COO Gary Cohn and CFO David Viniar: "$1.6bn of the $2bn sold, with the majority of the unsold bonds being investment grade. Equity more than 85% sold."[2280]

The Goldman sales force sold most of the Hudson securities prior to the CDO's closing in December 2006, and continued its sales efforts after the closing as well. Two months after the closing, in February 2007, Goldman had $296 million in unsold Hudson securities, not including the $6 million equity investment Goldman had announced in the Hudson

[2276] 10/19/2006 email from Mitchell Resnick to Jonathan Egol, Darryl Herrick, and David Rosenblum, GS MBS-E-009557391. "HGS1" refers to Abacus HGS1, a CDO^2 where Goldman, as in Hudson 1, held 100% of the short interest.

[2277] 10/20/2006 email from Paul Carrett to Darryl Herrick, GS MBS-E-018321286 [emphasis in original].

[2278] 10/11/2006 email from Darryl Herrick to Michael Swenson, David Lehman, and Josh Birnbaum, GS MBS-E-0000030518. Mr. Swenson told the Subcommittee he had no recollection of being involved in the marketing of Hudson 1. Mr. Swenson said he did not work on CDOs and would not typically be involved in the marketing of CDOs. Subcommittee interview of Michael Swenson (10/8/2010).

[2279] 10/12/2006 email from Michael Swenson to David Rosenblum and Peter Ostrem, GS MBS-E-0000030518.

[2280] 10/25/2006 email from Jonathan Sobel to David Viniar and Gary Cohn, GS MBS-E-009757821.

marketing material that it would purchase and hold. Over the following months, Goldman sold an additional $38 million worth of securities to investors, and received bids on several other securities but decided the bid prices were too low and kept the securities on its books instead.[2281] The unsold Hudson securities were split between the CDO Origination Desk and ABS Trading Desk.[2282]

Overall, Goldman sold Hudson securities to 25 investors. Morgan Stanley made the largest investment, taking $1.2 billion of the super senior portion of the CDO. Other investors included the National Australia Bank, which purchased $80 million worth of the AAA rated securities; Security Benefit Mutual, which bought $10 million of the AA rated securities; and Bear Stearns, which bought $5 million of the equity tranche.

Profiting from Hudson. On October 30, 2006, after Hudson 1 was presented to investors and pre-sold most of its securities, Peter Ostrem, the head of the CDO Origination Desk, sent a celebratory email to the ABS and CDO teams with Hudson highlights. He wrote: "Goldman was the sole buyer of protection on the entire $2.0 billion of assets," meaning Goldman had kept 100% of the short position. By shorting Hudson, Goldman had transferred $1.2 billion worth of risky ABX assets Goldman wanted off its books, and shorted another $800 million in RMBS securities. Mr. Ostrem also listed these "highlights":

- "P&L [Profit and Loss] booked of $8.5mm .... Plus, ongoing P&L to GS for acting as liquidation agent equal to $2.5mm per year for the next 4 years
- Hudson Mezz went long $1.2bln of BBB/BBB- ABX from ABS trading desk at market wides 4 weeks ago
- Fastest execution of a SP [Structured Product] CDO done at Goldman (4 weeks from inception to pricing)
- Over half the Equity was sold by Andy Davilman
- ... Super senior note ($1.2bln in size) was executed in the first week of the transaction and was a key driver of this deal[']s success (covered by Nicole Martin)."[2283]

[2281] Subcommittee interview of Darryl Herrick (10/13/2010).
[2282] Subcommittee interview of Darryl Herrick (10/13/2010). When asked if it was common to divide unsold securities between the CDO Desk and the ABS Desk, Mr. Herrick said unsold securities were usually split with the sponsor of a CDO. His response suggests that Goldman viewed the ABS Desk as the sponsor of Hudson 1, since it was designed to offset the risk associated with the ABS Desk's ABX assets. See also 2/28/2007 email from David Rosenblum to Peter Ostrem, GS MBS-E-001800707 ("are we still sharing 50pct of ups and downs on [Hudson].").
[2283] 10/30/2006 email from Peter Ostrem, "Great Job on Hudson Mezz," GS MBS-E-0000057866, Hearing Exhibit 4/27-90.

Over the next year, Goldman pocketed nearly $1.7 billion in gross revenues from Hudson 1, all of which was at the expense of the Hudson investors.[2284] As the value of the RMBS securities referenced in the ABX indices declined, Goldman, as the sole short party in Hudson, collected $1.393 billion in gains directly from the investors to whom it had sold the Hudson securities. Goldman's $1.393 billion gains were, in turn, offset internally at the firm by the ABX losses recorded on the books of its ABS Desk. Goldman made another $304 million in gains due to its short of the other $800 million in single name CDS contracts included in Hudson 1.[2285] That $304 million gain was also at the expense of the investors to whom Goldman had sold the Hudson securities.

Goldman also profited in other ways. It received substantial fees from the roles it played in underwriting and administering Hudson 1, including $31 million in underwriting fees, $3.1 million for serving as the liquidation agent, and $1 million for serving as the collateral put provider.[2286] The ABS Desk warehouse account that contained both the long ABX assets and the 80 offsetting single name CDS contracts reported a gain of approximately $1.2 million due to the higher value of the single name CDS compared to the ABX CDS.[2287]

Goldman also incurred some losses in connection with Hudson 1. Although Goldman sold some additional Hudson securities several months after the CDO closed, it incurred a $267 million loss from the Hudson 1 securities that it was unable to sell at the prices it wanted and instead retained in its inventory. Goldman lost another $111 million from serving as the collateral put provider for Hudson collateral securities which also lost value.[2288] Overall, however, Goldman recorded a profit from Hudson 1 of more than $1.35 billion.

In contrast to Goldman, Hudson 1 investors suffered substantial losses. In March 2007, less than three months after the issuance of the Hudson securities, when asked to analyze how a holder of Hudson securities could hedge against a drop in their value, a Goldman trader wrote: "their likelihood of getting principal back is almost zero."[2289] Six months later, the credit rating downgrades began. In September 2007, Moody's downgraded several Hudson 1 securities and followed with

[2284] Goldman told the Subcommittee that Hudson experienced a gross gain of $1.697 billion offset by a loss of $1.39 billion (rather than $1.2 billion) in ABX assets on its balance sheet. 8/4/2010 email from Goldman to the Subcommittee, PSI_QFR_GS0243.
[2285] See Goldman response to Subcommittee QFR at PSI_QFR_GS0239.
[2286] Id.
[2287] Id.
[2288] Id., at PSI_QFR_GS_0280.
[2289] 3/4/2006 email from Fabrice Tourre to George Maltezos, others, GS MBS-E-006638833.

additional downgrades in November 2007. S&P began downgrades of Hudson 1 in December 2007, and by February 2008, had downgraded even the AAA rated securities.[2290]

Morgan Stanley, the largest Hudson investor, lost $930 million.[2291] As other investors incurred increasing losses, they sold their securities back to Goldman at rock bottom prices. In September 2007, for example, nine months after the Hudson securities were first issued, Goldman repurchased $10 million worth of Hudson securities from Greywolf Capital at a price of five cents on the dollar; in October 2007, another hedge fund sold $1 million in Hudson securities back to Goldman at a price of 2.5 cents on the dollar.[2292] In November 2008, Hudson 1 was completely liquidated by Goldman. Today, Hudson securities are worthless.

Analysis. Goldman constructed Hudson 1 as a way to transfer its ABX risk to the investors who bought Hudson securities. When marketing the Hudson securities, Goldman misled investors by claiming its investment interests were aligned with theirs, when it was the sole short party and was betting against the very securities it was recommending. Goldman also implied that Hudson's assets had been purchased from outside sources, and failed to state that it had selected the majority of the assets from its own inventory and priced the assets without any third party participation. By holding 100% of the short position at the same time it solicited clients to buy the Hudson securities, Goldman created a conflict of interest with its clients, concealed the conflict from them, and profited at their expense.

BB. Anderson Mezzanine Funding 2007-1

In the summer of 2006, Goldman began work on Anderson Mezzanine Funding 2007-1 (Anderson), a synthetic CDO whose assets were single name CDS contracts referencing subprime RMBS securities with mezzanine credit ratings.[2293] To execute the Anderson CDO, Goldman partnered with GSC Partners (GSC), a New York hedge fund. Goldman personnel working on the CDO included Peter Ostrem, head of the CDO Origination Desk, and Matthew Bieber, a CDO Origination Desk employee assigned to be deal captain for the Anderson CDO.

[2290] See Goldman response to Subcommittee QFR, at PSI_QFR_GS0211.
[2291] 11/21/2008 letter from Goldman to Morgan Stanley, HUD-CDO-00005125.
[2292] See Goldman response to Subcommittee QFR, at PSI_QFR_GS0223 and PSI_QFR_GS0235.
[2293] "Mezzanine" CDS assets reference securities that carry a credit rating of BBB or BBB-. Mezzanine assets are riskier than AAA, AA, and A rated assets, but less risky than those that carry, for example, BB, B, or CCC ratings.

The CDO was originally conceived as part of the Hudson series of non-managed, proprietary CDOs in which Goldman acted as the principal.[2294] But Goldman decided to enlist GSC to take part in structuring the $500 million CDO.[2295]

Partnering on Anderson. GSC Partners was founded by Alfred C. Eckert, III, a former partner and former head of private equity, distressed debt investing, and corporate finance at Goldman.[2296] Goldman had a longstanding relationship with GSC. In addition to Mr. Eckert, at least five other former Goldman Managing Directors were employed by GSC, and at least eight other former and current Managing Directors had invested in one or more of GSC's funds.[2297] In the spring of 2006, GSC circulated information through Goldman about raising money for its Elliot Bridge Fund, a "fixed income arb[itrage] fund focusing primarily on ABS using cash and synthetics, long/short strategies."[2298] When discussing the fund with other Goldman employees, Curtis Willing, the Goldman sales representative responsible for covering GSC wrote: "They are a strategic partner with the Synthetic desk and have handed us multiple CDO/CLO mandates."[2299] After being informed of the internal conversations almost a month later, Mr. Sparks informed Mr. Willing that it was a "[m]istake not to involve me from early on," telling Mr. Willing, "I've run a bunch of traps for [GSC] in the past."[2300]

GSC agreed to partner with Goldman on the Anderson CDO and to share in the associated risk, including by splitting the equity tranche and sharing the risk with Goldman that the Anderson assets would lose value

[2294] Some documents indicate the CDO was slated to be Hudson Mezzanine 2006-2. But in December 2006, Goldman delayed Anderson in favor of issuing an ABX based CDO named Hudson Mezzanine 2006-2. Several of the documents cited in this section use the terms "Hudson" or "Hudson Mezz" when in fact they refer to Anderson. None of the Goldman employees interviewed by the Subcommittee could recall the reason for changing the name of the CDO to Anderson.
[2295] 9/25/2006 Goldman memorandum to the Mortgage Capital Committee, GS MBS-E-013475756-62 (hereinafter "9/25/2006 MCC Memorandum"). The MCC Memorandum states that Goldman was approached by GSC, but may be using standard language reused in many MCC Memoranda. In an interview with the Subcommittee, Edward Steffelin, a Senior Trader at GSC, stated that Goldman approached GSC about partnering in the transaction, and the memorandum language was "probably backward." Subcommittee interview of Edward Steffelin (12/10/2010).
[2296] 9/25/2006 MCC Memorandum, GS MBS-E-013475756-62.
[2297] See Goldman response to Subcommittee QFR at PSI_QFR_GS0434. Goldman noted in its QFR response that the information used for its response had been voluntarily provided by Goldman employees.
[2298] 5/10/2006 email from Curtis Willing to David Solomon and Dan Holland, GS MBS-E-013870906-7. The Elliot Bridge Fund eventually invested in Anderson.
[2299] 4/17/2006 email from Curtis Willing to David Solomon and Dan Holland, GS MBS-E-013870906-7.
[2300] 5/14/2006 and 5/10/2006 emails from Dan Sparks to Curtis Willing, GS MBS-E-013870906-7.

while being warehoused.[2301] GSC also participated in selecting the assets for the CDO.[2302] Later on, Goldman consulted with GSC on whether to liquidate or underwrite Anderson,[2303] and allowed GSC to participate in pricing issues,[2304] while GSC at times assisted in marketing Anderson.[2305]

Goldman offered to let GSC take a short interest in the CDO by offering to "sell protection on BBBs to GSC at market for 0.75% times notional," and agreeing to "source assets via GSC," meaning GSC could propose assets for the CDO that GSC wanted to get rid of or short.[2306] GSC responded by shorting a select group of RMBS securities to hedge its risk while those assets were in the Anderson warehouse account.[2307] For instance, at one point in October 2006, GSC sought to add $56 million in assets to the Anderson CDO, while also taking a short position on $9 million of those assets, which it described as "GSC Hedge Amount."[2308]

Designing Anderson. GSC and Goldman participated together in the selection of assets for Anderson. Anderson was designed to be a synthetic CDO whose assets would consist solely of CDS contracts referencing RMBS securities whose average credit ratings would be BBB or BBB-. GSC proposed some of the referenced RMBS securities, but it is

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[2301] 9/25/2006 MCC Memorandum, GS MBS-E-013475756-62.

[2302] 8/8/2006 email from Edward Steffelin to Peter Ostrem and others, "GS/GSC EB Prop deal," GS MBS-E-000904603. 8/8/2006 email from Peter Ostrem to Edward Steffelin, Joshua Bissu and others, GS MBS-E-000904603 (Mr. Ostrem writes: "Happy to source assets via GSC."). See e.g., 9/26/2006 email from Mr. Bissu to Matthew Bieber, "Names for tomorrow," GS MBS-E-014335388.

[2303] Subcommittee interview of Edward Steffelin (12/10/2010).

[2304] See 3/5/2007 emails between Matthew Bieber and Joshua Bissu, GS MBS-E-014605918.

[2305] See 3/6/2007 email from Joshua Bissu to Matthew Bieber and Peter Ostrem, GS MBS-E-014597705.

[2306] 8/8/2006 email from Edward Steffelin to Peter Ostrem and others, "GS/GSC EB Prop deal," GS MBS-E-000904603. GSC frequently executed trades with Goldman's Correlation Trading Desk, and was known to have a "long/short strategy" in which it shorted assets it considered expensive and went long assets it thought were undervalued. See 9/15/2006 email from Geoffrey Williams to Correlation Trading Desk, GS MBS-E-009471708. See e.g., 10/31/2006 email from Shelly Lin to Joshua Bissu, and Matthew Bieber, GS MBS-E-016473768.

[2307] 10/31/2006 email from Curtis Willing, GSC Trades, GSC-CDO-FCIC-0029698; 10/31/2006 email from Deeb Salem, "Re: GSC-Hudson Mezz 2," GS MBS-E-000905571. A former GSC employee interviewed by the Subcommittee also indicated that the short positions were taken on Anderson assets in an effort to hedge GSC's warehouse risk. Subcommittee interview of Edward Steffelin (12/10/2010).

[2308] 10/31/2006 email from Shelly Lin to Joshua Bissu and Matthew Bieber, GS MBS-E-016473768. See also 10/31/2006 email from Shelly Lin to Deeb Salem, Edwin Chin, and Matthew Bieber, GS MBS-E-000905571 ("GSC wants to short into the deal the amounts listed below. They'd like to trade the ones they want to hedge with your desk as well. I think they also did this with your desk a few weeks ago."). When Mr. Bieber was shown this document during his 10/21/2010 interview with the Subcommittee he stated he didn't know if GSC had shorted assets and that he didn't know what Ms. Lin meant by her statement. Subcommittee interview of Matthew Bieber (10/21/2010).

unclear how many were included in Anderson.[2309] GSC and Goldman employees interviewed by the Subcommittee had no specific recollection of the asset selection process, beyond each party selecting some RMBS securities and the other having veto rights.[2310]

Anderson's assets were purchased from 11 different broker-dealers from September 2006 to March 2007. Goldman was the source of 28 of the 61 CDS contracts in Anderson, and Goldman retained the short side. The next largest short party was Lehman Brothers which sold six CDS contracts to Anderson and retained the short side. Goldman also served as the sole credit protection buyer to the Anderson CDO, acting as the intermediary between the CDO and the various broker-dealers selling it assets.[2311]

By February 2007, the Anderson warehouse account contained $305 million out of the intended $500 million worth of single name CDS, many of which referenced mortgage pools originated by New Century, Fremont, and Countrywide, subprime lenders known within the industry for issuing poor quality loans and RMBS securities. Approximately 45% of the referenced RMBS securities contained New Century mortgages.[2312]

Falling Mortgage Market. During the same time period in which the Anderson single name CDS contracts were being accumulated, Goldman was becoming increasingly concerned about the subprime mortgage market, was reacting to bad news from the subprime lenders it did business with,[2313] and was building a large short position against the same types of BBB rated RMBS securities referenced in Anderson.[2314] By February 2007, the value of subprime RMBS securities was falling, and the Goldman CDO Origination Desk was forced to mark down the value of the long single name CDS contracts in its CDO warehouse accounts, including Anderson.

2309 Subcommittee interview of Matthew Bieber (10/20/2010); Subcommittee interview of Edward Steffelin (12/10/2010).
2310 Id.
2311 See Goldman response to Subcommittee QFR at PSI_QFR_GS0192.
2312 This number was compiled using a list of referenced securities supplied by Goldman at QFR_PSI_GS0192 and registration statements available at www.sec.gov. When looking at all mortgages underlying each reference security, New Century originated 48% by value of the underlying mortgages. However, each mortgage may have a different weight in the Anderson CDO based on the size of the reference security it is held in. Therefore, the economic effect of the New Century mortgages could be greater than or less than 48%. The next largest mortgage originator by value was Countrywide at 8%.
2313 See, e.g., 1/4/2007 Goldman presentation, "Sub-Prime Mortgage Lenders - Update," GS MBS-E-009978840-59, Hearing Exhibit 4/27-169.
2314 See discussion of Goldman's net short position, Section C(4), above.

Goldman was also aware that its longtime customer, New Century, was in financial distress. On February 7, 2007, New Century announced publicly it would be restating its 2006 earnings, causing a sharp drop in the company's share price. On February 8, 2007, Goldman's Chief Credit Officer Craig Broderick sent Mr. Sparks and others a press clipping about New Century and warned:

> "[T]his is a materially adverse development. The issues involve inadequate [early payment default] provisions and marks on residuals .... [I]n a confidence sensitive industry it will be ugly even if all problems have been identified. ... We have a call with the company in a few minutes (to be led by Dan Sparks)." [2315]

On some occasions, Mr. Sparks addressed negative news about New Century in the same email he discussed liquidating assets in warehouse accounts for upcoming CDOs. On March 8, 2007, for example, Mr. Sparks noted in an email to senior executives: "New Century remains a problem" due to loans experiencing early payment defaults, and informed them that the Mortgage Department had "liquidated a few deals and could liquidate a couple more."[2316]

On February 23, 2007, Mr. Sparks sent an email to senior Goldman executives estimating that Goldman had lost $72 million on the holdings in its CDO warehouse accounts, due to falling prices.[2317] He directed Mortgage Department personnel to liquidate rather than securitize the assets in certain warehouse accounts. Two days later, on February 25, 2007, Mr. Sparks informed senior executives of the possibility of liquidating Anderson:

> "[T]he CDO business liquidated 3 warehouses for deals of $530mm (about half risk was subprime related). ... One more CDO warehouse may be liquidated this week - approximately $300mm with GSC as manager."[2318]

Three days later, David Rosenblum, head of Goldman's Collateralized Loan Obligations activities, emailed Mr. Ostrem, head of the CDO

[2315] 2/8/2007 email from Craig Broderick to Daniel Sparks, David Viniar, others, GS MBS-E-002201486.
[2316] 3/8/2007 email from Daniel Sparks to senior executives, GS MBS-E-002206279, Hearing Exhibit 4/27-75.
[2317] 2/23/2007 email from Daniel Sparks to senior executives, GS MBS-E-009759477.
[2318] 2/25/2007 email from Daniel Sparks to Tom Montag, GS MBS-E-019164799. See also 2/23/2007 email from Daniel Sparks to senior executives, GS MBS-E-009759477 ("We liquidated 3 CDO warehouses today and started the liquidation of another. We may liquidate one more next week.").

Origination Desk, stating: "Dan tells me that SP [Structured Product] CDO desk has reported -77 [million dollars] from retained debt (Hmezz 1+2, etc), and -129 [million dollars] from unrealized and realized CDO WH [warehouse] markdowns."[2319]

On February 24, 2007, a Saturday, several persons from the Mortgage Department worked to analyze the costs of unwinding and liquidating the assets collected for the Anderson CDO. Deeb Salem, a trader on the ABS Desk, estimated that unwinding Anderson would result in a $60 million loss due to the falling value of its single name CDS.[2320] On the same day, Mr. Ostrem sent his colleagues this explanation of why the losses in the CDO warehouse accounts were growing so rapidly:

> "Each warehouse is marked by either (a) MTM [mark-to-market] on each asset or (b) mark to model [MTModel] which involves taking the portfolio through the expected CDO execution and calculating Goldman's P&L [profit and loss] given current market yields on debt and equity. MTM is preferred if CDO execution is highly uncertain or portfolio is small. Both the MTM and the MTModel take into account risk sharing arrangements with 3rd parties.
>
> As CDO execution has become more uncertain we have moved a couple warehouses closer to their MTM which has significantly increased our losses. Also, our MTModel results have shown losses as expected liability spreads have widened significantly and the overall strength of the CDO market has waned due to fundamental credit decline in 06/07 in RMBS subprime (90+% of assets) and increased co[r]relation between ABX/TABX levels and mezz debt levels in CDOs. We expect this co[r]relation to increase volatility in our warehouse marks for the [sic] a while (this series of events have happened quickly within the last month and the co[r]relation is getting closer to 1 as global markets get more familiar with fundamentals in subprime and trading levels in ABX/TABX).
>
> Additional losses have also resulted from the liquidation of 3 warehouses. In each case, the realized loss from the sale of assets has been higher than our MTM or MTModel. This is attributable to both volatility in subprime markets and that our competitors are closing their CDO warehouse accounts from buying our subprime or CDO positions. The buyer base has suddenly shrunk significantly. As this continues, we expect this lack of liquidity to further weaken

[2319] 2/28/2007 email from David Rosenblum to Peter Ostrem, GS MBS-E-001800707.
[2320] 2/24/2007 email from Deeb Salem to Michael Swenson, Edwin Chin, and Josh Birnbaum, GS MBS-E-018936137-38.

our MTMs and feed into our losses in our remaining warehouse marks."[2321]

At about 11 p.m. that Saturday night, February 24, 2007, Mr. Sparks seemed to reach a decision to liquidate Anderson. He sent an email to Mr. Ostrem, Mr. Bieber, and several others stating: "I want to liquidate Anderson Monday – we should begin the discussion with gsc asap."[2322]

After Mr. Sparks relayed this decision, Messrs. Ostrem and Bieber began to strategize ways to convince Mr. Sparks to reverse his decision.[2323] Messrs. Ostrem and Bieber assembled a list of likely buyers of the Anderson securities to present to Mr. Sparks, and brainstormed about other CDOs that could potentially buy Anderson securities for their asset pools.[2324] Mr. Ostrem also proposed allowing a hedge fund to short assets into the deal as an incentive to buy the Anderson securities, but Mr. Bieber thought Mr. Sparks would want to "preserve that ability for Goldman."[2325]

At some point, Mr. Sparks changed his mind and decided to go forward with underwriting the Anderson CDO. None of the Goldman personnel interviewed by the Subcommittee could recall why the final decision was made to go forward with Anderson. In one email on March 2, 2007, Jonathan Egol, head of the Goldman Correlation Trading Desk, suggested adding $195 million more in assets to Anderson, with Goldman selecting the assets internally and shorting them.[2326] Mr. Sparks rejected any expansion of Anderson, responding: "we are not ramping - execute deal as is."[2327]

The Anderson CDO closed on March 20, 2007. As finally constructed, 100% of its assets were CDS contracts referencing $307 million in mezzanine subprime RMBS securities, meaning RMBS securities carrying BBB or BBB- credit ratings. About 45% of the subprime mortgages in the referenced RMBS securities were issued by New Century. Another 8% were issued by Countrywide, and almost 7% were issued by Fremont. Goldman took about 40% of the short side of the Anderson CDO. Ten other investors held the rest of the short interest in the CDO.

[2321] 2/24/2007 email from Peter Ostrem to colleagues, GS MBS-E-010383828-29.
[2322] 2/24/2007 email from Daniel Sparks to Peter Ostrem, others, GS MBS-E-001996601, Hearing Exhibit 4/27-95.
[2323] 2/25/2007 Goldman internal email chain, GS MBS-E-001996601, Hearing Exhibit 4/27-97.
[2324] Id.
[2325] Id.
[2326] 3/2/2007 email from Jon Egol to Daniel Sparks and others, GS MBS-E-010637566, Hearing Exhibit 4/27-97.
[2327] 3/2/2007 email from Daniel Sparks to Jon Egol and others, GS MBS-E-010637566, Hearing Exhibit 4/27-97.

Selling Anderson. During March, selling Anderson securities became a top priority for Goldman. Goldman even put another deal on hold, the Abacus 2007-AC1 deal with the Paulson hedge fund, to promote Anderson. As Mr. Egol advised Goldman personnel: "Given risk priorities, subprime news and market conditions, we need to discuss side-lining [Abacus 2007-AC1] in favor of prioritizing Anderson in the short term."[2328]

On March 13, 2007, Goldman issued internal talking points for its sales force on the Anderson CDO. Among the points highlighted were:

> "Portfolio selected by GSC. Goldman is underwriting the equity and expects to hold up to 50%. ... Low fee structure[.] ... No reinvestment risk."[2329]

The talking points described Goldman as holding up to 50% of the equity tranche in the CDO – worth about $21 million, without mentioning that Goldman would also be holding 40% – about $135 million – of the short side of Anderson, placing its investment interests in direct opposition to the investors to whom it was selling Anderson securities.

The large number of poor assets referenced in Anderson raised investor questions and was an impediment to sales.[2330] One potential investor wrote to a Goldman sales representative explaining its decision not to purchase the Anderson securities:

> "We're going to pass on this deal for a number of reasons: Two bonds . . . have been downgraded or are on negative watch; Another 12 bonds in the portfolio are negatively impacted by the downgrades lower in the capital structure; 28% of the portfolio is failing delinquency triggers; We show that a lot of these bonds will take principal hits; Not crazy about the deal structure given the quality of the portfolio."[2331]

[2328] 3/2/2007 email from Jon Egol to colleagues, "Re: Abacus AC1," GS MBS-E-002676413, Hearing Exhibit 4/27-64.

[2329] 3/13/2007 email from Peter Ostrem to Scott Wisenbaker and Matthew Bieber, GS MBS-E-000898410, Hearing Exhibit 4/27-172.

[2330] In mid-March, Mr. Ostrem informed the GSI Risk Committee that Goldman's estimated losses on the assets in the Anderson warehouse account had reached $22.9 million. 3/16/2007 Goldman Sachs International Risk Committee memorandum, "GSI Warehousing for Structured Product CDOs," GS MBS-E-001806010-16.

[2331] 5/31/2007 email from Goldman client to Andrew Davilman, GS MBS-E-015550857-58. Andrew Davilman relayed the message to Matthew Bieber, who suggested the client might be interested in higher rated securities. Mr. Davilman responded: "I'll check, but given the portfolio I suspect he's looking for a cleaner start."

Other investors expressed concerns that the CDO would be downgraded.[2332] Goldman did not disclose to these investors that it had almost canceled the CDO, due to its assets' falling values.

Of particular concern for investors was the concentration of New Century mortgages in Anderson.[2333] On March 13, 2007, a potential investor, Rabobank, asked Goldman sales representatives: "how did you get comfortable with all the new centu ry [sic] collateral in particular the new century serviced deals – con sidering [sic] you are holding the equity and their servicing may not be around is that concerning for you at all?"[2334] Goldman and GSC prepared a list of talking points with which to respond to the investor:

"• Historically New Century has on average displayed much better performance in terms of delinq[uency] and default data
• Prepayments have tended to be higher lowering the extension risk
• Losses and REO [Real Estate Owned by a lender taking possession of a property] are historically lower than the rest of the market
• Traditionally the structures have strong enhancement/ subordination."[2335]

The talking points did not disclose that, in fact, Goldman, too, was uncomfortable with New Century mortgages. On March 8, 2007, five days before receiving the investor's inquiry, Mr. Sparks had reported to senior Goldman executives, including Co-President Gary Cohn and CFO David Viniar, that New Century mortgages "remain[ed] a problem for [early payment default]."[2336] On March 13, the same day as the investor inquiry, Goldman personnel completed a review of New Century mortgages with early payment defaults that were on Goldman's books and found fraud, "material compliance issues," and collateral problems. The review found that "62% of the pool has not made any pmts [payments]" and recommended "putting back 26% of the pool" to New Century for

[2332] 3/16/2007 email from Russell Brocato to Scott Wisenbaker, GS MBS-E-000902498, Hearing Exhibit 4/27-172. Mr. Bieber and Mr. Ostrem were also informed by a salesperson that the client was "out on Anderson – they feel like the deal will be dow[n]graded and have interest coverage issues." Mr. Ostrem instructed the Goldman salesperson to "[f]ix the miscommunication so the probability [of sale] goes up."
[2333] 3/14/2007 email from Matthew Bieber to Scott Wisenbaker and others, GS MBS-E-000908336, Hearing Exhibit 4/27-172 ("Looking like both dcp and terwin out. New Century issues.").
[2334] 3/13/2007 email from Wendy Rosenfeld at Rabobank to Olivia Ha at Goldman, GS MBS-E-000898417, Hearing Exhibit 4/27-172.
[2335] 3/6/2007 email from Joshua Bissu to Matthew Bieber and Peter Ostrem, GS MBS-E-014597705.
[2336] 3/8/2007 email from Daniel Sparks to senior executives, GS MBS-E-002206279, Hearing Exhibit 4/27-75.

repurchase "if possible."[2337] Goldman also did not disclose to the investor that it was shorting 40% of the Anderson CDO.

Some Goldman clients also had questions about GSC's involvement in Anderson. An Australian sales representative wanted "more color on asset selection process, especially with respect to GSC involvement."[2338] This clarification was necessary, because although GSC's role was mentioned in numerous internal Goldman documents, the official Anderson marketing materials did not mention GSC's role in asset selection.[2339] In previous drafts of the marketing materials, for example, Goldman stated that "Goldman Sachs and GSC Group co-selected the assets"; "GSC pre-screens and evaluates assets for portfolio suitability"; the CDO was "co-sponsored by Goldman and GSC Eliot Bridge Fund"; and "Goldman Sachs and GSC ha[ve] aligned incentives with Anderson Funding by investing in a portion of equity."[2340] But all of the references to GSC were removed from the final documents.[2341] Mr. Bieber told the Subcommittee that he did not recall specifically why the references to GSC were removed, but recalled GSC having an issue with disclosing its name in the offering documents.[2342] Edward Steffelin, a Senior Trader at GSC, also did not recall the specifics regarding why the references to GSC were removed, but told the Subcommittee that he felt GSC's role in the Anderson CDO did not rise to the level of "co-selecting."[2343] Mr. Steffelin said that although GSC had the ability to suggest assets and veto others, he

[2337] 3/13/2007 email from Manisha Nanik to Loren Morris, "New Century EPDs," at GS MBS-E-002146861, Hearing Exhibit 4/27-77. See also 2/2/2007 email from Matthew Nichols to Kevin Gasvoda and others, GS MBS-E-005556331 ("NC is running a 10% drop rate [due diligence drop] at ~6 points / drop and 4% EPD rate at close to 20 points."); 2/8/2007 email from John Cassidy to Joseph Ozment, others, GS MBS-E-002045021 ("Given the current state of the company I am no longer comfortable with the practice of taking loans with trailing docs . . . that we need in order to conduct compliance testing.").

[2338] 3/1/2007 email from Scott Wisenbaker to Peter Ostrem and Matthew Bieber, GS MBS-E-000893661, Hearing Exhibit 4/27-172.

[2339] 2/2007 Anderson Mezzanine Funding 2007-1, Ltd. Debt Marketing Book, GS MBS-E-000855351.

[2340] 2/2007 Anderson Mezzanine Funding 2007-1, Ltd. Equity Marketing Book, GS MBS-E-000892557-598 at 560, 569.

[2341] 2/2007 Anderson Mezzanine Funding 2007-1, Ltd. Debt Marketing Book, GS MBS-E-000855351. Anderson Mezzanine Funding 2007-1, Ltd. Debt Marketing Book, GSC-CDO-FCIC-0031712 at 726. Around the time Goldman was deciding whether to underwrite Anderson, Fred Horton, head of CDOs at GSC, left the firm. While discussing whether to issue or underwrite the CDO with Matthew Bieber, Mr. Ostrem commented: "Will need disclosure on Horton. This looks bad." 2/25/2007 email from Peter Ostrem to Matthew Bieber, GS MBS-E-001996601, Hearing Exhibit 4/27-95.

[2342] Subcommittee interview of Matthew Bieber (10/21/2010).

[2343] Subcommittee interview of Edward Steffelin (12/10/2010). The marketing materials also stated that the Anderson assets were "sourced from the Street." Mr. Steffelin described this as a "weird phrase," but felt it implied "it would be open, sourced from all over." See discussion of the phrase, "sourced from the Street," in the prior section on Hudson 1.

felt that "co-selecting" implied a level of control over the portfolio that GSC didn't have.[2344]

Despite the poor reception by investors, Goldman continued "pushing the axe" with its sales force to sell Anderson securities.[2345] Mr. Bieber identified and monitored potential investors and attempted to sell Anderson securities to pension funds and place Anderson securities in other Goldman CDOs as collateral securities.[2346] On March 20, 2007, when Mr. Bieber reported selling $20 million in Anderson securities, his supervisor, Mr. Ostrem, responded with the single word: "Profit!"[2347] In a separate email a week later, Mr. Ostrem told Mr. Bieber he did "an excellent job pushing to closure these deals in a period of extreme difficulty."[2348]

After several months of effort, Goldman was able to sell only a third, or about $102 million of the $307 million in Anderson securities.[2349] The nine investors included Beneficial Life, Moneygram, and GSC which purchased the entire $11 million class D portion of the CDO.[2350]

Losing Money from Anderson. Due to its inability to sell two-thirds of the Anderson securities, Goldman lost money overall on the CDO. Goldman's biggest gain came from holding 40% of the short position on certain Anderson assets, which produced a $131 million gain at the direct expense of the investors to whom Goldman had sold the Anderson securities. Goldman was also paid $200,000 for serving as the liquidation agent,[2351] and collected $2 million in CDS premiums while it warehoused Anderson assets.[2352]

Despite those gains, Goldman incurred a $185 million loss from the Anderson securities it was unable to sell and had to keep on its books. It

[2344] Id. Despite GSC's not being listed as having helped select the Anderson assets, some investors appeared to be aware of its involvement, perhaps from talking to Goldman personnel. See 3/28/2007 email from Matthew Bieber to Edward Steffelin, "ACA Meeting," GS MBS-E-014419176 ("Questions on [Anderson] – but also want to do manager due diligence. They've heard the GSC team shows well – so want to meet you in person.").
[2345] 3/12/2007 email from Robert Black to Matthew Bieber, others, GS MBS-E-000898037.
[2346] Id.
[2347] 3/20/2007 email from Peter Ostrem to Matthew Bieber and others, GS MBS-E-000906269, Hearing Exhibit 4/27-172.
[2348] 3/27/2007 email from Peter Ostrem to Matthew Bieber, GS MBS-E-000907935, Hearing Exhibit 4/27-172.
[2349] See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.
[2350] GSC paid a price of 108.21% for the securities. See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.
[2351] See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.

[2352] See Goldman response to Subcommittee QFR at PSI_QFR_GS0239.

incurred another $122 million loss due to the decreased value of the securities Goldman had purchased as collateral for the CDO.

Anderson's nine investors suffered more substantial losses. Seven months after its issuance, in November 2007, Anderson securities experienced their first ratings downgrades. At that point, 27% of the assets underlying Anderson were downgraded below a B- rating.[2353] GSC then sold back to Goldman a portion of the Anderson securities it had purchased at a price of 3 cents on the dollar.[2354] Within a year, Anderson securities that were originally rated AAA had been downgraded to BB. In the end, the Anderson investors were wiped out and lost virtually their entire investments.

Analysis. Goldman constructed the Anderson CDO using CDS contracts referencing subprime RMBS securities, the majority of which were issued by subprime lenders like New Century who were known for issuing poor quality loans. When potential investors asked how Goldman was able to "get comfortable" with the New Century mortgage pools referenced in Anderson, Goldman attempted to dispel concerns about the New Century loans, withheld information about its own discomfort with New Century, and withheld that it was taking 40% of the short side of the CDO, essentially betting against the very securities it was selling to its clients. Instead, Goldman instructed its sales force to tell potential investors that Goldman was buying up to 50% of the equity tranche. Goldman also did not disclose to potential investors that it had almost cancelled the CDO due to the falling value of its assets.

CC. Timberwolf I

Timberwolf I was a $1 billion hybrid CDO^2 transaction that Goldman constructed, underwrote, and sold. It contained or referenced A rated CDO securities which, in turn, referenced primarily BBB rated RMBS securities. The assets in Timberwolf were selected by Greywolf Capital Management, a registered investment adviser, with the approval of Goldman. Greywolf served as the collateral manager of the CDO.[2355] Goldman effectively served as the collateral put provider.[2356] Timberwolf was initiated in the summer of 2006, and closed in March 2007.

[2353] 1/3/2008 email from Shelly Lin to Mr. Sparks, GS MBS-E-021880171 (attached file, "Deal Summary," Excel Spreadsheet showing credit ratings for Anderson).

[2354] See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.

[2355] 2/2007 Timberwolf I, Ltd. Marketing Book, GS MBS-E-000676809, Hearing Exhibit 4/27-99a.

[2356] For more information about Goldman's actions as the collateral put provider for Timberwolf, see Section (iii)(BB), below.

Partnering with Greywolf. Greywolf Capital Management was founded by a team of former employees of Goldman's fixed income trading division.[2357] It had experience in constructing and investing in CDOs. In the summer of 2006, Peter Ostrem, head of Goldman's CDO Origination Desk, approached Greg Mount, a former Goldman trader working for Greywolf, and asked if Greywolf would be interested in managing a CDO^2 transaction.[2358] Goldman and Greywolf negotiated a risk sharing agreement, and worked through the profitability of the CDO^2 under expected market conditions. Greg Mount, as well as Joseph Marconi, another former Goldman trader, obtained approval from Greywolf's Chief Investment Officer to manage the CDO.

Greywolf agreed to purchase half of the Timberwolf equity tranche, sharing that risk with Goldman.[2359] In addition, Greywolf agreed to share with Goldman the risk of the assets being purchased for the CDO falling in value before the CDO issued its securities. Greywolf also accepted the responsibility of selecting the assets with the approval of Goldman, which would then keep them in a warehouse account for the Timberwolf CDO. Greywolf agreed to provide ongoing surveillance of the performance of the assets in the CDO and liquidate any assets deemed to be impaired.

Constructing Timberwolf. In September 2006, Greywolf began identifying, purchasing, and warehousing CDO securities or single name CDS referencing CDO securities for Timberwolf.

Before selecting an asset for inclusion in Timberwolf, Greywolf did a detailed credit analysis of the relevant CDO security, including examining its underlying mortgage portfolio, the CDO's cashflow structure, and the mortgage servicer.[2360] Once Greywolf finished its credit analysis, it submitted its choices to Goldman's CDO Origination Desk for review by Mr. Ostrem and Matthew Bieber, who was assigned to be the Goldman deal captain for Timberwolf. Goldman had the right to approve each asset going into the Timberwolf warehouse account and thus onto Goldman's warehouse balance sheet.

Once an asset was approved by both Greywolf and Goldman, it was acquired in one of two ways. In most instances, Greywolf circulated a list of the CDO securities or reference CDO securities that it was interested in buying to the broker-dealer community to get bids. To buy a single name

[2357] 2/2007 Timberwolf I, Ltd. Marketing Book, GS MBS-E-000676809, Hearing Exhibit 4/27-99a.
[2358] Subcommittee interview of Joseph Marconi (10/19/2010).
[2359] Greywolf eventually purchased the entire equity tranche in Timberwolf. See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.
[2360] Subcommittee interview of Joseph Marconi (10/19/2010).

CDS, Goldman wrote the CDS contract, taking the long side on behalf of Greywolf, while the broker-dealer who provided the best bid took the short side. The CDS contract would then be held by Goldman in the Timberwolf warehouse account until the CDO was ready to close.[2361] In some instances, after circulating a list for bids, a broker-dealer responded to Greywolf's request with a price for a single name CDS on a similar CDO security, which Greywolf analyzed and sometimes agreed to acquire.[2362]

Timberwolf's single name CDS and CDO securities were acquired from 12 different broker-dealers.[2363] Goldman was the single largest source of assets, providing 36% of the assets by value, including $15 million in single name CDS contracts naming Abacus securities.[2364] As a result, Goldman held 36% of the short interest in Timberwolf.[2365] Altogether, Timberwolf contained 56 different assets, of which 51 were single name CDS contracts referencing CDO securities and five were cash CDO securities.[2366] The 51 single name CDS contracts referenced both CDO and CDO^2 securities, and each CDO or CDO^2 security contained or referenced its own RMBS, CMBS, or CDO securities or other assets. In total, Timberwolf had over 4,500 unique underlying securities and a grand total of almost 7,000 securities.[2367] This process was further complicated by the fact that the CDO assets in Timberwolf were privately issued and often had little or no publicly available information on the underlying assets they contained.

By the time Greywolf and Goldman were nearing completion of the acquisition of the Timberwolf assets in the spring of 2007, Goldman was becoming increasingly concerned about the deteriorating subprime mortgage market and the falling value of the assets in its CDO warehouse

[2361] In some cases, Goldman was permitted to "top-up" the deal, taking the short side on an additional $5 million in the same CDO security at the same price paid by the auction winner. Greywolf's goal was for each reference asset to be $20 million in size, but often asked for bids on only $10-15 million worth of CDS protection in order to get a better spread. Goldman would then have the option of providing the remaining $5-10 million in CDS protection at the transaction price, resulting in a total position size of $20 million on the Timberwolf balance sheet.

[2362] Joseph Marconi told the Subcommittee that well over half the assets were obtained through auctions, while just a few were negotiated. Subcommittee interview of Joseph Marconi (10/19/2010).

[2363] See Goldman response to Subcommittee QFR at PSI_QFR_GS0192.

[2364] The Abacus securities were cash assets. However, due to the synthetic nature of the Abacus CDOs, Goldman retained a short interest in $15 million in Abacus securities.

[2365] Timberwolf had about one dozen short parties of which Goldman was the largest. See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.

[2366] A total of 84 CDS contracts produced the 51 unique reference assets. See Goldman response to Subcommittee QFR at PSI_QFR_GS0192.

[2367] 8/23/2007 email from Jay Lee to Matthew Bieber, David Lehman, and others, GS MBS-E-001927784.

accounts. In February 2007, Mr. Sparks, the Mortgage Department head, and Goldman senior executive Thomas Montag exchanged emails about the warehouse risk posed by Timberwolf and another pending CDO^2 called Point Pleasant. Mr. Montag asked Mr. Sparks: "cdo squared–how big and how dangerous?"[2368] Mr. Sparks responded: "[R]oughly 2bb [billion], and they are the deals to worry about." Mr. Sparks also told Mr. Montag that, due to falling subprime prices, the assets accumulated in the warehouse account for the $1 billion Timberwolf CDO had already incurred significant losses, those losses had eaten through all of Greywolf's portion of the warehouse risk sharing agreement, and any additional drops in value would be Goldman's exclusive obligation.[2369]

In March 2007, due to the falling values of subprime RMBS and CDO securities, Goldman decided against completing several CDOs under construction, and liquidated the assets in their warehouse accounts. Goldman decided, in contrast, to accelerate completion of Timberwolf.[2370]

Timberwolf I closed on March 27, 2007, approximately six weeks ahead of schedule.[2371] The final CDO had $1 billion in cash and synthetic assets, including $960 million in single name CDS referencing CDO securities, and $56 million in cash CDO securities.

Selling Timberwolf. Selling Timberwolf securities became a high priority for Goldman. Mr. Sparks worked with senior sales managers to review ideas, telling them: "I can't over state the importance to the business of selling these positions and new issues."[2372]

During the spring and summer of 2007, the Goldman Syndicate[2373] emailed the CDO sales force a list of "Senior CDO Axes" or sales directives on a weekly and sometimes daily basis, many of which placed a priority on selling Timberwolf securities.[2374] As early as February, the

[2368] 2/26/2007 email exchange between Tom Montag and Daniel Sparks, GS MBS-E-019164799.
[2369] 2/26/2007 email exchange between Tom Montag and Daniel Sparks, GS MBS-E-010989241.
[2370] 3/7/2007 email from Gaelyn Sharp, GS MBS-E-001800634.
[2371] 3/2007 email chain, "Timberwolf I, Ltd. Preliminary Offering Circular," GS MBS-E-001800634.
[2372] 3/9/2007 email from Daniel Sparks, "Re: Help," GS MBS-E-010643213, Hearing Exhibit 4/27-76.
[2373] According to Goldman personnel interviewed by the Subcommittee, the Syndicate coordinated sales efforts between the CDO Origination Desk and the CDO sales force.
[2374] See, e.g., 4/11/2007 Goldman internal email, "GS Syndicate Structured Product CDO Axes (INTERNAL)," Hearing Exhibit 4/27-101; 4/19/2007 Goldman internal email, Hearing Exhibit 4/27-102; 6/22/2007 Goldman internal email, Hearing Exhibit 4/27-166. These "axe sheets" contained directives for selling Goldman issued securities and other financial products, as well as congratulatory and motivational notes. Some Goldman traders had a negative view of the axe

Goldman sales force developed "broader lists" of clients to target for Timberwolf sales.[2375] After exhausting those initial lists, Goldman sales personnel began to target "non-traditional" buyers[2376] as well as clients outside of the United States.[2377] The sales force had some early successes. On March 28, 2007, for example, the Syndicate included a note in one of the axe sheets:

> "Great job Cactus Raazi trading us out of our entire Timberwolf Single-A position – $16mm. Sales – Good job over the last two weeks moving over $66mm of risk off the axe sheet. Please stay focused on trading these axes."[2378]

As sales began to flag in April, Mr. Sparks sent emails reminding Goldman sales personnel that Timberwolf "is our priority."[2379] On one occasion, on April 19, 2007, Mr. Sparks suggested to a sales manager offering "ginormous credits" as an incentive to sell Goldman's CDO securities: "for example, let's double the current offering of credits for [T]imberwolf."[2380] Mr. Sparks was informed in response: "[W]e have done that with timberwolf already."

On March 9, 2007, Harvey Schwartz, a senior executive at Goldman Sachs, expressed concern to Mr. Sparks and others about what Goldman sales personnel were telling clients: "Seems to me ... one of our biggest issues is how we communicate our views of the market – consistently with what the desk wants to execute."[2381] Mr. Sparks responded by outlining several concerns and the need for the sales team and traders to work together.[2382] He wrote:

> "3 things to keep in mind:
> (1) The market is so volatile and dislocated that priorities and relative value situations change dramatically and constantly.

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sheets. One trader wrote, for example, that he was "guessing sales people view the syndicate 'axe' email we have used in the past as a way to distribute junk that nobody was dumb enough to take first time around." 10/24/2006 Goldman internal email, GS MBS-E-009557699, Hearing Exhibit 4/27-170d.

[2375] 2/14/2007 email from Robert Black to Matthew Bieber and others, GS MBS-E-001996121.

[2376] 3/21/2007 email from Robert Black, "Non-tradition Buyer Base for CDO AXES," GS MBS-E-003296460, Hearing Exhibit 4/27-78.

[2377] 3/2007 Goldman internal email chain, GS MBS-E-010643213, Hearing Exhibit 4/27-76.

[2378] 3/28/2007 Goldman email from the Syndicate, GS-MBS-E-000740958, Hearing Exhibit 4/27-100.

[2379] See, e.g., 4/11/2007 email from Daniel Sparks, GS MBS-E-010533482, Hearing Exhibit 4/27-101.

[2380] 4/19/2007 email from Daniel Sparks to Bunty Bohra, GS MBS-E-010539324, Hearing Exhibit 4/27-102.

[2381] 3/8/2007 email from Harvey Schwartz, GS MBS-E-010643213, Hearing Exhibit 4/27-76.

[2382] 3/9/2007 email from Daniel Sparks, GS MBS-E-010643213, Hearing Exhibit 4/27-76.

(2) Liquidity is so light that discretion with information is very important to allow execution and avoid getting run over.
(3) The team is working incredibly hard and is stretched."

He concluded: "Priority 1 – sell our new issues and our cash positions."

Pricing Timberwolf Securities. Despite the urgency communicated by Goldman management, Timberwolf sales slowed. By May 11, 2007, only one Timberwolf sale had taken place in the previous several weeks.[2383] Goldman personnel also knew that the value of the Timberwolf securities, and the value of their underlying assets, were falling.[2384]

On May 11, 2007, Mr. Sparks notified Goldman senior executives that marking down the value of the unsold CDO securities so that, internally, the firm understood their current market value had become a "real issue":

> "Cdo positions and market liquidity and transparency have seized. I posted senior guys that I felt there is a real issue. ... We are going to have a very large markdown – multiple hundreds. Not good."[2385]

That same evening, Mr. Lehman sent out a "Gameplan" to colleagues in the Mortgage Department announcing that Goldman was going to undertake a detailed valuation of its CDO^2 securities using three different valuation methods, and would also take "a more detailed look" at the values of the assets in the CDO warehouse accounts and in Goldman's own inventory.[2386]

Also on May 11, Chief Credit Officer Craig Broderick sent an email to his team to set up a survey of Goldman clients who might encounter financial difficulty if Goldman lowered the value of the CDO securities they had purchased.[2387] As explained earlier, some Goldman clients had purchased their CDO securities with financing supplied by Goldman that required them to post more cash margin if the financed securities lost

[2383] See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.
[2384] In fact, the decline had begun within a month after Timberwolf closed in late March. 9/17/2007 email from Christopher Creed, "RE: Timberwolf," GS MBS-E-000766370, Hearing Exhibit 4/27-106 (showing price for Timberwolf securities carrying an AAA credit rating had fallen from $94 on 3/31/2007 to $87 on 4/30/2007).
[2385] 5/11/2007 email from Daniel Sparks to Richard Ruzika, GS MBS-E-019659221. Mr. Sparks also noted that he had a meeting with David Viniar, Don Mullen, and Gary Cohn to discuss the issue.
[2386] 5/11/2007 email from David Lehman, GS MBS-E-003361238. For more information on this CDO valuation project, see Section C(5)(a)(iii)BB, above.
[2387] 5/11/2007 email from Craig Broderick, "CDO's - Mortgages," GS MBS-E-009976918, Hearing Exhibit 4/27-84.

value. Other clients had invested in the CDO securities by taking the long side of a CDS contract with Goldman and also had to post more cash collateral if the value of the CDO securities declined. All of these clients would also have to record a loss on their books due to the lowered valuations.

With respect to the CDO securities that had yet to be sold, Goldman senior executive Harvey Schwartz raised another issue related to lowering the values of the CDO securities Goldman was selling to clients: "[D]on't think we can trade this with our clients andf [sic] then mark them down dramatically the next day. ... Needs to be a discussion if that risk exists."[2388] In an email to Mr. Sparks, Mr. Montag, and Mr. Schwartz, Goldman senior executive Donald Mullen acknowledged concerns "about the representations we may be making to clients as well as how we will price assets once we sell them to clients."[2389] The executives also agreed, however, not to "slow or delay" efforts to sell Timberwolf securities if they got "strong bids."[2390]

The CDO valuation project generated many comments on how to price the firm's unsold CDO securities, including Timberwolf. One Goldman employee, who was applying Goldman's most common valuation method to Timberwolf, wrote that the price should be dramatically lower: "Based on current single-A CDO marks, the A2 tranche of Timberwolf would have a price of 72 cents on the dollar."[2391] He also noted:

> "Based on a small sample of single-A CDOs for which we have a complete underlier marks, we believe that the risks of the RMBS underliers are frequently not fully reflected in the marks on the CDOs. If the trends in this small sample are extrapolated, the fair spread on the CDOs could even be double where they are marked now; if that were the case, the price of the A2 tranche of Timberwolf would actually be 35-41 cents on the dollar, depending on the correlation."[2392]

Several days later, in preparation for a meeting with senior executives on the valuation issue, the same Goldman employee calculated that, for the

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[2388] 5/11/2007 email from Harvey Schwartz to Daniel Sparks, Tom Montag, and others, GS MBS-E-010780864.
[2389] 5/11/2007 email from Donald Mullen to Daniel Sparks, GS MBS-E-010780849, Hearing Exhibit 4/27-103.
[2390] Id. at GS MBS-E-010780848-49.
[2391] 5/13/2007 email from Paul Bouchard to David Lehman, Daniel Sparks, and others, GS MBS-E-003361238.
[2392] Id.

A2 tranche of Timberwolf, the "price based on CDO marks" was 66 cents on the dollar, while the "price based on RMBS marks" was 24 cents on the dollar.[2393]

Throughout the valuation process, senior management, including Co-President Gary Cohn, was kept posted on how the Mortgage Department planned to value the firm's CDO assets.[2394] On Sunday, May 20, 2007, the Mortgage Department presented its findings in a 9:00 p.m. conference call with CFO David Viniar and others.[2395] The presentation's executive summary expressed concern about valuing a range of CDO assets, including unsold securities from Goldman-originated CDOs.[2396] The presentation stated: "[T]he desk is most concerned about the CDO^2 positions, comprised of the recent Timberwolf and Point Pleasant transactions. The lack of liquidity in this space and the complexity of the product make these extremely difficult to value."[2397]

The presentation recommended unwinding and selling the assets in the CDO warehouse accounts and using "independent teams" to continue to value the unsold CDO securities from Goldman originations. It also recommended switching to a targeted sales effort for the unsold CDO^2 securities, focused on four hedge fund clients: Basis Capital, Fortress, Polygon, and Winchester Capital.[2398] The Goldman sales force apparently felt those four hedge funds were the clients most likely to buy the CDO^2 securities, and two of them, Basis Capital and Polygon, did subsequently purchase Timberwolf securities.[2399] An appendix to the presentation

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2393 5/20/2007 email from Paul Bouchard, "Materials for Meeting," GS MBS-E-001863725.
2394 5/14/2007 email from Elisha Weisel, "Modeling Approaches for Cash ABS CDO/CDO^2," GS MBS-E-001863618.
2395 5/20/2007 email from Lee Alexander to Daniel Sparks, Donald Mullen, Lester Brafman, and Michael Kaprelian, "Viniar Presentation - Updated," GS MBS-E-010965211 (attached file "Mortgages V4.ppt," "Mortgages Department, May 2007," GS MBS-E-010965212).
2396 Id. At least two drafts of the presentation also stated about Timberwolf and Point Pleasant that "the complexity of the CDO^2 product and the poor demand for CDOs in general has made this risk difficult to sell and the desk expects it to underperform." This assessment was removed from the final version provided to senior executives. See 5/19/2007 email from Dan Sparks to Lee Alexander, and others, GS MBS-E-010973174 (attached file "Mortgages V3.ppt," GS MBS-E-010973175); 5/20/2007 9:52 a.m. draft presentation, "Mortgages V4.ppt," GS MBS-E-010952331; 5/20/2007 email from Lee Alexander to Daniel Sparks, Donald Mullen, Lester Brafman, and Michael Kaprelian, "Viniar Presentation - Updated," GS MBS-E-010965211 (final version) (attached file, "Mortgages Department," GS MBS-E-010965212).
2397 5/20/2007 email from Lee Alexander to Daniel Sparks, Donald Mullen, Lester Brafman, and Michael Kaprelian, "Viniar Presentation - Updated," GS MBS-E-010965211 (attached file "Mortgages V4.ppt," "Mortgages Department, May 2007," GS MBS-E-010965212 at 14).
2398 Id. at 24.
2399 Polygon had already purchased Timberwolf securities prior to the drafting of the presentation, and was apparently targeted for additional Timberwolf or Point Pleasant sales. See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235. Goldman had an existing relationship with Basis Capital. Goldman had engaged Basis Capital several months earlier as a collateral manager of a CDO Goldman was underwriting called Fort

identified another 35 clients for targeted sales efforts and provided an assessment of the CDO sales efforts for each.[2400] Several of those clients later purchased Timberwolf securities.[2401]

Despite Goldman's internal analysis that the value of the Timberwolf securities was in rapid decline, the firm did not lower the prices at which it marketed the securities to clients. In a May 14 email, Mr. Sparks explained his Timberwolf pricing strategy to Mr. Mullen and Mr. Montag:

> "I think we should take the write-down, but market at much higher levels. I'm a little concerned we are overly negative and ahead of the market, and that we could end up leaving some money on the table – but I'm not saying we shouldn't find and hit some bids."[2402]

As a result of the CDO valuation project, Goldman took substantial writedowns on the value of its CDO inventory on May 25, 2007.[2403] For example, Goldman marked down the AAA rated Timberwolf A2 securities to a value of $80.[2404] At the same time, Goldman continued to market them at inflated prices, selling Timberwolf A2 securities to clients at $87.00 on May 24, at $83.90 on May 30, and at $84.50 on June 11.[2405] On May 25, Goldman also marked the AA rated Timberwolf B securities to an internal value of $65.00. Over a month later, Goldman sold $9 million of those AA rated securities to Bank Hapoalim at a price of $78.25, but by then Goldman's internal valuation had fallen to $55, a difference of more than 30% of the market value.[2406]

Denison. Mr. Ostrem, head of the CDO Origination Desk, apparently had a low opinion of the firm, describing the firm in an email to Mr. Bieber as "paranoid" and "not very sharp." He told Mr. Bieber that Goldman should "be nice and just sell them stuff going forward." 1/15/2007 email from Peter Ostrem to Matthew Bieber, GS MBS-E-001125549.

[2400] 5/20/2007 email from Lee Alexander to Daniel Sparks, Donald Mullen, Lester Brafman, and Michael Kaprelian, "Viniar Presentation - Updated," GS MBS-E-010965211 (attached file "Mortgages V4.ppt," "Mortgages Department, May 2007," GS MBS-E-010965212 at 31).

[2401] See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.

[2402] 5/14/2007 email from Daniel Sparks to Tom Montag and Donald Mullen, GS MBS-E-019642797.

[2403] 5/26/2007 email from Michael Swenson to others, GS MBS-E-012443166 (attached file, "ABS Sec_0525," GS MBS-E-012443167).

[2404] These prices indicate a percentage of security's face (par) value. A price of $80 would be 80% of par or 80 cents on the dollar.

[2405] See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235; 6/1/2007 email from David Lehman to Daniel Sparks, GS MBS-E-001866889 (indicating Goldman sold Timberwolf securities to Tokyo Star Bank for $83.90, when Goldman's own mark was 80). Goldman took similar action with respect to its other CDO^2, Point Pleasant, marking down the internal value of its A2 securities to $82.50 on May 25, 2007, while on May 24, 2007, selling $40 million of the A2 securities to a client at a price of $91.00, a difference in market value of $3.4 million. See 5/26/2007 email from Michael Swenson to others, GS MBS-E-012443166 (attached file, "ABS Sec_0525," GS MBS-012443167).

[2406] See 7/12/2007 "Goldman Warehouse SP CDO positions and hedges_7-12-07," GS MBS-E-001866482; See also Goldman response to Subcommittee QFR at PSI_QFR_GS0223

In addition to marketing its CDOs at inflated prices compared to its internal valuations, the Mortgage Department told some clients that the mortgage market was strengthening. On May 14, 2007, for example, Edwin Chin, a trader on the Mortgage Department's ABS Desk, sent this upbeat commentary to both Goldman traders and clients:

> "Incredible as it may seem, the subprime mortgage slump is already [a] distant memory for some. It's been two months since the ABX market plunged amid worries about a housing meltdown, and already investors (and some dealers) are beginning to get 'complacent' again. Blame it on the CDO bids, but with subprime production projected down 40-60% from last year's level, appetite for spread products triumphs any risk concern in the marketplace right now. ABX Index is trading higher as dealers short cover their single name positions after a month of range-bound trading. Flows continue to weigh toward better seller of protection – longs outpace shorts by 3 to 1 as CDO demand has been robust the last two weeks. While warehouse activities might be slow, many CDOs are still looking to finish up their ramp post-closing."[2407]

Daniel Sparks responded to Edwin Chin's commentary by asking senior ABS traders, David Lehman, Mike Swenson, and Joshua Birnbaum: "Is this a head fake or does this make you bullish on all spread product?" Mr. Lehman responded: "[G]iven the sizable short interest in ABS/subprime mkt it does not surprise me that short covering is pushing spds [spreads] tighter. Not sure I would enter new longs here." Mr.

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and PSI_QFR_GS0235. In an interview with the Subcommittee, David Lehman explained that the bid/offer spread (the difference between the price at which a security is offered for sale ["offer price"] and the price at which a bank would buy the same security ["bid price"]) was the reason for the difference between Goldman's internal valuation of the price of the AA rated securities and price at which it sold them to Bank Hapoalim. However, in many instances during this period, it appeared as if Goldman's internal valuation price had no relationship to the bid and offer prices quoted to clients. For example, at the end of June 2007, Goldman provided Timberwolf investor Moneygram with an offer price of $86 for Timberwolf A2 securities and bid price of $83, indicating a bid/offer spread of 3 points. Meanwhile, Goldman had an internal valuation of $75 for the same securities, far different from $83 and $86 quoted to Moneygram. See Moneygram valuation, 7/5/2007 email from Goldman Sachs Operations, "MoneyGram Marks from GS as of 06/29/07," GS MBS-E-022023387; Goldman internal evaluations see "Warehouse SP CDO positions and hedges_6-29-07," GS MBS-E-010809241. See also 6/6/2007 email from Sheara Fredman, GS MBS-E-010795808 and attachment GS MBS-E-010795809. Goldman's pricing in such situations seemed consistent with the strategy articulated earlier by Mr. Sparks, the head of the Mortgage Department, that Goldman should write down the value of the assets, "but market [the CDO securities] at much higher levels," because he was concerned that Goldman was "overly negative and ahead of the market, and that [Goldman] could end up leaving some money on the table." 5/14/2007 email from Tom Montag to Daniel Sparks, GS MBS-E-019642797.

[2407] 5/14/2007 email from Edwin Chin, GS MBS-E-012553986.

Swenson responded: "I would characterize this as a great opportunity to be constructive on the market."[2408]

A few weeks later, Mr. Lehman forwarded an email to Goldman executives informing them "the market feels that GS is being more aggressive than other dealers moving CDO^2 paper," and marking down clients more than their competitors.[2409] Don Mullen responded: "Does this give any one pause about our selling prices?" Mr. Swenson responded to Mr. Mullen: "[N]o pause[.] [E]veryone else is afraid to execute at these levels and they will be wishing for these prices by the end of the summer." Mr. Sparks added: "There is real market meltdown potential (although far from certain)."[2410]

Timberwolf Sales to Basis Capital. At the conclusion of the CDO valuation project, which found that Timberwolf and Goldman's other CDO securities had lost significant value, the Mortgage Department resumed its efforts to push Timberwolf sales.

On Sunday, May 20, 2007, the same day the Mortgage Department made its valuation presentation to Mr. Viniar and recommended targeting Basis Capital for CDO sales, George Maltezos, the Goldman sales representative responsible for Basis Capital, emailed Mr. Lehman saying he would contact the Basis Capital principals immediately upon their return from a business trip the following day.[2411]

Mr. Maltezos began pressing Basis Capital to buy the securities. On May 22, Mr. Maltezos urged Basis Capital to consider buying the securities before the end of the quarter:

> "I appreciate you are flat chat [busy] at the moment, but pls [please] keep in mind GS is an aggressive seller of risk for QTR [quarter] end purposes (last day of quarter is this Friday). We would certainly

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2408 Mr. Birnbaum responded directly to Mr. Swenson: "what a beautiful quote." Id.

2409 6/6/2007 email from David Lehman, GS MBS-E-001936955.

2410 6/6/2007 email from Daniel Sparks, GS MBS-E-001922156. Mr. Lehman further responded: "thk abt this - if we establish a defined + healthy supply/demand dynamic in this product we can always create more CDO^2 at a significant profit vs current levels," meaning that since Goldman's internal marks were so much lower than the bids it was providing clients, if a client chose to buy additional securities at Goldman's bid price, Goldman could sell the securities by taking a short position on a CDS facing the client, and make money on the trade. 6/6/2007 email from David Lehman, GS MBS-E-001936955.

2411 5/20/2007 email from George Maltezos, Goldman Australia sales, to David Lehman, "T/wolf and Basis," GS MBS-E-001863555 ("FYI – basis are back from their 2 week business trip on Monday. My focus will go to timberwolf 100mm AAA and AA block trade with them .... Pls confirm you are willing to trade this at [then-current marks] and that you are not marking these bonds any wider at moment for month end May.").

appreciate your support, and equally help create something where the return on invested capital for Basis is over 60%."[2412]

At the same time Mr. Maltezos was claiming that a Timberwolf investment could provide over a 60% return on invested capital, Goldman's internal marks were showing that Timberwolf was continuing to fall in value.

Basis Capital indicated that it was interested in the Timberwolf securities, but had several issues it needed to work through. First, Basis Capital indicated that Goldman would have to help it find financing for the purchase price.[2413] Second, Basis Capital was concerned about the value of its existing CDO^2 investment with Goldman. On April 19, 2007, Basis Capital had purchased BBB rated Point Pleasant securities at a price of $81.72.[2414] Goldman had provided the financing for this purchase. Two weeks later, Goldman had marked down the value of the securities to $76.72, and asked Basis Capital to post additional cash collateral totaling $700,000.[2415] When Basis Capital asked how the value of the security had fallen $5 in just two weeks, Goldman responded that the price had gone back up to $81.72, and no additional cash was required.[2416]

In May and June 2007, Mr. Maltezos worked to convince Basis Capital to purchase $100 million in Timberwolf securities. At one point Basis Capital pressed for a lower sales price, but was told by Mr. Maltezos: "I don't think the trading desk shares the sentiment with regard to such spread levels [lower prices]."[2417] During the negotiations over the Timberwolf sale, on June 12, 2007, Goldman again marked down the value of the Point Pleasant securities to $75, and again asked Basis to post more cash collateral.[2418] When Basis Capital asked Mr. Maltezos to justify the lower value, Mr. Maltezos wrote:

[2412] 5/22/2007 email from George Maltezos to John Murphy of Basis Capital Management, JUL 000685.
[2413] See. e.g., 5/30/2007 email from George Maltezos to John Murphy and Stuart Fowler, JUL 002032.
[2414] See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.
[2415] See 5/1/2007 email from Macdara Molloy to Phillipa Chen, GS MBS-E-002003102.
[2416] Id.
[2417] 5/30/2007 email from George Maltezos to John Murphy and Stuart Fowler at Basis Capital, JUL 002032. "From a pricing perspective, we have been trading Timberwolf AAA and AA bonds. 550 dm on AAAs and north of 700dm on AAs is considered too wide for Timberwolf. . . . To be constructive, however, I know the desk is entertaining block size trades at the moment from real money accounts in the US and Asia at wide levels (much wider than what they have traded before). To give you a sense, I think these represent 400-450dm and 650-700dm respectively (for size) at the widest level of such enquiries." The notation "dm" refers to "discount margin." Higher discount margins correspond to greater markdowns from par prices. See e.g. Timberwolf I, Price-DM Table 05-16-2007.xls, GS MBS-E-001810225. Basis Capital eventually accepted the 450 and 650 prices suggested by Mr. Maltezos. See 6/13/2007 email from David Lehman to Tom Montag, GS MBS-E-001914580.
[2418] 6/12/2007 email from Sahil Sachdev to George Maltezos, GS MBS-E-001912398.

"[T]here has been further softening in the market since the Point Pleasant trade was put on 8 weeks ago. We have infact [sic] traded some Point Pleasant BBBs at this level in the last 2 weeks."[2419]

In fact, no such sales had taken place, and the lower value could not be justified by any sales transactions.[2420] The lower mark was instead related to Goldman's CDO valuation project in May, which had concluded that its CDO^2 securities had lost significant value.[2421]

Stuart Fowler at Basis Capital brought up the valuation issue in the context of the Timberwolf securities, and asked Mr. Maltezos: "I need to be very clear on this and are we going to see a similar problem on [T]imberwolf?"[2422] Mr. Maltezos responded: "Stuart – I assure you no foul here," and offered to set up some "1-on-1 time with the trading desk" to discuss pricing.[2423]

Mr. Sparks was closely monitoring Mr. Maltezos' ongoing effort to sell the Timberwolf securities to Basis Capital and, on June 13, 2007, sent this email to Mr. Maltezos:

"Let me know if you need help tonight - or feel free to wake up [Mr. Lehman and Mr. Egol] in [S]pain. I'd love to tell the senior guys on 30 at risk comm[ittee] Wednesday morning that you moved 100mm [$100 million]."[2424]

In response, Mr. Maltezos coordinated a call between Basis Capital and Mr. Lehman to "clarify any and all questions you have on the marking

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2419 6/12/2007 email from George Maltezos, PSI-Basis_Capital_Group-03-0001. Mr. Maltezos emailed Mr. Lehman and Mr. Egol about Point Pleasant pricing, asking them "does the 75 mark reflect actual trading or overall softness in the market? I know you had indicated 70 was more like the number." 6/12/2007 email from George Maltezos to David Lehman, Jonathan Egol, and Omar Chaudhary, GS MBS-E-002002522. The Subcommittee was unable to locate Goldman's response to his question.

2420 The most recent Point Pleasant sale had been $40 million worth of the AAA rated A2 securities, which sold on May 24, 2007, for a price of $91. The next most recent sale had been $20 million worth of the A2 securities on April 24, 2007, for a price of $91.30. See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.

2421 Internally, Goldman had marked down the value of the Point Pleasant securities to $50.00. The much higher bid provided to Basis appears consistent with Goldman's strategy to "market at much higher levels." Goldman consistently offered investors bid prices that were much higher than its internal marks during the months of May and June as it attempted to sell its CDO inventory. See 5/26/2007 email from Michael Swenson to others, GS MBS-E-012443166 (attached file, "ABS Sec_0525," GS MBS-012443167).

2422 6/12/2007 email from Stuart Fowler to George Maltezos, GS MBS-E-001912398.

2423 Id.

2424 6/13/2007 email from Daniel Sparks to George Maltezos, David Lehman, and Jon Egol, GS MBS-E-002006149. The reference to the "senior guys on 30" is to Goldman's senior executives who had offices on the 30th floor of the Goldman headquarters in New York.

policy of Goldman, the actual marking of Point Pleasant, and the overall trading that has been seen by the [Goldman] desk in the last 1-6 months."[2425] In that telephone call with Basis Capital, Mr. Lehman apparently corrected Mr. Maltezos' misstatement about recent Timberwolf sales, and Mr. Maltezos followed up with an email to Basis Capital:

> "[P]lease accept my sincerest apologies for the mis-information below. As David mentioned, the 75 mark on Pt Pleasant BBB was more reflective of an interpretation of softer AAA-AA rated CDO-sqd paper translating to BBB part of the curve."[2426]

Later that same day, June 13, 2007, Mr. Lehman reported that Goldman had reached agreement on $100 million in Timberwolf sales to Basis Capital. The sale consisted of the hedge fund taking the long side of a CDS contract with Goldman, referencing $50 million in AAA rated Timberwolf securities and $50 million in AA rated Timberwolf securities.[2427] Mr. Lehman told Mr. Montag that the CDS premiums that Basis Capital had agreed to accept implied a cash price of $84 for the AAA securities and $76 for the AA securities. Mr. Montag asked what Goldman's internal mark was for the Timberwolf AA securities, and Mr. Lehman responded: "$65."[2428]

The Timberwolf sale to Basis Capital was finalized on June 18, 2007.[2429] Goldman provided the financing. Just two weeks later, Goldman informed Basis Capital that the Timberwolf securities had lost value and required the hedge fund to post additional cash collateral.[2430] Basis Capital immediately questioned the new value and asked to see a "comparable market data point for the Timberwolf marks."[2431] In response, Mr. Lehman complained internally: "I would like to know what the precedent there is here – does GS need (outside of the client issue) to provide the below info to justify our prices???"[2432] After Goldman provided additional information, Basis Capital appeared to agree to post the additional collateral.

[2425] 6/13/2007 email from George Maltezos to Stuart Fowler and John Murphy at Basis Capital and others, GS MBS-E-001918603.
[2426] 6/13/2007 email from George Maltezos, PSI-Basis_Capital_Group-02-0001.
[2427] 6/13/2007 email from David Lehman to Tom Montag, GS MBS-E-001914580.
[2428] Id.
[2429] Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.
[2430] 7/4/2007 email exchange among David Lehman, George Maltezos, and others, GS MBS-E-001990127.
[2431] Id.
[2432] 7/4/2007 email from David Lehman, GS MBS-E-001990127.

Eight days later, on July 12, Goldman again marked down the value of the Timberwolf securities to prices of $65 and $60, after having sold them to Basis Capital one month earlier at $84 and $76.[2433] This repricing resulted in a $37.5 million movement in the value of the securities, and required Basis Capital to post substantially more cash collateral with the firm.[2434] On July 13, 2007, Basis Capital told Goldman that one of its funds was "in real trouble."[2435] On July 16, Goldman again marked down Basis Capital's securities to prices of $55 for AAA and $45 for AA.[2436] These prices matched Goldman's internal valuations.[2437] By the end of July, Basis Capital was forced to liquidate its hedge fund.[2438] Goldman bought back the Timberwolf securities from Basis Capital on July 31, at prices of $30 and $25.[2439]

Other Timberwolf Sales. Basis Capital was only one of several clients that Goldman contacted in connection with Timberwolf. On May 24, 2007, a Goldman sales associate told Mr. Lehman and Mr. Sparks that he wanted more information to send to a European hedge fund that was "not experts in the space at all but [I] made them a lot of money in correlation dislocation and will do as I suggest. Would like to show stuff today if possible."[2440] Mr. Lehman told the sales associate that he was available to get on the telephone with the clients, and forwarded him the Timberwolf offering circular and marketing materials.[2441]

On June 5, 2007, Goldman trader Benjamin Case emailed Mr. Lehman with a "[g]ameplan for distribution" or sales of Goldman's remaining CDO^2 securities.[2442] The plan was to target "institutional buyers that can take larger bite size than traditional CDO buyers ... for example Asian banks and insurance companies."[2443] Mr. Case also noted that Goldman was shorting "51 CDO names in the two portfolios [Timberwolf

2433 7/12/2007 email from Jon Egol, GS MBS-E-001866391. On the same day, Goldman's internal marks for the securities were even lower, at $60 for the AAA securities and $55 for the AA securities. As Basis Capital's financial situation became worse, Goldman responded by marking Basis Capital's securities to levels that were closer to Goldman's own internal evaluations.

2434 7/13/2007 email from David Lehman, "Re: Basis," GS MBS-E-001866391 at 93.

2435 Id. at 91.

2436 7/16/2007 email from Jon Egol, "Re: Basis," GS MBS-E-010169281. Goldman also marked down Basis Capital's Point Pleasant securities to $10, from an initial purchase price of $81.72.

2437 7/12/2007 Goldman datasheet, "Warehouse SP CDO positions and hedges_7-12-07," GS MBS-E-001866482.

2438 7/24/2007 email from David Lehman to others, GS MBS-E-013449641.

2439 7/31/2007 letter from Goldman Sachs International to Basis Capital, "Event of Default Under ISDA Master Agreement," JUL 003958.

2440 5/24/2007 email from Yusuf Aliredha to Mr. Sparks, Mr. Lehman, and others, "Priority Axes," GS MBS-E-001934732.

2441 Id.

2442 6/5/2007 email from Benjamin Case to David Lehman, GS MBS-E-001919861.

2443 Id.

and Point Pleasant] and we have been aggressively sourcing further protection in the CDS market on names in the two portfolios recently."[2444]

In early June, Goldman targeted a Korean insurance company called Hungkuk Life for Timberwolf sales. According to a Goldman employee in the Japan sales office, Jay Lee, "the largest hurdle from the client perspective is whether or not they can get the mandate to buy something backed by synthetically sourced CDO's [sic], as they have never bought CDO^2 before."[2445] Mr. Lee was also concerned that the value of the securities would drop soon after the office sold the Timberwolf securities to the insurance company. Mr. Lee stated:

> "[T]he largest hurdle from a sales' perspective is MTM [mark to market]. It is an important client, and if the mark widens out more than 1pt immediately after selling the asset to them, sales cannot sell it. Understanding that it is a volatile asset, sales wants to know that where we sell it to the client will not be more than 1pt less than where the mark would be, provided no new market information."[2446]

It is unclear how his valuation concern was addressed. Later the same day, on June 1, Mr. Lee reported that Hungkuk Life had purchased $36 million in AAA rated Timberwolf securities. Mr. Sparks responded "good job – keep going."[2447]

Six days later, on June 7, 2007, the head of the Goldman Japan sales office, Omar Chaudhary, contacted Mr. Sparks and Mr. Lehman about a possible additional sale of Timberwolf securities to Hungkuk Life. Mr. Chaudhary wrote that the head of Goldman's Korean sales office was "pushing on our personal relationships" to make the sale and wanted to be assured he'd be paid more if he "got it done":

> "Jay and I spoke to the head of Korea Sales today. He said that he feels we can push for H[ungkuk] Life to increase their size from the 36mm of AAA's and wanted to see if we would pay more GC's [sales credits] if he got it done. Told him that if we sell ~45-50mm+ [$45-50 million more] that we would honor the 7.0% even if we trade at the 84.5 dollar px [expected price]. Trust you will support

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[2444] Id.
[2445] 6/1/2007 email from Jay Lee to David Lehman, Matthew Bieber, and others, GS MBS-E-010958182.
[2446] Id.
[2447] Id.

this as we are pushing on our personal relationships to get this done."[2448]

Mr. Lehman and Mr. Sparks told Mr. Chaudhary to "go for it" and "[g]et 'er done."[2449] The Korean office did get it done, and Goldman sold another $56 million in Timberwolf securities to Hungkuk Life at a price of $84.50.[2450] The sales representative was awarded the 7% sales credit.[2451] Mr. Sparks wrote to the sales office: "you boys are awesome and many people are noticing."[2452] Mr. Montag, a senior Goldman executive monitoring the Timberwolf sales, told the mortgage team it had done an "incredible job – just incredible."[2453]

On June 11, 2007, Mr. Lehman received an email from the Goldman Syndicate asking whether the CDO axe sheet, which included directives to sell Timberwolf securities, could be sent to the Japan sales office for re-distribution to sales representatives across Asia. Mr. Lehman agreed: "let's send to all Japan sales."[2454] Two days later, on June 13, 2007, the Japan sales office reported over $250 million in new sales of Goldman's CDO securities, including Timberwolf.[2455]

Mr. Montag continued to monitor the sales of Timberwolf as well as other CDO securities in Goldman's inventory and warehouse accounts. On June 22, 2007, Mr. Sparks reported to him on the completion of a number of sales of CDO and RMBS securities that Goldman had purchased from the two failed Bear Stearns hedge funds. Mr. Montag asked Mr. Sparks to provide him with a "complete rundown" on "what[']s left."[2456] Mr. Sparks responded that the "main thing left" was $300 million in Timberwolf securities. Mr. Montag responded: "boy that timeberwo[l]f was one shitty deal."[2457]

2448 6/7/2007 email from Omar Chaudhary to Daniel Sparks, David Lehman, and Bunty Bohra, GS MBS-E-001866450, Hearing Exhibit 4/27-104.
2449 6/7/2007 emails from Daniel Sparks and David Lehman, GS MBS-E-001866450, Hearing Exhibit 4/27-104.
2450 See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.
2451 See Goldman response to Subcommittee QFR at PSI_QFR_GS0223.
2452 6/10/2007 email from Daniel Sparks to Omar Chaudary and Bunty Bohra, GS MBS-E-010971809.
2453 6/11/2007 email from Tom Montag, GS MBS-E-001866144.
2454 6/11/2007 email exchange between Syndicate and David Lehman, GS MBS-E-001914921-24.
2455 6/13/2007 email from Japan sales office, GS MBS-E-011212260.
2456 6/22/2007 email exchange between Tom Montag and Daniel Sparks, "Few Trade posts," Hearing Exhibit 4/27-105.
2457 Id.

Despite Mr. Montag's assessment of Timberwolf, he continued to press for the sale of Timberwolf securities to Goldman clients. On June 25, 2007, Mr. Sparks emailed Mr. Montag and others with another update on selling Goldman's remaining CDO assets.[2458] Mr. Sparks informed the group that Goldman would probably have to lower the values of the CDO assets over the next few days, but that the net effect for Goldman would be positive, since its short position was larger than its long. In fact, the Mortgage Department made $42.5 million that day.[2459] Mr. Montag remained focused on Timberwolf, responding: "[h]ow are twolf sales doing?"[2460]

On July 12, 2007, another Goldman sales representative, Leor Ceder, reported selling $9 million in Timberwolf securities to Bank Hapoalim at a price of $78.25.[2461] Goldman trader Mitchell Resnick asked Mr. Lehman "to pay him well on this."[2462] Mr. Ceder was paid an 8% sales credit.[2463] That was Goldman's last Timberwolf sale, even though its Syndicate continued to list the CDO as a top sales priority for months afterward.

Goldman ultimately sold about $853 million of the $1 billion in Timberwolf securities to about 12 investors. The unsold securities, with a face value of about $150 million, remained on Goldman's books.

Limited Disclosures. Despite their aggressive sales efforts, Goldman sales personnel typically did not help potential investors analyze the Timberwolf securities and the 4,500 unique assets underlying the CDO. One Goldman employee told his colleagues: "In terms of telling customers. I prefer to give them the general idea of the trade. Then give them the excel spread sheet with our info on ref obs [reference obligations] and let them draw their own conclusions."[2464] Another Goldman employee, discussing a potential buyer of Timberwolf, warned:

2458 6/25/2007 email from Daniel Sparks to Tom Montag, and others, GS MBS-E-010952698.
2459 6/26/2007 email from Deeb Salem to Michael Swenson, GS MBS-E-012371112.
2460 Id.
2461 Goldman's internal price was then $55, 23% less. See 7/12/2007 Goldman datasheet, "Warehouse SP CDO positions and hedges_7-12-07," GS MBS-E-001866482; see Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.
2462 7/6/2007 email from Mitchell Resnick to David Lehman, GS MBS-E-001866752.
2463 See Goldman response to Subcommittee QFR at PSI_QFR_GS0223 and PSI_QFR_GS0235.
2464 5/7/2007 Goldman email chain between Elisha Wiesel and others, "RE: Timeberwolf Analysis," GS MBS-E-003334218. Elisha Wiesel worked with Goldman's legal department on issues related to disseminating information to potential investors. On May 20, 2007, the same day the Mortgage Department presented the conclusions of its CDO valuation project to Mr. Viniar and others, Mr. Wiesel sent an email to Mr. Bieber underscoring concerns about its valuation process: "[G]iven how complex the data is for a CDO^2, there's little chance we'll ever get fully 'comfortable' beyond a shadow of a doubt that there's nothing materially misleading in the data cuts we provide. Is best outcome in this situation to just get a big-boy letter drafted?" 5/20/2007 email from Elisha Wiesel, GS MBS-E-001980637.

> "[H]e is going to want to look at the TWOLF trade on a fundamental basis with a lot of supporting runs to back up any additional mark downs we have – telling him we are busy when it comes to month end and we can't run that analysis because we are resource-constrained will not be good enough."[2465]

Still another Goldman employee stated with respect to Timberwolf and Point Pleasant: "The trickiest part about sharing this [pricing] analysis with custies [customers] is that it shows just how rudimentary our own understanding of these positions actually is."[2466]

Goldman also in many instances refused to provide investors with its pricing methodology or specific prices or values for the CDO securities it was selling. After its securities began to lose value, Basis Capital emailed George Maltezos, David Lehman, and others asking: "How many times do we have to request data points and scenarios by email. These were read out to us on the call and it was agreed that GS would send them through. I am getting weary of continually hearing about transparency and yet an obvious avoidance of 'putting things to paper.'"[2467]

Similarly, when Hungkuk Life requested additional information about the underlying Timberwolf assets, Goldman sent an asset report, but only after removing all of its pricing and valuing information related to those assets.[2468] In August 2007, Jay Lee from Goldman's Japan sales office told a sales associate who was seeking information about Goldman's marks for Tokyo Star Bank:

> "[U]nder no circumstances are we going to be able to provide materials specific to Timberwolf ... or even use the word 'mark' in written materials. ... Everything will be described in general terms, and if what we provide is too vague or general, the medium for further clarification must be oral, not written."[2469]

Mr. Lehman added: "[W]e should be clear that the information we are providing is not our pricing methodology but rather some tho[ugh]ts on the current market."[2470]

[2465] 7/16/2007 email to David Lehman, "Carlyle," GS MBS-E-011050254.
[2466] 5/7/2007 email from Elisha Wiesel, GS MBS-E-004735378.
[2467] 7/7/2007 email from Stuart Fowler, GS MBS-E-011183045.
[2468] 7/31/2007 email from Matthew Bieber to David Lehman, "FW: Requesting Compliance Approval," GS MBS-E-001920215.
[2469] 8/7/2007 email from Jay Lee to others, GS MBS-E-001927858.
[2470] 8/7/2007 email from David Lehman to others, GS MBS-E-001927858.

In an interview with the Subcommittee, Mr. Lehman defended Goldman's aggressive markdowns by noting that Goldman would buy or sell at the prices it quoted to a customer. He explained that if a client thought Goldman's mark was too low, the client could buy more of the securities from Goldman at the low price, then resell them for a profit. Since Goldman's internal valuations were much lower than the price quoted to clients, however, such sales would still produce a profit for the firm.[2471] Furthermore, as Goldman marked down the values in the summer of 2007, it began to decrease the volume of the securities it was willing to buy or sell at the prices it quoted to clients. Goldman was initially willing to buy or sell CDO securities in blocks of $10 million, but by July, it lowered the maximum size to $3 million for some securities and $1 million for others: "Given current market environment, we would like our bid for size for CDO valuations to be MAX $3mm for AAA to AA and $1mm for A and below. No valuations should go out with a bid for $10mm."[2472]

"A Day That Will Live In Infamy." The Timberwolf securities issued by Goldman steadily lost money from the day they were issued. Less than four months after they were issued, on July 16, 2007, Mr. Lehman instructed the Timberwolf deal captain, Mr. Bieber, to "create an 'unwind' spreadsheet ... where we can input CDS spds [spreads]/prices and liability prices so we can determine if unwinding these deals makes sense."[2473] The analysis appeared to show that it would cost Goldman $140 million to unwind Timberwolf, and the conclusion was to "Hold Off."[2474] Instead of unwinding, Goldman continued its sales push.

In September 2007, Mr. Montag asked for data tracking the drop in prices for a Goldman CDO that experienced a dramatic fall in value, such as Timberwolf.[2475] In response, a Goldman employee provided prices for the A2 tranche of the Timberwolf securities using a combination of Goldman's internal marks and the bids provided to investors, from the issuance of the CDO on March 27, 2007 through September. The data showed that, in six months, prices for Timberwolf's AAA rated A2 security had fallen from $94 per security to $15, a drop of almost 80%:

[2471] See 6/6/2007 email from David Lehman, GS MBS-E-001936955. Mr. Lehman stated: "thk abt this – if we establish a defined + healthy supply/demand dynamic in this product we can always create more CDO^2 at a significant profit vs current levels."
[2472] 7/11/2007 email from David Lehman, "CDO Marks," GS MBS-E-013427046 [emphasis in original].
[2473] 7/16/2007 email from David Lehman to Matthew Bieber, GS MBS-E-001913775.
[2474] See 7/17/2007 email from David Lehman to Daniel Sparks, GS MBS-E-010857643 (with attachment GS MBS-E-010857644).
[2475] 9/17/2007 email from Tom Montag, GS MBS-E-000766371, Hearing Exhibit 4/27-106.

"3/31/07	94-12
4/30/07	87-25
5/31/07	83-16
6/29/07	75-00
7/31/07	30-00
8/31/07	15-00
Current	15-00."[2476]

After receiving this pricing history, Mr. Bieber, the Timberwolf deal captain, described March 27, the Timberwolf issuance date, as "a day that will live in infamy."[2477]

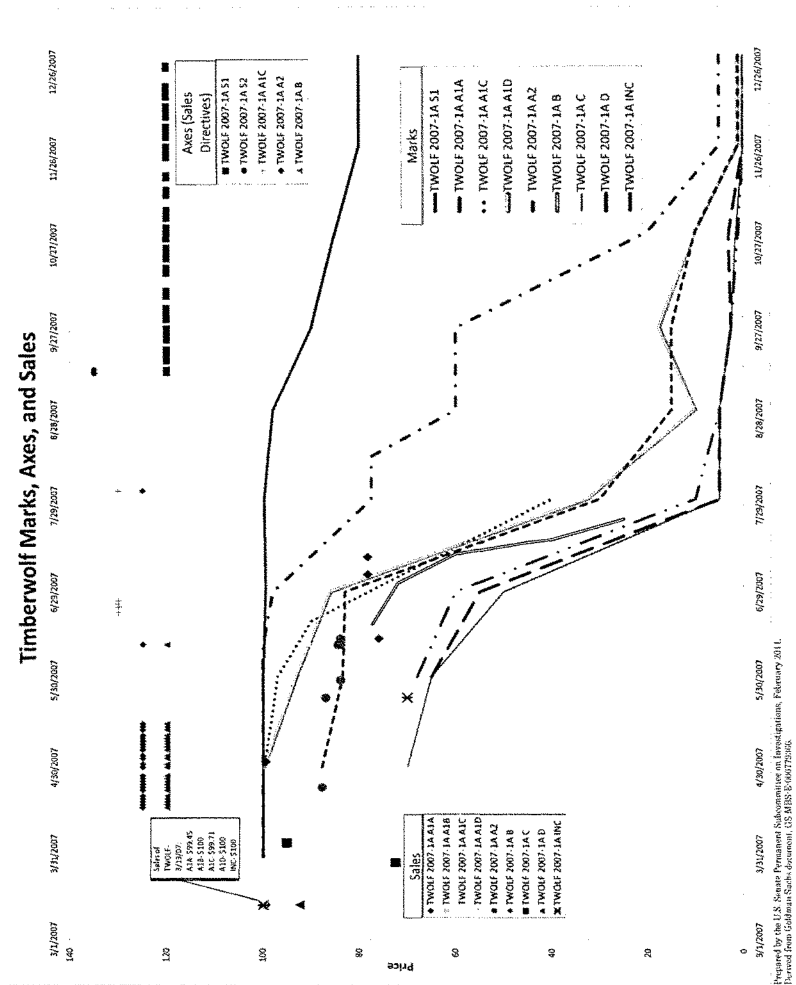
The chart on the next page shows how, between mid-June 2007 and early August 2007, the value of Timberwolf securities dropped precipitously, and that Goldman personnel were aware of its falling value while selling the securities to clients.

> [SEE CHART NEXT PAGE: *Timberwolf Marks, Axes, and Sales*, prepared by the Permanent Subcommittee on Investigations.]

Goldman profited in part from Timberwolf's decline in value due to its 36% short interest in the CDO. In addition, June was the month that Goldman built its $13.9 billion big short, which meant that the decline in most mortgage related assets translated into increasing profits for Goldman.[2478]

Timberwolf experienced its first credit rating downgrades in November 2007, just eight months after the CDO closed and issued its securities. The downgrades included the AAA rated securities. In March 2008, one year after Timberwolf was issued, its AAA securities were downgraded to junk status. In June 2008, a controlling class of debt investors voted to liquidate Timberwolf, and the deal was terminated in October 2008.[2479]

2476 9/17/2007 email from Christopher Creed, GS MBS-E-000766370, Hearing Exhibit 4/27-106.
2477 Id.
2478 Performance Review for Joshua Birnbaum, GS-PSI-01972, Hearing Exhibit 4/27-55c. See also 6/26/2007 email from Deeb Salem to Michael Swenson, GS MBS-E-012371112.
2479 See Goldman response to Subcommittee QFR at PSI_QFR_GS0030.


Timberwolf Marks, Axes, and Sales
Price
Sales
TWOLF 2007-1A A1A
TWOLF 2007-1A A1B
TWOLF 2007-1A A1C
TWOLF 2007-1A A1D
TWOLF 2007-1A A2
TWOLF 2007-1A B
TWOLF 2007-1A C
TWOLF 2007-1A D
TWOLF 2007-1A INC
Axes (Sales Directives)
TWOLF 2007-1A S1
TWOLF 2007-1A S2
TWOLF 2007-1A A1C
TWOLF 2007-1A A2
TWOLF 2007-1A B
Marks
TWOLF 2007-1A S1
TWOLF 2007-1A A1A
TWOLF 2007-1A A1C
TWOLF 2007-1A A1D
TWOLF 2007-1A A2
TWOLF 2007-1A B
TWOLF 2007-1A C
TWOLF 2007-1A D
TWOLF 2007-1A INC
Prepared by the U.S. Senate Permanent Subcommittee on Investigations, February 2011.
Derived from Goldman Sachs document,

Goldman's 36% short position in Timberwolf produced about $330 million in revenues at the direct expense of the clients to whom Goldman had sold the Timberwolf securities. Goldman also made $3 million in interest while the Timberwolf assets were in Goldman's warehouse account. At the same time, because Goldman was unable to sell about a third of the Timberwolf securities and had to keep the unsold securities on its books, it ended up losing $562 million from them. Goldman also lost $226 million from the decline in the value of the collateral securities securing the CDO. When offset by the profits from its Timberwolf short, Goldman ended up with a total loss of about $455 million.[2480]

Timberwolf's investors lost virtually their entire investments. Basis Capital ended up declaring bankruptcy and has filed suit against Goldman.[2481]

Analysis. Goldman constructed Timberwolf using CDO assets that began to fall in value almost as soon as the Timberwolf securities were issued, yet solicited clients to buy the securities. Timberwolf contained or referenced CDO assets with more than 4,500 unique mortgage related securities, but Goldman offered potential investors little help in understanding those securities, and targeted clients with limited or no experience in CDO investments. When marketing Timberwolf, Goldman withheld its internal marks showing the securities losing value and did not mention its short position. Senior Goldman executives knew the firm was selling poor quality assets at inflated prices. Within six months of issuance, AAA Timberwolf securities lost almost 80% of their value. Due to its short position, Goldman profited at the expense of the clients to whom it sold the Timberwolf securities, but it lost money overall because Goldman was forced to retain so many of the unsold Timberwolf securities on its books.

DD. Abacus 2007-AC1

Abacus 2007-AC1 was a $2 billion synthetic CDO whose reference obligations were BBB rated mid and subprime RMBS securities issued in 2006 and early 2007.[2482] It was a static CDO, meaning once selected, its reference obligations did not change.[2483] It was the last in a series of 16

[2480] Id. at PSI_QFR_GS0239.
[2481] Id. at PSI_QFR_GS0030.
[2482] See 3/23/2007 Goldman document, "Abacus 2007-AC1," at 11, GS MBS-E-002807082, Hearing Exhibit 4/27-120; Securities and Exchange Commission v. Goldman Sachs, Case No. 10-CV-3229 (S.D.N.Y.), Complaint (April 16, 2010), at 1, 6 (hereinafter "SEC Complaint against Goldman Sachs").
[2483] 4/2/2007 email from Fabrice Tourre, "ABACUS 07-AC1," GS MBS-E-002011152 (Abacus 2007-AC1 assets are "fully-identified, with no reinvestment, removals, substitutions or

Abacus CDOs referencing RMBS securities designed by Goldman. Goldman served as the underwriter or placement agent,[2484] the lead manager,[2485] and the protection buyer,[2486] and also acted in other roles related to the CDO.[2487] Unlike previous Abacus CDOs, Abacus 2007-AC1 used a third party to select its assets, referring to it as the portfolio selection agent.[2488]

Designing Single Tranche CDOs. Abacus CDOs were known as single tranche CDOs, a structure pioneered by Goldman through its Abacus platform.[2489] Goldman used this structure to design customized CDOs for clients interested in assuming a specific type and amount of investment risk. An Abacus CDO could be issued with a single tranche, designed in coordination with a client who could select the assets the client wished to reference, the size of the investment, and the amount of subordination or cushion before the single tranche of securities would be exposed to loss.[2490] Abacus also enabled investors to short a selected

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discretionary trading").

[2484] Goldman internal documents sometimes describe it as the underwriter for Abacus 2007-AC1, and sometimes as the placement agent. Compare 2/18/2008 Goldman document, "CDO Transactions (July 1, 2006 - December 31, 2007) in which Goldman Sachs acted as underwriter," GS MBS 0000004337, to 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," at 2, GS MBS-E-002406025, Hearing Exhibit 4/27-118 ("Goldman is solely working as agent but retains the option to underwrite the risk as principal.").

[2485] 2/27/2007 email from Curtis Willing, "ABACUS 2007 AC1, Ltd. -- New Issue Announcement (144a/RegS)," GS MBS-E-009209654.

[2486] 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," at 6, GS MBS-E-002406025, Hearing Exhibit 4/27-118 ("Goldman is acting as principal as a protection buyer . . . as well as taking other principal roles.").

[2487] Goldman's additional roles included acting as the basis swap counterparty, the basis swap calculation agent, the collateral put provider, the collateral put calculation agent, the collateral disposal agent, the credit default swap calculation agent, and the initial purchaser. 2/18/2008 Goldman document, "CDO Transactions (July 1, 2006 - December 31, 2007) in which Goldman Sachs acted as underwriter," GS MBS 0000004337; 3/12/2007 Goldman Sachs memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," GS MBS-E-002406025, Hearing Exhibit 4/27-118.

[2488] 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," GS MBS-E-002406025, Hearing Exhibit 4/27-118; April 27, 2010 Subcommittee Hearing at 421.

[2489] Goldman considered its Abacus platform, which commenced in 2004, to be "market-leading." 4/2/2007 email from Fabrice Tourre, "ABACUS 07-AC1," GS MBS-E-002011152; 2/27/2007 Goldman email, "ABACUS-2007-AC1 – Marketing Points (INTERNAL ONLY) [T-Mail]," GS MBS-E-008042545, Hearing Exhibit 4/27-116. See also 6/2007 Goldman document, "CDO Platform Overview," at 31, GS MBS-E-001918722 ("ABACUS is the Goldman brand name for single-tranche CLN [credit linked note] issuances referencing portfolios comprised entirely of structured products."); 4/2006 Goldman presentation "Overview of Structured Products," GS MBS-E-016067482.

[2490] "Subordination" is "[t]he measure of losses that must occur within a portfolio before a tranche is at risk to loss." Tranche size "[r]eflects the notional (value-at-risk) of a structured credit investment" and "is also a measure of leverage." 7/2006 Goldman presentation, "Structured Credit Investments," at 54, GS MBS-E-002055378; 4/2006 Goldman presentation, "Overview of Structured Products," GS MBS-E-016067482. Goldman contended that, in a group of RMBS or CDO securities at the same time. Goldman used the Abacus CDOs not only to sell short positions to investors, but also to carry out its own shorts. As summarized in one Goldman Mortgage Capital Committee Memorandum, the Abacus design allowed "Goldman to short spreads in our core structured products business in large size."[2491] Between 2004 and 2007, Goldman issued 16 Abacus deals referencing RMBS securities, including Abacus 2007-AC1, which together had an aggregate value of $13 billion.[2492]

Responding to Paulson Inquiry. In mid to late 2006, Goldman was approached by the hedge fund Paulson & Co. Inc. (Paulson), and asked to structure a transaction that would enable the hedge fund to short multiple RMBS securities.[2493] Goldman had previously worked with Paulson and was aware that Paulson held strong negative views of the residential mortgage market and was making investments based on that view. The Goldman Mortgage Capital Committee Memorandum seeking approval of Abacus 2007-AC1, for example, stated:

> "Paulson is a macro hedge fund that has taken directional views on the subprime RMBS market for the past few months. In 2006 the Desk worked an order for Paulson to buy protection on a supersenior tranche off a portfolio similar to the Reference Portfolio selected by ACA, and the AC1 Transaction is another means for Paulson to accomplish their trading objective: buying protection in tranched format on the subprime RMBS market."[2494]

An email sent to Daniel Sparks, head of the Mortgage Department, by Fabrice Tourre, a Correlation Trading Desk employee who led the effort on the Abacus CDO for Paulson, was even more blunt:

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single-tranche CDO, investors could customize the tranche risk/return profile by specifying the tranche subordination and tranche size, and that investors could create "credit enhanced" credit exposure through the use of subordination. 4/2006 Goldman presentation, "Overview of Structured Products," at 52, GS MBS-E-016067482. "Combined with tranche size, varying levels of subordination enable investors to tailor both the structural leverage and the risk/return profile of their investment." "Investors are "[n]ot limited by new issuance calendar and bond allocations," are "[n]ot limited by cash bonds in dealer inventory," can "customize[] by sector (e.g. RMBS, CMBS, ABS), rating, vintage, servicer, etc.," and can "meet various investment objectives via structure." 7/2006 Goldman presentation, "Structured Credit Investments," at 54, GS MBS-E-002055378.

2491 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," GS MBS-E-002406025, Hearing Exhibit 4/27-118.

2492 Goldman trading datasheet, GS MBS 0000004276 (showing closing dates and trade details on various CDOs, including Abacus).

2493 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," GS MBS-E-002406025, Hearing Exhibit 4/27-118.

2494 Id.

> "Gerstie and I are finishing up engagement letters ... for the large RMBS CDO Abacus trade that will help Paulson short senior tranches off a reference portfolio of Baa2 subprime RMBS risk selected by ACA."[2495]

These documents make it clear that Goldman knew Paulson's investment strategy was to identify a reference portfolio of assets for the Abacus CDO that Paulson believed would perform poorly or fail, so that its short position would profit at the expense of the long investors.[2496] In addition, during his Subcommittee interview, Mr. Tourre made it clear that he was aware of the Paulson investment strategy.[2497]

In response to the inquiry from Paulson, Goldman proposed structuring an Abacus CDO.[2498] Fabrice Tourre was given lead responsibility for organizing and structuring the Abacus transaction. Goldman's primary role was to act as an agent and administrator of the CDO, obtaining its profit from the fees it charged for the services rendered, rather than from any investment in the CDO itself. In effect, Goldman "rented" the Abacus platform to the Paulson hedge fund and served as Paulson's agent in carrying out the hedge fund's investment objectives. Mr. Tourre had been suggesting that Goldman employ such an approach and supported the arrangement.[2499]

Finding a Portfolio Selection Agent. According to Mr. Tourre, Paulson suggested that Goldman employ an outside portfolio selection agent for the CDO.[2500] However, Paolo Pellegrini, Paulson's Managing Director who led Paulson's selection of the reference assets for the Abacus 2007-AC1 transaction, told the SEC that it was Goldman's idea to have a portfolio selection agent.[2501] At the same time, Goldman internal communications made it clear that the objective was to select a portfolio

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[2495] 2/7/2007 email from Fabrice Tourre, GS MBS-E-003277939, Hearing Exhibit 4/27-114.

[2496] See also 12/18/2006 email from Fabrice Tourre, "Re: Paulson," GS MBS-E-003246145 (a series of email communications regarding the Abacus 2007-AC1 CDO in which Mr. Tourre referred to the asset portfolio that Paulson was proposing for the CDO as "a weak quality portfolio.").

[2497] Subcommittee interview of Fabrice Tourre (4/24/2010). Mr. Tourre also told the SEC that he believed Paulson's selection criteria, such as interest-only mortgages and high loan-to-value ratios, were based on Paulson's view that securities meeting those criteria were "weaker from the credit quality standpoint than other obligations that did not have those characteristics." SEC deposition of Fabrice Tourre (3/3/2009), GS MBS 0000022785, at 813-14.

[2498] Subcommittee interview of Fabrice Tourre (4/24/2010).

[2499] See, e.g., 12/10/2006 email from Fabrice Tourre to David Lehman, GS MBS-E-003453843, Hearing Exhibit 4/27-142.

[2500] Subcommittee interview of Fabrice Tourre (4/24/2010); 2/21/2007 email from Fabrice Tourre to David Lehman, GS MBS-E-011359460-61, Hearing Exhibit 4/27-115.

[2501] SEC deposition of Paolo Pellegrini (12/3/2008), PSI-Paulson-04 (Pellegrini Depo)-0001, at 82-85, 175.

selection agent that would comply with Paulson's suggestions for the assets to be referenced in the CDO. In an email to colleagues discussing the matter, Mr. Tourre suggested finding a manager that:

> "will be flexible w.r.t. [with respect to] portfolio selection (i.e. ideally we will send them a list of 200 Baa2-rated 2006-vintage RMBS bonds that fit certain criteria, and the portfolio selection agent will select 100 out of the 200 bonds)."[2502]

In the early part of January 2007, Mr. Tourre sent an email to prospective selection agents describing their anticipated role in the CDO. One of his points was the following:

> "Reference Portfolio: static, fully identified upfront, and consisting of approx 100 equally-sized mezzanine subprime RMBS names issued between Q4 [the fourth quarter of] 2005 and today. Starting portfolio would be ideally what the Transaction Sponsor shared, but there is flexibility around the names."[2503]

Goldman's internal communications also suggest that Goldman was, in fact, more interested in identifying cooperative portfolio selection agents for its own transactions, rather than locating one for the Paulson CDO. In an email chain discussing a portfolio selection agent for Abacus 2007-AC1, a Goldman employee wrote to a colleague that Mr. Tourre "suggested Faxtor was a potential portfolio selection agent [for Paulson] since they are relatively inexpensive and easy to work with." The colleague responded: "We already have a portfolio in front of Faxtor; they probably will be willing to structure a short that I believe we would want to keep for ourselves ... not sure if this is the best fit."[2504]

Jonathan Egol, chief architect of the Abacus structure and head of the Correlation Trading Desk, suggested that Goldman approach GSC Partners, a New York hedge fund that Goldman had worked with on other CDOs, including Anderson. Mr. Tourre sent an email to colleagues asking:

> "Do you think gsc is easier to work with than faxtor? They will never agree to the type of names paulson wants to use, I don't think steffelin [a senior trader at GSC] will be willing to put gsc's name at

[2502] 12/18/2006 email from Fabrice Tourre, "Paulson," GS MBS-E-003246145; 12/20/2006 email from Fabrice Tourre, GS MBS-E-002534649.
[2503] 1/10/2007 Goldman internal email, GS MBS-E-002480520, Hearing Exhibit 4/27-108; 1/9/2007 email from Fabrice Tourre, "For ACA," GS MBS-E-002480516.
[2504] 12/18/2006 Goldman internal email, GS MBS-E-003246145-46.

risk for small economics on a weak quality portfolio whose bonds are distributed globally."[2505]

A colleague replied:

"There are more managers out there than just GSC / Faxtor. The way I look at it, the easiest managers to work with should be used for our own axes. Managers that are a bit more difficult should be used for trades like Paulson given how axed Paulson seems to be (i.e. I'm betting they can give on certain terms and overall portfolio increase)."[2506]

On January 4, 2007, on behalf of Paulson, Goldman approached GSC Partners as well as two other companies to act as the portfolio selection agent for the Abacus CDO.[2507] Following a meeting among representatives of Goldman, Paulson, and GSC, Mr. Tourre sent an email to his colleagues summarizing the meeting and indicating that Paulson was also looking for a portfolio selection agent that would be willing to accept many of the reference assets it identified:

"At the end of the meeting, the Paulson team told us that they were happy to have met GSC and assuming that (1) GSC could get comfortable with a sufficient number of obligations that Paulson is looking to buy protection on in ABACUS format, (2) GSC could get comfortable being in the market as early as end of January with a transaction under which Gsc is disclosed as Portfolio Selection Agent (without any credit risk removal rights), and (3) Paulson, Goldman, and GSC agree[] on GSC's required compensation for a transaction like this, then Paulson will want to proceed with gsc as soon as possible and be in the market as soon as possible."[2508]

Subsequently, Mr. Tourre reported to his colleagues that GSC had declined the offer to act as the Abacus portfolio selection agent due to its negative views of the assets Paulson wanted to include in the CDO:

[2505] Mr. Egol also suggested HBK as a possible portfolio selection agent. 12/18/2006 email from Fabrice Tourre, "Re: Paulson," GS MBS-E-003246145.

[2506] Id. An email indicates that, in late December 2006, Mr. Tourre was contemplating several possible portfolio selection agents, including "Aladdin, DRCM, Greywolf, and . . . GSC." He also suggested Investec and TCW as possible candidates. 12/18/2006 email from Fabrice Tourre, "Re: Paulson," GS MBS-E-003246145.

[2507] See, e.g., 1/4/2007 email from Fabrice Tourre to Daniel Sparks, "Paulson post," GS MBS-E-002526707 (On January 4, 2007, Goldman "reached out [to] GSC, Greywolf and ACA today re: acting as portfolio selection agent for a Paulson-sponsored trade.").

[2508] 1/6/2007 Goldman email, GS MBS-E-003445985, Hearing Exhibit 4/27-152.

"As you know, a couple of weeks ago we had approached GSC to ask them to act as portfolio selection agent for that Paulson-sponsored trade, and GSC declined given their negative views on most of the credits that Paulson had selected."[2509]

Later, when Goldman began to market Abacus 2007-AC1 securities, Edward Steffelin, a senior trader at GSC, sent an email to Peter Ostrem, head of Goldman's CDO Origination Desk saying: "I do not have to say how bad it is that you guys are pushing this thing."[2510] When asked by the Subcommittee what he meant, Mr. Steffelin responded that he believed that particular Abacus CDO created "reputational risk" for GSC as the collateral manager and for the whole market.[2511]

Goldman and Paulson eventually settled on ACA Capital Management, LLC, a company with experience in selecting assets for CDOs. Goldman employees expressed the hope that ACA's involvement would improve the sales of the Abacus securities. In an internal memorandum seeking approval of the CDO, for example, Goldman personnel wrote: "We expect to leverage ACA's credibility and franchise to help distribute this Transaction."[2512]

Selecting Assets. During January, February, and March 2007, the Abacus reference assets were selected. The Paulson hedge fund initiated the asset selection process by providing Goldman with criteria for choosing RMBS securities for the CDO.[2513] According to Mr. Tourre,

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[2509] 1/29/2007 email from Fabrice Tourre, GS MBS-E-003248998, Hearing Exhibit 4/27-112.

[2510] 2/27/2007 email from Ed Steffelin to Peter Ostrem, "FW: ABACUS 2007-AC1, Ltd. -- New Issue Announcement (144a/RegS)," GS MBS-E-009209654.

[2511] Subcommittee interview of Edward Steffelin (12/10/2010).

[2512] 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," GS MBS-E-002406025, Hearing Exhibit 4/27-118 (The memorandum also stated: "We expect the strong brand-name of ACA as well as our market-leading position in synthetic CDOs of structured products to result in a successful offering." "Partnering with ACA on this innovative, franchise-building transaction will enhance our leadership in the market for structured product synthetic CDOs. We expect that the role of ACA as Portfolio Selection Agent will broaden the investor base for this and future ABACUS offerings." "We intend to target suitable structured product investors who have previously participated in ACA-managed cashflow CDO transactions or who have previously participated in prior ABACUS transactions."). See also SEC Complaint against Goldman at 8. When asked to confirm that Mr. Tourre "suggested that it would be easier to market or to find sort of a counterparty to [Paulson's] short trade if there was a portfolio selection agent involved," Mr. Pellegrini responded, "Right." SEC deposition of Paolo Pellegrini (12/3/2008), PSI-Paulson-04 (Pellegrini Depo)-0001, at 113. Mr. Tourre told the Subcommittee that having an agent gives comfort to potential investors. Subcommittee interview of Fabrice Tourre (4/24/2010).

[2513] At the Subcommittee hearing, Mr. Tourre testified that Paulson produced the portfolio selection criteria. Senator Levin then asked Mr. Tourre, "And did those criteria which Paulson gave to you, were they plugged into your model? Did they generate a list of possible reference securities for that portfolio?" Mr. Tourre responded: "Yes." They "were used to actually trim down the universe of RMBS." April 27, 2010 Subcommittee Hearing at 82.

Goldman's subsequent identification of candidate assets was essentially ministerial, as Paulson's specified criteria had restricted the scope of the RMBS securities that could be proposed.[2514] For example, Paulson wanted RMBS securities that had adjustable rate mortgages, low borrower FICO scores, and mortgages in states with slowing home price appreciation, like Arizona, California, Florida, and Nevada.[2515] Paulson specifically required 2006-vintage or 2007-vintage subprime RMBS that were rated BBB by S&P or Baa2 by Moody's.[2516] Goldman sent Paulson a database and spreadsheet listing the securities that met Paulson's criteria.[2517] Paulson used that database to select 123 securities, and Goldman forwarded the resulting list to ACA.[2518] Over the next two months, a series of negotiations and meetings took place to finalize selection of the reference assets and the structure of the CDO.

[2514] Subcommittee interview of Fabrice Tourre (4/24/2010).

[2515] Paolo Pellegrini told the SEC that Paulson's selection criteria for Abacus 2007-AC1 included RMBS with a maximum weighted average FICO score of 640 and a minimum percentage (80%) of adjustable rate mortgages. Paulson also sought a minimum portfolio size of $750 million. SEC deposition of Paolo Pellegrini (12/3/2008), PSI-Paulson-04 (Pellegrini Depo)-0001, at 140-142. Sihan Shu, an analyst working for Paulson on the Abacus 2007-AC1 reference asset selection, told the Subcommittee that Paulson's selection criteria generally included large percentages of adjustable rate mortgages; high concentrations of mortgages in areas such as California and Florida, where Paulson believed the housing bubble was greater than in other areas; and limited due diligence. Subcommittee interview of Sihan Shu (2/24/2010). See also SEC deposition of Sihan Shu (12/4/2008), PSI-Paulson-04 (Shu Depo)-0001, at 26-28. Similarly, the SEC Complaint listed Paulson's selection criteria as favoring "RMBS that included a high percentage of adjustable rate mortgages, relatively low borrower FICO scores, and a high concentration of mortgages in states like Arizona, California, Florida and Nevada that had recently experienced high rates of home price appreciation." SEC Complaint against Goldman Sachs at 9. However, Goldman's initial submission to the SEC listed Paulson's criteria as only 2006-vintage subprime RMBS rated Baa2 by Moody's. In the Matter of Abacus 2007-AC1 CDO, File No. HO-10911 (SEC), Submission on behalf of Goldman Sachs (September 10, 2009), at 11 (hereinafter "Goldman Sachs Submission"). Goldman's supplemental submission disclosed that Goldman did use additional criteria listed in draft engagement letters between Goldman and Paulson "to guide Goldman Sachs' preliminary search for potential reference securities" that complied with Paulson's criteria, which confirms what Mr. Tourre told the Subcommittee in his testimony at the April 27, 2010 Subcommittee Hearing. In the Matter of ABACUS CDO, File No. HO-10911 (SEC), Supplemental Submission on behalf of Goldman Sachs (September 25, 2009), at 3, 4 (hereinafter "Goldman Supp. Submission"). A January 3, 2007 draft engagement letter listed the following portfolio selection criteria: Baa2 ratings; RMBS issued after March 1, 2006; weighted average FICO scores between 600 and 675; and at least 80% adjustable rate mortgages underlying the RMBS. 1/3/2007 draft engagement letter, PAULSON-ABACUS 0252736, at 40. See also 1/6/2007 email from Fabrice Tourre to Ed Steffelin and others, GS MBS-E-002754054 (listing criteria for the Abacus portfolio as 2006 vintage bonds underwritten after March 1, 2006; Baa2 rated bonds; average FICO score between 600 and 675; RMBS transaction size greater than $500 million; and percentage of adjustable rate mortgages greater than 80%).

[2516] 1/29/2007 email from Fabrice Tourre to Peter Ostrem and others, GS MBS-E-003248998, Hearing Exhibit 4/27-112; Goldman Sachs Submission at 12 (citing Gerst Tr. 13-14).

[2517] See 1/9/2007 email from Gail Kreitman to Laura Schwartz, GS MBS-E-007974381.

[2518] Id.

On March 22, 2007, ACA and Paulson agreed on the final $2 billion reference portfolio for Abacus 2007-AC1.[2519] The assets consisted of 90 Baa2 rated mid and subprime RMBS securities issued after January 1, 2006.[2520] The RMBS securities were "equally-sized," each with a $22.22 million notional value.[2521] Each asset in the final reference portfolio was approved by both Paulson and ACA. Of the final 90 RMBS securities, 49 had been initially proposed by Paulson, and 41 had been initially proposed by ACA.[2522]

Goldman characterized Paulson's participation in the asset selection process as one in which the hedge fund merely "express[ed] [its] views" about the reference portfolio,[2523] which often happens in synthetic CDO transactions.[2524] The evidence indicates, however, that Paulson did more than express its views; it played an active and determinative role in the asset selection process. Paulson established the criteria used to identify the initial list of RMBS securities, proposed a majority of the reference assets in the final portfolio, and approved 100% of the reference assets. Moreover, the "views" expressed by Paulson directly conflicted with the interests of the investors to whom Goldman was marketing the Abacus 2007-AC1 deal. Mr. Pellegrini was quite clear about Paulson's intentions in a deposition with the SEC:

[2519] See 3/22/2007 email from Sihan Shu to Fabrice Tourre and David Gerst, GS MBS-E-003010587.
[2520] 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," GS MBS-E-002406025, Hearing Exhibit 4/27-118; 3/23/2007 Goldman presentation, "ABACUS 2007-AC1," GS MBS-E-002807082, Hearing Exhibit 4/27-120; SEC Complaint against Goldman Sachs at 11; Goldman Sachs Submission at 13.
[2521] 3/12/2007 Goldman internal memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," GS MBS-E-002406025, Hearing Exhibit 4/27-118.
[2522] See "Abacus 2007-AC1 Reference Portfolio," chart prepared by Subcommittee. See also 1/5/2007 email from Sihan Shu to Ed Steffelin, Fabrice Tourre, and others, GS MBS-E-002483408; 1/6/2007 email from Fabrice Tourre to Ed Steffelin and others, GS MBS-E-002754054; 1/9/2007 email from Gail Kreitman to Laura Schwartz, GS MBS-E-007974381; 1/22/2007 email from Laura Schwartz to Fabrice Tourre and others, GS MBS-E-002522389; 1/22/2007 email from David Gerst to Paolo Pellegrini and Sihan Shu, GS MBS-E-002480574; 1/28/2007 email from Fabrice Tourre to Gail Kreitman and David Gerst, GS MBS-E-002444359; 1/31/2007 email from David Gerst to Laura Schwartz, GS MBS-E-002620419; 2/1/2007 email from Laura Schwartz to David Gerst, GS MBS-E-003026086; 2/2/2007 email from Paolo Pellegrini to Laura Schwartz and Sihan Shu, GS MBS-E-002483499; 2/2/2007 email from Laura Schwartz to Paolo Pellegrini and Sihan Shu, GS MBS-E-002483496; 2/5/2007 email from Paolo Pellegrini to Laura Schwartz, GS MBS-E-003062009; 2/5/2007 email from Laura Schwartz to Paolo Pellegrini and others, GS MBS-E-002856966; 2/5/2007 email from David Gerst to Paolo Pellegrini and Sihan Shu, PAULSON-ABACUS 0253248; 2/26/2007 email from Fabrice Tourre to Keith Gorman, GS MBS-E-002444961; 3/22/2007 email from Sihan Shu to Fabrice Tourre and David Gerst, GS MBS-E-003010587; 3/23/2007 Goldman document, "ABACUS 2007-AC1," GS MBS-E-002807082, Hearing Exhibit 4/27-120. Goldman asserted: "The record in this investigation is clear that the overwhelming majority of the securities were identified by ACA." Goldman Supp. Submission at 13. However, the Goldman and Paulson documents reviewed by the Subcommittee show otherwise.
[2523] Goldman Supp. Submission at 10, 13.
[2524] Id. at 10.

Question: Your portfolio analysis was designed in large part to identify bonds that weren't going to perform, right?

Answer: Right.

Question: Because you wanted to short those bonds?

Answer: Right.[2525]

Goldman documents reviewed by the Subcommittee contain conflicting information on exactly who was involved in the asset selection process. Goldman's Mortgage Capital Committee Memorandum on the Abacus CDO, the key internal Goldman document describing the new CDO, stated: "The Reference portfolio has been selected and mutually agreed upon by ACA and Goldman."[2526] In an email to a colleague, however, Mr. Tourre wrote that the portfolio had been selected by "ACA/Paulson."[2527] The Abacus Marketing book identified ACA as the portfolio selection agent for the CDO, and stated that the portfolio selection agent had selected the reference assets.[2528] The Abacus Offering Memorandum stated: "The Initial Reference Portfolio will be selected by ACA Management, L.L.C."[2529]

Another email exchange, between Mr. Tourre and his colleague Mr. Egol, demonstrates the strong influence Paulson had in the selection process. IKB, a German bank that was a frequent investor in past Abacus CDOs and was considering purchasing securities issued by Abacus 2007-AC1, apparently asked to have certain RMBS securities removed from the portfolio and sent the following email to a Goldman sales representative:

> "[D]id you hear something on my request to remove Fremont and New Century serviced bonds? I would like to try to [sic] the advisory com[m]it[t]ee this week and would need consent on it."[2530]

The IKB email was forwarded to Mr. Tourre, who sent it to Mr. Egol with the following message: "Paulson will likely not agree to this unless we tell

[2525] SEC deposition of Paolo Pellegrini (12/3/2008), PSI-Paulson-04 (Pellegrini Depo)-0001, at 175-76.
[2526] 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," at 3, GS MBS-E-002406025, Hearing Exhibit 4/27-118.
[2527] 5/8/2007 email from Fabrice Tourre to Josh Birnbaum, GS MBS-E-003611826, Hearing Exhibit 4/27-123.
[2528] 3/23/2007 Goldman document, "Abacus 2007-AC1," at 11-12, GS MBS-E-002807082, Hearing Exhibit 4/27-120.
[2529] 4/26/2007 Goldman Sachs Offering Circular, "Abacus 2007-AC1, Ltd.," at 2, GS MBS-E-001918034.
[2530] 3/12/2007 email from Jorg Zimmerman (IKB) to Michael Nartey, GS MBS-E-002683134.

them that nobody will buy these bonds if we don't make that change."[2531] Mr. Tourre expressed concern, not about what ACA, the portfolio selection agent, might or might not agree to, but only about what the Paulson hedge fund might agree to.

Failing to Disclose Key Information. Evidence obtained by the Subcommittee indicates that Paulson's role in the Abacus asset selection process and its investment objectives for the CDO were not fully or accurately disclosed to key parties or investors at the time the CDO was being structured and sold.

Moody's, one of the credit rating agencies asked to rate the Abacus securities, was not informed of Paulson's role or investment objectives. At a Subcommittee hearing on the role of the credit rating agencies in the financial crisis, Eric Kolchinsky, a former Moody's managing director who oversaw its CDO ratings and was familiar with Abacus 2007-AC1, provided sworn testimony that he had not known of Paulson's involvement with the CDO at the time it was rated, did not know of Paulson's role in selecting the referenced assets, and believed his staff did not know either. He testified that allowing an entity that wants a CDO to "blow up" to pick its assets "changes the whole dynamic," and was information that he would have wanted to know when rating the securities:

> Senator Levin: And were you or your staff aware at the time that Moody's was working on the ABACUS rating that Paulson was shorting the assets in ABACUS and playing a role in selecting referenced assets expected to perform poorly?
>
> Mr. Kolchinsky: I did not know, and I suspect, I am fairly sure, that my staff did not know either.
>
> Senator Levin: And are these facts that you or your staff would have wanted to know before rating ABACUS?
>
> Mr. Kolchinsky: From my personal perspective, it is something that I would have wanted to know because it is more of a qualitative not a quantitative assessment if someone who intends the deal to blow up is picking the portfolio. But, yes, that is something that I would have personally wanted to know. It changes the incentives in the structure.

[2531] 3/12/2007 email from Fabrice Tourre to Jonathan Egol, GS MBS-E-002648826.

> Senator Levin: Are people usually putting deals together that want the deal to succeed? Isn't that the usual assumption?
>
> Mr. Kolchinsky: That is the basic assumption, yes.
>
> Senator Levin: And if the person wanting the deal to blow up is picking the assets, that would run counter to what the usual assumption is?
>
> Mr. Kolchinsky: It just changes the whole dynamic of the structure where the person who is putting it together, choosing it, wants it to blow up.[2532]

Moody's assigned AAA ratings to two tranches of the Abacus CDO.[2533]

ACA told the Subcommittee that, throughout the asset selection process, it was not informed and remained unaware of Paulson's true investment objective, which was to identify and short a set of assets that it believed would not perform and would lose value.[2534] According to ACA, it believed that Paulson was going to be a long investor in the CDO through its purchase of the equity share that would incur the first losses in the CDO. Contemporaneous ACA documents support that position. An internal ACA Commitments Committee Memorandum on Abacus 2007-AC1 dated February 12, 2007, for example, stated: "The hedge fund is taking the 0-9% equity tranche."[2535] Ten days later, on February 23, 2007, the ACA Managing Director who worked on the Abacus transaction spoke with a Goldman representative, and took notes of the conversation which stated in part: "Paulson taking 0-10%."[2536] In April 2007, the same ACA Managing Director sent an email to the CEO and President of ACA's parent company, ACA Capital Holdings Inc., which was considering buying Abacus securities for itself. Her email stated: "We did price $192 million in total of Class A1 and A2 today to settle April 26th. Paulson took down a proportionate amount of equity (0-10% tranche)."[2537]

[2532] April 23, 2010 Subcommittee Hearing at 63-64.
[2533] See 3/23/2007 Goldman document, "Abacus 2007-AC1," at 14, GS MBS-E-002807082, Hearing Exhibit 4/27-120. Moody's rating of Aaa is equivalent to a AAA rating. Standard and Poor's also rated the Abacus Class A-1 notes and the Class A-2 notes as AAA.
[2534] Subcommittee interview of Laura Schwartz (ACA) (4/23/2010).
[2535] 2/12/2007 "CDO Asset 'Management' Proposal for Abacus 2007-AC1," submitted to ACA Commitments Committee, at 2, ACA-ABACUS-0000121560-66.
[2536] 2/23/2007 handwritten notes of Laura Schwartz, ACA Managing Director of CDO asset management, ACA ABACUS 00004171 at 173.
[2537] 4/10/2007 email from ACA Managing Director Laura Schwartz, ACA-ABACUS-0000006327.

In addition, on January 10, 2007, a few days after ACA was first approached by Goldman about working on the Abacus CDO, Mr. Tourre sent ACA a "Transaction Summary" describing the proposed transaction. The Transaction Summary identified the Paulson hedge fund as the "Transaction Sponsor," described the "Contemplated Capital Structure" of the CDO, and indicated that the lowest tranche, "[0]%-[9]%," was "pre-committed first loss."[2538] The ACA Managing Director told the Subcommittee that the "[0]%-[9]%" tranche identified in the Transaction Summary matched the general description of an equity tranche, and the wording suggested that someone had already committed to buy it.[2539] She explained that it was typical for a CDO sponsor to purchase the equity tranche, and she believed that Paulson, as the Abacus "sponsor," had committed to buy that tranche.[2540] The Abacus Marketing book also specified that the "First Loss" tranche of the CDO, of a "[+10%]" size, was "Not Offered" for sale.[2541] The ACA Managing Director declared in a statement to the SEC that she had interpreted the phrase, "Not Offered," to indicate the equity tranche had been "pre-placed" and "ha[d] already been committed to purchase by an investor and [would] not be marketed."[2542] She thought that investor was the Paulson hedge fund.

When asked about the Transaction Summary description of the lowest tranche in the Abacus CDO, Mr. Tourre told the Subcommittee that the phrase "pre-committed first loss" normally indicated that the tranche had been sold. He stated that he actually meant to communicate that the tranche had not been sold, and that portion of the Transaction Summary was poorly worded.[2543]

In his prepared statement at the Subcommittee hearing, Mr. Tourre testified that he never told ACA that the Paulson hedge fund would be a long investor in the Abacus CDO:

> "I never told ACA, the portfolio selection agent, that Paulson and Company would be an equity investor in the AC-1 transaction or would take any long position in the deal. Although I don't recall the

[2538] 1/10/2007 email from Fabrice Tourre to Laura Schwartz, GS MBS-E-002480520, Hearing Exhibit 4/27-108.
[2539] Subcommittee interview of Laura Schwartz (4/23/2010). See also Statement of Laura Schwartz, ACA ABACUS 00004406 at 408.
[2540] Id. See also 1/10/2007 email from Fabrice Tourre to Laura Schwartz, "Transaction Summary," GS MBS-E-002480520, Hearing Exhibit 4/27-108; SEC Complaint against Goldman Sachs at 14, 15; Goldman Sachs Submission at 32 (citing 1/10/2007 email from Fabrice Tourre to Laura Schwartz, "Transaction Summary," GS MBS-E-003504901).
[2541] 3/23/2007 ACA/Goldman document, "Abacus 2007-AC1," ACA-ABACUS-002807082, Hearing Exhibit 4/27-120; Statement of Laura Schwartz, ACA ABACUS 00004406 at 408.
[2542] Statement of Laura Schwartz, ACA ABACUS 00004406 at 408.
[2543] Subcommittee interview of Fabrice Tourre (4/24/2010).

exact words that I used, I recall informing ACA that Paulson's fund was expected to buy credit protection on some of the senior tranches in this deal. This necessarily meant that Paulson was expected to take some short position in the transaction."[2544]

In addition, Mr. Tourre testified that he informed ACA that the Paulson hedge fund was going to invest only on the short side of the transaction:

> Senator Levin: You did not disclose to ACA that Paulson was on the short side of this deal. Is that correct?
>
> Mr. Tourre: I did mention to ACA that the expectation was that Paulson was going to buy protection on senior layers of risk in the transaction.
>
> Senator Levin: That they were going to be only on the short side.
>
> Mr. Tourre: Yes.[2545]

ACA has since filed a civil lawsuit against Goldman asserting that Goldman did not inform ACA that "Paulson intended to take an enormous short position" in Abacus and is seeking to recover $30 million in compensatory damages and $90 million in punitive damages for fraudulent inducement, fraudulent concealment, and unjust enrichment.[2546]

Regardless of the communications between Goldman and ACA, it is clear that the Abacus marketing material and offering documents provided by Goldman to investors contained no mention of Paulson's short position in the CDO nor the significant role it played in the selection of the CDO's reference assets. This was confirmed by Mr. Tourre at the Subcommittee hearing:

> Senator Levin: And was it reflected in the Goldman Sachs security offering to investors that Paulson had been part of the selection process? Was that represented in that document?
>
> Mr. Tourre: Paulson was not disclosed in the Abacus 07 AC-1 transaction, Mr. Chairman.

[2544] April 27, 2010 Subcommittee Hearing at 44.

[2545] Id. at 86.

[2546] ACA Financial Guaranty Corp. v. Goldman Sachs & Co., Index No. 650027/2011 (N.Y. Sup.), Complaint (January 6, 2011), at 1, 23 (hereinafter "ACA Complaint against Goldman Sachs).

Senator Levin: It was not?

Mr. Tourre: No, it was not.[2547]

Still another troubling omission was Goldman's failure to advise potential Abacus investors that the firm's own economic interests were aligned with those of the Paulson hedge fund. As part of the Abacus CDO arrangement, Paulson agreed to pay Goldman a higher fee if Goldman could provide Paulson with CDS contracts containing premium payments below a certain level.[2548] The problem with the fee incentive offer was that, while lower premiums would result in lower costs to Paulson, it would also result in lower premium payments to the CDO, directly reducing the amount of cash available to the long investors. The Paulson-Goldman compensation arrangement, thus, created a direct conflict of interest between Goldman and the investors to whom it was selling the Abacus securities.

Selling Abacus Securities. Abacus 2007-AC1 closed, and its securities were issued on April 26, 2007. They were issued later than the securities from the Hudson, Anderson, and Timberwolf CDOs and hit the market as subprime mortgages were hitting record delinquency and default rates. Goldman sold the Abacus 2007-AC1 securities to just three investors: IKB, the German bank; ACA, the portfolio selection agent; and ACA Financial Guaranty Corp., the owner of ACA and a wholly owned

[2547] April 27, 2010 Subcommittee Hearing at 86.
[2548] See 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transaction sponsored by ACA," GS MBS-E-002406025, Hearing Exhibit 4/27-118 ("Goldman will receive an upfront premium from Paulson for distributing risk at or within specified strike spreads." "If Goldman succeeds in placing a given Targeted Tranche inside the related Strike Spread, Goldman will receive from Paulson a fee on the notional amount of such Targeted Tranche distributed. Such fee will have a floor component (the 'Minimum Fee Rate') and an upside sharing component, under which Goldman will share with Paulson any execution delivered at levels tighter than the Strike Spreads."). See also 1/18/2007 email from Fabrice Tourre to David Lehman and others, GS MBS-E-002483446 (detailing the additional fees Goldman could earn by executing trades within the strike spread of each tranche); 3/14/2007 email from Paolo Pellegrini to Sihan Shu with "ACA ABACUS Paulson Fee Illustration" spreadsheet attached (the spreadsheet provides details of the incentive-based fees paid to Goldman, including for Goldman's pricing of spreads), PAULSON-ABACUS 0250401. Mr. Pellegrini told the SEC that Goldman and Paulson had discussions regarding Goldman's compensation, resulting in "a formula that tied their compensation to sort of kind of the spread that they sort of presented to or that they would present to us." SEC deposition of Paolo Pellegrini (12/3/2008), PSI-Paulson-04 (Pellegrini Depo)-0001, at 118-19. Mr. Tourre described the compensation agreement in an email to Mr. Sparks, writing that if Goldman could place super senior risk inside a certain spread, Paulson would pay Goldman an upfront fee and periodic fees reflecting the money Goldman saved Paulson. 9/8/2006 email from Fabrice Tourre to Dan Sparks, GS MBS-E-009516671. Mr. Tourre told the SEC that Paulson was "comfortable buying protection only to the extent that the spreads they were paying were less than a certain level." SEC deposition of Fabrice Tourre (3/3/2009), GS MBS 0000022785, at 899-900.

subsidiary of ACA Capital Holdings Inc.[2549] IKB bought $150 million of the AAA rated Abacus securities. ACA bought about $42 million in the AAA securities for placement in another CDO it was managing. [2550] ACA Financial Guaranty Corp. was by far the largest investor, taking the long side of a $909 million CDS contract referencing the super senior portion of the CDO.[2551] Goldman took the short side of the CDS contract, which it then transferred to Paulson.[2552]

Within months, the high risk subprime mortgages underlying the RMBS securities referenced in the Abacus portfolio incurred steep rates of default, and the Abacus securities began to lose value. According to the SEC, by October 2007, six months after the securities were issued, 83% of the underlying assets had received a credit rating downgrade and 17% of the underlying assets had been placed on a negative credit watch.[2553] On October 26, 2007, a Goldman employee sent an email about Abacus 2007-AC1 with an assessment even more negative than that of the SEC:

[2549] SEC Complaint against Goldman Sachs at 18. See Credit Default Swap Insurance Policy, ACA ABACUS 00001593. ACA complaint against Goldman Sachs at 15, 16.

[2550] See Goldman trading datasheet, GS MBS 0000004276 (showing closing dates and details on various deals, including Abacus).

[2551] 5/8/2007 email exchange between Joshua Birnbaum and Fabrice Tourre, "Post on Paulson and ABACUS 07-AC1," GS MBS-E-003352815; 4/13/2007 email exchange between Fabrice Tourre and Charlie Remnant, "ABACUS 07-AC1," GS MBS-E-002485172; 5/9/2007 email to Fabrice Tourre, "ABN Amro," GS MBS-E-002461503. ABN AMRO Bank N.V. (ABN), a large European bank, intermediated the swap between Goldman and ACA Financial Guaranty Corp.

[2552] The CDS contracts were executed between Goldman Sachs International and Paulson Credit Opportunities Master II Ltd., one of the Paulson hedge funds. 4/9/2007 email from Nicholas Friedman to Fabrice Tourre and others, "Re: ABACUS 07-AC1," GS MBS-E-002449178.

Shortly before the Abacus 2007-AC1 transaction closed, Goldman agreed to take the long side of a CDS contract on the performance of a small portion of Abacus' underlying assets when Paulson wanted to increase its short position at the last minute. Although Goldman ended up retaining this long investment, it did so only because it could not find an investor who would buy it. Mr. Tourre admitted this fact in the April 27, 2010 Subcommittee Hearing.

> Senator Levin: Did Goldman intend to keep a long stake in that transaction when the deal was structured? I know it ended up with a piece. Was it intended that it end up with a piece of that deal?
>
> Mr. Tourre: We tried to hedge our risk by selling that piece as well, but were not successful in doing so.
>
> Senator Levin: So it was intended to sell that piece?
>
> Mr. Tourre: For prudent risk management reasons, we were trying –
>
> Senator Levin: Oh, I am sure for all the right reasons. But it was intended that Goldman not have any long stake on that piece. Is that correct?
>
> Mr. Tourre: Yes.

See also 6/5/2007 email from David Gerst to Jonathan Egol, GS MBS-E-002469912, Hearing Exhibit 4/27-126.

[2553] SEC Complaint against Goldman Sachs at 3.

"This deal was number 1 in the universe of CDO's that were downgraded by Moody's and S&P. 99.89% of the underlying assets were downgraded."[2554]

The three long investors in Abacus 2007-AC1 together lost more than $1 billion. As the sole short investor, Paulson recorded a corresponding profit of about $1 billion.[2555]

On April 16, 2010, the SEC filed a complaint against Goldman and Mr. Tourre, alleging their actions constituted securities fraud.[2556] The SEC specifically alleged violations of Section 17(a) of the Securities Act of 1933, as well as Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.[2557] The SEC contended that Goldman had failed to disclose to potential investors materially adverse information, that the party shorting the reference assets was the same party that had played a significant role in selecting those assets.[2558] On July 14, 2010, Goldman reached a $550 million settlement with the SEC.[2559] In connection with the settlement, Goldman acknowledged:

"[T]he marketing materials for the ABACUS 2007-AC1 transaction contained incomplete information. In particular, it was a mistake for the Goldman marketing materials to state that the reference portfolio was 'selected by' ACA Management LLC without disclosing the role

[2554] 10/26/2007 email from Goldman salesman to Michael Swenson, "ABACUS 2007-AC1 – Marketing Points (INTERNAL ONLY) [T-Mail]," GS MBS-E-016034495.
[2555] SEC Complaint against Goldman Sachs at 3.
[2556] See SEC Complaint against Goldman Sachs.
[2557] Pursuant to 15 U.S.C. §78j(b) and 17 C.F.R. §240.10b-5, the SEC alleged that Goldman and Mr. Tourre, "in connection with the purchase or sale of securities or securities-based swap agreements, by the use of means or instrumentalities of interstate commerce or of the mails, directly or indirectly (a) employed devices, schemes or artifices to defraud; (b) made untrue statements of material facts or omissions of material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon persons." SEC Complaint against Goldman Sachs at 20-21. The SEC alleged that Goldman and Mr. Tourre "knowingly or recklessly misrepresented in the term sheet, flip book and offering memorandum for ABACUS 2007-AC1 that the reference portfolio was selected by ACA without disclosing the significant role in the portfolio selection process played by Paulson, a hedge fund with financial interests in the transaction adverse to IKB, ACA Capital and ABN. Goldman&Co and Tourre also knowingly or recklessly misled ACA into believing that Paulson invested in the equity of ABACUS 2007-AC1 and, accordingly, that Paulson's interests in the collateral section process were closely aligned with ACA's when in reality their interests were sharply conflicting." SEC Complaint against Goldman Sachs at 21. Similar charged were filed pursuant to 15 U.S.C. § 77q(a)(1), (2) and (3). See SEC Complaint against Goldman Sachs at 19.
[2558] SEC Complaint against Goldman Sachs at 2, 20, 21.
[2559] Securities and Exchange Commission v. Goldman, Sachs & Co. and Fabrice Tourre, Case No. 10-CV-3229, (S.D.N.Y.), Consent of Goldman Sachs, (July 14, 2010), at 1, 2, 10 (hereinafter "Consent of Goldman Sachs").

of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors."[2560]

Analysis. Goldman constructed Abacus 2007-AC1 to help a hedge fund short multiple RMBS securities. Goldman allowed the hedge fund to play a significant role in the selection of the CDO's referenced assets, while employing an outside portfolio agent to give the impression that the CDO assets were selected by a disinterested third party. Goldman failed to disclose the hedge fund's investment objective and asset selection role to a credit rating agency that assigned AAA ratings to two tranches of the Abacus securities. Goldman also failed to provide full disclosure to the long investors to whom it sold the Abacus securities. In addition, Goldman failed to disclose to the investors a compensation arrangement that provided incentives for Goldman to minimize the premium payments into the CDO. Within six months, the Abacus securities began incurring losses and ratings downgrades. Goldman watched the long investors to whom it had sold the securities lose virtually all the funds they had invested, while the hedge fund it had assisted walked away with a profit of approximately $1 billion.

(iii) Additional CDO Conflicts of Interest

In addition to creating and failing to manage conflicts of interest arising from its design and sale of CDO securities, Goldman at times allowed conflicts of interest to affect how it carried out key roles in the administration of its CDOs.[2561] Two examples, in which Goldman acted as the liquidation agent in Hudson 1 and the collateral put provider in Timberwolf, illustrate the problems. In both cases, Goldman used its administrative roles to promote and enhance its own financial interests at the expense of the clients to whom it had sold the CDO securities.

[2560] Consent of Goldman Sachs at 2. Despite this acknowledgment by Goldman as part of the settlement, when asked during the Subcommittee hearing if "a non-biased person [could] look at the facts [of Abacus 2007-AC1] as you see them and say there is a question of unethical behavior here," David Viniar, the executive vice present and chief financial officer for Goldman, stated he "didn't believe so." April 27, 2010 Subcommittee Hearing at 125.

[2561] Some of the administrative roles that Goldman filled in its CDOs, as described in its CDO agreements, included: Initial Purchaser, Synthetic Security Counterparty, Senior Swap Counterparty, Credit Protection Buyer, Liquidation Agent, Calculation Agent under U.S. Dollar Cash Flow Swap Transaction, Collateral Put Provider, CP Note Placement Agent, Portfolio CDS Counterparty, Hedge Counterparty - Cashflow Swap, Collateral Disposal Agent, Credit Default Swap Calculation Agent, Basis Swap Counterparty, and Basis Swap Calculation Agent. 2/18/2008 document prepared by Goldman Sachs, outlining the parties serving each role in Goldman underwritten CDOs, GS MBS 0000004337.

AA. Liquidation Agent in Hudson 1

In 2006 and 2007, several Goldman CDOs included provisions establishing a "liquidation agent" to sell any poorly performing assets in the CDO. This feature appeared in Hudson Mezzanine 2006-1, which is examined in this Report, as well as Hout Bay 2006-1, Hudson High Grade 2006-1, Hudson Mezzanine 2006-2, and Anderson Mezzanine 2007-1.[2562] In each instance, Goldman served as the initial liquidation agent, although in several CDOs, it later transferred the role to a third party. In Hudson 1, Goldman's dual roles as liquidation agent and sole short party in the CDO created a direct conflict of interest between Goldman and the clients to whom it sold the Hudson securities, which Goldman exploited by placing its own financial interests ahead of those of its clients.

Designing the Liquidation Agent Role. According to Goldman, appointing a CDO liquidation agent was a "fairly novel idea" that was first implemented in the 2006 Hout Bay CDO.[2563] Peter Ostrem, then head of the CDO Origination Desk, oversaw the drafting of the liquidation agent feature.[2564] He told the Subcommittee that Goldman wanted to issue static portfolio CDOs, meaning CDOs whose assets did not change over time, but also wanted to protect investors from poorly performing assets. He explained that the liquidation agent feature was intended to be triggered by a specified event and provided the liquidation agent with "no discretion" other than to sell the poorly performing asset, which was referred to as a "Credit Risk Asset." He explained that, without such a feature, poorly performing assets would "just stay there" in a CDO, further harming investors.[2565] The CDO Origination Desk also favored the approach, because it could be performed by Goldman itself at a lower cost than retaining a traditional collateral manager.[2566]

The liquidation agent provisions established criteria for identifying "Credit Risk Assets" and removing them from the CDO. In a July 2006 memorandum to the Goldman Mortgage Capital Committee, the CDO Origination Desk described the liquidation agent role as follows:

[2562] 2/18/2008 Goldman presentation, "CDO Transactions (July 1, 2006 - December 31, 2007) in which Goldman Sachs acted as underwriter," GS MBS 0000004337, at 4340; 7/19/2007 Goldman document, "GS Liquidation Agent Role in ABS CDOs," GS MBS-E-014055117.
[2563] Subcommittee interview of Darryl Herrick (10/13/2010).
[2564] Subcommittee interview of Peter Ostrem (10/5/2010).
[2565] Id. Although Mr. Ostrem helped design the liquidation agent feature, he was not employed by Goldman when its CDO assets were downgraded and triggered its liquidation agent duties.
[2566] See 7/17/2006 Goldman memorandum to the Mortgage Capital Committee, "Placing debt and equity on a static high grade structured product CDO Squared with Investec (UK) Limited," GS MBS-E-013458155.

"As Liquidation Agent, Goldman will liquidate assets determined by the Trustee to be 'Credit Risk Assets' based on specific guidelines. Goldman will have 12 months to sell these assets. Sales will be made under a competitive bidding process, whereby we will solicit three outside bids and select the highest. Prior to executing Hout Bay 1, in which we also played the Liquidation Agent role, we spoke to multiple counterparties as to our role as Liquidation Agent. We received approval for our role in this transaction from legal and accounting. ... Finally, we spoke with outside counsel, Wilmer Cutler, about potential issues related to the Investment Advisor Act. They are of the opinion that our role of Liquidation Agent does not cause us to be deemed an Investment Advisor based on the exception to the Advisors Act for a 'limited grant of discretion.'"[2567]

One key issue discussed in the memorandum was whether, by assuming the role of liquidation agent, Goldman would trigger registration and disclosure obligations under the Investment Advisers Act of 1940. The CDO Origination Desk wrote:

"We have discussed Goldman's role as Liquidation Agent internally with Tim Saunders [counsel in Goldman's legal department] and externally with outside counsel, Wilmer Cutler. One concern about that role was whether Goldman would be viewed as an Investment Advisor. We specifically crafted Goldman's role in Hout Bay 1 and in this case to eliminate both internal and external counsel's concern about Goldman being treated as an Investment Advisor. The main factors that made Tim Saunders and Wilmer Cutler comfortable that Goldman will not be treated as an Investment Advisor were:

- Goldman's role is Liquidation Agent and not Collateral Manager. Goldman is engaged by the CDO to liquidate Credit Risk Assets and will receive an ongoing Liquidation Agent Fee for such services;

- Goldman does not determine whether an asset is a Credit Risk Asset. Such determination is made by the CDO based on specific rules . . . ;

- Goldman must liquidate such Credit Risk Assets within 12 months of such determination and the price received on such liquidation must be in the context of a three-bid process;

[2567] Id.

- Goldman does not receive additional compensation and or control of the CDO for acting as a Liquidation Agent. ...

We will build a provision in the deal documents to allow Goldman to resign as Liquidation Agent if appropriate notice is given and a replacement Liquidation Agent is in place."[2568]

This memorandum indicates that, from its inception, the liquidation agent function was designed as a narrow, ministerial role, in part to avoid the legal obligations applicable under federal law to investment advisers.

The memorandum also indicated that "Credit Risk Assets" would be identified through objective criteria. For example, in the CDO under review, the memorandum stated that Credit Risk Assets would be defined as "[a]ny asset that is downgraded by Moody's or S&P below Ba2" and "[a]ny asset that is defaulted."[2569]

Credit Rating Downgrades. One year later, on July 19, 2007, after Mr. Ostrem had left Goldman and Mr. Lehman had assumed responsibility for all Goldman-originated CDOs, he held a conference call with members of the CDO team and Goldman in-house legal counsel Tim Saunders, to discuss how to carry out Goldman's CDO liquidation agent responsibilities. The prior week, Moody's and S&P had suddenly downgraded hundreds of RMBS and CDO securities in the first of many mass downgrades. Those downgrades suddenly caused a number of assets in Goldman's CDOs to qualify as Credit Risk Assets that had to be liquidated.

In advance of the conference call, Mr. Lehman's staff prepared a two-page summary of Goldman's liquidation agent duties, the liquidation procedures specified in the CDO documents, the CDOs affected, and the assets that Goldman anticipated would be affected by the downgrades.[2570]

Four days after the conference call, on July 23, 2007, Benjamin Case, who had been assigned lead responsibility for carrying out Goldman's liquidation agent functions, circulated a draft document describing Goldman's role. It stated that Goldman's goal as liquidation agent was:

"to attempt to maximize proceeds on the unwind of credit risk assets pursuant to the liquidation process governed by the CDO documents,

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[2568] Id.
[2569] Id.
[2570] 7/19/2007 Goldman document, "GS Liquidation Agent Role in ABS CDOs," GS MBS-E-014055117.

rather than to liquidate at an arbitrary pre-specified time without regard to market conditions."[2571]

It identified the assets that had been classified as Credit Risk Assets and provided Goldman's "Current Strategy" for handling them:

"– wait and continue to evaluate market conditions, rather than liquidating now.
- upside is that continued short-covering by hedge funds anxious to monetize profits could cause minor rally (5-10 points)[.]
- downside is that speed up of foreclosure process vs. current timeline expected by market could decrease IO value, or significant forced selling of similar names by CDO vehicles could push levels wider [lower prices]."

Hudson Liquidation Agent. Although the liquidation agent role was originally designed for use in Goldman's "high grade" CDOs, where "there is substantially less credit risk in the assets vs. a mezzanine structured product CDO portfolio," the feature was also added to some of its riskier mezzanine CDOs, including Hudson Mezzanine 2007-1 (Hudson 1).[2572] Hudson 1 was a synthetic CDO whose assets consisted entirely of CDS contracts referencing subprime RMBS or ABX assets with BBB or BBB- ratings. Goldman had selected 100% of the reference assets and held 100% of the short side of the CDO.

Hudson 1's marketing materials outlined Goldman's liquidation agent role. The Hudson marketing booklet, for example, told potential investors:

"Hudson CDOs are non-managed and static in nature and provide term non-recourse funding where Goldman Sachs acts as Liquidation Agent on an ongoing basis. The Liquidation Agent will be responsible for efficiently selling credit risk assets."[2573]

The Hudson term sheet provided additional information about the liquidation agent role and the "Credit Risk Assets" that would have to be liquidated:

[2571] 7/23/2007 email from Mr. Case to Mr. Bieber, "CDO Liquidation Agent Role - Draft Talking Points - INTERNAL USE ONLY," GS MBS-E-015240358.
[2572] 7/17/2006 Goldman memorandum to Mortgage Capital Committee, GS MBS-E-013458155, at 57. A "mezzanine" CDO is one in which the underlying assets carry credit ratings such as BBB or BBB-.
[2573] 10/2006 "Hudson Mezzanine 2006-1 Flipbook," GS MBS-E-009546963, Hearing Exhibit 4/27-87.

"Goldman as Liquidation Agent, will liquidate any asset determined to be a 'credit risk' within 12 months of said determination. Credit Risk assets will include: any asset downgraded by Moody's or S&P below Ba3 or BB-, any asset that is defaulted or would be experiencing a credit event as defined by the PAUG [Pay As You Go] confirm. There will be no reinvestment, substitution, discretionary trading or discretionary sales. After closing, assets that are determined to be 'credit risk' securities will be sold by the Liquidation Agent within one year of such determination."[2574]

The Hudson Offering Circular repeated that information and added:

"The Liquidation Agent will not have the right, or the obligation, to exercise any discretion with respect to the method or the price of any assignment, termination or disposition of a CDS Transaction; the sole obligation of the Liquidation Agent will be to execute such assignment or termination of a CDS Transaction in accordance with the terms of the Liquidation Agency Agreement. ... [T]he Liquidation Agent shall have no responsibility for, or liability relating to, the performance of the Issuer or any CDS Transaction, Reference Obligation, Collateral Security or Eligible Investment."[2575]

Goldman charged a 10 basis point ongoing fee for serving as the Hudson Liquidation Agent,[2576] which resulted in its being paid a total fee of approximately $3.1 million.[2577]

While Goldman was marketing Hudson in 2007, a client asked why the liquidation agent was "afforded up to 12 months to sell a credit risk asset."[2578] The Subcommittee was unable to find Goldman's contemporaneous response, but when asked the same question, Darryl Herrick, the Hudson deal captain, told the Subcommittee that there was "headline risk" associated with the downgrade of an asset, and twelve months gave Goldman "flexibility to try to get a better price later."[2579] When asked whether the "flexibility" to delay a sale violated Hudson's prohibition against discretionary trading by the liquidation agent, Mr. Herrick said that Goldman had "discretion based on a rule," and that the

2574 Goldman Sachs Hudson Mezzanine Funding 2006-1, LTD Preliminary Termsheet, GS MBS-E-001557869.
2575 12/3/2006 Hudson Mezzanine 2006-1, LTD. Offering Circular, GS MBS-E-021821196 at 234.
2576 10/2006 "Hudson Mezzanine 2006-1 Flipbook," GS MBS-E-009546963, Hearing Exhibit 4/27-87.
2577 See Goldman Sachs response to Subcommittee QFR at PSI_QFR_GS0239.
2578 10/6/2006 email from Michael Halevi to Olivia Ha, GS MBS-E-014338525.
2579 Subcommittee interview of Darryl Herrick (10/13/2010).

liquidation agent provisions had been vetted with the credit rating agencies which "probably wanted the deal to avoid forced sales."[2580]

Failure to Liquidate. In July 2007, after the credit rating agencies began the mass downgrades of RMBS securities, the first RMBS securities underlying the Hudson CDO lost their investment grade ratings, and the CDS contracts referencing those assets qualified as Credit Risk Assets requiring liquidation.[2581] Within three months, by October 15, 2007, over 28% of the Hudson assets qualified as Credit Risk Assets.[2582] As liquidation agent, Goldman should have begun issuing bids to sell the assets at the best possible price and remove them from the Hudson CDO, but it did not.

In October 2007, Goldman began to contact Hudson investors to discuss transferring its liquidation agent responsibilities to a third party. That transfer required investor consent. Benjamin Case took notes of two telephone conversations he had with a Hudson investor, National Australia Bank (NAB), discussing the issues.[2583] In the calls, Mr. Case explained why Goldman had yet to liquidate any of the Credit Risk Assets, explaining that Goldman was waiting for asset prices to improve.[2584] He also reported that Goldman was considering an amendment to the Hudson transaction that would extend the maximum liquidation period, as well as make other structural changes to the Hudson deal.[2585]

According to his notes, Mr. Case informed NAB that Goldman was seeking to transfer its liquidation role to a third party with more liquidation experience, because that change:

[2580] Id. Mr. Herrick was not employed by Goldman when its CDO assets were downgraded and triggered its liquidation agent duties.
[2581] 1/3/2008 email from Shelly Lin to Mr. Sparks, GS MBS-E-021880171 (attached file, "Deal Summary," GS MBS-E-021880172).
[2582] Id.
[2583] 10/15/2007 email from Naina Kalavar, "NAB/Hudson Mezz Update 2," GS MBS-E-015738973. Mr. Case used this email to circulate his notes of the two telephone conversations.
[2584] Id. at 2. The notes included the following: "[C]urrent distressed nature of the assets has been fully priced in and has not moved over the past 2 months – if unwound those cds would be at 80-90 points, that is % points to be paid up front to unwind swap – equiv of 20 cents to dollar in cash bond terms ... Across entire universe of loans already in liquidation – been generally se[e]n 50-60-70 % recovery rates. Rates are not coming back high enough to make the market opt[i]mistic that bonds will come back to recover princi[pal]. ... Our view that there is upside in waiting an[d] evaluating mtkt conditions before liquidating. ... We think that the shorts may get impatient – minor rallies from short covering – domino effect/momentum creates a rally b/c shorts get nervous at little rally – this provides potential upside to waiting to liquidate."
[2585] Id. at 3. Such an amendment would require investor consent.

> "will be in the best interest of investors – the credit obligation term was originally written with the expectation that was unlikely to happen. ...
> Good for several reasons:
> 1. Large institutional assets manager will be able to access more liquidity b/c [because] they can access other broker dealers and get good pricing[.]
> 2. Even keeping the deal the way it is, the decision of when in the 12 month period to liquidate could be better handled by an experienced manager[.]
> 3. Potential amendment could be made to benefit the deal by giving more flexibility to agent."[2586]

These notes indicate that, although Goldman was the architect of the Hudson CDO and selected itself to serve as liquidation agent at a fee of $3.1 million, when Goldman was called upon to execute its role, it believed the decision of when to liquidate the impaired assets "could be better handled by an experienced manager."

According to Mr. Case's notes, NAB sent Mr. Case an email asking if Goldman held any of the Hudson investments: "does GS hold any of this?" Mr. Case responded:

> "def own equity and different pieces of various tranches no [sic] exactly, but decent size and numbers of cl[a]sses on our books."[2587]

Mr. Case apparently did not disclose that, in addition to its $6 million equity tranche, Goldman also held 100% of the short position in the $2 billion CDO, and that its short investment would increase in value as the Hudson assets lost value.

According to Mr. Case's notes, NAB replied by asking Goldman to provide more specific information about Goldman's holdings in the transaction: "Could you please follow up with what Goldman holds?"[2588] When Mr. Case asked why NAB wanted that information, NAB responded: "Want to make sure you [Goldman] are making restructuring decisions for the right reasons – make sure serving the right interests." According to his notes, Mr. Case replied: "Our intended goal of

[2586] 10/15/2007 email from Naina Kalavar, "NAB/Hudson Mezz Update 2," GS MBS-E-015738973.
[2587] Id. at 75.
[2588] Id. at 76.

liquidation agent is to serve the best interests of the CDO – that is the duty of the liquidation agent – it is a policy and process."[2589]

In November 2007, Goldman took initial steps to transfer its liquidation agent responsibilities to a third party.[2590] At that point, Goldman had yet to liquidate any of the Hudson Credit Risk Assets.[2591] The nine assets that had become Credit Risks in July had already dropped significantly in value. One asset which, on July 16, had a value of 61% of its face (par) value, had fallen by November 1 to 16% of par.[2592] Another asset that, on July 16, had a value of 43% of par, had fallen in value by November 1 to 7% of par.[2593]

At the end of November, Goldman reached an agreement with Trust Company of the West (TCW), subject to investor approval, in which Goldman would assign its liquidation agent duties to TCW, and TCW would "share back" 30% of the fees with Goldman.[2594] Mr. Lehman told the Subcommittee that Goldman's decision to assign the liquidation agent rights to a third party was because liquidation was a non core business for Goldman, and TCW was better suited to liquidate the Credit Risk Assets.[2595] On December 18, 2007, while Goldman was still seeking investor approval to assign the liquidation agent role to TCW, a Goldman representative explained to an investor the firm's thinking:

> "GS [Goldman Sachs] is soliciting consent to assign GS role as liquidation agent to TCW bec[ause] when liquidation agent role was designed, it was very 'out of the money'; now when the risk is very real, it is much more efficient to have a sophisticated collateral manager bec[ause]
> (i) TCW can access better liquidity than GS, ie get bids from the entire street
> (ii) real asset manager can pursue further amendments to the doc to make liquidation more efficient bec[ause] is not an asset [manager] under the investment act in 1940 and cannot act [sic] investment advisory services and can't act with optimal discretion."[2596]

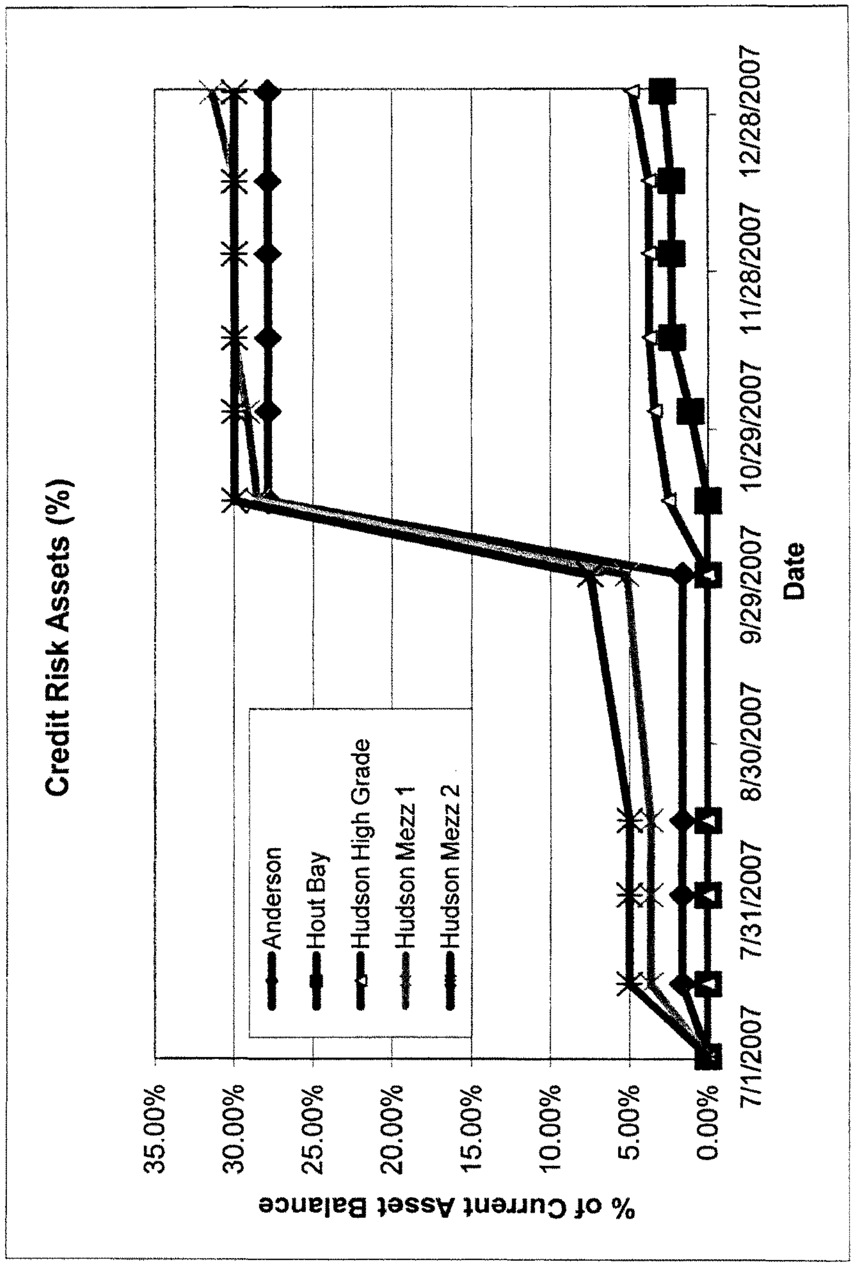
[2589] Id.
[2590] 11/9/2007 email from Mr. Case to Mr. Lehman, GS MBS-E-021876334.
[2591] 2/29/2008 letter from Morgan Stanley to Goldman, HUD-CDO-00006877.
[2592] Reference asset OOMLT 2006-2 M8. See 1/3/2008 email from Shelly Lin to Mr. Sparks, GS MBS-E-021880171 (attached file, "Deal Summary," GS MBS-E-021880172).
[2593] Reference asset MSAC 2006-WMC2 B3. See 1/3/2008 email from Shelly Lin to Mr. Sparks, GS MBS-E-021880171 (attached file, "Deal Summary," GS MBS-E-021880172).
[2594] See 11/29/2007 email from Mr. Case to Mr. Sparks, Mr. Lehman, and others, GS MBS-E-021876502.
[2595] Subcommittee interview of David Lehman (9/27/2010).
[2596] 12/18/2007 email from Lira Lee to [investor], GS MBS-E-021878556.

On December 19, 2007, Morgan Stanley, the largest Hudson long investor with a $1.2 billion interest encompassing the entire super-senior tranche,[2597] was presented with a consent form to assign the liquidation agent rights to TCW.[2598] Morgan Stanley told the Subcommittee that it had declined to consent to the transfer, because the liquidation agent role was ministerial, had no discretionary authority, and could quickly and easily be accomplished by Goldman.[2599] Morgan Stanley told the Subcommittee that it instead asked Goldman to begin liquidating the $596.5 million in Credit Risk Assets immediately, some of which had been designated as Credit Risks for five months, and all of which had declined in value.[2600]

On January 3, 2008, Daniel Sparks, the Mortgage Department head, was given a spreadsheet listing the Credit Risk Assets in each of the CDOs in which Goldman was serving as the liquidation agent, including Hudson 1. The spreadsheet showed that, in Hudson, 44 assets were Credit Risks with a face value of $635 million, totaling about 30% of the asset pool.[2601]

[SEE CHART NEXT PAGE: *Credit Risk Assets*,
prepared by Goldman Sachs.]

[2597] See discussion of Hudson 1, above.
[2598] 12/19/2007 email from Mr. Case to Nicole Martin of Morgan Stanley, GS MBS-E-021876172.
[2599] Subcommittee interview of Morgan Stanley (8/6/2009).
[2600] Id.
[2601] 1/3/2008 email from Shelly Lin to Mr. Sparks, GS MBS-E-021880171 (attached file, "Deal Summary," GS MBS-E-021880172).


Credit Risk Assets (%)
% of Current Asset Balance
35.00%
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
7/1/2007
7/31/2007
8/30/2007
9/29/2007
10/29/2007
11/28/2007
12/28/2007
Date
Anderson
Hout Bay
Hudson High Grade
Hudson Mezz 1
Hudson Mezz 2

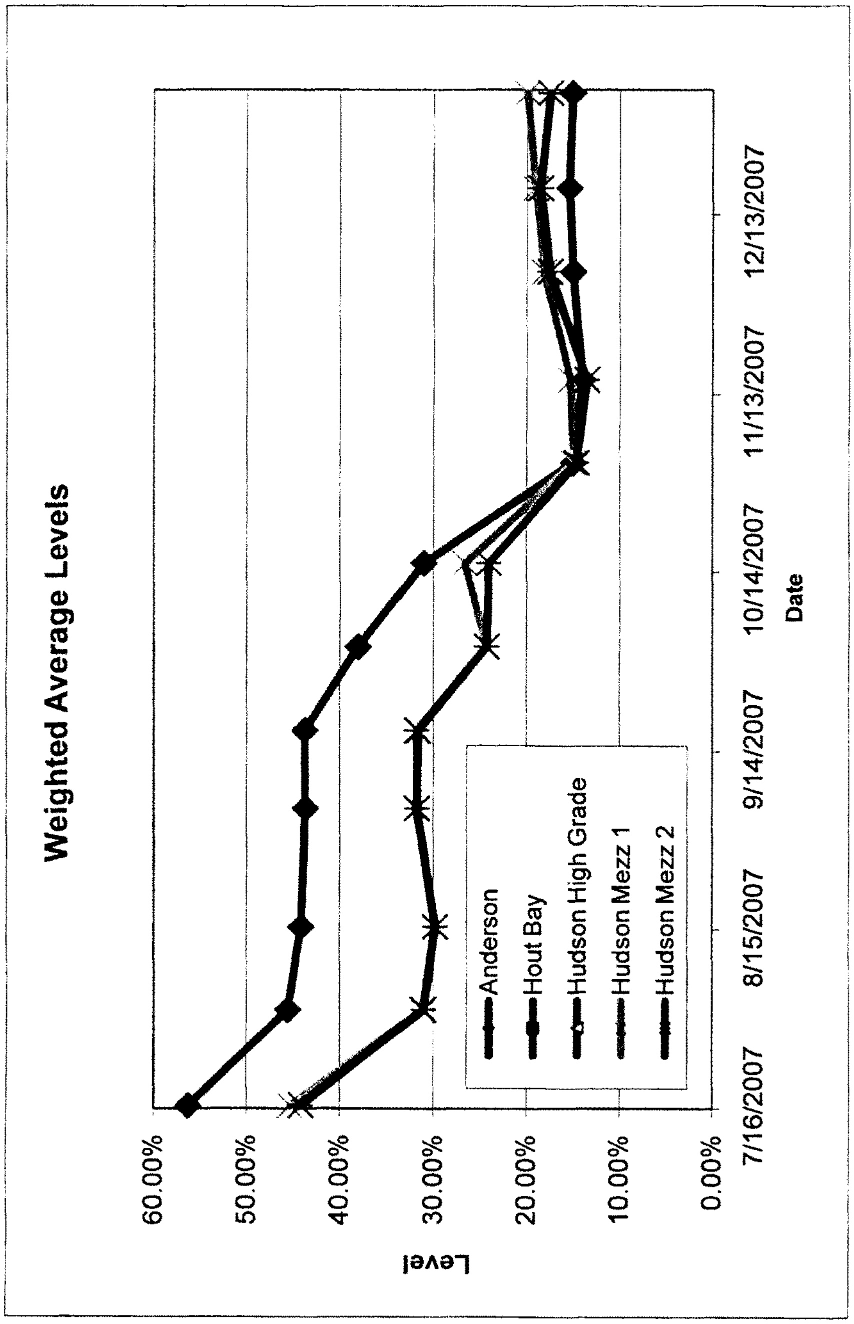
The spreadsheet also showed that the weighted average values of the Hudson assets had fallen dramatically, causing losses that could have been avoided had Goldman liquidated them sooner. The weighted average values had fallen from 45% of face (par) value in July, to a low of 15% on November 1, 2007, and were about 20% of par value on January 2, 2008.[2602]

[SEE CHART NEXT PAGE: *Weighted Average Levels*, prepared by Goldman Sachs.]

Hudson Conflict of Interest. Despite the falling values and Morgan Stanley's ongoing request to initiate liquidation of the Credit Risk Assets as set out in the Hudson 1 agreement, Goldman still did not begin liquidating.

During January and February 2008, Morgan Stanley engaged in frequent communications with Goldman personnel, including Mr. Lehman who oversaw Goldman's CDOs, and Mr. Case who oversaw the liquidation agent function, to initiate liquidation of the Hudson assets.[2603] The falling value of the Hudson assets caused sharp losses in Morgan Stanley's $1.2 billion investment, leading Morgan Stanley to press for the Credit Risk Assets to be liquidated and removed from the CDO as soon as possible. In contrast, as the Hudson assets fell in value, Goldman, as the CDO's sole short party, saw its short position become increasingly profitable. Goldman had little financial incentive to liquidate the Credit Risk Assets, because the more they fell in value, the more Goldman was able to maximize the profits from its short position in the CDO. Goldman's dual roles as liquidation agent and short party, thus, created a conflict of interest that disadvantaged the long investors in the Hudson CDO, such as Morgan Stanley.[2604]

[2602] Id.
[2603] See, e.g., 1/16/2008 email from Nicole Martin to Mr. Lehman, GS MBS-E-022164848.
[2604] Due to the extensive losses experienced by Hudson 1, by January 2008, Morgan Stanley was likely the only long investor whose investment was not completely extinguished.


Weighted Average Levels
Level
60.00%
50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
7/16/2007
8/15/2007
9/14/2007
10/14/2007
11/13/2007
12/13/2007
Date
Anderson
Hout Bay
Hudson High Grade
Hudson Mezz 1
Hudson Mezz 2

Morgan Stanley personnel expressed increasing frustration with Goldman's failure to liquidate the Hudson Credit Risk Assets, in both internal communications and with Goldman representatives. On January 16, 2008, for example, the key trader on Morgan Stanley's Proprietary Trading Desk dealing with Hudson wrote to a colleague: "Had another call with [Goldman's] sr. trader about GS's liquidation agent role in the $1.2bn HUDSON deal. They insist they are NOT acting as a fiduciary per the docs in this deal."[2605] On February 5, he sent Mr. Lehman an email: "[P]lease call when possible – $969mm now eligible to be liquidated post S&P do[w]ngrades."[2606]

On February 6, the Morgan Stanley trader wrote to a colleague:

> "[W]ent down the road with Goldman on liquidation agent assets (now ~$1bb of eligible assets post downgrades). They told me they will 'continue to take my opinion under advisement' but provided no course of action. I broke my phone. Will talk to [Morgan Stanley legal counsel] tomorrow but don't think there is any probable way for us to force them to liquidate assets."[2607]

On February 7, the Morgan Stanley trader sent another email to Mr. Lehman:

> "Spoke with Ben [Case] re: Hudson today.
> Goes without saying I remain very frustrated by the way GS is handling the liquidation agent role. There is almost $1bb of eligible assets in that deal now, every one of which has lost value since it was downgraded.
> No good reason to wait other th[a]n to devalue our position. It's a shame .... [O]ne day I hope I get the real reason why you are doing this to me."[2608]

According to Morgan Stanley, Goldman continued to explain its seven-month delay in liquidating the Credit Risk Assets by asserting that the market would rebound during a rally to cover shorts, and it should wait to liquidate until asset prices rose. In a February 13, 2008 telephone call

[2605] 1/16/2008 email from John Pearce of Morgan Stanley to Michael Petrick, HUD-CDO-00004851.
[2606] 2/5/2008 email from Mr. Pearce to Mr. Lehman and Nicole Martin, HUD-CDO-00004852.
[2607] 2/6/2008 email from Mr. Pearce to Michael Petrick, HUD-CDO-00005146.
[2608] 2/7/2008 email from Mr. Pearce to Mr. Lehman, HUD-CDO-00005147.

between Morgan Stanley and Goldman, for example, which was recorded and transcribed, Mr. Case stated:

> "So I think, as we see the short covering wave kind of continue to proceed ... it's gonna get to the point where it's in the best interest of the deal to start liquidating then. ... I know we've talked about this twelve month period ... it doesn't seem like it's gonna take till late in the twelve month process for the majority of these assets to get to that point."[2609]

Morgan Stanley asked if there was anything beyond the "technical nature of the markets," such as government intervention, to produce "any kind of real pop" that would improve the underlying fundamentals in the mortgage market. Mr. Case responded: "The chance that it could move in that direction, at least in the next few months . . . is de minimis I'd say."[2610] During the call, Morgan Stanley's representative again urged Goldman to begin the liquidation process: "Just so you know, my opinion stays the same, I'd like to see a bid list before three o'clock today."[2611]

Morgan Stanley told the Subcommittee that the Hudson assets had been in near continuous decline, and Goldman's refusal to liquidate assets shortly after they became Credit Risk Assets allowed them to decline further, rather than limiting losses for bondholders. By February 21, 2008, Morgan Stanley had calculated that the liquidation delay had cost it $130.5 million; the next week it calculated the losses had increased to $150 million.[2612]

Morgan Stanley told Goldman that by delaying the liquidation of the Credit Risk Assets, Goldman was in violation of the terms in the Hudson 1 offering circular, in particular the provision: "The Liquidation Agent will not have the right, or the obligation, to exercise any discretion with respect to the method or the price of any assignment, termination or disposition of a ... Credit Risk Obligation."[2613] On February 29, 2008, Morgan Stanley

[2609] Transcript of 2/13/2008 telephone call between Morgan Stanley and Goldman, HUD-CDO-00006894. See also 2/28/2008 email from Sue Fertel-Kramer to Mr. Case and others, GS MBS-E-021881029.
[2610] Transcript of 2/13/2008 telephone call between Morgan Stanley and Goldman, HUD-CDO-00006894.
[2611] Id.
[2612] 2/21/2008 email from Vanessa Vanacker to Mr. Pearce, HUD-CDO-00004882. 2/29/2008 letter from Morgan Stanley to Goldman, HUD-CDO-00006877.
[2613] 12/3/2006 Hudson Mezzanine 2006-1, LTD. Offering Circular, section entitled, "Disposition of CDS Transactions by the Liquidation Agent Under Certain Circumstances," GS MBS- E-021821196 at 241. See 2/29/2008 letter from Morgan Stanley to Goldman, HUD-CDO-00006877.

sent Goldman a letter demanding that it immediately initiate liquidation of $1 billion in Hudson Credit Risk Assets:

> "As Liquidation Agent, [Goldman] is currently responsible for liquidating approximately $1,000,000,000 of Credit Risk Obligations. The transaction documents clearly state that [Goldman] would not exercise investment discretion in its role as Liquidation Agent. [Goldman] has not yet liquidated a single Credit Risk Obligation, notwithstanding that some date back to August of 2007. The [Goldman] employee handling the liquidation has explained this by stating that he believes the price for these obligations will increase in the future and it is better for the deal to liquidate these obligations at a later date. ...
>
> The Liquidation Agency Agreement states that "the Liquidation Agent ... **shall not provide investment advisory services to the Issuer or act as the "collateral manager" for the Pledged Assets.** ...
>
> While the Liquidation Agency Agreement provides that the Liquidation Agent must complete the process of liquidating the relevant assets within twelve months, it does not provide the Liquidation Agent with any right to delay the liquidation process based on the exercise of Investment discretion. To the contrary, the Liquidation Agency Agreement and the [Offering Circular] clearly state that no discretion or investment advisory services are ever to be provided by the Liquidation Agent."[2614]

Morgan Stanley concluded by "demanding only that [Goldman] fulfill its contractual duties as required by the Liquidation Agency Agreement and assign, terminate or otherwise dispose of the relevant CDS transaction forthwith."

On March 10, 2008, Goldman responded:

> "[Y]our letter is entirely mistaken in its suggestion that Goldman Sachs has somehow breached its obligations under the Liquidation Agency Agreement. As [Morgan Stanley's] letter recognizes, Section 2(b) of the Liquidation Agency Agreement specifically provides that Goldman, acting as Liquidation Agent, has up to twelve months in which to assign, terminate or otherwise dispose of Credit Risk Obligations assigned to it for that purpose. Obviously,

[2614] 2/29/2008 letter from Morgan Stanley to Goldman, HUD-CDO-00006877 [emphasis in original].

establishment of a liquidation period of that duration contemplates – and, indeed, embodies Hudson's informed consent – that the Liquidation Agent will necessarily exercise judgement in determining when and how to dispose of Credit Risk Obligations assigned to it for that purpose. ...

Nor does this expressly intended contractual latitude transform Goldman Sachs into a *de facto* 'investment adviser' to Hudson, as you suggest. The Agreement ... in fact categorically disclaims that Goldman Sachs or its affiliates will be providing investment advisory services or otherwise acting as an adviser or fiduciary to Hudson by virtue of its liquidation services. That disclaimer is perfectly consistent with discretion routinely accorded to securities brokers in seeking to fulfill their obligation to obtain the best execution possible for their clients without making them 'investment advisors.'"[2615]

Several days before Goldman's response letter was sent to Morgan Stanley, however, Goldman began liquidating the Credit Risk Assets in Hudson 1. On March 7, 2008, Goldman liquidated eight assets, followed by more on March 20 and 28, liquidating nearly one third of the eligible assets over the course of the month.[2616] In its role as liquidation agent, Goldman was required to solicit bids from at least three independent dealers for the Credit Risk Assets, and Morgan Stanley was given an opportunity to bid on many of the liquidated assets.[2617] Liquidation proceeded over the next two months, from April through June.[2618] On July 22, 2008, Hudson's realized losses exceeded $800 million, and Hudson 1 went into default. Hudson's remaining assets were liquidated in November 2008. Morgan Stanley's losses from its Hudson investment exceeded $930 million.[2619]

Analysis. In several of the CDOs it constructed, Goldman established a new position of liquidation agent and appointed itself to play that role for a substantial fee. In the case of Hudson 1, by taking on the

[2615] 3/10/2008 letter from Goldman to Morgan Stanley, HUD-CDO-00006881. The letter also states: "Morgan Stanley's lack of standing even to advance many positions that are within the exclusive province of Hudson, and the preclusive effect on Morgan Stanley's contentions of the Agreement's broad exculpation and conflict waiver provisions provide sufficient response."
[2616] See 3/27/2008 email from Morgan Stanley to Goldman, HUD-CDO-00004378. On March 24, 2008, Goldman offered to unwind the Hudson 1 trade with Morgan Stanley by paying it 9% of the face (par) value of the Hudson securities. 3/24/2008 email from Goldman to Morgan Stanley, GS MBS-E-022012805.
[2617] See, e.g., 3/27/2008 email from Morgan Stanley to Goldman, HUD-CDO-00004378. See also 3/20/2008 email from Mr. Case, GS MBS-E-021880596.
[2618] See 6/6/2008 letter from Goldman as liquidation agent, "Hudson Mezzanine Funding 2006-1, Ltd. - Certain Dispositions of Assets," HUD-CDO-00003155.
[2619] See 11/21/2008 letter from Goldman to Morgan Stanley, HUD-CDO-00005125.

role of liquidation agent at the same time it was the sole short party in the CDO, Goldman created a conflict of interest. When the Hudson 1 assets began falling in value, the long investors wanted the poorly performing assets liquidated as soon as possible; Goldman, on the other hand, benefitted financially the farther the assets fell in value since that allowed Goldman to maximize the value of its short position.

Goldman delayed liquidating the Credit Risk Assets, despite urgent requests from the largest Hudson investor, Morgan Stanley, placing its own financial interests ahead of the client to whom it had sold a $1.2 billion Hudson investment.

BB. Collateral Put Provider in Timberwolf

The second example of a conflict of interest affecting how Goldman carried out a CDO administrative function involves Goldman's role as the collateral put provider in Timberwolf I. Synthetic CDOs like Timberwolf collected cash from the long investors that purchased its securities as well as from the short parties that paid CDS premiums to the CDO. A portion of the cash collected from the long investors was placed by the CDO into a "default swap collateral account" to be used if the CDO performed poorly and payments had to be made to the short parties.[2620] At one time, many CDOs used the cash in the default swap collateral account to purchase Guaranteed Investment Contracts (GICs), which guaranteed repayment of the principal and a fixed or floating interest rate for a fixed period of time. But in the years leading up to the financial crisis, CDO issuers sought to use the cash in the default swap collateral account to make investments that generated higher returns, in order to improve financial performance, obtain better credit ratings, and attract investors. To obtain those higher returns, CDO issuers began to invest the incoming cash in "default swap collateral securities."

Goldman's synthetic CDOs generally invested in default swap collateral securities, and its CDO agreements typically set out parameters for the types of default swap collateral securities that could be purchased with investor funds, often requiring them to be high quality, low risk,

[2620] The amount of assets in the default swap collateral account was required to equal the total face ("notional") value of the CDS entered into by the CDO. This arrangement provided assurance to the short parties that funds would be available if and when payments were due to them under the CDS. CDO agreements often required that the cash placed in the default swap collateral account be kept in very secure, short term, cash-like instruments such as Treasury notes or Certificates of Deposit (called "Eligible Investments") until the cash was used to acquire default swap collateral or make payments to a short party. If any credit event resulted in payments from the default swap collateral account to the short parties under the CDS contracts, the long parties might not receive all of their principal investment at the maturity of the deal.

liquid investments.[2621] If the CDO had a collateral manager, the manager often selected the CDO's default swap collateral securities. The returns earned by the default swap collateral securities often became an important component of the CDO's income. The principal proceeds of the default swap collateral securities were typically re-invested in similar securities until the CDO matured or the proceeds were needed to make payments to short parties.

Goldman's Dual Roles. In its synthetic CDOs, Goldman often took on two roles that affected the default swap collateral securities, acting as both the CDO's primary CDS counterparty[2622] and its collateral put provider. Goldman's synthetic CDOs typically followed industry practice by making one entity the sole counterparty for all of the CDS contracts issued by the CDO. In Goldman CDOs, that party was generally Goldman Sachs International (GSI), a United Kingdom subsidiary that was wholly owned by Goldman. Typically, GSI was the sole party that entered into a CDS contract directly with the domestic and offshore companies that served as the issuers of the CDO's securities (hereinafter collectively referred to as the "Issuer").[2623] GSI then acted as an intermediary for the Issuer by entering into a corresponding CDS contract with each party seeking to take a short position in the CDO. By inserting itself into the middle of the CDS transactions, GSI put Goldman's financial standing behind the CDS contracts issued by the Issuer and improved the credit ratings assigned to and investor confidence in the CDO. If a credit event later took place, the Issuer was responsible for making payments to GSI, and GSI, whether or not it received sufficient payments from the Issuer, was responsible for making the payments owed to the short parties in the corresponding CDS contracts. Sometimes, instead of contracting with a third party, GSI kept some or all of the short positions in the CDO on behalf of Goldman itself.

[2621] The parameters governing the type of default swap collateral securities that could be purchased with investor funds were generally outlined in the CDO agreement documents and offering memorandum. Typical criteria included: a AAA credit rating; a yield slightly greater than LIBOR; limitations on the maturation dates of the securities; and limited exposure to a single counterparty. Generally, the CDO agreement required that some of the default swap collateral be retained in Eligible Investments in order be able to fulfill any obligations or payments due in the short term. In CDOs reviewed by the Subcommittee, the default collateral securities were sometimes RMBS or CDO securities bearing AAA ratings. These securities often lost substantial value which the collateral put provider then had to absorb.

[2622] The Timberwolf Indenture agreement referred to this role as the "Synthetic Security Counterparty." See 3/27/2007 Timberwolf I, LTD. Indenture Agreement, at § 12.5(b), GS MBS-E-021825583 at 711.

[2623] Typically a shell company incorporated in a foreign jurisdiction (often the Cayman Islands) and a shell company incorporated in the United States (often Delaware) served as the "Issuer" and "Co-Issuer," respectively of the CDO. Generally, the financial institution that was underwriting the CDO, in this case Goldman, would arrange for the establishment of those entities. For simplicity, this section will refer to both companies as the "Issuer" of the CDO securities.

By acting as the primary CDS counterparty, GSI necessarily took the short side of each CDS contract it entered into with the Issuer. Those CDS contracts typically provided that, in the event of a specified credit event that required payment to GSI, GSI could collect a specified amount of funds from the Issuer. The Issuer paid its obligations to GSI by first drawing down any available cash in the default swap collateral account. If that cash was insufficient, GSI also had the right to identify one or more of the default swap collateral securities that together had a face (par) value equal to the amount owed to GSI. Those securities could then be sold and the sale proceeds used to satisfy the amount owed to GSI under the CDS contracts.[2624] GSI would then use the cash it received from the sale proceeds to pay off the short parties in the corresponding CDS contracts. Since GSI's financial obligations under the CDS contracts were dependent in part upon the quality of the default swap collateral securities, Goldman provided in the CDO agreement that those securities could be purchased only with the prior "consent" of GSI. This arrangement enabled Goldman to exert control over the selection of the default swap collateral securities.

In addition to acting as the primary CDS counterparty in the CDOs it constructed, Goldman often acted as the CDO's default swap collateral put provider (hereinafter "collateral put provider"). The collateral put provider essentially guarantees the face (par) value of the CDO's default swap collateral securities.[2625]

Since GSI was already acting as the primary CDS counterparty, the CDO indenture agreement typically provided that, if the market value of any default collateral security selected by GSI to satisfy an amount owed to GSI fell below its face (par) value, then GSI suffered the market risk, and could not recover additional funds from the Issuer to make up for the security's loss in value. GSI was still responsible, however, for making full payments to the short parties in the corresponding CDS contracts. This arrangement functioned effectively as a "put" agreement that guaranteed the face (par) value of the default swap collateral securities, and Goldman treated the arrangement as a put agreement.

Due to the dual roles played by GSI in its CDOs, many of Goldman's CDO indenture agreements did not contain an explicit put agreement, but

[2624] Another option was for Goldman to take physical possession of the security.

[2625] In a typical put agreement, the put provider guarantees to pay to the put purchaser the face (par) value of a specified security upon delivery of the security, or pay to the put purchaser the difference between the security's par value and actual market price when sold. In exchange for that protection, the put purchaser typically pays a fee to the put provider. In many of the CDS contracts associated with synthetic CDOs, as described above, GSI fulfilled the role of a put provider, by absorbing any shortfall between the face (par) value and market price of any default swap collateral securities sold to pay amounts owing to the short party in the CDS contract.

simply constructed GSI's CDS contracts to include the provisions that achieved the same result. For example, the Timberwolf Indenture agreement specified that the primary CDS counterparty in its CDS contract – GSI – bore the market risk associated with any default swap collateral sold to satisfy an obligation to that counterparty.[2626] In exchange for bearing the risk of not receiving the full payment owed to it from the sale of the default swap collateral securities, GSI received a discount – typically equal to 5 basis points – on the premiums GSI paid to the Issuer under the primary CDS contract. In a CDO deal of $1 billion, the premium discount would yield a "fee" of approximately $500,000.[2627] In most cases, however, the CDO indenture agreements did not specifically cite the connection between GSI's bearing the market risk of the default swap collateral sales and receiving a CDS premium discount. The CDO agreements simply included a reduced premium payment by GSI under the primary CDS contract with the Issuer.[2628]

[2626] See 3/27/2007 Timberwolf I, LTD. Indenture Agreement, at § 12.5(b), GS MBS-E-021825583 at 712. For accounting purposes, Goldman established a CDO Put Reserve, to account for potential losses that might result from its role as a collateral put provider in CDOs.

[2627] Any subsequent losses resulting from Goldman's role as the collateral put provider would reduce the profit resulting from that fee. In responses to Subcommittee questions for the record regarding 7 CDOs (Fort Denison, Camber 7, Timberwolf, Anderson Mezzanine, Point Pleasant, Hudson Mezzanine 2006-1, and Hudson Mezzanine 2006-2), Goldman reported that for most of the CDOs, the net profit was less than $500,000. One exception was Hudson Mezzanine 2006-1, which yielded a profit of approximately $1 million. See Goldman response to Subcommittee QFR at PSI_QFR_GS0249. For another CDO, Broadwick, Goldman also projected that the premium discount would yield a profit of more than $1 million, less any costs it might have to absorb in its role as put provider. See 4/12/2006 email from Peter Ostrem to John Little and Robert Leventhal, GS MBS-E-010808964 at 66-67 ("Can we agree on how we want to treat P&L [profit and loss] on Peloton relative to the put swap? We expect P&L of over $1mm [million] for the 5bp [basis point] reduction in the CDS premiums. ... I propose we separately book the put swap at close to zero (contingent MTM risk on 2 yr AAA diversified portfolio where Goldman retains selection optionality seems low), but we are open to booking 1bp in negative put cost (i.e., -$200k)."). In some other CDOs, the projected put fee was about $500,000.

[2628] Timberwolf used this reduced premium approach, but in a few other instances, such as Hudson Mezzanine 2006-1 and Point Pleasant, Goldman received a direct fee for acting as the collateral put provider. Goldman representatives told the Subcommittee that, because the put fee was "embedded" in the CDS agreement in some of the CDOs, Goldman's operations group sometimes overlooked and failed to "book" the profit and loss associated with those put arrangements. When this oversight was discovered in 2007, Goldman identified 18 CDO put arrangements that had not been identified and accounted for in Goldman's books. See 6/28/2007 email from Carly Scales to Phil Armstrong and Steve Schultz, GS MBS-E-015192547:

- "Current Put Option Booking State: 22 Deals with the Put Option Feature
- 4 Deals that do have a Put Option Booked:
  - For these trades, Ops [the operations group] knew about the Put as there was a confirmation and a trade booked. ...
- 18 Deals that do not have a Put option Booked:
  - For these deals, there was no mention of a Put at all at the time of closing. ...
  - The Put option was embedded into the deal documents (Indenture, Offering Circular, etc – both of which are reviewed by outside counsel and GS legal as a normal course of business – but are not reviewed by Operations.)
  - For these trades, an intermediation fee was being taken on the CDS trades, but no specific Put was booked in our systems.
  - The original explanation from the desk was the intermediation fee was being taken

Timberwolf Conflict of Interest. In the Timberwolf CDO, GSI acted as both the primary CDS counterparty and the collateral put provider. Documents provided to the Subcommittee show how these dual roles created a conflict between Goldman and the Timberwolf long investors, and how Goldman reacted by placing its interests before those of the clients to whom it had sold the Timberwolf securities.

In 2007, as the mortgage market deteriorated, the value of many types of default swap collateral securities also declined. Goldman became concerned that if the market value of the securities fell below par and a credit event occurred, those securities would provide insufficient funds to pay the amounts owed to GSI under its primary CDS contract with the Issuer. In addition, Goldman knew that the more the default swap collateral securities fell in value, the more of a shortfall Goldman would have to make up if GSI had to make payments to other short parties. Goldman wanted to maximize the value of the default swap collateral and what would be available to make all of the payments needed pursuant to Goldman's own short positions as well as any payments it would need to make to other short parties.

In the late spring of 2007, Goldman began to closely monitor the value of the default swap collateral securities in its synthetic CDOs.[2629] On June 20, 2007, Matthew Bieber, a Goldman employee on the CDO Origination Desk and the deal captain of the Timberwolf CDO, sent an email to his colleagues requesting information on CDOs that Goldman had "significant exposure to in terms of default swap collateral."[2630] Mr. Bieber identified 17 possible CDOs where the default swap collateral securities may have lost value and stated: "we need to get Dan [Sparks, the Mortgage Department head,] a list this morning."[2631] When asked about this email, Mr. Bieber told the Subcommittee that he did not recall why he had sent it or why he had to deliver the list to Mr. Sparks that same day, but he said he did recall that the decline in the value of the default swap securities was an issue.[2632] In response to the email, Goldman

for the risks associated with standing in between the Street and the deal with no mention of the Put."

[2629] One reason Goldman was so concerned about the value of the default swap collateral securities was because those securities included AAA rated RMBS securities whose values were declining in line with the entire mortgage market.

[2630] 6/20/2007 email from Matthew Bieber to Goldman colleagues, GS MBS-E-001912772 ("Below are the deals I recall us having significant exposure to in terms of default swap collateral. Who is responsible for each of the deals? We need to get Dan a list this morning. If there are any missing, please let me know.").

[2631] Id. Mr. Bieber listed the following CDOs: Adirondack 1; Adirondack 2; Coolidge Funding; Broadwick; Hudson High Grade; Hudson Mezzanine 1; Hudson Mezzanine 2; Fortius I; Fortius II; Camber 7; Hout Bay; Point Pleasant; Timberwolf; Anderson Mezzanine; Altius I; Altius III; and Altius IV.

[2632] Subcommittee interview of Matthew Bieber (10/21/2010).

employees associated with the various CDOs submitted lists of the existing default swap collateral securities with their par and market values.

As the mortgage market worsened, Goldman's attention to the value of the default collateral securities increased. On July 18, 2007, the Goldman Credit Department sent an email to Mr. Bieber indicating that Goldman had large, valuable short positions in six of the CDOs it had originated, but that the department needed to monitor the value of the default swap collateral securities in each CDO to understand Goldman's "exposure" under the CDS contracts:

> "From our discussion earlier today, we were able to verify the MTM [mark to market] exposures on the below CDOs against what we have in our credit systems (they are in fact as large as we mentioned). Our next step is understanding how the collateral pools are performing in each of the deals. Would you be able to give us a summary of the current marks and default writedowns for the below deals? This would help us in monitoring the collateralization in relation to our exposure from CDS."[2633]

The next day, July 19, 2007, Mr. Bieber informed David Lehman, who then oversaw Goldman's CDOs, that the Credit Department had asked the ABS Desk in the Mortgage Department to "mark" the value of all of the default swap collateral securities in the Goldman-originated CDOs to "get a sense of the MV [market value] supporting the deals['] obligation to pay us, if necessary."[2634]

Later that same day, another Credit Department official sent an email message to Mr. Lehman similar to the one that had been sent to Mr. Bieber:

> "We understand that you are responsible for marking the collateral in relation to the below CDOs. Is that true? If so, can you please put us on your distribution list for these. We have some sizeable in the money swap positions (i.e. cdo owes GS) and Credit needs to monitor these positions vs. collateral market value."[2635]

With respect to Timberwolf, on July 25, 2007, Fabrice Tourre, a Goldman employee on the Mortgage Department's Correlation Trading

[2633] 7/18/2007 email from Alfa Kiflu, GS MBS-E-001866507. The six CDOs in which Goldman had large short positions were: Hudson Mezzanine 1; Timberwolf; Camber 7; Hudson Mezzanine 2; GSC ABS Funding 2006-3G; and Anderson Mezzanine.
[2634] 7/19/2007 email from Matthew Bieber to David Lehman, GS MBS-E-011178225.
[2635] 7/19/2007 email from Patrick Welch, GS MBS-E-001866507.

Desk, circulated an internal Goldman analysis showing that the weighted average value or "mark" of Timberwolf's default swap collateral securities had declined over 3%.[2636] During the same period, the value of Goldman's short position had increased. Mr. Tourre suggested to his colleagues that as Timberwolf's default swap collateral securities matured, the resulting cash proceeds should not be re-invested in new securities, but instead be retained as cash:

> "We need to start monitoring MtM [mark to market value] of the CDS collateral for the Wolf, given how much in the money the CDS are - right now, average bid side for the AAA cash bonds is approx 96.89 - per Mahesh analysis below. Matt/Mehesh - maybe we should look at the collateral reinvestment provisions in this deal - ideally principal proceeds on the CDS collateral should not be reinvested but I guess Greywolfe [sic] has discretion on this, right?"[2637]

In response, Mr. Bieber noted that the same situation applied to all of Goldman's CDOs; the declining value of the default swap collateral securities was increasing Goldman's exposure, and a weekly monitoring program was being set up. He also noted that it would be difficult for Goldman to oppose re-investment of the cash proceeds from maturing securities across the board:

> "CDS across all of our transactions are in the money. We've had conversations at length with credit regarding our exposure to the default swap collateral and are setting ourselves up for weekly monitoring/pricing of the default swap collateral across the cdo business.
>
> We have discretionary approval over default swap collateral, however, it will be difficult for us to take the non-reinvestment approach."[2638]

The next day, on July 26, 2007, the collateral manager of one of Goldman's CDOs sought approval to purchase some new default swap collateral securities. A Goldman employee responded: "We are going to pass on this bond. Given current market conditions, we'd like to keep some cash in the default swap collateral."[2639] A few days later, after receiving more requests to approve the purchase of new default swap

[2636] 7/25/2007 email from Fabrice Tourre, GS MBS-E-001989091.
[2637] Id. Greywolf Capital was the collateral manager of the Timberwolf CDO.
[2638] 7/25/2007 email from Matthew Bieber, GS MBS-E-001989091.
[2639] 7/26/2007 email from Shelly Lin, GS MBS-E-015232129.

collateral securities, Mr. Bieber asked Mr. Lehman for a meeting to discuss how to proceed:

> "Have gotten several requests today for reinvestment (Greywolf on TWOLF and TCW on DS7 [Davis Square 7]). Would like to sit down this evening to discuss how we're going to respond as this comes up."[2640]

In early August, Goldman conducted an internal analysis to assess the decrease in the return to the CDOs if the default swap collateral was kept in cash rather than re-invested in securities.[2641] As expected, that analysis showed that using the cash in the default swap collateral account to buy new securities would yield a larger return and more money for the CDO investors.[2642] But buying new securities also meant that Goldman, as the primary CDS counterparty and collateral put provider, would bear the risk if those securities later declined in market value. If the securities' market value fell below their par value, but had to be sold to make payments to the CDOs' short parties, Goldman would have to absorb any shortfall in the course of making the required payments to the short parties. Goldman's risk would be mitigated, however, if the default swap collateral was kept in cash, since cash is not subject to the same market fluctuation. The result was that Goldman-benefitted more if the CDO default swap collateral was kept in cash, but the CDO investors benefitted more if the collateral was kept in securities. In short, what was best for Goldman clashed with what was best for the investors to whom Goldman had sold the Timberwolf securities.

Subsequent documents show that Goldman placed its financial interests before those of the CDO investors by taking actions to keep the CDO default swap collateral in cash, rather than securities. On August 21, 2007, Mr. Bieber sent an email to Mr. Lehman asking about what Goldman had decided regarding re-investment of the cash collateral: "Was there any further discussion over the past few days on what were going to be doing? With the 25th coming up, I suspect a bunch of

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[2640] 7/30/2007 email from Matthew Bieber to David Lehman, GS MBS-E-001867239.

[2641] See 8/6/2007 email from Connie Kang to David Lehman, GS MBS-E-001992556; 8/9/2007 email from Mahesh Ganapathy to David Lehman, Matthew Bieber, and Jonathan Egol, GS MBS-E-001930307; 8/12/2007 email from Mahesh Ganapathy to David Lehman and Matthew Bieber, GS MBS-E-001930343; 8/13/2007 email from Mahesh Ganapathy to Matthew Bieber, David Lehman, and Jonathan Egol, GS MBS-E-001930571.

[2642] In addition, since the yield of most default swap collateral securities was linked to their "face (par) value," when the same securities could be obtained at a price lower than their par value, their yield (return on investment) increased as long as they continued to meet their scheduled principal and interest payments. This was another potential benefit to the long investors which conflicted with the interest of Goldman, the short party.

managers are going to be looking to put cash to work."[2643] Mr. Lehman responded: "Nothing further – I think our gameplan remains to build cash for now." Mr. Bieber replied: "Ok. I think we should be proactive in letting managers know, then, rather than waiting for them to come to us for approval and then denying." Mr. Lehman agreed.

Greywolf Objections. Over the next three or four weeks, Goldman continued to refuse to consent to the purchase of new default swap collateral securities by the collateral managers of its CDOs.[2644]

At first, Goldman delayed telling Greywolf, Timberwolf's collateral manager, what it had decided. In late August and early September, Joseph Marconi, a Greywolf executive, former Goldman employee, and key member of the Greywolf team managing Timberwolf, sent Goldman several requests to buy new default swap collateral securities, without receiving a response. On September 6, 2007, a Goldman employee on the CDO Origination Desk forwarded one of the requests to Mr. Bieber with the comment: "Guess we can't delay talking to him anymore."[2645] Mr. Bieber informed Mr. Marconi that Goldman would no longer approve the purchase of additional default swap collateral securities for Timberwolf. When informed of Goldman's decision, Mr. Marconi protested in an email to Mr. Lehman, who was Mr. Bieber's supervisor:

> "David: I would like to have a call with you to discuss the purchase of Default Swap Collateral into Timberwolf. I understand you are traveling this week. Let me know when you will have some time to talk. In response to the attached message, Matt [Bieber] told me that GS will not approve the purchase of any additional Default Swap Collateral into Timberwolf. While GS does have consent rights regarding the purchase of Default Swap Collateral, a blanket refusal to approve any assets is inappropriate, inconsistent with the parties' original expectations and will negatively impact the performance of both the debt and equity issued by Timberwolf. Give me a call when you can."[2646]

[2643] 8/21/2007 email from Matthew Bieber to David Lehman, GS MBS-E-011273913.

[2644] See 9/21/2007 email from Marty Devote of Aladdin Capital Management to Benjamin Case, GS MBS-E 022138816 ("We, at the direction of Connie and Roman [Goldman employees], have not been reinvesting CDS collateral as it matures. We've brought the topic up a few times over the past few months with your team. Last I heard, you were re-evaluating the market, and would come back to us with a breakdown of acceptable replacements. As the cash balances continue to grow, I'd like to address this issue, as the amount of cash drag is beginning to become meaningful.").

[2645] 9/6/2007 email from Roman Shimonov to Matthew Bieber, GS MBS-E-000765873.

[2646] 9/6/2007 email from Joe Marconi to David Lehman, GW 107909.

When asked by Subcommittee what he meant when he wrote that "a blanket refusal to approve any assets is inappropriate, inconsistent with the parties' original expectations and will negatively impact the performance of both the debt and equity issued by Timberwolf," Mr. Marconi explained that if Goldman wouldn't approve any new purchases as the default swap collateral securities matured, the CDO would have an increasing amount of cash on hand that would produce less income for Timberwolf than if that cash were invested in new securities.[2647]

Later on September 6, 2007, Mr. Lehman telephoned and spoke with Mr. Marconi. Neither he nor Mr. Marconi recalled exactly what was discussed, but the following day Mr. Marconi sent Mr. Lehman an email that repeated Greywolf's objections to Goldman's decision not to consent to the purchase of new default swap collateral securities:

> "David: As we discussed yesterday, I believe that your refusal to approve the purchase of any additional Default Swap Collateral into Timberwolf is unreasonable and inconsistent with the way the transaction structure was originally presented to us. We were told that the purpose of the approval rights was to permit GS to review specific assets and approve or disapprove specific assets based on their relative credit merits. If we thought for a second that you had the right to prohibit all new purchases indefinitely, we would have implemented the much simpler GIC [Guaranteed Investment Contract] structure that is used in most other synthetic CDOs and CDO^2 transactions and thereby locked in a fixed spread to LIBOR for the term of our transaction. Also, the Timberwolf CDS economics include an ongoing fee to GS for the put swap component of the trade; we would not have agreed to those terms if we thought you had this option. Finally, I believe that if anyone on the deal team thought you had this option, it would have been clearly disclosed in the OM [Offering Memorandum]. Especially given current market conditions, I am surprised that you are taking a position that will directly result in less cash flow being available to debt and equity investors. As I said yesterday, we recognize the impact of current market conditions and, even before I spoke with Matt, I was suggesting we collectively focus on shorter average life AAA RMBS for the deal and I specifically solicited feedback on securities where GS would be comfortable. I continue to be surprised by your response."[2648]

[2647] Subcommittee interview of Joseph Marconi (Greywolf Capital) (10/19/2010).
[2648] 9/7/2007 email from Joe Marconi to David Lehman, GW 107909.

When asked by the Subcommittee why he sent such a strongly worded email to Goldman regarding its refusal to approve the reinvestment of Timberwolf's cash collateral, Mr. Marconi responded: "We felt strongly about this. We had an obligation to investors to do the right thing."[2649]

Mr. Marconi told the Subcommittee that Goldman had rationalized its decision by contending that it was less risky to have more cash and fewer securities. Mr. Marconi also told the Subcommittee that Greywolf felt Goldman's blanket refusal to approve the purchase of additional securities was inconsistent with the terms of the CDO, and if anyone at Greywolf had believed that Goldman possessed that authority, Greywolf would have structured the deal differently.[2650] In addition, Mr. Marconi's September 6 email pointed out that Goldman was receiving an "ongoing fee" to serve as the collateral put provider and undertake the risk of guaranteeing the par value of the default swap collateral securities. The email stated that Greywolf would not have agreed to pay that fee to Goldman if it had thought Goldman could use its approval authority to stop the purchase of all default swap collateral securities and mitigate the risk it was being paid to bear.

The exchanges between Greywolf and Goldman brought into question the proper interpretation of Section 12.5 of the Timberwolf Indenture agreement which required the CDO to purchase default swap collateral which satisfied certain criteria and which received the "consent" of and was not "objected to" by Goldman as the "Synthetic Security Counterparty."[2651] The issue was whether that authority allowed Goldman to block the purchase of all default swap collateral securities and essentially limit the default swap collateral to cash. In a July 2007 email, Mr. Bieber wrote: "We have discretionary approval over default swap collateral, however, it will be difficult for us to take the non-reinvestment

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[2649] Subcommittee interview of Joseph Marconi (Greywolf Capital) (10/19/2010).
[2650] Id.
[2651] Section 12.5(b) of the Timberwolf Indenture agreement stated: "The Synthetic Securities shall be structured as 'pay-as-you-go' credit default swaps. As part of the purchase of each Synthetic Security on or before the Closing Date, the Issuer will be required to purchase Default Swap Collateral which satisfies the Default Swap Collateral Eligibility Criteria set forth in the related Synthetic Security and the inclusion of which has been consented to by the Synthetic Security Counterparty in the amount required to secure the obligations of the Issuer in accordance with the terms of the related Synthetic Security which shall be in at least an amount equal to the Aggregate Reference Obligation Notional Amount. The Synthetic Security Counterparty shall have consent rights with respect to the Default Swap Collateral and no Default Swap Collateral objected to by the Synthetic Security Counterparty may be purchased by the Issuer. Default Swap Collateral shall be credited to the Default Swap Collateral Account. The amount payable by the Issuer to the Synthetic Security Counterparty under a Synthetic Security shall not exceed the Default Swap Collateral." 3/27/2007 Timberwolf I, LTD. Indenture Agreement, GS MBS-E-021825583 at 711.

approach."[2652] But when the Subcommittee asked about the matter, Goldman's legal counsel sent a written statement indicating the Indenture agreement authorized Goldman's actions:

> "Section 12.5 of the Indenture for the Timberwolf CDO confers on the Secured Party the right to consent to the selection and reinvestment of default swap collateral. It is the position of Goldman Sachs that neither Section 12.5 of the Indenture nor any other relevant deal documents impose any obligation on the Secured Party to consent to reinvestment of default swap collateral, either on a case-by-case basis or generally."[2653]

Goldman's internal documents show that on September 7, 2007, the day after the email exchange between Mr. Marconi and Mr. Lehman, Mr. Bieber scheduled a meeting with Goldman's legal counsel and a key compliance officer to discuss the issue. His email stated:

> "Pls see email we received below – wanted to get your take on what response (if any) we should craft. This is related to the default swap collateral account in Timberwolf used to collateralize the exposure we have to the CDO on the CDS contracts that are the assets in TWOLF."[2654]

The meeting was scheduled for 1:15 p.m. that same day,[2655] and one of the counsels requested a copy of the Offering Memorandum and "the operative documents that contain our rights/obligations with respect to the Collateral."[2656]

The Subcommittee did not locate any documents recounting exactly what was discussed at the meeting. The default swap collateral issue involved a significant number of Goldman CDOs, affected Goldman's relationships with investors and other financial firms serving as collateral managers of its CDOs, and entailed substantial financial risk for Goldman. Yet, when asked about it, the key participants said they could not recall whether the meeting took place, what was discussed at the meeting if it did take place, or what determinations were reached regarding Goldman's authority or actions. The participants who could not recall the meeting included Mr. Bieber, the Timberwolf deal captain; Tim Saunders, counsel

[2652] 7/25/2007 email from Matthew Bieber, GS MBS-E-001989091.
[2653] 1/7/2011 email from Goldman counsel to the Subcommittee.
[2654] 9/7/2007 email from Matthew Bieber to Tim Saunders, Susan Helfrick, and Jordan Horvath, GS MBS-E-021881077.
[2655] Id.
[2656] 9/7/2007 email from Susan Helfrick to Matthew Bieber, Tim Saunders, and Jordan Horvath, GS MBS-E-021881084.

from Goldman's legal department; Susan Helfrick, another legal counsel; and Jordan Horvath, the compliance officer. Mr. Saunders, the lead Goldman legal counsel on the matter, informed the Subcommittee that he had "no present recollection of the circumstances surrounding any disagreement between Goldman Sachs and Greywolf Capital Management LP regarding Goldman Sachs' right to consent to reinvestment of default swap collateral in Timberwolf."[2657] Mr. Bieber, the Timberwolf deal captain, told the Subcommittee that he did not recall whether Goldman developed any specific strategy limiting the type of default swap collateral securities that could be purchased for its CDOs.[2658]

However, documents obtained by the Subcommittee indicate that the meeting did take place, and Goldman did develop a strategy to respond to Greywolf's concerns. On September 7, 2007, the same day as the meeting, Mr. Lehman sent a email to Mr. Bieber stating:

> "U spoke w[ith] [Jonathan] egol? What ab[ou]t legal/compliance[?] Just make sure Dan [Sparks] is ok w[ith] it[.] Also I do th[in]k we sh[oul]d be consistent across deals . . . so if slmas and credit cards are 'ok' I th[in]k we tell our mgrs [managers] that . . . maybe 2 y[ea]rs and shorter."[2659]

Mr. Bieber responded: "Spoke with legal/compliance. Not doing anything w/o [without] discussing with dan [Sparks] first. Agree with the point on consistency."[2660]

Also on September 7, 2007, Jonathan Egol, head of the Mortgage Department's Correlation Trading Desk, sent an email to Mr. Lehman and others suggesting that Goldman identify a narrow set of very safe asset backed securities that it could propose to Greywolf as possible default

[2657] Mr. Saunders, Ms. Helfrick, and Mr. Horvath provided signed statements to the Subcommittee to the same effect. See written statements submitted to the Subcommittee by Timothy Saunders (12/22/2010), Susan Helfrick (1/7/2011), and Jordan Horvath (1/7/2011). Although Mr. Lehman was not invited to the meeting, he told the Subcommittee that he generally recalled having discussions with his colleagues, including Goldman's legal department, about the general issue of default swap collateral, but did not recall his conversation with Mr. Marconi. He also submitted a statement to the Subcommittee saying he had no recollection of whether the meeting took place or, if a meeting was held, what was discussed or decided. Written statement of Mr. Lehman (1/26/2011). Mr. Sparks, the head of the Mortgage Department, told the Subcommittee that while he had a general knowledge of the issue regarding default swap collateral securities, he had no recollection of any meeting or decisions made. Subcommittee interview of Daniel Sparks (1/13/2011).

[2658] Subcommittee interview of Matthew Bieber (10/21/2010).

[2659] 9/7/2007 email exchange between David Lehman and Matthew Bieber, GS MBS-E-000766414. The reference to "slmas" is to asset backed securities that were issued by Sallie Mae and backed by pools of student loans.

[2660] Id.

swap collateral securities, such as AAA rated securities backed by credit card receivables or student loans.[2661] Mr. Bieber sent an email the same day indicating he supported that approach, but wanted to speak first with Mr. Sparks, head of the Mortgage Department.[2662]

Subsequent documents indicate that Goldman reversed its initial position and decided to consent to the purchase of more default swap collateral securities. However, Goldman appeared to narrow the class of asset backed securities that it would consent to be acquired as default swap collateral. On September 10, 2007, Mr. Bieber sent an email to Mr. Lehman reporting:

> "Managed to catch up with Dan [Sparks] just now ... we're going to put together a list of SLMA floaters in our inventory to show Joe [Marconi at Greywolf]. Going over w/ Dan tomorrow before sending anything externally."[2663]

Goldman also sent a short list of commercial mortgage backed securities (CMBS) in its inventory that it would consent to be acquired for Timberwolf.[2664]

[2661] 9/7/2007 email from Jonathan Egol to Michael Swenson and David Lehman, GS MBS-E-000765854.

[2662] See 9/7/2007 email from Matthew Bieber to David Lehman, GS MBS-E-000766414 ("I need to speak with dan... we're thinking about offering some 1-3 year SLMAs.").

[2663] 9/10/2007 email from Matthew Bieber to David Lehman, GS MBS-E-000765316. "SLMA" refers to asset backed securities that were issued by Sallie Mae and backed by pools of student loans.

[2664] 9/25/2007 email from Matthew Bieber to Joe Marconi, GS MBS-E-000766338. The action taken by Goldman to stop the purchase of new default swap collateral securities was not the only instance in which it attempted to exert control over the collateral in the CDOs it constructed. In the case of the Broadwick CDO, for example, when some investors were entitled to the return of some collateral, Goldman attempted to have the CDO pay them with securities rather than cash, so that the CDO would preserve the cash in its collateral account. The Broadwick collateral manager objected and complained in an email sent to Mr. Sparks, stating in part:

> "In case I wasn't clear on the call, our three main points would be:
> 1. The aim of the collateral account was to provide LIBOR and not add additional risk to the deal.
> 2. GS said they would take market risk and clearly represented that to us and to the ratings agencies.
> 3. The only way the deal works, and the way the deal was marketed and explained to us, is that paydowns are equivalent to partial terminations. We do not believe you have any right to refuse to release excess cash that is no longer needed as collateral, and we do not believe you have the right to release bonds into the waterfall ever, and certainly not when cash exists. Perhaps the way you did these deals changed over time and you are comparing our deal to ones which you marketed or structured later/differently? I look forward to hearing from you."

11/20/2007 email from Ron Beller to Matthew Bieber, GS MBS-E-013746516.

Over the next two weeks, Goldman sent a list of acceptable securities to two more collateral managers of its CDOs.[2665] On October 15, 2007, Mr. Bieber provided virtually the same list to a Goldman colleague together with a short explanation of some of the criteria used to identify the securities:

> "Here are the shelves we'd like to use for default swap collateral reinvestment.
> RMBS: CBASS, GSAA, GSAMP, JPMAC, WFHET
> CARDS: AMXCA, BACCT, BOIT, MBNAS, CCCIT,CHAIT, DCMT
> AUTOS: COPAR, DCMOT, FORDO, HAROT, HDMOT, NALT, USAOT
> STUDENT LOANS: ACCSS, GCOE, KSLT, NCSLT, SLMA (FFELP)
>
> In addition to the default swap collateral constraints in the docs for each transaction, also looking to securities that are (a) floating rate (b) monthly pay (c) senior-most bond in capital structure (d) avg life of less than or equal to 2 years (e) currently amortizing.
> Please let me know if you have any questions."[2666]

All of the listed securities consisted of AAA rated securities backed by residential mortgages, credit card receivables, automobile loans, or student loans, and had an expected maturity of two years or less. It appears as if Goldman was restricting the selection of default swap collateral securities to a limited list of assets that it believed were likely to maintain their par value in order to minimize its financial exposure.

After indicating it would allow these new purchases, Goldman maintained tight control over the actual purchases made by the collateral managers. A September 27, 2007 email exchange between Mr. Marconi of Greywolf and Mr. Bieber of Goldman, for example, demonstrates Goldman's intense monitoring effort:

> Mr. Marconi: "Matt: I am seeing this list from another dealer. Can I assume that I can buy any name on your approved list?" ...
> Mr. Bieber: "No-we need to give approval on a security by security basis."[2667]

[2665] Documents show that a list of assets was sent to Aladdin Capital Management and Trust Company of the West. See 9/24/2007 email from Benjamin Case to Marty Devote of Aladdin Capital Management, GS MBS-E 022138816; 9/20/2007 email from Matthew Bieber to Vincent Fiorillo of Trust Company of the West, GS MBS-E-022141026-27.

[2666] 10/15/2007 email from Matthew Bieber to Matthew Verrochi, GS MBS-E-015732147. The list had one more RMBS security than the lists sent to the collateral managers.

[2667] 9/27/2007 email from Joe Marconi to Matthew Bieber, GW 108645.

When asked about these matters, both Mr. Sparks and Mr. Lehman characterized the default swap collateral securities issue as a minor issue. Mr. Lehman informed the Subcommittee that he did not recall significant debate with collateral managers on the matter.[2668] Mr. Sparks said the yield difference between keeping the collateral in cash and investing in securities was minimal and characterized the whole issue as "structured finance gymnastics."[2669] But information supplied by Goldman to the Subcommittee on seven Goldman-originated CDOs shows that, due to its duties as collateral put provider and the declining value of the CDOs' default swap collateral securities, Goldman eventually lost over $1 billion.[2670]

Analysis. In its synthetic CDOs, Goldman arranged for its subsidiary, GSI, to act as both the primary CDS counterparty and the collateral put provider. Goldman also arranged for GSI to receive a fee for serving as the collateral put provider, through paying reduced premiums in connection with the CDS contracts it entered into with the CDOs. Despite this fee, Goldman took actions to evade its responsibilities as the collateral put provider, including by refusing to approve the purchase of new default swap collateral securities whose values might decline below par value. Instead, Goldman tried to force the CDOs to keep their collateral in cash. While this effort provided more protection for Goldman's financial interest as the short party, it worked to the disadvantage of the CDO investors because it produced lower returns for the CDOs than the purchase of default swap collateral securities.

When the Timberwolf collateral manager objected, Goldman backed down and allowed the purchase of a narrow range of very safe, short term asset backed securities as collateral for Timberwolf and other CDOs. Goldman's conduct in the Timberwolf CDO demonstrates how a financial institution that plays multiple roles in a CDO can develop conflicts of interest and attempt to manipulate the CDO to place its own financial interests before those of the investors to whom it sold the CDO securities.

[2668] Written statement of David Lehman (1/26/2011).

[2669] Subcommittee interview of Daniel Sparks (1/13/2011).

[2670] The seven CDOs were Fort Denison, Camber 7, Timberwolf, Anderson Mezzanine, Point Pleasant, Hudson Mezzanine 2006-1, and Hudson Mezzanine 2006-2. Goldman lost $1.018 billion from acting as the collateral put provider for their default swap collateral securities. See Goldman response to Subcommittee QFR at PSI_QFR_GS0280.

(6) Analysis of Goldman's Conflicts of Interest

The Goldman Sachs case study identifies a number of practices that raise conflict of interest concerns. Those practices include the following.

1. **Shorting Its Own Securities.** In Hudson, Anderson, and Timberwolf, Goldman marketed CDO securities to clients, took a substantial portion of the short side of the CDO, bet the CDO would fall in value, and profited from its short position at the expense of the clients to whom it sold the securities.

2. **Failing to Disclose Key Information to Investors.** In Hudson, Anderson, and Timberwolf, Goldman represented to potential investors that its interests "were aligned" with theirs or advertised its retention of a portion of the CDO's equity tranche, without disclosing that it had an even larger short position in the CDO and held a financial interest directly adverse to the investors to whom it was selling the CDO securities.

3. **Misrepresenting Source of Assets.** In Hudson, Goldman provided 100% of the CDO assets using CDS contracts it controlled and priced, transferred $1.2 billion of risk from its own inventory to the CDO, and told investors the assets had been "sourced from the Street," when they had been supplied solely by Goldman and not priced from transactions with third parties.

4. **Failing to Disclose Client Involvement.** In Abacus, Goldman enabled a client who was shorting the CDO to help select the CDO's assets, solicited investors to buy the Abacus securities without disclosing the short party's asset selection role or investment objective, and helped the client gain a $1 billion profit at the expense of the investors to whom Goldman sold the securities.

5. **Minimizing Premiums.** In Abacus, Goldman entered into an undisclosed agreement with the sole short party to accept a fee for arranging low premium payments by the short party to the CDO, even though low premium payments meant less money for the long investors to whom Goldman had sold the Abacus securities.

6. **Selling Securities Designed to Fail.** Goldman sold Hudson and Abacus securities to clients knowing the securities were designed to fall in value and benefit the short party, which was a client in the case of Abacus and itself in the case of Hudson.

7. **Delaying Liquidation.** In Hudson, Goldman was paid a fee to serve as the liquidation agent, but delayed liquidating assets that were losing value for eight months, enhancing its financial gain as the CDO's short party at the expense of the long parties whose losses would have been staunched if the assets had been liquidated.

8. **Misrepresenting Assets.** In Anderson, when clients asked how Goldman got "comfortable" with poor quality New Century loans in the CDO, Goldman worked to dispel those concerns and failed to disclose its own discomfort with New Century loans and that it held 40% of the short side of the CDO, betting its assets would lose value.

9. **Taking Immediate Post-Sale Markdowns.** In Timberwolf, Goldman knowingly sold Timberwolf securities to clients at prices above its own book values and then, often within days or weeks of a sale, marked down the value of the sold securities, causing clients to incur quick losses and requiring some to post higher margin or cash collateral.

10. **Evading Put Obligation.** In Timberwolf, Goldman was paid a fee to serve as the collateral put provider, but refused for two months to allow the purchase of default swap collateral securities, even though they meant better returns for long investors, because Goldman did not want to assume the risk that the collateral securities might lose value.

11. **Using Poor Quality Loans in Securitizations.** Goldman provided securitization services and warehouse accounts to lenders with a history of issuing high risk, poor quality loans, and knowingly included poor quality loans in Goldman-originated RMBS and CDO securities.

12. **Concealing Its Net Short Position.** From late 2006 through most of 2007, Goldman engaged in a relentless effort to sell the CDO and RMBS securities it underwrote, without disclosing to the clients it solicited that Goldman was simultaneously shorting the subprime market and betting it would lose value.

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These practices raise a wide range of ethical and legal concerns. This section examines the key issues of whether Goldman had a legal obligation to disclose to clients the existence of material adverse information, including conflicts of interest, when selling them RMBS and CDO securities; whether Goldman had material adverse interests that should have been disclosed to investors; and whether Goldman had an obligation not to recommend securities that were designed to lose value. Many of these issues hinge upon the proper treatment of financial instruments, such as credit default swaps and CDOs, which enable an investment bank to bet against the very same securities it is selling to clients.

(a) Securities Laws

To protect fair, open, and efficient markets for investors, federal securities laws impose a range of specific disclosure and fair dealing obligations on market participants, depending upon the securities activities they undertake. In the matters examined by the Subcommittee, the key roles under the securities laws include market maker, underwriter, placement agent, broker-dealer, and investment adviser.

Market Maker. A "market maker" is typically a dealer in financial instruments that stands ready to buy and sell a particular financial instrument on a regular and continuous basis at a publicly quoted price.[2671] A major responsibility of a market maker is filling orders on behalf of customers. Market markers do not solicit customers; instead they maintain buy and sell quotes in a public setting, demonstrating their readiness to either buy or sell the specified security, and customers come to them. For example, a market maker in a particular stock typically posts the prices at which it is willing to buy or sell that stock, attracting customers based on the competitiveness of its prices. This activity by market makers helps provide liquidity and efficiency in the trading market for that security.[2672] Market makers do not keep the financial instruments they buy and sell in their own investment portfolio, but instead keep them in their sales portfolio or "trading book."

[2671] Section 3(a)(38) of the Securities Exchange Act of 1934 ("The term 'market maker' means any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis."); see also SEC website, http://www.sec.gov/answers/mktmaker.htm; see also FINRA website, FAQs, "What Does a Market Maker Do?" http://finra.atgnow.com/finra/categoryBrowse.do.
[2672] SEC website, http://www.sec.gov/answers/mktmaker.htm.

Market makers have among the most narrow disclosure obligations under federal securities law, since they typically do not actively solicit clients or make investment recommendations to them. Their disclosure obligations are generally limited to providing fair and accurate information related to the execution of a particular trade.[2673] Market makers are also subject to the securities laws' prohibitions against fraud and market manipulation. In addition, they are subject to legal requirements relating to the handling of customer orders, for example using best execution efforts when placing a client's buy or sell order.[2674]

Underwriter and Placement Agent. Underwriters and placement agents have greater disclosure obligations than market makers, because in this role they are actively soliciting customers to buy new securities they have helped an issuer bring to market.

When securities are offered to the public for sale, they are typically underwritten by one or more investment banks, each of which is a broker-dealer registered with the Financial Industry Regulatory Authority (FINRA).[2675] An underwriter is typically hired by the issuer of the new securities to help the issuer register the securities with the SEC and conduct a public offering of the securities. The underwriter typically purchases the securities from the issuer, holds them on its books, conducts the public offering, and bears the financial risk until the securities are sold to the public.

Investment banks can also act as "placement agents," assisting those seeking to raise money through a private offering of securities by helping them design the securities, produce the offering materials, and market the new securities to investors. Placement agents are also registered broker-dealers. While public offerings of securities are required to be registered and filed with the SEC, private offerings are made to a limited number of investors and are exempt from SEC registration. In the securitization industry, RMBS securities are generally sold through public offerings, while CDO securities are generally sold through private placements.

[2673] 1/2011 "Study on Investment Advisers and Broker-Dealers," study conducted by the U.S. Securities and Exchange Commission, at 55, http://www.sec.gov/news/studies/2011/913studyfinal.pdf, (hereinafter "SEC Study on Investment Advisers and Broker-Dealers").

[2674] See Goldman response to Subcommittee QFR at PSI_QFR_GS0046.

[2675] FINRA is the largest independent self-regulatory organization for securities firms doing business in the United States. FINRA has been delegated authority by the SEC and a number of securities exchanges to regulate the broker-dealer industry. Its stated mission is "to protect America's investors by making sure the securities industry operates fairly and honestly." See FINRA website, http://www.finra.org.

Whether acting as an underwriter or placement agent, a major part of the investment bank's responsibility is to solicit customers to buy the new securities being offered. Under the securities laws, an issuer selling new securities to potential investors has an affirmative duty to disclose material information that a reasonable investor would want to know.[2676] In addition, under securities law, a broker-dealer acting as an underwriter or placement agent is liable for any material misrepresentation or omission of material fact made in connection with a solicitation or sale of securities to an investor.[2677]

The Supreme Court has held that a fact is material if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[2678] The SEC has provided this additional guidance:

> "'The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor.' '[T]he reaction of individual investors is not determinative of materiality, since the standard is objective, not subjective.' '[M]ateriality depends on the significance the reasonable investor would place on the withheld or misrepresented information.' Although in general materiality is primarily a factual inquiry, 'the question of materiality is to be resolved as a matter of law when the information is 'so obviously important [or unimportant] to an investor, that reasonable minds cannot differ on the question of materiality.'"[2679]

[2676] See, e.g., SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 201 (1963) ("Experience has shown that disclosure in such situations, while not onerous to the advisor, is needed to preserve the climate of fair dealing which is so essential to maintain public confidence in the securities industry and to preserve the economic health of the country."). See also SEC Study on Investment Advisers and Broker-Dealers at 51 [citations omitted] ("Under the so-called 'shingle' theory ... a broker-dealer makes an implicit representation to those persons with whom it transacts business that it will deal fairly with them, consistent with the standards of the profession. ... Actions taken by the broker-dealer that are not fair to the customer must be disclosed in order to make this implied representation of fairness not misleading.").

[2677] See Sections 11 and 12 of Securities Act of 1933. See also Rule 10b-5 of the Securities Exchange Act of 1934. See also SEC v. Capital Gains Research Bureau, Inc., 375 U.S. at 200 ("Failure to disclose material facts must be deemed fraud or deceit within its intended meaning, for, as the experience of the 1920's and 1930's amply reveals, the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive."). See also Goldman response to Subcommittee QFR, at PSI_QFR_GS0046.

[2678] Basic v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

[2679] In the Matter of David Henry Disraeli and Lifeplan Associates, Securities Exchange Act Rel. No. 34-2686 (December 21, 2007) at 10-11 [citations omitted].

Unlike when a broker-dealer is acting as a market maker, a broker-dealer acting as an underwriter or placement agent has an obligation to disclose material information to every investor it solicits, including the existence of any material conflict of interest or adverse interest. This duty arises from two sources: the duties of an underwriter specifically, and the duties of a broker-dealer generally, when making an investment recommendation to a customer.

With respect to the duties of an underwriter, the First Circuit has observed that underwriters have a "unique position" in the securities industry:

> "[T]he relationship between the underwriter and its customer implicitly involves a favorable recommendation of the issued security. ... Although the underwriter cannot be a guarantor of the soundness of any issue, he may not give it his implied stamp of approval without having a reasonable basis for concluding that the issue is sound."[2680]

With respect to a broker-dealer, the SEC has held:

> "[W]hen a securities dealer recommends a stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts to which it is aware. That includes disclosure of 'adverse interests' such as 'economic self interest' that could have influenced its recommendation."[2681]

The SEC has also stated that, if a broker intends to sell a security from its own inventory and recommends it to a customer, "the broker dealer must disclose all material facts."[2682]

[2680] SEC v. Tambone, 550 F.3d 106, 135 (1st Cir. 2008) [citations omitted].

[2681] In the Matter of Richmark Capital Corporation, Securities Exchange Act Rel. No. 48757 (Nov. 7, 2003) (citing Chasins v. Smith Barney & Co., Inc., 438 F.3d 1167, 1172 (2d. Cir. 1970) ("The investor... must be permitted to evaluate overlapping motivations through appropriate disclosures, especially where one motivation is economic self-interest"). See also SEC Study on Investment Advisers and Broker-Dealers at 55. In this recent study examining the disclosure obligations of broker-dealers and investment advisers, the SEC has explained: "Generally, under the anti-fraud provisions, a broker-dealer's duty to disclose material information to its customer is based upon the scope of the relationship with the customer, which is fact intensive." According to the SEC, when a broker-dealer acts as an order taker or market maker in effecting a transaction for a customer, the broker-dealer generally does not have a duty to disclose information regarding the security or the broker-dealer's economic interest. The duty to disclose this information is triggered, however, when the broker-dealer recommends a security. Id.

[2682] SEC Study on Investment Advisers and Broker-Dealers at 56, n.252.

To help broker-dealers understand when they are obligated to disclose to investors material information, including any material adverse interest, FINRA has further defined the term "recommendation":

> "[A] broad range of circumstances may cause a transaction to be considered recommended, and this determination does not depend on the classification of the transaction by a particular member as 'solicited' or 'unsolicited.' In particular a transaction will be considered to be recommended when the member or its associated person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages."[2683]

Goldman's own compliance manual essentially incorporates this guidance and instructs Goldman personnel that a proactive effort to sell a specific investment to a specific customer constitutes a recommendation of that investment.[2684]

Once a broker-dealer, acting in the role of an underwriter or placement agent, has made an investment recommendation and triggered the duty to disclose any material adverse interest to a potential investor, it must disclose not only that the adverse interest exists, but also the "nature and extent" of the adverse interest.[2685] In addition, it is not enough to inform a customer that the underwriter or placement agent "may" have an adverse interest if, in fact, the adverse interest already exists.[2686] Further, there is no indication in any law or regulation that the

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[2683] FINRA Notice to Members 96-60.

[2684] See 2/1/2001 Goldman document, "United States Policies for the Preparation, Supervision, Distribution and Retention of Written and Electronic Communications," at 9, GS MBS 0000035799.

[2685] See ,e.g., In the Matter of Arleen Hughes, Securities Exchange Act Rel. No. 4048 (Feb. 1948) (holding a broker-dealer, who is also a registered investment adviser, violated the anti-fraud provisions of the federal securities laws by failing to at minimum disclose the "nature and extent" of its adverse interest); In the Matter of Edward D. Jones & Co., L.P., Exchange Act Rel. No. 50910 (Dec. 22, 2004) (settled order), at 21(broker-dealer consents to an order finding that disclosure to its customers was inadequate, because it failed to disclose the full nature and extent of its agreement, including "information about the source and the amount of the revenue sharing payments to [the broker-dealer] and the dimensions of the resulting potential conflicts of interest").

[2686] See, e.g., SEC v. Czuczko, Case No. CV06-4792 (USDC CD Calif.), Order Granting Plaintiff's Unopposed Motion for Summary Judgment (Dec. 5, 2007). In Czuczko, the defendant, who offered online investment advice, included a disclaimer on his website advising that officers, directors, employees and members of their families "*may, from time to time*, trade in these securities for their own accounts" [emphasis in original]. Id. at 8. Relying on SEC v. Blavin, 760 F.2d 706 (6th Cir. 1985), the court held such an assertion "is itself a material misstatement because the Defendant *knew* he, his father, and his business partner *did* trade in the stocks and *had a biased interest* in the recommended stocks" [emphasis in original]. Czuczko, at 8.

obligation to disclose material adverse information is diminished or waived in relation to the level of sophistication of the potential investor.[2687]

Suitable Investment Recommendations. In addition to requiring disclosure of material adverse information, federal securities laws and FINRA rules prohibit broker-dealers from making investment recommendations that would be unsuitable for any customer.[2688]

In a recent study, the SEC explained: "[W]hile the suitability obligation under the federal securities laws arises from the anti-fraud provisions, the SRO [Self Regulatory Organization] rules are grounded in concepts of ethics, professionalism, fair dealing, and just and equitable principles of trade."[2689] For example, FINRA Rule 2010, providing Standards of Commercial Honor and Principles of Trade, states: "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."[2690]

A broker-dealer violates the suitability rule if it makes a recommendation that "is unsuitable for any investor, regardless of the investor's wealth, willingness to bear risk, age or other individual characteristics."[2691] Under the applicable case law and FINRA rules, a broker-dealer is also obligated "to have an 'adequate and reasonable basis' for any security or strategy recommendation that it makes."[2692]

[2687] See FINRA Rules 2210(d)(1)(A) and 2211(a)(3) and (d)(1) (by rule all institutional sales material and correspondence may not "omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading."); and FINRA Rule 2310 and IM-2310-3 (suitability obligation to institutional customers). See also Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969) (holding that sophistication and knowledge of a broker's customers do not warrant a less stringent standard of conduct under federal securities laws); Spatz v. Borenstein, 513 F. Supp. 571, 580 (N.D. Ill. 1981) (finding investors' experience does not mitigate a broker's duty to fully and truthfully disclose material facts, nor does the potential for investors to discover information not disclosed by a prospectus vitiate any legal liability stemming from a failure to disclose material facts); Department of Enforcement v. Kesner, FINRA Complaint No. 2005001729501 (February 26, 2010) (finding sophistication of investors does not relieve a securities representative from disclosing material facts to investors).

[2688] SEC Study on Investment Advisers and Broker-Dealers at 61.

[2689] Id.

[2690] FINRA Rule 2010. See also Study on Investment Advisers and Broker-Dealers at 55 (broker-dealers also have an obligation under the federal securities laws and FINRA rules to deal fairly with their customers).

[2691] F.J. Kaufman and Co., Securities Exchange Act Rel. No. 27535 at 5 (December 13, 1989).

[2692] SEC Study on Investment Advisers and Broker-Dealers at 63 [citations omitted]. The suitability rule also requires the broker to determine that the specific security recommended is appropriate based on the customer's financial situation and needs. FINRA Rule 2310. The suitability obligation clearly applies to institutional customers, FINRA IM-2310-3 (suitability obligations to institutional customers require members have a reasonable basis for recommending a particular security or strategy), but may not apply when a broker-dealer solicits

Suitability rules are intended to prevent abuses that contributed to the stock crash of 1929 and the Great Depression of the 1930s, when Senators investigating investment bank activities at the time wrote the following:

> "[Investors] must believe that their investment banker would not offer them the bonds unless the banker believed them to be safe. This throws a heavy responsibility upon the banker. He may and does make mistakes. There is no way that he can avoid making mistakes because he is human and because in this world, things are only relatively secure. There is no such thing as absolute security. But while the banker may make mistakes, he must never make the mistake of offering investments to his clients which he does not believe to be good."[2693]

Investment Advisers. For investment banks that act, not just as a broker-dealer, underwriter, or placement agent, but also as an investment adviser to their customers, federal securities laws impose still a higher legal duty. When acting as an investment adviser, the law imposes a fiduciary obligation on the investment bank to act in the "best interests of its clients."[2694] A person qualifies as an "investment adviser" under the Investment Advisers Act if that person: provides advice regarding securities, is in the business of providing such advice, and provides that advice for compensation.[2695] A broker-dealer, however, is excluded from the Investment Advisers Act if the performance of its investment advisory services is "solely" incidental to its business as a broker-dealer, and the broker-dealer does not receive "special compensation" for providing those advisory services.[2696] Because Goldman appears to have acted primarily as an underwriter, placement agent, or broker-dealer in

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another broker-dealer to buy an investment since, under FINRA Rules, the term "customer" does not include a broker or dealer. FINRA Manual, 0120 Definition. On the other hand, the term "customer" has been given a broad definition under the securities case law. See, e.g., Department of Enforcement v. Zayed, FINRA Complaint No. 2006003834901 (August 19, 2010) ("Cases interpreting the term 'customer' in the securities context have viewed the term broadly to encompass individuals or entities that have some brokerage or investment relationship with the broker-dealer. Specifically, courts have rejected the argument that an account is necessary to establish an investor's status as a customer." [citations omitted]). When the Subcommittee asked Mr. Blankfein whether he believed there was a difference between a "customer" and a "client," Mr. Blankfein said he had "never distinguished" between the two terms. Subcommittee deposition of Lloyd Blankfein (12/15/2009), Hearing Exhibit 4/27-176 [Sealed Exhibit].

[2693] 6/16/1934 "Stock Exchange Practices," Report of the Senate Committee on Banking and Currency, S. Rep. 73-1455, at 88 (quoting "Who Buys Foreign Bonds," Foreign Affairs (1/1927)).

[2694] SEC Study on Investment Advisers and Broker-Dealers at 15-16.

[2695] Id.

[2696] Id.

carrying out its securitization activities, this section analyzes Goldman's conduct in that context and not in the context of an investment adviser.[2697]

(b) Analysis

One key issue is whether Goldman was acting as a market maker versus an underwriter or placement agent when it recommended that its clients purchase its CDO and RMBS securities, since those roles have different disclosure and suitability obligations under the law. A second key issue is whether Goldman withheld material adverse information when recommending its securities to its clients, including the fact that it was shorting the securities it was selling. A third key issue is whether Goldman violated its obligation to make suitable investment recommendations when urging customers to purchase securities that Goldman knew were designed to lose value.

(i) Claiming Market Maker Status

Given its active role in the securitization markets, Goldman assumed a variety of roles in the development, marketing, and trade of RMBS and CDO products. At times, it acted as a market maker responding to client orders to buy and sell RMBS and CDO products. In addition, from 2006 to 2007, Goldman originated and served as an underwriter or placement agent for 27 CDOs and 93 RMBS securitizations, and sold the resulting RMBS and CDO securities to a broad range of clients around the world.

In public statements and testimony regarding the financial crisis, Goldman has often highlighted its role as a market maker and downplayed its role as an underwriter or placement agent in the securitization markets.[2698] In the April 27, 2010 Subcommittee hearing, for example, Goldman executives repeatedly highlighted the firm's role as market makers – buying and selling RMBS and CDO securities at the request of clients – while deemphasizing that the firm also originated

[2697] The Subcommittee did not examine the extent to which Goldman was acting as an investment adviser within the meaning of the Investment Advisers Act when recommending that various customers buy its RMBS and CDO securities.

[2698] See, e.g., 3/1/2010 letter from Goldman's legal counsel to the Financial Crisis Inquiry Commission, GS-PSI-01310 (discussing Goldman Sachs' "Role as a market maker" in detail and distinguishing it, in a much shorter description, from its underwriting and placement roles). Although the letter acknowledged that Goldman acted as an underwriter and placement agent for RMBS and CDO transactions, it also suggested that those transactions were commonly designed in response to client inquiries and did not discuss efforts by the firm to solicit customers to buy the securities: "Goldman Sachs' CDOs ... were initially created in response to the request of a sophisticated institutional investor that approached the firm specifically seeking that particular exposure. Reverse inquiries from clients were a common feature of this market."

new securities and affirmatively solicited clients to buy those new securities.

In an exchange with Senator Susan Collins, for example, executives from Goldman's Mortgage Department were asked questions about whether they were investment advisers with a fiduciary duty to their clients. While not denying this duty, they emphasized their role as market makers with more limited client obligations:[2699]

> Senator Collins: Thank you, Mr. Chairman. I would like to start my questioning by asking each of you a fundamental question. Investment advisers have a legal obligation to act in the best interests of their clients. Mr. Sparks, when you were working at Goldman, did you consider yourself to have a duty to act in the best interests of your clients?
>
> Mr. Sparks: Senator, I had a duty to act in a very straightforward way, in a very open way with my clients. Technically, with respect to investment advice, we were a market maker in that regard. But with respect to being a prudent and a responsible participant in the market, we do have a duty to do that.
>
> Senator Collins: Mr. Swenson?
>
> Mr. Swenson: I believe it is our responsibility as market makers to provide a market-level bid and offer to our clients and to serve our clients and helping them transact at levels that are fair market prices and help meet their needs.

Mr. Tourre made similar representations in his prepared testimony to the Subcommittee:

> "Between 2004 and 2007, my job was primarily to make markets for clients. I made markets by connecting clients who wished to take a long exposure to an asset – meaning they anticipated the value of the asset would rise – with clients who wished to take a short exposure to an asset – meaning they anticipated the value of the asset would fall. I was an intermediary between highly sophisticated professional investors – all of which were institutions. None of my clients were individual, retail investors."[2700]

[2699] April 27, 2010 Subcommittee Hearing Transcript at 26-27.
[2700] Prepared statement of Fabrice Tourre, April 27, 2010 Subcommittee Hearing at 1.

In another exchange, when Subcommittee Chairman Levin asked Goldman CEO Lloyd Blankfein about the firm's duty as an underwriter and placement agent to disclose its adverse interests when selling its CDO securities to potential investors, Mr. Blankfein responded that market makers had no such disclosure obligations:

> Senator Levin: You are betting against the very security that you are selling to that person. You don't see any problem? You don't see that you have to disclose, when you have put together a deal and you go looking for people to buy those securities, it just adds insult to injury when your people think it is a pile of junk. But the underlying injury is that you have determined that you are going to keep the opposite position from the security that you are selling to someone. You just don't see any obligation to disclose that. That is what seems to be coming through here.
>
> Mr. Blankfein: I don't believe there is a disclosure obligation, but as a market maker, I am not sure how a market would work if it was premised on the assumption that the other side of the market cared what your opinion was about the position they were taking.
>
> Senator Levin: Do they have a belief that you, at least when you are going out peddling securities, that you want that security to succeed? Don't they have that right to assume that if you are going out selling securities, that you have a belief that that is something which would be good for that client?
>
> Mr. Blankfein: I think we have to have a belief, and we do have a belief that if somebody wants an exposure to housing –
>
> Senator Levin: They don't want – you are out there selling it to them. You are out there selling these securities. This isn't someone walking in the door.
>
> Mr. Blankfein: Again, I want –
>
> Senator Levin: You are picking up the phone. You are calling all these people. You don't tell them that you think it is a piece of junk. You don't tell them that this is a security which incorporates or which in some way references a whole lot of bad stuff in your own inventory – bad lemons, they were called. ... You are out there looking around for buyers of stuff, whether it is junk or not junk, where you are betting against what you are selling. You are intending to keep the opposite side. This isn't where you are just selling something from your inventory. This is where you are

betting against the very product you are selling, and you are just not troubled by it. That is the bottom line. There is no trouble in your mind –

Mr. Blankfein: Senator, I am sorry. I can't endorse your characterization.

Senator Levin: It is a question, not a characterization. I am saying, you are not troubled.

Mr. Blankfein: I am not troubled by the fact that we market make as principal and that we are the opposite – when somebody sells, they sell to us, or when they buy, they buy from us.[2701]

Although Goldman representatives routinely emphasized the firm's role as a market maker, when asked directly if the firm also functioned as an underwriter or placement agent when selling the CDO securities it originated, its executives agreed that in some circumstances, the firm played that role:

Senator Pryor: OK. But let me ask this: When you are selling a security such as a CDO, my understanding is you are not a market maker. Isn't it true that you are placement agent and as a placement agent you have a duty of full disclosure?

Mr. Sparks: Senator, that is correct.[2702]

Similarly, in a written response to a Subcommittee question asking about the firm's role in relation to Anderson, Hudson 1, Timberwolf and other CDOs, Mr. Blankfein wrote: "Goldman Sachs or an affiliate served as a placement agent."[2703]

Despite this acknowledged fact, Goldman continued to claim it was a market maker with limited disclosure and client obligations. On May 1, 2010, for example, less than a week after the Subcommittee's April 27 hearing, an article entitled, "Goldman Sachs' Lloyd Blankfein Defends 'Market Maker' Firm on 'Charlie Rose' Show," described Mr. Blankfein's statements on the televised show as follows:

"Asked by Rose whether Goldman investment advisers had ever bought securities from the firm, sold them to clients, and then bet against those same securities, Blankfein paused. And after a solid

[2701] April 27, 2010 Subcommittee Hearing at 137-138.
[2702] Id. at 53.
[2703] Goldman response to Subcommittee QFR at PSI_QFR_GS0026.

> six seconds of silence, sought to explain … Goldman's role as a 'market maker.'
>
> 'We're like a machine, that lets people buy and sell what they want to buy and sell' Blankfein said. 'That's not the advisory business. That's just a facility for market making.'"[2704]

During the interview, Mr. Blankfein compared Goldman's activity to that of the New York Stock Exchange, claiming that the firm was a market maker taking buy and sell orders from clients.[2705] At one point, Mr. Rose asked: "Has there ever been a time when Goldman's investment advisers bought securities from Goldman for a client and at the same time Goldman was simultaneously shorting it?" Mr. Blankfein responded: "I have to explain, see this is a problem. As a market maker, we are buying and selling a thousand times a minute, probably." Mr. Blankfein also stated during the interview: "If we believed it would fail, the security wouldn't work, we would not sell it."[2706]

(ii) Soliciting Clients and Recommending Investments

Under federal securities law and FINRA Rules detailed above, when a broker-dealer, acting as an underwriter or placement agent brings a specific security to the attention of a particular customer, it is considered to be recommending the security to that customer and has an obligation to disclose all material adverse information to that customer, including any adverse interest that a reasonable investor would consider material in considering the broker-dealer's recommendation. Despite Goldman's frequent efforts to characterize its CDO and RMBS sales efforts as a market making activity in response to client demand, Goldman's internal documents, emails, and interviews indicate that, from late 2006 through 2007, Goldman was not always responding to client demand, but was also aggressively soliciting customers in an attempt to sell its CDO and RMBS products.

In December 2006, for example, Goldman CFO David Viniar instructed the Mortgage Department to reduce its long position in mortgage related assets, including by selling RMBS and CDO products

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[2704] "Goldman Sachs' Lloyd Blankfein Defends 'Market Maker' Firm On 'Charlie Rose Show,'" Huffington Post (5/1/2010), http://www.huffingtonpost.com/2010/05/01/goldman%1esachs%1elloyd%1eblank_n_559606.html (video of Charlie Rose interview of Lloyd Blankfein embedded).

[2705] Id.

[2706] April 30, 2010 Transcript of The Charlie Rose Show at 12-14. Mr. Blankfein made similar claims the following week on CNBC's "Power Lunch" during a one-on-one interview with David Faber. May 7, 2010 Transcript of Power Lunch at 4.

on its books.[2707] The Mortgage Department responded with a concerted effort to sell to clients the bulk of the RMBS and CDO products in its inventory. The Subcommittee saw no evidence that this intensive selling campaign was undertaken in response to client demand. To the contrary, the evidence shows that the sales effort was undertaken at the request of senior management, despite what was then waning investor interest in securitization products.

In December 2006, on the same day Mr. Viniar directed the Mortgage Department to reduce its long assets, Kevin Gasvoda, head of the desk that handled RMBS securities, told his staff to "move stuff out even if you have to take a small loss."[2708] In January 2007, Mr. Sparks, head of the Mortgage Department, asked a senior executive to compliment the CDO Origination Desk head and his staffer for their efforts to sell a specific CDO's securities over the prior month: "They structured like mad and traveled the world, and worked their tails off to make some lemonade out of some big old lemons."[2709] In March 2007, Mr. Sparks emailed a call for "help" to Goldman's top sales managers around the world to "sell our new issues – CDOs and RMBS – and to sell our other cash trading positions."[2710] He wrote: "I can't over state the importance to the business of selling these positions and new issues. … Priority 1 – sell our new issues and cash positions."[2711] In April 2007, the Mortgage Department issued one of many sales directives to Goldman's global sales force, placing a priority on selling certain CDO securities in its inventory, including securities from Anderson, Timberwolf, Point Pleasant, and Altius CDOs, and Mr. Sparks recommended providing large sales credits for those able to complete the sales.[2712]

The documents also show that Goldman personnel worked relentlessly to identify possible clients and pitch CDO securities to them. In March 2007, for example, the Syndicate Desk contributed a list of "non-traditional buyers" that could be targeted for CDO sales, writing

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[2707] See, e.g., 12/14/2006 email from Daniel Sparks to Thomas Montag, "Subprime risk meeting with Viniar/McMahon Summary," GS MBS-E-009726498, Hearing Exhibit 4/27-3; Subcommittee interview of David Viniar (4/13/2010).
[2708] 12/14/2006 email from Kevin Gasvoda to his staff, "Retained bonds," GS MBS-E-010935323, Hearing Exhibit 4/27-72.
[2709] 1/31/2007 email from Daniel Sparks to Tom Montag, "MTModel," Hearing Exhibit 4/27-91.
[2710] 3/9/2007 email exchange between Mr. Sparks and sales managers, "help," GS MBS-E-010643213.
[2711] Id.
[2712] 4/19/2007 email from Daniel Sparks to Bunty Bohra, GS MBS-E-010539324, Hearing Exhibit 4/27-102.

that "we continue to push for leads."[2713] A Goldman sales manager suggested targeting European and Middle Eastern banks and hedge funds.[2714] In New York, a Goldman sales representative recounted that the Abacus CDO security "has been showed to selected accounts for the past few weeks. Those selected accounts previously declined participating in Anderson mezz, Point Pleasant, and Timberwolf."[2715]

When CDO sales slowed in May 2007, the Mortgage Department produced a new "target" list of four primary and 35 secondary clients for CDO sales.[2716] A few days later, a Goldman salesperson reported that he planned to contact a hedge fund about Timberwolf and Point Pleasant securities, noting that the customer was "[n]ot expert[] in this space at all but [I] made them a lot of money in correlation dislocation and will do as I suggest."[2717] In Australia, a Goldman sales representative contacted an Australian hedge fund, Basis Capital, and mounted a sustained effort to sell it $100 million in Timberwolf securities, overcoming investor concerns to make the sale.[2718] In Korea, a Goldman sales representative attempting to sell $56 million in Timberwolf securities to a Korean life insurance firm was encouraged to "Get 'er done" and "go for it" by his superiors when he informed them "we are pushing on our personal relationships to get this done."[2719]

These and other documents show that, in late 2006 and 2007, Goldman was not acting as primarily a market maker responding to client demand when it originated and sold Hudson, Anderson, Timberwolf, and Abacus securities, or when it sold other RMBS and CDO assets that senior management wanted to remove from the firm's books due to their declining values and increasing risk. Instead, Goldman was acting as an underwriter, placement agent, or broker-dealer, aggressively soliciting its clients to purchase the CDO and

[2713] 3/21/2007 email from Syndicate, "Non-traditional Buyer Base for CDO ASEX," GS MBS-E-003296460, Hearing Exhibit 4/27-78.
[2714] 3/9/2007 email exchange between Mr. Sparks and sales managers, "help," GS MBS-E-010643213, Hearing Exhibit 4/27-76.
[2715] 3/30/2007 email from Fabrice Tourre to Mr. Sparks and others, GS MBS-E-002678071.
[2716] 5/20/2007 Goldman presentation, "Mortgage Department, May 2007," GS MBS-E-010965212. See also 3/1/2007 email from Michael Swenson, "names," GS MBS-E-012504595 (SPG Trading target list tiered according to likelihood of purchasing); 2/14/2007 email to Matthew Bieber, "Timberwolf I, Ltd. – Target Account List," GS MBS-E-001996121 (list of U.S. accounts "we should be directly targeting" for Timberwolf sales); 3/2/2007 email from David Lehman, "ABX/Mtg Credit Accts," GS MBS-E-011057632 (mortgage credit business shared with SPG Trading Desk "a fairly lengthy list of accounts that are considered to be 'key'").
[2717] 5/24/2007 email from Ysuf Aliredha to Mr. Sparks and others, "Priority Axes," GS MBS-E-001934732.
[2718] See, e.g., 5/20/2007 email from George Maltezos to Mr. Lehman, "T/wolf and Basis," GS MBS-E-001863555; 5/22/2007 email from Mr. Maltezos to Basis Capital, JUL 000685.
[2719] 6/7/2007 email from Omar Chaudhary to Mr. Sparks and others, GS MBS-E-001866450, Hearing Exhibit 4/27-104.

RMBS products that senior management wanted to eliminate from its inventory.

(iii) Failing to Disclose Material Adverse Information

Goldman's marketing and solicitation efforts to sell Hudson, Anderson, Timberwolf, and Abacus securities, along with other CDO and RMBS assets, to clients raise multiple questions about whether Goldman met its obligation to disclose material adverse information to potential investors. A related question is whether Goldman met its obligation to avoid material misrepresentations and omissions of material facts when recommending the purchase of those securities. One key issue is whether Goldman's failure to disclose its shorting activities, which would enable it to profit from a decline in the value of the very securities Goldman was recommending to its clients to purchase, qualified as an "omitted fact" that "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" about the security being recommended by Goldman.[2720]

Taking the Short Side of a CDO. In the four CDOs examined in this Report, Goldman took 100% of the short side of Hudson, 40% of the short side of Anderson, and 36% of the short side of Timberwolf.[2721] In each of these CDOs, Goldman also made a relatively small investment in the long side of the CDO by initially retaining all or a portion of its equity tranche, allowing Goldman to claim an "interest" in the CDO's long term success.[2722] In Abacus, Goldman did not intend to make any investment in the CDO itself, and instead enabled the client that had requested construction of the CDO and played a key role in selecting its assets to hold 100% of the short side of the CDO.

Goldman did not accurately or fully disclose its short interest in Hudson, Anderson, or Timberwolf to potential investors.[2723] Instead, the CDOs' offering materials advised potential investors, in difficult to understand language, that a Goldman affiliate "may" adopt a financial interest or investment position adverse to the investors when, in fact,

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[2720] Basic v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Industries v. Northway, 426 U.S. 438, 449 (1976)). Utilizing the SEC's guidance, the issue could also be framed as evaluating "the significance the reasonable investor would place on the withheld or misrepresented information."

[2721] Goldman Response to Subcommittee QFR at PSI_QFR_GS0192.

[2722] Typically, the equity tranche, which is the first to incur any losses sustained by a securitization, is retained by the originator. Equity tranches are typically not rated by the credit rating agencies and often not sold to third parties.

[2723] In Abacus, Goldman also failed to disclose the role of the hedge fund in the Abacus asset selection process. See Abacus section C(5)(b)(ii)DD, above.

Goldman had already determined to do so. In a section entitled, "Certain Conflicts of Interest," for example, the Hudson 1 Offering Circular stated in part:

> "Certain Conflicts of Interest. Various potential and actual conflicts of interest may arise from the overall activities of the Credit Protection Buyer, the overall underwriting, investment and other activities of the Liquidation Agent, the Senior Swap Counterparty and the Collateral Put Provider, their respective affiliates and its clients and employees and from the overall investment activity of the Initial Purchaser, including in other transactions with the Issuer. The following briefly summarizes some of these conflicts, but is not intended to be an exhaustive list of all such conflicts.
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> "The Credit Protection Buyer and Senior Swap Counterparty. GSI [Goldman Sachs International] will be the initial Credit Protection Buyer and the initial Senior Swap Counterparty. The following briefly summarizes some potential and actual conflicts of interests related to the Credit Protection Buyer and Senior Swap Counterparty, but the following isn't intended to be an exhaustive list of all such conflicts. ...
>
> "GSI and/or any of its affiliates may invest and/or deal, for their own respective accounts for which they have investment discretion, in securities or in other interests in the Reference Entities, in obligations of the Reference Entities or in the obligors in respect of any Reference Obligations or Collateral Securities (the "Investments") or in credit default swaps (whether as protection buyer or seller) .... In addition, GSI and/or any of its affiliates may invest and/or deal, for their own respective accounts or for accounts for which they have investment discretion, in securities (or make loans or have other rights) that are senior to, or have interests different from or adverse to, any of the Investments and may act as adviser to, may be lenders to, and may have other ongoing relationships with, the issuers or obligors of Investments and obligations of any Reference Entities."[2724]

This disclosure indicates that GSI or an affiliate "may invest and/or deal" in securities or other "interests" in the assets underlying the

[2724] 12/3/2006 Goldman Offering Circular, "Hudson Mezzanine 2006-1, LTD.," at 56, GS MBS-E-021821196. The Goldman offering circulars for Timberwolf and Anderson contain similar sections. See 3/23/2007 Goldman Offering Circular, "Timberwolf I, LTD.," GS MBS-E-021825371 at 427; 3/16/2007 Goldman Offering Circular, "Anderson Mezzanine Funding 2007-1, LTD.," GS MBS-E-000912574, at 623.

Hudson CDO, and "may invest and/or deal" in securities that are "adverse to" the Hudson "investments." The Offering Circular, however, misrepresented Goldman's investment plans. At the time it was created in December 2006, Goldman had already determined to keep 100% of the short side of the Hudson CDO and act as the sole counterparty to the investors buying Hudson securities, thereby acquiring a $2 billion financial interest that was directly adverse to theirs.[2725]

A federal court has held that disclosing a potential adverse interest, when a known adverse interest already exists, can constitute a material misstatement to investors.[2726] In the case of the Hudson CDO, much of the profit Goldman obtained would be generated from the losses incurred by clients that bought Hudson securities, creating an actual, undisclosed adverse interest. This construct, in which Goldman's profits depended in part upon its clients' losses, created a clear conflict of interest between Goldman and the clients to whom it was selling the Hudson securities, once Goldman had decided to become a short party in the CDO it was simultaneously marketing.

In another part of the Offering Circular, Goldman stated that GSI would serve as the sole counterparty to the CDO, but that disclosure was made in the context of a common industry practice in which the CDO originator or its designate typically took the entire short side of the transaction in the first instance and was the only party that dealt directly with the shell corporation actually issuing the CDO's securities. The CDO originator, or its designate, then acted as an intermediary between the shell corporation and the other broker-dealers buying short positions in the CDO on behalf of themselves or a customer. By placing itself in the middle of each CDS contract, the originator or its designate provided stronger financial backing for the CDS contracts being issued by the CDO and obtained more favorable credit ratings for the CDO securities. In the CDOs examined by the Subcommittee, Goldman followed industry practice by designating its affiliate, GSI, as the initial sole

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[2725] See, e.g., Goldman response to Subcommittee QFR at PSI_QFR_GS0192 and PSI_QFR_GS00235.

[2726] See, e.g., SEC v. Czuczko, Case No. CV06-4792 (USDC CD Calif.), Order Granting Plaintiff's Unopposed Motion for Summary Judgment (Dec. 5, 2007) (finding defendant made a material misstatement to potential investors when he disclosed that officers, directors, employees and members of their families "may" trade in the stocks recommended on his website, without disclosing that he, his father, and business partner were trading in those stocks and had an interest in them). See also In the Matter of Arleen Hughes, Securities Exchange Act Rel. No. 4048 (Feb. 1948) (holding a broker-dealer, who is also a registered investment adviser, had to disclose the "nature and extent" of its adverse interest); In the Matter of Edward D. Jones & Co., L.P., Exchange Act Rel. No. 50910 (Dec. 22, 2004) (settled order), at 21 (disclosure inadequate for failing to disclose full nature and extent of the broker-dealer's conflict of interest).

counterparty in the Hudson, Anderson, and Timberwolf CDOs.[2727] Customers learning of GSI's role as the initial sole counterparty in the Hudson CDO would likely have assumed that GSI planned to sell its initial short position to other parties, since that was industry practice. What Goldman failed to disclose to those customers is that it planned to hold (or already held) all or a substantial portion of the short side of the CDO as a proprietary investment adverse to the interests of the customers to whom Goldman was selling the CDO securities. Had those customers known of Goldman's substantial short investment, they would likely have understood that Goldman viewed the very CDO securities it was recommending they purchase as likely not to perform.

Goldman's failure to disclose its short interest was further compounded when it told investors that its interests "were aligned" with those of the long investors or when it advertised its retention of a portion of the CDO's equity tranche. The Hudson marketing booklet stated: "Goldman Sachs has aligned incentives with the Hudson program by investing in a portion of equity and playing the ongoing role of Liquidation Agent."[2728] What made the statement misleading and what Goldman failed to disclose in the booklet was that its $6 million equity investment[2729] was far outweighed by its $2 billion short investment.[2730] In addition, Goldman later used its liquidation agent position to benefit its short investment at the expense of the long investors in Hudson.[2731] In Anderson, talking points prepared for the Goldman sales force advocated telling investors: "Goldman is underwriting the equity and expects to hold up to 50%."[2732] What the talking points left out was that Goldman's $21 million equity investment in Anderson was less than one sixth the size of its $135 million short position.[2733] In Timberwolf, the marketing booklet stated that Goldman was purchasing 50% of the equity tranche, and the collateral manager Greywolf was purchasing the other 50%.[2734] Again, the booklet failed to disclose that Goldman's equity investment was far outweighed by its short investment.[2735] In each CDO, Goldman withheld from investors information that it had a

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[2727] Goldman sometimes referred to this position as the "Credit Protection Buyer" or "Synthetic Security Counterparty."
[2728] 10/2006 Hudson Mezzanine Funding 2006-1, LTD., GS MBS-E-009546963, at 966, Hearing Exhibit 4/27-87.
[2729] See Goldman response to Subcommittee QFR at PSI_QFR_GS0223.
[2730] See, e.g., 10/30/2006 email from Mr. Ostrem, "Great Job on Hudson Mezz," GS MBS-E-0000057886, Hearing Exhibit 4/27-90.
[2731] See discussion of Goldman's actions as the Hudson liquidation agent, above.
[2732] 3/13/2007 email from Mr. Ostrem to Scott Wisenbaker and Matthew Bieber, GS MBS-E-000898410, Hearing Exhibit 4/27-172.
[2733] See Goldman response to Subcommittee QFR at PSI_QFR_GS0192.
[2734] Timberwolf flipbook, GS MBS-E-000676809, Hearing Exhibit 4/27-99a.
[2735] Goldman purchased its share of the Timberwolf equity tranche in March 2007, actually held it for only two months, and then, in May, sold it to Greywolf. See also Goldman response to Subcommittee QFR at PSI_QFR_GS0226.

more significant financial interest in seeing the CDO decline in value than increase in value. In light of its short investments, Goldman's claims that its interests were aligned with, rather than adverse, to the investors to whom it was selling the CDO securities were misleading.

Shorting the Subprime Market. Goldman also failed to disclose to clients that, at the same time it was recommending investments in Goldman-originated RMBS and CDO securities, it was committing billions of dollars to short the same types of securities, as well as their underlying assets,[2736] and even some of the lenders whose mortgage pools were included or referenced in the securities.[2737] In February 2007, Goldman's net short totaled about $10 billion.[2738] In June 2007, its net short reached about $13.9 billion. A significant issue is whether this omitted information – that Goldman was heavily shorting the same types of investments it was recommending – "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" about the securities Goldman was recommending.[2739]

Other Adverse Information. In addition to its failure to disclose that it was shorting specific CDOs as well as the subprime mortgage market as a whole, Goldman failed to disclose other arrangements which created conflicts of interest and undisclosed financial interests that were adverse to its clients. Concerning Abacus, Goldman failed to disclose a compensation arrangement in which Goldman agreed to accept a fee for arranging low premium payments by the short party; those lower payments disadvantaged the long investors by reducing cash payments to the CDO. Concerning Hudson, Goldman failed to disclose that its dual roles as liquidation agent and sole short party meant that it could

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[2736] See, e.g., 6/5/2007 email from Benjamin Case to David Lehman, GS-MBS-E-001919861 (indicating Goldman was shorting some of the assets underlying Timberwolf using CDS contracts outside of the CDO).

[2737] See, e.g., Goldman spreadsheet produced in response to a Subcommittee QFR, at GS MBS 0000037361 (identifying lenders whose stock Goldman shorted).

[2738] See discussion of Goldman's net short positions, section C(4)(b), above.

[2739] That Goldman's own investment decisions might be material information for an investor is demonstrated by a court ruling in a famous case in the 1970s, in which Goldman, an exclusive dealer, was sued by an investor who alleged that Goldman had sold it Penn Central notes without disclosing, among other things, that Goldman had recently reduced and placed limits on its own inventory of those same notes. Alton Boxboard v. Goldman, Sachs and Company, 560 F.2d 916 (8th Cir. 1977). Although the court decided the case on another basis, the Eighth Circuit found that the materiality of the undisclosed facts alleged was a question to be decided by a trier of fact. The court took note of the testimony from two sophisticated institutional purchasers concerning Goldman's reduction of inventory in Penn Central notes. Id at n.10. One sophisticated investor "testified that this information would have been a 'red flag' to him, and had he known of Goldman Sachs' inventory decision, he would have wanted notes from another issuer." Id. The other witness "stated he would have been concerned about such information and would have conveyed it to his customers, because it indicated that Goldman, Sachs did not have confidence in ... [the] notes." Id.

delay liquidating Hudson assets that were losing value and simultaneously increase the value of its short position; that same action increased the losses of the long investors. In Timberwolf, Goldman failed to disclose that it viewed its role as collateral put provider allowed it to refuse to consent to the purchase of default swap collateral securities and avoid any risk that the securities would decline in value – the very risk the long investors were paying Goldman a fee to assume.[2740] In each CDO, Goldman took actions that created an undisclosed conflict of interest between itself and the investors to whom it recommended and sold the CDO securities.

These types of arrangements, when undisclosed, can result in conflicts of interest that disadvantage investors. The existence, nature, and extent of such arrangements are the type of material adverse information that the securities laws were designed to ensure were accurately described and disclosed to investors.

(iv) Making Unsuitable Investment Recommendations

In addition to the disclosure issues, Goldman's efforts to sell Hudson, Anderson, Timberwolf, and Abacus securities raise a set of issues related to whether Goldman met its obligation to engage in fair dealing with its clients and avoid recommending investments that were unsuitable for any investor. The focus here is on Goldman's sale of CDO securities that were designed to lose value, either because the short party selected the assets or the assets were so poor that Goldman knew or should have known they would perform poorly or fail, yet marketed them to customers anyway.

As detailed earlier, broker-dealers are required to deal fairly with their customers and observe high standards of honor in the conduct of their business.[2741] When a broker-dealer, acting as an underwriter, makes an investment recommendation to a client, it is implicit that the broker-dealer has a reasonable basis to believe that the issue is sound.[2742] A broker-dealer is also required "to have an 'adequate and reasonable basis' for any security or strategy recommendation that it makes."[2743] Broker-dealers are barred from offering investments that are unsuitable for any investor.[2744] Goldman itself, in response to a Subcommittee question, has acknowledged that broker-dealers owe a "general suitability" obligation to its institutional investors, and "[t]his suitability

[2740] Each of these matters is discussed in detail, above.
[2741] SEC Study on Investment Advisers and Broker-Dealers at 55.
[2742] SEC v. Tambone, 550 F.3d 106, 135 (1st Cir. 2008) [citations omitted].
[2743] SEC Study on Investment Advisers and Broker-Dealers at 63 [citations omitted].
[2744] Id. at 61.

duty requires the broker-dealer to determine, in the first instance, that the transaction is suitable for at least some investors."[2745] Despite those requirements, the evidence gathered by the Subcommittee indicates that Goldman did not view any of the four CDOs examined in this Report as sound investments for the clients to whom it sold the securities.[2746]

Selection of Assets by Short Party. Internal documents and emails from Goldman indicate that both Abacus and Hudson were designed with the expectation they would lose value and produce a profit for the short side of the CDOs. The sole short party in Abacus was the Paulson hedge fund; the sole short party in Hudson was Goldman itself.

With respect to Abacus, Goldman knew that the Paulson hedge fund wanted to take 100% of the short side and would profit only if the CDO lost value, yet allowed the hedge fund to play a major but hidden role in selecting the CDO assets.[2747] The Goldman employee with lead responsibility for Abacus, Fabrice Tourre, called it a "weak quality portfolio."[2748] The Paulson hedge fund executive who participated in the asset selection process acknowledged he selected assets that he expected would not perform well.[2749] A Moody's executive who oversaw CDO ratings when Abacus was rated – and testified that he did not know of Paulson's role in the Abacus asset selection process – explained that "[i]t just changes the whole dynamic of the structure where the person who is putting it together, choosing it, wants it to blow up."[2750] When Goldman began to publicly market the Abacus securities, Ed Steffelin, a Senior trader at GSC who had declined Goldman's request that his firm serve as the CDO's portfolio selection agent, sent an email to Peter Ostrem, head of Goldman's CDO Origination Desk, stating: "I do not have to say how bad it is that you guys are pushing this thing."[2751] When asked by the Subcommittee what he meant by that comment, Mr. Steffelin said that he believed the Abacus CDO created "reputational risk" for the collateral manager industry and the whole market.[2752] When Mr. Tourre later sought to book two CDS contracts referencing the Abacus

[2745] See Goldman response to Subcommittee QFR at PSI_QFR_GS0048.
[2746] See, e.g., 1/23/2007 email from Fabrice Tourre to Marine Serres, GS MBS-E-003434918, Hearing Exhibit 4/27-62 (Tourre wrote: "[S]tanding in the middle of all these complex, highly levered, exotic trades he [Mr. Tourre] created without necessarily understanding all the implications of these monstruosities [sic] !!!").
[2747] See discussion of Abacus in section C(5)(b)(ii)DD, above.
[2748] 12/18/2006 email from Fabrice Tourre, "Paulson," GS MBS-E-003246145, Hearing Exhibit 4/27-107.
[2749] SEC deposition of Paolo Pellegrini (12/3/2008). PSI-Paulson-04 (Pellegrini Depo)-0001, at 175-76.
[2750] April 23, 2010 Subcommittee Hearing Transcript at 64.
[2751] 2/27/2007 email from Ed Steffelin to Peter Ostrem, GS MBS-E-009209654.
[2752] Subcommittee interview of Ed Steffelin (12/10/2010).

securities, a Goldman salesman wrote: "seems we might have to book these pigs."[2753]

As planned, once issued, the Abacus securities quickly lost value. In October 2007, six months after the Abacus securities were issued, the credit rating agencies downgraded them, and a Goldman salesperson noted: "This deal was number 1 in the universe of CDO's that were downgraded by Moody's and S&P. 99.89% of the underlying assets were downgraded."[2754] The three investors that bought Abacus securities together lost more than $1 billion, while the Paulson hedge fund, as the sole short party, recorded a corresponding $1 billion profit.2755 In July 2010, Goldman agreed to settle a securities fraud complaint brought by the SEC by paying a fine of $550 million and "acknowledging it was a mistake for the Goldman marketing materials to state that the reference portfolio was 'selected by' ACA Management, LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors."[2756]

With respect to Hudson, Goldman designed the CDO from its inception as a way to transfer the risk of loss associated with ABX assets from Goldman's inventory to the Hudson investors.[2757] Goldman documents state, for example, that Hudson was "initiated by the firm as the most efficient method to reduce long ABX exposures,"[2758] and the CDO was an "exit for our long ABX risk."[2759] Goldman created and took the short side of $2 billion in single name CDS contracts referencing RMBS securities that it wanted to short, and sold them to the Hudson CDO. The end result was that Goldman wrote 100% of the CDS contracts that made up Hudson's assets and took 100% of the short side of the CDO, which meant that Goldman would profit if the CDO fell in value. Goldman marketed the CDO without disclosing its status as the sole short party, instead telling investors that its interests were "aligned" with theirs. The Hudson securities immediately began losing value. Within a year, while the holders of the Hudson securities lost virtually their entire investments, Goldman's profits reached $1.7 billion, which it then used to offset other mortgage related losses.

[2753] 4/15/2007 email from Cactus Raazi to Daniel Chan, "Dan: ABACUS 07-AC1," Hearing Exhibit 4/27-82.
[2754] 10/26/2007 email from Goldman salesman to Michael Swenson, "ABACUS 2007-AC1 – Marketing Points (INTERNAL ONLY) [T-Mail]," GS MBS-E-016034495.
[2755] Securities and Exchange Commission v. Goldman Sachs, Case No. 10-CV-3229 (S.D.N.Y.), Complaint (April 16, 2010).
[2756] SEC v. Goldman, Sachs & Co. and Tourre, Case No. 10-CV-3329 (BSJ) (S.D.N.Y.), Consent of Defendant Goldman, Sachs & Co (July 14, 2010).
[2757] See discussion of Hudson CDO in section C(5)(b)(ii)AA, above.
[2758] Goldman response to Subcommittee QFR at PSI_QFR_GS0249.
[2759] 9/20/2006 email from Arbind Jha to Josh Birnbaum, GS MBS-E-012685289.

In both CDOs, Goldman took actions that disguised that the transactions were designed to lose value. In Abacus, Goldman omitted mention of the Paulson hedge fund's involvement in the asset selection process and hired a well known third party portfolio agent, ACA Management, to "leverage ACA's credibility."[2760] In Hudson, Goldman omitted that it had written all of the CDO's CDS contracts and it referenced $1.2 billion in ABX assets in Goldman's own inventory, and instead told investors that Hudson's assets were "sourced from the Street" and Hudson was "not a Balance Sheet CDO."[2761]

Goldman marketed the Abacus and Hudson securities to clients knowing that each CDO had been designed to lose value and produce a profit for the short party. Given that information, Goldman marketed CDOs that it knew or should have known were not suitable for any investor.

Selection of Poor Quality Assets. Similar concerns apply to Goldman's origination and marketing of the Anderson and Timberwolf CDOs, which contained such poor quality assets that Goldman knew or should have known that they would perform poorly or fail. Yet Goldman recommended them to investors anyway. The issue is whether, by recommending that investors purchase the Anderson and Timberwolf securities, Goldman violated its fair dealing obligation and recommended investments that were not suitable for any investor.

With respect to Anderson, Goldman personnel knew before marketing its securities that the CDO had poor quality assets that were losing value. Nearly 45% of the referenced RMBS securities in Anderson were dependent upon loans issued by New Century, while another 7% depended upon loans issued by Fremont, two subprime lenders known, including by Goldman personnel, for issuing poor quality loans and poorly performing RMBS securities.[2762] On February 24, 2007, Goldman personnel calculated that the assets in the Anderson warehouse account had already lost $60 million in value from the time they were purchased.[2763] In response, Mr. Sparks, the Mortgage Department head, decided to cancel the CDO.[2764] Later, he changed his

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[2760] 3/12/2007 Goldman memorandum to Mortgage Capital Committee, "ABACUS Transactions sponsored by ACA," GS MBS-E-002406025, Hearing Exhibit 4/27-118.
[2761] 10/2006 Hudson Mezzanine Funding 2006-1, LTD., GS MBS-E-009546963, at 978, Hearing Exhibit 4/27-87.
[2762] See discussion of Anderson CDO in section C(5)(b)(ii)BB, above. Another 8% were dependent upon loans issued by Countrywide.
[2763] 2/24/2007 email from Deeb Salem to Michael Swenson and others, GS MBS-E-018936137.
[2764] 2/24/2007 email from Mr. Sparks to Mr. Ostrem and others, GS MBS-E-001996601, Hearing Exhibit 4/27-95.

mind and rushed Anderson to market with only $305 million of the $500 million in assets that had been planned. Goldman was the largest short party, with 40% of the short interest in Anderson.

Anderson issued its securities on March 20, 2007. Goldman knew at the time that both New Century and Fremont were in financial distress.[2765] In addition, the week before, Goldman had conducted reviews of both a New Century and a Fremont loan pool on the firm's books, and found that 26% of the New Century loans[2766] and 50% of the Fremont loans[2767] reviewed had deficiencies and should be returned to the lender for refunds. Goldman nevertheless continued to market the Anderson securities. When some potential investors expressed concerns about Anderson's underlying assets, in particular the New Century loans, Goldman tried to dispel those concerns even while harboring its own low opinion of New Century loans.[2768] Goldman managed to sell approximately $102 million in Anderson securities to nine investors who lost virtually their entire investments within a year.[2769]

With respect to Timberwolf, Goldman personnel knew that the CDO's assets had begun losing value almost from the time they were acquired.[2770] Timberwolf was a CDO^2 transaction comprised of 56 different CDO assets with over 4,500 unique underlying securities.[2771] In February 2007, Mr. Sparks told a senior Goldman executive that it was a deal "to worry about," and that its assets had already incurred such significant losses that they had exhausted the share of the warehouse risk held by Goldman's partner in the transaction.[2772] Despite that loss in value, Goldman continued with the issuance of the Timberwolf securities in March 2007. By May, a special CDO valuation project undertaken by the Mortgage Department found that the Timberwolf's

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[2765] See, e.g., 2/8/2007 email from Craig Broderick to Mr. Sparks and others, GS MBS-E-002201486 (calling New Century's announcement that it would restate its earnings "a materially adverse development"); 3/14/2007 Goldman email, "NC Visit," GS MBS-E-002048050 (stating Fremont still has cash "but not for long"); 3/13/2007 email from Mr. Ostrem to Scott Wisenbaker and Matthew Bieber, GS MBS-E-000898410, Hearing Exhibit 4/27-172 (providing talking points for selling Anderson securities to customers).

[2766] 3/13/2007 email from Manisha Nanik, "New Century EPDs," GS MBS-E-002146861, Hearing Exhibit 4/27-77.

[2767] 3/14/2007 Goldman email, "NC Visit," GS MBS-E-002048050.

[2768] See, e.g., 3/6/2007 email from Joshua Bissu to Mr. Ostrem and Mr. Bieber, GS MBS-E-014597705 (talking points for Goldman personnel to respond to investor concerns about the New Century loans).

[2769] See e.g., Goldman response to Subcommittee QFR at PSI_QFR_GS0223.

[2770] See, e.g., 9/17/2007 email from Christopher Creed, "Timberwolf," GS MBS-E-000766370, Hearing Exhibit 4/27-106 (showing price for Timberwolf securities dropped from $94 on 3/31/2007 to $87 on 4/30/2007).

[2771] 8/23/2007 email from Jay Lee to Mr. Lehman and others, GS MBS-E-001927784.

[2772] 2/26/2007 email exchange between Mr. Sparks and Mr. Montag, GS MBS-E-019164799, Hearing Exhibit 4/27-71.

assets had lost still more value.[2773] Despite its lower internal valuation, Mr. Sparks advised Goldman senior executives that his CDO pricing strategy was to "take the write-down, but market at much higher levels" to avoid "leaving some money on the table."[2774]

During the spring and summer of 2007, Goldman aggressively marketed Timberwolf securities to investors around the world, eventually selling about $853 million in Timberwolf securities to 12 investors.[2775] Goldman sold the securities at prices substantially above its internal book values for the Timberwolf securities. After making a sale, Goldman then, sometimes only days or weeks later, marked down the value of the securities it had sold, resulting in investors realizing losses and sometimes requiring the investor to post additional cash margin or collateral.[2776] In September 2007, an internal Goldman analysis found that, in just six months, Timberwolf's AAA rated securities had lost 80% of their value. One of Goldman's senior executives monitoring Timberwolf pronounced it "one shitty deal."[2777] The CDO was liquidated in October 2008, and the investors who purchased Timberwolf securities lost virtually their entire investments.

Goldman CEO Lloyd Blankfein said publicly about the firm's securities: "If we believed it would fail … the security wouldn't work, we would not sell it."[2778] But Goldman marketed the Anderson and Timberwolf securities to clients knowing that each CDO had poor quality assets that were continually losing value. It marketed them at the same time it was investing on the short side of the CDOs and the subprime mortgage market as a whole, and its Mortgage Department head was telling his staff that it was "Game Over" and time to "get out of everything."[2779] Within a year, the Anderson and Timberwolf securities were virtually worthless. Given what Goldman knew when marketing Anderson and Timberwolf, Goldman was recommending investments that were most likely not suitable for any investor.

This analysis examines Goldman's conduct in the context of the law prevailing in 2007. Since then, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has established new conflict of

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[2773] 5/20/2007 email from Paul Bouchard, "Materials for Meeting," GS MBS-E-001863725.
[2774] 5/14/2007 email from Mr. Sparks to Mr. Montag and Mr. Mullen, GS MBS-E-019642797.
[2775] See, e.g., Goldman response to Subcommittee QFR at PSI_QFR_GS0223.
[2776] See, e.g., example involving Basis Capital in discussion of Timberwolf in section C(5)(b)(ii)CC, above.
[2777] 6/22/2007 email from Mr. Montag to Mr. Sparks, "Few Trade Posts," GS MBS-E-010849103, Hearing Exhibit 4/27-105.
[2778] April 30, 2010 transcript of The Charlie Rose Show, at 14.
[2779] 3/12/2007 Goldman Firmwide Risk Committee, "March 7th FWR Minutes," GS MBS-E-00221171, Hearing Exhibit 4/27-19; 3/3/2007 email from Mr. Sparks, "Call," GS MBS-E-010401251, Hearing Exhibit 4/27-14.

interest prohibitions that would apply to this type of conduct, including Section 621 which bars any underwriter or placement agent of an asset backed security from engaging in any transaction "that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity."

(7) Goldman's Proprietary Investments

When reviewing the conflict of interest issues related to Goldman's mortgage related activities in 2006 and 2007, another issue examined by the Subcommittee was the extent to which Goldman's Mortgage Department was engaged in proprietary trading.[2780]

In 2007, Goldman was not a commercial bank, and proprietary trading was not illegal. The issue that concerned the Subcommittee was the extent to which its proprietary activities may have contributed to the conflicts of interest that affected how Goldman operated.[2781] In a recently issued "Report of the Business Practices Committee," Goldman reaffirmed as its first business principle: "Our clients' interests always come first."[2782] Contrary to that statement, however, Goldman documents showed its employees repeatedly expressing concern about

[2780] Until its repeal in 1999, the Glass-Steagall Act prohibited banks from engaging in proprietary trading. Glass-Steagall Act, Section 16. The Act's prohibition on proprietary trading was weakened over the years and finally repealed by the Financial Services Modernization Act of 1999, P.L. 106-102 (1999). Since Goldman did not become a bank holding company until 2008, neither the Glass-Steagall prohibition nor its repeal affected its activities during the time period examined by the Subcommittee.

[2781] Financial institutions that trade for their own accounts at the same time that they conduct trades on behalf of their clients may experience conflicts of interest. See, e.g., 4/23/2010 letter from John Reed, former Chairman and CEO of Citigroup, to Senators Merkley and Levin ("When a firm is focused on market gain through proprietary trading, it too often will employ every available device to achieve those gains – including take advantages of clients and putting the firm at risk."); In re Merrill Lynch, Pierce, Fenner & Smith, Incorporated, Exchange Act Rel. No. 34-63760, Admin. Proc. 3-14204 (Jan. 25, 2011) (settling allegations that Merrill Lynch's proprietary traders misused information about their customers' trading); 7/19/2005 speech by Annette Nazareth before the Securities Industry Association Compliance and Legal Division Member Luncheon (discussing increased potential for conflicts of interest). In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-603, restored the prohibition on proprietary trading by banks, subject to certain exceptions. See Section 619, amending the Bank Holding Company Act of 1956, to be codified at 12 U.S.C. §1851. Regulations implementing Section 619, also known as the Merkley-Levin provisions after the Senators who authored them or the Volcker Rule after former Federal Reserve Chairman Paul Volcker who championed the ban, are due by October 2011.

[2782] 1/2011 "Report of the Business Standards Committee," at 1. In May 2010, at Goldman's annual shareholders' meeting, CEO Lloyd Blankfein announced the formation of a Business Standards Committee to conduct an extensive review of the firm's business standards and practices to determine the extent to which the firm was adhering to its own written "Business Principles," and to make appropriate recommendations. Id. The Committee's January 2011 report provided recommendations in the areas of Client Relationships and Responsibilities, Conflicts of Interest, Structured Products, Transparency and Disclosure, Committee Governance, and Training and Professional Development.

the firm's interests, but rarely mentioning or placing a priority on the interests of its clients. In fact, after Goldman announced record profits for its Mortgage Department in the third quarter of 2007, when many of its clients were suffering substantial losses from the mortgage investments they purchased from Goldman, Peter Kraus, co-head of the Investment Banking Division, wrote the following to Goldman CEO Lloyd Blankfein:

> "I met with 10+ individual prospects and clients ... since earnings were announced. The institutions don't and I wouldn't expect them to, make any comments like ur good at making money for urself but not us. The individuals do sometimes, but while it requires the utmost humility from us in response I feel very strongly it binds clients even closer to the firm, because the alternative of take ur money to a firm who is an under performer and not the best, just isn't reasonable. Clients ultimately believe that association with the best is good for them in the long run."[2783]

The tension between Goldman's efforts to make money on behalf of itself versus on behalf of its clients raises a number of conflict of interest concerns, particularly when its efforts to profit from shorting the mortgage market or particular RMBS or CDO securities occurred simultaneously with its efforts to market mortgage related securities to its clients.

Goldman's Proprietary Activities. Until recently, when asked about the extent of the firm's proprietary activities, Goldman generally claimed that its proprietary investments contributed only approximately 10% of the firm's profits.[2784] In January 2011, however, Goldman announced in an SEC filing that it was changing the categories under which it reported income. Goldman added a new category called "Investments and Lending" to segregate the firm's proprietary investment income from the income it derived from activities undertaken on behalf of clients.[2785] Based on earnings reported in January 2011 for Goldman's full fiscal year 2010, the proprietary investment income recorded under "Investments and Lending" accounted for $7.5 billion, or

[2783] 9/26/2007 email to Mr. Blankfein, "Fortune: How Goldman Sachs Defies Gravity," GS MBS-E-009592726, Hearing Exhibit 4/27-135.
[2784] See, e.g., 1/21/2010, The Goldman Sachs Group Inc., 4Q 2009 Earnings Call Transcript, Q&A (CFO David Viniar states that, in most years, proprietary trading accounts for "10% roughly plus or minus a couple of percent."), http://seekingalpha.com/article/183723-the-goldman-sachs-group-inc-q4-2009-earnings-call-transcript?part=qanda.
[2785] 1/11/2011 Goldman Form 8-K filed with the SEC (announcement of change in reporting categories). Goldman's change in its reporting categories implemented one of the recommendations outlined in Goldman's "Report of the Business Standards Committee" published in January 2011.

about 20% of Goldman's net revenues.[2786] Goldman did not specify how it defined proprietary investments and lending for purposes of its earnings report, nor what desks or activities contributed to the total, how it calculated the reported amount, or why it was double the amount cited a year earlier.

To date, three Goldman units have been identified as engaging explicitly in investments on behalf of the firm. One, based in New York, is called Goldman Sachs Principal Strategies or "GSPS," which Goldman is reportedly in the process of dismantling.[2787] The second is the Global Macro Proprietary Trading Desk, which had traders in New York and London and reportedly invested in foreign exchange markets, interest rate markets, stocks, commodities and other fixed income markets.[2788] The third, according to Goldman, is the Special Situations Group or SSG, which is reportedly engaged primarily in long term investments on behalf of the firm and clients, with little short term trading or sales activities.[2789]

Proprietary Activities in the Mortgage Area. In the mortgage area, until 2005, Goldman had a dedicated proprietary investment desk in the Mortgage Department called the Principal Finance Group, often referred to as Principal Investments.[2790] According to Goldman personnel, that desk specialized in long term investments on behalf of Goldman in assets such as distressed mortgages and credit card and energy receivables, but only rarely engaged in short term trading.[2791] In 2005, Principal Investments was folded into the Special Situations Group (SSG), which was then a Goldman business unit located in Asia and not part of the Mortgage Department.[2792] After Principal

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[2786] See 1/19/2011 Goldman press release on 2010 earnings, available at www2.goldmansachs.com.

[2787] Subcommittee interview of David Viniar (4/13/2010). See also "More Goldman Traders to Exit for Funds," Financial Times (1/9/2011). Goldman may be eliminating the desk in response to the Dodd-Frank prohibition on proprietary trading.

[2788] See "Goldman to Shut Global Macro Trading Desk," New York Times (2/16/2011). Goldman may be eliminating this desk in response to the Dodd-Frank prohibition on proprietary trading.

[2789] Subcommittee interview of Darryl Herrick (10/13/2010). To the extent that its activities are limited to long term investments, the SSG unit would not be affected by the Dodd-Frank prohibition on proprietary trading which applies only to trading accounts used "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)," and does not affect long term investments. See Section 619(h)(6). Under Section 620 of the Dodd-Frank Act, banking regulators are also conducting an 18-month review of all permitted bank investment activities, both long and short term, to gauge the risk of each activity, any negative effect the activity may have on the safety and soundness of the banking entity or the U.S. financial system, and the "appropriateness" of each activity for a federally insured bank.

[2790] Subcommittee interview of Darryl Herrick (10/13/2010).

[2791] Id.

[2792] Id.

Investments personnel moved to SSG, the Mortgage Department operated without a desk that was explicitly dedicated to proprietary trading during 2006 and 2007.

When asked whether the Mortgage Department engaged in proprietary activities during 2006 and 2007, Goldman executives and traders in the Mortgage Department generally resisted providing a direct answer, declined to identify any proprietary trades or investments, and declined to estimate or calculate how much of the Mortgage Department's 2007 revenues or profits were proprietary.

When asked about particular transactions, Goldman executives or traders often described them as examples, not of "proprietary trading," but "principal trading" in which Goldman acted as a market maker. Goldman personnel told the Subcommittee that to fulfill the firm's role as a market-maker, Goldman used its own capital to amass an inventory of assets in anticipation of customer demand, and acted as a "principal" when building that inventory. They indicated that the mortgage related assets were acquired for the purpose of accommodating existing or anticipated client buy and sell orders and not to produce proprietary profits for the firm.

At the same time, several Goldman executives and traders told the Subcommittee that all of Goldman's trading desks, including those in the Mortgage Department, were given discretion to trade some amount of the firm's capital within certain limits.[2793] Daniel Sparks told the Subcommittee: "We told [the Firmwide Risk Committee] what we wanted to do, and they told us how much we could do."[2794] Joshua Birnbaum said that the amount of proprietary trading that a desk was allowed to do depended upon certain risk limits, but could not recall a specific or typical dollar amount of any risk limit assigned to the Mortgage Department as a whole or to any of its trading desks for proprietary trading purposes.[2795] Goldman's Chief Risk Officer Craig Broderick told the Subcommittee that the firm did not distinguish between "proprietary" versus other types of risk, because the aggregate risk levels would be the same.[2796] Mr. Broderick said that the firm's proprietary trading, outside of GSPS, was "embedded" in the routine

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2793 Subcommittee interviews of Mr. Sparks (4/15/2010); Mr. Birnbaum (4/22/2010); and Mr. Broderick (4/9/2010). See also 12/17/2007 email from Michael DuVally to Mr. Sparks, "WSJ Responses," GS MBS-E-013821884 ("Some traders are allowed to express their own market views using the firm's capital.").

2794 Subcommittee interview of Daniel Sparks (4/15/2010).

2795 Subcommittee interview of Joshua Birnbaum (4/22/2010).

2796 Subcommittee interview of Craig Broderick (4/9/2010).

business conducted by various trading desks and was not specifically segregated as "proprietary."[2797]

Until enactment of the Dodd-Frank Act in 2010, federal securities law contained no statutory or regulatory definition of proprietary trading by banks and generally did not require firms to identify or monitor their proprietary investments.[2798] The Subcommittee investigation found that the terms "proprietary" and "prop" were commonly used in the financial services industry to describe business performed on behalf of, or for the benefit of, a financial firm itself, while the term "flow" was used to refer to market-making transactions involving, or for the benefit of, the firm's customers.[2799]

A number of internal Goldman documents in 2006 and 2007, used the terms "prop" and "flow" when referring to mortgage related activities. In a 2006 email to Goldman senior executives, for example, Mr. Sparks, the Mortgage Department head, used the terms when criticizing a decision by Morgan Stanley to move its most experienced mortgage traders from its mortgage department's "franchise" desk to a dedicated proprietary desk.[2800] Mr. Sparks argued against Goldman's doing the same by claiming exposure to customer trades or "flows" made mortgage traders "more effective" in their proprietary trades:

> "Morgan Stanley is going overboard by taking most of their experienced and known traders out of the franchise. We should keep our franchise leaders in the seats and continue to allow them

[2797] Id. Goldman's Chief Financial Officer David Viniar provided similar information in response to questions from the Financial Crisis Inquiry Commission, indicating that Goldman did not specifically "break out" its proprietary trading from its other business results. See FCIC Hearing, Testimony of David Viniar (7/2/2010), www.fcic.gov.

[2798] The Dodd-Frank Act defines "proprietary trading" as "engaging as a principal for the trading account of [a] banking entity . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract or any other security or financial instrument that the appropriate Federal banking agencies ... may, by rule ... determine." 12 U.S.C. § 1851(h)(4). The Act further defines "trading account" as one used for "near term" trading or for capturing profits from "short term price movements." Section 1851(h)(6). These provisions are subject to further refinement through implementing regulations.

[2799] See, e.g., description of proprietary trading in Deutsche Bank's 3/26/2008 Form 20-F filed with the SEC at 24 ("Within Corporate Banking & Securities, we conduct proprietary trading, or trading on our own account, in addition to providing products and services to customers. Most trading activity is undertaken in the normal course of facilitating client business. For example, to facilitate customer flow business, traders will maintain long positions (accumulating securities) and short positions (selling securities we do not yet own) in a range of securities and derivative products, reducing this exposure by hedging transactions where appropriate. While these activities give rise to market and other risk, we do not view this as proprietary trading. However, we also use our capital to exploit market opportunities, and this is what we term proprietary trading.").

[2800] 4/13/2006 email from Mr. Sparks to Messrs. Cohn, Sobel, and Mullen, "Morgan Super Traders Worry Hedge Funds," GS MBS-E-016187625.

to take prop views – the customer flows they see make them more effective."[2801]

This email shows, not only that Mr. Sparks and other Goldman executives used the terms "prop" and "flow," but they also knew Goldman mortgage traders were handling both customer and proprietary transactions at the same time.

In November 2007, Mr. Sparks received an email from the Mortgage Department's business manager, John McHugh, indicating that proprietary trades made up a substantial portion of the Department's activities.[2802] In the email, Mr. McHugh provided Mr. Sparks with a draft of the Department's 2008 business plan which included a description of the projected business activities of the Structured Product Group – the Mortgage Department trading desk that then handled RMBS, CDO, and other mortgage related trading activities. Under the heading, "Prop vs. Flow," the draft plan stated: "Prop/flow components of SPG Trading will be roughly equal."[2803] Under another section entitled, "Assumptions/ Initiatives in ABS [Asset Backed Security] p&l [profit and loss]," the draft business plan stated:

- "Good prop opportunity capitalizing on selling pressure, selective distressed asset purchases.
- Expect prop flow split to be roughly 50/50."[2804]

The draft business plan suggests that fully half the 2008 SPG and ABS activities were expected to involve proprietary investments.

When the Subcommittee asked Mr. Sparks about the "prop/flow components of SPG Trading" in the Department's 2008 draft business plan, Mr. Sparks indicated that he was not sure what his business manager meant and was unable to estimate what percentage of the SPG Trading Desk's activities was spent on proprietary trades.[2805] In a later written response to Subcommittee questions about the email, Mr. Sparks wrote: "'Prop' or 'proprietary' can mean different things to different people." He continued that Mr. McHugh's email appeared to use "prop" to refer to investments made with a longer holding period, such as

[2801] Id. See also Glenn Bedwin, International Research Director, Thomson Financial, Trading for Investors Forum, Financial News Supplement at 14 (2004) (noting the value of "information [banks] gain from looking at the flow going through their desk").
[2802] 11/16/2007 email from John McHugh to Mr. Sparks, "FICC 2008 business plan presentation to Firm," GS MBS-E-013797964.
[2803] Id.
[2804] Id.
[2805] Subcommittee interview of Daniel Sparks (10/3/2010).

months or years, while "flow" seemed to refer to investments with a shorter holding period:

> "Defined this way, both 'prop' and 'flow' trades can involve customers, although sometimes the term 'proprietary' is used to describe business that does not involve a customer. (Sometimes proprietary is used to describe any activity that involves use of a firm's own capital.)."[2806]

Goldman's Net Shorts As Proprietary Investments. Goldman's practice of embedding its proprietary trading activities within the ordinary trading conducted on its market-making mortgage trading desks, together with its unwillingness to estimate its proprietary activities, made it difficult to determine the extent of the proprietary trading that took place within the Mortgage Department from 2006 to 2007.[2807] Nonetheless, many of the transactions undertaken by the Mortgage Department from late 2006 to late 2007 appear to have been undertaken to advance the financial interests of the firm, rather than primarily to make markets for clients.

Several factors suggest that transactions undertaken to build and profit from Goldman's two large net short positions in 2007 were completed for Goldman's own benefit, rather than on behalf of its clients. First, the two net short positions – totaling $10 billion in February and $13.9 billion in June 2007 – were far larger than a financial institution would establish simply to meet anticipated client demand.[2808] Second, the magnitude of the risk attached to those short positions was also outsized. As indicated earlier, the Mortgage Department typically contributed only about 2% of Goldman's total net revenues, yet in 2007, it was allowed to continually exceed its permanent Value-at-Risk (VAR) limit and incur up to 54% of firmwide

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[2806] Daniel Sparks response to Subcommittee QFR at PSI-QFR_GS0452.

[2807] The difficulties associated with distinguishing between proprietary trading and market making activities are examined in a recent study by the new Financial Stability Oversight Council (FSOC), an intra-governmental council established by the Dodd-Frank Act, comprised of ten regulators in the financial services sector, and charged with identifying risks and responding to emerging threats to U.S. financial stability. See FSOC FAQs, www.treasury.gov; 1/2011 "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds" (hereinafter "FSOC Study"), at 22-44. The FSOC Study observed: "Absent robust rules and protections, banking entities may have the opportunity to migrate existing proprietary trading activities from the standalone business units that are presently recognized as 'proprietary trading" into more mainstream 'sales and trading' or other operations that engage in permitted activities." Id. See also "Proprietary Trading Goes Under Cover: Michael Lewis," Bloomberg, (10/27/2010) (quoting a bank trader who reportedly said "from here on out, if he wants to take a proprietary position ... he will argue that he bought the position because a customer wanted to sell the position, and he was providing liquidity").

[2808] These totals include Goldman's net shorts from both its mortgage trading and CDO securitization activities.

risk. The Subcommittee uncovered no evidence to suggest that Goldman incurred and sustained that disproportionately high level of risk to accommodate client demands or to hedge positions taken on to accommodate clients.

A third factor indicating the net short positions were proprietary in nature was how long Goldman held onto them. For example, the Mortgage Department maintained a $9 billion ABX AAA short for six to nine months in 2007. While that short was initially used to hedge certain long positions held by various Mortgage Department desks, it was retained even after those long positions were sold off or written down. Mr. Sparks later described the ABX AAA short as "disaster insurance" in case the subprime market collapsed.[2809] The Subcommittee found no evidence indicating that the $9 billion short was maintained over such a long period of time to accommodate client demand.

A fourth factor indicating Goldman's net short positions were proprietary in nature was the Mortgage Department's affirmative effort to solicit clients to buy RMBS and CDO assets in its inventory.[2810] The Subcommittee saw no evidence that this sales activity was undertaken to accommodate client demand; to the contrary, the documents show that the Mortgage Department's sales efforts took place amid a deteriorating mortgage market and waning investor interest in mortgage related products.[2811]

Still another indicator that the Mortgage Department's net shorts were proprietary was that, when clients expressed interest in acquiring certain short positions, Goldman at times refused to accommodate their requests. For example, in June 2007, when Goldman began building its second large net short position, its Mortgage Department refused client requests to purchase the short side of CDS contracts with Goldman: "Really don't want to offer any [shorts to customers]" and "too late!"[2812]

[2809] Subcommittee interview of Daniel Sparks (4/15/2010).
[2810] See, e.g., documents cited in Section C(4)(b) (sales efforts to reduce Goldman's $6 billion long position) and Section C(5)(a)(iii) (sales efforts to reduce Goldman-originated RMBS and CDO securities), above.
[2811] See, e.g., emails noting difficult sales environment. 1/31/2007 email from Mr. Sparks to Mr. Montag, "MTModel," Hearing Exhibit 4/27-91 (making "lemonade out of some big old lemons"); 3/9/2007 email from Mr. Sparks to Mr. Schwartz and others, GS MBS-E-010643213, Hearing Exhibit 4/27-76 ("team is working incredibly hard and is stretched"); 3/27/2007 email from Mr. Ostrem to Mr. Bieber, GS MBS-E-000907935, Hearing Exhibit 4/27-172 (congratulating Mr. Bieber for "an excellent job pushing to closure these deals in a period of extreme difficulty"); 6/11/2007 email from Mr. Montag, GS MBS-E-001866144 (after a sale of Timberwolf securities, telling the sales team they had done an "incredible job – just incredible").
[2812] 6/10/2007 email from Michael Swenson, "CDS on CDOs," GS MBS-E-012568089; 6/13/2007 email from sales, "CDO protection," GS MBS-E-012445931. See also 9/7/2007 Fixed Income, Currency and Commodities Annual Individual Review Book, Salem 2007 Self-

On another occasion in March 2007, a Goldman employee told Goldman's Chief Risk Officer Mr. Broderick that the Mortgage Department was no longer buying subprime assets: "Just fyi not for the memo, my understanding is that desk is no longer buying subprime. (We are low balling on bids.)."[2813] Refusing client requests and lowballing bids to avoid purchases indicate that the Goldman Mortgage Department was not acting as a market maker to accommodate client demand.

Perhaps the strongest indicator that Goldman's large net short positions were proprietary investments are the statements made by Goldman's own executives and traders. Goldman's head ABX trader, Joshua Birnbaum, described the Department's decisions in February and June to build and profit from its net short positions, not as efforts to accommodate anticipated client demand, but as investments made on behalf of the firm to produce large profits:

> "Whereas execution of strategies has clearly been a concerted team effort, I consider myself the initial or primary driver of the macro trading direction for the business. I would highlight 3 major calls here:
> 1. Dec-Feb: ... The prevailing opinion within the department was that we should just 'get close to home' and pare down our long. ... I concluded that we should not only get flat, but VERY short. ... [W]e all agreed the plan made sense. ... [W]e implemented the plan by hitting on almost [every] single name CDO protection buying opportunity in a 2-month period. Much of the plan began working by February when the market dropped 25 points and our profitable year was underway. ...
> 3. Jun-Jul: the BSAM [Bear Stearns Asset Management failure] changed everything. I felt that this mark-to-market event for CDO risk would begin a further unraveling in mortgage credit. Again, when the prevailing opinion in the department was to remain close to home, I pushed everyone on the desk to sell risk aggressively and quickly. We sold billions of index and single name risk such that when the index dropped 25pts in July, we had a blow-out p&l [profit & loss] month, making over $1Bln that month. ...

Review, GS-PSI-03157 at 71 (in his self-evaluation Mr. Salem wrote that his desk sold short positions on single name CDS contracts only to customers that could provide Goldman with useful information: "We were very aggressive with pricing and only shared risk [short positions] with smart guys if they gave us insight on names to go short or go long in return.").

[2813] 3/2/2007 email exchange between Mr. Broderick and Patrick Welch, GS MBS-E-009986805, Hearing Exhibit 4/27-63.

We made money: a) taking large directional views, the direction of which we changed several times, b) ... betting the bad names would get much worse vs. the good ones, c) shorting CDOs, d) capturing the index to single name basis ... among other things."[2814]

In a later presentation put together to propose a new compensation arrangement for the SPG Trading Desk's trading activities, Mr. Birnbaum was unequivocal that the net shorts the desk had acquired were not hedges to offset risk, but "outright" short investments to produce profits:

"By June, all retained CDO and RMBS positions were identified already hedged. ... SPG trading reinitiated shorts post BSAM [Bear Stearns Asset Management] unwind on an outright basis with no accompanying CDO or RMBS retained position longs. In other words, the shorts *were not a hedge*."[2815]

In his 2007 self-evaluation, Michael Swenson, head of the Mortgage Department's SPG Trading Desk, described the net short positions undertaken by the firm in this way:

"It should not be a surprise to anyone that the 2007 year is the one that I am most proud of to date. ... extraordinary profits (nearly $3bb [billion] to date). ... I directed the ABS desk to enter into a $1.8 bb short in ABS CDOs that has realized approx. $1.0bb of p & l [profit and loss] to date. ... [W]e aggressively capitalized on

[2814] 9/26/2007 EMD Reviews, Joshua Birnbaum Self-Review, GS-PSI-01975, Hearing Exhibit 4/27-55c. Mr. Birnbaum's comments indicate that Goldman's proprietary activities extended to its CDO activities. As explained earlier, while Abacus 2007-AC1 was undertaken in response to a client request, Hudson 1 was conceived by the Mortgage Department as a way to transfer risk associated with poorly performing ABX assets in its inventory. Goldman supplied 100% of the CDS contracts that made up Hudson's assets, took 100% of the short side, and profited at the expense of the Hudson investors. In October 2006, Mr. Ostrem, head of the CDO Origination Desk, wrote to Mr. Sparks that a client was upset, because it knew "Hudson Mezz (GS prop deal) is pushing their deal back," clearly identifying Hudson as a "prop" or proprietary transaction. 10/16/2006 email from Mr. Ostrem to Mr. Sparks, GS MBS-E 010916991, Hearing Exhibit 4/27-59. See also 2/25/2007 email exchange between Peter Ostrem and Matthew Bieber, at GS MBS-E-001996601, Hearing Exhibit 4/27-95 (Mr. Ostrem proposed allowing a hedge fund to include assets in Anderson and then short them, but Mr. Bieber thought Mr. Sparks would want to "preserve that ability for Goldman"); 12/29/2006 email from Mr. Birnbaum to Mr. Lehman, GS MBS-E-011360438, Hearing Exhibit 4/27-5 (when discussing certain proposed CDO deals that would generate $1 to $3 billion in short positions and reference certain RMBS securities, Mr. Birnbaum stated: "On baa3 [RMBS securities with credit ratings of BBB-], I'd say we definitely keep it for ourselves. On baa2 [RMBS securities with BB ratings], I'm open to some sharing to the extent that it keeps these customers engaged with us.").

[2815] 10/3/2007 "SPG Trading - 2007," presentation prepared by Joshua Birnbaum with input from other SPG employees, but which was not ultimately provided to senior management, GS MBS-E-015654036, at 44 [emphasis in original]. Mr. Birnbaum reaffirmed his analysis in a 2010 written response to Subcommittee questions. See Mr. Birnbaum's response to Subcommittee QFR at PSI_QFR_GS0509.

the franchise to enter into efficient shorts in both the RMBS and CDO space."

Mr. Swenson's description of the net short position he "directed" to be built in CDOs and the resulting $1 billion in profit makes no reference to client demands. Mr. Salem, a trader on the ABS Desk, was equally clear in his 2007 self-evaluation that the desk made a deliberate bet on the direction of the mortgage market: "Mike, Josh, and I were able to learn from our bad long position at the end of 2006 and layout the game plan to put on an enormous directional short."[2816] Each of these three Mortgage Department employees played a key role in building the firm's net short positions. Their own statements indicate that they perceived acquiring the 2007 net short positions to be for the benefit of the firm, and not to build an inventory of assets to respond to anticipated client demand.

Other internal documents also portray the net short positions as decisions made by the firm to advance its own financial interests. In an internal presentation to the Goldman Board of Directors regarding the "Subprime Mortgage Business," for example, the Mortgage Department wrote that, in the first quarter of 2007, "GS reverse[d] long market position through purchase of single name CDS and reductions of ABX."[2817] In September 2007, the Goldman Board of Directors summarized its mortgage business this way: "Although broader weakness in the mortgage markets resulted in significant losses in cash position, we were overall net short the mortgage market and thus had very strong results."[2818] Talking points prepared for CFO David Viniar prior to a March 2007 earnings call with analysts stated: "The Mortgage business' revenues were primarily driven by synthetic short positions."[2819] In an October 2007 letter sent to the SEC, Goldman wrote:

> "[W]e are active traders of mortgage securities and loans and ... we may choose to take a directional view of the market .... For

[2816] 9/7/2007 Fixed Income, Currency and Commodities Annual Individual Review Book, Salem 2007 Self-Review, GS-PSI-03157, at 71.
[2817] 3/26/2007 Presentation to Goldman Board of Directors, "Subprime Mortgage Business," GS MBS-E-005565527, Hearing Exhibit 4/27-22.
[2818] 9/17/2007 Board of Directors Meeting Financial Summary, GS MBS-E-009776907, Hearing Exhibit 4/27-42.
[2819] 3/9/2007 email from Sheara Fredman to David Viniar and others, GS MBS-E-009762678, Hearing Exhibit 4/27-16. When preparing a later internal presentation, in October 2007, Dan Sparks was even more blunt: "The desk benefitted from a proprietary short position in CDO and RMBS single names." 10/5/2007 draft of "Business Unit Townhall Presentation, Q3 2007," prepared by Mr. Sparks, Hearing Exhibit 4/27-47. Mr. Sparks removed this phrase from the final version of the presentation and told the Subcommittee he had been mistaken to include it in the earlier draft.

> example, during most of 2007, we maintained a net short sub-prime position and therefore stood to benefit from declining prices in the mortgage market."[2820]

In an October 2007 internal presentation to another Goldman unit, Chief Risk Officer Craig Broderick wrote:

> "So what happened to us? ... In market risk – you saw in our 2nd and 3rd qtr results that we made money despite our inherently long cash positions. – because starting early in '07 our mortgage trading desk started putting on big short positions ... and did so in enough quantity that we were net short, and made money (substantial $$ in the 3rd quarter) as the subprime market weakened."[2821]

In a November 2007 email to his colleagues, Goldman CEO Lloyd Blankfein wrote: "Of course we didn't dodge the mortgage mess. We lost money, then made more than we lost because of shorts."[2822] None of these internal documents suggests that the Mortgage Department's net short transactions were undertaken to accommodate existing or anticipated client trades.

In January 2011, the new Financial Stability Oversight Council (FSOC) issued a study that focused, in part, on criteria that can be used to distinguish between proprietary and market making activities.[2823] Applying those recently developed criteria to the Mortgage Department's 2007 activities also supports viewing that activity as the result of proprietary rather than market making activities. For example, the Mortgage Department was building its net shorts with the expectation that they would appreciate in value rather than provide assets to facilitate customer transactions; the position created risks out of proportion to those necessary to accommodate customer demand; the Mortgage Department actively and aggressively solicited clients to build its short positions; the Mortgage Department accumulated an unpredictable inventory profile in terms of volume and in relation to customer demand; and it had a relatively low inventory turnover with the

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[2820] 10/4/2007 letter from Goldman to the SEC, GS MBS-E-009758287, Hearing Exhibit 4/27-46.
[2821] 10/29/2007 presentation by Craig Broderick to the Tax Department, GS MBS-E-010018512, Hearing Exhibit 4/27-48. See also 10/5/2007 draft presentation by Mr. Sparks, for a Business Unit Townhall meeting, GS MBS-E-013703468, Hearing Exhibit 4/27-47 ("The desk benefited from a proprietary short position in CDO and RMBS single names.").
[2822] 11/18/2007 email from Mr. Blankfein, "NYT," GS MBS-E-009696333, Hearing Exhibit 4/27-52.
[2823] 1/2011 "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds," at 22-44.

bulk of the profits derived from inventory appreciation when Goldman covered its shorts.

Advocating More Proprietary Trading. One last set of documents shines additional light on the role of proprietary investments in the Goldman Mortgage Department in 2006 and 2007. As indicated earlier, for several years, Goldman's Mortgage Department had a proprietary trading desk, Principal Investments, that was explicitly and exclusively dedicated to engaging in transactions for the benefit of the firm. In 2005, it was moved to the SSG unit. Internal Goldman documents show that some in the Mortgage Department wanted to revive that desk, increase the amount of proprietary trading in the mortgage area, or claim a greater share of the proprietary profits created by the Mortgage Department for the firm.

In August 2006, for example, the CDO Origination Desk proposed that Goldman establish a formal proprietary trading fund or proprietary trading operation within the Mortgage Department to conduct mortgage related transactions on behalf of the firm. In an August 2006 email, Peter Ostrem, the CDO Origination Desk head, made the proposal to Mr. Sparks, the Mortgage Department head:

> "Let's do our own fund. SP [Structured Product] CDO desk. Big time. GS [Goldman Sachs] commits to hold proportion of equity outright. This could be big. ... I need real leverage. Got some structured ideas too. When can we talk strategy for an hour or so?"[2824]

Mr. Sparks responded: "Next week. In the meantime calm the blank down."[2825] Later the same day, he later wrote to Mr. Ostrem: "Not going to happen."[2826] When asked about these emails, Mr. Sparks told the Subcommittee that Goldman decided not to allow the Mortgage Department to set up its own hedge fund or explicit proprietary trading desk.[2827]

In March 2007, after a series of large trades with the Harbinger hedge fund on the ABS Desk, Deeb Salem, an ABS trader, emailed Mr. Birnbaum, Mr. Swenson, and Mr. Chin with a proposal for a proprietary CDO:

[2824] 8/10/2007 email from Mr. Ostrem to Mr. Sparks, "Leh CDO Fund," GS MBS-E-010898470.
[2825] Id.
[2826] 8/10/2007 email from Mr. Sparks to Mr. Ostrem, "Leh CDO Fund," GS MBS-E-010898476.
[2827] Subcommittee interview of Daniel Sparks (10/4/2010).

"Am I crazy to be thinking we might want to grow the harbinger trade and do our own abs desk cdo. There'll be so much juice in it. It would blow out. We could sell supersenior and maybe some equity. Then the remaining mezz would be a cover of a couple hundred million of our cdo short. Haven't crunched the numbers, but I'm guessing we'd effectively cover well north of 1000 plus own some call rights. Or we also keep the equity and own it for free.

To select the portfolio, we look at the underlying rmbs deals in our cdo shorts. And replicate that as best as possible."[2828]

Mr. Birnbaum replied: "I like it."[2829] Mr. Swenson responded: "Love it we will give dan [Sparks] a heart attack."[2830] Two months later, in June 2007, Mr. Swenson wrote Mr. Salem: "Talk to me now things are developing - dan wants you to be the epicenter of the subprime universe which is not a bad position to be in."[2831] Mr. Salem replied:

"That's fine. My number 1 concern is that it[']s traded by the right people bc [because] the opportunity is huge. It's a product that needs to be traded as a prop product. ... U need to be in charge and we need prop minded guys involved."[2832]

That same month, however, the Bear Stearns' hedge funds collapsed due to losses from their subprime holdings. In July, the mass ratings downgrades took place, and the RMBS subprime market began to shut down as well. The Subcommittee saw no evidence that the proprietary CDO proposed by Mr. Salem was carried out.

In July 2007, Mr. Birnbaum, Goldman's head ABX trader, remarked that Goldman was giving John Paulson, the head of the Paulson Partners hedge funds, "a run for his money" in shorting the mortgage market, and claimed Goldman was "No. 2" behind the Paulson hedge funds in profiting from a massive net short position.[2833] In October 2007, Mr. Birnbaum drafted a proposal that the SPG Trading Desk be compensated in accordance with a hedge fund model, rather than through Goldman's bonus pool, so the desk could obtain a portion

[2828] 3/3/2007 email from Mr. Salem, "Another idea . . .," GS MBS-E-012511081.
[2829] Id.
[2830] Id.
[2831] 6/7/2007 email from Mr. Swenson to Mr. Salem, "Fyi," GS MBS-E-012444245.
[2832] Id.
[2833] 7/12/2007 email from Mr. Birnbaum, GS MBS-E-012944742, Hearing Exhibit 4/27-146 ("He's definitely the man in this space, up 2-3 bil on this trade. We were giving him a run for his money for a while but now are a definitive #2.").

of the proprietary profits it was generating.[2834] He discussed the proposal with other Mortgage Department personnel, but did not present it to senior management.[2835] The Mortgage Department personnel who helped build the net shorts nevertheless received substantial compensation for their 2007 efforts.[2836]

Proprietary trading was not prohibited by law in 2007, and Goldman was free to and did engage in billions of dollars in mortgage related trades for its own account. The Goldman case study also demonstrates how proprietary trading, when undertaken at the same time as trading on behalf of clients, can give rise to conflicts of interest between the bank's financial interests and those of its clients. The new proprietary trading and conflict of interest restrictions in the Dodd-Frank Act are designed to address and reduce these conflicts.

D. Preventing Investment Bank Abuses

Developments over the past two years offer a number of ways to address problems identified in the Goldman Sachs and Deutsche Bank case studies. The success of those alternatives will depend in large part upon how they are implemented, and the degree to which the market disruptions caused by the financial crisis convince investment banks to realign their use of structured finance products, curb their proprietary trading, and respect the interests of their clients. Success will also depend upon sensible implementation of the measures enacted into law by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

(1) New Developments

The Dodd-Frank Act contains several measures that affect investment banking practices. Three key provisions involve proprietary investments, conflicts of interest, and a new study of permitted banking activities.

Proprietary Trading Restrictions. Commercial banks, their holding companies, and affiliates, including any investment banks,[2837] are prohibited by the Dodd-Frank Act from engaging in proprietary trading, subject to certain provisions allowing them to continue to serve

[2834] See slides prepared by Mr. Birnbaum, "SPG Trading - 2007," GS MBS-E-015654036 -50.
[2835] Mr. Birnbaum response to Subcommittee QFR at PSI_QFR_GS0509.
[2836] Mr. Birnbaum, for example, received $17 million in 2007. Subcommittee interview of Joshua Birnbaum (4/22/2010).
[2837] Two of the largest U.S. investment banks, Goldman Sachs and Morgan Stanley, are currently structured as bank holding companies and so are subject to the ban on proprietary trading.

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clients and reduce risks.[2838] The proprietary trading ban will still allow banks, for example, to continue to engage in transactions as market makers for clients, hedge their risks, and maintain very limited investments in private funds they sponsor or manage for others.[2839]

The proprietary trading provision also addresses conflicts of interest and high risk activities. It explicitly bars any proprietary trading activity that "would involve or result in a material conflict of interest ... between the banking entity and its clients, customers, or counterparties," or that would result "in a material exposure by the banking entity to high-risk assets or high-risk trading strategies."[2840] Those express limitations are intended to reduce not only the risk of proprietary trading losses, but also the conflicts of interest that arise when a bank-affiliated investment bank enters into an activity that allows it to profit at the expense of its clients.

Investment banks that have no bank affiliation are not subject to the law's proprietary trading prohibition. If, however, an investment bank is designated by the newly-created Financial Stability Oversight Council as a systemically critical firm, the Dodd-Frank Act would subject its proprietary trading to additional capital requirements and quantitative limits. Those restrictions are intended to ensure large investment banks have sufficient safeguards in place when engaging in risky proprietary activities to prevent them from damaging the U.S. financial system as a whole or necessitating a taxpayer bailout if they get into financial trouble.

Private Fund Restrictions. To ensure that the proprietary trading restrictions are effective, the Dodd-Frank Act prohibits banks and their affiliates, including any investment banks, from bailing out any private fund they advise or sponsor, including an affiliated hedge fund or private equity fund.[2841] This prohibition would apply, for example, to Deutsche Bank and its affiliated hedge fund, Winchester Capital, which made a large proprietary investment in mortgage related products.[2842] These restrictions would not apply to investment banks that are not affiliated with a bank. If, however, the investment bank is designated as a systemically critical firm, it would become subject to additional capital charges to account for the risk that it may end up bailing out a private fund. The private fund provision also addresses the issue of eliminating

[2838] Section 619 of the Dodd-Frank Act (creating a new §13(a) in the Banking Holding Company Act of 1956).
[2839] Id. at §13(d)(1).
[2840] Id. at §13(d)(2).
[2841] Id. at §13(d)(1)(G) and (I); (d)(4); and (f).
[2842] Id. See section discussing Deutsche Bank, above.

any unfair advantage that banks may have from being able to rely on the special privileges of being a bank to implicitly guarantee a private fund, and ensures that a federally insured bank will not be put at risk if an affiliated private fund suffers losses.[2843]

Conflict of Interest Prohibitions. In 2009, one well known investment adviser described the link between proprietary trading and conflicts of interest as follows:

> "Proprietary trading by banks has become by degrees over recent years an egregious conflict of interest with their clients. Most if not all banks that prop trade now gather information from their institutional clients and exploit it. In complete contrast, 30 years ago, Goldman Sachs, for example, would never, ever have traded against its clients. How quaint that scrupulousness now seems. Indeed, from, say, 1935 to 1980, any banker who suggested such behavior would have been fired as both unprincipled and a threat to the partners' money."[2844]

The Dodd-Frank Act contains two conflict of interest prohibitions to restore the ethical bar against investment banks and other financial institutions profiting at the expense of their clients. The first is a broad prohibition that applies in any circumstances in which a firm trades for its own account, as explained above.[2845] The second, in Section 621, imposes a specific, explicit prohibition on any firm that underwrites, sponsors, or acts as a placement agent for an asset backed security, including a synthetic asset backed security, from engaging in a transaction "that would involve or result in any material conflict of interest" with an investor in that security.[2846] Together, these two prohibitions, if well implemented, will protect market participants from the self-dealing that contributed to the financial crisis.

Study of Banking Activities. Section 620 of the Dodd-Frank Act directs banking regulators to review what types of banking activities are currently allowed under federal and state law, submit a report to Congress and the Financial Stability Oversight Council on those activities, and offer recommendations to restrict activities that are inappropriate or may have a negative effect on the safety and soundness

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[2843] Id. See, e.g., 6/12/2010 Cambridge Winter Center report, "Test Case on the Charles," (explaining how State Street Bank bailed out the funds it managed, but then itself needed several emergency taxpayer-backed programs).
[2844] "Lesson Not Learned: On Redesigning Our Current Financial System," GMO Newsletter Special Topic, at 2 (10/2009), available at http://www.scribd.com/doc/21682547/Jeremy-Grantham.
[2845] Section 621 of the Dodd-Frank Act (creating a new § 27B(a) in the Securities Act of 1933).
[2846] Id. at § 621.

of a banking entity or the U.S. financial system. This study could evaluate, for example, the use of complex structured finance products that are difficult to understand, have little or no track record on performance, and encourage investors to bet on the failure rather than the success of financial instruments.

Structured Finance Guidance. In connection with provisions in the Dodd-Frank Act related to approval of new products and standards of business conduct,[2847] the banking agencies, SEC, and CFTC may update and strengthen existing guidance on new structured finance products. In 2004, after the collapse of the Enron Corporation, the banking regulators and SEC proposed joint guidance to prevent abusive structured finance transactions.[2848] This guidance, which was not finalized until January 2007, was issued in a much weaker form.[2849] The final guidance eliminated, for example, warnings against structured finance products that facilitate deceptive accounting, circumvention of regulatory or financial reporting requirements, or tax evasion, as well as detailed guidance on the roles that should be played by a financial institution's board of directors, senior management, and legal counsel in approving new products and on the documentation they should assemble.

(2) Recommendations

To prevent investment bank abuses and protect the U.S. financial system from future financial crises, this Report makes the following recommendations.

1. **Review Structured Finance Transactions.** Federal regulators should review the RMBS, CDO, CDS, and ABX activities described in this Report to identify any violations of law and to examine ways to strengthen existing regulatory prohibitions against abusive practices involving structured finance products.

[2847] Section 717 and Title IX of the Dodd-Frank Act.
[2848] "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities," 69 Fed. Reg. 97 (5/19/2004).
[2849] "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities," 72 Fed. Reg. 7 (1/11/2007) (issued by the Office of the Comptroller of the Currency; Office of Thrift Supervision; Federal Reserve System; Federal Deposit Insurance Corporation; and Securities and Exchange Commission).

2. **Narrow Proprietary Trading Exceptions.** To ensure a meaningful ban on proprietary trading under Section 619, any exceptions to that ban, such as for market-making or risk-mitigating hedging activities, should be strictly limited in the implementing regulations to activities that serve clients or reduce risk.

3. **Design Strong Conflict of Interest Prohibitions.** Regulators implementing the conflict of interest prohibitions in Sections 619 and 621 should consider the types of conflicts of interest in the Goldman Sachs case study, as identified in Chapter VI(C)(6) of this Report.

4. **Study Bank Use of Structured Finance.** Regulators conducting the banking activities study under Section 620 should consider the role of federally insured banks in designing, marketing, and investing in structured finance products with risks that cannot be reliably measured and naked credit default swaps or synthetic financial instruments.

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APPENDIX

FOOTNOTE LOCATOR LIST and BATES LOCATOR LIST

The following two lists, *Footnote Locator List* starting below, and the following *Bates Locator List*, reference documents referred to in the Report's footnotes. Footnotes which are not contained in either list are explanative, reference Subcommittee interviews for which records are not available to the public, or reference a widely available public document.

Many documents are referenced in multiple footnotes. To locate a document by footnote number refer to the *Footnote Locator List*, using the first footnote in which the document is referenced. To locate a document by bates number, refer to the *Bates Locator List*. Both lists then provide the page number where the document can be found. That page number appears in the top right-hand corner of the Footnote Exhibits.

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GS-PSI-04100	1619	3394
GW 107909	2646	5382

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HUD-CDO-00004851	2605	5278
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MIS-OCIE-RMBS-0364942	1159	728
MIS-OCIE-RMBS-0419014	1113	642

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Moody's 2008 Global CDO Review (3/3/2008)	1264	771
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OTSWME06-039 0000205	694	323
OTSWME06-039 0000214	691	319
OTSWME07-067 0001082	704	350
OTSWME07-075 0000780	868	412
OTSWMEF-0000032053	855	411
OTSWMEN-0000000274	703	328
OTSWMEN-0000020983	700	326
OTSWMS06-007 0001020	729	397
OTSWMS07-011 0001294	708	384
OTSWMS08-015 0001216	628	261
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PAULSON-ABACUS 0250401	2548	5225
PAULSON-ABACUS 0252736	2515	4764
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PSI Chart: "Abacus 2007-AC1 Reference Portfolio"	2522	4788
PSI Chart: "Fact Sheet for Three Examples of Failed AAA Ratings"	1034	595
PSI Chart: "Goldman Sachs Expected Profit from RMBS Securitizations"	1238	769
PSI email exchange with Goldman counsel (1/7/2011)	2653	5388
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PSI-Basis_Capital_Group-02-0001	2426	4533
PSI-Basis_Capital_Group-03-0001	2419	4515
PSI-Deutsche Bank-31-0004	1278	848
PSI-Deutsche Bank-32-0001	1278	844
PSI-Deutsche_Bank-02-0005	1267	811
PSI-DeutscheBank-17-Gemstone7-0001	1347	1489
PSI-FDIC-10-0001	776	399
PSI-FDIC-13-000001	947	477
PSI-M&T_Bank-02-0001	1393	1698
PSI-MOODYS-RFN-000001	1046	613
PSI-MOODYS-RFN-000007	1123	666
PSI-MOODYS-RFN-000009	1046	611
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PSI-MOODYS-RFN-000031	1083	624
PSI-MOODYS-RFN-000032	1081	621

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PSI-MOODYS-RFN-000035	1212	765
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PSI-MOODYS-RFN-000040	1175	742
PSI-MOODYS-RFN-000044	1003	582
PSI-MOODYS-RFN-000045	1003	583
PSI-Paulson&Co-02-0001	1011	588
PSI-Paulson-04 (Pellegrini Depo)-0001	2501	4739
PSI-Paulson-04 (Shu Depo)-0001	2515	4758
PSI-S&P-RFN-000001	1191	753
PSI-S&P-RFN-000002	1088	633
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PSI-S&P-RFN-000006	1046	605
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PSI-S&P-RFN-000044	1152	724
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PSI-SEC (S&P Exam Report)-14-0001	1145	699
PSI-Standard&Poor's-04-0001	1131	674
Quigley_Lori-00231631_001	716	387
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S&P SEN-PSI 0007442	1201	760
S&P-PSI 0000028	991	568
S&P-PSI 0000036	991	575
S&P-SEC 067708	1004	584
S&P-SEC 067733	1004	585
S&P-SEC 067740	1004	586
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SEC_OCIE_CRA_011217	981	545
SEC_OCIE_CRA_011218	982	546
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Statement submitted to PSI by Timothy Saunders (12/22/2010)	2657	5404
Transcript-Blankfein on CNBC Power Lunch (5/7/2010)	2706	5455
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FOOTNOTE EXHIBITS

Office of Thrift Supervision

FACT SHEET

1700 G Street, N.W., Washington, D.C. 20552 • Telephone (202) 906-6677 • www.ots.treas.gov

FOR RELEASE:
Thursday, September 25, 2008
OTS 08-046A

CONTACT:
William Ruberry
(202) 906-6677
Cell – (202) 368-7727

OTS Fact Sheet on Washington Mutual Bank

Institution Profile

- Total assets as of June 30, 2008: $307.02 billion
- Primary executive and business segment headquarters are located in Seattle, Washington.
- Branches: 2,239 retail branch offices operating in 15 states
- 4,932 owned and branded ATMs
- Employees: 43,198 at June 30, 2008

Recent Deposit Flows

- Because of adverse events in the financial markets, material outflows began on September 15, 2008. Coupled with further rating agency downgrades of Washington Mutual Inc. (WMI, the top-tier holding company) and Washington Mutual Bank (WMB or the Bank), the Bank experienced a net deposit loss of $16.7 billion through September 24, 2008.

Other Financial Details (as of June 30, 2008)

- Total deposits: $188.3 billion
- Brokered deposits: $34.04 billion
- Total borrowings: $82.9 billion primarily comprising Federal Home Loan Bank advances of $58.4 billion and $7.8 billion of subordinated debt
- Loans held: $118.9 billion in single-family loans held for investment - this includes $52.9 billion in payment option ARMs and $16.05 billion in subprime mortgage loans
- Home Equity Lines of Credit (HELOCs): $53.4 billion
- Credit Card Receivables: $10.6 billion

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- Total loan servicing: $689.7 billion total loans serviced, including $442.7 billion in loans serviced for others and $26.3 billion of subprime mortgage loans
- Non-performing assets: $11.6 billion, including $3.23 billion payment option ARMs and $3.0 billion subprime mortgage loans

Institution History

- WMI is the top-tier savings and loan holding company and owns two banking subsidiaries, WMB and Washington Mutual Bank, fsb (WMBfsb), as well as nonbank subsidiaries.
- Since the early 1990s, WMI expanded its retail banking and lending operations organically and through a series of key acquisitions of retail banks and mortgage companies. The majority of growth resulted from acquisitions between 1996 and 2002. On October 1, 2005, the Bank entered the credit card lending business by acquiring Providian Financial Corporation. These acquisitions enabled WMB to expand across the country, build its customer base, and become the largest savings and loan association in the country.
- The Bank had four business segments: the Retail Banking Group, the Card Services Group, the Commercial Group and the Home Loans Group. WMB is a leading originator and servicer of both single- and multi-family mortgages and a major issuer of credit cards.

Recent Events

- *Changes in Business Strategy* - Beginning in late 2006 through today, WMB was proactively changing its business strategy to respond to declining housing and market conditions. Changes included tightening credit standards, eliminating purchasing and originating subprime mortgage loans, and discontinuing underwriting option ARM and stated income loans. Management reduced loans originated for sale and transferred held for sale loans to the held for investment portfolio. WMB was focusing on shrinking its balance sheet and developing a retail strategy through its branch operations.

- *Reduction of Overhead Expenses* - In December 2007, WMB announced the resizing of its Home Loans business including the elimination of approximately 2,600 employee positions, closure of approximately 190 home loan centers and sales offices, and closure of nine loan processing and call centers.

- *Maintaining Capital* - In late 2006 and 2007, WMB began to build its capital level through asset shrinkage and the sale of lower-yielding assets. In April 2008, WMI received $7.0 billion of new capital from the issuance of common stock. Since December 2007, WMI infused $6.5 billion into WMB. WMB met the well-capitalized standards through the date of receivership.

- *Operating Losses* - WMB recorded a net loss of $6.1 billion for the three quarters ended June 30, 2008. In the second quarter of 2008, WMB management disclosed that the Bank's credit quality had deteriorated and it might incur up to $19 billion in losses on its single-family residential mortgage portfolio. WMB increased its loan loss provisioning in response to the deteriorating housing market. Loan loss provisions increased from $1.6 billion in the fourth quarter of 2007, to $3.6 billion in the first quarter of 2008 and $6.0 billion in the second quarter of 2008.

- *Deposit Outflows* – Since July 2008, the pressure on WMB increased market conditions continued to worsen. Significant deposit outflows began on September 15, 2008. During the next eight business days, WMB deposit outflows totaled $16.7 billion, shortening the time available to augment capital, improve liquidity, or find an equity partner. Given the Bank's limited sources of funds and significant deposit outflows, it was highly likely to be unable to pay its obligations and meet its operating liquidity needs.

- *Receivership* - With insufficient liquidity to meet its obligations, WMB was in an unsafe and unsound condition to transact business. OTS placed WMB into receivership on September 25, 2008. WMB was acquired today by JPMorgan Chase. The change will have no impact on the bank's depositors or other customers. Business will proceed uninterrupted and bank branches will open on Friday morning as usual.

OTS Enforcement Actions

- October 17, 2007 – Issued a Cease and Desist Order related to deficiencies in Bank Secrecy Act/Anti-Money Laundering (BSA/AML) programs
- October 17, 2007 – Assessed Civil Money Penalties (CMPs) related to violation of flood insurance regulations
- November 14, 2007 – Initiated a formal examination of the appraisal process to assess the validity of a complaint filed by the New York Attorney General's (NYAG) Office
- February 27, 2008 – Issued overall composite ratings downgrade and received a Board resolution in response to the supervisory action
- June 30, 2008 – Issued Memorandums of Understanding to WMI and WMB
- September 19, 2008 – Issued overall composite ratings downgrade

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OTS Profile
Established - 1989
Thrift institutions supervised as of June 30, 2008 - 829
Thrift industry assets supervised as of June 30, 2008 - $1.51 trillion
OTS employees - 1,055
Washington Mutual Bank assessment revenue – 12.2 percent of 2008 OTS budget

Business Publications

0 Comments

Washington Mutual to Acquire PNC's Residential Mortgage Business

Business Wire, Oct 2, 2000

Business Editors

SEATTLE--(BUSINESS WIRE)--Oct. 2, 2000

Transaction to Make Washington Mutual Nation's Third Largest

Mortgage Originator and Fourth-Largest Servicer of Home Mortgages

In a major step that expands its home loan origination and servicing business nationally, Washington Mutual (NYSE:WM) today announced the signing of a definitive agreement to acquire the residential mortgage business of the PNC Financial Services Group for approximately $605 million in cash subject to customary closing adjustments. The acquisition further diversifies Washington Mutual's mortgage operation geographically and enhances the company's already strong position in the home loan business, making it the country's third-largest mortgage originator and fourth-largest servicer of residential mortgages, based on data for the first half of 2000.

Under the terms of the agreement, Washington Mutual will pay a premium of $212 million over the agreed-upon fair-market value of PNC's equity, which was $393 million at June 30, 2000. The purchase price represents a multiple of approximately 9.4 times the adjusted net income for the PNC Financial Services Group's residential mortgage business for the 12 months ending June 30, 2000. The mortgage servicing rights being acquired are valued at 2.27 percent of the $85 billion mortgage servicing portfolio of PNC.

As a result of the transaction, which will be accounted for as a purchase, Washington Mutual expects to record total intangible assets or "goodwill" of $249 million, which includes $37

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million of acquisition-related expenses. The vast majority of this goodwill is tax deductible. The acquisition is expected to be accretive to both cash and reported earnings per share by 2002.

With the completion of this transaction - - and the recently announced agreement to acquire Bank United of Texas - - Washington Mutual would manage a mortgage servicing portfolio of approximately $291 billion, based on June 30, 2000 data. In addition, PNC's significant fixed-rate origination capacity will complement Washington Mutual's adjustable-rate mortgage focus. Over the past three years, PNC's mortgage originations have averaged $20.0 billion. Washington Mutual generated mortgage originations totaling $39.4 billion for the 12 months ended June 30, 2000.

"In one move, we have greatly accelerated Washington Mutual's progress in achieving one of its key business initiatives: combining the strengths of a portfolio lender and mortgage banker to enhance our capacity to originate loans throughout the entire interest-rate cycle and to do so through a broad national footprint," said Kerry Killinger, Washington Mutual's chairman, president and CEO.

"PNC Mortgage is a terrific match for our company in a business that will increasingly require just this sort of scale, breadth and flexibility to deliver shareholder value in the future."

The transaction will not only complement Washington Mutual's already substantial penetration in its key markets in the West, but will offer Washington Mutual significantly broader distribution in highly attractive Midwestern and Northeastern markets. Based on originations for the first half of 2000, the combined entity would hold the No. 1 mortgage-market-share position in the states of California, Connecticut, Illinois, Massachusetts, Oregon, Pennsylvania and Washington. The combined entity would also possess a top-five-market-share position in the nation's five largest mortgage origination states: California, Florida, Illinois, New York and Texas.

PNC announced its plans to explore a potential sale of its residential mortgage business in July, citing the significant capital investment that would be needed to meet the accelerating scale requirements of the business.

"Washington Mutual provides the scale that will be required to compete effectively in the mortgage business of the future," said James E. Rohr, president and chief executive officer of The PNC Financial Services Group. "We will continue to deliver a full line of residential mortgage products to PNC's customers through an agreement with Washington Mutual, and are committed to working with them to maintain the high level of service that PNC's customers expect from us."

Killinger added that PNC's fixed-rate origination capacity should enhance Washington Mutual's ability to generate additional fee income from gain-on-sale and loan servicing activities. In addition, the transaction adds a mature correspondent business that complements Washington Mutual's retail and wholesale brokerage distribution channels. It also further broadens Washington Mutual's capabilities with the addition of a private mortgage conduit business that includes a master-servicing portfolio of approximately $36 billion.

6

"PNC Mortgage not only enhances our competitive position in the marketplace, it enables us to build upon an already strong foundation of scale, efficiency and premier service," Killinger concluded.

Washington Mutual said that it plans to undertake a comprehensive review of the combined operations to determine the optimal combination of sales, service and administrative resources, with resulting cost synergies ranging from $60-65 million.

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NPV

Washington Mutual

MEMORANDUM

DATE: June 1, 2004
TO: Board of Directors
FROM: Kerry Killinger
RE: Strategic Direction

INTRODUCTION

2004 marks the fifth year of the current five-year plan. In 1999, we developed a plan to increase shareholder value by growing a national consumer banking and mortgage lending franchise. Five years ago, we had just over 1,000 financial centers (predominantly located in the Pacific Northwest and California), with total deposits of $81 billion, consumer loans of $8.5 billion and annual mortgage originations of $40 billion. By the end of 2004, we will have about 1,948 financial centers, $165 billion of deposits, $40 billion of consumer loans and annual mortgage originations of approximately $224 billion.

In this five-year plan, we set out several financial targets. The most important targets included achieving an average ROE of 20% and an EPS growth rate of 13%. Secondary targets included maintaining a NPA ratio of less than 1%, maintaining a tangible common equity ratio of at least 5%, and achieving a 45% operating efficiency ratio.

Financial performance over the five-year period is expected to modestly under-perform the long-term financial targets. Prior to revisions in our 2004 Financial Plan for recent increases in interest rates, both ROE and EPS growth exceeded target. However with revisions based on a 4.75% 10-year Treasury yield in 2004 (versus 4.00% in the Plan), EPS growth over the five-year period is expected to reach 11% and ROE will average close to 20%. Over this five-year period, it is expected that the NPA ratio will have averaged 0.8%, the tangible common equity will have averaged 5.12% of assets, and the operating efficiency ratio will have averaged 52%. It should be noted that we did achieve our 45% efficiency ratio target for several quarters during the period.

Reflecting back over the past five years, there were several notable strategic successes for our retail banking group. The acquisitions of Dime Savings and Bank United helped expand our consumer banking franchise. We also had successful de novo market entries into Las Vegas, Phoenix, Atlanta, Denver, and Chicago. Our award-winning advertising drove in net customer growth of close to three million banking households. We introduced the Occasio store designs and opened nearly 500 new stores. Our brand position and name recognition grew throughout the nation.

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #148

We were also successful in expanding our home lending franchise. The acquisitions of PNC Mortgage, Fleet Mortgage, Home Side Lending, and North American Mortgage were augmented with de novo growth. Our national market share of mortgage originations and servicing increased from about 3% in 1999 to close to 10% in the first quarter of this year.

$1.5bil investment 01 - 600 02 $1.?bil 03 - $1.3bil.

Finally, we expanded our multi-family lending business, becoming the national market leader, with a market share exceeding 10% in all of our West Coast markets.

On the challenge front, we experienced ongoing regulatory, compliance, and technology issues. These were primarily centered in our home lending business and were caused by rapid growth, attempts to develop cutting edge technology solutions, and a series of refinancing booms which delayed our ability to complete the acquisition integrations. We also needed to develop the capacity to manage complex MSR and pipeline hedging. And we needed to replace some management personnel and bring in several new executives to help manage a much more complex company.

Overall, shareholders did very well over this five-year period. The share price increased from $17.06 (split adjusted) on December 31, 1999 to $ 43.90 per share on May 31, 2004. This increase, combined with increasing cash dividends, provided a total compounded annual return of 28% per year versus -6% for the S&P 500 over the same period.

Our overall assessment is that shareholders and other constituencies benefited from the successful execution of this five-year plan.

NEW FIVE-YEAR PLAN

Following is a broad framework for a new five-year strategic plan. As always, we will adjust the plan for significant changes in the financial environment and new opportunities and threats that inevitably occur over a five-year period.

We believe that successful execution of this plan has the potential to create significant value for our shareholders. We also believe that the risks inherent in the plan are reasonable and can be appropriately managed.

Mission

WaMu is better positioned than any company in America to build a nationwide network of stores serving every day, average consumers with attractively priced financial services. We take care of these customer's needs for checking, savings, investments, insurance, home loans, home equity loans, credit cards and small business needs. The market is huge and we have a head start over competitors who have traditionally had difficulty effectively serving this customer base. Our keys to success are 1) focus, 2) driving world class efficiency, 3) maintaining a friendly service culture and 4) crisp execution.

Strengths?

Test: 1) doing few things
2) World class Efficiency
3) friendly service
4)² Execution - quick turn times

Accordingly, our mission is to create one of the nation's leading retailers of financial services to consumers and small businesses. By providing products and services which offer great value and friendly service, by attracting and retaining the best and brightest employees in our industry, and by helping our communities prosper, we will achieve our mission and, thereby, create significant long-term value for our shareholders. We will pursue our corporate mission by adhering to our corporate values of integrity, respect, teamwork, innovation, and excellence.

Long-Term Financial Targets

Our primary financial targets for the next five years will be to achieve an average ROE of at least 18% and average EPS growth of at least 13%. We believe achievement of these targets will likely result in above-average performance and could place us in the top one-third of financial industry competitors. For a perspective, median ROE and EPS growth for the S & P Financial Index was 15% and 10%, respectively, over the past five years ('98 – '03). The preliminary 2005-2009 plan suggests average ROE and earnings per share growth meeting these targets, although 2005 is expected to be another difficult year. Both 2004 and 2005 are severely impacted by the sharply higher interest rate environment and its effect on the mortgage business.

Q, 20.8 to 28%

It should be noted that purchase accounting and the creation of goodwill on the Dime acquisition reduced ROE by about 3%. This, along with our expectation of higher interest rates caused us to revise our long-term ROE target to 18%. It is also noted that long-term earnings growth is the key to creating shareholder value. As has been the pattern in the past, we anticipate a certain amount of year-to-year earnings volatility driven by changes in interest rates and other non-controllable factors. As Exhibit A illustrates, even with our forecasted 2004 results, the current five-year period's volatility is significantly lower than that of the prior five-year period.

Very illustrative – Around 13% Growth Target

Secondary financial targets include achieving an operating efficiency ratio of 45% by 2009, maintaining a tangible equity ratio of at least 5% and maintaining average annual net charge offs of 0.25% over the period.

In summary, despite our greatly increased size and a relatively low inflation environment, we are maintaining a robust average earnings growth target over the five-year planning period.

WaMu in 2009

Before digging into the details, let's visualize the size and scale of Washington Mutual at the end of 2009. We hope to see assets grow by at least 10% per year, reaching about $500 billion in 2009. We see this annual asset growth being funded about 50% by deposits and 50% by collateralized borrowings such as FHLB advances and repurchase agreements. We will strive to keep annual asset and deposit growth to plus or minus 5% around the 10% growth target (5% to 15% asset growth range).

We assume, as a rough approximation, that capital will be deployed 40% through cash dividends, 10% through share repurchase and 50% through retention to support balance sheet growth. Our basic plan assumes neither acquisitions nor the raising of additional capital.

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Smaller bus

1) 2)

We expect our balance sheet growth to be driven by consumer loans, multi-family loans, 3) residential non-prime, and adjustable rate mortgage loans. Because percentage growth in consumer, multi-family, and residential non-prime loans will be especially strong, we expect to slightly increase the percentage of our balance sheet made up of these higher yielding loans.

We expect to increase our financial center store system by at least 250 stores per year, reaching close to 3,100 stores by 2009. We believe that continued new store growth is critical to our ability to meet our financial targets and build long-term franchise value. We will focus our new store growth in existing markets and may open in two or three new urban markets over that five-year period. Excluding any stores we may close in non-footprint markets, our home loan center system will expand by about 25 locations annually over the next five years, and we should end 2009 with approximately 500 stores concentrated in markets where we have banking stores. We will more closely align home loan centers and financial centers in 2005 and beyond which may affect the projected growth number for home loan centers over the next five years. Combining all stores, we expect to increase our store total from 2,400 by the end of this year to about 3,600 by 2009.

As indicated with our financial targets, our goal is to increase EPS by at least 13% per year on average. Based on our five-year financial forecast, we hope to achieve absolute earnings of about $7 billion and EPS of just over $8.00 in 2009. This translates into average EPS growth of 18% over the period off of our depressed 2004 starting point.

Assuming a $40 per share stock price at year end 2004, a 40% cash dividend payout over the five-year period, and the successful attainment of our growth forecast, total shareholder return over this period could reach 19% per year if our stock sells at ten times earnings in 2009. While our business model, which will continue to include cyclical mortgage banking components, may continue to produce a below average price/earnings multiple, some expansion could occur if we bring down our cost base and demonstrate best-in-class execution over the next five years. Expansion of the price/earnings multiple to 12 would result in a 23% annual total shareholder return. We believe returns in this range will compare very favorably to the S&P 500 and most financial services companies.

In a consolidating industry, it is appropriate to continually assess if shareholder value creation is best achieved by selling for a short-term change of control premium or to continue to build long-term value as an independent company. We believe remaining an independent company is appropriate at this time because of the substantial growth opportunities we see ahead. We are especially encouraged with growth prospects for our consumer banking group. We would also note that our stock is currently trading at a price which we believe is substantially below the intrinsic value of our unique franchise. This makes it even more important to stay focused on building long-term shareholder value, diligently protecting our shareholders from inadequate unsolicited takeover proposals and maintaining our long held position of remaining an independent company. comments from investors

Retail Banking Strategy

Our strategy over the next five years is to more fully penetrate our existing markets through the opening of at least 250 new retail banking stores per year and to improve the cross sales of products to all of our customers. We believe market demand is sufficient to support the new store growth. The states in which we operate are some of the most populated and fast growing states in the country. While we may wish to enter two or three additional markets over the next five years, our existing footprint states appear to provide plenty of growth opportunities for Washington Mutual. Attached in Exhibit B is a summary of current and projected market shares for key products and services. You will note that, given our 2.7% assumption for average growth in the bank deposit market, we need to achieve increased market share in deposits and consumer loans in order to meet our asset and deposit growth targets. By 2009, we need to increase our share of deposits from 4.5% to 5.8%, and our share of consumer loans (Home Equity 2[nd]s) from 5.6% to 7.3% in our current and planned footprint states. We believe these growth targets are aggressive, but attainable if the overall deposit and consumer loan markets continue to grow at reasonable rates.

The summary operating tactics required to achieve our overall strategy for our Consumer Banking Group over the five-year period include the following:

- We will continue our program to open at least 250 new banking stores per year over the next five years.
- We will initially seek to drive in about $13 billion of deposit growth per year, rising to about $18 billion per year by the end of the five-year plan. We expect retail deposits will contribute about 4/5 of the deposit growth on average, with the balance coming from wholesale deposits. Deposit distribution will be primarily through the financial centers, but augmented by wholesale deposit taking, Internet, and call center sales. Emphasize internet
- We will continue to lead with our Free Checking and Platinum accounts. Our goal is to drive in at least 750,000 net new accounts per year.
- We will continue to focus on our cross selling efforts with a goal of increasing our products and services cross sales ratio from the current 5.7 to 7.0.
- We expect consumer lending to continue to show high growth over this period, averaging at least 15% per year. The key product will be home equity loans and we expect that portfolio to grow by approximately $10 billion per year.
- We plan to aggressively promote Free Checking for small businesses throughout this period. Our recent national launch of this product has been successful and we look to add net growth in total business checking of about 240,000 accounts per year.
- how work? We will focus our distribution of insurance and securities products through a force of licensed bank personnel. By 2009, we expect to have 1,500 licensed bank personnel selling these products, up from only 75 today.
- We intend to maintain limited distribution of insurance and securities products through Series 7 licensed financial consultants. We have not been particularly successful in leveraging this distribution force over the years and have achieved mixed financial results. However, these services are important for maintaining overall relationships with our wealthier customers.
- We are examining strategic alternatives for our mutual fund complex. Our fund complex has had good performance and grown over the past few years, but at around $20 billion of assets under management, it is a small player in the mutual fund industry. We also face management succession issues in our investment management company. Finally, we will continue to carefully monitor changing regulatory and enforcement actions in the mutual fund industry.

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- We intend to launch a WaMu credit card product in 2005. Marketing will be focused on existing WaMu customers. We will carefully manage credit and anticipate balances increasing to about $2.3 billion at the end of the five-year planning period.

Mortgage Banking

Over the past five years, we worked to create scale and a leading market position. Through a series of acquisitions, we created a very broad-based mortgage banking operation serving all channels of delivery (retail, wholesale, correspondent, Internet, call centers, affinity groups and financial centers), with a broad set of products over a wide geography. While this strategy helped us claim leading market share, it also ballooned our cost structure and limited our ability to focus on value-added activities. The inherent cyclicality and rapid shifts in market size and competition which characterize the mortgage banking business also added enormous volatility to our earnings, due to MSR management, the variability in the amount of gains on mortgage sales, and the difficulty in managing the business to match expenses with falling revenues during periods of rising interest rates.

As our 2004 and 2005 projections demonstrate, our business has embedded volatility driven by the effects of interest rate cycles on mortgage banking earnings and the inherently high volatility of some key parts of the mortgage banking business model, such as MSRs. This is in contrast to the relative stability we experience in our retail banking and commercial businesses. Although we are taking further actions to reduce volatility in our mortgage business, we have concluded that we cannot eliminate all of the volatility in our business without hurting the fundamental profitability of the company. The inescapable fact is that there is volatility in the mortgage banking business and investors need to understand that our earnings can be volatile at certain points in the cycle and that short-term volatility is not a reflection on operating performance, but an expected part of our business strategy. We intend to clearly communicate this to the investment community.

That doesn't mean we're "giving up" on reducing the volatility in the mortgage banking business by any means. We are working right now on plans to "right size" the interest rate driven variability of our mortgage banking model to find that "sweet spot" that creates the mixture of net income and volatility that delivers the highest total shareholder return to our investors over the period.

Over the next five years, we believe it is appropriate for us to narrow our focus in the mortgage area and take advantage of our unique strengths rather than trying to spread ourselves too thin. In other words, our strategy is shifting from being a national market share leader to a focused national mortgage lender emphasizing areas of strategic advantages.

We believe we have several key strategic advantages:

- Because of our balance sheet size, we can portfolio more loans than most major competitors.
- By bringing the management of the consumer banking and mortgage banking operations together and integrating parts of the organization, we have a good chance of cracking the code of cross sales to mortgage customers.

- By focusing our retail mortgage activities in footprint states (those states where we have a retail banking franchise), we will be able to leverage the WaMu brand and marketing spend and focus on customers with a high propensity to purchase our products.
- Our retail home loans sales force is one of the most productive in the industry.
- We have a robust data base which should allow us to use customer data to improve credit decisioning and MSR prepayment management.
- We have good experience in managing non-prime residential loans.

Due to these advantages, we will refine our mortgage strategy to focus on retail mortgage origination in our footprint states. Wholesale and correspondent will be nationwide and retooled to deliver higher margin products. Instead of maximizing national market share, our goal will be to maximize *profitable* market share in footprint states. We do not have market share as a goal, but we do expect our share of market in footprint states to gradually increase from 10.8% in 2004.

- We view the retail and wholesale origination channels to be the key to building a sustainable home lending franchise. Correspondent lending, on the other hand, has little franchise value and should be utilized on an opportunistic basis to originate higher margin products or during those parts of the cycle when we want to acquire MSR assets.
- While we hope to improve the economics of mortgage servicing rights by increasing cross sales to those customers, there is little evidence to suggest that we can do this effectively in geographic areas other than where we have a retail banking presence. As such, we will focus on maximizing our servicing market share in those footprint states in which we have a retail banking presence.
- Our goal over the next five years is to increase the cross sell ratio of mortgage customers from 2.86 relationships (excluding Long Beach Mortgage & Specialty Mortgage Finance) to 3.6. Key products for sale to mortgage customers include home equity loans and checking accounts.
- We must significantly reduce the cost of originating mortgages by adopting automated underwriting and other loan fulfillment processes. Our multiple origination platforms have led to very poor efficiency. Our goal is to increase automated underwriting to 80% or more, which we expect to have a positive affect on the cost of origination. The prime residential mortgage business has very thin margins and it is essential to become a low cost originator. We have a long way to go in becoming an industry leader in efficiency.
- Our mortgage servicing portfolio is approximately $723 billion. While our servicing portfolio will probably increase gradually, we anticipate that a growing percentage of the serviced loans will be portfolio loans versus loans serviced for others. It is also critical that we become an industry leader in loan servicing efficiency. Due to maintaining two servicing systems we are currently incurring above-average servicing costs. Our goal is to decrease the cost of servicing a loan from today's $106 to $80 by 2009. Our conversion to a common servicing system in the middle of 2004 will aid in this effort and additional operational excellence initiatives will be required.
- MSR assets provide modest returns (averaging about 9-13% ROE over the cycle) and extraordinary volatility. MSRs are highly sensitive to minor changes in interest rates and technical market factors, and despite the best efforts of our Treasury team, never perfectly match up to hedge performance. The accounting for these assets exacerbates their effect on reported earnings. The result is quarterly and annual earnings volatility

which investors (and management) find troublesome. In addition, high levels of MSR assets as a percentage of capital cause rating agency and regulatory concerns. We are actively pursuing a number of potential methods for gradually reducing our exposure to MSRs, including selling off IO tranches, decreasing core servicing fees, decreasing excess servicing fees and selling off non-strategic loan servicing (in non-footprint states). Our goal is to reduce MSR balances to a level that produces acceptable levels of quarterly and annual volatility without reducing net income excessively.

Multi-Family Lending

Our strategy is to be the nation's dominant multi-family lender. We pioneered the development of low-cost, highly efficient and standardized underwriting, processing, and servicing for small multi-family loans in select urban markets. These capabilities catapulted us into the No. 1 position in the industry. We intend to leverage our leadership position in key markets in footprint states by originating both adjustable-rate and fixed-rate multifamily products. We will generally retain adjustable rate products in our portfolio and sell the fixed-rate products to the secondary markets. We expect our strategic partnership with Fannie Mae to significantly increase the origination of adjustable rate multi-family loans over the next five years. We anticipate annual portfolio growth of about $6 billion over this period. – whole comml area

issue – limits w/ larger borrowers

Non-Prime Residential Mortgages

Our non-prime residential activities currently include originations through Long Beach Mortgage, our purchased portfolio of non-prime residential loans (SMF portfolio), and loans originated through our home loans group. Loans of this type held in our portfolio currently total approximately $60 billion. Our SMF and Long Beach activities have provided excellent risk-adjusted returns over the past several years, consistently exceeding our 20% return thresholds. However, the bulk of our non-prime loans have been originated through the home loans channel with uniform pricing and terms that did not reflect their true risk profile. opportunity for improvement

Through Long Beach Mortgage, our origination market share of non-prime residential mortgages is currently around 4%. Long Beach has focused its past distribution through the wholesale channel. Over the next five years, we will seek to carefully increase our national origination market share of non-prime mortgages. To accomplish this, we will need to develop a retail distribution to complement the existing wholesale distribution, focused primarily in our footprint states. We may also leverage the Bank's financial center system to distribute some non-prime residential mortgages.

Over time, we plan to increase the percentage of non-prime residential loans originated by Long Beach which are held in portfolio. To maximize this flexibility, we may seek to make Long Beach a subsidiary of our federal association.

We believe there is a good opportunity to expand the origination of non-prime residential first and second mortgages through both our consumer banking and home loan stores. Automated underwriting tools and risk-based pricing should help us increase the returns on non-prime loans originated through these channels. Because of the growing importance of non-prime lending, we

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are in the process of developing a comprehensive non-prime lending policy for the entire complex.

Industry Leading Efficiency

To achieve our financial targets, it is essential that we become best-in-class operators in each of our businesses. We have significant work to do to accomplish this objective. While we made good progress in improving our efficiency ratios in 2000 and 2001, the last couple of years were challenging because of mortgage banking acquisitions and a rapid escalation in corporate support activities. It is imperative that we complete those acquisition integrations and focus on bringing best-in-class efficiencies in all areas of the organization.

As a general rule, we will seek to achieve 5% productivity improvements in all areas of the organization each year over the next five years. Our overall plan is to grow our asset base and revenues by approximately 10% per year while limiting our expense growth to about 5%. While these are very ambitious goals (over the past five years the top ten banks have produced productivity gains that averaged 0.7%), our efficiency ratio is currently higher than almost all of our peer banks so we believe that there is significant opportunity for us to produce productivity gains for an extended period.

We intend to migrate the excellent work which has been done in attacking the $1 billion in cost savings into an ongoing commitment to improving productivity. We have the key tools in place with Operational Excellence and will charge the Operating Forum (group of senior leaders headed by Craig Chapman) with driving consistent oversight of productivity improvements. It is important that we establish best-in-class benchmarks for efficiency for each business unit and corporate support group and to drive efficiency improvements on a comprehensive, company-wide basis. This will be a multi-year effort of historic proportions, and will require fundamental shifts in the company's processes, organizational structure and culture. The dislocations will be severe and many of our employees will be unhappy with this shift and resistant to necessary change. We will focus on open and regular communication with our employees to help them see that this approach to productivity is necessary for the success and independence of the company and not a passing "fad."

Our long-term target is to improve the operating efficiency ratio to 45% from the current level of about 60%. As we gain traction on productivity enhancements, it is possible we can reduce the efficiency ratio even further. As an aside, the efficiency ratio is volatile because of changing revenue sources, such as margin and gains on sale. Accordingly, we will also target improving the ratio of operating expenses to average assets from today's 2.8% to 2.2% by 2009.

Diversification

We have been engaged for some time in a discussion internally and with you about the benefits and costs of further diversification of our business lines, balance sheet and income statement. The more deeply we have looked into this question, the more we have come to the conclusion that our current business model is likely to deliver higher total shareholder returns over the next five years than any more diversified model that could be reasonably achieved by our company over that period. This is a function both of our confidence that a combination of balance sheet growth, management focus and high productivity can drive very strong earnings for the company in its current configuration and of our conclusion that any effort at business line diversification over the next five years, whether organic or based on acquisitions, would be unlikely to materially change our risk/return profile or price/earnings multiple, given our enormous size and the predominance of mortgage-related assets on our balance sheet.

So over the next five years our watchwords will be "narrow and focused" rather than "broad and diversified." We will put all our efforts into ~~our core~~ businesses 1) of retail banking for the broad middle market, including consumer and small business deposits and consumer lending; 2) mortgage banking, with a concentration on our ~~retail footprint and the~~ generation of assets for our balance sheet; ~~and~~ 3) the commercial group's growing multifamily, commercial real estate and non-prime mortgage lending lines.

As I mentioned earlier, this does mean that we will be willing to accept some more of the earnings volatility inherent in our mortgage-driven business model than we might experience if we were a more "fully" diversified commercial bank. On the other hand, we will not be exposed to some of the risks taken by diversified companies. One only needs to look at the financial and reputational penalties being paid by money-center banks for some of their diversified activities to see that diversification itself brings risks. Focus also means that our management team and employee base can concentrate on innovative approaches to the businesses they know best and put all their energies into the task that will have the greatest impact of all on our five-year shareholder return and our longer-term financial and competitive success —creating a best-in-class culture of productivity and efficiency.

Enterprise Risk Management

Over the past couple of years, we have greatly improved the overall measurement and management of our enterprise risk management. With the expected implementation of the Basel II requirements, effective measurement and management of enterprise risk become even more important.

For Washington Mutual, we expect our key risks to continue to center on interest rate risk and credit risk. As we balance these risks, we intend to generally take on less interest rate risk (by reducing exposure to the MSR asset) and more credit risk (with more home equity, Alt A and non-prime residential loans) over the next five years. Regarding credit risk, we are targeting a 0.25% average annual charge-off. Based on long-term historical averages and our projected change in asset mix, the worst-case and best-case charge-off ratios we could expect to encounter at any point during the five-year plan should run from a maximum of 0.60% to a minimum of 0.15%. It is noted that charge-offs in the past couple of years have averaged only 0.10% (excluding WM Finance). Our goal over the next five years is **not** to minimize credit risk but to achieve annual credit charges within the targeted range and to average 0.25%. We plan to gradually increase our risk exposure to the targeted levels. This will entail gradual increases in home equity, Alt A, non-prime residential and multi-family lending portfolios.

We will maintain appropriate loan loss reserves relative to the anticipated credit charges. Based on probable loan portfolios, we will likely maintain loan loss reserves of about three to four times expected annual charge-offs.

Regarding interest rate risk management, we will continue to experience margin variations because of the re-pricing lag of our adjustable rate mortgage assets when interest rates change. Our targeted net interest margin over the five-year period is 3%, and we expect the range of the margin to be 2.8% to 3.2% in a normal, upwardly-sloping yield curve. A dramatic flattening of the yield curve would push the margin below 2.8%; however, the cost of reducing interest rate risk beyond this amount is prohibitively expensive and not recommended.

We also encounter significant interest rate risk with the management of MSRs. Because this asset must be continuously marked to market, it can fluctuate in value by over $1 billion in a short period of time. Much of this fluctuation can be hedged, but there is no such thing as a perfect hedge. Accordingly, the best risk mitigation strategy may be to simply limit the size of the asset. We are analyzing what MSR balance will deliver the optimal level of earnings and lower volatility; as a placeholder we believe a target for net MSR to tangible equity of 25% - 35% may be reasonable. In comparison, Wells Fargo's net MSR was equal to 25.1% of tangible equity and Countrywide's was equal to 72.9% at the end of March.

Other keys risks for the organization are reputation and operational risk. We believe the execution of the new five-year plan will reduce both of these risks from what was incurred with the rapid expansion of the past five years. By focusing on our core businesses and operating predominantly in our footprint states, we should be in an improved position to assess and manage these risks.

Technology

We will need to continue to invest heavily in technology. To achieve our desired 5% per year improvement in productivity, we will need continuous improvements in all of our key operating systems. We do not plan to develop any leading-edge technology, but will rely primarily on large, stable platforms. We expect our core banking deposit system to support our growth over the next five years.

We do anticipate making significant investments in front-end and middleware systems that will allow us to better connect all of our legacy systems at point-of-sale and other customer interaction points.

Lessons learned from the past five years are that we will insist on all acquisitions being fully integrated into the complex within a few months or deliberately left to operate separately on a permanent basis; that we will not develop any cutting-edge new technology platforms; that we will improve the documentation and change management processes for all new systems and applications; and that we will closely monitor the total capital expenditures through corporate prioritization processes.

Acquisitions and Divestitures

The financial services industry continues to go through significant consolidation. Most financial services companies have limited opportunities to grow revenues and, thus, are looking for cost savings initiatives to help fuel earnings growth. Acquisitions are an obvious way to achieve cost efficiencies. For Washington Mutual, we believe we can meet our financial targets without making any acquisitions as long as we achieve our annual productivity improvement targets. As such, we will review acquisitions on an opportunistic basis, but do not feel compelled to acquire.

Priorities for acquisitions include branch delivery systems (which would aid in growing our consumer bank), multi-family originators and non-prime origination businesses. At present, our relatively low price/earnings multiple makes stock-based acquisitions very challenging from a financial standpoint and large cash transactions put pressure our capital levels. We do not believe that acquisitions are required to expand our product lines as quality products can often be achieved at very attractive economies of scale through other parties. As such, we do not feel compelled to acquire credit card or insurance companies for access to these products.

Regarding divestitures, businesses which are not viewed as core currently include homebuilder finance, commercial banking and mutual fund management. In assessing these businesses, we will review return on common equity, earnings growth potential, management distraction, new capital requirements, and possible sales prices.

Key Challenges

Following are the key challenges we will face in executing our strategic plan:

Competition will be intense in all business lines. In retail banking, Wells Fargo, Wachovia, and Bank of America are expected to be keen competitors. They are all currently focused on the consumer market, have improved their operating efficiencies, and have greatly improved customer service. We do expect this competition to make it more difficult to achieve the same new customer growth that we experienced during the past five years. However, we continue to believe that our value propositions will result in achieving our growth targets.

In the mortgage banking business, top competitors are Countrywide, Wells Fargo, and, to a lesser degree, Chase, Citigroup, and Bank of America. Countrywide is arguably the strongest competitor at this time because of system stability, strong profitability, excellent risk management and aggressive growth plans. Countrywide has publicly stated its desire to increase national market share from 10% to 30% over the next five years. Rather than competing with them everywhere in the country, we believe we will be best served by focusing on our footprint states and with portfolio products which emphasize our much stronger balance sheet.

In the multi-family lending area, our primary competitors are smaller independent banks around the country. Only Citigroup and ABN AMRO-LaSalle among the larger banks have any significant share. Another potential competitor in this space over the next five years could be Countrywide, which could copy the consumer mortgage-inspired operational and credit model we use. We have a clear head start in achieving excellent efficiency in standardizing the approaches to distributing multi-family loans. We do not see another national competitor at this time impacting our growth.

plans $100 bil to 200 bil
pretax ~~to~~ $2 bil to $6 bil

In the non-prime residential area, key competitors are Ameriquest, Option One, New Century, HSBC/Household, Wells Fargo, and Countrywide. GE Capital recently entered this business through an acquisition and several Wall Street firms are increasing their commitment as well.

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Another challenge concerning us is the rapid escalation in **housing prices**. Fueled by improving employment and very low interest rates, housing prices over the past 12 months have increased at unsustainably high levels. We need to carefully watch all key markets around the country, and while we are not alarmed at this point, the possibility of housing price declines is greater than normal. The most probable scenario is for a flattening in housing prices around most parts of the country, but it is possible that higher priced homes will come under pressure in certain communities.

We believe our franchise is capable of very strong asset generation, but **deposit growth** is less certain because of competitive pressures and cyclical factors causing deposits to grow and then stabilize or contract. Our five-year plan assumes 2.7% average industry deposit growth over the next five years and we intend to grow at a rate close to 10%, and therefore will need to increase our share of deposits in order to reach our plan. Even if we attain our deposit growth goals, we will have significant wholesale borrowings through the FHLB and Wall Street sources. While most of these borrowings are collateralized, it is possible that market disruptions or political pressures could impact access to borrowed funds.

Another important challenge is to maintain a **growth orientation** in a post Sarbanes-Oxley environment. Boards and management have simply become much more risk-averse in this new era. Increasing oversight by boards has led management to spend a larger percentage of their time on risk aversion rather than growth initiatives. In Washington Mutual's case, there has been a significant escalation in the resources devoted to enterprise risk management without a corresponding increase in growth initiatives. We believe it is important for the Board and management to consistently balance appropriate risk management with a focus on growing the business. We believe the pendulum has swung a little too far to the side of risk management over the last couple of years. It is important that we all focus on growth initiatives and risk taking. Above average creation of shareholder value requires significant risk taking.

Community Commitment

We will maintain our commitment to returning 2% of pretax profits back to the communities we serve through grants, sponsorships and various programs designed to support our education and affordable housing initiatives. We expect to meet or exceed the $375 billion ten-year commitment we made to support lending in low-to-moderate income neighborhoods.

Preliminary Plan for 2005

Our 2004 financial plan was built on an assumption of a 4.0%, ten-year Treasury yield. This appeared reasonable and even conservative throughout the first three months of the year when interest rates fell to as low as 3.7%. In the second quarter, ten-year interest rates jumped to 4.85% and this will have a huge impact on our 2004 results if rates remain at these levels over the balance of the year.

Higher interest rates are leading to greatly reduced gain on sales of mortgages and pressures on our margins. These tidal wave impacts are overshadowing our efforts to reduce costs and grow other sources of income. We are also facing increased hedging costs for our MSR asset (due to negative convexity) and unusual volatility in MSR hedge performance. Overall, it is shaping up to be one of the most difficult years in many years. We appear to be on plan in managing the things we can control. But the impact of changing interest rates could reduce 2004 earnings per share significantly below our previous target of $4.40, which assumed a 4.0% ten-year Treasury yield. Our current assessment is that earnings per share may come in closer to $3.55 if the ten-year Treasury yield remains at the 4.75% level.

We expect to enter 2005 with mixed momentum. We would expect 2005 earnings per share to increase to about $4.25 with a 4.75% ten-year Treasury yield. On the plus side, we should have excellent asset growth, low credit costs, good non-mortgage-related fee income growth and declining expenses. On the negative side, gains on mortgage loan sales will continue to be low, loan servicing income will be low (because of increased hedging costs) and the margins will still be pressured by increasing interest rates.

In line with our five-year plan, the following are the assumptions we are using in our planning process for 2005. We believe these assumptions are sound and achievable.

- Open 250 new banking stores in existing markets. No new market entries in 2005.
- Increase net checking accounts by at least 750,000.
- Increase banking fee income by 10%.
- Increase deposits by $13 billion.
- Increase consumer loan balances by $10 billion.
- Increase non-prime residential first mortgage portfolio by $3.5 billion.
- Increase multi family loan balances by $6 billion.
- Increase residential mortgage portfolio (primarily option ARMs) by $25 billion.
- Increase securities licensed bank personnel from about 75 to about 1,000.
- Increase assets under management in the WM Group of Funds from $20 billion to $25 billion.
- Open 30 new home loan centers (15 Johnson Development Centers & 15 regular HLCs) not including potential closures.
- Complete the $1 billion cost save initiative.
- Originate $223 billion of residential mortgages (including Long Beach).
- Increase the loan servicing portfolio to about $740 billion, but reduce the MSR asset by an amount sufficient to bring MSR related volatility down to more acceptable levels. Note that net MSR balances will go up in any event if interest rates rise due to mark-to-market.

By executing these priorities, we should be able to battle the higher interest rates and a lower mortgage market and still achieve EPS growth in 2005. Not only will it likely be a difficult operating environment, but a very challenging year due to modest margin compression, reduced gain-on-mortgage sales and the increased costs to hedge the MSR asset. We will strive to reach EPS targets, which will range from around $3.57 if the ten-year Treasury yield averages 5.25% and the yield curve flattens to around $4.77 if the ten-year Treasury yield averages 4.00%.

While the environment could change dramatically with a change in interest rates, we have assumed the following in our planning:

- The mortgage origination market will contract from about $1.9 trillion in 2004 to $1.7 trillion in 2005.
- The economy will perform well, growing at an approximately 4% annual rate.
- Housing will remain solid but prices will be flat, reflecting higher interest rates and a pause after hyper growth in 2003 and 2004.
- Regulators will remain cautious, but generally supportive. We do not anticipate significant changes other than the implementation of Basel II.
- Somehow, we will get through SOX 4044 certifications.
- Accounting policies will remain relatively constant, after a busy year of adopting FAS 133 and changing the accounting for mortgage gains.
- Competition will remain fierce. Large commercial banks will stay focused on the consumer market and the mortgage industry will go through a price war until excess capacity is reduced.

Overall, 2004 and 2005 will be challenging years for WaMu. Despite our efforts to reduce cyclicality, we are still impacted significantly by interest rates and the mortgage market. We believe we are making excellent progress in improving the core franchise and operating efficiencies. But it will take an improved environment for these efficiencies to be reflected in strong earnings. It is also noted that our earnings performance in 2004 and 2005 will likely under-perform major commercial bank's earnings growth. The likely environment of higher interest rates and a strong economy are generally beneficial to commercial banks but negative to mortgage banks. Because of our above-average exposure to declining mortgage banking and little exposure to improving commercial and industrial lending, we will likely produce growth below that of the banking industry.

Being out of cycle with major commercial banks is nothing new for Washington Mutual. This is an inevitable outcome of our strategy. In prior periods, we added greatly to shareholder value by repurchasing our stock at depressed levels and re-issuing those shares through acquisitions at higher price levels. We intend to opportunistically repurchase our stock if Wall Street presents us an attractive buying opportunity.

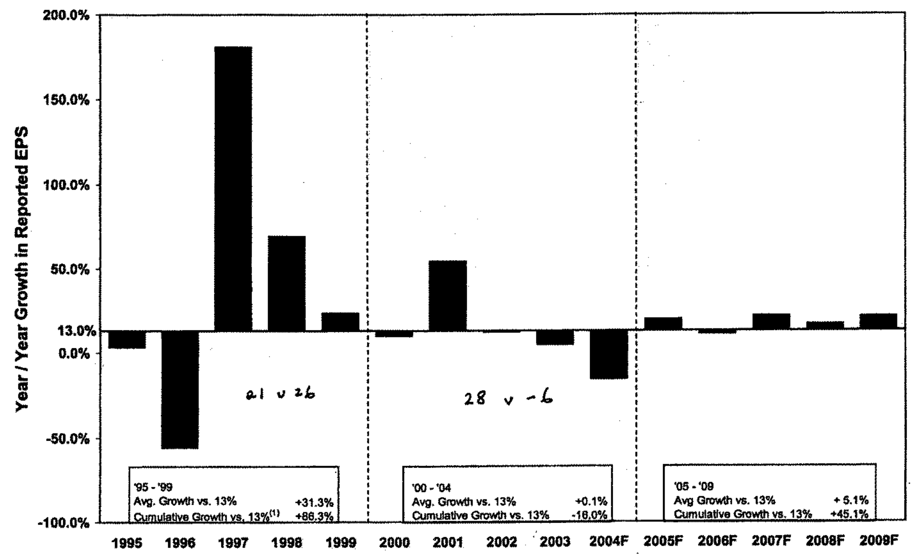
Human Capital

We have the deepest pool of talent in the history of the Company. While there are always opportunities to increase talent, the combination of recruiting in several key executives, plus the maturing of our talent management program, has given us good bench strength in most areas. We do have some near-term concerns with senior management retention. Increasing interest rates reduce expected earnings. Despite terrific efforts to reduce costs and expand revenues, it is possible that our pay programs will produce below-average results. Many of our senior leaders are recognized as top performers in the industry and are being heavily recruited by competitors. We need to maintain competitive pay programs and adjust the plans as appropriate to reflect changing market conditions.

It is also noted that our people have been working extraordinarily hard over a long period of time. Keeping up with rapid growth, the re-fi boom of 2001 and 2002, the 2003 and 2004 cost cutting initiatives and the various compliance requirements have left many people very tired. Add the rumors of a potential sale of the Company with the cost cutting initiatives and the inevitable outcome is more uncertainty and reduced employee morale. We need to come out of the Board strategic planning session with a clear agreement on strategy, a commitment to executing the strategy as an independent company, and a robust communications plan for both internal and external audiences.

Footnote Exhibits - Page 0024

Exhibit A
Reported EPS Growth 1995 - 2009



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(1) Cumulative Growth vs. 13% compounded annual EPS growth
(2) 2004 - 2009 is based on the WaMu Long Range Forecast

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Office of Thrift Supervision
Department of the Treasury — *West Region*

Pacific Plaza, 2001 Junipero Serra Boulevard, Suite 650, Daly City, CA 94014-1976
P.O. Box 7165, San Francisco, CA 94120-7165 • Telephone: (650) 746-7000 • Fax: (650) 746-7001

June 30, 2004

MEMORANDUM FOR: Lawrence Carter, Examiner-in-Charge

FROM: Zalka A. Ancely, Examiner Z

SUBJECT: Washington Mutual Bank, FA (#08551)
Washington Mutual Bank, FSB (#11905)
Examination as of March 15, 2004

During the examination, memorandums were issued to management presenting Criticisms, Recommendations, and Observations. A summary of the asset quality (and related) memorandum's and management responses are as follows:

Joint Memo #1 - Counterparty Risk Management

- *Violation of Regulation F – Interbank Liabilities:* Criticism that a Regulation F - Interbank Liability Policy has not been annually approved by the Board of Directors as required by regulation. Also, there has been no quarterly monitoring of the capital levels of correspondent banks with significant exposures. Management **agrees** with the criticism. By July 31, 2004 a formal policy will be reviewed and approved by the Board and quarterly monitoring of substantive correspondent bank exposures will begin with 2nd quarter 2004 financial data.
- *Global Review of Counterparty Risk:* Recommendation to perform a global review of counterparty risk throughout the organization, including identifying all counterparties, determining the level of risk and the adequacy of monitoring, and determining if the function should be centralized within Counterparty Risk Credit Management. Management only **partially agrees** with the recommendation. Management agrees to centrally monitor and manage counterparty credit risk throughout the organization. A formal review to identify all substantive counterparty risk elements will be started by July 31, 2004 and a comprehensive policy established and implemented by December 31, 2004. The response is acceptable.
- *Counterparty Risk Policy:* Recommendation to amend the Counterparty Risk Policy to include quarterly report of top 25 counterparty exposures, together with a summary of management's analysis of their credit risk, and to report any material violations of approved limits. Management **agrees** with the recommendation and the policy will be updated by December 31, 2004. Appropriate risk-based reporting will be developed including updated Board disclosure by October 31, 2004.
- *Annual Review of Counterparties:* Recommendation to complete and document annual reviews of approved counterparties using a risk-based approach. Management only **partially agrees** with the recommendation in that the finding indicates there is no effective system to track and report exceptions to the annual review requirements. Management indicates that in April 2004, phase-one of the web-based credit platform was released to house all counterparty credit reviews, related entity information, credit lines, exposures, ratings, and financial information. The new platform has the functionality to track and report review exceptions. Nevertheless, the credit review process will be addressed within the full review and implementation of the revised policy by December 31, 2004. The response is acceptable.
- *Unlimited Exception to Policy Authority For the Chief Credit Risk Officer:* Recommendation to amend the policy to require that all policy exceptions above a certain threshold be reported to an appropriate committee in a

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timely manner. Management agrees with the recommendation and exception thresholds and required notification and reporting will be included in the revised policy by December 31, 2004.

- *Excel and Web-Based Credit Exposure Models:* Recommendation to complete the independent validation, parallel testing, and full implementation of these models by December 31, 2004. Management agrees with the recommendation. Validation of the credit exposure models will be done by July 31, 2004 and implementation sometime in July/August 2004.

Joint Memo #2 – Credit Scoring SUCCESS Model for Consumer Loan Product

Repeat finding in that three of the four items noted in the prior examination Joint Memo #6 had not been adequately addressed, but Internal Audit had closed the items. The repeat items pertain to inadequate vintage analysis, dual scorecard validation, and portfolio chronology log. Overall credit quality of the home equity loan products remains good, but inadequate scorecard monitoring and validation may have led to some deterioration in quality for recent volume.

- *Vintage Analysis and Dual Score Validation for the SUCCESS Scorecard:* Recommendation to follow up with additional analysis of the deterioration in the ability of the custom score to rank-order risk. Analysis should be followed up to ensure that no changes to score cuts or pricing are necessary. Management only **partially agrees** with the recommendation in that the model is in process of being redeveloped and through-the-door and approved FICO scores and CLTVs have continued to improve and portfolio performance has not shown deterioration. Management will implement an automated centralized credit scoring and portfolio-monitoring package in the Enterprise Modeling and Decision Systems organization under Corporate Credit Risk Management and enhance its vintage MIS reporting during the 2nd quarter of 2004. At the same time, management is moving aggressively forward with the redevelopment of the SUCCESS model with completion scheduled for August 2004. However, the overall targeted completion date is December 31, 2004. The response is acceptable.
- *Portfolio Chronology Log:* Recommendation to enhance the portfolio chronology log. Management **agrees** with the recommendation and set a targeted completion date of July 31, 2004.

Joint Memo #3 – Residential Real Estate Appraisal Operations

- *One-to-Four Residential Appraisal Compliance Review:* Recommendation that USPAP compliance at WAMU is an ongoing issue that needs improvement. Management **agrees** with the recommendation and provided July and August target dates for specific actions, however overall target date is April 1, 2005 (next exam timeline).
- *Standard 3 Technical Review (Report):* Recommendation to update the report used for reviewing residential appraisals to address the current sales history reporting requirements of USPAP and overall appraisal compliance with USPAP. Management only **partially agrees** with the recommendation in that an Appraisal Procedures Bulletin was communicated and distributed to all reviewers to include a three year sales history. While not currently updated, the form will be updated by July 15, 2004. The response is acceptable.
- *Appraisal Assignment/Engagement Request Form:* Recommendation that the owner's estimate of market value should be eliminated from the request form in order to prevent appraiser independence from being compromised. Management only **partially agrees** with the recommendation since it has historically had little significance for appraisers and there is seldom market foundation for the estimate. Nevertheless, target date of August 15, 2004 provided by management to make system enhancement to eliminate the estimate of value from the engagement letter. The response is acceptable.
- *Automated Valuation Model (AVM) and Taxed Assessed Value (TAV):* Observation that AVM and TAV documentation in loan files is minimal, but the information is electronically stored on the OptisValue system. Interagency working group concluded an institution must have a process to validate and test each type of AVM used and its credibility; and, validate and test the TAV process for the validity and accuracy of the results in each county in which it is used. Based on the review at this examination, what WAMU is doing is adequate, but management must continue to validate the AVM/TAV process on a regular basis to ensure the results of the

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process are credible. Management agrees with the observation. Plans are to increase AVM audits to quarterly, AVM testing will still be yearly, and TAV audits will occur twice during 2004.

Joint Memo #4 - Commercial Real Estate Appraisal Operations

- *Quality Assurance Report:* Recommendation to ensure that quality assurance reports comply with policy review criteria and review ratings reported for appraisers and reviewers in all production offices, since not all appraisers and production offices were reviewed in the 4th quarter 2003. Management only **partially agrees** with the recommendation in that the current guidelines were not finalized until January 2004 and the Commercial Appraisal Department quality assurance group was not fully staffed in the 4th quarter of 2003. Management established a target date of September 30, 2004 to achieve the required level of reviews. The response is acceptable.
- *Appraisal Engagement Contract (Letter of Engagement):* Recommendation to revise the Appraisal Engagement Contract to include both the intended use of the appraisal and the intended users of the appraisal report. Management **agrees** with the recommendation and set a target date of June 30, 2004.
- *Complete Summary Report (CSR):* Recommendation to revise this report form to include the definition of market value, a more comprehensive scope of work section, and the certification page must include the appraiser's license number, State, and expiration date. Management **agrees** with the recommendation and set a target date of June 30, 2004.
- *Use of an Obsolete Internal Evaluation Form:* Recommendation to ensure the evaluation forms used to estimate market value for SFR interim construction loans comply with TB 55a requirements. Examiners noted isolated use of obsolete form by a single individual at NOC in Dallas. Management **agrees** with the recommendation and a corrective procedures memo was distributed during the exam with no further actions required.
- *Discounted Appraisals and the Calculation of Supervisory LTV Ratios:* Observation that there is an outstanding issue from prior examination concerning requirement to use discounted appraisals for projects involving five or more units for tracking supervisory LTV exceptions. On May 14, 2003, management had formally requested the OTS to adopt guidance to clarify the issue in connection with revolving lines of credit secured by subdivisions with five or more unsold units. Interagency appraisal working group has not provided a response and has extended the estimated completion date to September 30, 2004. **No management response was required.**
- *Multi-family Appraisal – Automating Appraisal Project:* Observation that WAMU has initiated a project to automate part of the multi-family appraisal process. Management must ensure that for federally related transactions, all appraisals shall, at a minimum, conform to USPAP requirements. Management indicated that the project is specifically designed to meet all requirements of USPAP and FIRREA. **No management response was required.**
- *Multi-family Review Sampling Proposal:* Observation that the Commercial Appraisal Department proposes to reduce the level of multi-family appraisal reviews from 100 percent to 25 percent for those prepared by internal staff appraisers in established markets with loan requests of $3 million or less and LTV's of 60 percent or less. Management requested OTS to review and comment on the proposal. OTS voiced no regulatory concern with the proposal as presented. **No management response was required.**
- *Draft – Appraisal Review Guidelines for Commercial Mortgaged-Backed Securities (CMBS) Loans:* Observation that the Commercial Appraisal Department has developed a proposed matrix for administrative, technical, field, and post closing review of appraisals for CMBS loans. Management requested OTS to review and comment on the proposal. OTS voiced no material concerns or objections to the proposed matrix. **No management response was required.**

Joint Memo #5 - Long Beach Mortgage Company Intercompany Line of Credit

- *Overline Documentation:* Recommendation that all out-of-formula situations be documented, documentation should clearly stipulate the reason for noncompliance, how/when cured, and be reported to the CPC. Management only **partially agrees** with the recommendation since overline and out-of-formula are not the same and the loan was never "overline", meaning in excess of committed line of credit. However, management does acknowledge that the loan was out-of-formula four times since the prior examination, but was cured within the

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allowed one-day cure period; therefore, additional reporting and documentation was not deemed necessary. Management agreed to document all out-of-formula situations on the borrowing base certificates and to report these to the CPC if they exceed the allowed one-day cure period. A summary of out-of-formula situations will also be included on the credit requests and annually reported to the CPC. The target date for completion is May 31, 2004. The response is acceptable.

- *Borrowing Base Certificates – Ensuring Data Accuracy:* Recommendation to implement a procedure to review collateral information provided by the Custodian to ensure the information is accurately reflected on the borrowing base certificates. On February 11, 2004 the Custodian had incorrectly included ineligible mortgages in the borrowing base and an out-of-formula situation occurred without management's knowledge. Management agrees with the recommendation with a targeted completion date of May 31, 2004.
- *Annual Due Diligence Review:* Recommendation to obtain and review LBMC's policies and procedures on an annual basis to augment the arms-length nature of the affiliated relationship. Management agrees with the recommendation and will include the most recent lending and investment policies in the underwriting files by June 30, 2004.
- *Certification of Borrowing Base Certificates:* Recommendation to ensure that all proper signatures are obtained on required documentation. The review found that required individuals do not consistently sign the borrowing base certificates. Management agrees with the recommendation and hard signatures by facsimile or courier will be obtained by May 17, 2004. Management will also work with the legal department to establish procedures to allow for electronic submission of borrowing base certificates.

Joint Memo #6 - Middle Market Business Lending Portfolio

- *Monitoring Lending Policy Exceptions:* Criticism that numerous credits were extended with exceptions to underwriting standards and there is no method to monitor the exceptions. Management agrees with the criticism. New Credit Standards are being developed and a Credit policy and Credit Standards Exception Report will be developed to track, trend, and report true exceptions. Target date is December 31, 2004.
- *Formal Goals and Objectives:* **Repeat** Recommendation to develop formal written Front-End Guidance for the middle market business lending segment of the bank. Management agrees with the recommendation and the targeted date for completion is September 30, 2004.
- *Loan Covenant Compliance Monitoring:* Recommendation to develop a system-wide automated system for monitoring loan covenant compliance to be used by all Commercial Banking Centers (CBCs). Management agrees with the recommendation with a targeted date of September 30, 2004 to determine what process or system to be utilized, and March 31, 2005 as a targeted implementation date.
- *Collateral Examination Process:* Recommendation to develop procedures for responding to collateral examination findings and how to resolve any differences should they occur. Management agrees with the recommendation and an e-mail will be distributed by June 30, 2004 to reiterate the process and need to follow up by the Regional Manager and Credit Administration to resolve issues.
- *Tracking Reports For Trailing Documents:* Recommendation to develop procedures to ensure all CBC's adhere to internal guidelines established for addressing and clearing exception items that remain outstanding. Management agrees with the recommendation and revised procedures are targeted for September 30, 2004 addressing post closing exception items to strengthen management review and ensure resolution.

Joint Memo #7 - Small Business Lending Review

Repeat finding in that management has yet to develop sound credit administration policies for this small business lending segment. Although the consolidated portfolio is quite small at $217 million outstanding and another $221 million committed but unfunded, management is projecting a six-fold increase in lending volume to $360 million in 2004.

- *SBL Lending and Credit Administration Policies and Procedures*: **Repeat** finding that is elevated to a Criticism that management has yet to develop sound credit administration procedures and underwriting policies for SBL.

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SBL policies have been in flux for the last two examinations. Management agrees with the criticism and the targeted completion date for revised credit standards is August 31, 2004.

- *Internal Loan Grades and Corporate Credit Review:* Criticism that assigned loan grades do not accurately reflect the risk evident in the portfolio and there is a need to complete a corporate credit review for this area. Management agrees with the criticism and the Small Business Credit team will work with Corporate Credit to establish a methodology for assigning risk grades at origination and several outside vendors are being reviewed regarding portfolio management products to score the portfolio on a quarterly basis. A corporate credit review of the portfolio is scheduled for September 2004. Targeted completion date is December 31, 2004.
- *Management Information Systems:* Recommendation to develop reports that will fully compare the quality of newly originated loans with those originated in prior periods. Management agrees with the recommendation and is working to refine the existing production reports and portfolio MIS to ensure use of vintage analysis and detail of credit characteristics. Targeted completion date is September 30, 2004.
- *2004 Front End Guidance:* Recommendation to expand the front-end guidance for SBL to include how a six-fold increase in lending will be generated, business channels to be used, types of loans, staffing requirements, credit administration procedures, and monitoring tools. Management agrees with the recommendation and the 2005 front-end guidance will include more detail guidance regarding small business segment. Targeted completion date is March 31, 2005.
- *FDIC/DFI Loan Sample Review For Acquired SBL Portfolio:* Observation that 13 of the 15 loan files requested for review were not provided during the loan review time frame. Although a written response was not required, management responded they would enhance the communication and coordination for sending and receiving loan files. **No management response was required.**

Joint Memo #8 – Loans to "Higher-Risk Borrowers"

The current level of subprime/"higher-risk" assets approaches 200 percent of WMI's Tier 1 capital, and, except for the $20 billion limit established for Specialty Mortgage Finance, the Board of Directors have not formally approved any limits for this credit concentration. There is no comprehensive, enterprise-wide monitoring, measuring, or reporting on the level of "higher-risk" assets, nor has management adopted a definition of the characteristics of a "higher-risk borrower".

- *Definition of "higher risk":* Recommendation to specifically define "higher risk" residential and consumer borrowers for all single-family residential and consumer product types and origination sources. Management agrees with the recommendation and set a target date of June 30, 2004.
- *Monitoring, Measuring, and Reporting the Level of "Higher-Risk" Assets:* Recommendation to measure, monitor, and report the level of loans to "higher-risk borrowers" by business line and legal entity and to aggregate the data. Management agrees with the recommendation and set a target date of September 30, 2004.
- *Concentration of Credit:* Recommendation to establish limits governing exposure to "higher-risk borrowers" by product type and expressed as a percentage of capital by legal entity. Management agrees with the recommendation and set a target date of September 30, 2004.

Joint Memo #9 - Subprime Lending Strategy

WMI continues to increase its exposure to subprime borrowers without an enterprise-wide, clearly articulated subprime lending strategy. There is a need to develop a clear strategy document to lay the foundation for agreement on WMI's role and positioning in the marketplace as a subprime lender.

- *Subprime Lending Strategy:* Recommendation to develop a subprime lending strategy document or policy, which includes appropriate segregation for FDIC- and OTS-regulated subsidiaries. Policies, procedures and standards should be updated to reflect the subprime lending strategy. Management agrees with the recommendation and the strategy will be created as a recommendation to the Board of Directors with a target date of October 31, 2004.

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Joint Memo #10 - Specialty Mortgage Finance

Significant growth in the SMF purchased subprime portfolio to $15.6 billion as of February 29, 2004. Also, the concentration limit was increased from $14 billion to $20 billion during review period.

- *Reliance On Ameriquest For Loan Purchases and Loan Servicing:* Recommendation to develop and implement a policy that identifies concentration limits and expands the analysis for SMF's counterparty relationships, especially with Ameriquest. Management agrees the SMF business is concentrated with Ameriquest. The Counterparty Credit team will undertake a full and complete review of this relationship. This independent credit analysis will be completed by July 31, 2004. Counterparty Cried twill also work closely with SMF management to review the entire business conducted with Ameriquest. A framework will be developed to manage this concentrated relationship will be completed by September 30, 2004.
- *Management Information Reports for SMF Activities:* Observation that reports could be enhanced to ensure that strong early warning monitoring capabilities are in place to support the management and growth of the SMF portfolio, including expanded use of industry comparisons and performance metrics. Management agrees with the observation and an ongoing review of pool data will be implemented by June 30, 2004.

Joint Memo #11 – Long Beach Mortgage Company Management Reporting

LBMC's reporting to WMI senior management needs improvement. Numerous errors in the internal LBMC reports were disclosed by our review this examination remains problematic.

- *LBMC Report Errors:* Recommendation to implement new oversight and review procedures to ensure the accuracy of future management reports, and to resolve discrepancy in delinquency numbers noted by the examiners. Management agrees with the recommendation. Controls over financial and management reporting to be established and differences resolved by August 30, 2004, including resolving discrepancy in delinquent numbers noted by the examiners. Comprehensive publication of reports by September 30, 2004.

Joint Memo #12 - Home Builder Finance

As of the date of this memorandum, management had not responded to the Findings Memo.

- *HBF Inventory and Renewal Monitoring:* Recommendation to establish a timeline for completion of inventory monitoring initiative and to track project or unit renewals required beyond initial maturities. Management ......
- *Eligibility and Portfolio Diversification Standards For Borrowing Base and Unsecured Facilities:* Recommendation to establish specific borrower eligibility criteria and concentration/diversification standards for unsecured and borrowing base facilities. Management ....
- *Credit Standards/Procedures For Borrowing Base and Unsecured Facilities:* Recommendation to expand credit policies and procedures to reflect actual lending practices and identify risk tolerances. Credit policies should also include minimum acceptable underwriting standards, terms, and conditions with clear and measurable credit criteria as advocated by the Interagency Real Estate lending Guidelines. Management ....
- *WL Homes, LLC Borrowing Base Line:* Recommendation to improve underwriting and handling practices for WL Homes, LLC. Management ....

Joint Memo #15 - Credit Scoring - SUCCESS and Transitional Proprietary Models

Management has elected to develop the bank's own scoring models for residential lending in addition to the SUCCESS scorecard used in consumer lending. With the assistance of the Portfolio Defense Group, the Proprietary Model (PM), and subsequently the Transitional Proprietary Model (TPM),

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was developed. Management is currently developing PM.2, which will eventually replace TPM. This finding provides additional comments to those offered in Joint Memo #2 – Credit Scoring SUCCESS model.

- *Policy Guidelines:* Recommendation to enhance and consolidate policy guidelines into a single policy governing the credit scoring function. Specific items were recommended for the consolidated policy, including the responsibility of the Board of Directors and senior management. Management only **partially agrees** with the recommendation in that they do not believe that specific approval authority for individual credit scoring models need to be approved by the Board of Directors. Nevertheless, management agrees that a single revised policy is appropriate and set a target date of September 30, 2004. The response is acceptable.
- *SUCCESS Model Definition of a "Bad" Account:* Recommendation to use a "two-track" approach to the "bad" account definition to differentiate the use for credit scoring models (60 days) versus Basel II purposes (90 days). Management already established a "two-track" approach for time horizon; credit scoring models (24 months) versus Basel II (12 months). Management **agrees** with the recommendation and will maintain a degree of independence for performance definitions and outcome periods between credit scoring models and Basel II implementation. Target date is September 30, 2004.
- *SUCCESS Dual Score Approval Matrices:* Recommendation to revise procedures for use of dual matrix scoring systems to require documentation of how matrix grades and score cuts are determined. Management **agrees** with the recommendation and will document the process in its policy by October 30, 2004.
- *TPM Definition of a "Bad" Account:* Recommendation to use a "bad" definition of 90 days or more past due for the TPM model, rather than the current definition of "an account which becomes REO", which is extremely restrictive and impacted by the bank's practice of selling loans before they migrate to REO. Management **agrees** with the recommendation with a targeted date of June 30, 2004.
- *TPM and Loan Purpose:* Recommendation to analyze and compare the performance of the two approaches being considered (separate models or separate approval grids) for different loan purposes (refinance, cash-out refinance, and purchases) that have different risk profiles and must be treated differently. Management **agrees** with the recommendation with a target date of September 30, 2004.
- *Model Development Timetable:* Observation that implementation and development timetables appear aggressive given the redevelopment of SUCCESS, development of PM.2, and new models planned for Small Business, Multi-Family, and Credit Cards all by the 2nd quarter of 2005. Management **agrees** with the observation and will create an overall project plan by August 31, 2004.

Joint Memo #19 - Corporate Risk Oversight

Since the initiatives for the Corporate Risk Oversight areas for both the Consumer and Commercial Group have not yet been implemented, our review of the effectiveness of the proposal was limited. Our review focused on those proposals that were initiated previously for the credit review function. Copy of this memo also goes to the Finance Committee.

- *Management Response to Corporate Risk Oversight Reports:* Criticism concerning pattern of untimely management responses to corporate credit reports. Requirement that a monitoring mechanism be implemented to enable the Finance Committee to track compliance with planned reviews, management responses, and corrective actions. Management **agrees** with the criticism and immediate action included several changes to assist the business units in providing timely responses. Changes include both a short-term action plan and long-term Global issues tracking mechanism under development in the Enterprise Risk Management Group. Targeted completion date is August 30, 2004.
- *2003/2004 Review Plan Objectives:* Recommendation for the Finance Committee to approve changes to plan objectives and scope of reviews. The department did not meet the initial Review Plan objectives for 2003 and many reviews were changed from a full Comprehensive Review to a Target Review with no rating assigned despite significant issues being disclosed. Management only **partially agrees** in that quarterly changes in risk profile and the Review Plan are communicated to the Finance Committee. Nevertheless, management agrees to

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enhance reporting structure to the Finance Committee and implement a process to elevate significant issues disclosed in target reviews and provide risk based rating for these issues. Targeted completion date is September 30, 2004. Response is acceptable.

- *Consumer Risk Oversight Proposal:* Recommendation to establish calendar dates when credit reviews are to be performed by the Consumer Risk Oversight group and incorporate these dates into the Review Plan for Finance Committee approval. Additionally, OTS commented that the goals and objectives for the consolidation of all QA functions and compliance testing is a significant undertaking. The transition plan and dates established for the realignment of the Consumer Risk Oversight area appear optimistic. Management **agrees** with the recommendation with a targeted implementation date of July 31, 2004. Monthly updated will be provided to the Finance Committee regarding progress with the transition plan.
- *Counterparty Risk Review:* Recommendation that a review of the counterparty risk area be conducted in 2004. Management **agrees** to conduct a review of counterparty risk with a targeted completion date of September 30, 2004.
- *Credit Review Function:* Observation that the credit review function has evolved with the formation of the Corporate Risk Oversight group and Problem Loan Review to supplement those reviews conducted at the NOC. With the corporate restructuring, corporate-wide Policy and Credit Standards should reflect the types of reviews being conducted and responsible party conducting these reviews for the corporation. **No management response was required.**

Joint Memo #20 – Third Party Originators (TPO) Performance Review Committee

WAMU acquires the majority of its home loans through mortgage brokers and correspondent lenders (Third Party Originator or TPOs). There are approximately 20,000 such TPOs and oversight of their performance is complex.

- *Scope of TPO Committee:* Recommendation to extend the scope of the TPO committee to include the Mortgage Banking Finance (MBF) lending program and incorporate information about brokers receiving credit from MBF into the Seller Tracking and Risk System (STARS). Management **agrees** with the recommendation and will evaluate the most effective approach for inclusion of this information. Targeted development date is November 30, 2004.
- *STARS - Correspondent Application Enhancement and Documentation:* Recommendation to enhance STARS-Correspondent to incorporate the reports required to support the TPO committee and to review documentation to ensure that a different person can perform the current inquiry function if necessary. Management only **partially agrees** with the recommendation due to the costs and likelihood of definitional and formatting changes in reports to support the TPO committee and determination it is more effective to generate the reports in a non-production analytics environment rather than hard coded into the application. Management agrees to sufficiently document the current inquiry process and the underlying data in STARS-Correspondent will be migrated to a non-production analytics environment by September 30, 2004. The response is acceptable.
- *STARS Post Implementation Review:* Recommendation to complete a post implementation review of STARS. Management **agrees** with the recommendation with a targeted completion date of December 31, 2004.

Joint Memo #22 - National Operations Center Recordkeeping

Transition of commercial real estate, multi-family, and commercial real estate construction servicing at the NOC is relatively complete, but considerable work still needs to be done on file documentation and inputting information in systems.

- *File Organization and Documentation:* Recommendation to organize files in a standardized fashion at the NOC and to inventory files to ensure critical credit information is contained therein. CRE, commercial construction, and HBF loan files were disorganized and lacked important credit information. Management only **partially agrees** with the finding in that they feel that the sampling of commercial construction files (three) did not

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adequately reflect the status of files. Management responded that the other files will be restacked by July 31, 2004 and a document level tracking system is planned for implementation by the 1st quarter of 2005. The response is acceptable.

- *CREAM and Filenet Loan Monitoring and Servicing Systems:* Recommendation to inventory the information contained within these systems, determine what information is needed for individual borrowers, and ensure the data is available. Information used to track and monitor borrowers on these systems is often incomplete. Management agrees with the recommendation with a targeted date of January 15, 2005.

Joint Memo #23 - Loan Pricing

- *Pricing of Saleable Fixed-Rate Loans:* Recommendation to reassess the loan pricing for loans originated through the correspondent and wholesale channels along with the profitability goals of these channels. Recent reports indicate that certain types of loans produced though the correspondent channel have been priced at a loss or unacceptably low profitability. Management only **partially agrees** with the recommendation in that these channels add value that is not captured in the gain on sale, such as captive reinsurance, servicing efficiencies, and reduced guarantee fees due to volumes delivered to GSEs. Management will continue to review both gain on sale and overall strategic value of these channels, and develop products that will enhance the profitability of these channels for saleable loans, such as new production compensation plan, ALT-A product, and AUS for Option ARMs, with a target date of December 30, 2004. The response is acceptable.
- *Product Lines:* Recommendation to simplify product lines and to automate much of the pricing rules now incorporated in the pricing manual. Currently the number of products approximates 190 and the pricing manual used to administer pricing for these products approximates 300 pages. Management **agrees** with the recommendation with a target date of December 31, 2004.

Joint Memo #24 - Mortgage Service Delivery

- *Customer Complaints:* Recommendation to develop a comprehensive report for customer complaints that is in one place. Management **agrees** with the recommendation and will look at technology, metrics, and the ownership of the function to continue to evolve this activity. Various interim target dates are established starting with working groups to evaluate current systems by 3rd quarter of 2004 and to begin implementation of refined process and reporting by 2nd quarter of 2005. (The response is also provided in Compliance Joint Memo #8 – Fair Lending Review).
- *Vendor Management:* Recommendation to enhance practices and processes for monitoring and assessing vendor performance, including "best practices". Management **agrees** with the recommendation and will establish a vendor management program for all of Service Delivery. Targeted completion date is December 31, 2004.
- *Default Management:* Recommendation to designate a regulatory compliance liaison for Default Management and to ensure that material strategies within Default Management are reviewed by the Regulatory Compliance Department. Management only **partially agrees** in that they feel that most of the items mentioned are already in place. Nevertheless, plans are to hire a Business Unit Compliance Officer responsible for monitoring and supporting all Service Delivery compliance operations, including Default Management. Target date to hire loan servicing Business Unit Compliance Officer is July 31, 2004. The response is acceptable.
- *MSD Regulatory Relations Department:* Recommendation to maintain a central repository of all documents pertaining to MSD and develop a comprehensive report that captures relevant internal and external audit review findings pertaining to MSD. Management **agrees** with the recommendation and will establish a central repository by July 31, 2004 and develop and implement a tracking tool by September 30, 2004. However, a corporate-wide, web-based issue control tool known as the Enterprise Risk Issue Control System (ERICS) is being developed with a target date of March 31, 2005.

Joint Memo #25 - Data Quality Initiative

- *Data Quality Pertaining to Mortgage Loans:* Recommendation to evaluate critical data information to ensure data integrity, including expanding the process to obtain current credit scores to include LSBO. Data in loan

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systems and databases appear to contain many errors and omissions; especially credit scores. Management only **partially agrees** in that there are some circumstances where the lack of credit scores is legitimate (foreign nationals, etc.), and that the process for capturing credit scores for LSBO loans has been in production for several years; therefore, expanding the credit score "refresh" is not required. However, management responded that a critical data element project for Consumer Group Lending is being re-initiated with interim step target dates of December 31, 2004 and overall completion date of October 31, 2005. The response is adequate.

OTS Memo #1 - Mortgage Banker Finance

- *Monitoring Reports on Subprime Credit Exposure:* Criticism that the ProMerit system needs to be enhanced to improve management reports related to the monitoring of subprime credit exposure. Management **agrees** with the criticism and the ProMerit system is to be upgraded by September 30, 2004.
- *MBF Policies and Procedures:* Recommendation that policies and procedures need to be enhanced concerning discussion of Early Purchase Facilities (EPF) and Flex-EPF programs and that management needs to be more proactive to ensure policies, procedures, and standards are current and reflect actual practices. Management only **partially agrees** with the recommendation because credit procedures for these programs were approved through a documented internal approval process. However, management states that the credit approval process took longer than optimally it should have; therefore, the approval process will be streamlined and staff added to the credit procedures team by June 30, 2004. Also, management states that credit procedures and portfolio management will be revised and enhanced by July 31, 2004. The response is acceptable.

OTS Memo #2 - Residential Quality Assurance

RQA reviews of newly originated loans indicated a high level of unacceptable credit quality ratings related to the number of critical errors found. Realignment of quality assurance functions that will be centralized into one group, Consumer Risk Oversight, is currently in process.

- *Update of Matrices Used by RQA and CRO to Track Findings and Corrective Actions:* Recommendation that Consumer Risk Oversight group or a third party should update matrices used to track findings and corrective actions rather than the respective channel management. Management **agrees** with the recommendation and a revised process is to be developed by June 30, 2004.
- *Outdated RQA Policies and Procedures Posted on the Intra-net:* Recommendation to update the RQA policies and procedures posted on the intra-net. Management **agrees** with the recommendation and new policies and procedures will be completed by September 30, 2004 as part of the consolidation of quality assurance functions into the Consumer Risk Oversight group.
- *Communication of Examination Findings:* Recommendation that all reports issued by the Consumer Risk Oversight group should be distributed to senior management and the Finance Committee and that the reports should be reviewed for accuracy and reflect any changes that may have been made to these reports. Management **agrees** with the recommendation and a schedule of reports with distribution lists will be developed by July 31, 2004.

OTS Memo #3 - Servicing Quality Assurance

SQA is now part of the Consumer Risk Oversight group. SQA performs monthly and quarterly reviews of compliance with investor servicing requirements for FHA and VA loans, loans serviced for government sponsored enterprises, private investors, and the owned portfolio.

- *Scope of SQA Reviews:* Recommendation that the scope of SQA reviews should be expanded to include key servicing functions not currently reviewed by SQA. Management only **partially agrees** with the recommendation in that loans serviced for GNMA are addressed in a government insured testing program.

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Nevertheless, management stated that the scope and testing programs for SQA reviews will be expanded and an early warning indicator system will be developed by March 31, 2005. The response is acceptable.

- *Washington Mutual Mortgage Securities Corporation (WMMSC):* Recommendation that the scope of SQA should be expanded to include a review of WMMSC's policies, procedures, and practices related to its responsibility for oversight and monitoring of third party servicers. Management agrees with the recommendation with a target date of December 31, 2004 for development and implementation of comprehensive testing programs for WMMSC, FHLB, and loans serviced by others. Additional staff is also being recruited.
- *Reporting of SQA Findings to Senior Management:* Recommendation that the timeliness of SQA reports needs improvement. Senior management executive summary reports and tracking reports issued by SQA have not been timely and have not been issued since November 2003. Management agrees with the recommendation and all outstanding reports and testing completed in June are to be published by July 15, 2004 and all future reports within 15 business days of completion of field testing.
- *Distribution Lists of Pertinent Reports:* Recommendation that SQA be on the distribution list for various reports that document concerns in the servicing area. Management agrees with the recommendation with a target date of July 31, 2004.

OTS Memo #4 – Washington Mutual Mortgage Securities Corporation (WMMSC)

WMMSC master servicing portfolio approximates $103 billion as of March 31, 2004. WMMSC performs master servicing functions for this portfolio, including overseeing and monitoring third party servicers. Internal audits disclosed continuing control deficiencies pertaining to Sporty, a network file server, that provides the operating platform for several separate applications/data bases. A Sporty second generation upgrade has been placed on hold, but a Sporty 1 G Remediation Project is currently being developed to address the internal audit issues.

- *WMMSC Policies, Procedures, and Practices:* Recommendation to amend policies to include verification of D&O liability insurance in on-site reviews of third party servicers and that blank fields on the Servicing Process Review forms should be completed. Also desk audits of third party servicers did not indicate that a depository rating/score was obtained as required by policy. Management only partially agrees with the recommendations with exception to a statement that "... the relevant data was obtained and reviewed, and that the data sources had simply been omitted." Instead, management indicated the statement should have correctly stated that "... the data was obtained, reviewed and is retained in the applicable files currently, however, the data sources were not listed on the review form." Nevertheless, management agreed to update the applicable policies and procedures, and the IDC rating will be verified for all new and already completed desk audits in 2004. Target completion date is August 31, 2004. The response is acceptable.
- *WMMSC Internal Controls:* Recommendation that management should continue to monitor the status, timeliness, and efficacy of corrective actions concerning internal control weaknesses still outstanding and the completion of the Sporty 1 G Remediation project. Management agrees with the recommendation and will continue to monitor the status, timeliness, and effectiveness of such actions with a targeted completion date of October 31, 2004.

OTS Memo #5 - SFR Loan Origination Quality

Past examinations concentrated on assessing underwriting analysis documented in loan files. Since prior examinations and internal reports have already established that underwriting concerns exist, file review was not conducted during the 2004 examination. For this examination, OTS concentrated on reviewing and assessing internal processes that may contribute to underwriting concerns.

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- *Consumer Group Goals:* Recommendation that the Consumer Group should establish and quantify goals with respect to desired asset quality and communicate the expectation to those involved in the production process. Management only **partially agrees** with the recommendation in that a target ratio of non-performing loans/total loans of less than 1 percent has already been established by Consumer Group Credit Risk Management. Nevertheless, by September 30, 2004 management will establish, quantify, and communicate a Consumer Group goal with respect to asset quality as part of the overall strategic objectives/goals. The response is acceptable.
- *Metrics Used to Monitor Performance in the Loan Fulfillment Centers:* Recommendation to track performance with sufficient detail and frequency to trace problems to specific channel and LFC and to effect the desired change in underwriting. Management **agrees** with the recommendation. Targeted completion date of July 30, 2004 for the identification of risk metrics and the establishment of risk tolerance and performance standards. Targeted completion date of September 30, 2004 for implementation of the revised performance measurement standards.
- *Incentive Compensation For Loan Fulfillment Centers:* Recommendation to enhance the incentive compensation plan for the LFCs manager position to more heavily emphasize credit quality concerns. Management **agrees** with the recommendation with various individual target dates from July 1, 2004 to January 1, 2005 pertaining to enhancing the incentive compensation plan.
- *Management Support For Loan Fulfillment Centers:* Recommendation that management should provide additional support to the LFCs to help implement policy and procedure changes, including the writing of desk procedures for each position in the LFCs and revise these desk procedures concurrently with each notice of a policy or procedural change. The timeliness and adequacy of training should also be reviewed. Management only **partially agrees** with the recommendation in that there are several techniques in place to lessen the impact of changes to both LFC management and staff, including following up large impact changes with meetings and training to ensure the changes are communicated to all applicable levels. Nevertheless, management provided a July 31, 2004 target date to, 1) continue to ensure all policies are rolled out with as much notice as possible, 2) utilize LFC team meetings to review and train on new policies and procedures, 3) continue to issue HLPAs weekly with a two week implementation window prior to effective date of changes, and 4) utilize channel management communication avenues to refresh and re-enforce communications on a monthly basis. The response is acceptable.

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Footnote Exhibits - Page 0037

	No	Topic	Issued To	Issued From	Status	Level of Concern	Response Requested	Response Received	Response Accepted
		2004 Findings Memos							
		Safety and Soundness							
WMB	1	Call Report	Jay Ledwon	Stewart/Mann	Issued 5/21	R	N	NA	NA
	2	IRR-Contravention	Lobo/Mcarthy	Rook	Issued 5/20	C	Y		
	3	Single Family	Mark Hillis	Dong	Issued 5/20	R/R/O	Y	6/4: A/A/A	6/7
Joint	1	Counter-party Risk Management	Vanasek/Boyle	LeCong/Naylor	Issued 5/13	R/C/R/R/R/R	Y	6/2: PA/A/A/PA/A/A	6/8
	2	Credit Scoring SUCCESS Model	Tim Bates	Vance/Rokich/Nuxoll	Issued 5/10	R/R	Y	5/19:PA/A	6/8
	3	Residential Appraisals	Francois Madath	Thorvig/Bernd/Burr	Issued 5/14	R/R/R/O	Y	5/25:A/PA/PA/A	6/8
	4	Commercial RE Appraisal Ops	James Calderon	Thorvig/Bernd/Burr	Issued 5/13	R/R/R/R/O/O/O/O	Y	6/3: PA/A/A/nbc	6/8
	5	LBMC LOC	David Purcell	Ancely/Brady/Burr	Issued 5/13	R/R/R/R	Y	6/10: PA/A/A/A	6/21
	6	Middle Market Portfolio	Dan Gilbert	Hoskovec/Smieszek/Burr	Issued 5/20	C/R/R/R/R	Y	6/14: A/A/A/A/A	6/15
	7	Small Business Lending	Michele Kennedy	Hoskovec/Hickok/Burr	Issued 5/14	C/C/R/R/O	Y	6/2:A/A/A/A/A	6/8
	8	"High Risk Borrowers"	James Vanasek	Brady/Ancley/Burr	Issued 5/14	R/R/R	Y	5/25: A/A/A	6/4
	9	Subprime Strategy	James Vanasek	Carter/Kroemer/Ransom	Issued 5/14	R	Y	5/25: A	6/4
	10	Specialty Mortgage Finance	Chapman/K. Johnson	Henry/Brady	Issued 5/13	O/R	Y	6/18: A/A	6/22
	11	Longbeach Mortgage B&R	Gotshcall/K. Johnson	Bisset/Brady/Burr	Issued 5/14	R	Y	6/3: A	
	12	HBF	Frank Hattemer	Ball/Kodani/Burr	Issued 5/20	R/R/R/R	Y		
	13	MSR-follow up	Lowery/Dobrowoski	Archibald/Gershow	Issued 5/17	O/O/R/R/R	Y		
	14	MSR-Policy	Lowery/Dobrowoski	Archibald/Gershow	Issued 5/14	R/R	Y	6/8:A/A	
	15	Credit Scoring TPM	Tim Bates	Rokich/Nuxoll/Ancely	Issued 5/20	R/R/R/R/R/O	Y	6/2: PA/A/A/A/A/A	6/9
	16	IRR-MV	Steve Lobo	Diogo/Kirch/Rook	Issued 5/18	R/R	Y		
	17	IRR-NI	Lobo/McCarthy	Rook/Kirch	Issued 5/20	C/C/C/R/O	Y		
	18	Pipeline Management	Griffith/Kula/McCarthy	Miyasiro/Thorpe/Clute	Issued 5/20	R/R/R/R	Y		
	19	Corporate Risk Oversight	Melissa Martinez	Hedger/Knorr/Burr/Rudenick	Issued 5/17	C/R/R/R/O	Y	6/8: A/PA/A/A	6/8
	20	TPO Committee	Ann Tierney	Durbin/Rudenick/Burr	Issued 5/20	R/R/R	Y	6/3: A/PA/A	6/8
	21	IA	Reid Adamson	Costagna/Regan	Issued 5/17	R/R/R/R/O	Y	6/2: A/A/A/A/A	6/3
	22	NOC Recordkeeping	Ken Hannold	Rudenick/Burr/Kodani	Issued 5/18	R/R	Y	6/2: PA/A	6/3
	23	Pricing	Megan Davidson	Orban/Franklin/Clute/Burr	Issued 5/20	R/R	Y	6/8: PA/A	6/15
	24	Loan Servicing Ops	Dyan Beito	Sinclair/Lim/Rudenick/Burr	Issued 5/20	R/R/R/R	Y	6/8: X/A/PA/A	6/15
	25	Data Quality	Anthony Meola	Durbin/Rudenick/Burr	Issued 5/20	R	Y	6/2: PA	6/15
OTS	1	MBF	Frank Hattemer	Santos	Issued 5/13	C/R	Y	6/8: A/PA	6/8
	2	ROA	Melissa Martinez	Melanson	Issued 5/14	R/R/R	Y	6/8: A/A/A	6/10
	3	Servicing Quality Assurance	Melissa Martinez	Sinclair/Lim	Issued 5/18	R/R/R/R	Y	6/8: PA/A/A/A	6/15
	4	WMMSC	Tammy Spriggs	Sinclair/Lim	Issued 5/18	R/R	Y	6/8: PA/A	6/15
	5	SFR Loan Origination Quality	Meola/Hillis	Durbin	Issued 5/12	R/R/R/R	Y	6/9: PA/A/A/PA	6/10

S & S Findings Memos: AQ Memos

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		EXAMINER FINDING MEMOS 2004 Regulatory Examinations		FINDING*				OTS/FDIC APPROVED
				C	R	O	REPEAT	
STATUS		SAFETY & SOUNDNESS EXAMS	RESPONSIBLE MANAGER					
		Joint Memos						
Completed	P	Joint Memo 1 - Counter-Party Risk	Hugh Boyle	1	5			✓
Completed	P	Joint Memo 2 - SUCCESS Credit Scoring Model	Tim Bates		2		1	✓
Completed	P	Joint Memo 3 - Residential RE Appraisal Operations	Francois Madath		3	1	1	✓
Completed	P	Joint Memo 4 - Com'l RE Appraisal Operations	Jim Calderon		4	4		
Completed	P	Joint Memo 5 - LBMC LOC	Dave Purcell		4			
Completed		Joint Memo 6 - Middle Market	Dan Gilbert	1	4		1	✓
Completed		Joint Memo 7 - Small Business Lending Review	Michele Kennedy	2	2	1	1	✓
Completed		Joint Memo 8 - Loans to Higher Risk Borrowers	Jim Vanasek		3			✓
Completed		Joint Memo 9 - Subprime Strategy	Jim Vanasek		1			✓
Exec Review		Joint Memo 10 - Specialty Mortgage Finance	Keith Johnson		1	1		
Completed		Joint Memo 11 - LBMC Books & Records	Troy Goschall/Keith Johnson		1			
Exec Review	P	Joint Memo 12 - HBF	Frank Hattemer		4			
Exec Review	P	Joint Memo 13 - MSR Follow-up	Hongqing Chen/Lowery/Marc Ma		3	2		
Completed		Joint Memo 14 - MSR Policy	Rob Miles/John Dobrowolski		2			✓
Completed	P	Joint Memo 15 - SUCCESS and TPM	Tim Bates		5	1		✓
Exec Review		Joint Memo 16 - IRR NPV	Steve Lobo		1	1		
Exec Review	D,P	Joint Memo 17 - NI Sensitivity	Steve Lobo / Michelle McCarthy	3	1	1		
[redacted]	P	Joint Memo 18 - Pipeline & Warehouse	Griffith / Kula / McCarthy		4			
Completed	P	Joint Memo 19 - Corporate Risk Oversight	Melissa Martinez	1	3	1		✓
Completed	P	Joint Memo 20 - TPO Oversight	Ann Tierney		3			✓
Completed		Joint Memo 21 - Internal Audit	Reid Adamson		4	1		✓
Completed	P	Joint Memo 22 - NOC	Ken Hannold		2			✓
Exec Review	P	Joint Memo 23 - Loan Pricing	Megan Davidson		2			IN REVISION
Completed	P	Joint Memo 24 - Mortgage Service Delivery	Dyan Beito		4			
Completed	P	Joint Memo 25 - Mortgage Loan Data Quality	Tony Meola / Mark Hillis		1			✓
		OTS Memos						
Completed	P	OTS Memo 1 - Mortgage Banker Finance	Frank Hattemer	1	1			
Completed		OTS Memo 2 - Consumer Risk Oversight	Melissa Martinez		3			
Completed	P	OTS Memo 3 - Servicing QA	Melissa Martinez		4			
Completed		OTS Memo 4 - WMMSC	Tammy Spriggs		2			
Completed	P	OTS Memo 5 - SFR Loan Origination Quality	Tony Meola / Mark Hillis		4			
Completed		OTS Memo 6 - Seller Credit Administration	Debbie Andres		2			
		FDIC-DFI Memos						
Completed		FDIC-DFI Memo 1 - Call Report	Jay Ladwon		1			NA
Exec Review	P	FDIC-DFI Memo 2 - Joint Policy Statement on IRR	Steve Lobo / Michelle McCarthy	1				
Completed		FDIC-DFI Memo 3 - SFR Underwriting	Mark Hillis / Tony Meola		2	1		✓
			TOTAL S&S FINDINGS	10	88	15	4	

P.B.A.

Updated: 6/24/2004 8:24 AM
Source: Regulatory Relations

Regulatory Relations Tracking Matrix

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OTSWME04-0000005370

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WASHINGTON MUTUAL BANK FA/FSB
OTS# 08551 & 11905
March 15, 2004

Summary of AQ Findings Memos

Date: 6-25-04
Prepared By: Z
Reviewed By:
Index #: 200-13a

OTSWME04-0000005371

Washington Mutual, Inc.
Washington Mutual Bank, FA
Finance Committee
Minutes

Date & Place: January 18, 2005
Washington Mutual Tower, 15th floor Boardroom
Seattle, Washington

Attendance:

Members Present:

Margaret Osmer McQuade
Phillip D. Matthews
Michael K. Murphy, Chair
Mary E. Pugh
William G. Reed, Jr.
William D. Schulte

Members Absent: Stephen E. Frank

Also Present:

Sean Becketti
Hugh F. Boyle
Thomas W. Casey
Craig J. Chapman
William W. Green, Jr.
Mark R. Hillis
Kerry K. Killinger
Melissa R. Martinez
Joseph P. Mattey
Michelle McCarthy
Anthony T. Meola
Stephen J. Rotella
Craig E. Tall
Susan R. Taylor, Secretary
James G. Vanasek

The Finance Committee of Washington Mutual, Inc. ("WMI" or the "Company") met concurrently with the Finance Committee of Washington Mutual Bank, FA ("WMBFA") on January 18, 2005. The meeting took place at the Company's boardroom in Seattle, Washington.

Mr. Michael K. Murphy, the Committees' Chairman, called the meeting to order at 10:00 a.m.

Minutes from December 21, 2004 Meeting
Upon a motion duly made by Ms. Pugh and seconded by Ms. Osmer McQuade, the minutes from the December 21, 2004 meeting were approved.

Doc #108764

Mr. Murphy then noted that because Mr. Frank had not yet arrived due to his attendance at the Human Resources Committee meeting, he would like the order of the items on the agenda to shift to accommodate Mr. Frank's possible attendance towards the end of the meeting. The minutes below reflect the order in which items were presented and discussed.

WMI and WMBFA Finance Committee Charters
Ms. Taylor presented suggested changes to the charters for the Committee members to consider as part of their annual review of the charters. Upon a motion duly made and seconded, the Committees agreed to recommend the proposed changes to the full Boards for adoption.

Committee Checklist
Ms. Taylor reviewed the proposed checklist with the Committee for 2005.

WMBFA Credit Standards
Mr. Green reviewed the Credit Standards that were newly adopted or modified by the Credit Policy Committee during the fourth quarter of 2004.

Corporate Credit Highlights
Mr. Green reviewed the Corporate Credit Highlights for the fourth quarter of 2004, noting trends and implications. Several of the Directors asked questions of management concerning the outlook for credit quality and the implications of possibly increasing the concentration of loans to higher risk borrowers. Mr. Vanasek reviewed some of the economic factors that underlie both current borrower behavior and current lender decision making and product offerings. He described some of the possible scenarios that might result if economic factors, such as interest rates, employment rates or the housing market, should change. In response to a question from Ms. Pugh, Mr. Hillis described the progress made by the credit group with simplifying and automating the underwriting standards and process so that exceptions will be reduced. Mr. Hillis described some of the analytics and strategies used by the credit risk management group to assess and manage credit risk, including sales of problem loans. Mr. Meola commented on the advantages of the automatic decision process. Mr. Rotella stressed the importance of relying on the right tools and analytics to maximize our opportunity in this market. Mr. Vanasek noted that the proper provisions and limits will be necessary components of a successful strategy.

Corporate Risk Oversight Highlights
Ms. Martinez reviewed the contents of the presentation entitled, "Corporate Risk Oversight Highlights December 2004." She reported that although the Continuous Comprehensive reviews are in process, no ratings are being delivered to the Committee pending further review of the rating structure. Ms. Martinez reported on some of the comprehensive testing results, noting that results in multi-family lending and home loans are good, while issues remain in Long Beach Mortgage Company and the retail channel. In response to a question from Ms. Osmer McQuade, Ms. Martinez noted that compliance at Long Beach is improving now that staff turnover has decreased although there is still a

lag due to training time. Overall compliance is progressing well. Ms. Martinez reported on the status of those corporate risk oversight examination matters requiring board attention. Ms. Martinez noted that there were no material issues regarding untimely or inadequate responses to report.

Fourth Quarter Allowance for Loan and Lease Loss Analysis
Mr. Green reported on the fourth quarter allowance for loan and lease losses ("ALLL"). There were no significant changes.

Status of Prepayment Methodology Project
Mr. Becketti told the Committee that he had been hired by the Company in July of 2004 to strengthen the prepayment modeling process and to develop proprietary models to replace the vendor designed models. He described the issues raised by the OTS in findings memos, including issues related to backtesting and the comparability of prepayment performance of portfolio loans compared to loans serviced by others. He reported that the staff in the department has tripled and that progress is being made, although certain issues are still outstanding. He explained that the old tools developed by vendors reflected industry average behavior, rather than the behavior of our customers, which differs from the average partially because of varying geography, products, acquisitions and policies. He reported on the progress now being made to develop proprietary models reflecting Washington Mutual loan experience. He discussed his meetings with the OTS and the concerns raised by them. He then left the meeting.

Single Family Residential Integrated Loan Servicing Strategy and Channel Profitability
Mr. Chapman reported on the progress made to identify the profitability of making single family residential loans by channel and product. He reported that pricing is now managed by channel and that the accuracy of assessing profitability continues to improve. Some of the costs, in particular, still need to be further refined. In response to a Director's question, Mr. Meola commented that Home Loan Center managers now have information on their center's profits and losses and that those figures are impacting compensation. In response to a question from Mr. Reed, Mr. Meola and Mr. Rotella both commented on the relative profitability of the correspondent and retail channels and some of the different challenges in each channel. Mr. Chapman then left the meeting.

WMI Key Non-Bank Subsidiaries Report
Mr. Meola reported to the Committee on the Company's insurance subsidiaries and their businesses. He described the businesses as generally falling into three categories: first, the captive mortgage reinsurance business, second, the flood and force placed reinsurance business and third, the traditional agency business for life and homeowners' insurance. Mr. Meola noted that Carl Formato manages the insurance business. Internal and external audits are clean and the business is stable. Mr. Meola then left the meeting.

WMI Common Stock Dividend
Mr. Casey asked the Committee to consider recommending a dividend payable on the Company's shares of 46 cents per share. He directed the Committee members' attention to the peer comparison in his materials, noting that the Company's dividend payout ratio is projected to return to the 45% target during the fourth quarter of 2005 given currently available information. In response to a question from Mr. Schulte, Mr. Casey noted that attention should be paid to clearly communicating and involving investors should any changes to our dividend policy be considered. Upon a motion duly made and seconded the Committee agreed to recommend approval of the proposed dividend to the full Board.

Washington Mutual Bank, FA Dividend
Mr. Casey asked the Committee to recommend to the full Board of WMBFA that a dividend of up to $250 million be paid to the holders of that company's common stock. Mr. Casey reviewed the company's available liquidity and noted that it was well capitalized. Upon a motion made by Ms. Osmer McQuade and seconded by Ms. Pugh, the Committee agreed to recommend to the full Board that the dividend be declared.

Asset Allocation Initiative – Higher Risk Lending Strategy
Mr. Vanasek presented the proposed Higher Risk Lending Strategy for the Committee's review and approval. He introduced Joseph Mattey, who has assisted with the development of the strategy. Mr. Vanasek reminded the Committee of some of the background behind the strategy being proposed, including the Board's discussions at its strategic planning retreat in 2004 regarding higher risk loans. He also noted some of the issues that were raised by the OTS and FDIC in 2004, as articulated in the 2004 Safety and Soundness Exam Joint Memos 8 and 9, including our agreement to: adopt a definition for "higher risk loans," monitor, measure and report on these loans, establish portfolio concentration limits as a percent of capital and seek the Board's approval on an overall strategy for this type of lending. Mr. Killinger arrived at this time. Mr. Vanasek then reviewed the proposed definition for what constitutes higher risk loans, referencing the materials provided to the Committee in advance of the meeting. Mr. Hillis reviewed the current and projected exposure for such loans for 2005, expressed both in total dollar terms and as a percentage of risk-based capital. In response to a question from Mr. Reed, Mr. Vanasek described some of the factors that were considered in assessing whether the projected credit risk exposure is appropriate. The net charge-off objectives and expected loss rates were then discussed. In response to a comment from Ms. Pugh, Mr. Hillis discussed tools for responding to the higher credit losses, including loan sales and pooled mortgage insurance. In response to a question from Mr. Matthews, Mr. Hillis and Mr. Mattey described the resulting credit profile forecast after adoption of the strategy. In response to a question from Ms. Pugh, Mr. Vanasek stated that the proposed capital concentration limit of 200% of total risk-based capital was self-imposed. Management and the Directors discussed the likelihood that credit losses would lag behind origination of these higher risk loans by several years. In response to a question from Ms. Pugh, Mr. Hillis noted that he would lead the newly formed Asset Allocation Committee. In response to a question from Mr. Schulte, Mr. Hillis reported that he believed we could staff the front line with people who will comply with the rules that may be established for

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originating and servicing higher risk loans, and that these people will be overseen by the credit group. Mr. Matthews asked about the incremental profit to the Company expected from adopting this strategy. Mr. Casey committed to getting that information. Mr. Casey and Mr. Vanasek discussed the differences between the strategy being proposed and the business that Long Beach is currently engaged in, noting that the new strategy contemplates retaining more of the higher risk product as opposed to selling it. Mr. Casey noted the importance of proper pricing to the success of the strategy. Mr. Hillis reviewed the next steps to launch the strategy. He committed to report any deviation from the 200% limit to the Committee. After the conclusion of the presentation the Committee continued to discuss with management the implications of adopting the strategy and management's views of the strategy, including the timing, the pricing, the tools and support available and the associated risks. Upon a motion made by Ms. Pugh, seconded by Mr. Reed, the Committee approved the Higher Risk Lending strategy as presented.

Asset and Liability Management Reports

Ms. McCarthy reviewed the contents of the ALMP Reports. She handed out replacement pages entitled "Market Value Risk Management – Core MSR Risk Management Portfolio" and "Market Value Risk Management – Pipeline/Warehouse MSR Risk Management Portfolio." She noted that the Core MSR risk was measured using the levels approved at the December meeting. The report showed volatility risk that was partly offset by basis risk. She reported that the basis risk and yield curve risk measures for the pipeline/warehouse MSR were at a warning level as of year end. The warehouse of consumer home loans exceeds the aging limit. Ms. McCarthy reported that the management of this portfolio is improving. Ms. McCarthy also reported that the total MSR asset value for the Company is approaching the limit of 50% of tangible capital. She commented that this limit has no regulatory basis and should be considered.

There being no further business, the meeting was adjourned.

Attested to by:

____

Susan R. Taylor, Secretary

Footnote Exhibits - Page 0045

From:	Rotella, Steve <steve.rotella@wamu.net>
Sent:	Sunday, October 16, 2005 4:19 PM
To:	Killinger, Kerry K. <kerry.killinger@wamu.net>
Subject:	Re: Plan meeting

Thanks. Still not 100%. Hope to be better for our big week. To continue our email dialogue:
-I agree on retail. Our field culture and basic model is outstanding. If we can match it with a differentiated free checking offer, stronger brand governance, great marketing, stronger leadership and a more efficient infrastructure, we will add huge value. I can see it and am beginning to feel it, and appreciate your clarity of vision, which has helped a lot. We are at a critical time. I am driving this hard, but at all key points, will bring you in for your input, guidance, and buy in. I think this is a great opportunity for WaMu and a great example of how we can partner to accelerate progress.
-I also agree that mlf is a strong performer for us and we are well positioned. We should drive this business hard, but given the size of the industry it won't be the kind of long term contributor that other businesses can be. I think Al is there on the mass version of this and from my interactions with him, will not be a limiter with some coaxing.
-on Long beach, cost is important but as a wholesaler, what we pay to the broker (80-90 bps) and our sales people (80) are the big drivers. While we can drive efficiencies in ops cost, these are dwarfed by the above. Which is why I am pushing Craig harder on referrals from HL and heq, retention, and a phone/web based retail unit. You lose the 160-170 bps of cost and will drive the highest margin business possible. I am going to begin digging in here and sorting through the low earnings and high volatility that has been evident this year.
-on HL, we will end up with a 2006 bottom line, keeping msr at 200mm (this is subject to review) above 300mm. No doubt that doesn't feel good. Several thoughts:
-we do have to keep in mind the portfolio in place and being created that results in significant earnings. This will increase as we drive heq and subprime referrals. I don't think we would get these earnings without the prime biz.
-we have defined a "box" for this business that is brutal. If we asked our friend Angelo how successul he could have been if he could only be a prime lender (no alt a, no heq, no subprime) with no portfolio to smooth earnings, not to mention a business that has not focused on realtor connections, coops in NY, or retention (our rates are very low), he would tell you in his Bronx accent "fagget about it". I guarantee you that if we pulled out everything but prime and interpolated for size differences, their returns would not look good at all. I also know they would be better than ours, almost entirely due to an inefficient production platform. We did these kind of analyses all the time at Chase which led us to run as fast as we could into home eq, alt a, subprime (our investment banking brethren stopped us from going too far here). We viewed prime as a source of scale benefits in servicing for the other areas and a conduit of higher margin product and aimed to hold our prime servicing flat to down.
I feel strongly that where we need to land is a new home loans unit that includes prime, heq, and subprime. It is a far superior model. There are huge cost saves, it will drive higher cross sell, will align production with capital markets ala Lehman and Cntrywide and smooth earnings and be more comparable to other big players. I can cite many examples of waste and inconsistency as I examine these businesses.
I feel the only question is when not if, but would like your views. The timing is complicated by my feeling that David is too new to take on all this (I think he could easily take heq, but not lbmc right now) and Craig frankly shouldn't take on more. I have questions about his long term role with us.

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #197

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JPM_WM00665373

Well enough by email. I will get some time to kick this around.
PS much as the Rome trip entices me, there is too much going on right now, so I am going to pass.

Sent from my BlackBerry Wireless Handheld
-----Original Message-----
From: Killinger, Kerry K. <kerry.killinger@wamu.net>
To: Rotella, Steve <steve.rotella@wamu.net>
Sent: Sun Oct 16 08:36:06 2005
Subject: RE: Plan meeting
Steve,
This is a good recap. Thus you can see my wrist slicing comments on Friday.
I agree with your comments with a couple of twists. The retail group has plenty of upside, but the overall returns are pretty good. It will be important for us to preserve the strengths of the model which is our culture and being a mass market retailer with little market segmentation, while we attack the cost structure. If we do this correctly, we could emerge as the best in the country.
Regarding Commercial, returns on the multi family appear pretty good and it is hard to know if those returns could be even higher if they are pushed even further towards a mass marketing approach. Al will find it hard to let loose from his commercial real estate biases of doing one off deals. So he might be a limiter. On the other hand, Chapman creates a lot of challenges himself. I am not sure where truth is on this one.
Regarding Longbeach, I think there is a good opportunity to be a low cost provider and gain significant share when the industry implodes. I agree we shouldn't make life easier for Ameriquest. Regarding our own performance, I don't have a handle on how far away fom optimal we are performing. With loans being held, then sold, with residuals moving around, etc., I don't have a sense as to how we are really doing.
On the home loans group, we may have a broken business model. I was surprised to hear David present a plan with such poor returns and then say there may be another $50 million of upside. Compared to the capital and number of employees deployed, this is our poorest performing business by far. The reason I was trying to draw out thoughts around where on a good to bad scale the operating environment will be in 2006, was to assess the viability of our current business model. It makes sense to leverage the home loans distribution channels with home equity, sub prime and alt. A. But we don't necessarily need a prime home lender to be leaders in these product areas. Using a poor analogy, Delta, American and United all had flawed business models and they tried to compete with Southwest by bolting on their own versions of discount carriers. They could never compete because some competitors didn't have to overcome a flawed core model. There appear to be two things we can do to change our model: change our MSR hedging to better mirror Countrywide. And second, to fully embrace EDE or whatever technologies we can find to radically change the costs of delivering mortgages. I am troubled that our adoption of EDE so far has not radically changed how we underwrite loans. If we can't make a shift in our business model, we might be better off exiting the prime space. As I said before, the last thing we want to be is a Countrywide wanna be.
On the card business, it is still too early to assess if the numbers are going to be o.k.
Regarding the enablers, I agree that Deb was spot on. We should find ways to give her visibility in order to show all of the enablers what can be done. Maybe she should have a role at the senior managers meeting. Regarding Vanasek, I suspect there are some significant efficiencies to be had out of several areas. My guess is that most of these are in Melissa's world and perhaps in credit if we can get behind EDE.

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I hope you're feeling better. See you tomorrow.
Kerry
-----Original Message-----
From: Rotella, Steve
Sent: Sat 10/15/2005 1:57 PM
To: Killinger, Kerry K.
Subject: Plan meeting
Despite the fact that I believe we are going to get our 2006 plan in shape, I left the plan meeting with a great deal of unease. .
-retail, for all the strength of the model and our field staff, is an under earning business with mediocre productivity. You are aware of the work underway to get better leadership, improve new stores, marketing, free checking etc. This actions will help. While the leadership search proceeds, I am knee deep here and pushing for more efficiency. . Lots of upside exists and we have great strengths to build on. But as I get deeper it exposes the spotty to weak talent pool down several levels. Lots to do here.
-i was annoyed by the commercial discussion. Keith's presentation was weak and inaccurate at times. I managed a subprime business and did not feel good about the answers we got. LBMC is also under earning, which Craig now acknowledges. Understanding margins are tight, I think we have favored share without proper balance to profits and have in fact fueled price irrationality by constantly supporting ameriquest's liquidity crises. This was one of my first real exposures to keith. Besides a weak presentation it is hard to get past a feeling that this guy is "oily". His comments about not losing any LCs for 18 months makes no sense unless we are paying too much. I suspect we are. And the comments about cost to originate were inconsistent with past info. I am also confused about how Craig views his key talent. Al is being castigated for not growing fast enough, yet all his metrics are superb and Craig said his 2006 plan was done and buttoned "as usual" yet keith's was described as " a train wreck" yet Keith is his number one guy. Craig's behavior was argumentative, and nearly insubordinate at times. I have an ongoing struggle with the lack of transparency and other difficulties with Craig. I plan to begin digging into more detail on LBMC.
-Home loans needs a lot of discussion. I share your concerns. I thought David did a decent job in discussing a tough topic after 8 weeks with us. The discussion reinforced several thoughts for me; we need to continue to drive to grow our way past prime sfr being such a big part of our business and reconsider how much growth we really want in this sector, and we (you, me, maybe Tom) need to brainstorm on our business model and how we organize around it. I think our focus needs to be on organic growth of home eq, and subprime, and greater utilization of HL as we know it today to facilitate that at lower acquisition costs and greater efficiency. There is a 50-100mm opportunity on the cost side across those three businesses and strong internal growth dynamics that we are missing. These three businesses have too many similarities to remain separate over the long term. I don't want to underplay the need for a serious discussion about the strategy in prime only, which is necessary, but I think our current business model is flawed. We should get an hour so so on this.
-the support units were a mixed bag. Deb was, as usual spot on, Tom was fine. I tried to be gentle with Jim, but I think we all saw gaps and anything but a scale oriented mind set. Probably not worth too much pushing on jim here, but the new guy needs to reexamine everything. Some of those fte numbers were outsized, particularly in compliance.
Lots to talk about. See you next week.

Sent from my BlackBerry Wireless Handheld

To: Michelle McCarthy
From: Dave Griffith
RE: Sub Prime Chronology

You've asked for a chronological recap of ERM market risk involvement with Longbeach and the sub prime conduit. I'm preparing this from memory and have not taken the time to go back to find specific memos, meeting notes and power point decks. I've assumed the intent is not to document the expression of our past concerns as it is to help prepare a frank "what we did right; what we could have done better" fashion.

(you may want to strip the first section out entirely if it's not relevant)

2004: I conducted an informal but fairly intensive market risk audit of Longbeach while I was reporting jointly to David Beck and Steve Lobo, shortly before coming over to your group. We had just undergone a management change in Home Loans and Longbeach was in the commercial group. Frank(?) Johnson was the new CEO. I borrowed Harrison Luvai from HL and sent him and Paul Herbst down there for three days with a list of questions and people to interview.

The climate was very adversarial. Dennis Lau was buying sub prime whole loan packages directly into the portfolio and outside any governance or reporting. He considered himself as reporting directly to Kerry.

We found a total mess. Rate locks were issued as faxed loan files arrived from brokers. There was no pricing discipline; if a broker needed a better price, they asked for it. Systems to track commitment were non existent and tracking didn't begin until underwriting approval. They were not hedging and basically they were just being pulled along by a bull market and wide spreads.

I prepared a summary report without the inflammatory language and make a presentation to MRC which was still pretty harsh. Tom was pretty upset and it may have played a role behind the scenes in moving Dick and Dave C into the LB picture. You never know.

Sept. 2005: At least one, possibly two reorgs later. Craig Chapman was running home loans and David had moved soley to Capital Markets. You and I joked a lot about my needing a bullet proof vest.

That's because we discovered WCC had plans to begin buying loans into an Alt A conduit in two weeks. At that time we neither offered nor had approval to offer Alt A's at the bank and no corporate approval for a conduit. There were risk systems and plans to build the financial reporting along the way. At that point WCC considered itself outside the bank's ALMP/governance and felt that the conduit was an extension of its business.

I objected, you backed me and all heck broke loose. But the non emotional result was that we passed the first program authority for the Conduit (exclusively Alt A at that point) with a $500m limit and a fairly conservative set of reporting requirements and exclusions. One of those exclusions was "no subprime".

At the same time I prepared a detailed set of steps needed for the business to have our support for full delegated authority. There was a huge burst of interest initially and then months of no progress until the conduit began to approach its limit. As they did, they came back to revisit the path to delegated and asked for an increase to $750mm and then about three months later another to $1billion.

I supported both increases because by then we has printed and distributed our first deal (a huge milestone) and had gone through a full reconciliation audit.

Subprime came along in early 06 with all the risk systems and reporting positioned as an extension of Alt A. Using the Alt A conduit template. MRC granted program authority of $500m with many of the same conditions we had used for Alt A. This time however we carved out the right for ERM to approve one-off additional increases on a case by case basis. You effectively delegated that to me and for most of the summer it wasn't an issue.

The business began to approach the $500m limit in September a month or so after George Davie (our sp trader) joined the firm. But we were already starting to see delays in deal issuance due to problems with servicing transfers. The story line at that time was that our servicing problems were tied to the big sale to Wells and impacted by the various. But the fact was that the deal planned for August had to be delayed.

After that deal had been priced ($300m) but before it had settled I began to engage in an almost daily dialogue with George about upcoming bids. He bid on a couple of pools with my assurance that if we won, I'd grant approval since it would take the total over the limit.

After we won a couple of those, the approved one-offs took us effectively to a $750 limit. I never saw the need to go back to MRC because we always had deal in the works that would bring us back down, we had a good dialogue underway and a lot of progress on the loan tracking. It helped that if anything George was as, if not more, concerned with the back office servicing transfers as I was.

Then in late Sept or early October a $500m pool from People's Choice came up. We had just finished due diligence on a deal scheduled for October but it had not yet traded. But we did know with reasonable certainty that the loans has been transferred correctly. Before approving that bid, I literally got Doug out of the shower at Cedarbrook to ask him bluntly if this was a compelling business opportunity. He thought it was.

So we went forward after joking with George that we were now intentionally feeding the pig to the python. If we had operational problems despite all the assurances that all was fine, we knew it would surface now. (This probably strikes a cord as I recall saying exactly that to you).

With perfect hindsight I should have asked you for permission to get on a plane to Jacksonville under the guise of learning about servicing transfers so that I could do our own dd. I thought about it but never asked figuring it was too far a field of market risk. Besides, at the same time, I was being pounded daily by Mr. Drastal saying "Cheryl has approved this".

As we know, the python spit out the pig. Our FPD problem which we had initially assigned to bad transfers and would self cure when we got the paperwork right turned out to be actual FPD's. But instead of finding that out in 60 days, it took us (and still might) 90 or more because of the continuing servicing issues. By year end we had to file an 8k (which no one has ever figured out to my knowledge) admitting that we has securitized delinquent loans.

To add insult to injury, we had a very tough time marketing the People's Choice loans because investors didn't like the name. The investors were right.

By Feb the FPD's and delinquencies were surging and the SubPrime conduit was shut down by agreement. That gave us time to bail the boat without new water pouring in. It remains effectively closed and as recently as this morning George is in no hurry to test the waters.

Unsaid in all this is why I supported full delegated authority which was granted in January. That was a philosophy change from traffic cop to facilitator which is certainly rooted in Ron's philosophy of delegation and my belief that the discipline of EC and the formal planning process should be enough. To make the business once again prove its case after the plan has been approved by the EC and the Board just doesn't seem right. After having been given top level authority to go out and build a sub prime conduit at the highest levels, it no seemed appropriate to say "well that's nice, but you've got to convince me too."

So I supported, designed and proposed the master authority tied to the plan concept.

Bottom line; biggest thing we did right was to slow them down and force proven successes before granting broader authority. We also built solid one:one dialogues which have resulted in straight talk because we're not the enemy.

Biggest mistake: not setting up tougher objective standards. We could have used the "ops risk is recognized as market risk" philosophy to have demanded objective evidence of progress and had we done so, the pain would be lower now.

Footnote Exhibits - Page 0052

From: Hillis, Mark R.
Sent: Wednesday, November 24, 2004 3:09 PM
To: Chapman, Craig J. <craig.chapman@wamu.net>
Subject: FW: LBMC Transfers of Piggiebacks from HFS to HFI!

Craig,

You know my thoughts on these high CLTV seconds. I know we are making huge improvements in LBMC, but if we are parking higher risk on the balance sheet, I'd like it to be focused on the following:

1) Sub Prime – lower LTV loans
2) Recourse/risk sharing to enable us to advance our SFR prime decisioning capabilities
3) MFL
4) Home Equity <90% CLTV

Please let me know your thoughts. I think it would be prudent for us to just sell all of these loans.

-----Original Message-----
From: Smith, Michael C.
Sent: Wednesday, November 24, 2004 11:29 AM
To: Hillis, Mark R.
Cc: Green Jr, Biff W.
Subject: LBMC Transfers of Piggiebacks from HFS to HFI!

Mark --

Just a heads-up that you may be getting some outreach from Carroll Moseley (or perhaps someone higher up in the chain) at Long Beach regarding their interest in exploring the transfer of what Carroll described as a small amount (maybe $10-20mm in UPB) of Piggieback "seconds" (our favorite toxic combo of low FICO borrower and HLTV loan) from HFS to HFI.

As Carroll described the situation, these are of such dubious credit quality that they can't possibly be sold for anything close to their "value" if we held on to them. So the proposal would be to write them down to near zero (maybe 5% of UPB?) but hold on to them (meaning an HFI classification) rather than sell them for practically nothing, and figure to earn more on the actual loans than their sale price would have fetched.

He acknowledged that they had already missed the Oct.25 deadline we'd agreed to earlier for submission of *any* request to transfer LB loans from HFS to HFI this quarter, and also pointed out that with a mega-writedown (not against the ALLL), their BV would produce nary a ripple in our reported numbers. However, I underscored that it wasn't just a question of timing, and that you had raised a number of serious issues in the LB QBR about the approvals not yet granted for this kind of a product to come into our portfolio. I urged him to reach out to you directly on these questions. (E.g., it's entirely possible we might want to make a business decision to keep a small amount of this crap on our books if it was already written down to near zero, but we would want all parties to be clear that no precedent was being set for the product as a whole, etc., etc.)

All of the above took place in an informal "back channel" phone call he placed to me in the interest of keeping clear communication channels open, but I was quite emphatic that this one would have to be considered, reviewed and decided well above my and his pay scale, as the expression goes.

Have a happy Thanksgiving (if I haven't just ruined it) MCS

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #218

Confidential Treatment Requested by JPMC

JPM_WM01407692

Washington Mutual
Internal Audit Department

TO:	Keith Johnson, President & Chief Operating Officer, LBMC	DATE:	09/21/2005
FROM:	Becky Odlozil, Sr. Audit Manager Randy Melby, General Auditor	PHONE:	(214)492-4380
SUBJECT:	Review of Long Beach Mortgage	LOCATION:	4397ADTX

EXECUTIVE SUMMARY

Rating.....**OPPORTUNITIES FOR IMPROVEMENT**

Long Beach Mortgage Company (LBMC) is a non-bank subsidiary of Washington Mutual Inc. specializing in underwriting sub-prime mortgage loans secured by one-to-four family residences. Loans are originated through a broker network or purchased through a correspondent network. Historically, loan production was securitized with retention of the servicing rights. However, LBMC management made a recent strategic decision to hold a portion of the loans for investment. In the first quarter 2005, this restructure of the balance sheet began with an initial transfer of $1.8 billion from *loans held for sale* to *loans held for investment*.

Internal Audit evaluated the adequacy and effectiveness of internal controls over loan origination policies and procedures, related accounting, loan origination system data integrity, wire approvals, and monitoring of the collateral custodian relationship. The securitization process, balance sheet valuation, financial reporting process and servicing process as well as certain specific lending regulations covered in separate enterprise-wide audits were not included in the scope of this audit. The migration to a new loan origination system is currently under evaluation as an ongoing system development project managed by the IT Audit group. LBMC management anticipates full implementation of the new loan origination system by September 2006.

Over the past year, significant progress has been made in establishing adequate policies, procedures and ongoing sustainable processes. LBMC currently operates in a manually intensive processing environment resulting in an increased propensity for errors. LBMC management recognized this increased risk and the potential impact on loan quality, and embedded quality assurance initiatives into their process. They also formed a quality assurance group and stabilized staffing. While the improvements in the processes should ultimately result in an effective control environment, we found these processes were not consistently followed. The Opportunities for Improvement rating is primarily attributed to the following control weaknesses:

- Policies designed to mitigate the risk of the following predatory lending practices are not always followed.
  - Origination of loans providing no net tangible benefit to the borrower - In 24 out of 27 (88%) of the refinance transactions reviewed, policies established to preclude origination of loans providing no net tangible benefit to the borrower were not followed.
  - Loan flipping – In 8 out of 10 (80%) of the non-seasoned refinance loans reviewed, there was no evidence of the required History Pro report used to assist in the determination of loan flipping.

While predatory lending laws are specific to certain states, both state and federal regulators continue to scrutinize predatory lending practices particularly in the sub-prime industry. Failure to comply with policies designed to mitigate the risk of any lending practices which could be construed as predatory increases the company's regulatory, reputation and credit risk.

- Underwriting guidelines established to mitigate the risk of unsound credit decisions were not always followed, and the decisioning methodology was not always fully documented. The majority of exceptions resulted from using unverified income or the unsupported exclusion of debt items in the debt-to-income calculation.
- Controls within the loan origination system can be overridden to allow employees without documented authority to approve loans. Additionally, the Risk Level Authority Matrix used by management to document and grant lending authority commensurate with employees' job levels and experience is not kept up to date.
- The loan approval forms documenting the clearing of conditions were not fully completed in 60% of the files reviewed.
- Not all LFCs require secured card entry at the facility resulting in sensitive customer information, including credit reports and loan applications, not being adequately secured at these locations.

Management self-identified some of the control weaknesses, and remediation efforts for all issues are underway. These issues are being remediated through training, reinforcement of policies, creation of job aides to assist with underwriting decisioning and documentation, and random in-house audits. By October 2005, remediation plans are scheduled to be fully implemented. Management will validate the effectiveness of the remediation plans through a series of in-house audits which we be completed in the first quarter of 2006.

BACKGROUND

Long Beach Mortgage Company (LBMC) became a non-bank subsidiary of Washington Mutual Inc. in 1999. Operating as a separate legal entity, LBMC originates, purchases, and sells subprime residential mortgage loans secured by one-to-four-family residences. LBMC's borrower base consists of individuals who can not qualify for traditional "A" credit due to their credit histories or debt-to-income ratios.

Loans are originated through a broker network (wholesale loans) of 15,000 brokers or purchased from correspondent mortgage bankers (correspondent loans). The loan broker submits the loan file to Long Beach Mortgage Loan Fulfillment Centers (LFCs) where the loan is underwritten.

Historically, LBMC did not hold the loans in its portfolio but rather securitized them and retained the servicing rights. Pools are created by the Capital Markets Group that match the requirements of the proposed securitization. While the majority of loans originated will continue to be securitized, LBMC reallocated assets on the balance sheet resulting in an initial transfer of $1.8 billion from loans held for sale to loans held for investment. This transfer was completed in the first quarter 2005 with an ultimate goal of having $3.5 billion in loans held in investment.

OBJECTIVES AND SCOPE

The objectives of this audit were to evaluate the adequacy and effectiveness of the system of internal controls over loan originations at LBMC and to determine the adequacy of and compliance with related policies and procedures and applicable laws and regulations.

The scope consisted of interviews with management and review of:

- Loan origination policies and procedures, and related accounting
- Compliance with predatory lending regulations, the Fair Housing Act, Unfair or Deceptive Acts and Practices, and the National Flood Insurance Reform Act
- Underwriting guidelines
- Loan origination system data integrity
- Monitoring of the collateral custodian relationship
- Wire approvals
- A random sample of loans selected from 1st quarter 2005 originations

A separate audit of the LBMC default servicing functions is currently in process and will be reported separately. LBMC securitizations, balance sheet valuations and financial reporting processes are audited by the Treasury and Capital Markets Internal Audit group and were not included in the scope of this audit. Specific lending regulations covered in separate enterprise-wide audits, including Equal Credit Opportunity Act, Fair Credit Reporting Act, Home Mortgage Disclosure Act, Real Estate Settlement Procedures Act and Truth-In-Lending, were also not included in the scope of this audit.

Thank you for the cooperation received during the audit engagement. Please call if you have any questions or comments.

cc: Steve Rotella, Craig Chapman, Jim Vanasek, Mark Hillis, Melissa Martinez, Michael Giampaolo, Amy Marcussen, Larry Breitbarth, Matt Place

ATTACHMENT I
AUDIT ISSUES & MANAGEMENT ACTION PLANS

	AUDIT ISSUE	RISK	MANAGEMENT ACTION
1	***Predatory Lending Practices (Criticism)*** LBMC policies and procedures designed to prohibit the origination of refinance transactions for which a net tangible benefit to the borrower cannot be demonstrated are not always followed. LBMC procedures require the completion of a net tangible benefit worksheet for all refinance transactions. However, for 88% of the refinances selected for testing, the net tangible benefit worksheet was not fully completed or supported by information in the loan files. Although the net tangible benefit worksheet requires the signature of a second reviewer, no management sign off is required. Additionally, 80% of the non-seasoned refinances tested did not show evidence of the History Pro report, which is required by policy to mitigate the risk of loan flipping and predatory lending.	Refinancing loans for which a net tangible benefit to the borrower is not fully documented and supported puts the company at risk for noncompliance with state specific legislation governing predatory lending practices. Additionally, given the increased scrutiny on predatory lending by state and federal regulators, specifically in the sub-prime lending industry, the company risks reputation damage should their lending practices be construed as predatory in nature. Resulting loss of market share in an extremely competitive industry could occur and impede the company's ability to meet strategic initiatives.	Management completed additional programming which will print the net tangible benefit worksheet with each amendment to the loan and implemented a policy change to require an update of the worksheet to reflect changes to the terms of the loan. Additonally, policies regarding the use of History Pro were not clear at the time of release. Management has provided policy clarifications and training on the use of History Pro since the completion of this audit. Management will further address these policies within each LFC and provide additional training between August and October 2005. The effectiveness of the remediation efforts will be monitored through a series of in-house audits which will be completed in the first quarter of 2006.
2	***Underwriting Quality and Documentation (Criticism)*** Underwriting guidelines and policies established to mitigate the risk of unsound underwriting decisions were not always followed and the decisioning methodology was not always fully documented. We found exceptions to policy or were unable to verify compliance with policy due to missing documentation existed in minimum credit score requirements, applicant identification form, mortgage and rental credit history, consumer credit, capacity to repay, full documentation program, stated income program, verbal employment verification, age of documents, and verification of recording. A significant portion of the exceptions pertained to the debt to income calculation and were the	Failure to adhere to underwriting guidelines and policies compromises the underwriting process and could result in unsound underwriting decisions. The risks associated with unsound underwriting decisions include regulatory fines and criticisms, diminished loan quality, and reputation risk in the secondary market. Losses in the form of fines, penalties, reduced market value of the loans, and early payment default by the borrower could also result. Additionally, failure to adequately document and support the decision puts the company at risk for the appearance of non-compliance with policies and subjects the company to regulatory criticisms.	Management developed corrective action plans including system enhancements to prohibit less than the minimum credit scores, creation of job aides to assist with documenting decisioning, additional underwriter training to address the findings, and re-training on the use of established quality control checklists. On August 1, 2005, management rolled out the Underwriting Decision Summary Form which clearly documents the underwriter's decision. Additionally, all underwriters received training to reinforce guidelines regarding stated income and debt to income calculations. By October 2005, additional job aides addressing the components of the underwriting decision and along with training will be complete. The effectiveness of the remediation efforts will be

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AUDIT ISSUES & MANAGEMENT ACTION PLANS

	AUDIT ISSUE	RISK	MANAGEMENT ACTION
	result of using unverified income in the calculation or excluding certain undocumented debt items from the ratio. The details of exceptions on individual loans were provided to management.		monitored through a series of in-house audits which will be completed during the first quarter of 2006.
3	***Underwriter Approval/Condition Clearing (Criticism)*** Before funding, guidelines require the loans to be reviewed and approved by the designated level of authority and conditions cleared. However, these controls are not operating effectively. Although the company established the Risk Level Authority and Condition Clearing Matrix commensurate with employees' job title and experience, the loan origination system can be overridden to allow employees without designated authority to approve loans. Additionally, we found two employees granted authority in the matrix higher than their job title and experience would warrant. According to management these two cases resulted from input errors. Additionally, the matrix was not updated regularly to reflect new employees or delete employees no longer employed by LBMC. We also found the clearing of approval conditions to not be fully documented on the Loan Approval form in a significant portion of the loans tested.	Loans that are not originated in accordance with established guidelines governing designated levels of authority and condition clearing jeopardize the soundness of the underwriting process and puts the company at risk for losses through the origination of poor quality loans, errors and omission in the loan package.	By October 2005, management will add a quality control check to validate approvers in the Risk Level Matrix. Employees with lending authority will also supplement their initials with the use of a name stamp to avoid confusion due to illegible handwriting. Additionally, management will re-train on the completion of the Loan Approval forms. The effectiveness of the remediation efforts will be monitored through a series of in-house audits which will be completed in the first quarter of 2006.
4	***Pricing (Recommendation)*** Errors were found in pricing loans in 27% of the loan files reviewed. Determination of the loan price involves manual calculations, which increases the chance of errors. These errors were not documented as pricing exceptions, and accordingly were not approved or reported as such, and resulted in loans that may not be priced commensurate with the borrower's	Pricing loans outside of the established pricing guidelines puts the company at risk for pricing that may not be reflective of the borrower's credit risk classification and may be construed as discriminatory or predatory in nature subjecting LBMC to regulatory criticisms and fines.	Management previously addressed errors in pricing by implementing a pricing tool called "Flash Quote", which eliminates some of the manual calculations inherent in pricing loans. By August 1, 2005, all underwriters received refresher training in connection with the introduction of the Underwriter Decision Summary. Emphasis was placed on the use of the correct FICO score within this tool so that

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AUDIT ISSUES & MANAGEMENT ACTION PLANS

	AUDIT ISSUE	RISK	MANAGEMENT ACTION
	qualifications. Additionally, one loan contained a rate in the note which did not match the rate which was approved.		loans are priced accurately. The effectiveness of the remediation efforts will be monitored through a series of in-house audits which will be completed during the first quarter of 2006.
5	***Quality Assurance Initiatives (Recommendation)*** Although management addressed controls in the manually intensive environment by embedding quality control checks into loan processing, the pre-boarding checklists, DOCs Out and DOCs In checklists, and prefunding checklists were not always fully completed.	Failure to fully complete or fully document quality assurance checklists diminishes their effectiveness and puts the company at risk for non-compliance with regulations and underwriting guidelines, missing documentation, poorly documented underwriting decisions, the origination of poor quality loans, and could impede the efficiency of the origination loans. Regulatory criticisms, reduced gains on securitization, early payment default and a higher incidence of fraudulent and incomplete submissions could result.	By October 2005, management will provide re-fresher training to all functional roles within the LFCs and will monitor the effectiveness through in house audits which will be completed in the first quarter of 2006.
6	***Security of Borrower Information (Recommendation)*** Not all LFCs require secured card entry at the facility resulting in sensitive customer information, including credit reports and loan applications, not being adequately secured at these locations.	Failure to adequately secure customer information could result in misuse of the customers' personal data for fraudulent purposes and result in customer dissatisfaction, and liability on the part of LBMC should the customer incur losses. Additionally, given the increased attention from the public and media regarding consumer privacy issues, reputation damage could result should the company fail to protect sensitive customer information.	Management installed card entry at the Dallas LFC so that only authorized employees can enter the department. During nonbusiness hours, entry is limited to cleaning personnel who are bonded. Management is addressing secured entry for all LFC locations.
7	***Date Integrity - Input into LOS (Observation)*** The information in FiTech did not agree to information contained in the loan files for appraisal amounts (i.e., CVR report) in 27% of the transactions tested. Management was aware of the differences which resulted from issues with information received from the Optis Value system. The problems with the data received from Optis Value are corrected.	Failure to adequately support information input into FiTech could result in inaccurate pipeline management reporting. The pipeline reports are used for a variety of reasons including developing performance metrics, monitoring time that loans are in the pipeline in order to comply with regulations, populating the Loans-In-Process general ledger account, and inclusion of balances in the Corporate 10k reports. Inaccurate pipeline reporting could result in	Although the discrepancies resulted from data problems within the WaMu Optis Value system, management devised a form for employees to use to check the information input into FiTech. By August 2005, the use of the form will be fully implemented. The effectiveness of the remediation efforts will be monitored through a series of in-house audits which will be completed during the first quarter of 2006.

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AUDIT ISSUES & MANAGEMENT ACTION PLANS

	AUDIT ISSUE	RISK	MANAGEMENT ACTION
		poor business decisions, regulatory non-compliance and inaccurate financial reporting.	
8	***Manager Approval for Wire Requests (Observation)*** Evidence of wire request authorization by a LFC Team Manager is not specified on the Funding Template and is not always evidenced as required by policy on the "Wire Funds Information Sheet." Several instances were found where the "Wire Funds Information Sheet" was approved by a level below that of an LFC manager or for which no authorization was evidenced. Although wire logs are received twice daily from the Funding Quality Control department and LFC managers are required to review the validation of the wires to the log, no evidence of review is required or maintained.	Unapproved or misdirected disbursement of loan proceeds puts the company at risk for losses and errors in the funding process which impedes operational efficiency and could result in customer dissatisfaction .	Management feels that notification by the Funding Quality Control department for wires that cannot be sent and the related reversal of the wire in the LOS along with the the wire logs prepared twice daily and sent to the LFCs mitigates the risk of unapproved wires. However, management will clarify through additional training, the applicable documents to be reviewed and signed by the Team Manager. The effectiveness of the remediation efforts will be monitored through a series of in-house audits which will be completed in the first quarter of 2006.

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From:	Carter, Lawrence D
Sent:	Friday, August 13, 2004 12:53 PM
To:	Finn, Michael E <finnme@office of thrift supervision.com>
Cc:	Chow, Edwin L <chowel@office of thrift supervision.com>; Dyer, Nicholas J <dyernj@office of thrift supervision.com>
Subject:	Craig Chapman

As you suggested, I contacted Craig Chapman yesterday to bring him up to speed on our findings and conclusions in the area of home lending. I also suggested to Craig that we talk regularly. Our next call is scheduled for 8/23 at 9 a.m. He will include Mark Hillis next time, who is the new chief credit officer over the home lending area. We will talk more about progress in moving forward in improving home lending operations. Mark has already put in place a lot of changes and should be able to provide some feedback on how those changes are taking hold.

Craig has been around the country visiting home lending and fulfillment offices. His view is that band-aids have been used to address past issues and that there is a fundamental absence of process. He indicated that Craig Davis had an approach of "mass customization," i.e., trying to make every loan they could rather than concentrating on a narrower, homogeneous product set of profitable products. Craig Chapman will be working to get more focused on a profitable product set and establish processes that can be carried out consistently across the various home loan and fulfillment centers. I advised Craig that he was on the right page and that execution of his plans should address our issues with underwriting inconsistencies and simplify the process of addressing our other issues with pricing and data integrity. Craig is well aware of channel pricing issues and risk-based pricing issues at the loan level. I reiterated to Craig the importance of addressing the need to identify and properly manage subprime lending activities head on. I told him thoroughly supporting capital allocation was critical in that we were requiring double risk weighting or more for many of our institutions who could not support lesser capital on their own. I told him we really would like to avoid dancing around the issue of using the term, "subprime," with which he wholeheartedly agreed.

Nick had received two "complaints" from competitors, on which I followed up with Craig: (1) WAMU qualifying borrowers at rates as low as 4-4.5 percent and (2) WAMU matching Countrywide's significant dropping of start (teaser) rates. Craig will follow up to see what WAMU has done in these two areas of underwriting and obtain supporting rationale as appropriate. He should be providing me a response by email.

I asked Craig whether the organizational structure would change now that he is in charge of mortgage banking, to which he responded "no." Essentially, Craig will manage the mortgage banking segment of the Consumer Group, even though Deanna still heads up that group. In other words, mortgage banking will not be moved to the Commercial Group nor, as best as I can tell, will Craig and Deanna's roles change as heads of the two main business segments.

I asked Craig about competition with Countrywide. He believes Countrywide has a very broad product set. He thinks Countrywide's service is as bad as WAMU's right now. He concedes Countrywide has better technology. Craig wants to improve WAMU's service in terms of turnaound times and become a low-cost producer of a narrower range of products. He believes WAMU would have a competitive advantage here.

In terms of losing people, Craig feels they have not really lost many individuals they did not want to lose anyway. Candidates for CFO are coming in next week. Morale is somewhat of an issue in the Loan Fulfillment Centers because that is where a lot of changes are occurring. Otherwise, he feels they are okay.

As an aside, as Nick already informed you, I am trying to set up a call for next Monday or Tuesday with Tom Casey to get his take on what BlackRock meant in their presentation as far as regulators impacting MSR valuation and hedging practices.

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Report Footnote #275

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From: Rotella, Steve
Sent: Wednesday, February 16, 2005 3:31:27 PM
To: Meola, Tony T.
Subject: FW: Follow-Up on Credit Expansion Discussion wwith Diane

I am beginning to have some fun with this.

-----Original Message-----
From: Hillis, Mark R.
Sent: Wednesday, February 16, 2005 10:31 AM
To: Rotella, Steve
Subject: RE: Follow-Up on Credit Expansion Discussion wwith Diane

I do not agree. The grids and the BEDE engine do the following:

1) All products are eligible for approval. Today there is a 680 min FICO requirement for 5/1 IO loans. Under the BEDE grids (which are in production today), the 5/1 IO's, 7/1's, etc can be approved down to 620 automatically by the system. All Tim is saying is that given we are using a proprietary algorithm, we can't just say to the field that all 620's will be approved automatically. It is dependent on their overall credit profile, and the internal models use LTV and mortgage credit performance and large drivers of the score – something FICO does not.
2) The LTV approvals for solid customers are well above the levels approved today.
3) We also have an approved to component in the system. If a borrower applies for x amount at y LTV, we may in fact (and over $1B/month do), provide LTV guidance and loan amount guidance that exceeds their requests.
4) The BEDE system and these rules are operating today in the LFC's. John Schleck has seen the value, and it is significant, I just don't think Tim explained this well.

I will send more concrete information across. Please let me know if you want to discuss.

> -----Original Message-----
> **From:** Rotella, Steve
> **Sent:** Wednesday, February 16, 2005 10:19 AM
> **To:** Hillis, Mark R.
> **Subject:** FW: Follow-Up on Credit Expansion Discussion wwith Diane
>
> So, sounds like there isn't much new news after all. Do you agree?
>
> -----Original Message-----
> **From:** Meola, Tony T.
> **Sent:** Wednesday, February 16, 2005 6:08 AM
> **To:** Rotella, Steve
> **Subject:** FW: Follow-Up on Credit Expansion Discussion wwith Diane
>
> FYI
>
> I Didn't think we had any "good news" items I was holding back from the field unfortunately I was correct.
>
> -----Original Message-----
> **From:** Bates, Timothy
> **Sent:** Tuesday, February 15, 2005 7:33 PM
> **To:** Meola, Tony T.
> **Cc:** Ludlow, Diane L.; Hillis, Mark R.
> **Subject:** Follow-Up on Credit Expansion Discussion wwith Diane
>
> Tony,
>
> Diane asked me to email you regarding progress on the discussion and request you made earlier today to assemble some examples of enhancements surrounding credit policy that will be welcomed by sales. We're still plugging through some analysis and verifying a few things with Ops folks, but here's a general sense of what we're going to provide.

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The most significant enhancements are centered around expanded LTV and loan amount parameters based on our new underwriting grids; specifically, we will be able to auto-approve loans up to $1 mil at up to 90% LTV. Since the relief is primarily driven by the PM2 score with combinations of other factors such as Owner Occupied, Cash Out, and Number of Units, it's difficult to put a hard and fast statement out there about Fico. We have to do a little bit more analysis to provide the general Fico parameters, but we this should provide a general sense of what we're doing.

So, by tomorrow we should be able to provide a statement such as this: For loan amounts up to $1 million, and for Fico scores down to X (analysis due back tomorrow), Owner Occupied, 1 Unit and No Cash Out, we will go up to 90% LTV with an auto-approval. Also, on these same deals, we will also provide income and asset documentation relief to the borrower.

This would apply to the following products:

- 1 and 3 month Option ARM
- Flex 3 and 5
- 5/1 I/O

Do you want to provide this with a targeted implementation date or just take this to President's Club as an example of the expansion?

Hope this is what you're looking for- let me or Diane know if you have any questions or if you're looking for something different.

Tim Bates
Washington Mutual
Enterprise Modeling and Decisioning Systems
206 377 4919 voice
206 490 4427 facsimile
timothy.bates@wamu.net

From: Feltgen, Cheryl A.
Sent: Wednesday, June 14, 2006 1:07:03 PM
To: Pollack, Wayne A.
Subject: FW: FW: HEQ

Attachments: Picture (Metafile)

From: Hillis, Mark R.
Sent: Wednesday, June 14, 2006 7:32 AM
To: Feltgen, Cheryl A.
Cc: Myhre, Jennifer; Kido, Ken; Cathcart, Ron; Corcoran, James
Subject: FW: HEQ

Cheryl,

I wanted to weigh in on a couple of the items you've identified for the Equity expansion opportunities.

On the first two bullets, you are right on. We are tracking well toward a July 80/20 implementation and it is going well. Also, you guys did a nice job on the ERMC portfolio purchase decision, and that seems to be moving along well.

Regarding the next two items, I'm assuming you are looking at sub-prime second models for Longbeach. If not, we need to sit down and have a role clarity discussion. Our team is currently focused on several HE modeling initiatives to include higher risk lending and the next generational enhancement of our existing custom algorithms. We are in the final validation stages of a tool that will be implemented in October to swap-in much more of the 580-620 population and enhance our 620-660 approval rates. In the interim, we are adjusting our decision engine rules for a July roll out to allow for 580-620 and LT 80% CLTV loans to be referred to a manual "sub-prime" underwriting team that we are putting in place. Of course I still need to run this by the CPC for final approval.

On your bullet point for the opportunity we've done a very thorough scrub of our TTD population and we see this 580-620 segment as the biggest opportunity where we aren't lending today. Clearly, there are additional market opportunities through the capital markets side that you'll exploring.

Finally, on the collateral side we have some individuals who've done some really good work on AVM validations as well as the overall cascade logic that we utilize. We expect some nice quality enhancements and cost saves as this logic is implemented this summer.

In this expense environment, we need to make sure we have everyone focused on the right things, and to avoid duplication and/or overlap if it exists. If you see this differently, then let's sit down and discuss.

Let us know how we can further help. We've got good momentum going, as evidenced by our May jump in approval rates given the March rule and policy changes that we made. We are now seeing more of a bar-bell distribution starting to occur with more lending being done down in the lower score intervals. These further changes will enhance that considerably.

From: Kido, Ken
Sent: Tue 06/13/2006 3:18 PM
To: Myhre, Jennifer; Hillis, Mark R.
Subject: FW: HEQ

-----Original Message-----
From: Schneider, David C.
Sent: Tuesday, June 13, 2006 2:36 PM
To: Rotella, Steve; Kido, Ken
Subject: Fw: HEQ
Importance: High

An update on the HE issue.

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Wall Street & The Financial Crisis
Report Footnote #303

-----Original Message-----
From: Feltgen, Cheryl A.
To: Schneider, David C.
Sent: Tue Jun 13 13:10:30 2006
Subject: FW: HEQ

David:

There are various activities that have been completed or are underway in connection with "expanding the home equity credit parameters":

* Our "80/20" program has all needed credit approvals. By the end of June, we will be able to offer a WaMu first/non-WaMu second and by the end of July, we will offer a WaMu first and a WaMu second. The later is dependent on Retail Bank systems (Visual Banker, Transact). We were able to work together to move it up in their technology queue from November to July. The program is 100% CLTV (previously only 95% was offered), $250,000 second, max combined loan amounts of $1.25 million, FICO down to 620.

* $4 billion home equity investment program approved with some delegated authority to Home Loans in the inaugural Enterprise Risk Management Committee last Friday. High CLTVs (up to 100%) and lower FICOs (down to 600) permitted with some concentration limits.

* Vijay Bhasin and team are building a subprime scorecard for EDE that will enable the greater understanding of the risk and return tradeoffs for subprime home equity

* Vijay Bhasin and team are working on the analytics necessary to identify the "sweet spot" in the FICO/LTV possible combinations for optimal risk and return. Mark Hillis has completed an analysis which I have seen which suggests the targeting of the lowest FICOs (580 to 620) in combination with the lowest CLTVs (less than 80%). Vijay's analysis will help us to confirm whether Mark's recommended approach is indeed the "sweet spot". Mark Hillis has not shared all the details of what he plans to do, but I believe he intends to present something to the Credit Policy Committee in July.

* Collateral risk is important for this product type and credit profile. Vijay will also be working on analytics to better assess collateral risk and hence identify opportunity.

We do see opportunity in continuing to expand the credit box for home equity. It is one of the elements of our effort to increase credit risk while achieving the appropriate risk-adjusted return.

Cheryl

From: Schneider, David C.
Sent: Monday, June 12, 2006 1:34 PM
To: Feltgen, Cheryl A.
Subject: FW: HEQ

From: Rotella, Steve
Sent: Monday, June 12, 2006 1:11 PM
To: Kido, Ken; Schneider, David C.
Subject: HEQ

Where are we in examining the possibility of expanding the home eq credit parameters?

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From:	Feltgen, Cheryl A. <cheryl.feltgen@wamu.net>
Sent:	Sunday, February 5, 2006 2:54 PM
To:	Joans, Michelle L. <michelle.joans@wamu.net>; Shaw, Robert H. <robert.shaw@wamu.net>
Subject:	Fw: 80/20

Michelle and Bob:

See attached string of emails. Michelle, please contact Ralph Melbourne to understand exactly what is wanted to allow 80/20 in Retail and Wholesale. Then work to prepare request for approval. Bob, your help will be needed. Bob, note my comment below that I think we should raise the subject at the QBR meeting to assess the level of support we will receive from Hugh etal. Keep me advised of the progress and what you hear from various interested parties.. Thanks for your help.

Cheryl

Sent from my BlackBerry Wireless Handheld

-----Original Message-----
From: Meola, Tony T.
To: Schneider, David C.; Feltgen, Cheryl A.
Sent: Sun Feb 05 10:27:47 2006
Subject: Re: 80/20

Spot on, the issue is a role clarity - the consumer bank plays the role of portfolio manager as does alco and to a degree credit. There is no one decision maker in the world of heloc. We all think we "own it and thus there is no final say" that clarity would unlock this - very similiar to the underwriting debacle we sorted through. This is an endless voting process.

ATM

-----Original Message-----
From: Schneider, David C.
To: Meola, Tony T.; Feltgen, Cheryl A.
Sent: Sun Feb 05 10:23:14 2006
Subject: RE: 80/20

A few thoughts:

1. The process seems to be flawed when a product can be ☐tabled☐ until next meeting. Why are we running the business based one meeting schedules? Also, I have no problem with credit expressing concerns about controls, etc. I do think, however, that their main job is to approve credit parameters. They should, of course, set the right expectations for control and I think it would be appropriate to request a final sign off that would allow credit to review the controls that are established by the business and ensure they are adequate.

2. I don☐t understand the concerns from the retail bank. We are working with them on a number of projects and I assume this is aligned under Ralph and his team.

We need to decide soon that this will or will not be ok from a credit perspective.

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From: Meola, Tony T.
Sent: Sunday, February 05, 2006 6:06 AM
To: Feltgen, Cheryl A.; Schneider, David C.
Subject: RE: 80/20

The issue is pretty simple - we do not have an 80/20 capability at all on any jumbo product. While we did just get the capability on agency product for retailt, we process, close and deliver the product in Nexsta's name. Wholesale odesn't have it and Correspondent has not been approved yet, Hillis tabled it at the Credit committee as you know, I have kept it in the May release in spite of that. Let us deal with the system issue, we do a number of things today that our systems do not support (eg : Wholesale Equity Lending), that is a bit of a smoke screen in this history. Thanks Cheryl.

From: Feltgen, Cheryl A.
Sent: Sat 02/04/2006 9:28 PM
To: Schneider, David C.; Meola, Tony T.
Subject: RE: 80/20

David and Tony:

The whole subject of □80/20□ (and also 100% CLTV loans) is a complicated story at WaMu with a history (as Tony knows). . .the discussion of it stretches back for probably years. There has historically been some resistance from Enterprise Risk to aspects of it. Let me try to describe where we are now and what I think needs to be done to get to where I believe the two of you want to be.

On first mortgages:

We now have products with a 100% CLTV. Until late last year/early this year, the system would not support it and we finally now can support the conf FRM as a 100% CLTV. The conf Hybrid is approved and the system will be updated mid-06 to allow us to implement it. Option ARMs have a max CLTV of 95% and interest only has a max CLTV of 90%. Further, 100% CLTV opportunities, beyond what Fannie/Freddie permit, are now available in the Alt A product in the Correspondent and Retail channel, with Wholesale coming out with the implementation of Dorado.

On second mortgages:

In Correspondent, a proposal was presented at last week□s Consumer Credit Subcommittee to introduce a second that could go to 100% CLTV behind our Alt A first. The intent is to sell these loans to WCC for immediate securitization with minimal warehouse time. The vote was tabled until next month□s meeting. Further information was requested by Mark Hillis about controls and how issues would be managed. Mark Hillis and Jennifer Myhre also wanted to do a comparison to the controls that are being built in the Retail Bank for their new stand alone equity product originated for a secondary market execution. Despite the delayed vote, implementation is still on track for May 2006. We will work to cover all the bases before the next meeting to assure approval.

Beyond Correspondent, we have no system capability to process the seconds. Possible solutions might be to outsource to Nexstar as we do now for Retail/Consumer Direct. When/if we implement Palisades (still a long time from now), it has that capability. I understand also that MLCS can be made to include that functionality, but doesn□t have it today. If we wanted to make this a priority from a systems standpoint, other projects would need to be deferred to accommodate it, which could certainly be done. I don□t really control that.

As we progress our thinking on the 80/20s, there may be some resistance from the Retail Bank seeing our efforts as infringing on theirs. They are working on a stand alone equity product that would be originated through correspondents. It would be sold in the secondary market. They may expand beyond that in the future. (Note: there is currently a Board Policy that prohibits the holding of first/second 100% CLTV loans). Corporate Credit Risk has some concerns given the point in the housing cycle and given the pending interagency guidance on higher risk lending. These concerns can certainly be addressed, but it is an item to be aware of.

Tony, you have asked that my team develop credit/underwriting guidelines for 80/20 loans that would be originated in the Retail and Wholesale Channels. We can do that working with Ralph Melbourne and his Product Development Team. At the moment, I don□t see the development of guidelines as the constraint, but rather developing the system capabilities and making them a priority. I think it is typically Ralph and team (Krysti Kovarik) that leads that effort. We will be happy to help where we can.

We have the HL Quarterly Business Review with the Corporate Credit Risk team on Wednesday, February 15 from 3:00 to 4:30 p.m.. David is scheduled to attend with me. David, I think it would be good for us to raise the subject so that you can express your enthusiasm for the product and so that we can assess the support we will receive from Corporate Credit Risk. Tony, I had spared you from this meeting, but it might be good to have you on for at least part of the call as well, particularly to talk about this subject. As you may recall, we included it in the Front End Guidance that we reviewed with them, but really didn□t have time to discuss it.

Would welcome your thoughts. Thanks.

Cheryl

From: Schneider, David C.
Sent: Friday, February 03, 2006 10:34 PM
To: Meola, Tony T.; Feltgen, Cheryl A.
Subject: RE: 80/20

What is the answer?

From: Meola, Tony T.
Sent: Thu 02/02/2006 10:48 AM
To: Feltgen, Cheryl A.
Cc: Schneider, David C.
Subject: 80/20

Cheryl,

We continue to get pressure for the 80/20 product particularly in the jumbo arena, where are we on the 80/20? To date we have said we would consider it, Long beach has it, but we have been reluctant to grant it to homeloans. There maybe some systems issues, but I think we can side step them. This was a follow up to David□s Cedarbrook meeting.

From: Schneider, David C.
Sent: Friday, November 30, 2007 4:44:33 PM
To: McMurray, John; Killinger, Kerry K.; Rotella, Steve; Cathcart, Ron; Casey, Tom; Corcoran, James; Baker, Todd
CC: Beck, David; Berens, John; Woods, John F.
Subject: RE: Modifications

John,

Thanks for putting together this summary. I agree with your points and they are consistent with our current plans around this issue. As of this time, it is my sense that we need to be prepared to work all borrowers who are current and express a willingness to stay in their home. This will, by necessity, be a loan by loan process although we can streamline some of the activities required to execute a mod.

I also think it is clear that the economic benefit of providing modifications for these borrowers is compelling for the following reasons:

- None of these borrowers ever expected that they would have to pay at a rate greater than the start rate. In fact, for the most part they were qualified at the start rate
- We need to provide incentive to these borrowers to maintain the home - especially if the home value has declined
- When we booked these loans, we anticipated an average life of 2 years and never really anticipated the rate adjustments

All that said, we are doing the math to show breakeven points. My sense is that Mods are the best bet. In fact, this is what the investment community is saying through their support of the national efforts.

ds

From: McMurray, John
Sent: Friday, November 30, 2007 3:08 PM
To: Killinger, Kerry K.; Rotella, Steve; Cathcart, Ron; Casey, Tom; Schneider, David C.; Corcoran, James; Baker, Todd
Subject: Modifications

There have been numerous separate conversations over the past several days on modifications. These discussion have included the potentially material consequences on provisions and sale treatments. The purpose of this email is to briefly summarize the situation and advocate three recommendations.

I. **Political Reality.** The political reality of this situation is increasingly misaligned with economic and accounting realities.

A. Activist Agenda. The activists have their own agenda and have exploited this situation by out-lobbying banks and investors. In some respects, previous activist activities around expanding homeownership via more accommodating credit standards may have ironically contributed to the current situation. A common refrain I've heard from various activists is: "get 'em in, keep 'em in."

B. Existing Processes. Except for isolated (mostly subprime only) servicers, there were already robust processes for work-outs and modifications (see II.A . below). This fact was so poorly communicated by the industry that it now matters little from a political perspective.

C. Foreclosure Consequences. Another poorly communicated, or at least poorly understood, fact is that lender/investors do not benefit from a foreclosure.

II. **Economic Reality.** Modifications should be pursued to optimize the economic consequences for the affected parties (i.e. the borrower and lender/investor), whose interests are usually aligned in a default situation.

A. Existing Practice. For most, if not all, of the situations where a modification would make sense, loans were already being modified by mainstream servicers. Existing practice is to tailor the work-out or modification to the specifics of each situation thereby maximizing its chance of success.

B. No Panacea. The "one-size fits all" modifications being promoted in DC will likely be much less successful than advertised. Here are a few reasons where a modification many not be successful:

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1. The loan was for a speculative purchase. These transactions were more prevalent in this cycle even though some consumers may have camouflaged the true nature of their transaction.

2. The consumer purchased a new property and cannot sell their previous property, which they no longer occupy.

3. The consumer has negative equity and does not wish to remain in the property.

4. The consumer can't afford any payment as the result of a job loss or other actuarial event. Some of these situations can be saved with a work-out plan, but a simple rate reduction isn't one of the approaches that typically works.

C. Economic Alignment. The approach John Woods described in Wednesday's MCR is the right one. We need to have a reliable model/approach for predicting which specific modifications are likely to be economically viable. An unviable modification where the consumer eventually defaults is adverse to the interests of all parties, including the consumer, the lender and the investor (for sold portfolios).

III. **Accounting Reality.** The accounting issues relative to modifications have been raised repeatedly. So far, however, those entities which need to provide relief (e.g., FASB, SEC) have not seemed anxious to do so.

A. HFI portfolio. The provision for anything we modify is generally going to be higher than had we not modified the loan.

B. Sold Portfolio. A misstep here could have catastrophic consequences with many sold loans coming back onto the balance sheet.

IV. **Recommendations.** My recommendations are outlined below. I believe that some of these approaches may already be embodied in the initiative underway, which was commissioned by Schneider and led by Beck.

A. Viability. We should seek to do only those modifications that will be economically viable because that's what's best for the affected parties (borrower and lender/investor).

B. Company Position. Wherever we ultimately land with regard to changes in our work-out and modification strategies, we should crystallize our internal and external positions on this high visibility issue to promote understanding and avoid being outmaneuvered by those with competing agendas.

C. Accounting & Economic Consequences. We should understand the accounting and economic consequences before committing to any large-scale modification program.

Hybrid ARM Lending Survey

1. Hybrid ARMs are offered to many different types of borrowers. Of your hybrid ARM[1] offerings, what percentage (and amount) is lent to subprime borrowers? What percentage (and amount) would be considered Alt-A? For the two groups, what percentage (and amount) includes a "below-market" introductory rate? A "market rate" for this purpose might be considered the current fully indexed rate on the loan if it were reset today according to the terms of the contract.

Answer:

- Hybrid ARMs with 2-yr or 3-yr introductory rates represented approximately 66% of subprime channel origination volume in 2006, none of which were considered Alt-A. The subprime channel does not offer Alt-A products, which represent approximately 13% of February 2007 total volume, down from 15% in January 2007. Alt-A Hybrid products with introductory rate periods of three years or less represent less than 1% of total Alt-A volume in February 2007.
- All (100%) of the hybrid ARM products have introductory note rates that are below their corresponding fully-indexed rate. However, these introductory rates are closely matched with their corresponding term in the market yield curve. Thus, we do not consider an introductory rate that is tied to the market yield curve but below the fully-indexed rate to be "below market".

2. What are the borrower qualification criteria for subprime and Alt-A Hybrid ARMs? Specifically, what is the interest rate used to calculate the DTI ratio and how does this rate relate to the initial note rate, the fully indexed rate and the lifetime maximum rate? What are the maximum LTV and DTI ratios allowed? Are taxes, insurance and other housing related expenses included in underwriting subprime and Alt-A Hybrid ARMs? How do lower credit scores, higher LTV ratios, stated income and credit history affect the qualification analysis?

Answer:

- The note rate is used to calculate the qualifying monthly payment and DTI ratios. Taxes, insurance and other housing related expenses as well as other debt payments are included in the monthly payment calculations for both disposable income and DTI requirements.
- For Subprime currently up to 100% LTV/CLTV with 50% DTI is allowed for Full Doc depending on FICO score. Up to 95% LTV/CLTV is allowed with 50% DTI for Stated Doc depending on FICO score. There are higher FICO score minimum requirements for lower Credit Grades and higher CLTV. Usually higher FICO score is required for Stated Doc than Full Doc.
- For Alt-A Full Doc programs, currently up to 97% LTV / 100%CLTV with 45% DTI is allowed depending on the FICO score. For No Income Verification, No Income No Ratio, and No Income No Asset only up to 95% LTV/CLTV is allowed.

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[1] In this document, Hybrid ARMs refers to hybrid adjustable rate mortgages for which the interest rate is fixed for a relatively short period such as two or three years.

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- Risk-based pricing is applied to all subprime and Alt-A Hybrid ARMs. Higher risk transactions require risk-adjusted pricing (mostly by Doc type, FICO score and CLTV). Additional risk-based pricing add-ons are applied for various layered risk such as Non-owner occupied and multiple unit housing. Risk-based pricing is reflected in the note rate and qualifying rate. Loans that are not approved using an automated underwriting system are evaluated and qualified by seasoned underwriters, who utilize all information provided by the applicant to determine qualification and reasonableness of stated income or stated assets.

3. Given your experience, what is the percentage of subprime and Alt-A hybrid ARM borrowers who (a) prepay by refinancing into loans classified as prime products (b) prepay by refinancing into another subprime or Alt-A hybrid ARM product, or (c) do not prepay. For each group, indicate whether those borrowers' credit scores improved or declined (and by how much) during the initial fixed-rate period.

Answer: With a subprime market share of less than 10%, WaMu does not have much experience with Hybrid ARM subprime borrowers refinancing with WaMu and we do not control the lender selected by mortgage brokers, who source almost all volume through our subprime channel. However, we have a program that assists subprime borrowers to receive prime products and pricing when inquiries occur. Most subprime borrowers payoff their loan prior to the expiration of the contractual term, frequently before or just after the end of the introductory fixed-rate period if a Hybrid ARM.

4. For subprime and Alt-A Hybrid ARMs originated through broker or correspondent channels, do the third party's underwriting standards vary from the guidelines you use for originating your own loans? In what ways? What is the usual compensation for third parties involved in originating subprime and Alt-A Hybrid ARMs versus subprime and Alt-A non-Hybrid ARMs? Is third party compensation influenced by the existence of a prepayment penalty on subprime and Alt-A Hybrid ARMs?

Answer:

- We currently do not have different underwriting standards for brokers. We have also tried to match the correspondent underwriting standards or what we purchase from them with our own underwriting guidelines.
-
- The YSP that brokers can earn is limited to 1% for subprime loans that do not have a 3 year prepayment penalty. Brokers negotiate rates, fees and points with the borrower, which the brokers can choose to have paid in the form of a YSP. In some cases, a prepayment fee is required in order for WAMU to recoup enough yield to cover the YSP in the event that the loan pays off early.

5. By product type, can you provide examples of Notes and any Riders, copies of Regulation Z, and RESPA disclosure statements provided to consumers when originating subprime and Alt-A Hybrid ARMs. Also, can you provide copies of any additional documentation distributed to or targeted to consumers that describes subprime and Alt-A Hybrid ARM terms. Please include sample solicitations and other marketing materials.

Answer: See attached documentation. We have provided copies of the ARM Program Disclosures, TIL Disclosure statements and the notes used in our subprime channel. We have also attached the ARM program disclosures and notes used for our Alt A Hybrids. We will be following up with the TIL Disclosure statements for the Alt A Hybrids and sample marketing materials.

6. Given the potential for payment shock associated with subprime and Alt-A Hybrid ARMs that have "below market" introductory rates, how does the institution determine a borrower's repayment ability once the rate and payment increases (particularly for borrowers with lower credit scores, high LTV ratios or high DTI ratios)?

Answer:

- WaMu does not directly evaluate a subprime borrower's ability to repay their Hybrid ARM loan after the introductory rate and term expire. Our underwriting process is consistent for prime and subprime originations, in which future events are not considered (changes in interest rates, household income or debt, sources of income, property values or other criteria used in the underwriting process). We perform employment verification, and check the reasonableness of the income on all applicants. We also have managed the risk of borrowers by other means such as eliminating layered high risk borrowers by FICO, CLTV, loan purpose and loan documentation type. Historically, we have found these factors to be far more predictive of loan performance than projected DTI ratios.

From: Joans, Michelle L.
Sent: Wednesday, March 1, 2006 6:56 PM
To: Gordon, Scott A. <scott.gordon@wamu.net>
Subject: Re: Tommy Ramirez

Especially wo MI!
Michelle Joans
Washington Mutual Bank, FA
Manager, Credit Policy
206-490-5552
CSQ 608

-----Original Message-----
From: Gordon, Scott A.
To: Joans, Michelle L.
Sent: Wed Mar 01 15:46:35 2006
Subject: RE: Tommy Ramirez

I'm not sure Cheryl and/or David have the authority to put these loans in the portfolio. Rick Ellson would need to agree - based on previous experience it will be a very difficult to sell him on the concept.

Scott Gordon
Home Loans Credit Product Management
415.336.6425

This message (including any attachments) is CONFIDENTIAL and may contain SENSITIVE information. DO NOT disseminate this information to parties who do not have the authorization to view this material.

-----Original Message-----
From: Joans, Michelle L.
Sent: Wednesday, March 01, 2006 3:44 PM
To: Gordon, Scott A.
Subject: Fw: Tommy Ramirez

What do you think of Cheryl's comment about no MI??? I wanted to say, no way.
Michelle Joans
Washington Mutual Bank, FA
Manager, Credit Policy
206-490-5552
CSQ 608

-----Original Message-----
From: Feltgen, Cheryl A.
To: Joans, Michelle L.
Sent: Wed Mar 01 15:37:27 2006
Subject: Re: Tommy Ramirez

Thanks, Michelle. Look forward to getting the material. You guys can send it to me in an attachment. I will synch up my laptop in my room and then take it with me to the meeting. As to partners, I think where we are headed is that we would keep this in the portfolio since it is likely unsaleable by the time we are done. I think Tommy wants us to do this without MI.

Cheryl

-----Original Message-----

From: Joans, Michelle L.
To: Feltgen, Cheryl A.
Sent: Wed Mar 01 15:19:32 2006
Subject: RE: Tommy Ramirez

Should have something to you in an hour or so - I am hoping that Ernie's email provided some of the background you were seeking - Scott and Ernie are in a much better position to talk to you about the past, as there is an extensive past as you might sense from the passion in Ernie's response! (-:

I think you will find that our summarized feedback will describe where we might be able to offer more and quite frankly, where those loans are now on a system that will enable us to allow DU EA approvals.

This pilot is a jumbo inner city affordable product, combining all the features of our lending up to $650k and > 95% LTV. We agreed to allow the use of DU and at the time could not allow DU EA due to system issues. DU EA (Desktop Underwriter Expanded Approval) is virtually Alt A or A- lending.

Other influences:

Our MI partners. Only one stepped forward and recently PMI was interested. This is another area we could explore and maybe negotiate more expansive guidelines but everyone has to be clear that this is not all up to us, we have external partners to deal with.

From: Feltgen, Cheryl A.
Sent: Wed 03/01/2006 1:23 PM
To: Joans, Michelle L.
Subject: RE: Tommy Ramirez

Thanks, Michelle. I am meeting with David, Tony and Wayne in a few hours this afternoon. Send things to me so that I can read in the body of the email. I need to know what we have allowed Tommy to do in the past, the details of the pilot and most importantly what it is that we would recommend we do in the future. Can you send me again the details of the DU EA? I am not sure I really understand the implications of what you described below. Steve Rotella obviously now has a feeling that we have taken forever and not provided much to Tommy and his team. Whether that is true or not, Steve has put us in a position that we will have to offer up something. I look forward to receiving the information. Thanks.

Cheryl

-----Original Message-----
From: Joans, Michelle L.
Sent: Tuesday, February 28, 2006 8:15 PM
To: Feltgen, Cheryl A.
Subject: Re: Tommy Ramirez

I will be in early and plan to have something waiting for you. Can you provide any insight into David's comment about a broken process. We created a product eclusively for this loan consultant and what he wants is an alt a like product. Can you open attachments or do you want everything in the body of the email.

1. Ability to make fico exceptions locally - we talked about this a little bit and I am all for pushing authority to the loan level. Not sure about the request though, the example provided appears to be around the 680 for low doc, the uw can go to 660, so is this request that they can go further locally and up to 80 points below the requirement? This is an extreme exception and again brings us into alt a territory. If we decide to do this, we need to address it for the entire country from a fairlending perspective I would expect. Then, where we reqiure 680, is a 600 ever acceptable?

2. They want us to accept cash on hand. We do to a certain extent but this is really an issue for investors as assets from the borrower or the borrower's investment is a critical factor. Tomorrow I will give you the facts of the program.

3. I had sent you an outline of this program. During the last review it was determined that being able to us DU EA would bring a significant lift and we are very close to working this out. Before they got off to an alt a type product, everyone acknowledged that the loans were being approved under DU EA. We are overcoming system issues to get this done.

I have not idea what the comment about realtor broker fees is about. I will follow up with Scott and Ernie, do you have any ideas?

These loans are generally over 80% and subject to MI - a significant factor.

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Michelle Joans
Washington Mutual Bank, FA
Manager, Credit Policy
206-490-5552
CSQ 608

-----Original Message-----
From: Feltgen, Cheryl A.
To: Joans, Michelle L.; Shaw, Robert H.; Mortensen, Ernie
Sent: Tue Feb 28 18:34:24 2006
Subject: Fw: Tommy Ramirez

See attached and my earlier email. I need as much of what I asked for as you can possibly put together in time for my meeting with David , Steve and Tony tomorrow. Thanks.

Cheryl

-----Original Message-----
From: Schneider, David C.
CC: Feltgen, Cheryl A.; Meola, Tony T.; Pollack, Wayne A.
Sent: Tue Feb 28 16:53:18 2006
Subject: Re: Tommy Ramirez

Having sat through the wholesale meeting and seeing this from steve, my conclusion is that there is a broken process. We have all been in place long enough to recognize that we can no longer blame the old team. Let's have the 4 of us get together tomorrow (say late afternoon at 5) to discuss. Does that time work?

-----Original Message-----
From: Rotella, Steve
To: Schneider, David C.
CC: Feltgen, Cheryl A.; Meola, Tony T.
Sent: Tue Feb 28 15:18:45 2006
Subject: Tommy Ramirez

I had a meeting with Tommy and his crew and want to express my views about the work they do and why the company is not meeting their needs and what I think we must do.

David and Cheryl, you are just getting to know these guys, but besides the volume tsunami they produce, they are intertwined in their community and have produced great quality for us. Further, they live our values and are not price conscious I met them last year and was so impressed, I suggested we use them to spawn similar operations in Hispanic communities across the US if possible using them to model, train, and certify the work. Frankly not much has happened.

We should fall all over ourselves to have a business segment that attracts minorities, is almost all Option Arms, is not price driven, delivers great quality, and is oriented to the average guy, our market.

So here I was again a year later withan expectation that they wanted the world. The usual list of demands from whiny mortgage LCs!!?? Nope, a short and I think largely reasonable list of asks that I want to quickly discuss, resolve, and move on. What frustrates me a bit, is if any group has earned some flexibility, these guys have, yet they can't seem to get the process and organization to act without getting "muscle" (read me) involved, which I don't mind.

So what do they want?

1. Flexibility to have their local underwriters go below 660 (to 600) on FICO rather than the cumbersome process of sending these off to other "senior" credit people. This seems ok to me with a good governance process and a random QA process. Again these guys are serious players and deserve flexibility.

2. The ability to count assets in the underwriting that are not in a financial institution at time of the process, but would be a contingency at closing to be in Wamu.

3. Some changes to the 97 product we rolled out that has been a flop. We set a 150mm max test and the criterea have blunted any action. Also the ability to have realtor broker fees on these.

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I would like a quick discussion with you when you return on these and assuming some agreements, a call with Tommy and crew after. Thanks.

Mary, would you set up a 1/2 call with David, Cheryl, and Tony. Thx.

Sent from my BlackBerry Wireless Handheld

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From: Pohlmann, Andrew P.
Sent: Tuesday, June 6, 2006 11:52 AM
To: Perry, Rich <u158466@wamu.com>
Subject: FW: Option ARM Sales Mastery Program

Who can I contact to get enrolled in the HLC manager version of this training program?

AP

-----Original Message-----
From: e-Flash
Sent: Monday, June 05, 2006 1:12 PM
Subject: Option ARM Sales Mastery Program

e-FLASH **Washington Mutual**

Subject: 06.05.06 - Option ARM Sales Mastery Program

To: Retail Production Sales (including Emerging Markets and Banking)
From: Steve Stein

Over the last month, you've heard the details of our refined business model from David Schneider and me. I want to thank you for attending the Production meetings in May, asking questions and working together to support this strategy.

We are beginning to focus on higher-margin products like our flagship product, the Option ARM. This is a fantastic product for almost any borrower. To help our sales force feel more comfortable with selling the Option ARM to a wide variety of borrowers, we are rolling out a comprehensive skills assessment and training initiative. The program was reviewed with all managers on my June 2 conference call.

This initiative is not about selling the Option ARM to everyone. We will always stay true to our values, and provide the right loan for every customer. This is about helping our sales force identify when the Option ARM might be a good choice for the customer, and how to explain the features and benefits of the product effectively. Through the skills assessment, training, role playing and a best-practices selling tips video, I think this Retail sales team will be unstoppable with the Option ARM.

HLC Managers will be proxy enrolled for the Talent Builder curriculum end of day June 6. This will give managers a week to get familiar with the training before Loan Consultants, Associate LCs, and Banking LCs are proxy enrolled end of day June 13.

The Option ARM is our product and we can sell it better than anyone. I have great confidence that we'll improve our Option ARM market share quickly, like the experts we are.

Thank you in advance for attending training and supporting this product.

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Confidential Treatment Requested by JPMC JPM_WM0324605

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From: e-Flash <e-Flash@wamu.net>
Sent: Monday, July 3, 2006 5:47 PM
To:
Subject: 2006 Option ARM Blitz - Quarterly Incentive Campaign
Attach: Retail LC 3-Mo Production_vSFR 6-28.xls

e-FLASH Washington Mutual

Subject: 07.03.06 - 2006 Option ARM Blitz - Quarterly Incentive Campaign

To: Retail Production, including Emerging Markets
From: Steve Stein

You've seen and heard a lot recently about our refined business model and focus on higher margin products, especially Option ARMs. To further drive this focus, I'm pleased to announce the 2006 Option ARM Blitz - Quarterly Incentive Campaign. This will allow eligible Loan Consultants to earn 5 additional basis points on all Option ARM volume funded during the 3rd quarter 2006.

Summary of how it will work:

- Goal: Challenge each Retail Loan Consultant to increase individual product mix percentage funded of Option ARMs by 10 incremental percentage points (or more). Each month during the quarterly campaign – July, August, and September (the measurement months) – the Retail Loan Consultant's individual product mix percentage will be compared independently against the baseline product mix percentage.
- Participants: Tier 3 and higher Retail Loan Consultants in the Retail Loan Consultant position effective 3/1/06. (Banking Loan Consultants and Associate Loan Consultants are ineligible. Tiers 1 & 2 Retail Loan Consultants are not eligible in any given month when at Tiers 1 or 2. However, should he/she subsequently achieve Tier 3, 4, or 5 status during any campaign month, he/she will be eligible for that month.)
- Products: 1 & 3 month MTA & COFI Option ARMs
- Baseline: Loan Consultant's average product mix percentage of Option ARM volume funded during March, April, and May 2006, as queried from FDM.
- Tier achievement: Tier achievement will be determined by the monthly Tier Report produced by the Enterprise Incentive Reporting team.
- Award: 5 additional basis points (in addition to basis points awarded under the 2006 Retail Loan Consultant Incentive Plan) will be earned by eligible participants on all Option ARM volume funded for each given campaign month (July, August, September) if, during such month:
  - The Retail Loan Consultant is Tier 3 or higher, and
  - The Retail Loan Consultant achieves a minimum of 10 incremental percentage points increase in desired product mix when compared against the baseline percentage.
- Reporting: Results from a given month during the campaign will be published via eFlash by the 15th of the following month. For example, July results will be available by August 15th.

For example:
A Loan Consultant funded $2.5M in Option ARM volume for the three months of March, April, and May and had $10M in total product fundings for the same time period, as reflected in data queried from FDM. His/her baseline would be 25% ($2.5M divided by $10M). If, during the month of July, he/she achieves tier 3 or higher and his/her product mix of Option ARMs is 35% (or more) then he/she will earn an additional 5 basis points on all July Option ARM fundings. If this same Retail Loan Consultant achieves 35% (or higher) product mix of Option ARMS in August (or September), then he/she would again earn 5 bps on all Option ARMs that fund in the given month where all criteria for the payout are met.

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Confidential Treatment Requested by JPMC JPM_WM04471113

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Calculation specifics:
The calculation of Option ARM product mix percentage will be based on SFR volume only (Equity products not included) for the baseline periods as well as the measurement periods. The baseline percentage for each Loan Consultant is defined in the attached list. The Option ARM product mix percentage for each of the measurement months will be calculated by Finance based on volume funded for the month as posted in FDM by the first business day of the following month (i.e./ all July fundings posted by August 1st will be July's full month's fundings for calculation purposes).

When earned, the additional 5 basis points will be paid 30 days after the measurement month's end. For example, incentive earned on July Option ARM fundings would be paid at the end of August. The incentive will be paid on a normal month-end paycheck. For Retail Loan Consultants in a partnership, the partnership will be considered to be a solo participant. If the partnership earns the additional 5 bps in any given month of the campaign, the award will be split per the applicable basis point commission split as reported in the partnership agreement. Incentive costs will be charged to the originating HLC's cost center.

This is a brief summary of the program. Full details, including all applicable conditions, will be provided in the 2006 Option ARM Blitz – Quarterly Incentive Campaign Program Document, which I encourage you to refer to.

<u>Following is a selection of material to help kick off your efforts:</u>

Once you click through to any given section, look for other Option ARM marketing available to you in that section.

Presentation:	PowerPoint presentation for Realtors *eMarketing Tools/Presentations 18176*
Consumer Flier:	Promote 1% start rate *Fliers/Consumer 19023*
Matrix:	Product matrix *Printed Collateral/Brochures and Fact Sheets 18060*
Brochure:	Rack-size brochure that provides in-depth descriptions of each of the four payment options and contains the Option ARM Sample Statement *Printed Collateral/Brochures and Fact Sheets 18077*
Ad:	Monthly ad targeting First Time Homebuyers *Ads/Consumer AD-080*

I'm excited about the focus of this campaign and look forward to seeing the results. Let's go out and make it happen!

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From: e-Flash <e-Flash@wamu.net>
Sent: Thursday, August 17, 2006 6:08 PM
To:
Subject: Option ARM Parameter Enhancements

e-FLASH Washington Mutual

Subject: 08.17.06 Option ARM Parameter Enhancements

To: Production and Operations - Consumer Direct, Wholesale, and Retail (including Banking and Emerging Markets)
From: Steve Stein, Arlene Hyde, and John Schleck

PURPOSE

This communication announces the following enhancements to the Option/Flex ARM Products:

- Attached properties (including condos and co-ops) are allowed to higher loan amounts.
- Certain eligibility parameters have been enhanced for low doc second homes.

OPTION/FLEX ARM PARAMETER ENHANCEMENTS

The Option/Flex ARM Enhancements described below are effective on August 21, 2006. All impacted systems will be updated as of this date.

One unit attached properties are now allowed on Option/Flex ARM loans up to $3 million. Product parameters (LTV, CLTV, FICO) will be the same for detached and attached properties for each tier as listed in the Product Parameter pages of the PPG. This change includes the following:

- 1 & 3 month MTA and COFI Option ARM and Flex 5 Option ARM products
- Full and Low Doc
- 1-unit owner-occupied properties and 1-unit second homes
- Purchase, limited cash-out refinance and cash-out refinance transactions
- All attached property types, including 1-unit co-ops

Since product parameters for Option/Flex ARM co-ops up to $3 million will now match the 1-unit product parameters for other attached properties (such as condos), separate Option/Flex ARM Co-op Product Parameter pages will no longer be published in the PPG. A note will be added to the standard Option/Flex ARM Parameter Pages as a reminder of the co-op policy.

PARAMETER ENHANCEMENTS

Option/Flex ARM product parameters have been enhanced to allow greater flexibility. The impacted parameters are Low Doc 1-unit second homes on Purchase and Limited Cash-out Refinance transactions.

Low Doc 1-unit Second Homes (Standard Parameters)

Max Loan Amount	Current LTV	New LTV	Current LTV/CLTV	New LTV/CLTV	FICO
$1.5 million	70%	75%	70%/70%	75%/75%	640
$3.0 million	65%	70%	65%/70%	70%/70%	680

NEW APPLICATIONS AND PRE-LOCKS

- The enhancements are available for all new applications and Wholesale pre-locks received on August 21, 2006.
- Expired locks that relock on August 21, 2006 will follow standard relock policy.

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JPM_WM0327778

PIPELINE LOANS
All pipeline loans as of August 21, 2006 may be eligible for approval under the new enhancements. Standard change request processes apply.

Questions concerning this communication should be directed to your manager. An HLPA is to follow.

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From: e-Flash <e-Flash@wamu.net>
Sent: Friday, August 18, 2006 4:47 PM
To:
Subject: Option ARM Sales Mastery Program Added to New Hire Training

e-FLASH Washington Mutual

Subject: 08.18.06 - Option ARM Sales Mastery Program Added to New Hire Training

To: Managers - Retail Production Sales (including Emerging Markets and Banking)
From: Allen Myers, Home Loans Training

In June, the Option ARM Sales Mastery Program was launched with the goal of increasing knowledge and skills of our sales force in selling the Option ARM, including explaining the product effectively and identifying when the product would be a good fit for a potential borrower.

Effective August 7, 2006 we have extended this initiative to include all new hires in Loan Originator positions by adding the Option ARM Sales Mastery Program to the following mandatory training curricula, available in Talent Builder:

- Power Pac and New Loan Consultant Retail Training Curriculum
- Banking Loan Consultant (BLC) Curriculum
- Associate Loan Consultant Program e-Learning Curriculum

New Loan Originators participating in these training curricula will complete the Option ARM Sales Mastery Program after attending the workshop component of their specific curriculum. Through skills assessment, training, role playing and a best-practices selling tips video, continuing this approach is geared to increase sales performance of the Loan Consultants.

Action Required:
As HLC Managers, you will register new Loan Consultants, Associate Loan Consultants, and Banking Loan Consultants into the appropriate new hire training curriculum referenced above. The Option ARM Sales Mastery Program is automatically included in the curriculum. A critical component to the success of this program is the role play and presentation activities. Remember, you are still responsible for administering, providing feed-back and determining ultimate qualification for each of your Loan Originators.

If you have any questions regarding training, please e-mail us at HomeLoansTraining@wamu.net, and for other training information for Home Loans, visit our website at Home Loans Training.

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #375

From: e-Flash <e-Flash@wamu.net>
Sent: Thursday, August 31, 2006 1:31 PM
To:
Subject: Consumer Direct Pricing Improvements

e-FLASH Washington Mutual

Subject: 08.31.06 Consumer Direct Pricing Improvements

To: Consumer Direct
From: Mary Ann Kovach

Introducing....the pricing specials for September:

The specials for September will focus on three of our higher margin products; Jumbo Fixed, Option Arm, and Nonprime Loans. These specials are in line with our direction to originate high margin products.

1) Option Arms – waive all **closing costs** with the exception of $295 appraisal deposit. Collect $295 appraisal deposit at application. Customer is responsible for paying per diem interest, mortgage tax stamps and escrows.

2) Jumbo 15/30 Fixed – reduce the **rate** by an 1/8th (.125%)

3) Nonprime – reduce the **discount** by .50

Price Specials will be in effect from Friday, September 1st through Saturday, September 30th. Also, Price Specials are not applicable for Employee Loans.

Loan Consultants must complete a pricing exception form and have their Sales Manager approve the form for each loan where the Price Special will be used.

Reminder: All previously announced pricing specials expire on August 31, 2006.

Please contact your manager, should you have any questions.

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Report Footnote #376

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Footnote Exhibits - Page 0085

From: e-Flash <e-Flash@wamu.net>
Sent: Thursday, October 12, 2006 3:12 PM
To:
Subject: Fall Kickoff Classic-Revised October Price Specials
Attach: Consumer Direct HL 4th QTR Sales Contest 09.06 v2.pdf

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e-FLASH Washington Mutual

Subject: 10.12.06 Fall Kickoff Classic-Revised October Price Specials

To: Consumer Direct
From: Mary Ann Kovach

Fall Kickoff Classic

It was brought to my attention that the October Price Specials included in the Fall Kickoff Classic e-flash announcing the contest, were not consistent with the New October Price Improvements e-flash I sent out on 9/28. I apologize for any inconvenience this has caused. Please review the corrected Price Specials on page 2 of this e-flash. See your manager if you have any questions.

Welcome to the Fall Kickoff Classic Contest! Consumer Direct will be hosting the 4th Quarter Fall Kickoff Classic beginning October 1, 2006, which includes weekly contests, a quarterly contest and some great awards!

Weekly Contests

For the 13 weekly contests, the Loan Consultant from each Sales team, who accumulates the most points receives an IncentOne Gift Card with a face value of $100.00.

Option ARM applications	"Touchdown"	(7 Points)
Jumbo-fixed applications	"Field Goal"	(3 Points)
Equity applications	"Field Goal"	(3 Points)
Nonprime applications	"Field Goal"	(3 Points)

In the event of a tie, dollar units will be used to decide the winner.

4th Quarter Contest

At the end of the 4th Quarter, Grand Prize awards will be issued to the top 15 Loan Consultants, Top 3 Sales Managers and Top Site Manager based upon total funded Option ARMs, Jumbo-fixed, Equity, and Nonprime units.

Loan Consultants

Loan Consultants will be ranked based on total Option ARM, Jumbo-fixed, Equity and Nonprime units funded during the quarter.

Ranked 1-5	$1000.00 IncentOne Gift card
Ranked 6-10	$500.00 IncentOne Gift card
Ranked 11-15	$250.00 IncentOne Gift card

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Sales Managers
Sales Managers will be ranked based on average fundings for Option ARM, Jumbo-fixed, Equity and Nonprime for Loan Consultants on their teams during the quarter.

1st place	$1000.00 IncentOne Gift card
2nd place	$500.00 IncentOne Gift card
3rd place	$250.00 IncentOne Gift card

Site Managers
Site Managers will be ranked based upon unit fundings for Option ARM, Jumbo-fixed, Equity and Nonprime within their site for the quarter and the overall winner will be awarded a $1000.00 IncentOne Gift card.

We've announced some great pricing specials for October to get you off to the right start for our Fall Kickoff Classic Contest.

1. Option Arms – we will continue to waive all closing costs and we will not be collecting the $295 appraisal deposit at application. Customer is responsible for paying per diem interest, mortgage tax stamps and escrows.
2. Jumbo 15/30 Fixed – reduce the rate by 1/8th (.125%).
3. **Fixed Rate Loans Over $200,000 – reduce the rate by 1/8th (.125%) (ICO loans are not eligible)**

Price Specials cannot be combined.

Price Specials are not applicable to ICO, Nonprime or Employee Loans.

Go out and make your coach proud this quarter! Originate an Option ARM and score a touchdown or originate a Jumbo-fixed, Equity or Nonprime and score a field goal. Bring home a victory and you will win some great prizes!

Please contact your manager, should you have any questions.

Footnote Exhibits - Page 0087

From: e-Flash <e-Flash@wamu.net>
Sent: Monday, November 13, 2006 6:07 PM
To:
Subject: Consumer Direct November Pricing Improvements

e-FLASH Washington Mutual

Subject: 11.13.06 Consumer Direct November Pricing Improvements

To: Consumer Direct
From: Mary Ann Kovach

We've clarified the fees that will be waived on the November Pricing Improvements Please note the changes, which are highlighted in red. The following price specials are available in November:

1. **Option ARMS – $1,000 off closing costs for loans under $300,000.**

   Option ARM loans over $300,000—Waive all fees.

   We will not be collecting the $295 appraisal deposit at application. Customer is responsible for paying per diem interest, mortgage tax stamps, and escrows. This Price Special is not applicable to Nonprime **or Prime Texas loans.**

2. **Alt A 10/20—waive all WaMu Fees for loans under $300,000.**

   We will not be collecting the $295 appraisal deposit at application. Customer is responsible for paying per diem interest, mortgage tax stamps, escrows and title. This Price Special is not applicable to Nonprime **or Prime Texas loans.**

   Alt A 10/20 loans over $300,000—waive all fees.

   We will not be collecting the $295 appraisal deposit at application. Customer is responsible for paying per diem interest, mortgage tax stamps, and escrows. This Price Special is not applicable to Nonprime **or Prime Texas loans.**

3. **5/1 Jumbo I/O—waive all WaMu Fees for loans under $500,000.**

   We will not be collecting the $295 appraisal deposit at application. Customer is responsible for paying per diem interest, mortgage tax stamps, escrows and title. This Price Special is not applicable to Nonprime **or Prime Texas loans.**

   5/1 Jumbo I/O loans over $500,000—waive all fees.

   We will not be collecting the $295 appraisal deposit at application. Customer is responsible for paying per diem interest, mortgage tax stamps, and escrows. This Price Special is not applicable to Nonprime **or Prime Texas loans.**

4. **Nonprime—** *Applies ONLY to Nonprime to Nonprime (existing LBM or SMF customers – existing Prime customers do not receive)*—**Reduce the discount by .50%.**

5. **Conventional Fixed Rate Loans Over $300,000. Reduce the rate by 1/8th (.125%). This Price Special is not applicable to Nonprime or Prime Texas loans.**

- Price Specials are not applicable on Employee Loans.

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- Price Specials will be in effect 11/1/06 – 11/30/06.
- Loan Consultants must complete a pricing exception form and have their Sales Managers approve.
- Please contact your manager, should you have any questions.

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Feb 24, 2005

TO: Executive Committee

FROM: Jim Vanasek

SUBJECT: Critical Pending Decisions

We have come to a critical point with respect to decisions about credit exposure for the balance of this year and on into '06. The recent concern about asset growth has lead to considerable discussion about options involving higher risk exposure in a variety of products to include more LBMC loan retention (over and about the $5bn already in the plan), retention of 80/20 Piggyback seconds originated through LBMC etc.

From a risk perspective we are in a classic bind. In the current environment the assets that we seem to be able to grow most readily with reasonable spreads are those assets with higher risk profiles – Option ARM's, sub-prime, interest-only, and 100% LTV. While our '05 Plan contemplated a significant increase in sub-prime assets, it did not include all the products currently up for discussion.

More importantly the Finance Committee only approved the '05 Plan based upon assurances from Credit that the contemplated exposures were reasonable and could be managed. My interpretation of the Committee's reaction was that they have healthy concern about where we might be in the economic cycle and whether it makes sense to significantly expand our higher risk exposure at this point in time.

Almost concurrent with that Finance Committee meeting, the OTS expressed concern about deterioration in credit terms in home equity lending. Our historic conservative posture with respect to home equity allowed us to deflect that discussion, but obviously any move to retain sub-prime, 100% LTV seconds would fly in the face of their concerns.

But what about our own management view of the market? Kerry and Bill have both repeatedly expressed concerns about the housing market and the possibility that we are in the latter stages of the cycle. We have seen home prices in places like Las Vegas increase 47% in one year. That being the case, the appropriate question is how much additional risk do we want to take on at this time? On the one hand, we need asset growth and the likely products to produce that growth are higher risk, and on the other, we have an instinctive caution about the super heated housing markets on both coasts where we are most heavily exposed.

This unreconciled issue lurks behind many of our conversations. Tom fears that we will not have asset growth sufficient to fully leverage the capital that we are generating. Others fear that we cannot make the plan. My credit team and I fear that we are considering expanding our risk appetite at exactly the wrong point and potentially

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walking straight into a regulatory challenge and criticism from both the Street and the Board. Said another way I fear that the timing of further expansion into higher risk lending beyond what was contemplated in the '05 Plan and most especially certain new products being considered is ill-timed given the overheated market and the risk higher interest rates. There is considerable anecdotal information suggesting that people are speculating heavily on further price increases in housing. Consumer debt levels are a national concern. A few of you have privately expressed concerns that you have about the situation but are reluctant to bring the discussion into the open.

The most immediate issues have to do with specific new high risk loan products. The more significant risk is the '06 Plan that we will have to take to the Board in June. If we meet the '05 Plan objectives for higher risk lending, we will have maxed out our current limit tied to capital. At this time we do not have an adequate feel for the regulatory reaction should we attempt to increase that limit. Sooner rather than later we risk hitting the wall with either OTS or the Board on this issue. And the issue will not limited to higher risk lending, it will be wrapped together with neg am and payment shock if my read of the regulatory environment is correct.

There are no easy answers about the situation in which we find ourselves, but I feel compelled to bring issue forward and place it on the table for discussion.

One other observation, several of you have looked at the current losses and concluded that there is no real problem at this point in time. Some have questioned the 25bps as an average target charge-off ratio, pointing out correctly that commercial banks operate at higher charge-offs levels with no problem whatsoever. From my perspective one of our advantages from the standpoint of the stability of our stock price has been our credit performance. If losses were to double to 15 bps, the institution is still very adequately reserved and by no means in jeopardy but that does not mean that the Street will not react negatively and the same is true for the bank regulators. We certainly can move to higher loss levels safely (assuming adequate margins), but the question will be how quickly and how well we have prepared our constituencies for that change. It also depends upon the timing and market conditions.

So we come down to the basic question, is this the time to expand beyond the "05 Plan and/or to expand into new categories of higher risk assets? For my part I think not. We still need to complete EDE, reduce policy exception levels, improve the pricing models, build our sub-prime collection capability, improve our modeling etc. We need to listen to our instincts about the overheated housing market and the likely outcome in our primary markets. We need to build further credibility with the regulators about the control exercised over our SFR underwriting and sub-prime underwriting particularly in LBMC.

I fully recognize the challenge that this creates particularly in '06. It means we must put on the table the possibility of slower asset growth, tighter NIM, deployment of excess capital etc.

I raise these issues not for the purpose of challenging any member of the Executive Committee, but rather to encourage healthy discussion and debate. There is no question that the Street demands growth but equally there is no question that we need to ensure that the growth is prudent.

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WaMu

Enterprise Risk Management Committee
December 15, 2006
WMC 32, Boardroom 2:00 – 4:00
Phone 877-921-4307, Passcode 825867

Attendees

Voting Members:

Ron Cathcart (Chair)	Al Brooks	Tom Casey	Fay Chapman
James Corcoran	Deb Horvath	Steve Rotella	Benson Porter
Joe Saunders	David Schneider		

Non-Voting Members:

Hugh Boyle	Cheryl Feltgen	Mark Hillis	Michelle McCarthy
Richard Lewis	Randy Melby	Robert Williams	Marc Wright

Other Participants:

Tom Henning (secretary)	David Beck	Youyi Chen	Ramon Gomez
Ann Tierney	Tom Morgan	Cynthia Abercrombie	Joe Mattey
John Stewart			

Agenda

Topic	Presenter	Objective	Time
1. Review Prior Meeting Minutes	Tom Henning		5 Min
• October 4, 2006		Approve	
• October 10, 2006			
• Outstanding Action Items		Update	
2. Approve Policies & Standards:			
• None			
3. Approve Home Loans CDO Proposal	David Schneider/David Beck	Approve	30 Min
4. Approve Enterprise Risk Management 2007 Plan	Hugh Boyle/Michelle McCarthy	Approve	30 Min
5. Review Data Management Program Presentation to the Board	Tom Morgan	Review	10 Min
6. Update on Compliance Review Results Reporting	Richard Lewis	Review	15 Min
7. Corporate Credit Review Organizational Update	Cynthia Abercrombie	Review	15 Min
8. Discuss Compliance with FFIEC Guidance on Authentication in an Internet Banking Environment	Deb Horvath	Review	10 Min

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
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Enterprise Risk Management Committee Minutes
October 4, 2006

The Enterprise Risk Management Committee (ERMC or Committee) for Washington Mutual, Inc. and Washington Mutual Bank met on October 4, 2006 in the Board Room of the Washington Mutual Center, Seattle, WA.

Voting Members Present:

Ron Cathcart (Chair)	Al Brooks	Tom Casey	Fay Chapman
Deb Horvath	Benson Porter	David Schneider	

Non-Voting Members Present:

Hugh Boyle	Chaomei Chen *	Mark Hillis	Richard Lewis
Michelle McCarthy	Randy Melby	Marc Wright	Robert Williams

Other Participants Present:

Karin Znamirovschi (Secretary)	Cynthia Abercrombie	Amy Alexander*
Robert Collins	Thomas Henning	Robert Shaw

* Attended by telephone

A quorum being present, Mr. Cathcart called the meeting to order at 8:04 a.m.

The June 28th meeting minutes were approved as presented, and the prior meeting action items reviewed.

Value at Risk Limit Adjustment

Ms. McCarthy reviewed with the Committee the Change to Value at Risk Limit and Annual Review and Approval of the Asset and Liability Management Policy presentation. The proposed change to the Policy adjusts the existing one quarter, two standard deviation confidence Value at Risk limit for Market Value Managed businesses (the "quarterly" limit) from the existing $700 million to $500 million. The adjustment reflects the reduction in risk exposure caused by the sale of $2.6 billon of the Mortgage Servicing Rights portfolio in July 2006. An additional related limit was also proposed of $230 million calculated based on a 10 day, 99% confidence Value at Risk (the "10 day" limit). This measurement approach is the regulatory standard and is expected to be the basis of market risk capital for these assets beginning in 2008. It is the short term intention to utilize both limits in parallel, and consider retiring the quarterly based limit in 2007.

Ms. McCarthy and the Committee further discussed the current low utilization of the limit and the rationale for the proposed new level.

The Committee voted on and recommended that the Boards of Directors' Finance Committees of Washington Mutual, Inc. and Washington Mutual Bank, and the Board of

Enterprise Risk Management Committee Minutes
October 4, 2006

Directors of Washington Mutual Bank fsb approve the adjustment of the quarterly limit and the adoption of the 10 day limit.

Operational Risk Management Policy Annual Approval

Ms. McCarthy reviewed with the Committee the revised Operational Risk Management Policy. The Policy includes three key revisions:

- Proposes an Operational Risk Economic Capital limit of 18% of available financial resources, and further proposes requiring that the Enterprise Risk Management Committee establish a targeted level of Operational Risk Economic Capital on at least an annual basis.
- Streamlines the Operational Risk Management Committee membership and meetings and changes the name to Operational Risk Committee. The Committee will approve Operational Risk Standards and oversee implementation of the Operational Risk Framework set forth in the Policy and associated standards.
- Establishes governance over Operational Risk Economic Capital Model changes.

The Committee engaged Ms. McCarthy in a discussion of the readiness of the Company to establish an Economic Capital limit and the timing given the continuing development of the Basel II compliance program. Upon further discussion and clarification, the Committee determined that the Policy should be submitted to the Audit Committee without the proposed Economic Capital limits. The Economic Capital limits will be re-presented after further planned development of the Basel II measurement methodology.

The Committee voted on and recommended that the Boards of Directors Audit Committees of Washington Mutual, Inc. and Washington Mutual Bank, and the Board of Directors of Washington Mutual Bank fsb approve the Policy as amended to exclude the Operational Risk Economic Capital limit.

Corporate Credit Review Policy Approval

Mr. Boyle and Ms. Abercrombie presented to the Committee the Corporate Credit Review Policy. The Policy establishes an independent Corporate Credit Review function reporting to the Chief Credit Officer. The function focuses on only the credit aspects of lending versus the previously combined credit and compliance reviews performed by the former Corporate Risk Oversight Department. This function performs various testing activities to provide an independent assessment of credit risk and quality and to ensure lending and credit risk management practices are consistent with corporate business strategies and risk tolerance objectives.

Mr. Cathcart further clarified the role of the function as a back-end oversight and detective control that places responsibility for complying with lending policies and standards with the business units. This arrangement compliments the Chief Credit Officer's responsibility to set credit risk strategy. Mr. Boyle further noted that this group

Enterprise Risk Management Committee Minutes
October 4, 2006

would not oversee the counterparty credit risk function which reports directly to Mr. Boyle. Counterparty credit oversight will be provided by Audit Services.

The Committee voted on and recommended that the Boards of Directors' Finance Committees of Washington Mutual, Inc. and Washington Mutual Bank, and the Board of Directors of Washington Mutual Bank fsb approve the Policy as presented.

Enterprise Fraud Management Standard Approval

Mr. Hillis presented to the Committee the Enterprise Fraud Management Standard of the Operational Risk Management Policy. The Standard sets forth the framework, delegation of authority, and oversight authority for fraud management at WaMu. The Standard was created in line with industry best practice and in response to regulatory criticism. It allows management to leverage best practices across the organization and increases management's ability to understand the nature and amount of fraud risk. The Standard assigns responsibility to the Operational Risk Committee for subsequent approvals of the Standard and monitoring compliance.

The Committee voted on and approved the Standard as presented.

Basel II Data Management Gaps and Data Governance as an Emerging Risk

Ms. McCarthy, Ms. Alexander, and Mr. Collins reviewed with the Committee the Basel II Data Governance Project presentation. Basel II requires data integrity checks as a basic element of any Basel II compliance program. Demonstrating control over the data is a requirement for receiving program certification from the regulators. Data integrity is further an overall Operational risk concern, beyond Basel II requirements.

The project created data standards, identified gaps against the standards, notified the data element owners, and initiated issue tracking and resolution. In response to the results, a permanent data integrity resource was hired to carry on the verification of data integrity controls for Basel II data and to broaden the verification of data integrity controls to reduce operational risk. Analysis of the gaps identified two root causes, examples of which were discussed: a lack of accurate system mapping, and poor control over process changes that impact downstream data users.

The Committee discussed the broader data management issues within the Company, including establishing data ownership over all data elements, and similar data management efforts that could be leveraged for best practices.

Mr. Melby discussed with the Committee the Data Governance – Emerging Risk Issue which is included in the third quarter Audit Services report to the Audit Committee. The issue notes data ownership and stewardship as an enterprise issue, and that recent audit reports have highlighted the need for enhanced data governance. Audit Services referenced a core team tasked with developing a proposal for a cross-functional Data

Enterprise Risk Management Committee Minutes
October 4, 2006

Governance structure that leverages the existing Basel II effort. Audit Services is recommending to the Audit Committee that it receive periodic progress updates.

2007 Business Unit Risk Strategy Overviews

Ms. Znamirovschi introduced the 2007 Business Line Risk Management Overviews. The Overviews are a preliminary assessment of the elements of risk in the 2007 Plan, and a summary of the associated risk management strategies and initiatives. The Overviews will be further supplemented by a quantification of the credit risks and concentration limits for each business line in Front End Guidance which will be presented at the October 12 and 13 Monthly Business Review.

The Chief Risk Officers of each business, with Robert Shaw substituting for Cheryl Feltgen of Home Loans, presented their business line Risk Strategy Overviews, focusing on the 2007 initiatives and responded to questions from the members.

October 2006 ERM Board Report

Mr. Cathcart introduced to the Committee the ERM Board Report which will be delivered to the Board of Directors at the October 17 meeting. The members were invited to review the report and provide questions and comments to the report writers. Mr. Cathcart committed to scheduling an abbreviated Enterprise Risk Management Committee meeting to further to discuss the report and respond to members' questions prior to the Board meeting.

There being no further business to discuss, the meeting adjourned at 10:00 a.m.

Respectfully submitted:

Ronald Cathcart, Chairman

Karin Znamirovschi, Secretary

Enterprise Risk Management Committee Minutes
October 10, 2006

A special session of the Enterprise Risk Management Committee (ERMC or Committee) for Washington Mutual, Inc. and Washington Mutual Bank met on October 10, 2006 in the Board Room of the Washington Mutual Center, Seattle, WA. The meeting was called to review the October 2006 Enterprise Risk Management Board Report prior to submission to the Board.

Voting Members Present:
Ron Cathcart (Chair) Tom Casey Deb Horvath Benson Porter
Steve Rotella

Non-Voting Members Present:
Hugh Boyle Cheryl Feltgen Mark Hillis Richard Lewis *
Michelle McCarthy Randy Melby Marc Wright

Other Participants Present:
Karin Znamirovschi (Secretary) Thomas Henning

* Attended by telephone

A quorum being present, Mr. Cathcart called the meeting to order at 11:05 a.m.

Enterprise Risk Management Board Report

The individual sections of the Enterprise Risk Management Report to the Board of Directors of Washington Mutual, Inc, and Washington Mutual Bank were presented and discussed. The member's questions were responded to and revisions agreed to.

There being no further business to discuss, the meeting adjourned at 12:05 a.m.

Respectfully submitted:

Ronald Cathcart, Chairman Karin Znamirovschi, Secretary

Enterprise Risk Management Committee
December 15, 2006
Prior Meeting Action Items

Meeting dated October 4, 2006:

Action	Responsibility	Status
Provide the Committee further analysis on the state and MSA credit concentration limits with the objective of determining whether the current limits are prudent and appropriate.	Hugh Boyle	**Completed** - Subsequent to the meeting, the Chief Enterprise Risk Officer arbitrated an agreement between the Chief Executive Officer, business line Presidents, and Chief Risk Officers. The recommended 50% and 25% state and MSA limits were subsequently presented to and approved by the Finance Committee. Further analysis will be performed during the 2007 planning cycle to determine whether the limits should be lowered.
Schedule an abbreviated Enterprise Risk Management Committee meeting for further discussion of the Enterprise Risk Management Board report.	Ron Cathcart/Karin Znamirovschi	**Completed** - A meeting was conducted on Tuesday October 10^{th}.
Michelle McCarthy to convene a meeting with Deb Horvath, Tom Casey, and other subject matter experts from their areas to discuss data governance issues and share best practices from their remediation programs and approaches.	Michelle McCarthy	**Completed** – Meetings conducted.

Meeting dated October 10, 2006:

Action	Responsibility	Status
Schedule for a future meeting an overview presentation on the Risk Control Self Assessment Process, how it is used within each business line, and how it is linked to the SOX 404 process.	Michelle McCarthy	**Completed** – Presentation materials on this topic have been created and were presented at a CFMC offsite. We are also including these hierarchies in Finance's Enterprise Hierarchy Initiative. A presentation to ERMC is no longer required.

WaMu

ABS CDO Business Proposal

ERMC Meeting Recommendation

Capital Markets Portfolio Management

December 15, 2006

WaMu

Business Components for Approval

ERMC Recommendation

WaMu Capital Markets Portfolio Management is requesting approval to establish a CDO Asset Management Group. The Group will manage the issuing of cash flow arbitrage CDO securities (cash, synthetic, and hybrid), including acquiring underlying collateral assets and hedge the warehouse risks in the ramp up period, partially retain the preferred shares (equity tranche), and will manage the CDO assets. WaMu Capital Corp will expand its broker-dealer business to underwrite and distribute the CDO securities.

1. Warehouse Limit: $2 billion in aggregate cash securities with delegated authority vested with the portfolio management division; $2.5 billion with delegated authority vested with the head of Capital Markets and the HL Chief Risk Officer
2. Warehouse underlying collateral mix: 25% non-investment-grade (rated BB+ and below)
3. Warehouse financing: Internal funding through treasury. Business retained the option to use an external dealer if conditions warrant
4. Underlying collateral types: Include RMBS, HEL, CMBS, CDOs of the foregoing asset types and no more than 15% of other asset classes ("Other Assets"), which are either (a) approved and listed on the bank's ALMP, or (b) are, in the opinion of the bank's legal counsel, permissible under applicable provisions of the Home Owners Loan Act, the Federal Deposit Insurance Act and FDIC and OTS regulations, in each instance, with authority delegated to HL Chief Risk Officer, the head of Corporate Credit, the head of Capital Markets and the head of the Market Risk Management to determine the amount (not to exceed the 15% limitation in the aggregate) and specific types of Other Assets
5. Equity Retention: less than 50% of total equity value, subject to independent auditors' true sale opinion on a deal by deal basis (FIN 46R, page 24)
6. Market Risk Limit: Aggregating risk position (DV01 and VaR) into existing Capital Markets limit allowance; Portfolio Managers are to follow existing mandatory ERMC/MRC risk management and reporting processes
7. ABS CDO warehouse accumulation will not commence until a robust derivatives capability has been established

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WaMu

Endorsements/Clearances

The following business and functional leaders have reviewed and endorsed ERMC approval of this CDO proposal:

- **Presenters:**
  Home Loans Capital Markets - David Beck
  Home Loans Risk Management - Cheryl Feltgen

- **Endorsements/Clearances:**
  Credit - Hugh Boyle
  Market - Michelle McCarthy
  Compliance - Richard Lewis
  Legal - Carey Brennan
  Finance - Steve Fortunato
  Controller - John Woods

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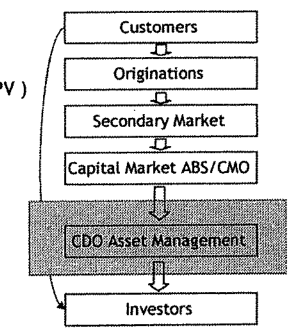
WaMu

ABS CDO

- The efficient distribution of credit risks is a strategic imperative for WaMu. The ABS CDO business model empowers our best execution efforts by improving the pricing, liquidity, and distribution of credit structure securities
- Year to date, nearly 60% of our Long Beach ABS mezzanine securities were sold to CDO asset managers for resale to end investors
- The ABS CDO business has three distinct income streams
  - Underwriting and Distribution: 25 bps at deal closing
  - Asset Management Fee (new business): 35 bps per annum (2% NPV)
  - Return on retained equity piece (1% to 2% of UPB): 20%
- The investment on ABS CDO infrastructure will enable future ALM initiatives such as reducing the tangible common equity ratio target through synthetic balance sheet securitization
- The ABS CDO business is a natural extension of our existing business that offers significant additions to our shareholder value



WaMu

CDO Revenue

Revenue Sources

The ABS CDO business model enhances WaMu best execution efforts by improving the pricing, liquidity and distribution of credit structure securities

The ABS CDO business has four distinct income streams

- Underwriting and distribution fee — 25 bps at closing
- Asset management fee — 35 bps per annum (2% NPV)
- Return on retained equity — 20%
- Warehouse income — 100 bps

Pro Forma Projection

3- Year Pro Forma Projection

Without balance sheet deals

$ MM	Year One	Year Two	Year Three	Total
Numbers of Deals	3	4	4	11
Issuance	1,500	3,000	4,000	8,500
Retained Equity	34	68	90	191
Total Retained Equity	34	101	191	191
Under-writing Fee (Retained)	1.9	6.0	8.0	15.9
Warehouse Income	1.9	3.8	5.0	10.6
Management Fee	2.6	10.5	18.0	31.1
Retained Equity Income	3.4	13.5	29.3	46.1
Deal Cost	(4.5)	(9.0)	(12.0)	(25.5)
Total	5.3	24.8	48.3	78.3

Assumptions

Underwriting Fee	0.25%	50% retained at year one; 80% retained for years 2 and 3
Management Fee (per annum)	0.35%	Includes both senior and subordinate management fees
Deal Cost	0.30%	25 bps in underwriting / distributing fee and 5 bps other
Retained Equity	45%	25% to 49% target range, actual limitation is subject to review
Capital Allocation	100%	Subject to review by ERMC
Return on Retained Equity	20%	Typically higher return on hybrid and synthetic deals

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WaMu® ABS/SF CDO Underlying Collateral & Approval Status

	Approved Or Not		Conditions and Limitations
Asset-Backed Securities			
Consumer finance-related instruments:	Yes	1	In all cases, investment is subject to ALM Policy limits.
Auto (loan or lease)	Yes		
Credit Card	Yes		ALM Policy limits include three-part test ("CIM"):
Student Loan	Yes		A. Corporate Debt Security
Manufactured Housing	Yes		B. Investment Grade
Equipment Leases	Yes		C. "Marketable"
Entertainment Royalties (as collateral)	Conditionally		
Small Business Loans	Yes		If not CIM, then "pass-through" analysis is needed: underlying
Mutual Fund Fees	Conditionally		asset must be one in which the bank can legally invest.
Health Care cash flows (as collateral)	Conditionally		In certain cases, 30 days advance notice may be required.
Home Equity Loans/Lines of Credit	Yes		
ABS NIM	Conditionally	2	Pass-through analysis will most likely be required
PIK Interest on ABS and MBS	TBD	3	Most often seen in subordinate tranches. Pass-through analysis likely required
Stripped MBS and Other RMBS derivatives	Conditionally	1	In all cases, investment is subject to ALM Policy limits.
Commercial Mortgage-Backed Securities			
Conduit	Yes	1	In all cases, investment is subject to ALM Policy limits.
Large Loan	Yes		"Pass-through" analysis is easy because bank has clear
Credit Tenant Lease	Yes		authority to invest in underlying assets, but 30 days advance
Residential Mortgage-Backed Securities			notice to OTS and FDIC required if WM has control of issuer
			after issue of securities.
Residential A	Yes		
Residential B&C	Yes		
CDO (Cash)			
ABS CDO (Cash)	Yes	1	In all cases, investment is subject to ALM Policy limits.
Non-mortgage CDO (Cash)	Yes		ALM Policy limits include three-part CIM test or
Trust Preferred CDO (Cash)	Yes		alternative "pass-through" analysis (see above)
CLO (Cash)	Yes		
All above CDO/CLOs but non-cash (Hybrid / Synthetic)	TBD		Must show authority to hold asset (CIM, pass-through ABS or loan) or issue guarantee (not insurance) during ramp-up and investment period. Legal researching
ABX	Yes	1	Subject to Safety and Soundness requirements & ALM or Credit Policy
Credit Linked Notes	TBD	1	Subject to Safety and Soundness requirements & ALM or Credit Policy
Credit Derivatives (Synthetic Securities / CDS, Total Rate of Return Swaps)	TBD	1	Subject to Safety and Soundness requirements & ALM or Credit Policy
Other Debt/Loans			
Investment Grade Corporate Bonds (include REIT debt)	Yes	1	In all cases, investment is subject to ALM Policy limits.
High Yield Bonds	NO	x	
Leveraged Loans	TBD	4	Subject to Safety and Soundness requirements & ALM or Credit Policy
Variable Funding Notes	Yes	1	Subject to Safety and Soundness requirements & ALM or Credit Policy
Emerging Market Debt	Conditionally	x	In all cases, investment would be subject to ALM Policy limits.
Project Finance Debt	Conditionally		Subject to Safety and Soundness requirements & ALM or Credit Policy
New Investment			
ABS CDO Equity	TBD		

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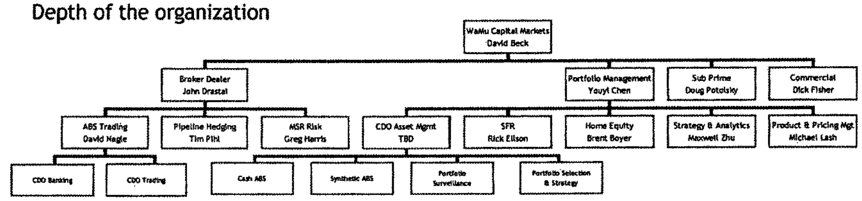
WaMu

Organizational Structure

WaMu Advantages

Breadth of product

Depth of the organization



Functional Roles	
CDO Asset Manager	Internal
Research, Modeling, & Analytics	Internal
Technology Support	Internal
Finance / Valuation	Internal
Underwriting / Distribution	Int/External
Trustee Services	External
Accounting / Audit	Int/External
Legal	Int/Internal

Time line		
ALCO Approval	Oct-06	✓
HL POG Initial Gateway	Nov-06	✓
HL POG Approval Gateway	Nov-06	✓
HL POG Plan Gateway	Dec-06	
ERMC Approval	Dec-06	
HR Review and Approval	Dec-06	
OTS	Dec-06	
Hiring process for CDO Managers	Dec-06	
HL POG Implementation Gateway	Jan-07	
MRC on credit derivatives	Jan-07	
VC on credit derivatives and valuation	Feb-07	
1st deal to market	Apr-07	

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WaMu

Organization and Infrastructure

Infrastructure	Requirements	Current Status/Plan
CDO Asset Management Business Unit	Need to recruit a CDO Asset Management team and reassign some existing portfolio management resources	Engage HR after ERMC approval
Research, Modeling, and Analytics	Need dedicated subject matter experts. Hire analysts to work with asset managers on asset surveillance and performance tracking	Current research is being performed using existing resources. Wait for ERMC approval to proceed with next steps
Legal and Compliance	Legal Department to select external counsel with extensive knowledge of CDO business development	Engaged external counsel after ALCO approval
Underwriting and Distribution	Leverage existing capabilities. Identify a wall-street partner for structuring and distributing assistance in year one	Will begin negotiations after ERMC approval and designation of a business lead
Finance and Accounting	Need dedicated accounting and valuation support	Accounting engaged in preliminary discussions. Need for dedicated valuation resources has been identified.
Market Risk and Credit Risk	Utilize the existing infrastructure and support in the pipeline and warehouse risk management area. Working to enhance trade capture and risk management systems to enable handling of synthetics ABS products such as CDS	ERMC 12/15/2006 agenda
IT Support	Need dedicated systems support and enhanced analytics. Important requirement for obtaining favorable agency rating on asset management capabilities	A dedicated resources have been identified. Will commit resources after ERMC approval

WaMu

Risks and Mitigation Strategies

Risk Factors	Risk Effects	Mitigating Measures
Financial risk	Unexpected credit loss will cause the write-down of the retained equity piece. WaMu would be expected to retain less than 50% of the equity tranche. Equity tranche ~4% deal. Potential reputational risk with investors.	Third-party investors hold over 50% of the equity. Asset knowledge and expertise are competitive advantages.
Credit Risk	Exposure to the credit spreads during the ramp-up period, and very limited credit spread risk tolerance during the reinvestment period (3 to 5 years for managed CDOs).	The ramp-up period can be relatively short; approximately two months. ABX can be used to hedge and lock-in credit spreads
Market Risk	Lower rates/spreads during the investment/revolving period will reduce the equity returns. Potential mismatch in asset and liability durations	Considerable amount of risk is transferred to CDO investors. Swap can be embedded in the structure to mitigate asset and liability duration mismatch
Legal, Regulatory and Compliance Risks	CDOs differ from the traditional ABS/CMO transactions. Documentation, rating agency analysis, investor reporting, and transaction monitoring are significantly different	The market is well established. Extensive research and selection of experienced legal counsel will facilitate managing legal, regulatory and compliance risks
Operational Risk	New systems and processes will be introduced (as listed on p. 13)	HL POG Gateway in place to guide the process. The CDO Asset Management team will work within the framework of the Operational Risk Management Policy
Model and Valuation Risk	Asset valuation and modeling are complex and require strong analytical systems infrastructure and software resources	Working with leading software systems provider and partnering closely with TSG. Enhancement in research and analytics necessary for CDO also should benefit the management of other products in WaMu's portfolio
Liquidity Risk	Limited liquidity for deteriorating equity in particular	Partnership with a strong underwriter and securities broker dealer in the beginning. Expand WCC's overseas distribution capacity where strong investor demand for CDOs exists

WaMu

CDO Legal, Compliance, and Regulatory Overview

Legal

CDOs are mature products with well defined and well understood documentation and execution patterns. The actual mix of legal documents such as indentures, offering memoranda, special purpose entity organizational documents, trusts, distribution agreements, listing agreements, etc. vary from deal to deal, depending on the deal's nature and scope. In the case of a new program such as WaMu's CDO business, legal will require additional lead time for drafting and negotiating documents and setting up initial arrangements, but the disclosure risks and related transaction management processes are virtually indistinguishable from those that WaMu performs well with respect to its securitizations of home mortgages, credit cards, or commercial mortgages.

For WaMu, the key legal analysis arising from the CDO project are based on the need to address banking and regulatory law because the intended business will be conducted through the thrift and its operating subsidiaries. The legal questions outlined immediately below this paragraph, and those set forth under the "Regulatory" heading further below in this document, are being managed by a legal team coordinated by Richard Careaga.

- Potential Banking Powers limitations arising from
  - Asset types
  - Asset management powers
    - Upon launch
    - Future needs as number and nature of WaMu CDOs evolves.
- Affiliate transactions
  - Address investment manager separation
    - Fiduciary role is a first time issue
    - Maintaining a demonstrable separation of investment manager

CDOs issued by special purpose vehicles (SPVs) are most commonly formed offshore to assure pass-through treatment of proceeds from CDO collateral and to avoid subjecting foreign investors to U.S. taxation. In connection with WMB's CDO program, WMB will acquire assets (e.g., RMBS, other ABS, CDS or other Authorized Assets as defined by the ALMP), - and restructure the combined cashflows into different classes of securities ranging, for example, from AAA to subordinate and non-rated classes. At this time, we expect that a subsidiary of WMI will be created to act as the Asset Manager for the CDO program, and will provide these services to WMB pursuant to a services agreement.

WaMu

CDO Legal, Compliance, and Regulatory Overview

Regulatory

John Robinson is working to arrange a meeting with the OTS examiners in Seattle during December 2006 to introduce the CDO concept and WaMu's plans for this new business. The goal is to give the OTS a sense of WaMu's intended direction and next steps in the development of the CDO initiative. Additionally, we intend to ask for the OTS's views on the initiative and solicit their advice regarding potential concerns or roadblocks. WaMu attendees at the OTS are meeting are expected to be limited to a small group comprised of members from Regulatory Relations and a senior representative from the business and legal. The OTS meeting is expected to touch on the following issues:

- Description of the business fit for the CDO initiative
- Authority for the business
- Explain WaMu's conclusions regarding
  - -Primary reliance on pass-through authority
  - -Plan to monitor proposed asset mix to ensure continued ability to rely on pass-through authority or alternative analysis
  - -Where the bank is taking risk and what are the corresponding controls and mitigants
- Identify FDIC-insured banks or thrifts that have taken similar steps in the creation of CDOs
  - -Be ready to compare and contrast business models and approaches
- Provide details regarding proposed underlying assets and CDO structures
- Describe internal review and governance processes
- Address capital impact on bank
  - -Cash flow model
  - -Balance sheet model
  - -Capital treatment of retained pieces

WaMu CDO Legal, Compliance, and Regulatory Overview

Compliance

CDOs are highly transparent structures. A collateral manager's ability to acquire assets for a CDO is subject to rating and limited by detailed investment criteria defined in the post-closing deal's indenture and offering documents. Trades are modeled for compliance with applicable deal parameters and indenture limitations before the trade is executed in close coordination with the deal trustee's administrative agent. The focus of these compliance checks include extensive coverage and asset-quality tests tailored to the deal's parameters set forth in the deals indenture and offering documents.

CDO trading activity and deal performance is reported monthly to investors by the trustee in highly detailed reports. Monthly performance reports cover, among other things, portfolio composition, trading activity, deal performance, a full balance sheet and an income statement describing sources and uses of cash.

CDO investors are highly sophisticated users of monthly trustee reports and review them with rigor. Rating agencies supplement deal level transparency (CDOs are generally private transactions and performance report distribution is limited to actual or potential investors) by aggregating deal information and reporting on the CDO market in general. Rating agency reports customarily provide extensive deal-, asset- and vintage-level data as well as sector comparisons.

CDO infrastructures and systems, often developed jointly with the trustee, include a compliance reporting component that enables systems-based monitoring and surveillance. This system-based access is augmented by close collaboration with the trustee who acts in a fiduciary capacity for the benefit of investors. WaMu's CDO business leaders have interviewed and held extensive discussions with leading CDO trustees. Compliance has attended many of these presentations. Compliance is highly confident that the systems used by these trustees offer compliance monitoring and surveillance tools that reflect the state of the art in the industry. Furthermore, trustees compete in the maintenance and enhancement of compliance tools and Compliance expects that WaMu will continue to benefit from these developments.

Legal has been closely involved in the development of the proposed program, identifying and resolving potential regulatory requirements or obstacles and developing expertise in credit default swaps and other derivative instruments. Legal is planning to assign two attorneys to support the program full-time during 2007 deal cycles and as needed at other times.

WaMu

Counterparty Risk in Credit Default Swaps

Counterparty Risk in Pay-As-You-Go (PAUG) CDS Transactions

The ability to meet the obligations of the notes in the CDO is dependent upon the receipt of payments from the counterparty under the credit default swap

To manage this risk exposure, the standard industry practice includes:

(1) factor in the appropriate risk of the counterparty into the pricing / valuation model

(2) include counterparty rating triggers that would require the counterparty to

- (a) collateralize potential reimbursable amounts
- (b) assign its position at its own cost to a qualified third party
- (c) obtain a qualified credit support provider once the rating of the counterparty fell below specified thresholds

(3) employ the use of an escrow account which would hold potential reimbursable payments until the end of the transaction

In addition to common industry practice, the CDO Manager will comply with all policies and standards set by Corporate Credit

Standard Practices

Short-term debt rating by Moody's of at least "P-1" or long-term senior unsecured rating by Moody's of at least "A3" and, if rated "A3" by Moody's, such rating is not on watch for downgrade, and an issuer credit rating by S&P of at least "A+"

Corporate Credit Standards (WaMu CCS 510)

Must be a WaMu approved Counterparty

Within Maximum Potential Exposure (MPE) and Notional limits

WaMu

Operations Systems

Operations Systems

Description	System	Availability
Structuring	Rating Agency Models	Dec - 06
Software for Managing & Monitoring CDOs	CDO Sentry	Jan - 07
Interest Rate Derivatives	Summit	✓
CDS	Summit	Jan - 07
CDO	Summit	Jan - 07
Accounting - External	Trustee Servicer	✓
Accounting - Internal	CDO Sentry / Intex Desktop	Jan - 07
Trade Record	Bloomberg	✓
Valuation - CMO	CDO Sentry / Intex Desktop	Jan - 07
Valuation - ABS	CDO Sentry / Intex Desktop	Jan - 07
Valuation - CDO	CDO Sentry / Intex Desktop	Jan - 07
Valuation - Residual	CDO Sentry / Intex Desktop	Jan - 07

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CDO Risk Capital Requirements

Regulatory (Basel II)

- Unrated tranches
  - 100% capital through deduction from Tier 1 and Tier 2 *or*
  - Application of Supervisory Formula Approach (SFA)
- The SFA approach is extremely data intensive but can result in a lower (than the 100% requirement implied by deduction) capital requirement for unrated tranches. The approach requires:
  - PD and LGD ratings for the instruments within the securitization structure
  - Lower and upper bounds of loss levels
  - Basel II capital for the underlying instruments, if unsecuritized and in whole-loan form
  - Granularity parameters
  - Etc.
- Externally rated tranches have capital requirements prescribed from a ratings-based approach
  - AA requires 0.64% capital
  - A requires 0.96% capital
  - A- requires 1.6% capital
  - BBB requires 4.8% capital
  - BB- requires 5.2% capital, etc.
- Regulatory risk-based capital requirements (Basel I and Basel II) recognize retained vs. sold risk positions in synthetic securitization structures. *However, regulatory leverage ratio requirements do not recognize synthetic securitization structures.*

Economic Capital

- For unrated tranches, 100% capital requirement initial assumption; this is considered a good assumption for an equity tranche
- A more precise measure is dependent on deal-specific information. For example:
  - Tranche thickness with lower and upper loss levels
  - Granularity of securitization structure (number of loans in the structure)
  - Loss correlation in underlying instruments
  - Expected loss levels for underlying instruments
- Given economic capital's definition of a 1-year loss at a 99.89% confidence level:
  - Most equity tranches will have capital levels near 100% of the tranche value
  - Application of the more advanced, data intensive approaches makes the most sense for mezzanine, unrated tranches
- For rated tranches, the ratings based approach within Basel II is a reasonable approximation
- Economic capital recognizes retained vs. sold risk positions in synthetic securitization structures.

CDO Risk Capital Requirements
John Stewart
Nov 21, 2006

100% capital deduction from tier 1 and tier 2, and 100% economic capital allocation for retained equity shares will be assumed at the start

WaMu

Appendix

Collateral

And

Model Portfolios

WaMu

CDO Collateral - Model Portfolios

CDO Collateral - Model Portfolios

ABS cash, synthetic, and hybrid CDOs vary extensively in terms of collateral mix, bond eligibility criteria, reinvestment periods, and deal constraints on the quality and composition of the underlying collateral

In an actively managed portfolio, a CDO manager must manage the collateral substitutions, subject to collateral quality tests and eligibility criteria set forth in the indenture

The following three slides demonstrate the vast array of characteristics that are used to define individual ABS CDO Model Portfolios

These portfolio characteristics are deal-dependent and are created based on

- Investor demand
- Rating agency limitations
- Prevailing market spreads

WMI will be a minority holder of the Preference Shares (equity)
WMI's risk appetite should be balanced with external investors' risk appetite and return demands

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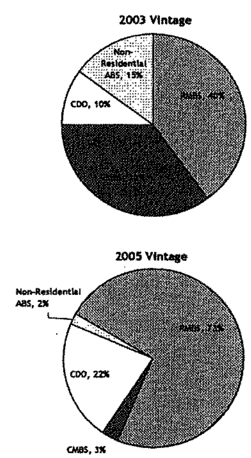
CDO Collateral Mix

Collateral Concentration Changes

Collateral composition of ABS CDO has moved toward a higher concentration of RMBS, HE, and CDO

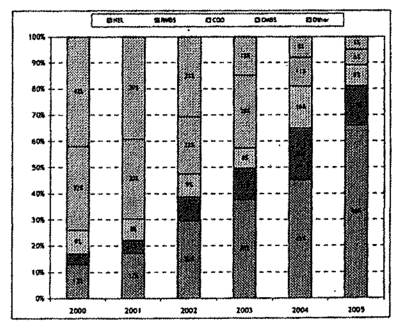
High Grade (HG) ABS CDO Collateral Distribution



Source: Citigroup

Mezzanine SF CDO Collateral Distribution

Year	HEL	RMBS	CDO	CMBS	Other
2000	13%	4%	9%	32%	42%
2001	17%	5%	8%	30%	39%
2002	30%	9%	9%	22%	31%
2003	38%	12%	8%	28%	15%
2004	45%	20%	16%	11%	8%
2005	66%	15%	8%	6%	5%



Source: Credit Suisse

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ABS CDO Asset Diversification / Correlations

Moody's Asset Correlation

For structured finance cash flow CDO transactions, Moody's Asset Correlation parameter is used instead of Moody's Diversity score to measure the diversity/concentration/correlation of collateral

- The Asset Correlation is calculated based on
  - Common default probability
  - Common recovery rate
  - Expected number of assets
  - Distribution of Key Agents
    - Number of issuers/servicers
    - Percentage of concentration of issuers/servicers
  - Geographic concentration of assets

A maximum level for the Asset Correlation is usually specified in the indenture as part of the collateral quality tests

The normal Asset Correlation for structured finance CDO transactions ranges from 20%-32%

WaMu

CDO Collateral Mix

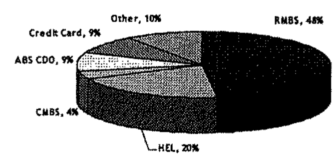
Sample Asset Portfolio - Asset Type and Rating Breakdown

Drivers of Asset Type and Rating Allocations

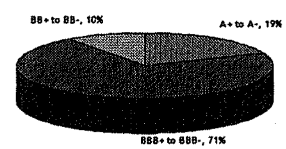
- Market supply and investor demand
- Rating agency models
- Target equity return

Asset Type	A+ to A-	BBB+ to BBB-	BB+ to BB-	Total
RMBS	8%	36%	4%	48%
HEL	2%	16%	2%	20%
CMBS	1%	2%	1%	4%
ABS CDO	3%	5%	1%	9%
Credit Card	3%	5%	1%	9%
Other	2%	7%	1%	10%
Total	19%	71%	10%	100%

Sample Portfolio Asset Allocation



Sample Portfolio Rating Allocation



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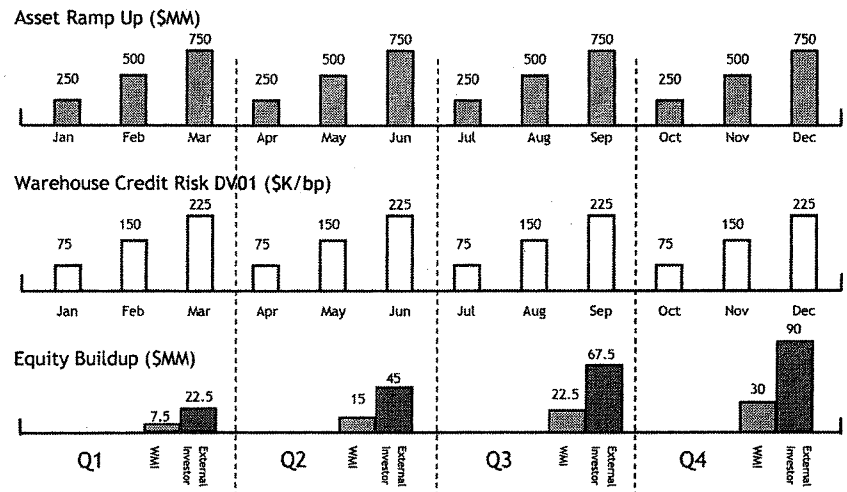
CDO One Year Time Line

CDO Position Risk Time Line - One Year

WaMu and external investors share moderate mark-to-market risks as demonstrated below



Assumptions: $750 MM deal per quarter, 3 year spread duration, 4% equity and 25% retention rate.

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CDO Ramp-Up

Typical Terms for CDO Asset Accumulation

70-90% of the CDO assets are expected to be purchased (or committed for purchase) by the closing date. The CDO asset managers and traders within the CDO Asset Management unit will select and purchase assets based on relative value and constrained by:

- Asset "bucket" limitations as prescribed by rating agencies and investor appetite
- Aggregate asset limits imposed by ERM

Weekly reports will be produced to verify compliance with binding constraints. This will be supplemented by independent oversight.

Warehouse Limit Proposal

- $2 billion in aggregate cash securities, authority delegated to the portfolio management division; $3 billion delegated authority to the Executive of Capital Markets, the Home Loans Chief Risk Officer and the Executive of Market Risk Management
- No more than 25% non-investment grade (rated BB+ and below)

Utilization of credit derivatives and interest rate derivatives solely to mitigate in-warehouse risk

WaMu

Warehouse Funding

Typical Terms for Warehousing

During the ramp-up, the warehoused CDO assets will expose WaMu to credit and interest rate risk. The assets can be funded internally or externally via a dealer warehouse facility.

Utilizing dealer warehouse, the credit and interest rate risk can be transferred in whole or in part (see CS presentation in Appendix II). This has significant drawbacks:

- loss of carry
- less control over asset selection
- business is subject to dealer's liquidity risks

Proposal

- The warehouse will be funded (on balance sheet) by Treasury through FTP with 1-month rate and the asset risks will be hedged by the CDO Asset Management unit
- The business will retain the option to use a dealer warehouse if conditions warrant. Daily P&L reports will be provided and risk limits established as with any other market value book.

WaMu

CDO Reinvestment Period

Typical Terms for CDO Reinvestment Period

During the reinvestment period, the CDO Management Unit will reinvest funds received by the CDO issuer in excess of interest payments to security holders in additional collateral subject to eligibility criteria and limitations applicable to each CDO transaction.

- Interest Coverage and Overcollateralization tests
- Collateral quality tests
- Concentration limits as set forth in the indenture

Equity returns may be reduced if spreads during the reinvestment period are tighter than during the ramp-up and/or basis risk increases.

Proposal

- Retention of equity amount no more than FIN 46's threshold for consolidation (< 50%)
- Valuation assumptions and procedures subject to valuation committee approval

WaMu

FIN 46R

When would FIN 46R require a collateral manager to consolidate a CDO?

FIN 46R requires a test (*primary beneficiary test*) to determine whether the collateral manager is required to consolidate a CDO

The FIN46R test is a cash flow scenario analysis to identify if the collateral manager's interest (management fees, equity securities*) absorbs the majority of the expected losses, expected residual returns or both of the CDO.

As equity securities ownership is a variable input into the FIN46R test, Portfolio Management recommends the equity securities holdings to be equal to or less than the maximum equity ownership allowed under FIN 46(R) while not consolidating the CDO.

Portfolio Management believes 20-25% equity ownership, based on similar CDO structures, would not require consolidation.**

Excerpt from D&T Securitization Accounting Manual - July 2005

"If the collateral manager has only a 20 percent holding in the unrated equity securities, it is fairly unlikely that the collateral manager's total holding represents a majority of the CDO's expected losses or expected residual returns, unless its management fees absorb a significant amount of the entity's variability."

Source

1. Deloitte Securitization Accounting - The Ins and Outs (And Some Do's and Don'ts) of FASB 140, FIN46R, IAS39 and More, July 2005

Assumes Collateral Manager does not retain mezzanine or senior securities, this is consistent with Portfolio Management recommendation for CDO security retention.

** In order to ensure compliance with FIN 46R, every CDO structure would require an independent primary beneficiary test to determine actual threshold for equity ownership to maintain off balance sheet accounting (no consolidation).

Enterprise Risk Management: Review of 2007 Plan

Enterprise Risk Management Committee Presentation

December 15, 2006

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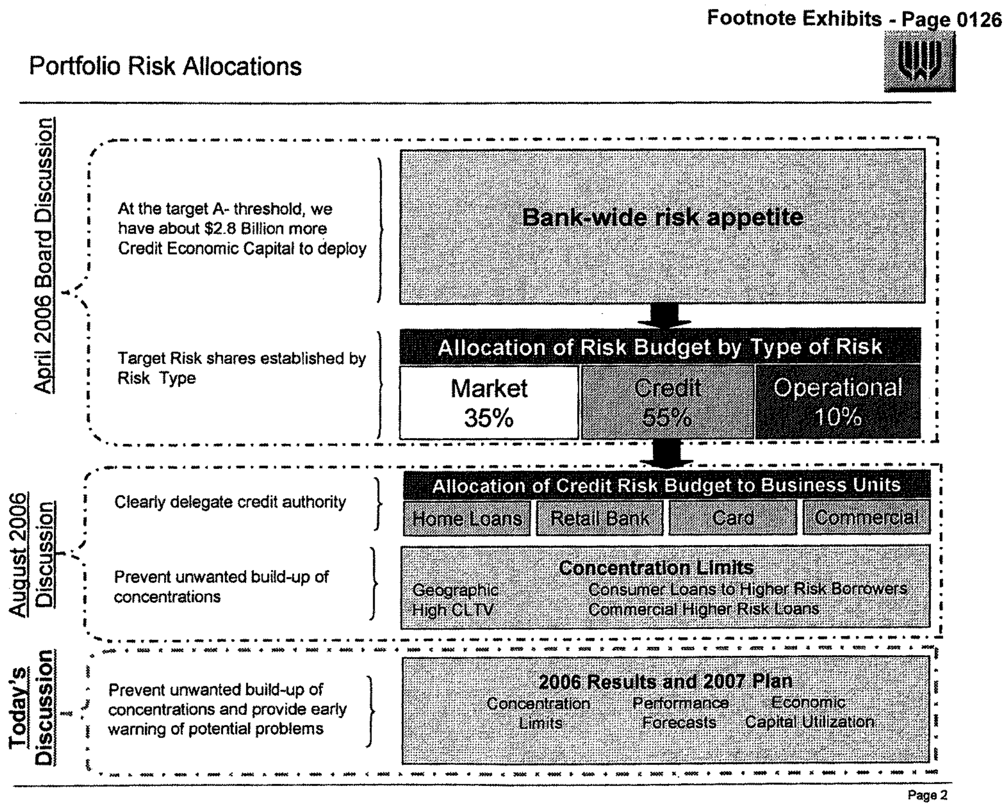
Overview

At the previous 2006 Board meetings, we communicated a high level Credit Risk Strategy and Bank-wide framework for risk appetite and combined this Enterprise Risk framework with our strategic efforts to remix our balance sheet.

In the third quarter we worked collaboratively with the business segments and finance to establish 2007 forecasts for utilization of Economic Capital, Credit Concentrations, and Model Portfolio Composition. Limits, performance targets and triggers were established.

Today, we share 2006 results as of 11/30/06 and review the ERM implications of the 2007 plan.

Footnote Exhibits - Page 0126



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Credit Risk Concentration Limits

Credit Concentration Limits and Current Utilization

- Consistent with our strategic plan we are increasing credit risk in our 2007 business plan. These limits, and utilization there-under, will be monitored and actively managed through the Enterprise Risk Committee.

Credit Risk	Consumer Loans		Commercial Loans	
	Consumer Loans to Higher Risk Borrowers (FICO)	Consumer Loans with High Combined LTV (CLTV)	Geographic Concentrations Single State / Single MSA	Higher Risk Commercial Loans
11/06 Levels:	15.2% (Total)	6.0% ≥ 90 (w/o MI)	46.2% in a single state (CA) 20.5% in a single MSA (LA)	1.0% DSCR < 1.15 0.45% LTV > 75
2007 Plan Levels:	22.9% (Total)	7.3% ≥ 90 (w/o MI)	48.2% in a single state (CA) 21.4% in a single MSA (LA)	1.7% DSCR < 1.15 0.4% LTV > 75
Trigger: 85% of Limit or as states	21.3%	8.5% ≥ 90 (w/o MI)	48% in a single state (CA) 24% in a single MSA (LA)	1.7% DSCR < 1.15 0.9% LTV > 75
Limit:	25% (Total)	10% ≥ 90 (w/o MI)	CA ≤ 50% No MSA > 25%	2% DSCR < 1.15 1% LTV > 75

* As a percentage of total Held-For-Investment Portfolio and Credit Card on a Managed Receivable basis.

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Portfolio Performance

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Portfolio Performance

- Economic drivers are consistent with assumptions in the 2007 Business Plan.
- Provision and chargeoff expenses are expected to increase in 2007 as we return to more normalized credit conditions and implement a planned shift to a more credit-intensive asset mix.
  - Provision is expected to increase $300MM over 2006 to $1.1B
  - NPAs are expected to increase $3.0-3.5Bn
  - NPA will be ≤1% based on $350.6Bn in assets forecast for 2007
  - Charge-offs are expected to increase $145MM to $660MM

Business Unit	Provision $millions		NPA $millions		Chargeoffs $millions	
	2006 Expected	2007 Forecast	2006 (Nov-06)	2007 Forecast	2006 (Nov-06)	2007 Forecast
Card (GAAP basis)	750	603	-	-	-284	-373
Commercial [1]	-79	40	112	-	-6	-6
Home Loans (LBMC, Sub-Prime/HEL Conduit, MBF)	187	272	328	-	-120	-143
Retail Bank (SFR, originated HEL/HELOC, Small Business, Consumer)	169	210	1,722	-	-106	-138
Corporate Support and Other	-177	33	-	-	0	0
Foreclosed Assets	-	-	476	-		
Total WMI	**850**	**1,158**	**2,638**	**$3-3.5B**	**-516**	**-660**

[1] Commercial - includes $4MM for CCBI; Corporate Support and other $35MM

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Credit Mix Shifts Expected in 2007

- Commercial Lending will expand higher margin lending through its Multi-Family "Proceeds" product; anticipate other credit intensive enhancements to existing products and programs. Also expect to see continuing deterioration of Debt Service Coverage due to interest rate environment and impact on Net Operating Income (NOI)
- Home Loans will continue to expand its higher margin offerings and Capital Markets instruments including:
  - Expansion of Subprime and Alternative product offerings
  - New higher margin product innovations – such as Roswell (1st lien with a HELOC that is self-restoring as 1st lien balance is paid down)
  - Introduction of higher margin Collateralized Debt Obligation (CDO) including residual retention
- Card Services does not expect significant changes in credit mix in 2007. They do expect weaker performance in early 2007, but expect it to improve over '07.
- Small Business Lending also expects its credit mix to remain fairly stable in the coming year. It is a relatively new business expecting significant growth in 2007 and correspondingly its use of credit economic capital will more than double.

Managing the Credit Shifts

- Board limits and triggers, as well as other Credit limits (model portfolio concentration limits and performance forecasts) are monitored monthly by Business Risk Committees and further by Corporate Credit Risk Management in Quarterly Credit Reviews
- Business unit Risk Committees monitor performance to Board and other limits and manage trigger events. Trigger events are communicated to Credit and Enterprise Risk Committees and monitored for action.
- The Credit Risk Management Committee (CRMC) monitors cross-business performance, reviews and addresses business unit performance when enterprise limits are at risk.
- Enterprise Risk Management Committee (ERMC) will review and resolve cross-business issues related to concentration limit trigger events where more than one business is driving high utilization and allocation is at issue.
- Will continue build-out of sub-limits in 2007

(Note: see Appendix for business unit detail)

Market Risk & Operational Risk

Footnote Exhibits - Page 0134

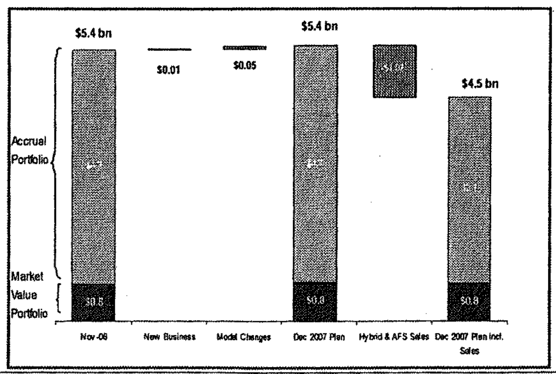
Market Risk Shifts Expected in 2007

Market Value Businesses

- Utilization of the current 10 day Value at Risk ("VaR") limit of $230 million has ranged from 25% to 50%
- The 2007 does not create large shifts in VaR; we estimate the plan would increase utilization by 4% or $10 million
- We expect VaR utilization to rise by about 14% when we introduce additional spread risk factors by mid-2007 as the sub-prime and Alt-A spread risk that is increased by the plan is more volatile
- Finally, the addition of prepayment model variability risk to our VaR calculation will increase utilization by about $17 million or 7%
- In total, utilization of the VaR limit should increase by about 25% in 2007

Accrual Businesses

- The market risk of the accrual books is not significantly changed in the plan, but is expectedly to decrease modestly
- The recent approval to sell Hybrid ARM loans and sell AFS securities should reduce market risk economic capital by over **6%** of total economic capital, moving market risk to below its target level as a percent of economic capital



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Operational Risk Shifts Expected in 2007

- By decreasing activity in traditional business such as 30 year Fixed rate mortgages, and increasing activity in items where we are still building systems and capabilities (such as the Conduit and the Collateralized Debt Obligation businesses), we would expect the plan to increase operational risk
- However, we expect Operational Risk Capital to decrease as we improve our measurement capabilities by
  - Reducing use of external data and replacing it with WaMu-specific operational risk scenarios
  - Reducing the businesses' operational risk capital utilization when their controls and capabilities improve
  - Removing expected losses from the Operational Risk Capital calculation as we are able to prove they are steady and already appear in budgets
- Netting these two effects, we expect a modest decrease in Operational Risk Capital utilization in the 2007 plan

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Economic Capital

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Economic Capital Trends

- Total deployment of economic capital as a percent of available financial resources (dominated by tangible equity) is projected to increase from 71% in Nov. 2006 to 75% in Dec. 2007*
  - Economic capital increases $14.6 to $15.8 BN
  - Available financial resources increases $20.6 to $21.2 BN*
- Key driver is a shift to higher credit risk assets within projected balance sheet growth at the same time that capital composition is tightly managed; credit risk increases from 44% to 47% of total economic capital
- Trends in total economic capital as well as economic capital composition are consistent with strategic goals
- Key drivers:
  - Credit risk: Declining Prime SFR balances, with increasing balances in higher credit risk assets including Credit Card, Small Business Lending, Commercial Real Estate, and Home Equity Loans and Lines of Credit
  - Market risk: Similar aggregate risk profile as current state; minor increase in required economic capital due to portfolio growth and inclusion of potential model risk capital; note that subprime residuals are included in credit risk for economic capital purposes
  - Operational risk: Assumed similar risk profile as current state; increasing economic capital scales with key income and expense drivers

*It is noted that projections of available financial resources in Dec. 2007 including tangible equity are preliminary

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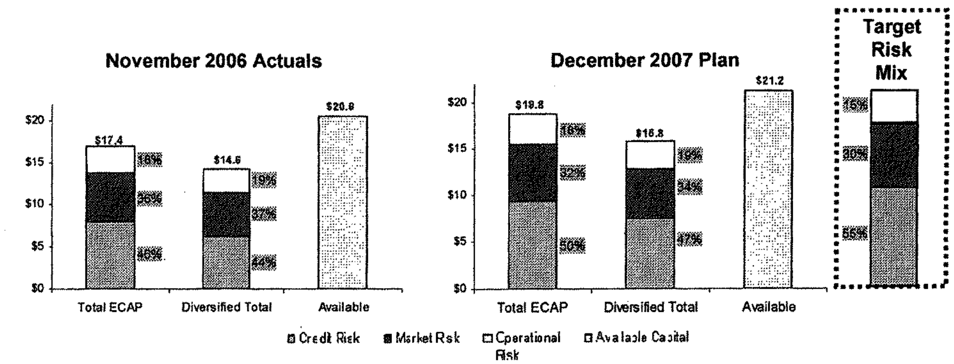
Current & Dec. 2007: Capital Required vs. Available

Economic Capital Required and Available
Nov. 2006 and Dec. 2007



Notes: 1) Available capital in 2007 is based on a rough approximation driven by balance sheet size.
2) The December 2007 Plan does not incorporate our current asset sale initiative.

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Appendix

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Key Credit Risk Concentration Limits—Conceptual Design

Concentration Limits

- Credit concentration limits reinforce and efficiently drive business unit credit risk appetite consistent with the Company's strategic plan.
- Transparent, well communicated credit concentration limits foster improved risk-vs-return planning and should be formally reviewed and ratified/changed annually consistent with the Strategic Plan.
- The credit concentration limits below are among the most important in framing credit risk appetite.

Credit Risk

	Consumer Loans		Commercial Loans	
Key Risks	Consumer Loans to Higher Risk Borrowers (FICO)	Consumer Loans with High Combined LTV (CLTV)	Geographic Concentrations	Higher Risk Commercial Loans
	"Higher Risk Borrowers" are all loans originated through sub-prime programs, 1st Lien SFR prime and Home Equity products < 620 FICO at origination, and 2nd Lien Home Equity, Credit Card and other unsecured products < 660 FICO at origination.	High LTV/CLTV lending can expose the bank to higher levels of loss frequency and severity, particularly during a housing market downturn.	Economic drivers (e.g., employment, available housing stock and home price determinants) are shared within individual geographic regions (e.g., Cities, States). Overexposure to any one particular market could have a significant negative effect on overall frequency and severity of losses.	"Higher Risk Commercial Loans" are those with Debt Service Coverage Ratios (DSCR) lower than 1.15x or LTV Ratios greater than 75%.

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Proposed Credit Concentration Limits and Current Utilization

Concentration Limits

- The credit concentration limits below are designed to be consistent with the Strategic Plan of enhancing our overall returns, in part, by reallocating the balance sheet towards more credit intensive assets.
- Also consistent with our Strategic Plan, the geographic concentration limits are designed to encourage diversification of our California exposure, reinforcing our nationwide franchise.

[Note: The proposed geographic concentration limits should be considered target limits and will be reviewed within the context of the 2007 business plan.]

Credit Risk

	Consumer Loans		Commercial Loans	
	Consumer Loans to Higher Risk Borrowers (FICO)	Consumer Loans with High Combined LTV (CLTV)	Geographic Concentrations	Higher Risk Commercial Loans
April 30th Levels*:	15.9% (Total)	3.4% ≥ 90 (w/o MI)	45.4% in a single state (CA) 20.9% in a single MSA (LA)	0.4% DSCR < 1.15 0.1% LTV > 75
Proposed Limit*:	**25% (Total)**	**10% ≥ 90 (w/o MI)**	**CA ≤ 50% No MSA > 25%**	**2% DSCR < 1.15 1% LTV > 75**
	Not more than 25% of the total Held-For-Investment (HFI) portfolio can be in Consumer Loans to Higher Risk Borrowers.	Overall, Loans with Combined Loan-To-Value rates of 90% or higher are limited to 10% of the total HFI portfolio unless they have Mortgage Insurance (MI). [Note: this limit is subject to the Supervisory LTV limit of 100 % of total capital]	Geographic Concentrations are limited so that no more than 50% of the total HFI portfolio is in California and no more than 25% in any single MSA.	Not more than 2% of the total HFI portfolio can be to Commercial borrowers whose Debt Service Coverage Ratio (DSCR) is lower than 1.15X or 1% to those whose LTV is above 75%.

* As a percentage of total Held-For-Investment Portfolio and Credit Card on a Managed Receivable basis.

Recommendation Approved 7/18/06

Credit Risk Concentration Limits:

- ***Consumer Loans to Higher Risk Borrowers***
  - *All loans originated through the sub-prime programs, SFR prime and 1st Lien Home Equity products < 620 FICO at origination, and 2nd Lien Home Equity, Credit Card and other unsecured products < 660 FICO at origination.*
  - *Limit of 25% of total HFI loans**
- ***Consumer Loans with High Combined LTV (CLTV)*****
  - *Limit of 10% of HFI loans* at a CLTV greater than or equal to 90 unless insured.*
- ***Geographic Concentration***
  - *Limit of 50% of total HFI loans* in any one state (e.g., California)*
  - *Limit of 25% of total HFI loans* in any one metropolitan area (e.g., Los Angeles)*
- ***Higher Risk Commercial Loans***
  - *Limit of 2% of total HFI loans* to commercial borrowers with a Debt Service Coverage Ratio (DSCR) below 1.15X.*
  - *Limit of 1% of total HFI loans* to commercial borrowers with an LTV greater than 75%.*

*HFI loans are defined as all HFI loans in portfolio plus all additional managed credit card loans.

**This limit on Consumer Loans with High CLTV is in addition to the existing regulatory-based limit specified in Credit Policy 408, which restricts Supervisory LTV Exception loans to at most 100% of capital.

Data Management Program

Tom Casey
Debora Horvath
Tom Morgan

December 19, 2006

Footnote Exhibits - Page 0144

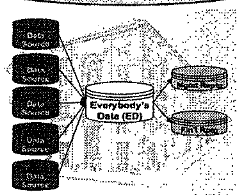
Data Management Problem Statement

WaMu lacks a standard, enterprise approach to data management, which has resulted in higher total cost of ownership, competing versions of the "truth" and lost opportunities for competitive decision making.

Poor Data Management Impacts Speed of Delivery, Quality, Cost, and Risk Resulting in Loss of Competitive Edge

Evolution of Data Management at WaMu

Past

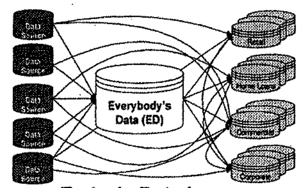


History of Data Management

- The existing data warehouse (ED) was launched within the Finance organization in the early 1990s to provide a common financial reporting framework.
- Reporting was one-dimensional since WaMu was viewed as a single segment.
- As a result of acquisitions -- PNC, Fleet, Dime -- WaMu's reporting environment became more complex over time with the need to support multiple segments.

Basic

Present

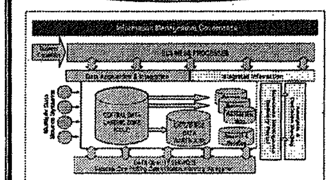


Today's Data Issues

- Through our growth, we have developed over 160 databases supporting various business segments.
- Business decisions often rely on data gathered from multiple sources.
- Users mistrust data that is not controlled within their own segments.
- There is no enterprise-wide data inventory to know what is available.
- SOX 404 compliance and accurate financial and non-financial disclosures are achieved within required timeframes but only with numerous manual reconciliations and work-arounds.

Evolved

Future State



Future State Vision

- Enable better business decisions with timely, accurate data.
- Drive consistent data definitions and controls around data usage through Enterprise Data Governance.
- Increase cross-sell revenue opportunities through a single view of customer relationships across segments.
- Drive cost savings and reduce risk with a unified data environment: clear roles, consistent tools and standards; and repeatable, scalable processes.

Designed

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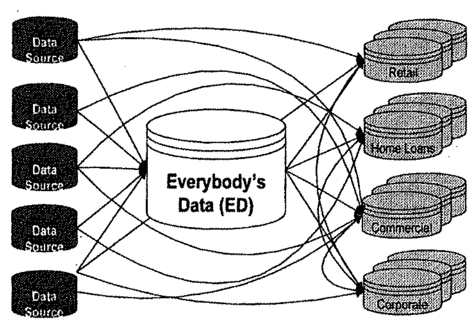
Today: Current State Need for Data

Relevant Issues	
Multiple, redundant data stores	Lack of Data Governance
Manual reconciliation & validation	Complicated processes, lack of clear roles
Redundant data extracts	Difficulty in finding relevant data



Business Impact
Fragmented data ownership and accountability.
Higher risk of data inconsistency, with potential impacts to valuations and business decisions: **Actual Losses** • Incentive Overpayment of Long Beach loans that were originated but not closed: 2.5M (200K per month) over 2 years, 2005-2006 • Basis Floater: inconsistent prepayment data led to misfit of prepayment model; correction led to downward revaluation of asset $42M in 2006 **Near Misses** • $90M service fee error in 2004 • $130M MSR valuation change in 2005
Lack of enterprise insight into customer relationships, service, and profitability
Complexity of data movement increases effort and risks to enhance, retire, or add applications
Manually intensive reconciliations increase labor costs and reduce overall data quality

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JPM_WM02657021

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Data Management Roadmap

Conduct Strategic Planning Gain Executive Approval	Finalize Roadmap Begin Program Execution	Continue Program Execution
2005	**2006**	**2007 - 2008**
✓ Conduct Voice of the Customer ✓ Identify & Prioritize Business Drivers ✓ Develop Strategy for Future State ✓ Develop Phased Program Plan Gain Executive Committee Approval	✓ Launch Data Mgmt Program ✓ Launch Technology Data Governance ✓ Partner with Business Initiatives to Drive Early Value ✓ *Deposit Data Repository (Fraud)* ✓ *Commercial Data Warehouse* ✓ *Siebel Analytics* ✓ Begin Building Technical Foundation ✓ *Central Data Landing Zone (CDLZ)* ✓ *Metadata Program (Data Dictionary)* *Expense $ 3.8M* *Capital $ 6.0M*	➢ Launch Enterprise Data Governance ➢ Continue to Partner w/ Business Initiatives ➢ *Synergy Program* ➢ *Direct Marketing Re-Platform* ➢ *Enterprise Hierarchy Initiative* ➢ Continue Building Technical Foundation ➢ *Enterprise Data Warehouse* ➢ *Data Quality Services* ➢ Develop Core Data Processes ➢ Conduct Training & Awareness *Expense $10.2M* *Capital $17.3M*

Business Priorities Drive Future State Data Management

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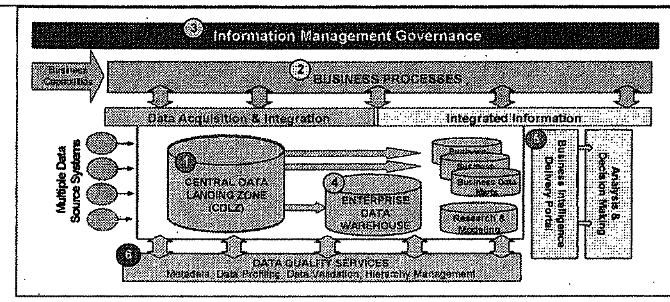
Data Management: Integrated Program View



2006 | 2007 | 2008

1. **Build CDLZ, Populate w/ First Sources** | Continue to Add Sources & Functionality to CDLZ
2. **Ongoing Alignment w/ Business Initiatives in Support of Business Processes**
3. **Launch Data Governance (Technology)** | Launch Information Management Governance (Enterprise)
4. Select Vendor & Build Data Warehouse | Populate Warehouse w/ Integrated Data
5.
   - Begin Delivery of Integrated Data
   - Rationalize & Migrate Legacy Data Systems
6. **Build Data Quality Services in Phased Approach** | Mature & Measure Data Quality Services

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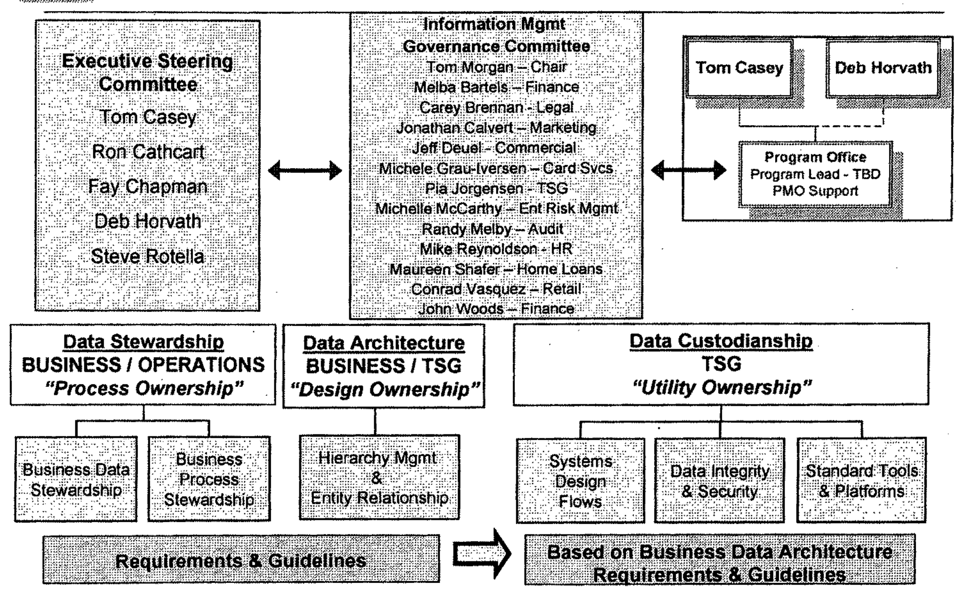
Information Management Governance



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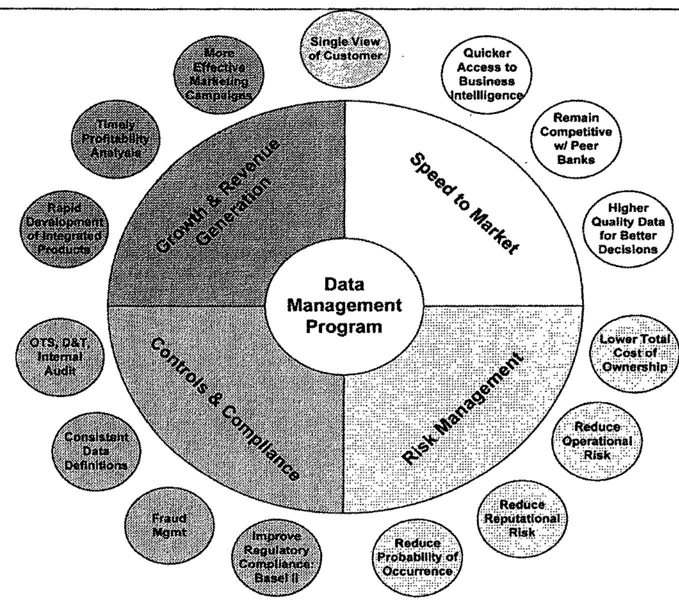
Data Management: Benefits to WaMu



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Next Steps & Milestones

- Launch Information Management Governance – January 2007
- Identify and Prioritize Top 50 Business Processes – February 2007
- Identify Key Data Fields Required by Top Processes – Q2-Q3
- Establish Business Line Accountability for Data Stewardship – Q2-Q3
- Continue Execution of Enterprise Data Management Initiatives – 2007
  - Select Vendor for Enterprise Data Warehouse – January 2007
  - Launch Next Phase Data Quality Services – May 2007
  - Data Warehouse in Production – June 2007

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Corporate Compliance Review Update to ERMC

December 15, 2006

Overview

Corporate Compliance Review (CCR) tests loan originations for Home Loans mortgages, home equity loans and lines, and Commercial loans. The full testing and reporting cycle has been completed for July through September fundings. In addition, Card Services Compliance identifies issues through various detective controls, and Retail Bank Compliance performs targeted testing of new high-risk deposit accounts. This report highlights key issues identified in the reviews that are of concern to Compliance management.

- Home Loans Mortgages: Eighteen of the 90 compliance requirements tested had error rates above tolerance levels in September. These errors span seven federal and one state regulation. Of the 18 above-tolerance issues, 6 affect only a small proportion of customers.
- Home Equity: Five of the 77 compliance requirements tested had error rates above tolerance levels in September. These errors span two federal regulations and one state regulation. Of the five above-tolerance issues, 3 affect only a small proportion of customers.
- Commercial Lending: No error rates were above tolerance in September for the Commercial Group.
- Card Services: The number of unresolved compliance issues at continues to be low. In addition, their severity and the number of customers affected do not warrant escalated attention.
- Retail Bank: Compliance testing of new high-risk deposit accounts (including Non-Resident Aliens and Small Business) for adherence to the USA PATRIOT Act Customer Identification Program did not reveal any significant findings in the most recent testing period.

Some of the above-tolerance issues show favorable error rate trends or are only marginally above tolerances, and are not considered by Compliance management to warrant ERMC attention. However, the three above-tolerance issues summarized in this report are sufficiently material or persistent to warrant ERMC awareness. Each has had persistently high error rates and involve regulatory requirements that apply to essentially all funded or nonfunded loans of the affected business units. If not corrected, they could result in regulatory criticism or other enforcement action. Remediation of each is in process, but continued focus on execution is needed to ensure that the fixes are effective.

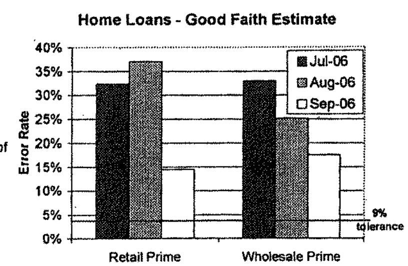
Process Change Note: Corporate Compliance Review will be changing to a quarterly review cycle in 2007, from the current monthly cycle, with increased use of risk-targeted reviews. This change is being made to increase the cost effectiveness and risk focus of the program.

Risk Issue: Good Faith Estimate (RESPA) – Customary lender, broker, escrow, and/or title fees not disclosed correctly on GFE.

Risk to WaMu: Per VOCALS, upfront accurate fee disclosure is our Home Loans customer's primary concern. Inaccurate disclosure may cause customer dissatisfaction, increased complaints, and reputation damage. Also, there is a potential for regulatory criticism if not corrected.

Cause: Failure to follow established policies and procedures, coupled with a lack of systemic controls to drive results.

Remediation Status: Retail and Wholesale processes as well as automated controls recently have been modified to further reduce the error rates. That being the case, CCR trend reports published in early 2007 should reflect the positive impact of these system updates. Furthermore, the long-term solution is being built into the new LOS for each channel.



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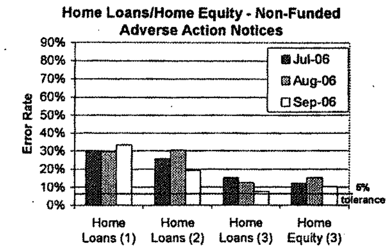
Risk Issue: Adverse Action Notices are incomplete, inaccurate or missing (ECOA & FCRA)

Risk to WaMu: There is a potential for regulatory criticism if not corrected. In addition, inaccurate notification to customers may result in reputation damage and an increase in customer complaints.

Cause: Underwriters not accurately completing this information on the Notice. Error rates are above tolerance in all Home Loans channels.

Remediation Status: Extensive ECOA and FCRA training conducted in all LFCs in August 2006. Underwriting has reissued policies and procedures, implemented a second review program, and conducts internal self-monitoring.

Note: Other adverse action notice requirements also have above-tolerance error rates, but affect much more limited customer populations and, thus, pose substantially less risk.



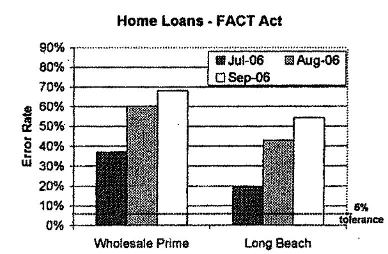
Legend
(1) Incomplete or inaccurate bureau information (FCRA)
(2) Inaccurate reasons for action taken (ECOA)
(3) Missing or inaccurate notice (ECOA)

Risk Issue: FACT Act – Notice to Home Loan Applicant and Credit Score Disclosure missing or inaccurate.

Risk to WaMu: New regulatory requirement, expected to be examined by OTS in 2007. Potential regulatory criticism if not corrected.

Cause: The Wholesale vendor solution (Dorado) was attempted in June 2006, but was unsuccessful. In addition, as a separate issue, the vendor was not displaying or capturing required ("5th factor") information correctly. For LBM, errors resulted from inaccurate system programming. A vendor solution for Retail, Emerging Markets and CD was implemented successfully in February 2006, and error rates for those channels are now within tolerance.

Remediation Status: For Wholesale, all systematic programming corrections were implemented in October. For LBM in November, 50% of the system defects were resolved and the remaining 50% will be resolved with a December system fix. Additionally, these requirements are being built into the LOS for each Channel.



Washington Mutual

CORPORATE COMPLIANCE REVIEW

SUMMARY TREND REPORT

July - September 2006

Report Date: November 2006

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Washington Mutual

CORPORATE COMPLIANCE REVIEW

SUMMARY TREND REPORT
SCORECARD

Number of Compliance Requirements with Error Rates Above Tolerance *Based on Three Month Overall Error Rates*								
Division/Channel	Funded Review				Non Funded Review			
	High	Medium	Low	Total	High	Medium	Low	Total
Home Loans	2	8	1	11	0	8	0	8
Banking (BLCs)	6	2	5	13	0	8	0	8
Consumer Direct	0	4	1	5	0	8	1	9
Long Beach Mortgage	1	5	1	7	0	6	0	6
Retail Banking	1	6	2	9	0	8	0	8
Wholesale	1	6	2	9	0	8	0	8
Home Equity	1	1	0	2	0	3	0	3
CLPC	1	1	1	3	0	3	0	3
FC	0	3	0	3	0	3	0	3
Commercial	0	1	0	1	NA	NA	NA	NA
CRE	0	3	0	3	NA	NA	NA	NA
MFL	0	0	0	0	NA	NA	NA	NA

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Version 1.3

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Washington Mutual
CORPORATE COMPLIANCE REVIEW

Highlighted items are those discussed in the Corporate Compliance Review Update to ERMC

SUMMARY TREND REPORT
Errors Over Tolerance

DIVISION	REVIEW TYPE	CATEGORY	EVENT DESCRIPTION	RATING	July Cited	July Applies	July %	August Cited	August Applies	August %	September Cited	September Applies	September %	3 Month Total Cited	3 Month Total Applies	3 Month Total %
Commercial	Funded	FLOOD DISASTER PROTECTION ACT	Flood Hazard Determination not obtained prior to funding.	Medium	7	101	6.9%	5	106	4.7%	5	110	4.5%	17	317	5.4%
Home Loans	Funded	FAIR CREDIT REPORTING ACT	Notice to Home Loan Applicant and Credit Score Disclosure was missing from the file or inaccurate (Applies to approved, declined and counter-offered loans) (FACT Act)	Medium	119	742	16.0%	223	756	29.5%	266	763	34.9%	608	2261	26.9%
		HIGH COST/PREDATORY	NTB Test Insufficient Information and/or Documentation (Missing Source Documents) to determine whether benefit or no benefit	Medium	14	73	19.2%	3	72	4.2%	3	67	4.5%	20	212	9.4%
		HOMEOWNERS PROTECTION ACT (HPA)	No evidence of HPA disclosure for Fixed Rate Loan missing Inaccurate or incomplete	Medium	3	21	14.3%	7	23	30.4%	2	21	9.5%	12	65	18.5%
			HPA Amortization Schedule not in file or referenced as being provided. (Fixed rate Loans).	Medium	2	20	10.0%	0	15	0.0%	1	19	5.3%	3	54	5.6%
		REGULATION X	The Submission checklist and/or evidence of required broker/builder services missing from file	Medium	1	8	12.5%	1	15	6.7%	2	13	15.4%	4	36	11.1%
			IEAD/AATB not in the file or is inaccurate.	Medium	22	312	7.1%	25	331	7.6%	31	309	10.0%	78	952	8.2%
			Customary lender/broker/title/escrow fees not disclosed on the GFE	Low	178	805	21.9%	180	808	22.3%	95	813	11.7%	451	2426	18.6%
		REGULATION Z	NORTC dates were missing or incorrect	High	10	442	2.3%	9	373	2.4%	14	466	3.0%	33	1281	2.6%
		STATE SPECIFIC	Broker Pre-App DisclosureFee Agreement not signed by broker and applicants (or written statement of no separate fee agmt). Also, broker fees disclosed on final HUD_1 not equal or less than disclosed on GFE	High	3	12	0.25	1	9	11.1%	1	13	7.7%	5	34	14.7%
			Initial 1003 not signed by broker (NY Only)	Medium	2	11	18.2%	0	9	0.0%	1	13	7.7%	3	33	9.1%
		USA PATRIOT Act	Customer Identification Program (CIP) documentation is not in the file, incomplete, inaccurate or unsigned	Medium	49	821	6.0%	44	820	5.4%	53	822	6.4%	146	2463	5.9%
	Non-Funded	FAIR CREDIT REPORTING ACT	Notice of Action Taken did not completely identify FCRA name, address or phone number when credit history was reason for adverse action	Medium	40	133	30.1%	50	170	29.4%	46	139	33.1%	136	442	30.8%
			Counteroffer reason does not properly identify reporting agency if reason is credit related	Medium	20	64	31.3%	14	39	35.9%	8	49	16.3%	42	152	27.6%
			Notice of Action Taken did not reflect the FCRA box checked when applicable	Medium	41	194	21.1%	59	209	28.2%	34	188	18.1%	134	591	22.7%
		REGULATION B	NOIA missing from file or insufficient	Medium	15	33	45.5%	27	57	47.4%	19	47	40.4%	61	137	44.5%
			Counteroffer disclosure missing inaccurate or insufficient.	Medium	56	107	52.3%	38	80	48.0%	15	82	18.3%	107	269	39.8%
			Notice of Action Taken does not accurately / consistently state reasons for action taken	Medium	78	305	25.6%	95	313	30.4%	77	402	19.2%	250	1020	24.5%
			Bank Creditor information not provided on Notice of Action Taken (Bank, LFC address, phone number)	Medium	56	327	17.1%	38	339	11.2%	36	425	8.5%	130	1091	11.9%
			Notice of Action Taken missing from the file or insufficient	Medium	101	663	15.2%	84	675	12.5%	50	663	7.5%	235	1999	11.8%
Home Equity	Funded	FLOOD DISASTER PROTECTION ACT	Flood Hazard Determination not obtained prior to funding.	Medium	579	820	70.6%	9	835	1.1%	1	618	0.2%	589	2273	25.9%
		STATE SPECIFIC	Evidence of Texas 12-day cooling off period not in file or insufficient	High	0	2	0.0%	0	1	0.0%	2	10	20.0%	2	13	15.4%
	Non-Funded	REGULATION B	Counteroffer disclosure missing inaccurate or insufficient.	Medium	12	18	66.7%	7	17	41.2%	7	19	36.8%	26	54	48.1%
			NOIA missing from file or insufficient	Medium	2	7	28.6%	1	1	100.0%	0	0	NA	3	8	37.5%
			Notice of Action Taken missing from the file or insufficient	Medium	33	272	12.1%	39	256	15.2%	23	224	10.3%	95	752	12.6%

* Events displayed are based on the overall 3 month percentage over tolerance

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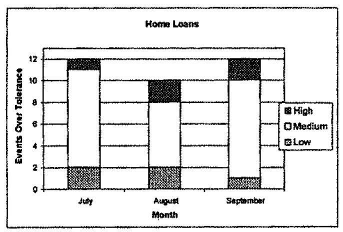
Washington Mutual

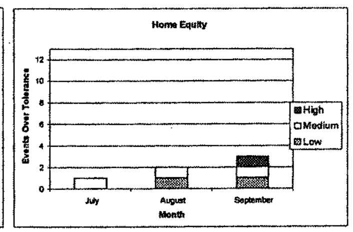
CORPORATE COMPLIANCE REVIEW

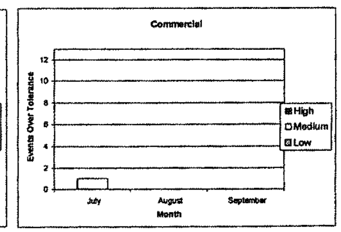
SUMMARY TREND REPORT
FUNDED TREND ANALYSIS

Funded Trend Analysis- Number of Events Over Tolerance
By Month

Division	July				August				September				October				November				December			
	High	Medium	Low	Total	High	Medium	Low	Total	High	Medium	Low	Total	High	Medium	Low	Total	High	Medium	Low	Total	High	Medium	Low	Total
Home Loans	1	9	2	12	2	6	2	10	2	9	1	12												
Home Equity	0	1	0	1	0	1	1	2	1	1	1	3	Will be available once reviews are completed											
Commercial	0	1	0	1	0	0	0	0	0	0	0	0												







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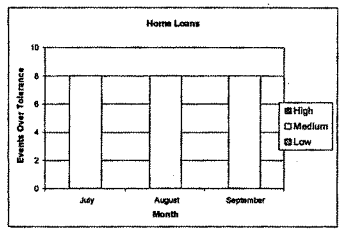
Washington Mutual

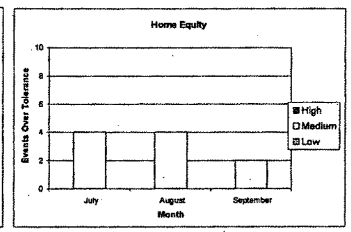
CORPORATE COMPLIANCE REVIEW

SUMMARY TREND REPORT
NON-FUNDED TREND ANALYSIS

Non-Funded Trend Analysis- Number of Events Over Tolerance
By Month

Division	July				August				September				October				November				December			
	High	Medium	Low	Total	High	Medium	Low	Total	High	Medium	Low	Total	High	Medium	Low	Total	High	Medium	Low	Total	High	Medium	Low	Total
Home Loans	0	8	0	8	0	8	0	8	0	8	0	8												
Home Equity	0	4	0	4	0	4	0	4	0	2	0	2	Will be available once reviews are completed											





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Washington Mutual

CORPORATE COMPLIANCE REVIEW

SUMMARY TREND REPORT
Percent of Loans with Findings

Percentage of Loans with one or more Compliance Errors *Based on Three Month Overall Results*		
Division/ Channel	**Funded Review**	**Non Funded Review**
Home Loans	61%	31%
Banking (BLCs)	77%	35%
Consumer Direct	42%	33%
Long Beach Mortgage	59%	27%
Retail	54%	31%
Wholesale	81%	36%
Home Equity	37%	17%
CLPC	30%	15%
FC	41%	20%
Commercial	11%	NA
CRE	26%	NA
MFL	7%	NA

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Corporate Credit Review
Organizational Update

Presented to
Board of Directors' Finance Committee
of Washington Mutual Bank and Washington Mutual, Inc.
December, 2006

WaMu

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Corporate Credit Review
Role and Responsibilities

Corporate Credit Review is responsible for providing an independent assessment of credit risk and credit quality for the Board of Directors and Senior Management to ensure that lending and credit risk management practices are consistent with corporate business strategies and risk tolerance objectives. Activities include:

- Independent credit risk reporting framework which supports the enterprise risk governance structure and the proactive identification and monitoring of credit risk and credit quality throughout the enterprise
- Analysis of credit risk trends that may adversely affect portfolio performance and credit quality
- Independent review and analysis of risk rating accuracy and timeliness, risk rating migration, and risk rating methodologies including the evaluation of the Bank's internal risk rating processes
- Tracking of credit risk issues that exceed agreed upon risk tolerance performance benchmarks. This includes tracking and testing the remediation plans established by the business to ensure resolution of the identified risk.
- Evaluation of credit risk mitigation and default management activities including Special Assets and problem loan management
- Review and evaluation of business compliance with and effectiveness of the Bank's internal policies, procedures, business strategies and risk tolerance levels, applicable laws and regulations

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Value Add Proposition

Corporate Credit Review fulfills the regulatory requirement and mandate for an independent internal asset review function and is designed to be leveraged by the business line and integrated with the various business quality assurance processes. In addition, Corporate Credit Review supports the Chief Credit Officer's governance structure by focusing on the proactive identification of emerging risk issues throughout the enterprise through the following value add orientation:

- Data and analytically driven approach
- Risk based annual review plan
- Indepth assessment and review of each business line or credit portfolio focused on key risk drivers unique to that business line or portfolio
- Partnership and collaboration with the business to create a consistent view of credit risk
- Understands, anticipates, and communicates industry trends in various portfolios
- Subject matter expertise, and knowledge base regarding credit related Regulatory developments and Basel II

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Methodology and Performance Metrics

Consistent with the strategic plan and the Bank's efforts to expand credit exposure, Corporate Credit Review is mandated in its role to ensure there is a risk based methodology and performance metrics driven approach to monitoring and measuring credit risk and adherence to the bank risk strategy. Activities are managed using a risk based annual review plan that determines review intervals and priorities. Corporate Credit Reviews primary activities include:

Targeted Reviews:
Limited in scope with a focus on specific factors that may contribute to potentially higher risk. Targeted reviews are conducted on an as needed basis where emerging risk issues have been identified, or to evaluate changes in credit related activities, and/or portfolio risk management and oversight activities. (Example: Long Beach EPD/FPD, and Commercial Group Data Integrity and Quality Issues).

Portfolio Risk Reviews:
Focused on specialized credit risk management activities on non-homogenous portfolios. These portfolios are not subject to the continuous testing process but are reviewed periodically on a quarterly, semi-annual, or annual risk-based review cycle with review ratings assigned based on a comprehensive assessment of credit risk that includes credit quality, credit risk management, portfolio oversight and compliance with regulations and internal policy. Ratings are consistent across all review types: Satisfactory, Satisfactory with Qualification, Requires Improvement, and Unsatisfactory. Portfolios included in this review type include:

- Mortgage Banker Finance
- National SBA Lending
- Community Lending and Investment
- Special Assets
- Card Services
- Large Borrower s
- Home Builder Finance
- Wind down portfolios
- Small Business Lending
- Appraisal Valuation (Consumer and Commercial)
- National Operations Center (Royal Ridge)
- Construction Lending

Post-Funding Testing Oversight:
Oversight of continuous transactional testing for all homogenous type portfolios performed by the Chief Risk Officers testing teams who provide weekly and monthly feedback to the business unit. The reviews are designed to provide immediate feedback on transactional defects and elevate systemic risk issues that may materially impact liquidity or salability of portfolio assets within 30-days of loan origination.

- Home Loans Group
- Specialty Lending
- Retail Lending Group
- Multi-Family Lending
- Commercial Mortgage Lending

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Revised Post-Funding Testing Event Codes

Working with the Chief Risk Officers, their business unit risk teams, and legal this process was repositioned. The process refinements implemented not only enhanced efficiency, but developed and established materiality thresholds and layered risk elements. Risk events were reduced from 578 events to 199 events. The Chief Risk Officers were given responsibility for the day to day execution of the testing activities.

Event Definitions	
Primary Events	These are the credit exceptions that are deemed to be material and high risk events.
Secondary Events	A sub-set of primary events which are designed to provide the business with granularity on the key risk drivers of primary events. If more than one secondary event rolls up to the same primary event it is only counted as one primary. If the secondary events have different severity levels, the higher level event rolls up to the primary.
Severity Level Definitions	
High Severity Level	Material collateral, credit, and documentation errors that directly impact loan performance, enforceability, and/or salability. This definition includes fraud and material misrepresentation. Must be immediately addressed by management with an associated action plan.
Medium Severity Level	Collateral, credit and documentation errors considered non-critical in isolation, but have the potential to cause a material impact when combined with other risk factors. These exceptions create the need to review for potential impacts to the performance of the credit and/or salability. These errors are considered noteworthy to management and when each occurs at a rate over a predetermined materiality threshold they are deemed to be material and require management's attention and the establishment of an action plan.
Materiality and Layered Risk	
Materiality Threshold	Given that even a single citing of a High event is considered material and results in an Unsatisfactory rating for the loan under review, there is no materiality threshold relating to High events. Effectively, the threshold for materiality is 0%. Each medium event is assigned a materiality threshold ranging from 2% to 5%. Medium events impact the "Satisfactory", "Satisfactory with Qualification", and/or "Requires Improvement" loan ratings if the error rate on that specific medium event is over the materiality threshold. This is based on the last reported trailing three month performance data relating to the respective channel.
Layered Risk	There are six medium severity primary events that are identified as layered risk events. In the event an individual loan is cited with any combination of three or more of these layered risk issues a high severity event is triggered. These will be used for the purpose of calculating the individual loan rating.

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Revised Post-Funding Testing Event Codes

Each loan that is reviewed in the post-funding testing activity is assigned one of four possible ratings: Satisfactory, Satisfactory with Qualification, Requires Improvement, or Unsatisfactory. Performance benchmarks (risk tolerance thresholds) have been set to track and report origination performance in the respective business lines.

Individual Loan Rating Definitions	
Unsatisfactory	A loan is rated "Unsatisfactory" when it is cited with one or more High events.
Requires Improvement	A loan is rated "Requires Improvement" when it is cited with two or more Medium events that are over the stated materiality threshold, but no High events.
Satisfactory with Qualification	A loan is rated "Satisfactory with Qualification" when it is cited with one Medium event that is over the stated materiality threshold, but no High events.
Satisfactory	A loan is rated "Satisfactory" when it is not cited with any High event or any Medium event that is over the stated materiality threshold.

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Summary

- Corporate Credit Review is an integral part of the Bank's enterprise risk governance structure with a focus on the independent assessment and proactive identification of credit risk issues throughout the enterprise.
- Elevation of issues to Executive Management and the Board are focused on those high and medium risk issues that may impact one of the following:
  - Liquidity and Salability of portfolio assets
  - Regulatory risk
  - Credit practices when inconsistent with established corporate business strategies and credit risk tolerance objectives
- Corporate Credit Review is a uniquely qualified group of professionals with a broad spectrum of financial services product knowledge, experience, and professional certifications including: Professional Risk Managers, Certified Risk Professionals, and OCC, OTS, FDIC and Federal Reserve Bank experience.

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MEMORANDUM

DATE: **December 8, 2006**

TO: **Board of Directors' Finance Committee of Washington Mutual Bank and Washington Mutual, Inc.**

FROM: **Hugh Boyle, Chief Credit Officer**
Cynthia Abercrombie, Senior Credit Risk Officer

RE: **Organizational Update**

In June 2006, Corporate Risk Oversight & Compliance became separate Organizations reporting to two separate Senior Executives, Hugh Boyle, Chief Credit Officer and Richard Lewis, Chief Compliance Officer, respectively. Both Senior Executives report to the Chief Enterprise Risk Officer.

Alignment of the newly created Corporate Credit Review function under the Chief Credit Officer preserves the independent credit risk focus of the group on a firm wide basis.

Corporate Credit Review (CCR) has responsibility for providing an independent assessment of credit risk and credit quality for the Board of Directors and Senior Management to ensure that lending and credit risk management practices are consistent with corporate business strategies and risk tolerance objectives. Corporate Credit Review is an integral part of the Bank's enterprise risk governance structure with a focus on the independent assessment and proactive identification of credit risk issues throughout the enterprise. In addition, Corporate Credit Review fulfills the regulatory requirement for an independent internal asset review function.

To ensure greater effectiveness, the day to day execution of credit risk management and asset quality is delegated to the Chief Risk Officers. Chief Risk Officers received a turn-key operation including skilled resources, a centralized post-funding testing group within their Division, and a quality control process.

Transition of Activities to Chief Risk Officers

- Completed Phase I and Phase II transition of Post funding testing and risk rating activities to the Chief Risk Officers.
    - Developed an open communication protocol with each Chief Risk Officer (CRO) group;
    - Transitioned the Post Funding Review Process (and seasoned loan review in the Commercial portfolio) to the Chief Risk Officer organization:
        - Established minimum testing criteria
        - Revised the event codes incorporating a Primary and Secondary structure as well as a multi-layered component

- Established Materiality Thresholds that more appropriately define the risk of the event
- Developed definitions for Loan Level Ratings
- Defined the Performance Benchmarks for the Loan Level Ratings
- Provided training in three phases that included web cast presentations, job aids and detailed instructions

- Transitioned the Change Request Summary "CRS" Approval Process to the Chief Risk Officer organization;
- Transitioned ownership of Commercial risk rating development to the Chief Risk Officer organization, with Corporate Credit Review maintaining oversight;
- Transitioned ownership of the Mortgage Banker Finance risk rating development to the Home Loans Chief Risk Officer organization, with Corporate Credit Review maintaining oversight.

Roles and Responsibilities

At the direction of the Chief Enterprise Risk Officer and the Chief Credit Officer, Corporate Credit Review is responsible for providing management and the Board of Directors with an independent, objective, accurate, and timely assessment of credit risk and credit quality. This includes:

- Independent credit risk reporting framework which supports the enterprise risk governance structure and the proactive identification and monitoring of credit risk and credit quality throughout the enterprise.
- Analysis of credit risk trends that may adversely affect portfolio performance and credit quality;
- Conducting early warning activities to identify and assess potential emerging credit risk exposures in the Bank's portfolios;
- Analysis and oversight of post-funding testing results;
- Evaluation of credit quality and underlying trends;
- Evaluation of risk mitigation and default management activities including Special Assets and problem loan management;
- Independent review and analysis of risk rating accuracy and timeliness, risk rating migration, and risk rating methodologies including evaluation of the Bank's internal risk rating process;
- Development of an annual Corporate Credit Review plan, principal activities and report timeframes to focus on the evaluation and assessment of the critical risk elements of the Bank's credit related activities and emerging credit risk issues. This includes assessment of compliance with and effectiveness of the Bank's credit risk management and portfolio oversight processes, internal policies, procedures, laws and regulations;

- Quarterly, semi-annual, or annual credit risk reviews and credit related processes that are not included in post-funding testing activities (MBF, HBF, CL&I, Special Assets, Appraisal, Large Borrower Relationships, and Card Services, etc.);
- Development and measurement of key risk performance indicators and a risk reporting framework to support governance and monitoring.
- Development and maintenance of an appropriate organizational structure including staffing levels;
- Providing the Finance Committee of the Washington Mutual Bank Board of Directors and Senior Management with objective, accurate, and timely information regarding the Company's adherence to its credit strategies and risk tolerance objectives;
- Ensuring the qualifications and training of personnel are commensurate with the requirements necessary to perform CCR activities.

Credit Review Value Add Proposition

Corporate Credit Review supports the Chief Credit Officer's governance structure by focusing on the proactive identification of emerging credit risk issues throughout the enterprise, utilizing robust metrics and meaningful analytics to identify and assist the business in mitigating portfolio credit risk for the organization. Credit risk exposure is determined relative to the business line or credit portfolio being reviewed, in addition to the entire corporation.

This oversight function is carried out through review and oversight of the post-funding testing activities performed by the Chief Risk Officers, the completion of targeted reviews of emerging credit risk issues, reviews of various credit support functions, and quarterly, semi-annual, or annual portfolio risk reviews.

The Corporate Credit Review Value Add Orientation:

- Is based upon a data and analytically driven approach
- Utilizes a risk based annual review plan
- Indepth assessment and review of each business line or credit portfolio focused on key risk drivers unique to that business line or credit portfolio
- Provides a partnership and collaboration with the business to create a consistent view of credit risk
- Is focused on fulfilling the Regulatory requirement for an independent internal asset review function
- Is designed to be leveraged by the business line and integrated with the various business quality assurance processes
- Corporate Credit Review understands, anticipates, and communicates industry trends in various portfolios
- Provides subject matter expertise, and stays abreast of credit related Regulatory developments and Basel II.

- Corporate Credit Review professionals have worked across a broad spectrum of Financial Services products. Our team members have performed numerous Credit reviews across virtually every asset class (prime and sub prime) including:
  - Commercial Real Estate
  - Credit Cards
  - Construction Lending
  - Asset Based Lending
  - Appraisal (Consumer and Commercial)
  - Loans and Lines
  - Mortgage (Prime and Sub prime)
  - Auto
  - Timeshare
  - Small Business
  - Syndications/Participations
  - Agriculture Loans
  - Troubled Asset Disposition
  - Commercial & Industrial
  - Leasing
  - Student Lending
  - Home Equity

Professional Certifications

We encourage our Credit Risk professionals to attain specialized certifications as a way to enhance our skills and demonstrate our commitment to providing clients with the highest level of service and collaboration. Our diverse team has the following professional certifications:

- Commissioned Bank Examiner (OCC, OTS)
- Professional Risk Manager
- Certified Risk Professional
- Credit Business Analyst
- Certified Fraud Examiner
- Project Management Professional
- Certified Public Accountant
- Six Sigma Experience
- Chartered Robert Morris Associate

In addition to these certifications, a number of the team members hold advanced degrees (MA, MS, PhD, and MBA) in specialized disciplines. The breadth and depth of the Credit Risk team's experience and professional certifications, ensures that there is a robust corporate level credit review of the business.

Methodology and Performance Metrics

Consistent with the strategic plan and the Bank's efforts to expand credit exposure, Corporate Credit Review is mandated in its role to ensure there is a risk based methodology and performance metrics driven approach to monitoring and measuring credit risk and adherence to the bank risk strategy. Corporate Credit Review activities are managed using a risk based approach determining review intervals or priorities. The review schedule is set forth in the Annual CCR Review Plan. The Plan is reviewed and approved by the Chief Credit Officer and the Chief Enterprise Risk Officer. CCR evaluates the risk profile of each credit portfolio on a quarterly basis to determine any material shifts in credit risk strategy and identify any emerging risk issues which would create the need to reprioritize or change the annual Plan. The risk assessment is based on a combination of indicators, including, but not limited to the following:

- A comparison of Front End Guidance/Quarterly Credit Risk Review objectives to actual results
- Portfolio performance/risk rating migration trends
- Credit attribute root cause analysis (post-funding testing results)
- Economic and/or product type impact on the risk profile of the portfolios
- Changes within the loan servicing organization or significant changes to investor requirements

CCR delivers on this mandate and the Annual Review Plan through the use of three primary review activities:

- **Targeted Reviews:** A Targeted Review is limited in scope with a focus on specific factors that may contribute to potentially higher risk. Targeted Reviews are conducted on an as needed basis where emerging risk issues have been identified. A targeted review focuses on specific higher risk portfolios, specific segments of portfolios, or specific processes. Targeted reviews may also be considered for areas/departments involved in credit related activities, and/or portfolio oversight, that are not directly responsible for managing assigned credit portfolios.
- **Portfolio Risk Reviews:** CCR provides quarterly, semi-annual, or annual portfolio risk reviews to the Chief Risk Officers outlining identified key risk areas. The CRO's have the opportunity to provide feedback on the review. The final report, with Business Unit and CRO response, is issued to the Head of the Business, the Chief Enterprise Risk Officer, the Chief Credit Officer, Internal Audit, and other Business Unit management as appropriate. The Chief Credit Officer, Credit Risk Management and the Chief Enterprise Risk Officer are briefed on any significant risk issues by CCR Senior Managers.

Both Targeted Reviews and Portfolio Risk Reviews are developed utilizing a documented Review Plan which includes; a specific scope and focus, risk based sampling methodology, assessment of risk rating accuracy and timeliness, policies and procedures adherence, credit quality, credit risk management assessment, and Regulatory adherence. Review ratings are assigned by CCR based on a comprehensive assessment of credit risk that includes analysis of pertinent data from both internal and external sources. Ratings are consistent across all review types: ***Satisfactory, Satisfactory with Qualification, Requires Improvement, and Unsatisfactory***.

- **Post-Funding Testing Oversight:** Homogenous and non-homogeneous (MFL/CML) loan portfolios are subject to post-funding testing performed by the Chief Risk Officer of each line of business.

  CCR conducts an independent assessment of the post-funding transactional loan testing completed by the Chief Risk Officer teams to ensure the integrity of the testing system and methodology, and appropriate reporting of risk errors and events. The following business Units are part of this oversight activity: Home Loans, Retail Bank, and Commercial (multifamily lending and commercial real estate). Each Channel has a separate sampling methodology focusing on a number of risk events, categorized by the following: ***credit evaluation, operational evaluation/process, and collateral.***

  Utilizing this approach, emerging risk issues surface quickly, providing the organization with meaningful and timely information through weekly loan level detail and monthly trending reports. This information and reporting assists the Chief Risk Officers and business units in developing remediation plans with assigned responsibility and target dates for completion.

Working closely with the various Chief Risk Officers we reassessed the post-funding testing events, eliminated the confusion caused by the previous low risk events, and created materiality thresholds and layered risk elements in the process. The new process elevates those high and medium risk issues that can materially impact liquidity and salability of portfolio assets. Performance metrics have been agreed to by each business unit's Chief Risk Officer and integrated into business management of these products.

Revised Post-Funding Testing Event Codes

The process refinement efforts in this area have been exhaustive taking four months to complete and implement. Working with the Chief Risk Officers:

- The previous event coding was reduced from 578 events to 199 events, 42 of which are defined as primary events.
- Post funding testing event codes were revised incorporating a Primary and Secondary event structure as well as a Layered risk component.
- Each loan that is reviewed is assigned one of four possible ratings (Satisfactory, Satisfactory with Qualification, Requires Improvement or Unsatisfactory); and performance benchmarks (risk tolerance thresholds) have been set to track and report origination performance in the respective business lines.

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Severity Level Definitions	
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Materiality and Layered Risk	
Materiality Threshold	Given that even a single citing of a High event is considered material and results in an Unsatisfactory rating for the loan under review, there is no materiality threshold relating to High events. Effectively, the threshold for materiality is 0%. Each medium event is assigned a materiality threshold ranging from 2% to 5%. Medium events impact the "Satisfactory", "Satisfactory with Qualification", and/or "Requires Improvement" loan ratings if the error rate on that specific medium event is over the materiality threshold. This is based on the last reported trailing three month performance data relating to the respective channel.
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Individual Loan Rating Definitions	
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Satisfactory with Qualification	A loan is rated "Satisfactory with Qualification" when it is cited with one Medium event that is over the stated materiality threshold, but no High events.
Satisfactory	A loan is rated "Satisfactory" when it is not cited with any High event or any Medium event that is over the stated materiality threshold.

Debt Capacity Error Event Coding

The following is an example of the *Debt Capacity Error* primary and secondary event coding. In this example the Primary Event is shaded. All of the Secondary Events which provide further granularity on the issue are also provided. Let's focus on Secondary event code #1013905 and see how the citing of that event makes it through the system and gets reported to the business.

- When reviewing a file, the Analyst refers to the Desk Aid to view the Test Criteria and applies the test criteria to the loan. If the Analyst discovers a finding they apply the applicable Event Code to the finding.

All DTI related Event Codes

Secondary Event Codes rolling up to Primary Event

	EVENT TYPE	CODE	DESCRIPTION	Home Loans Test Criteria
1	Primary	1013900	Debt Capacity or Debt Ratio Error	Review and compare credit report and application for inconsistencies and accuracy and calculate debt to income ratio. Verify payments on the loan approval, credit report, and other documentation are taken into consideration in the Debt to Income Ratio, such as paystub or divorce decree debts. Check the accuracy of the PITI using the correct qualifying rate and escrows as indicated on final HUD 1 and compare to final approval AUS for inconsistencies and calculate debt to income ratio for acceptance.
2	Secondary	1013902	There was an error in the calculation of income, but did not result in a final debt ratio that exceeded guidelines	Recalculate income from paystubs, W2's, VOE, bank statements or tax returns and compare to underwriter's calculation/approval for accuracy. Review per tolerance of Channel being reviewed.
3	Secondary	1013903	There was an error in the calculation of income that resulted in a debt ratio that exceeds guidelines	Recalculate income from paystubs, W2's, VOE, bank statements or tax returns and compare to underwriter's calculation/approval for accuracy. NOTE: If does not exceed guidelines cite 1013902.
4	Secondary	1013904	Income was used to qualify that did not meet guidelines, and if removed would not result in a debt ratio that exceeds guidelines	Review income source documents for adherence to program parameters and/or guidelines. Confirm bonus or OT had sufficient history confirmed to use. Confirm commission, self-employed, or 2nd job time is sufficient to use income. NOTE: If income is removed, and recalculated debt ratio exceeds guidelines cite 1013905.
5	Secondary	1013905	Income needed to qualify did not meet guidelines and if removed results in a debt ratio that exceeds guidelines	Review income source documents for adherence to program parameters and/or guidelines. Confirm bonus or OT had sufficient history confirmed to use. Confirm commission, self-employed, or 2nd job time is sufficient to use income. If income is removed, determine if debt ratio exceeds guidelines.
6	Secondary	1013914	Liabilities shown on the application or elsewhere in the file were not all used in the submission to AUS	Compare liabilities on the application, credit report and /or bank statements to the AUS findings. N/A for LBMC
7	Secondary	1013915	There was insufficient documentation for the exclusion of debts	Compare documentation, approval conditions for clarification and documentation on removal of debts from final debt to income ratio (ie: If another party pays the debt but it is not properly documented OR student loan deferment not properly documented). NOTE: If debts required to be paid off at closing, but not documented, cite 3071800.
8	Secondary	1013919	An error in the debt calculation was identified and when calculated correctly the debt to income exceeds bank maximum	Review and compare credit report and application for inconsistencies and/or inaccuracies and calculate debt to income ratio. Cite this event if the tolerances are exceeded
9	Secondary	1013920	An error in the debt calculation was identified and when calculated correctly the debt to income does not exceed bank maximum	Review and compare credit report and application for inconsistencies and/or inaccuracies and calculate debt to income ratio. Cite this event if the tolerances were not exceeded

Figure 1: Debt Capacity Error, Primary and Secondary Event Codes

- The Analyst enters the applicable Event Code into the Database.
- Once entered, the Event Code becomes eligible for the Weekly Report, which is pulled from the database.
- The Event Codes are reported to the business via the Weekly Report. See Circle A (figure 2, next page).

WaMu Corporate Credit Review Quarterly Update
December 2006

Washington Mutual **SPECIALTY LFC WEEKLY FINDINGS REPORT**

REPORT DISTRIBUTION DATE: 7/3/06 LFC RESPONSE DATE: 7/10/06
REPORT DATE: 07-03-06
RELATIONSHIP MANAGER: David Viesbrock

LFC: Stockton, Long Beach
HIGH AND MEDIUM EVENTS

LFC RESPONSE

Loan Number	Borrower Name	Date Funded	CRO Rating	SEC Rating	Process Category	Sub Category	Event Code	Event Description	Supplemental Description	Concur Yes/No	Field Response	Response Date
0698079902	SAUL MADRIGAL	12-May-06	High	4	CREDIT EVALUATION	DEBT CAPACITY	193000	Documentation found in the file did not support stated income and Risk Mitigation or Loss Detection confirmed misrep.	Misrepresentation of the borrower's stated income was confirmed by the Risk Mitigation Department.) The application states borrower has been self-employed for three years, two months, however the LBMC credit report reflects employment information with Affina reported 02/06(occupation unknown) and Brake Parts Inc. since 1991 reported as recent as 01/05. Both of these jobs are reported during the same period of time the borrower has	YES	LFC CONCURS WITH FINDINGS. UNCORRECTABLE ERROR. FINDINGS WERE REVIEWED WITH THE EMPLOYEE WHO SIGNED OFF ON THE CONDITION, SLC, AND THE AUDIT PROCESS THAT SHOULD HAVE BEEN FOLLOWED. EMPLOYEE WAS COUNSELED	07/13/2006
			Medium	3	CREDIT EVALUATION	DEBT CAPACITY	103905	Income needed to qualify did not meet guidelines and if removed results in a debt ratio that exceeds guidelines	Using the income verified on Transcripts from IRS and the stated room rent to be received the income would change from $5,564.00 per month down to $4,013.95 causing the ratios to exceed guidelines at 65.44/65.44	YES	LFC CONCURS WITH FINDINGS. UNCORRECTABLE ERROR. FINDINGS WERE REVIEWED WITH THE EMPLOYEE WHO SIGNED OFF ON THE CONDITION, SLC, AND THE AUDIT PROCESS THAT SHOULD HAVE BEEN FOLLOWED. EMPLOYEE WAS COUNCELED	07/13/2006

A

B

Figure 2: Detail Weekly Report

- Business Concurs or does not Concur with finding and sends Responses. See Circle B in (figure 2, above).
- If the business does not concur with the Event Code decision, an arbitration process begins with the business providing a basis for their non concurrence.
- The Arbitration Process ends in one of two outcomes. Business unit provides documentation supporting non-concurrence which would remove the event from any future reporting; or, the documentation is not sufficient and the event is included in the reporting.
- The Monthly Report is sent to the CRO and the business unit officers.

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Post Funding Performance Benchmarks

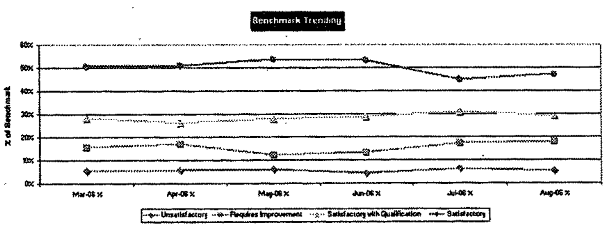
The following is an example of the post funding performance benchmark scorecard from the Home Loans Credit Review Trending Report. Performance metrics have been agreed to by each business unit Chief Risk officer and integrated into business management of these products.

Home Loans

WaMu SCORECARD

HOME LOANS CREDIT REVIEW

HOME LOANS									
	Benchmarks	Jun-06 #	Jun-06 %	Jul-06 #	Jul-06 %	Aug-06 #	Aug-06 %	Total	Total %
LOAN REVIEW RATINGS									
Unsatisfactory	</= 2.5%	40	4.4%	58	6.4%	50	5.3%	148	5.4%
Requires Improvement	</= 10%	123	13.5%	157	17.4%	168	18.0%	448	16.3%
Satisfactory with Qualification	</= 20%	265	29.0%	281	31.2%	274	29.3%	820	29.8%
Satisfactory	>/= 80%	486	53.2%	406	45.0%	443	47.4%	1335	48.5%
SAMPLE									
Sample Requirement		875		900		875		2,650	
# of Loans Reviewed		914		902		935		2,751	



- Home Loans Benchmark Trending is inclusive of post-funding performance of loans originated through the Retail Home Loans, Wholesale, Consumer Direct, and Long Beach Mortgage origination channels.
- Unsatisfactory loan ratings coming out of the prime channels (subprime issues are addressed in the Appendix) are being driven largely by documentation issues that have an adverse impact on the security instruments and appraisal issues that could impact values. Examples would include: Security instrument (Notes, Deeds of Trust) that are inaccurate or missing; and or, appraisal discrepancies relating to a property type that may not be acceptable to the Bank, or comparable sales that are not within the same market or inappropriate to support the underlying collateral in a transaction These findings have been used as a basis for providing training and counseling to the accountable staff.
- The Requires Improvement and Satisfactory with Qualification loan ratings in the prime channels are being driven largely from errors impacting the evaluation of the credit and the ultimate loan decision as well as errors relating to the accuracy of information stated on the applications. Examples would include: the lack of

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proper verification of income, employment, and/or other borrower assets that would provide additional strength to support the credit decision. A remediation plan is being developed.

WaMu

Risk Rating Administration

Corporate Credit Review provides Basel II support through our Risk Rating Administration group. As WaMu's riskr ating systems evolve, the group will be responsible for ensuring that the developed Basel II risk rating systems are performing as intended and that risk ratings are timely and accurate. These activities include:

- To meet Basel II requirements, CCR is aligned to provide independent oversight due to its own independence from all in-house designers and developers (system and model designers) and raters (ratings and parameter assigners in the risk rating process).
- This effort will include a comprehensive, coordinated, and independent review process to ensure that ratings are accurate and that the rating system is performing as intended.
- In large part this oversight will entail checking and confirming the work of others and ensuring that the rating system's components work well together.

Management Activities

Other activities in which Corporate Credit Review participates include:

- Credit Risk Management Committee
- Senior Loan Committee
- Front End Guidance Meetings
- Quarterly Credit Risk Review Meetings
- Problem Loan Reporting
- Other management activities as requested

Appendix: Annual Review Plan

Review Program Components	Review Frequency	Review Schedule															
		2006				2007											
		Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Commercial																	
Commercial Real Estate Lending	Semi-Annual		●		●			●						●			●
Commercial Mortgage Lending	Quarterly		●					●						●			●
Multifamily Lending	Quarterly		●				●			●			●			●	
CL&I Investments/Loans	Quarterly	●		●			●			●			●			●	
Large Borrower	Quarterly		●			●			●			●			●		
Wholesale	Semi-Annual						●							●			
Portfolio Management (NOC)	Annually					●											
Special Assets	Annually		●														
Real Estate Collateral Valuation	Annually			●													
National SBA Lending	Annually						●										
Wind-Down Portfolios	Annually							●									
Home Loans																	
Mortgage Banker Finance	Quarterly	●			●			●			●			●			●
Long Beach - Originations	Quarterly		●			●			●			●			●		
Sub-Prime Conduit - Purchased Loans	Quarterly		●			●			●			●			●		
Home Loans - Originations	Quarterly		●			●			●			●			●		
National Home Builder Finance	Semi-Annual	●						●						●			
Retail Bank																	
Retail Lending - Originations	Quarterly		●			●			●			●			●		
Small Business Lending	Semi-Annual		●				●						●				
Real Estate Collateral Valuation	Annually			●													
Specialized																	
Card Services - Originations	Quarterly		●			●			●			●			●		
Automated Decisioning - EDE	Annually						●										
Clayton Management	OTS Request					●								●			

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FFIEC
Strong Authentication Update

December 2006

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Strong Authentication Guidance

PURPOSE

- In October 2005, the Federal Financial Institutions Examination Council (FFIEC) issued guidance for "Authentication in an Internet Banking Environment". This guidance specifically addresses the need for risk-based assessments, customer awareness, and security measures to authenticate customers accessing Internet-based services. This guidance applies to all retail and commercial customers. Although the guidance is focused on the risks and risk management techniques associated with the internet delivery channel, the principles are applicable to all forms of electronic banking activities. (1)

KEY POINTS (2)

- The agencies consider single factor authentication, as the only control mechanism, to be inadequate for high risk transactions involving access to customer information or the movement of funds to other parties.
- Financial Institutions offering Internet-based products and services to their customers should use effective methods to authenticate the identity of customers using those products and services.
- The authentication techniques employed by the financial institution should be appropriate to the risks associated with those products and services.
- Where risk assessments indicate that the use of single-factor authentication is inadequate, financial institutions should implement multi-factor authentication, layered security, or other controls reasonably calculated to mitigate those risks.

OTS DIRECTION for WaMu

The OTS has stated they expect Washington Mutual to be in *substantial* compliance with the guidance by December 2006. "Substantial" compliance for WaMu has been defined as stronger authentication measures in production for Personal Online Banking and Commercial Online Banking, and the remaining In-Scope sites having formal project plans in place by 12/2006, with a planned production implementation no later than 12/2007.

---

(1) "Electronic Banking" includes telephone banking.

(2) OTS October 12, 2005 memo, referencing FFIEC "Authentication in an Internet Banking Environment Guidance, Summary of Key Points".

Footnote Exhibits - Page 0184

Strong Authentication Program
Executive Dashboard
12/12/2006

Washington Mutual

Program	Metric	Status	Trend *	Problem Statement	Corrective Action
Program Goals: • Identify the universe of electronic banking sites impacted by the FFIEC guidance • Perform a risk assessment to determine if sites are in scope of the FFIEC Guidance • Document in scope electronic banking sites and report on compliance • Implement Program Governance Model • Initiate Strong Authentication tracking for relevant sites **Program Objectives:** • Reduced risk exposure • Program Governance and Oversight • Consolidated reporting of program to the OTS	*Scope*	G	Steady		
	Schedule	R	Problem	Currently, Personal Online Banking and Commercial Online Banking are targeted to be compliant by 1/31/2007 and 3/31/2007 respectively.	Work with the OTS to validate Personal Online Banking dates are considered adequate. Initiated a QuickValue to evaluate expediting compliance for Commercial Online Banking.
	Resource	G	Steady	Program Governance Structure needs to be formalized.	Assigned a dedicated Program Manager to facilitate reporting and tracking of Strong Authentication Program initiatives.
	Quality	G	Steady		
	Overall Health	Y	Problem	WaMu will not be in compliance with FFIEC Guidance by the 12/31/2006 date. Additionally, 10 other sites are considered within scope of the FFIEC Guidance and need to be compliance by EOY 2007.	Implemented Program Governance Model to track and report on compliance status of all 12 in-scope sites. Communicated requirements to all Lines of Business and corresponding TSG representative. Secured Executive Sponsorship and support of the Strong Authentication compliance initiatives.

Executive Summary

RESULTS

- Enterprise Strong Authentication solution selected and approved in 2005
- Personal Online Banking is on track for compliance with FFIEC Guidance by 1/31/2007 - >90% of high risk transactions coded; customer challenge Q&A in full progress.
- Interim solution identified for Commercial Online Banking using tokens and internal ACE server
- Inventory and Risk Assessment of in-scope sites has been completed
- Strong Authentication Working Group established under the auspices of the Corporate Information Security Committee
- Business and Technology representatives have been identified for each in-scope site.
- Program Manager has been assigned

NEXT STEPS

- Deliver OTS PERK items to include: Summary; Project Plans; Inventory; Risk Assessment; and Status Reports
- Establish Architectural Lead
- Schedule regular status meetings
- Update the Access Management Policy to include Strong Authentication requirements for go-forward compliance
- Develop status report format and frequency

WHAT'S WORKING

- Executive Sponsorship has been secured
- Compliance requirements communicated
- Work teams identified and mobilized

CHALLENGES

- Prioritization of resources and projects to achieve compliance milestones
- Consistent status reporting
- Competing priorities

3

Washington Mutual

In-Scope Applications

Internet Facing Application Name	Line of Business	Type of Customer	Planned Solution to provide Strong Authentication	Planned Date of Compliance
On-Line Banking (POB)	Corporate Support	Retail	RSA Adaptive	1/31/2007 – >90% of high risk transactions coded; customer challenge Q&A in full progress.
ATM Network	Retail	Retail	Multi-layer sufficient – Card and PIN authentication in place.	Completed Multi-layer sufficient – Card and PIN authentication in place.
Kana Response	Retail	Retail	RSA Adaptive solution utilized to secure access to Kana.	1/31/2007
ECC IVR	Retail	Retail	RSA Adaptive	4Q07
Commercial Online Banking	Commercial	Commercial	Partial – Tokens to be fully deployed by EOY 2006	3/31/2007. Looking at option to improve schedule
Framework	Commercial – CCB	Employee, 3rd party, Commercial	RSA Adaptive won't work for 3rd party access and a Strong Auth solution will be implemented as part of the integration project in 2007.	7/31/2007
Framework - Integrated Cash Management System	Commercial – CCB	Commercial	Strong Auth will be implemented as part of the integration project.	7/31/2007
Mortgage Banker Finance Web	Home Loans	Mortgage Warehouse funding, Commercial Type	RSA Adaptive	10/31/2007
Customer Service IVR	WMCS	Retail, Employee	RSA Adaptive	2007
wamurealrewards.com	WMCS	Retail, Employee	Hosted by Vendor (Maritz)	2007
wamucanhelp.com	WMCS	Retail	Hosted by Vendor (Online Resources)	2007
wamucards.com (OLA)	WMCS	Retail	RSA Adaptive	2007

Washington Mutual

Talking Points: Steps Taken To Date

12/05 – 12/06

- CIS worked with WaMu Online Banking Team to identify a workable solution that could be leveraged across the enterprise – RSA Adaptive Authentication.
- CIS worked with the Commercial Online Banking team to identify a short-term solution (RSA Tokens) that could be leveraged for commercial customers only.
- CIS formed a Strong Authentication Working Group comprised of key senior business and technology managers to ensure ongoing focus during 2006 and 2007.
- CIS developed an initial inventory of sites and performed an initial risk assessment based on guidance criteria. Based on the risk assessment of 99 WaMu-owned sites, 12 sites have been identified as In-Scope for compliance to the strong authentication guidance.*
- Business/BSP's have identified a representative for each identified site who will manage the implementation of stronger authentication. A Strong Authentication Program Manager has also been assigned to oversee status and reporting to ensure plan progression and on-time compliance.
- CIS has ensured all 12 site representatives are aware of project plan deliverable dates, requirements for 07 compliance, and WaMu's enterprise solution for stronger authentication.

* "Risk assessment criteria", per Guidance is, a) type of customer (Retail, Commercial), b) allows the movement of funds, c) allows access to non-public customer information, d) ease of using communication method, and e) volume.

Washington Mutual

Talking Points: Steps To Be Taken in the Future

1/07 – 12/07

- Deliver documents pertaining to Strong Authentication for inclusion in the Preliminary Exam Review Kit for OTS. Documents include Summary of Current Status, Project Plans, Inventory and Risk Assessment, and Status Reports to Senior Managers.
- Establish architectural lead to evaluate solution and address enterprise implementation strategy, working with site representatives to ensure consistent technical approach for compliance.
- Program Manager to maintain ongoing project statuses from site representatives to ensure satisfactory progression.
- Hold regularly scheduled meetings with the Strong Authentication Working Group to address issues and Program status.
- CIS to develop Strong Authentication Policy to ensure new or modified Internet-based sites meeting the criteria for stronger authentication are developed and delivered in compliance.
- Keep ERMC and OTS informed of Program status and direction as requested.

The Asset-Liability Management Committee

October 25, 2006

Asset / Liability Management Committee

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Washington Mutual

1

JPM_WM02406624

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #422

Footnote Exhibits - Page 0189

Agenda

The Asset-Liability Management Committee
Wednesday, October 25, 2006
WMC 33 Vashon
9AM – 11AM (PST)

	Time
1. Approve Minutes (Separate Document)	9:00 – 9:05
2. Economic Backdrop and Analytics Update	9:05 – 9:30
– 2007 Plan Overview	
3. Business Line Topics:	
– Home Loans: CDO Proposal (David Beck)	9:30 – 9:45
– Home Loans: SFR Portfolio (David Beck)	9:45 – 10:00
4. Corporate Topics:	
– AFS Portfolio Update	10:00 – 10:15
– Capital Projections	10:15 – 10:30
– Return Rates on Products – Industry Analysis	10:30 – 10:45

Asset / Liability Management Committee Confidential - Internal Use Only Washington Mutual 2

2

JPM_WM02406625

From: Cathcart, Ron
Sent: Wednesday, February 14, 2007 6:43:18 PM
To: Boyle, Hugh F.
Subject: RE: Initial Option Arm NPA Results

Oh dear...

From: Boyle, Hugh F.
Sent: Wednesday, February 14, 2007 2:16 PM
To: Cathcart, Ron
Subject: FW: Initial Option Arm NPA Results

Hugh F. Boyle
Credit Risk Management
Washington Mutual
Tel: 206 500 4198

This message (including any attachments) is CONFIDENTIAL and may contain SENSITIVE information. DO NOT disseminate this information to parties who do not have the authorization to view this material. If you are not the intended recipient of this information or an employee or agent responsible for delivering this message to the intended recipient(s), please do not read, disseminate, distribute or copy this information. If you have received this message in error, please contact the sender immediately. Washington Mutual reserves the right to monitor all e-mail. Electronic mail sent through the Internet is not secure.

From: Mark, James
Sent: Tuesday, February 13, 2007 4:49 PM
To: Ellson, Richard W.; Liu, Michael; Chan, Susan; Jackson, Melissa; Dooley, James; Smith, Michael C.; Coultas, Dave; Potolsky, Doug; Boyle, Hugh F.
Subject: Initial Option Arm NPA Results

Below are the initial bid results from the 1st Quarter Option Arm NPA sale. This pool was 240MM that was made almost entirely of loans 2 payments delinquent or greater. Further, 86.5% of this pool was in foreclosure status.

Clearly the initial pricing on this pool is lower than what has been experienced in the three prior Option Arm NPA pools.

Some of the major reasons mentioned by the bidding participants for the pricing deterioration were the increase of supply in the market place (1.9BB out for bid this week alone), longer foreclosure timelines given continued deterioration of housing market, and capacity concerns is some of the participant's warehouse. One participant mentioned recent litigation against a Option Arm originator (Chevy Chase) as a reason for backing off their bid (below is a link).

http://www.baltimoresun.com/business/investing/bal-bz.chevy19jan19,0,4783281.story?coll=bal-investing-headlines

From a collateral standpoint, this pool was inferior from prior pools given its delinquency profile and a large percent of loans in excess of 1MM (16.75%).

<< OLE Object: Picture (Metafile) >>

EMC was the only bidding participant that had levels that exceeded the Hold/Sell threshold (at 95%+). It was decided not to invite back another participant if their initial pricing did not exceed the Hold/Sell level.

EMC is currently unaware that they are not in a completive auction. It is imperative that continues to be the case.

Once we get EMC's final level we will assess whether it make sense to sell the entire pool to them or potentially carve out some assets that we feel are undervalued.

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #424

Confidential Treatment Requested by JPMC

JPM_WM00652762

Footnote Exhibits - Page 0191

If we decide not to sell any of the pool, we have communicated to them that we will reimburse them $150 per file.

James Mark
Washington Mutual
Sub-Prime Capital Markets
206-302-4186

WaMu

Audit Report
AUDIT SERVICES

Disclosure Management

December 28, 2007

Executive Committee Owner:
Tom Casey, Chief Financial Officer
Ron Cathcart, EVP - Chief Enterprise Risk Officer
Stewart Landefeld, Chief Legal Officer (Interim)
Steve Rotella, President & COO

Business Process Owner:
Nancy Barnett, Sr Mgr-HR Comm & Marketing
George Boa, Chief Risk Officer- Commercial
Chaomei Chen, Chief Risk Officer-Card Svcs
Cheryl Feltgen, Chief Risk Officer-Home Loans
Diana Graham, Chief Risk Officer - Retail Bank
Karen Horn, Sr Mgr-Internal Communications
Sophie Hume, Assistant GC-Team Lead
Elizabeth Hutchinson, Sr Mgr-Corp Media & Issues Mgm
Alan Magleby, Div Exec-Investor Relations
Pradeep Narayan, Sr Mgr-Enterprise Risk Process
Ann Shannon, Sr Mgr-Technology Comm
Glen Simecek, Group Mgr-Treasury

From:
Monica Hira, Senior Audit Manager
Erin Dunlap, Audit Director

Copy:
Melissa Ballenger, Div Exec-Corp Controller
Kristina Bennett, (Additional Report Distribution)
Alfred Brooks, President Commercial Group
James Corcoran, President-Retail Banking
Daryl David, Chief HR Officer
Barry Davis, (Additional Report Distribution)
Deloitte, LLP
Alan Elias, Sr Mgr Communications
Alan Gulick, Sr Mgr Communications
Thomas Henning, FVP - Enterprise Risk Governance
Debora Horvath, Chief Information Officer
James MacKenzie, Group Mgr-Accounting
Michelle McCarthy, Div Exec-Market Risk Mgmt
Thomas McGovern, Additional Report Distribution
Randy Melby, Div Exec-General Auditor
Adam Nelsen, (Additional Report Distribution)
Sheri Pollock, Sr Mgr Communications
A Rodriguez, Div Exec-Communications
Daysi Rojas, (Additional Report Distribution)
David Schneider, President - Home Loans
Anthony Vuoto, President WM Card Services
Maynard Wagner, (Additional Report Distribution)
Frank Whitemaine, (Additional Report Distribution)

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #474

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57323.990

Report Rating:
SATISFACTORY WITH QUALIFICATION

Executive Summary

The Corporate Disclosure Committee (CDC) established Disclosure Standards in September 2004. The Standards require review of all external and broad internal WaMu (the Company) communications containing material disclosure first by the business segment or corporate support group (collectively, Business Units) and subsequently by representatives of Legal and Financial Reporting ('Corporate Review')

In September 2005, Audit Services performed an audit of External and Broad Internal Disclosure at the request of the CDC. This report was rated as Opportunities for Improvement and identified issues related to lack of process ownership, disclosure training, and documentation.

The issues noted in the prior audit were enterprise-wide and the Legal Department took the lead on developing a robust process over external and broad internal communications. A project team consisting of members from Legal and Corporate Communications was formed to address the issues raised by Audit Services. The CDC approved the project team's recommendations in December 2006, which resulted in decentralization of the processes and establishing accountability at the Business Unit level.

A Communication Lead was designated within each Business Unit as a single point of contact. The Communication Lead is responsible for review and approval of external and broad internal communications, obtaining Corporate Review and approval, establishing and maintaining documented disclosure processes within their group, adhering to document retention requirements, ensuring that Business Unit managers and employees receive appropriate training, attending Regulation FD / Disclosure training and coordinating such training for others as appropriate.

Prior to transferring responsibility to the Communication Leads, the project team enrolled employees involved in preparing, approving, or presenting communications containing material disclosure in an online Disclosure Standards training course.

By taking the actions above, the project team created a sound disclosure management framework which sought to ensure that the Company's disclosures are appropriately vetted within the necessary control environment. The results of the current audit reflect meaningful improvements to disclosure processes since 2005. However, we identified opportunities to enhance the existing control environment to facilitate adherence to the Disclosure Standards and Disclosure Policy. These relate to Disclosure Standards training, obtaining approvals from the Corporate Review groups, and maintaining an Authorized Spokespersons list.

The following issues represent a medium level of risk to the Company if not addressed appropriately:

- Business Unit Communication Leads do not consistently track and monitor employees' Disclosure Standards training. There is no guideline or enforcement of a time requirement for training completion.
- Business Units did not obtain Corporate Review for some material communications sampled, resulting in one instance of erroneous disclosure to an external audience.
- There is no method for tracking Authorized Spokespersons. As a result, it is not possible to determine if all Authorized Spokespersons have attended Company-sponsored Regulation FD / Disclosure training as required by the Disclosure Policy.

Management concurs with these findings and has developed action plans to resolve the issues listed in this report by February 29, 2008. Audit Services will complete a follow-up audit of the action plans upon remediation. A description of audit objectives and scope, and a list of issues are included in the following sections of the report.

Background

Disclosure Standards were developed to ensure that material information communicated to external audiences, or disseminated on a broad internal basis, is thoroughly and consistently reviewed. The Standards apply to all business units within the Company and are supported by the CDC.

The CDC is responsible for overseeing compliance with the disclosure control requirements of the federal securities laws, including the Sarbanes-Oxley Act. The CDC has responsibility over the Disclosure Standards. Legal is responsible for reviewing, maintaining and posting the Disclosure Standards.

Audit Objective and Scope

The audit objective was to assess the adequacy and effectiveness of the Company's Disclosure Policy and Disclosure Standards and to assess Business Unit compliance with these policies and standards. Audit Services evaluated the controls that enable accurate and appropriate disclosures, including review and approval procedures, disclosure training for employees, and oversight by the Corporate Disclosure Committee.

The audit scope included external and broad internal communications of the Company and all of its subsidiaries between April 1, 2007 and September 30, 2007 for the following Business Units:

Retail Banking and Financial Services Group, Home Loans Group, Commercial Group, Card Services Group, Corporate Legal, Corporate Communications (Internal & External), Corporate Investor Relations, Treasury/Capital Markets, Enterprise Risk Management, Technology, Marketing, Human Resources and Audit Services

The audit scope excluded the 10K, 10Q, earnings release, 8K, and miscellaneous SEC filings since these disclosures are evaluated within a separate auditable unit.

Applicable Laws and Regulations

SEC Regulation Fair Disclosure prohibits selective disclosure. Material nonpublic information about the Company cannot be provided to any select party or group, such as investors, analysts, or investment bankers, to the exclusion of others.

The SEC has suggested, but not required, that companies form disclosure committees responsible for considering the materiality of information and determining disclosure requirements on a timely basis.

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Audit Issues

The audit team and management discussed and agreed upon the action plan(s) and completion date(s) listed below. Definitions for issue ratings are included at the end of this report.

No:	Rating:	Issue Summary:	Due:	Owner:
1.0	Medium	REPEAT ISSUE - There is no process in place for Business Unit Communication Leads to track and monitor employees' disclosure training	02/29/2008	N. Barnett, G. Boa, C. Chen, C. Feltgen, D. Graham, K. Horn, S. Hume, E. Hutchinson, P. Narayan, A. Shannon, G. Simecek

Audit Issue:
There is no process in place for Business Unit Communication Leads to track and monitor employees' disclosure training. In addition, there is no guideline or enforcement of a time requirement for training completion.
According to the Disclosure Standards, Communication Leads have responsibility for attending Regulation FD/Disclosure compliance training and for ensuring that managers and employees receive appropriate training. Regulation FD / Disclosure training records reflect that 38% of Communication Leads have not completed this Company-sponsored training. Additionally, approximately 47% of Level 1-6 employees as of 09/30/07 have not completed the Disclosure Standards Awareness course. For non-Level 1-6 employees identified by Communication Leads as having a regular role in material communications, 65% have not completed an online Disclosure Standards course.
Impact:
Disclosure training not obtained by impacted employees increases the risk of improper disclosure which could potentially lead to regulatory investigation or reputation damage.
Action Plan:
Action plan: The Legal Department will review the Disclosure Standards to ensure appropriate guidance regarding acceptable timeframe for completing the online education is included. To ensure each Communication Lead can more efficiently meet the Disclosure Standards requirement of completing Reg FD training, the Legal Department will develop an online Reg FD training course and proxy enroll all current Communication leads and ensure they complete the course.

Business Unit Communication Leads will monitor level 1-6 employees within their business units to ensure Disclosure Standards Awareness training completion. A training status report will be developed to allow Communication Leads to monitor training completion from Learning Central. Utilization of this training status report will be individually tracked for each business unit via separate issues in ERICS.

No:	Rating:	Issue Summary:	Due:	Owner:
2.0	Medium	REPEAT ISSUE - Required approvals from Legal or Financial Reporting were not obtained prior to publication.	01/31/2008	K. Horn, A. Magleby

Audit Issue:
Approval from Legal and Financial Reporting were not obtained for one communication, resulting in erroneous disclosure to an external audience. In addition, Financial Reporting approval was not obtained for two broad internal communications containing material financial disclosure.
Impact:
Lack of proper review and approval of communications prior to dissemination may result in the disclosure of erroneous or restricted information which could potentially lead to regulatory investigation or reputation damage.
Action Plan:
Approval for all communications containing material disclosure will be obtained from Legal and Financial Reporting. Business Unit Communication Leads have provided a business unit specific management action plan for obtaining appropriate approval. These specific management action plans will be individually tracked via separate issues in ERICS.

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No:	Rating:	Issue Summary:	Due:	Owner:
3.0	Medium	A method for tracking all Authorized Spokespersons does not exist.	01/31/2008	S. Hume, E. Hutchinson

Audit Issue:
A method for tracking all Authorized Spokespersons does not exist. As a result, it is not possible to determine if all Authorized Spokespersons have attended Company-sponsored Regulation FD / Disclosure training as required by the Disclosure Policy. This may result in violation of company policy.
Audit Services noted that there is no record of completion of Regulation FD / Disclosure training for one member of the Executive Committee, who is an Authorized Spokesperson as defined by the Disclosure Policy.
Impact:
Without a method for tracking Authorized Spokespersons, WaMu is unable to determine if appropriate training was provided to employees who may speak on behalf of the Company. Without training, disclosure of inappropriate or restricted information may occur which could potentially lead to regulatory investigation or reputation damage.
Action Plan:
Corporate Communications will compile an initial list of Authorized Spokespersons. Subsequently, the Legal Department will review and update the list of Authorized Spokespersons on a quarterly basis via coordination with Business Unit Communication Leads. The Legal Department will develop an online Regulation FD training module to more efficiently administer and track Regulation FD training for the Authorized Spokespersons.

No:	Rating:	Issue Summary:	Due:	Owner:
4.0	Low	REPEAT ISSUE - Approvals and supporting documentation for material disclosure are not consistently maintained by the Business Units.	01/31/2008	K. Horn, S. Hume, G. Simecek, E. Hutchinson, C. Chen

Audit Issue:
Approvals and supporting documentation for material disclosure are not consistently maintained by the Business Units. The Disclosure Standards require Business Units to retain Legal and Financial Reporting approval and supporting documentation for material disclosure for five years.
Of the disclosures sampled, 19% of relevant communications did not evidence approval by Legal, and 33% lacked evidence of Financial Reporting approval. Overall, 30% of communications requiring some form of Corporate Review (either Legal or Financial Reporting) lacked evidence of appropriate approval. Supporting documentation was not maintained for 11% of relevant communications.
Impact:
Failure to maintain disclosure documentation may result in the inability to support disclosures in the event of litigation, audits, or regulatory exams.
Action Plan:
Approvals and supporting documentation for material disclosure will be maintained for one year. Business Units have provided group-specific action plans to address the issue.

No:	Rating:	Issue Summary:	Due:	Owner:
5.0	Low	The Corporate Disclosure Program Statement has not been updated. There is no method to facilitate periodic review of the Disclosure Policy and Disclosure Standards by the CDC.	01/31/2008	S. Hume

Audit Issue:
The Corporate Disclosure Program Statement has not been updated since inception and does not reflect the current status of the Corporate Disclosure Committee (CDC) and Program. Furthermore, there is no method to facilitate periodic review of the Disclosure Policy and Disclosure Standards by the CDC.
Impact:
If the Corporate Disclosure Program Statement and related Policy and Standards are not current, disclosures which are not in alignment with company policy may occur.
Action Plan:
Corporate Disclosure Program Statement review and updates will be addressed by the CDC by end of January 2008. Additionally, Disclosure Policy and Disclosure Standards review will be added to the annual CDC calendar to facilitate annual review of the Policy and Standards.

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Improvement Considerations

Documentation: Regularly update and maintain key documentation such as the Disclosure Standards, Communication Lead Review Matrix, and disclosure training materials. In addition, the Disclosure Standards may be enhanced to provide users of the procedures with a clear understanding of specific roles and responsibilities.

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Definitions

Issue and report ratings are based on the auditor's judgment. In determining the report rating, the auditor will consider the following guidelines.

Report Ratings

Satisfactory	The overall system of risk management and internal control is effective and well-documented. Few minor control deficiencies exist with minimal resulting exposure. Business risk has been managed at an acceptable level. Repeat findings, if any, are not significant and non-compliance with regulatory requirements results in minimal exposure.
Satisfactory with Qualification	The overall system of risk management and internal control is generally adequate and functions effectively; however, isolated control deficiencies require management attention. While these isolated deficiencies create some exposure, business risk has been managed at an acceptable level. Repeat findings, if any, are not significant and non-compliance with regulatory requirements is isolated.
Requires Improvement	The overall system of risk management and internal control has deficiencies related to multiple business activities. Exposure is considerable and immediate corrective action is essential in order to limit or avoid considerable losses, reputation damage, or financial statement errors. Repeat findings are significant or non-compliance with regulatory requirements is substantial.
Unsatisfactory	The overall system of risk management and internal control has major weaknesses resulting in unacceptable level of risk. Exposure is considerable and immediate corrective action is essential in order to limit or avoid considerable losses, reputation damage, or financial statement errors. Repeat findings are significant or non-compliance with regulatory requirements is substantial.

Issue Rating

	High	Medium	Low
Impact	Affects the overall control environment and the achievement of relevant key business objectives	Could affect the overall control environment and the achievement of relevant business objectives if left uncorrected	Not severe enough to affect the overall control environment or the achievement of relevant business objectives
Exposure = (Impact X Probability)	Considerable exposure to financial statement errors, losses, reputation damage, fines and penalties, or loss of business	Moderate exposure to financial statement errors, losses, reputation damage, fines and penalties, or loss of business	Minimal exposure to financial statement errors, losses, reputation damage, fines and penalties, or loss of business

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From: Stack, Fergal
Sent: Tuesday, February 27, 2007 2:47:20 PM
To: Fortunato, Steve
Subject: FW: Option ARM

fyi

From: Stack, Fergal
Sent: Tuesday, February 27, 2007 9:42 AM
To: Chen, Youyi; Griffith, David
Cc: Murray, William; Strausbaugh, Rebekah; Jurgens, Rolland
Subject: RE: Option ARM

Thanks Youyi

To provide additional comments if you can incorporate
1) origination month is Jan and Feb 2007 only
2) future intent for these loans is to change as of which date? We will clearly need the specific loan characteristics to automate upfront designation.
3) the upfront designation is defined with rules in HI. We need to include the technology owner (Name?) to ensure this is done and the time required. [it may also be worth taking a look at what the current rules state and how much of that is automated upfront designation]
4) the transfer to hfs will not occur by Feb 28th, and the approvals will not be in place by Feb 28th, so this is a March issue
5) who are required approvals. Policy currently states that ALCO approval is the defining moment. Who else will be approving.
6) clear communication of what business/market circumstances have changed since Dec 31st to redesignate the loans. This needs to be detailed formalized documentation both by Business and for ultimate Approvals.
7) Valuation of these Option ARM loans...same drill as the hybirds...this is ultimately most complicated. Prior to moving the loans to HFS a formal approved Pricing Valuation framework must be in place (and based on expected sale execution).

Hope this helps tee up the issues from a Finance perspective.

From: Chen, Youyi
Sent: Tuesday, February 27, 2007 8:20 AM
To: Stack, Fergal; Griffith, David
Subject: RE: Option ARM

I am to suggest keeping one more bucket: 3-4 units. I will send a note out shortly.

Again, this is to suggest KEEPING the following (therefore sell everything else)

1. Super Jumbo of size greater or equal to 3 MM
2. Advantage 90 loans (high LTV)
3. Foreign Nationals
4. FICO less than 620 (except employee loans)
5. 3 – 4 units

From: Chen, Youyi
Sent: Tuesday, February 27, 2007 10:25 AM
To: Griffith, David
Cc: Stack, Fergal
Subject: RE: Option ARM

David,

We sell all 295+ margin and other OA and COFI, and KEEP the 4 categories going forward due mostly to non-salable reasons.

Youyi

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #477

From: Griffith, David
Sent: Tuesday, February 27, 2007 10:03 AM
To: Chen, Youyi
Cc: Stack, Fergal
Subject: RE: Option ARM

Youyi – In order to craft the approval we will need another level of precision. If the intent is to sell all of the loans in each category we should state so with an estimate of dollar amounts. Is the intent to sell all of the Advantage 90's and all of the sub 620 FICO's? If not we need to specify those where we no longer have the intent and ability to hold. ERM and HL Finance will need to monitor exactly what loans are transferred and we'll need enough detail to do so.

I noticed you dropped Employee Loans. Was that intentional?

Also, is this population exclusively Option ARMS? We are also currently directing super jumbo hybrids to portfolio.

I'll go over the NII calculation with HQ if that's ok with you. Am I right that it's $335m annualized? That's almost 10bps off of NIM.

From: Chen, Youyi
Sent: Monday, February 26, 2007 4:59 PM
To: Griffith, David
Subject: FW: Option ARM

David,

Attached is some NII analysis on the impacts. The pretax is about - $ 100 MM.

Let's talk tomorrow AM.

Youyi

<< File: Book8.xls >>

From: Chen, Youyi
Sent: Monday, February 26, 2007 6:09 PM
To: Griffith, David
Subject: FW: Option ARM

David,

We are still reconciling the numbers on the NII impacts. What are your thoughts on following criteria that we are to bring to MRC?

6. Super Jumbo of size greater than 3 MM
7. Advantage 90 loans (high LTV)
8. Foreign Nationals
9. FICO less than 620 (non-salable)

Also, please see my email to Fergal on some of the detailed background on this issue.

Regards,

Youyi

From: Chen, Youyi
Sent: Monday, February 26, 2007 6:04 PM
To: Stack, Fergal

Footnote Exhibits - Page 0201

Cc: Murray, William; Jurgens, Rolland; Strausbaugh, Rebekah; Beck, David; Fortunato, Steve
Subject: RE: Option ARM

Fergal,

We intend to stop transferring high margin 295BP+ option ARM and COFI ARM production into portfolio starting Jan 1st, 2007. As a result, we need to direct all the future rate locks of these loans from HFI to HFS. We will get a MRC vote on this decision very soon. We expect this decision to remain for the foreseeable future (i.e. Q2, and remaining of 07 will be HFS unless this strategy is revised)

The remaining HFI criteria for the option ARM and COFI ARM is expected to be as follow (under review, and subject to MRC approval)

10. Super Jumbo of size greater than 3 MM
11. Advantage 90 loans (high LTV)
12. Foreign Nationals
13. FICO less than 620 (non-salable)

As the change is happening within the quarter, and some of the loans have been directed to HFI already, we would need Steve, you and John Wood to review and sign off to let us transfer back to HFS those (mostly) high margin option ARM that are either locked or closed to HFI in Q1-07 already (about $1.3 billion and growing, as of last week).

As to what lead to the above recommendations, you are right, it's driven by combination of overall balance sheet strategy, credit out look, and current option and COFI ARM market conditions.

As you know, capital market portfolio management is regularly reviewing the balance sheet strategy with the senior management and ALCO in particular. We will always discuss with your team on new portfolio strategies.

Regards,

Youyi

From: Stack, Fergal
Sent: Monday, February 26, 2007 5:40 PM
To: Stack, Fergal; Chen, Youyi
Cc: Murray, William; Jurgens, Rolland; Strausbaugh, Rebekah
Subject: RE: Option ARM

And what are the facts and circumstances to take this action...net interest margin, credit....

Is it possible that there will be more transfers in Q2, Q3, Q4 etc..this is a sensitive accounting topic with SEC and others

Thanks

From: Stack, Fergal
Sent: Monday, February 26, 2007 2:26 PM
To: Chen, Youyi
Cc: Murray, William; Jurgens, Rolland; Strausbaugh, Rebekah
Subject: Option ARM

If we are intending to transfer from hfi to hfs can you answer following questions

1) what population are proposed being transferred...I have seen it may be only 2007 originated loans? What changed since Jan and Feb that changes the companies intent by Feb 26th.
2) what is intent on other option Arm loans (2007 originated and prior year originated)
3) what is intent for future originations of option Arms ie March and Q2 originations
4) what is likelihood of ongoing transfers for option arms

In general do you have the intent rules on what goes to HFS versus HFI under current infrastructure?

Confidential Treatment Requested by JPMC JPM_WM03117798

HISTORICAL PERSPECTIVE HL - UNDERWRITING

Providing a Context for Current Conditions, and Future Opportunities

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Overview

Home Loans Credit and Underwriting

Credit Risk Management is driving towards a vision of increasing the organizations Net Interest Margin and an emphasis on Credit becoming a significant component of Shareholder value. As such, our organization has been focused on improving Underwriting and Origination quality and consistency to enable our ability to expand into new and more profitable market niches. Specifically, we have been supportive of both SMF and LongBeach expansion given their ability to demonstrate excellent origination, pricing and account management discipline. We have also been focused on identifying and targeting several other areas of credit expansion to include near-prime HELOC borrowers and expansion in our Multi-Family base. Credit Risk Management also supported and drove strategies to enable expansion into Alt-A and Option ARM lending for our Correspondent channel.

Our Home Loans prime organization has jeopardized our ability to enable these margin improvements through disciplined credit expansion due to the inconsistency, and poorly disciplined processes that have also eroded organizational credibility with external parties including Rating Agencies, GSEs, and our Thrift Regulators.

As mentioned, Credit and Underwriting within the Home Loans organization has been an area of noted interest by many. Internally, our Executive Leadership has been focused on improving on eliminating Regulatory criticisms, and our Risk Management team has driven hard for the application of consistency and discipline in the origination process. Further, rating agencies have been pushing for originator reviews driven by performance fluctuations as well as information gathered in prior visits. This paper provides a context for the historical conditions, key events, and management decisions that have led to our current condition, and how that may impact our ability to be successful in achieving the mission described above.

Our Home Loans channel emerged as essentially the combination of a collection of different originator's platforms, policies and cultures. As such, Credit Policy and Underwriting began as a combination of highly ineffectual, outdated and inconsistent policies and strategies. This led to the inability for our organization to establish the foundation for developing a consistent and discipline origination culture. As early as 1999 (Check the date and provide references – Bill Longbrake may know this), the OTS began raising concerns regarding the consistency, independence and quality of our Home Loans origination process. Prior to this, Washington Mutual had no Credit Risk Oversight function in place in any of its core business units with the exception of WMF. These primary concerns resulted in the hiring of the organizations first Chief Credit Risk Officer, Jim Vanasek in 1999.

With Jim's arrival, he recognized quickly that there was no Credit expertise in Home Loans and Consumer risk products. Therefore, he began the process of identifying, selecting and developing a core team of seasoned credit risk professional.

Historical Perspective

1999-2003

The new Credit Risk Team began the process of working with key business units to identify issues, concerns and opportunities for applying advance Credit Risk tools and systems. During this review, the team noted the following major weaknesses:

- No data reporting to review portfolio performance
- No forecasting of expected losses or delinquencies
- Legacy credit systems were essentially a combination of poorly implemented Third Party tools far from best proactive
- No collections workflow systems
- No adaptive control systems
- No linking of credit fundamentals, models, and expectations to strategic objectives and planning

The team began working quickly to first develop a unified data infrastructure to identify opportunities for improvement. Many such opportunities were identified early within the Retail Banking organization, and key strategies began to take place.

First, the Credit Risk team embarked on developing enhanced reporting capabilities. Second, it spearheaded the launch of a development cycle of a front-end decisioning system, proprietary models, and adaptive control systems.

Once the team was well underway in this development, the team looked toward other business units that might benefit from the investments being made in these systems. At this point in our history, the team began the process of attempting to work with the Home Loans organization to leverage these Enterprise capabilities.

Numerous attempts were made to demonstrate the benefits of the systems, and the opportunities for the Home Loans organization. At each point, the Home Loans Executive Management team rejected all such solutions, and stated that they would build all of this within the Optis application. The Optis platform was essentially two main components. Optis .1 which focused on the origination platform, embedded a series of tools that were hard coded, inflexible, and very difficult to change. Optis .2, led to significant investment write-offs as an approach to building systems around the end-to-end origination process.

Following on the path of these challenges, the Credit Risk team implemented Quarterly Business Reviews for all units to provide updates on core portfolio performances, expectations, and risk mitigating strategies.

SECTION III

Regulatory History

Key weaknesses identified by Regulatory Bodies

Andy, please fill out this section.

SECTION IV

2003-2004

Key Events and Decisions Leading to Today's Environment

With the Optis disaster, key financial misses and tremendous Regulatory scrutiny, the core Home Loans Executive Staff was dismissed and replaced.

Deanna Oppenheimer was given responsibility for the Home Loans organization in addition to Retail Banking. With this appointment, Deanna and Jim began to insert members from the Corporate team directly into the Home Loans Credit operation.

Parallel to these management changes, the organization identified a mandatory $1B expense cutting exercise. These cuts were distributed amongst all areas of the corporation, but fell heavily on the Home Loans organization. On the credit front, significant cuts were mandated in

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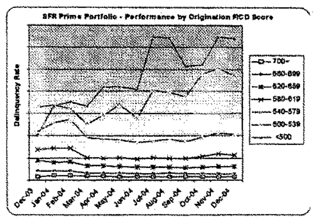
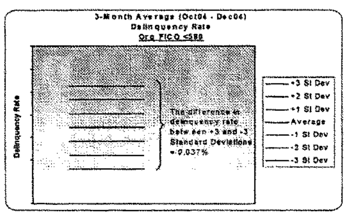
the Appraisal, Credit and Underwriting organizations. These cuts were mandated in the face of over 56 (check this Andy) core Regulatory concerns and criticisms with the Credit organization as the principle owner required to fix these challenges.

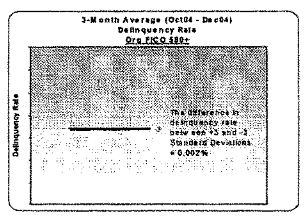
Early on, the team had noted an absolute absence of underwriting standards which began to drive up Non-Performing loans to an accelerated level. The primary driver for these poor performances was the continued underwriting and retention of loans that fell into low credit quality segments with no credit quality floors and an absence of pricing differentiation. This led to profitability challenges of sub-prime borrowers originated at prime prices without a clear financially viable exist strategy. In essence, this created a cross-subsidization of our prime borrowers as originators attempted to focus on a wide range of borrowers without being held accountable for profitability.



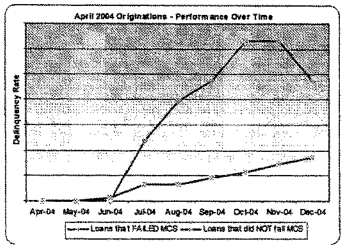
The graph below shows the delinquency rate of our SFR Prime portfolio over the past 13 months by origination FICO score. The lower the FICO score, the worse the performance of the loan. In fact, as of December 2004, loans originated with FICO scores less than 580 have a delinquency rate more than five times as large as those originated with FICO scores greater than 580.

Not only is overall performance worse for lower credit quality loans, but the *volatility* of performance is also much greater. The graph to the left shows *average* performance by origination FICO; in fact, the performance of some loans is much worse than average. In addition to average delinquency rate, the following two graphs show the standard deviation of performance over the past three months for loans with origination FICO score less than 580 and those with origination FICO scores greater than 580:



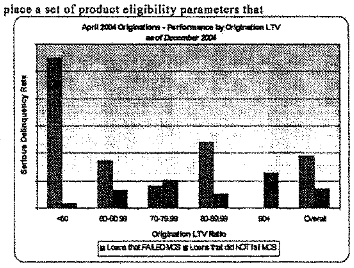


The standard deviation is a measure of the amount of variation in performance. From the graphs above, it is clear that the variability in performance is significantly higher for low credit quality loans than it is for higher credit quality loans. The difference in delinquency rate between +3 and -3 standard deviations for loans with origination FICO score less than 580 is more than 18 times as large as the difference for loans with origination FICO scores greater than 580, indicating that some loans will take even more time and resources to service than the average poor credit quality loan. Lower credit quality loans contribute disproportionately to delinquencies and losses. This is one reason that the Minimum Credit Standards (MCS) were put into place. These loans also contributed greatly to the pool of NPA's that were sold over the course of the last six quarters.



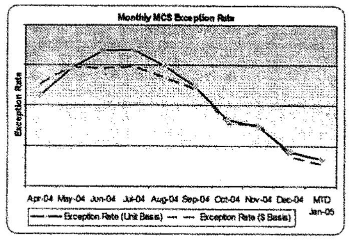
The graph to the left shows the delinquency rates for loans originated in April of this year (the first month that the MCS were rolled out). Even after only nine months in our portfolio, the difference in performance between loans that failed the MCS and those that did not is clear – the loans that did not meet the MCS are contributing disproportionately to the delinquency in our portfolio. Though the performance of MCS failures improved slightly between November and December, as of December 2004, loans originated in April 2004 that failed the MCS still have a delinquency rate three times that of originations that did not fail the MCS. Additionally, as of December, loans that did not meet the MCS have a serious delinquency rate (4+ Payments Past Due) that is six times the serious delinquency rate of loans that did not fail the MCS.

Prior to the introduction of MCS, we had in place a set of product eligibility parameters that attempted to achieve levels of credit performance by limited Loan Amounts and LTVs. In 2004, the Credit team began to reverse this strategy with significant expansions in allowable loan amounts and LTVs to reduce the amount of the parameter exceptions – up to 20% at one point - while attempting to gain a small degree of control of borrower credit quality with very low hurdles for minimum credit quality. (540 Minimum FICO in most instances) Furthermore, Credit spearheaded the development and introduction of the Exception pricing tool, moving it much closer to point-of-sale for speed and accuracy as well as moving the exception pricing surcharge rate from over 60% to almost 0.



Questions have been raised regarding whether low loan to value (LTV) ratios can be considered compensating factors for applicants with FICO scores below the Minimum Credit Standards In order to address this question, we looked again to April 2004 originations. The graph to the right shows the performance of MCS exceptions and non-exceptions (originated in April) as of December 2004 by LTV ratio. Not surprisingly, the MCS failures tend to perform worse than originations that were not MCS exceptions across all origination LTV ranges. The biggest difference in performance is actually within the lowest origination LTV range (<60%), where MCS exceptions have a serious delinquency rate (4+PPD) 32 times the seriously delinquency rate of loans that did not fail MCS. This indicates that from a performance standpoint, lower exposure is not a compensating factor for lower credit quality.

We have made significant progress over the past few months in eliminating exceptions to the Minimum Credit Standards, as shown in the chart to the right. In fact, the percentage of MCS exception approvals and commitments has been less than 1% so far in January.



By not looking the deals that don't make sense, we will have greater consistency and efficiency, and will be able to focus more time on our core customers and enhance our product offerings in core areas.

Making these changes to our business today will create long-term, lasting benefits. Not only will we see better profitability through lower costs and predictable credit performance, but we will have more satisfied customers because we will be able to decision their loans quickly and efficiently.

As a next step on the horizon, our team began an exercise, while simultaneously slashing expenses, to implement key control mechanisms. The first of these began with the introduction of Minimum Credit Standards in (Andy provide the date, and also list other key underwriting enhancements from our document).

Credit Risk also noted many areas for loosening of credit standards. In fact, the team made several key enhancements to underwriting standards that significantly benefited the Sales Organization, and would provide Sales opportunities well in excess of the 4-5% of expected volume loss from the introduction of the standards.

Several attempts were made to enforce these standards, and loopholes continued to emerge that were exploited by the sales team. The Credit Risk team, then worked with the business to eliminate sub-prime loans from the origination process as well to reduce volatility and ensure adequate returns were realized within the portfolio.

Any attempts to enforce more disciplined underwriting approach were continuously thwarted by an aggressive, and often times abusive group of Sales employees within the organization.

In mid 2004, a leadership flip-flop occurred, putting Craig Chapman in charge of the Home Loans organization.

During several key Home Loans Executive Staff meetings, several key mandates were set:

- Achieve an 80% decisioning automation rate and corresponding reduction in underwriting personnel by 2Q '05.
- Immediately implement a version of Risk Based Pricing

This first initiative demanded a core rethinking of our origination strategy. Essentially, to meet this and other efficiency targets, the organization would require undergoing a fundamental cultural shift from one of mass customization in the Home Loans origination process, to one where products and processes were much simpler. It also required the design of key collateral and Customer segments that would not fit into the model due to the costly nature of underwriting these loan types, or the challenge in selling and securitizing product sets.

The Credit team then worked to design a set of "In the Box" criteria, to enable the strategic goals. During these design sessions, the team also wanted to begin focusing on areas of credit expansion that made sense to again hopefully make this more palatable for the Sales Organization. (Elizabeth, insert the "In the Box" document here.) In fact, it was noted that the areas for expansion, were far more significant than the areas of proposed reduction.

Throughout the year, the Credit team attempted to provide a balance between the reduction of highly volatile assets and the need to continue to grow. (Alan, insert the application rate improvement rate).

In order to begin implementing these cultural changes, the Credit team was instructed to begin implementing the box specifically with 5/1 IO loans to allow no exceptions. We believe that this and the introduction of a very limited Risk Based Pricing initiative led to much of the noise we are hearing today. This form of Risk Based Pricing was significantly constrained by an Optis .1 change implementation restrictions. The strategy employed was essentially Capital Markets not Credit driven and only incorporate a single FICO adjustment for Low Doc loans. A more optimal Risk Based Pricing framework should incorporate much broader differentiation by credit quality and LTV to eliminate some of the pricing subsidization charges to our best Customers, and requiring higher risk borrowers to pay an appropriate rate given likely volatility and performance. Enabling this broader pricing vision will also serve us well as we focus on NIM expansion.

Towards the end of the year (Elizabeth and Alan, add the BEDE engine and rules key features and benefits here)

Comment [u1]: I would portray B-EDE as a start on our effort to introduce Streamlined Doc in a way that we do not get hit in Capital Markets executions or portfolio performance with the surcharges/risk of our current Low Doc program, while moving toward the 80 percent auto-decisioning rate.

SECTION V

Key Concerns and Opportunities

Home Loans Credit and Underwriting

Credit believes that the Sales force does not recognize the historical context, need for change, and significant credit enhancements given to the Sales team by the Credit Risk team. Clearly, our team wants nothing less than the organization to grow and prosper. We believe strongly that the Sales team is clearly one of the biggest key's to this success. However, we do not feel that leadership is providing the necessary catalyst to bring the teams together in a partnership approach to solving the organizations long-term issues.

The following bullets summarize the key concerns of the credit risk organization:

- The aggressiveness of the Sales team, and in many cases inappropriate, rude and or insulting behavior towards Underwriting staff is infectious and dangerous.
- A lack of a fundamental understanding by many Loan Consultants as to what constitutes an acceptable credit is lacking

Footnote Exhibits - Page 0210

- The organization is at significant risk in its Option ARM and Hybrid portfolios of payment shock created by abnormally low Start, or teaser rates, and aggressively low underwriting rates. The Executive team agreed to and implemented a process for managing these concerns based upon an algorithm and process recommended by Credit. Unfortunately, the process agreed to has disintegrated into an ad-hoc decision making process without any clear rational or alternative process for the future. Credit has been open to, and has provided recommendations for, alternatives if the existing process creates too much near term turmoil. We face some additional challenges as these procedures were shared earlier with Regulators with the full commitment of Executive Management for immediate implementation. It is our contention that in the upwardly sloping rate environment and likely housing appreciation flattening, we are putting borrowers into homes that they simply cannot afford. This is not only a Washington Mutual challenge, it is likely to be an industry challenge as many borrowers will likely be unable to refinance themselves into loan structures with payment amounts near their current levels.

- We need our Sales team to partner effectively with other groups to assist in driving operational efficiencies and excellence. These disciplines will enable a much broader ability to expand credit and opportunity for the Sales team in the near, intermediate and long-run. A reversion to an undisciplined Sales culture and high degrees of underwriting "customization" will subject the organization to significant Regulatory scrutiny that may impact the ability of the organization to meet its 5-year Strategic Plan.

Most importantly however, we know that all of the change cannot occur at once thereby risking the retention of large numbers of our Sales force. However, we believe that Executive Management can quickly engage in quelling the "noise" in the Sales force by educating them on the tremendous efforts that Credit Risk has done to provide tools to enable them and the organization to succeed. Further, Executive management should be very clear about what constitutes acceptable levels of credit characteristics for the prime SFR portfolio.

From:	Schneider, David C.
Sent:	Thursday, February 28, 2008 8:01 PM
To:	Alexander, Elinor A. <elinor.alexander@wamu.net>
Subject:	FW: 2008 Leadership Bonus
Attach:	2008 Leadership Bonus Charts Final2-21-08.xls

Please print

From: David, Daryl D.
Sent: Thursday, February 28, 2008 11:22 AM
To: Baker, Todd; Cathcart, Ron; Horvath, Debora; Rotella, Steve; Brooks, Alfred R.; Corcoran, James; Schneider, David C.; Casey, Tom; Landefeld, Stewart M.; Vuoto, Tony
Cc: Killinger, Kerry K.
Subject: 2008 Leadership Bonus
Importance: High

EC,

This week the HR Committee approved the formula and measures for the 2008 Bonus plan. I wanted to bring you up to date since we last discussed this at the EC meeting on the 19th. The key points are:

1. The changes I described for Senior Leaders down through level 8 remain as was presented. A full communication to all participants will begin roll out next week. Your HR person will be able to help you handle any questions.

2. The corporate measures and weights stay the same. There were some slight adjustments to the goal numbers in the payout grids based on our updated plan. I have attached the final grids for you to review.

3. We will be filing an 8K disclosure describing the plan to the shareholders next week. The disclosure covers the measures, weights and how the committee will determine the final rating. Please see the text below. If you have any questions, let me know.

For the 2008 Bonus Plan the Committee selected the following performance measures and relative weights:

- *The Company's 2008 net operating profit, weighted at 30%, calculated as operating profit before income taxes and excluding the effects of (i) loan loss provisions other than related to our credit card business and (ii) expenses related to foreclosed real estate assets;*
- *The Company's 2008 noninterest expense, weighted at 25%, calculated to exclude expenses related to (i) business resizing or restructuring and (ii) foreclosed real estate assets;*
- *The Company's 2008 depositor and other retail banking fees, weighted at 25%; and*
- *The Company's 2008 customer loyalty performance, weighted at 20%, based upon a proprietary rating system designed by the Company and an outside vendor.*

In evaluating Company financial performance, the Committee may adjust results to eliminate the effects of charges for discontinued operations, extraordinary items and items of gain, loss or expense determined to be extraordinary or unusual in nature or infrequent in occurrence or related to the disposal of a segment or a business or related to a change in accounting principle.

In light of the challenging business environment and the need to evaluate performance across a wide range of factors, the Committee will take a three-step approach to determine actual annual cash bonus payments. Accordingly, after the end of 2008, the Committee will exercise its discretion under the 2008 Bonus Plan to determine the final cash bonus payouts for each executive officer, including the Named Executives, by:

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #572

1) reviewing and considering performance results for the four pre-established Company performance measures noted above;
2) reviewing other appropriate factors and measures of Company financial performance; in particular, the Committee will subjectively evaluate Company performance in credit risk management and other strategic actions that impact overall corporate profitability; and
3) evaluating each executive 's individual performance during 2008 to determine whether it is appropriate to adjust the executive 's final bonus payout from the amount that would be payable based solely on the Committee 's assessment of Company performance under steps (1) and (2) above.

Daryl David

WaMu®

February 25, 2008

Credit Risk Overview

Report to the Board of Directors

John McMurray
Chief Credit Officer

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #625

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Background

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Credit Risk

- Credit Risk is the risk of an obligor or counterparty defaulting
- We are exposed to credit risk through various activities, including:
  - Lending
  - Investing
  - Deposit taking
  - Contracting

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Basic Terms of Business

- Borrower types
  - Consumer
  - Commercial
- Counterparty/Sponsor support
  - With or without recourse
  - Guaranty
- Unsecured or Secured; if secured:
  - Real property
  - Personal property
- Pricing
  - Risk-based
  - Average

WaMu

Why We Take Credit Risk

Rationale for taking credit risk includes:

- ***Return***. We generally earn an expected return for retaining credit risk.
- ***Earnings***. Taking credit risk is one of the primary ways financial institutions generate earnings.
- ***Diversification***. We realize diversification benefits since this risk is not highly correlated with other risks we face (primarily interest rate risk).
- ***Prerequisite***. We cannot participate in most transactions without being exposed to some credit risk.

Footnote Exhibits - Page 0218

Risk Transfer & Retention

WaMu

Loan/Transaction - Level Measures	Portfolio - Level Measures	Retained Risk Positions
· **Credit Policy** · **Collateral Evaluation** - appraisal - AVM, other · **Underwriting, Rating & Scoring** - AUS - traditional · **Insurance** - loan (e.g. PMI) - hazard (including flood) · **Credit Review / QC** - consumer - commercial · **Surveillance** - performance monitoring - re-underwriting/rating/scoring - marketing collateral to market · **Line Management** · **Loss Mitigation & Workout**	· **Insurance** - pool - bond · **Non-recourse Sales** - card - GSE - private MBS/ABS - whole loan · **Risk-based Pricing** · **Reserves** · **Diversification** - geographic - temporal - amplitudinal - sourcing - product - broker/counterparty/sponsor - offsetting positions & risks	· **Whole Loans** - HFS inventory - HFI portfolio · **Rep & Warrant** - general - EPD · **Interest "Strips"** - MSRs - spread accounts (card) - residuals (card, mortgage) · **Reinsurance** · **Counterparty**

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WaMu

Drivers of Credit Risk

- Market Environment
  - Collateral prices (typically real estate prices)
  - Market prices (often interest rates)
  - Competitor offerings & actions
  - Macroeconomic conditions
  - Consumer & business sentiment
  - Demographics
- Collateral Characteristics / Quality
  - Value
  - Condition
  - Marketability / Liquidity
  - Type
- Borrower/Counterparty Characteristics / Quality
  - Target customer
  - "Ruthlessness" (default, prepayment, other)
  - Concentrations (loans to one borrower)
  - Credit (history, obligations)
  - Capacity (income/profitability, reserves/liquid assets, net worth/leverage)

Footnote Exhibits - Page 0220

WaMu

Drivers of Credit Risk
(continued from the previous page)

- Manufacturing Quality
  - Process
  - Adverse selection potential
  - Data integrity

See appendix for more complete list of transaction quality elements

Footnote Exhibits - Page 0221

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Geographic Concentrations & Home Prices

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Footnote Exhibits - Page 0222

Nonresidential Credit Exposures

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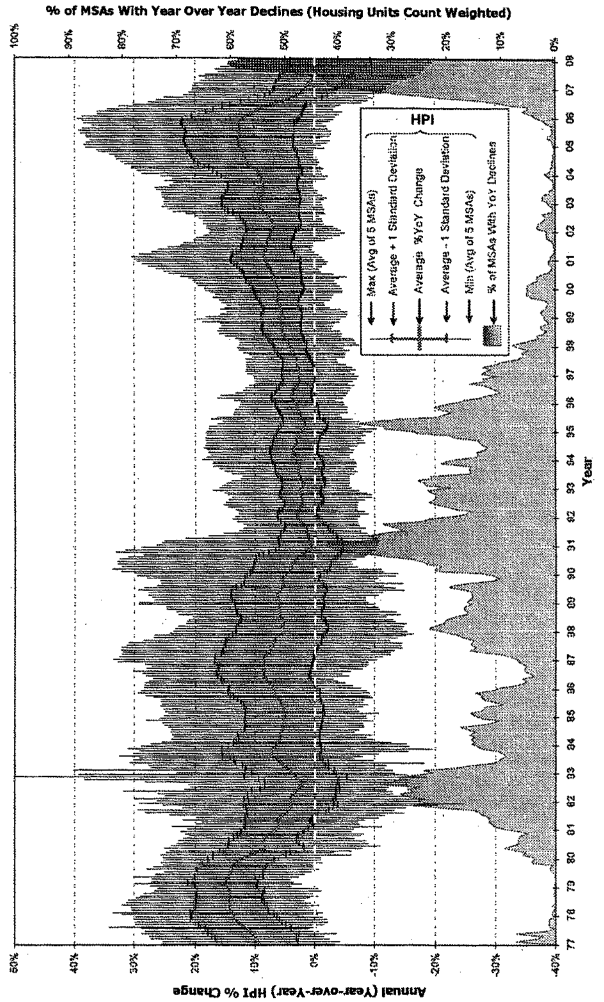
- Card
  - Losses are very sensitive to unemployment
  - Losses will be higher than recent lows, but within expectations provided that economic conditions (unemployment) remain benign
  - Securitization is a key risk
  - More pricing and line management alternatives
- Commercial RE
  - Still performing well
  - Delinquencies and losses increasing though still within expectations
  - Our MF should be less vulnerable than other Commercial RE
- Small Business
  - Balances are relatively low ($1.4B drawn, $1.4B open to buy)
  - Delinquencies and losses have been well above expected levels
  - Multiple actions underway to address adverse performance; new volume down significantly

Footnote Exhibits - Page 0223

WaMu

Housing Values - MSA Level

FARES Single Family Residence Home Price Index[1] (January 2008)



(1) Source: First American Real Estate Solutions. All statistics are weighted by MSA-level housing unit count.

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Footnote Exhibits - Page 0224

WaMu Real Estate Loan Exposure[1] by County HFI Portfolio

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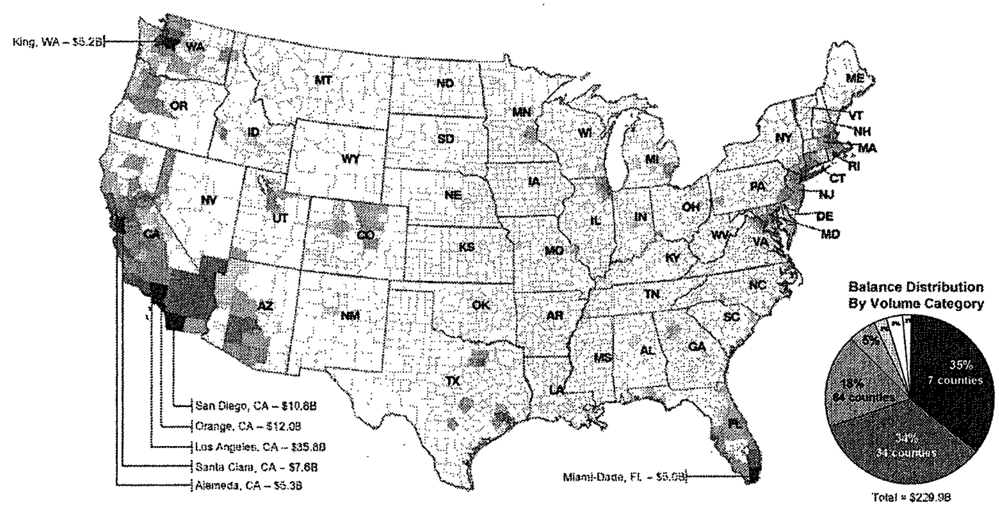

$5.0B-$36B | $1.0B-$4.9B | $0.25B-$0.9B | $0.1B-$0.24B | $50MM-$99MM | $10MM-$49MM | <$10MM

(1) Includes SFR Prime, SMC, Commercial, & Home Equity loans. Does not include Other Consumer products. Excludes accounting adjustments and loans with invalid county designations totaling $5.5 billion.

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WaMu Card Loan Exposure(1) by County HFI Portfolio

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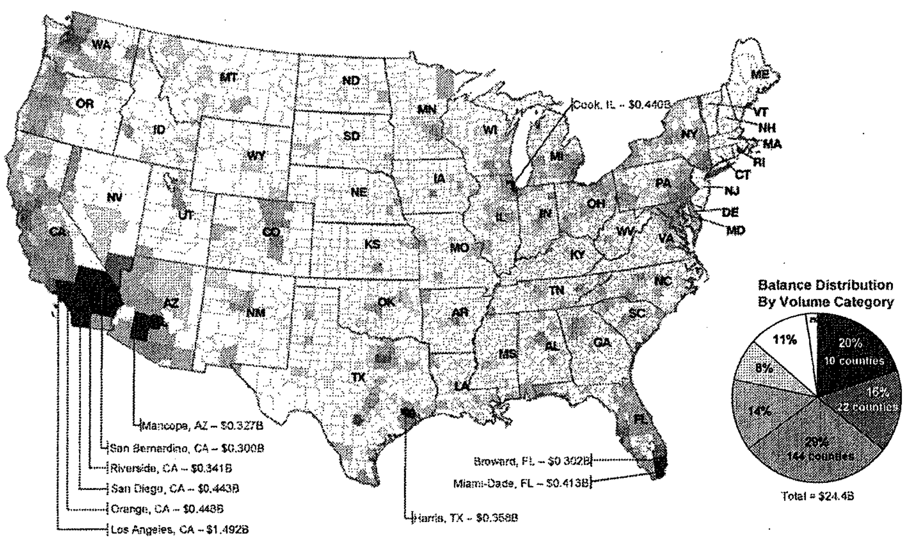

$300MM-$1.5B | $100MM-$299MM | $25MM-$99MM | $10MM-$24MM | $5MM-$9MM | $1MM-$4MM | <$1MM

(1) Card Services on a Managed basis. Excludes accounting adjustments and loans with invalid county designations totaling $2.6 billion.

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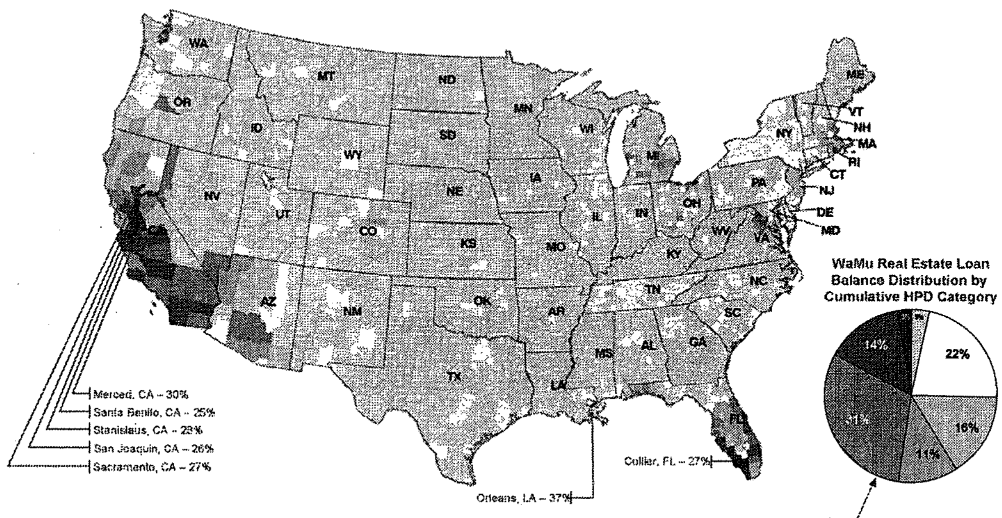
Footnote Exhibits - Page 0226

Cumulative Home Price Depreciation (Peak to Jan 08) WaMu
FARES County-Level HPI Data



Almost half of our RE portfolio is in areas where prices have already declined by more than 15%

25.1%-30.0%	20.1%-25.0%	15.1%-20.0%	10.1%-15.0%	5.1%-10.0%	≤5.0%	- N/A

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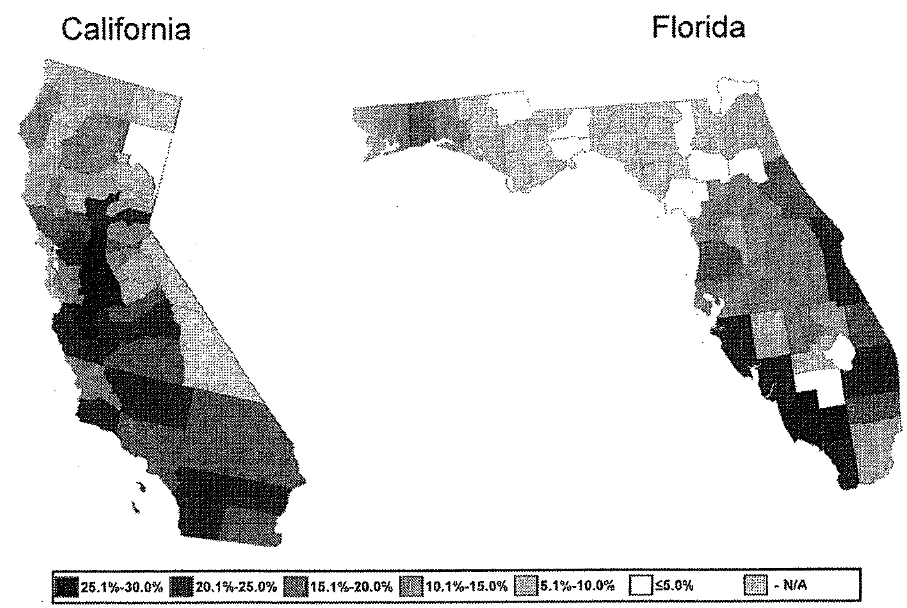
Cumulative Home Price Depreciation (Peak to Jan 08) WaMu
FARES County-Level HPI Data



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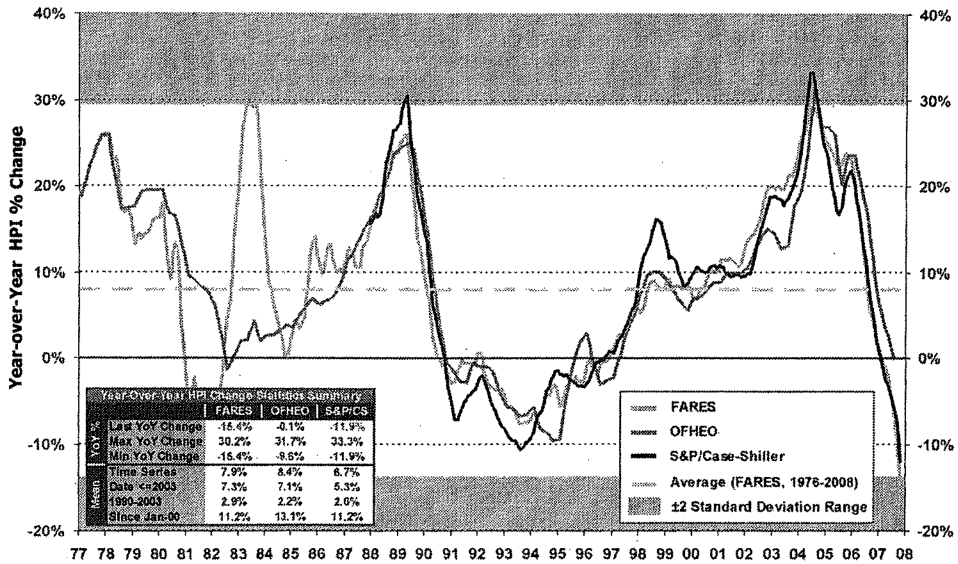
Footnote Exhibits - Page 0228

WaMu

MSA Examples – YoY HPI Change
Los Angeles-Long Beach-Glendale, CA



Year-Over-Year HPI Change Statistics Summary

		FARES	OFHEO	S&P/CS
YoY %	Last YoY Change	-15.4%	-0.1%	-11.9%
	Max YoY Change	30.2%	31.7%	33.3%
	Min YoY Change	-15.4%	-9.6%	-11.9%
Mean	Time Series	7.9%	8.4%	6.7%
	Date <=2003	7.3%	7.1%	5.3%
	1990-2003	2.9%	2.2%	2.0%
	Since Jan-00	11.2%	13.1%	11.2%

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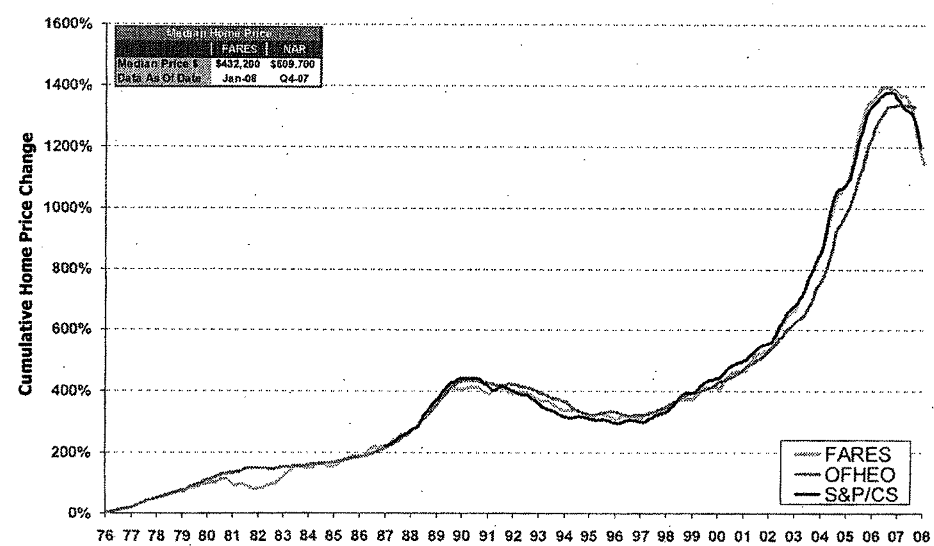
MSA Examples – Cumulative Appreciation WaMu

Los Angeles-Long Beach-Glendale, CA

Median Home Price	FARES	NAR
Median Price $	$432,200	$609,700
Data As Of Date	Jan-08	Q4-07



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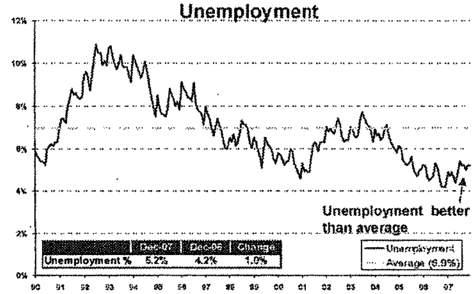
WaMu

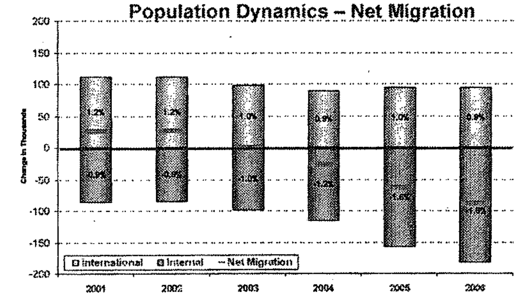
MSA Examples – Economy

Los Angeles-Long Beach-Glendale, CA

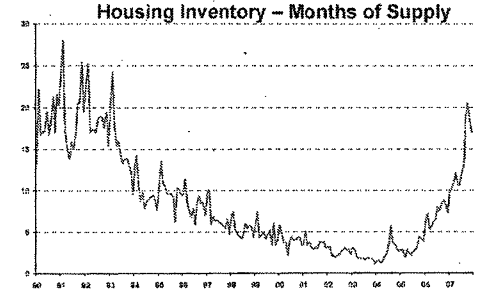
Unemployment



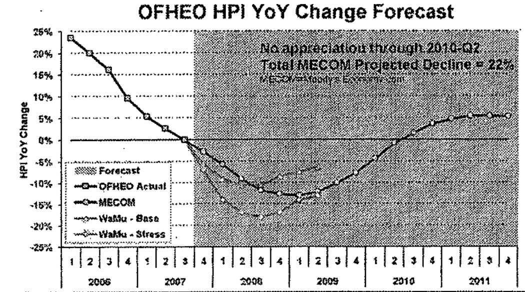
Population Dynamics – Net Migration



Housing Inventory – Months of Supply



OFHEO HPI YoY Change Forecast



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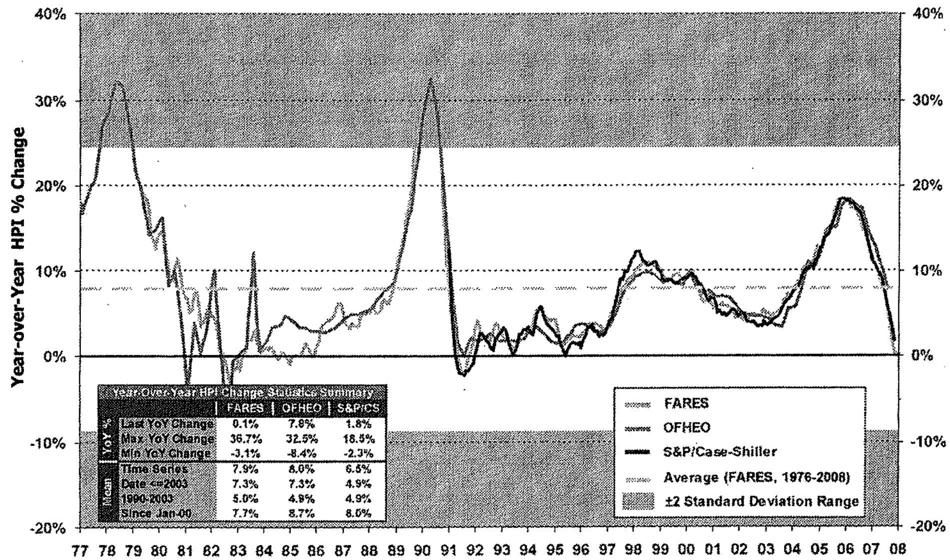
WaMu

MSA Examples – YoY HPI Change
Seattle-Bellevue-Everett, WA



Year-Over-Year HPI Change Statistics Summary

		FARES	OFHEO	S&P/CS
YoY %	Last YoY Change	0.1%	7.8%	1.8%
	Max YoY Change	36.7%	32.5%	18.5%
	Min YoY Change	-3.1%	-8.4%	-2.3%
Mean	Time Series	7.9%	8.0%	6.5%
	Date <=2003	7.3%	7.3%	4.9%
	1990-2003	5.0%	4.9%	4.9%
	Since Jan-00	7.7%	8.7%	8.0%

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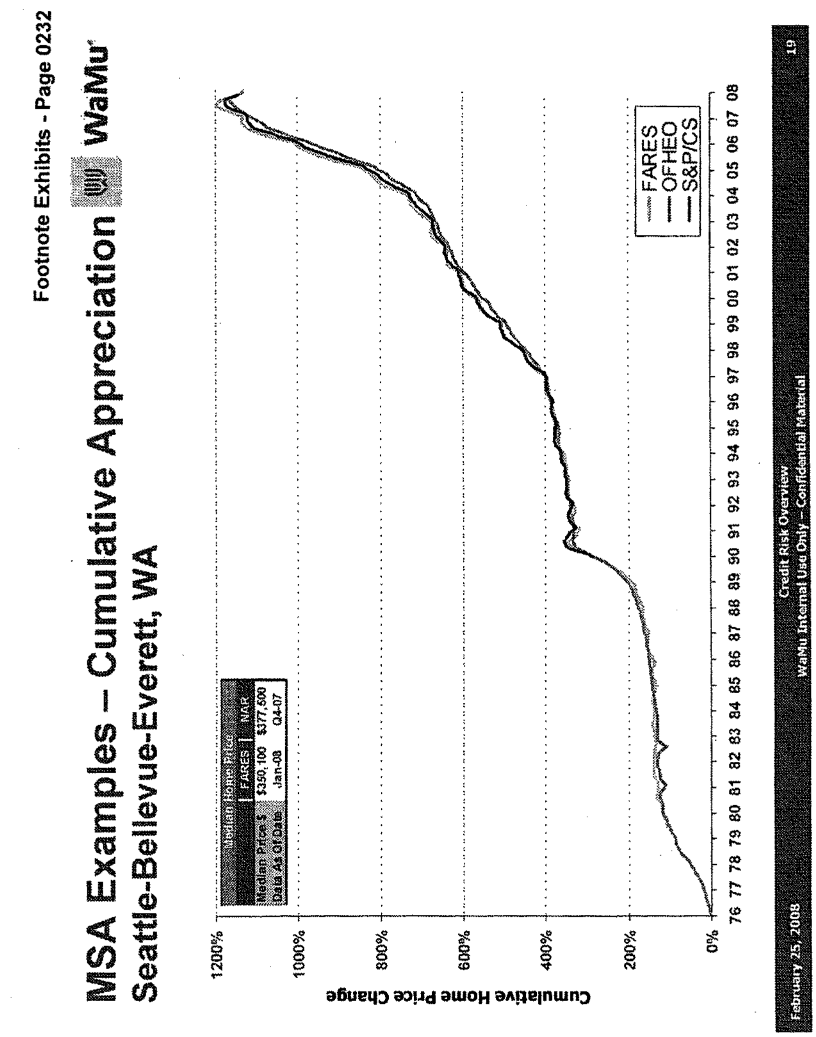

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Footnote Exhibits - Page 0233

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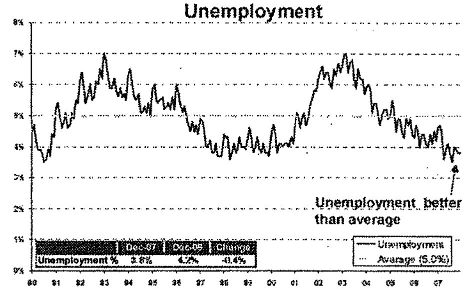
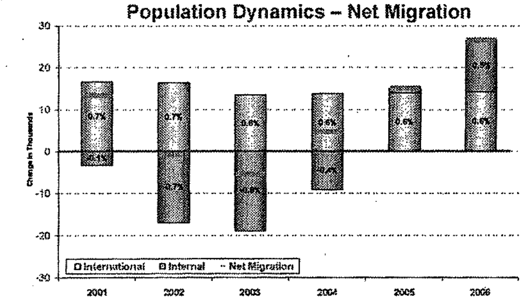
MSA Examples – Economy
Seattle-Bellevue-Everett, WA

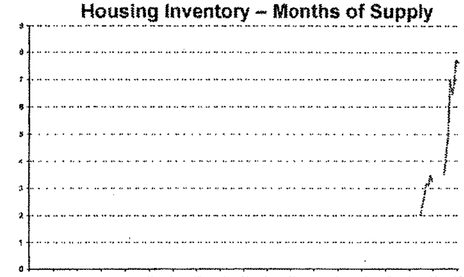
Unemployment



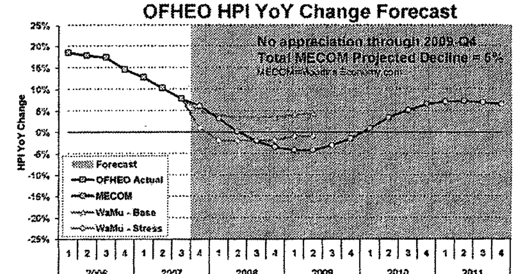
Population Dynamics – Net Migration



Housing Inventory – Months of Supply



OFHEO HPI YoY Change Forecast



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Footnote Exhibits - Page 0234

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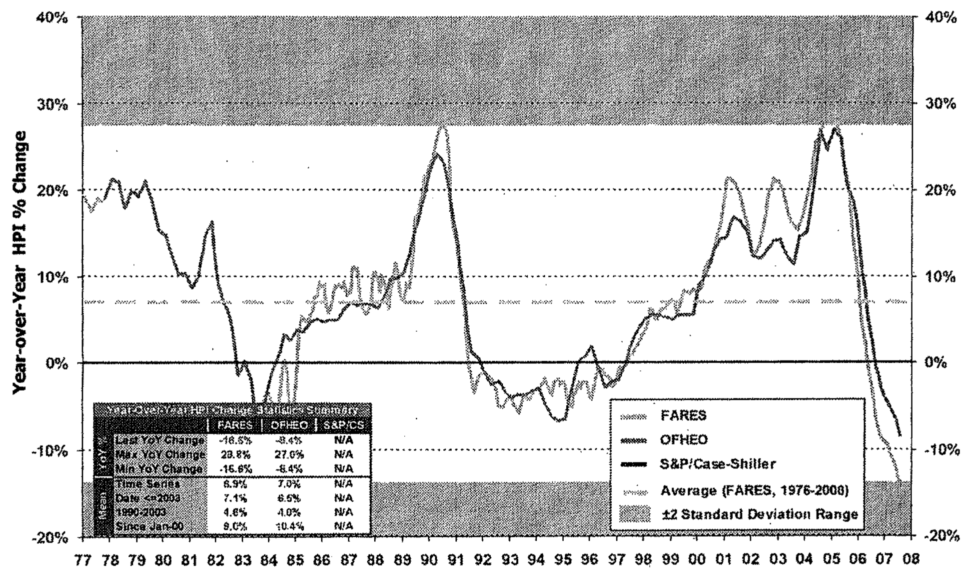
MSA Examples – YoY HPI Change

Sacramento--Arden-Arcade--Roseville, CA



Year-Over-Year HPI Change Statistics Summary

		FARES	OFHEO	S&P/CS
YoY %	Last YoY Change	-16.5%	-8.4%	N/A
	Max YoY Change	28.8%	27.0%	N/A
	Min YoY Change	-16.6%	-8.4%	N/A
Mean	Time Series	6.9%	7.0%	N/A
	Date <=2003	7.1%	6.6%	N/A
	1990-2003	4.6%	4.0%	N/A
	Since Jan-00	9.0%	10.4%	N/A

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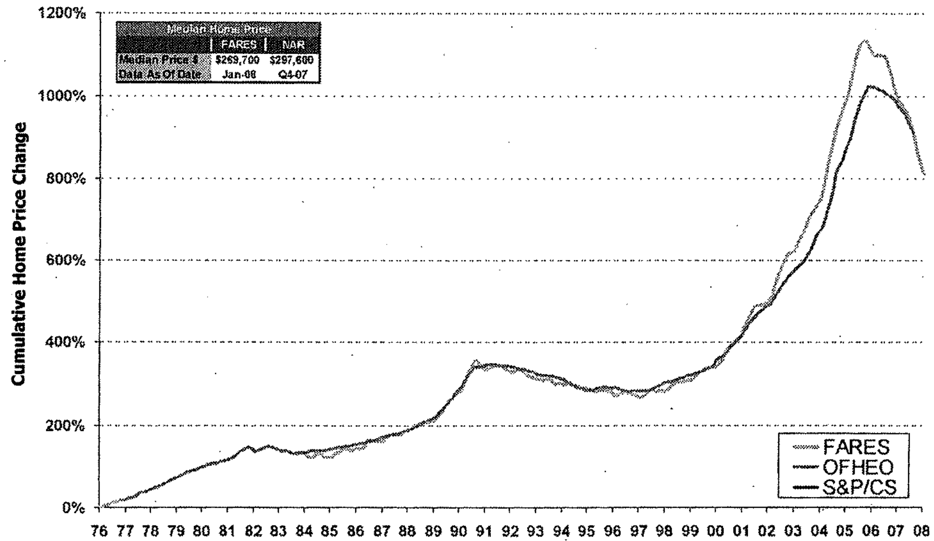
MSA Examples – Cumulative Appreciation WaMu

Sacramento--Arden-Arcade--Roseville, CA



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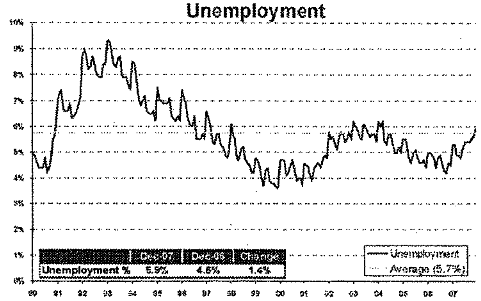
MSA Examples – Economy

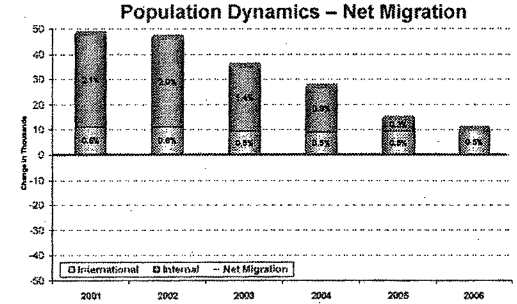
WaMu

Sacramento--Arden-Arcade--Roseville, CA

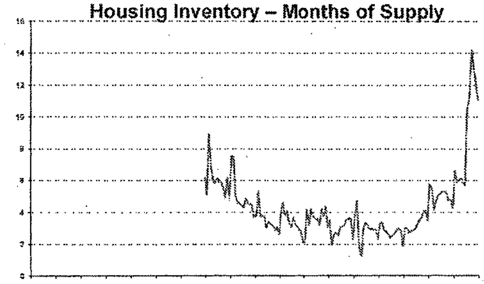
Unemployment



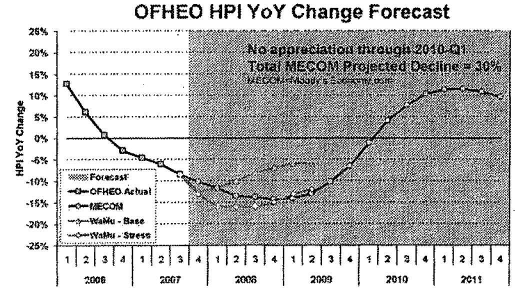
Population Dynamics – Net Migration



Housing Inventory – Months of Supply



OFHEO HPI YoY Change Forecast



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Key Prerequisites for a Peak in Mortgage-Related Losses/NCOs

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- ***Liquidity Improvement***. Financial markets begin to provide liquidity for Jumbo and otherwise non-conforming loan products. Otherwise, there will continue to be fewer potential homebuyers in major areas of the country, especially where we have high concentrations. *Current Outlook: liquidity continues to be extremely constrained.*
- ***Prepayments Rebound***. Loans typically terminate in full payoff of the loans, leaving fewer loans outstanding for subsequent potential default. Prepayments have been suppressed by weak home sales and lack of refinancing opportunities, leaving more cumulative loss potential on our books. *Current Outlook: Prepayment outlook is mixed depends upon loan type and borrower attributes.*
- ***Rate of House Price Declines Bottoms Out***. Declining home values have increased loss frequency and severity. The acceleration of loss rates are unlikely to abate until the rate of decline in home prices slows. *Current Outlook: prices continue to decline, especially where we have high concentrations.*
- ***Economy Stabilizes***. More homeowners are losing their jobs as the deflation of housing markets and disruptions in financial markets ripple through the economy. Resumed strength in employment growth and a halt to the uptrend in unemployment would be welcome signs of stabilization. *Current Outlook: recession probability has increased.*

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Federal Policy Initiatives

Initiatives:

- Federal Reserve Actions
  - 125 bp cut in Fed funds target
  - Term Auction Facility
- Fiscal Policy Actions
  - Tax rebate for households
  - Business tax changes
- Regulatory/Other Changes
  - FHA expansion
  - Increase in GSE conforming loan limits

Expected Impact is Minimal:

- Increase in NIM
- Reduction in ARM and HELOC payment/accrual rates
- Delay in Option ARM recasts
- Reduction of ARM payment shock
- Prepayment of low credit risk loans, including those that meet the new GSE conforming limits

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Portfolio Performance & Provision

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Footnote Exhibits - Page 0240

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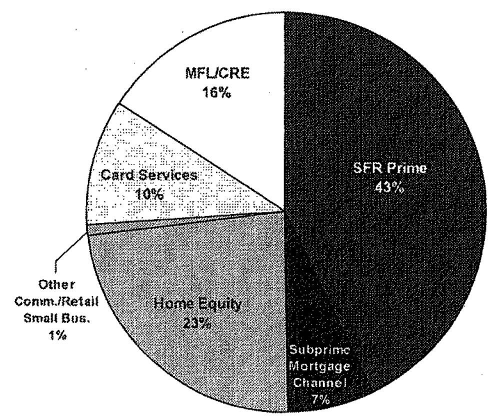
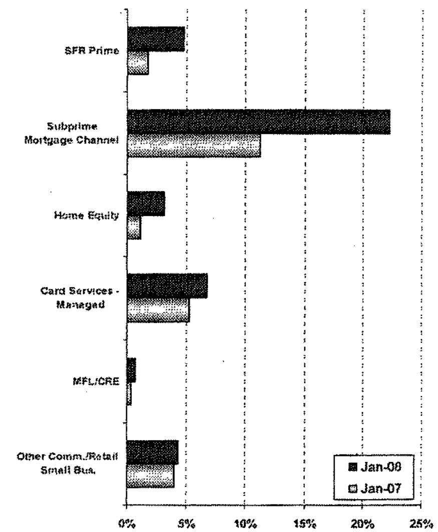
Portfolio Summary

Composition



Total Delinquency



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Footnote Exhibits - Page 0241

Mortgage Concentration at Top 20 Banks

WaMu

Sorted by Total Mortgage Concentration; Source: FBR report dated 02-06-2008

Institution	Ticker	Market Cap	As % of Common Tangible Equity: Home Equity	1st Liens	Total Mortgages
Washington Mutual	WM	18,962	457%	910%	1366%
Northwest Bancorp, (MHC)	NWSB	1,400	146%	649%	795%
TCF Financial	TCB	2,788	262%	469%	732%
Webster Financial	WBS	1,810	283%	435%	718%
National City	NCC	11,398	352%	364%	716%
Citigroup Inc.	C	148,290	198%	486%	684%
Countrywide Financial	CFC	4,396	269%	398%	668%
Sovereign Bancorp, Inc.	SOV	6,292	152%	516%	668%
First Horizon	FHN	2,794	365%	217%	583%
Huntington Bancshares	HBAN	5,168	295%	270%	565%
Bank of America	BAC	199,838	148%	391%	538%
SunTrust Banks, Inc.	STI	23,807	210%	315%	524%
Wells Fargo & Company	WFC	111,045	243%	250%	493%
Regions Financial	RF	17,847	165%	246%	410%
U.S. Bancorp	USB	58,752	150%	235%	385%
PNC Financial Services	PNC	22,649	170%	200%	369%
Citizens Republic	CRBC	1,087	145%	221%	366%
M&T Bank Corporation	MTB	10,337	154%	201%	355%
Associated Banc-Corp	ASBC	3,670	164%	165%	329%
Fifth Third Bancorp	FITB	14,947	170%	148%	318%

Environment & Concentrations Drive Portfolio Performance

WaMu

- **Adverse Environmental Conditions.** This cycle has been especially severe as a result of several unique circumstances, including:
  - Guideline Expansion: prior to the recent melt-down in the capital markets, industry guidelines expanded beyond what had existed in previous cycles.
  - Home Prices: house price patterns in recent years departed substantially from historical norms.
  - Liquidity: the continuing absence of liquidity in the primary and secondary markets is without precedent.
  - Negative Feedback Loop: many of these conditions are self-reinforcing thereby further worsening the environment
- **High Product and Geographic Concentrations.** We're heavily concentrated in several key dimensions:
  - Residential Mortgages: we're highly exposed to this asset class, which has performed very poorly in this cycle.
  - High Risk Products: within residential, we generally retained higher risk products (e.g., Option ARMs, 2nd Liens, Subprime, Low Doc), which are also particularly impacted by current primary market liquidity conditions.
  - Geography: we're heavily exposed in highly stressed markets such as California and Florida

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Other Issues Affecting Portfolio Performance WaMu

- **Portfolio Management Choices.** Some choices have benefited and others have exacerbated our ongoing results, including:
  + Loan Sales: we sold greater than normal proportions of 2006 and 2007 originations
  + Guidelines: we tightened guidelines earlier than other lenders
  + Residuals: we sold and wrote down mortgage residuals aggressively
  – Credit Enhancements: we generally have not used credit enhancements for the retained risk portfolio
  – Line Management: while ahead of most banks, in early stages and needs to be even more aggressive in Home Equity and Small Business

- **Manufacturing Defects.** While our guidelines were generally managed more conservatively than industry leaders, manufacturing quality was inconsistent with established standards.

- **Data Challenges.** As a result of manufacturing quality and integration issues, data quality is poor; consequences include:
  – Measurement is less precise and the processes that depend on them are less effective
  – Models built using the data are less reliable

February 25, 2008 Credit Risk Overview WaMu Internal Use Only – Confidential Material 30

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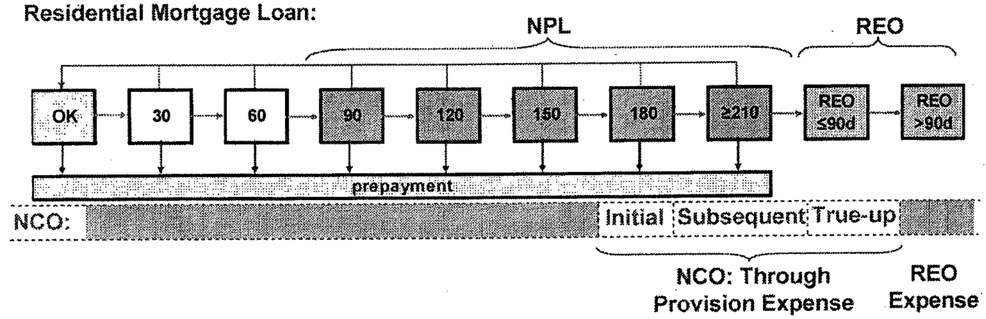
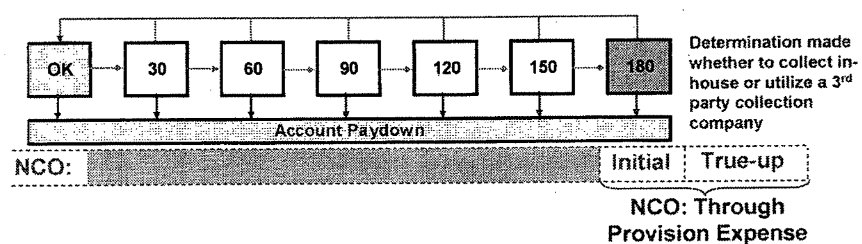
WaMu

Consumer Transition Timelines

Residential Mortgage Loan:



Credit Card:



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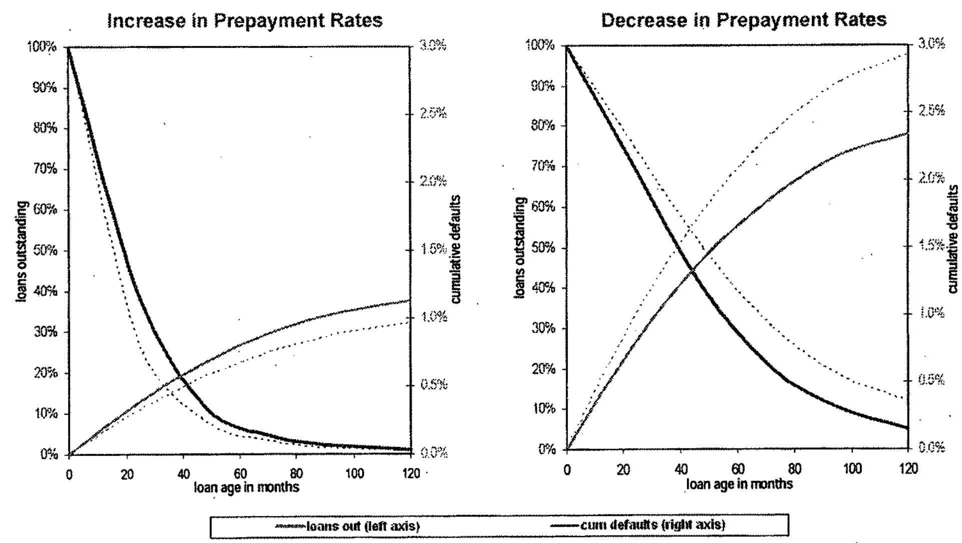
Impact of Prepayments on Losses[1]

WaMu



(1) For illustrative purposes only. Assumes all other factors held constant. Numbers do not represent actual default or pool factor figures.

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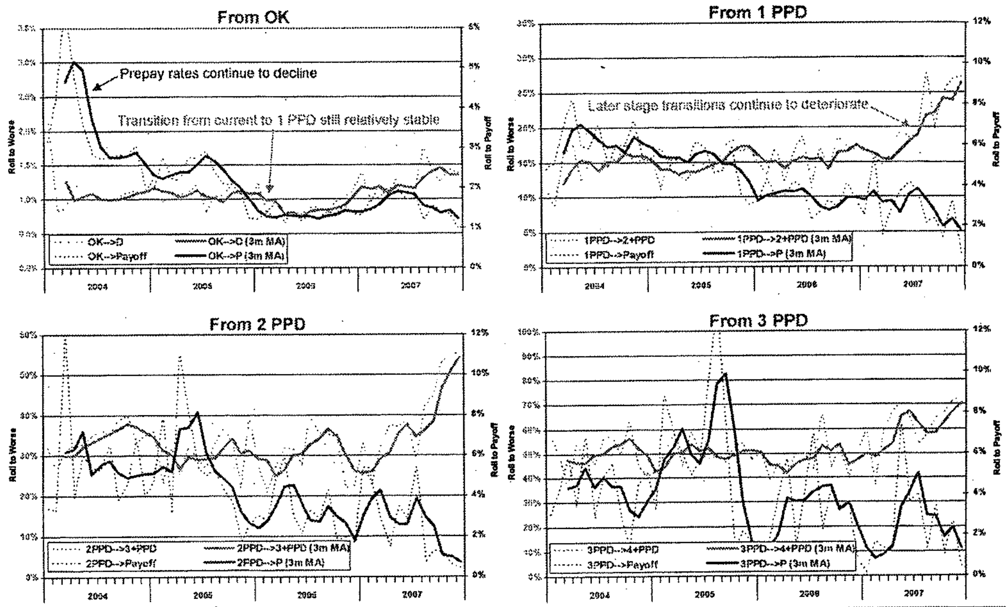
Loan Transition Time Series

WaMu

5/1 Prime Hybrid ARM HFI Port – One Month Roll Rates



February 25, 2008 | Credit Risk Overview | WaMu Internal Use Only – Confidential Material | 33

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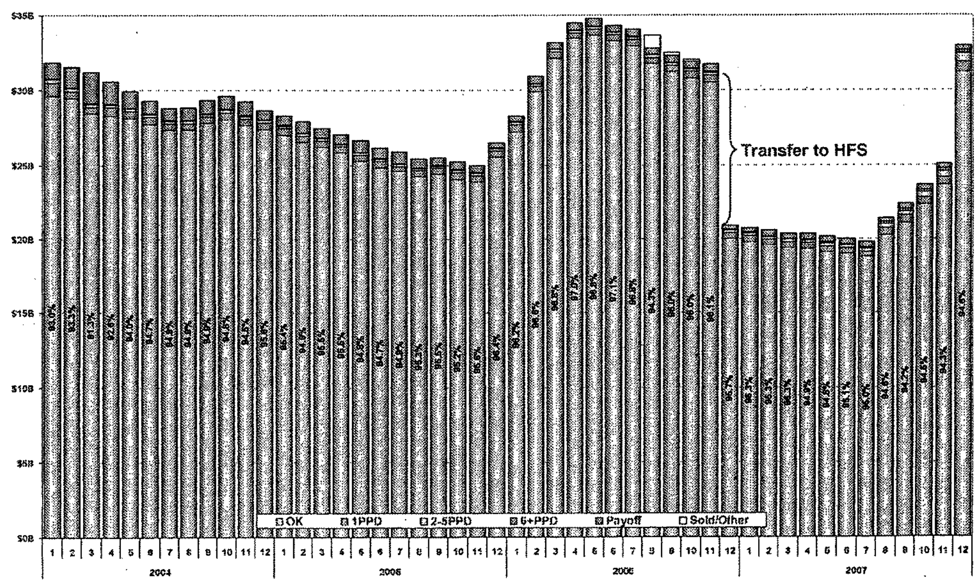
Loan Transition Time Series

WaMu

5/1 Prime Hybrid ARM HFI - Month Ahead Portfolio Status



February 25, 2008

Credit Risk Overview
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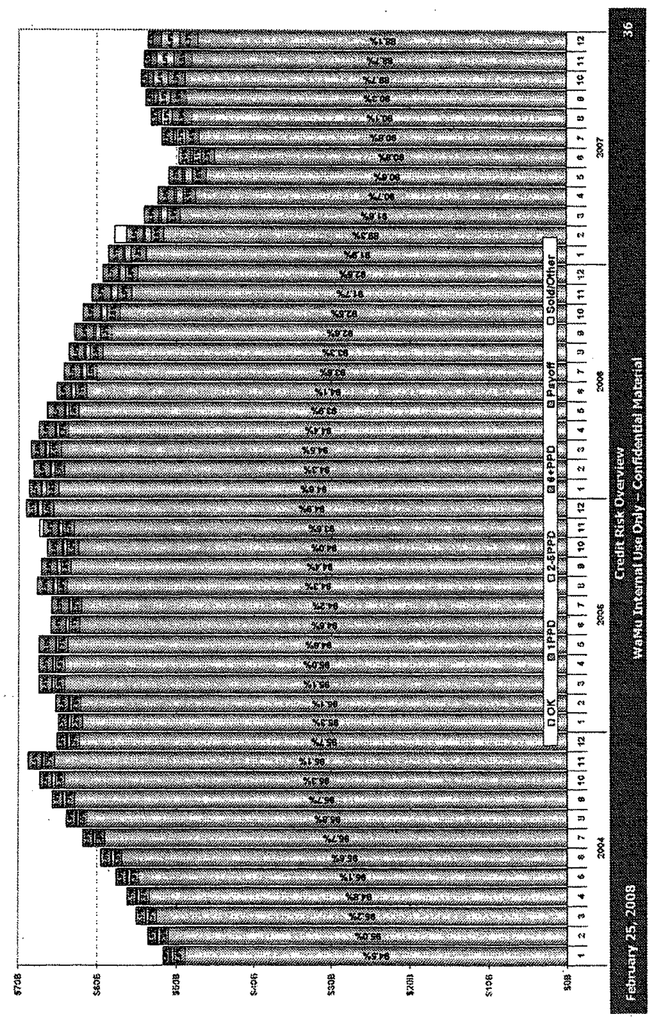
Loan Transition Time Series

Option ARM HFI - Month Ahead Portfolio Status



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ALL, NCOs & Provision

WaMu

ALL Basics

- ***ALL***. Allowance for Loan Losses (reserve) is an estimate of incurred losses.
- ***NCOs***. Net charge-offs deplete the ALL balance.
- ***Provision***. The ALL needs to be replenished (as a result of charge-offs) and may be increased (if incurred loss expectations are higher) through the provision.
- ***Transfer***. ALL adjustment, typically as a result of loans moving from HFI to HFS (usually card).

NCO Considerations

- ***Accuracy***. Measurement of NCOs must be accurate as these are the basic building blocks for any estimate or forecast of future NCOs, provisions, and ALL requirements.
- ***Current Provision Forecast***. The primary change between the previous and the current provision forecast is an update of Home Loans' NCO forecast, which was revised from $2.9B to 4.9B.
- ***Lags***. There are a number of lags built into the NCO process and forecast, including home price indexes, property valuations for NPL loans and transition rate assumptions.
- ***Infrastructure***. As the volume of NCO activity has accelerated from a standstill to warp speeds, the infrastructure has proven to be inadequate.

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Provision Roll Forward

WaMu

	2006	2007	2008	2008 Update
Beginning ALL (Reserve)	$ 1,695	$ 1,630	$ 2,580	$ 2,571
Net Charge-offs	(510)	(1,592)	(3,830)	**(5,200) to (6,200)**
Transfer (Card Securitization)	(370)	(579)	(125)	(100) to (200)
Provision	816	3,121	7,600	10,500 to 12,500
Ending ALL (Reserve)	$ 1,630	$ 2,580	$ 6,225	$6,500 to $9,000
Coverage Ratio	3.2	1.6	1.6	1.2 to 1.5
Coverage Ratio (Q4 NCO annualized)	3.0	0.9	1.5	1.0 to 1.5
Q4 NCO	(136)	(747)	(1,033)	

	Q1 2008	Q1 2008 Update
Beginning ALL (Reserve)	$ 2,580	$ 2,571
Net Charge-offs	(917)	**(1,200) to (1,400)**
Transfer (Card Securitization)	(35)	0 to 50
Provision	1,900	2,000 to 3,500
Ending ALL (Reserve)	$ 3,528	$3,200 to $4,500
Coverage Ratio	1.0	0.6 to 1.0

Change between the previous and the current provision forecast is an update of Home Loans' NCO forecast, which was revised from $2.9B to 4.9B

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WaMu

Provision Volatility

We expect actual provisions and the provision outlook to remain volatile as a result of multiple factors, including:

- Environmental uncertainties
- NCO
  - Absolute levels
  - Process changes
- ALL
  - Recalibrations
  - Potential upward adjustment of cap on Qualitative
  - Reconciliation with Home Loans
  - Introduction of new approach
- Card securitization

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WaMu

S&P Levels

- Widely used external benchmarking tool
- An important instrument internally, given our data and modeling limitations
- Generates a spectrum of cumulative loss forecasts associated with different rating levels
- Recent internal and external news indicate an acceleration of the timing and increase in the level of expected cumulative losses (i.e. we may be experiencing something worse than a BB event).

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S&P Levels Output

WaMu

Portfolio	Vintage	Balance Oct '07	S&P LEVELS 'B'		S&P Levels 'BB'	S&P Levels 'BBB'	S&P Levels 'A'
		($mm)	(%)	($mm)	($mm)	($mm)	($mm)
SubPrime Mortgage		**19,643**	**9.8%**	**1,916**	**2,538**	**3,395**	**4,187**
	2004 & Earlier	4,723	2.7%	128	211	335	460
	2005	4,762	6.7%	317	459	658	858
	2006 or 2007	10,158	14.5%	1,471	1,868	2,402	2870
Home Equity		**59,015**	**3.9%**	**2,281**	**3,416**	**4,867**	**5,998**
1st Lien		15,823	0.5%	85	134	201	271
	2004 & Earlier	7,119	0.2%	14	24	38	53
	2005	2,755	0.9%	25	35	49	64
	2006 or 2007	5,949	0.8%	46	75	114	153
2nd Lien		**43,192**	5.1%	**2,195**	**3,281**	**4,666**	**5,727**
	2004 & Earlier	10,458	1.2%	121	230	393	533
	2005	9,671	5.7%	554	808	1,127	1376
	2006 or 2007	23,064	6.6%	1,520	2,244	3,146	3817
Prime Mortgage		**109,946**	**2.2%**	**2,422**	**3,551**	**5,091**	**6,651**
Option ARM		54,893	3.5%	1,918	2,761	3,908	5,053
	2004 & Earlier	17,106	1.3%	229	355	544	740
	2005	13,226	3.5%	467	696	1,007	1317
	2006 or 2007	24,560	5.0%	1,222	1,710	2,358	2997
Other		55,053	0.9%	504	790	1,183	1,598
	2004 & Earlier	23,149	0.4%	81	140	229	329
	2005	8,131	1.0%	77	128	197	271
	2006 or 2007	23,773	1.5%	345	522	756	998
Home Loans & Home Equity		**188,604**	**3.5%**	**6,619**	**9,505**	**13,352**	**16,836**

Plan to update with Jan data

Footnote Exhibits - Page 0254

Actions Underway or to Consider

WaMu

- Temper Pervasive Themes
  - Customer Service
  - Efficiency
- Continue to implement aggressive Line Management
- Clarify Asset Strategy
- Establish and follow a Geographic Strategy
- Strengthen NCO Processes and Infrastructure
- Revamp ALL approach for residential mortgages
- Fortify Pricing Strategies

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WaMu®

Appendix

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WaMu

Manufacturing Quality

supplement to section one (Background)

- Manufacturing Quality; Transaction elements
  - Basic transaction terms (recourse, guaranty, security)
  - Sourcing (retail, wholesale, correspondent, bulk)
  - Insurance (placement & availability of both loan and hazard)
  - Adverse selection potential
  - Equity (LTV, CLTV, lien position)
  - Collateral valuation method (appraisal, AVM, PIW)
  - Documentation (employment, income, assets)
  - Loan size
  - Loan purpose (purchase, rate refinance, cash-out refinance)
  - Property type (SFR, condo, 2-4, multifamily, office, hotel, ...)
  - Occupancy (owner, second, investor)
  - Maturity & amortization type (30 vs. 15 yr, IO, negative amortization)
  - Seasoning (age of the loan and delinquency history)
  - Product type (fixed vs. ARM, Neg Am vs. IO vs. Amortizing, ...)
  - Number of borrowers per loan
  - Utilization for "revolving" obligations
  - Call protection (prepayment penalties, yield maintenance)

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Credit Performance Outcomes

WaMu

(in $ Millions)

SFR Prime	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Jan-08
Outstanding Portfolio Balance	$123,179	$101,562	$95,522	$90,593	$106,003	$112,614	$112,194
Total Delinquencies	$1,449	$1,661	$1,730	$2,164	$3,086	$4,703	$5,310
Total Delinquency Rate	1.18%	1.64%	1.81%	2.39%	2.86%	4.18%	4.73%
Non Performing Loans	$603	$667	$731	$1,038	$1,496	$2,358	$2,707
Non Performing Loan Rate	0.49%	0.66%	0.77%	1.15%	1.39%	2.09%	2.41%
Net Charge-offs	$15	$20	$35	$21	$52	$100	$97
Annualized Net Charge-off Rate	0.05%	0.07%	0.14%	0.09%	0.20%	0.36%	1.03%

Subprime Mortgage Channel	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Jan-08
Outstanding Portfolio Balance	$21,245	$20,700	$20,360	$20,457	$19,996	$18,617	$18,166
Total Delinquencies	$1,883	$2,172	$2,289	$2,680	$3,495	$3,963	$4,047
Total Delinquency Rate	8.86%	10.49%	11.24%	13.10%	17.48%	21.29%	22.28%
Non Performing Loans	$1,122	$1,282	$1,503	$1,707	$2,356	$2,721	$2,789
Non Performing Loan Rate	5.28%	6.19%	7.38%	8.34%	11.78%	14.61%	15.35%
Net Charge-offs	$47	$48	$40	$92	$145	$273	$132
Annualized Net Charge-off Rate	0.91%	0.92%	0.77%	1.79%	2.85%	5.73%	8.64%

Home Equity	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Jan-08
Outstanding Portfolio Balance	$52,842	$52,882	$53,374	$55,776	$59,120	$60,966	$61,146
Total Delinquencies	$462	$589	$634	$778	$1,154	$1,708	$1,898
Total Delinquency Rate	0.87%	1.11%	1.19%	1.40%	1.95%	2.80%	3.10%
Non Performing Loans	$161	$231	$297	$378	$533	$835	$978
Non Performing Loan Rate	0.30%	0.44%	0.56%	0.68%	0.90%	1.37%	1.60%
Net Charge-offs	$6	$11	$26	$52	$101	$244	$113
Annualized Net Charge-off Rate	0.04%	0.09%	0.20%	0.38%	0.70%	1.62%	2.22%

Home Loans SFR Prime includes SFR Prime, Custom and Builder portfolios
Subprime Mortgage Channel includes Purchased SMF, Long Beach Mortgage, HEL Subprime, and HEL Purchased portfolios
Home Equity includes HEL and HELOC portfolios; excludes Other Consumer portfolio

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Credit Performance Outcomes

WaMu

(in $ Millions)

Card Services	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Jan-08
Outstanding Portfolio Balance	$21,921	$23,518	$23,628	$24,987	$26,227	$27,239	$27,047
On Balance sheet Delinquencies	$206	$289	$244	$291	$299	$379	$389
On Balance sheet Rate	2.34%	2.66%	2.57%	2.93%	3.41%	4.29%	4.51%
Managed Delinquencies	$1,212	$1,234	$1,216	$1,277	$1,503	$1,762	$1,829
Managed Rate	5.53%	5.25%	5.15%	5.11%	5.73%	6.47%	6.76%
On Balance sheet Net Charge-offs	$27	$19	$30	$34	$36	$30	$40
On Balance sheet Net Charge-off Rate	1.19%	0.79%	1.13%	1.35%	1.57%	1.35%	5.46%
Managed Net Charge-offs	$311	$331	$367	$392	$413	$464	$197
Managed Annualized Net Charge-off Rate	5.71%	5.81%	6.21%	6.40%	6.38%	6.92%	8.70%

MFL/CRE	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Jan-08
Outstanding Portfolio Balance	$33,046	$36,684	$36,031	$35,999	$39,001	$41,126	$41,552
Total Delinquencies	$123	$169	$131	$190	$280	$233	$291
Total Delinquency Rate	0.37%	0.46%	0.36%	0.53%	0.72%	0.57%	0.70%
Non Performing Loans	$58	$71	$87	$101	$151	$168	$174
Non Performing Loan Rate	0.17%	0.19%	0.24%	0.28%	0.39%	0.41%	0.42%
Net Charge-offs	$0	$0	-$1	$2	$0	$5	$1
Annualized Net Charge-off Rate	0.00%	0.00%	-0.01%	0.02%	0.00%	0.05%	0.03%

Other Comm./Retail Small Bus.	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Jan-08
Outstanding Portfolio Balance	$2,004	$1,929	$1,994	$2,005	$2,030	$2,031	$2,104
Total Delinquencies	$62	$70	$80	$84	$77	$91	$92
Total Delinquency Rate	3.11%	3.63%	4.05%	4.19%	3.79%	4.48%	4.35%
Non Performing Loans	$43	$42	$52	$50	$40	$38	$38
Non Performing Loan Rate	2.15%	2.19%	2.64%	2.50%	1.95%	1.89%	1.81%
Net Charge-offs	$5	$7	$6	$12	$16	$28	$12
Annualized Net Charge-off Rate	1.06%	1.40%	1.26%	2.46%	3.10%	5.61%	6.77%

MFL/CRE includes MFL and CRE portfolios; excludes Other Commercial/Retail Small Business

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FACT SHEET 12 - Securitizations

WaMu could not execute any new securitizations after the secondary market disruption occurred in 2007. The bank had previously securitized nonconforming mortgage loans and credit card loans. Asset securitization had been an important source of funding, and the loss of access to this market had a negative impact on the bank's liquidity.

During 2006 and 2007, WaMu sold loans and retained servicing responsibilities as well as senior and subordinated interests from securitization transactions. WaMu received servicing fees equal to a percentage of the outstanding principal balance of mortgage loans and credit card loans being serviced. Generally, WaMu also received the right to cash flows remaining after the investors in the securitization trusts have received their contractual payments.

The allocated carrying values of mortgage loans securitized and sold during the years ended December 31, 2007 and 2006 were \$82.58 billion and \$110.08 billion, which included loans sold with recourse of \$6 million and \$959 million during the same periods. The allocated carrying values of credit card loans securitized and sold were \$10.65 billion and \$7.11 billion during the years ended December 31, 2007 and 2006.

WaMu realized pretax gains of \$484 million and \$1 billion on mortgage loan securitizations during 2007 and 2006. Pretax gains realized on credit card securitizations were \$533 million and \$279 million during 2007 and 2006.

WaMu did not issue any new nonconforming mortgage or credit card securitizations in 2008 because of continued market illiquidity, deterioration in the financial condition of the bank, and the poor performance of WaMu's outstanding securitizations.

The table below summarizes the size of outstanding mortgage securitizations and the performance of the underlying loans as of March 31, 2008*:

Type	Number	UPB	30 pd	60 pd	90 pd	Foreclosure	REO	Total Delinquency
Subprime	46	\$28.9B	6.17%	4.01%	6.11%	12.93%	8.94%	38.16%
Prime/AltA	200	\$98.6B	3.01%	1.22%	1.25%	2.25%	0.84%	8.57%

*Source: March 2008 Securitization Report to the Market Risk Committee. Non-Prime delinquencies based on OTS method. Prime/Alt-A delinquencies based on MBA method.

Total delinquencies on subprime mortgage loans were extremely high, at 38.16 percent. Total delinquencies on Prime/AltA securitized loans were 8.57 percent, more than twice the industry average of 4.21 percent.

As of March 2008, there were 22 WaMu credit card securitizations outstanding with a principal balance of approximately \$16.9 billion. The annualized net charge-off rate on managed credit card balances (on-balance sheet plus securitized credit card loans) as of June 30, 2008 was 10.78 percent, compared to 6.40 percent a year earlier. Managed

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #626

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credit card balances greater than 30 days past due increased from 5.11 percent to 7.11 percent over the same period.

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Washington Mutual

March 17, 2008

Darrel W. Dochow
Regional Director, West Region
Office of Thrift Supervision
2001 Junipero Serra Boulevard, Suite 650
Daly City, CA 94014-1976

Dear Mr. Dochow:

On behalf of the Board of Directors of Washington Mutual Bank, this letter responds to your February 27, 2008 letter advising the Board of revisions to our supervisory ratings and requesting a Board Resolution. The Board understands and shares your concerns as they are outlined in your letter. The events in the credit markets over the last eight months have been truly extraordinary, have adversely affected Washington Mutual Bank in significant ways, and require extraordinary actions on our part to ensure the continued safety and soundness of the Bank.

While we have already taken a number of important steps to manage these risks, we also recognize the need for further steps as market conditions continue to deteriorate. As you know from our discussions last week, we are currently embarked on actions that we have every reason to believe will put Washington Mutual Bank in a position to withstand the current pressures on earnings, capital and liquidity as well as foreseeable continued market deterioration. As additional assurance of the Board and management's commitment to manage these risks, the Board has unanimously adopted a Board Resolution to take appropriate action as you have requested. A certified copy of that Board Resolution is enclosed.

The Board is actively involved with and monitoring the progress of management execution of these actions. We will also continue to keep you apprised of our progress and appreciate any assistance the Office of Thrift Supervision can provide as we drive these actions towards a successful conclusion.

Sincerely,

Kerry Killinger

Kerry Killinger, Chairman

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OTS/WEST

Enclosure

Corporate Executive Offices
1301 Second Avenue
Seattle, WA 98101

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #628

OTSWMS08-015 0001216

WASHINGTON MUTUAL BANK
CERTIFICATE OF SECRETARY

I, William L. Lynch, Secretary of Washington Mutual Bank (the "Association"), a federal savings bank duly authorized and existing under the laws of the United States of America, hereby certify that, at a meeting duly called and held on March 17, 2008, the Board of Directors of the Association duly adopted the following resolutions:

RECITALS

A. The Board of Directors ("Board") of Washington Mutual Bank ("Association") received a letter from the Regional Director of the Office of Thrift Supervision ("OTS") dated February 27, 2008 ("Ratings Letter'), notifying the Board of the decision of the OTS to adjust the Association's composite rating, and ratings with respect to components of the composite rating, including Asset Quality, Earnings and Liquidity;

B. The Association's financial strength and safe and sound operation is of vital importance to the Association and its continuing success;

C. The Ratings Letter asks the Board to send to the OTS a duly certified Resolution of the Board committing to take appropriate action to ensure that weaknesses and concerns are promptly addressed;

D. At its meeting on Monday, March 17, 2008, Management presented to the Board an outline of initiatives to address the weaknesses that the Ratings Letter identified as to Asset Quality, Earnings and Liquidity.

NOW THEREFORE BE IT RESOLVED

1. The Board endorses undertaking those strategic initiatives to improve Asset Quality, Earnings and Liquidity; and further commits to take appropriate further actions as required to address those weaknesses and concerns raised in the Ratings Letter; and

2. The Board hereby authorizes and directs management to implement and report to the Board on the implementation of its initiatives to address the concerns raised by the Ratings Letter.

IN WITNESS WHEREOF, I have hereunto subscribed my name this 19th day of March, 2008.

William L. Lynch, Secretary

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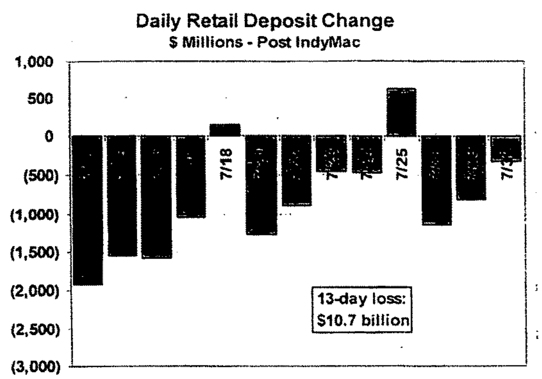
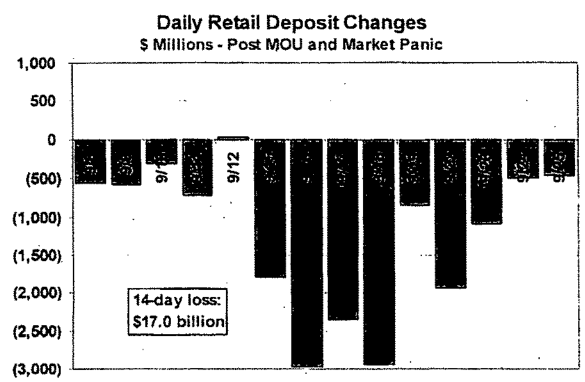
OTSWMS08-015 0001217

Footnote Exhibits - Page 0263





Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #632

FDIC-PSI-01-000009

WAMU BANK
SUPERVISORY TIMELINE
(2000 / 2001 / 2002 / 2003 / 2004 / 2005 / 2006 / 2007 / 2008)

01/05/00	Transmitted Report of Examination (ROE) for 09/20/99, WMBFA ratings 2/222223 as of 09/20/99, 2/222222 as of 08/24/98, and 2/222222 as of 06/02/97. Examination was conducted concurrently with the safety and soundness examinations of WMBFA's sister banks, WMB and WMBFSB and their holding company, WM Inc. Key issue identified – Interest Rate Risk has increased as measured by both the OTS and internal model, this risk worsened to the category of 'significant risk' and a '3' rating for sensitivity to market risk has been assigned accordingly.
01/14/00	Capital Distribution (February Dividend) – WMBFA not to exceed $275 million and WMB not to exceed $65 million.
	OTS no objection letter issued - Acquisition of Alta Residential Mortgage, Inc. and its wholly owned subsidiary, ARMT, Inc. through the merger of Aristar Financial Resources, Inc. with and into Alta; merger was effective on 02/01/00.
	Approved WM to establish a new subsidiary, WMFS Insurance Services of Nevada, Inc. 01/28/00 - recd copy of FDIC approval dated 01/26/00.
01/16/00	Washington Mutual Inc. reported record earnings for the fourth quarter and full year 2000, and the company's chief executive said the Seattle-based company is looking for acquisitions and markets to expand into in 2001.
04/13/00	Capital Distribution (May Dividend) – WMBFA not to exceed $575 million and WMB not to exceed $90 million.
04/19/00	Washington Mutual Inc. reported record first-quarter net income, boosted its dividend by a penny a share and said it will buy back as many as 55 million shares of stock. The Seattle-based savings bank and financial services company earned $458.5 million, or 83 cents a share, compared with year-ago first quarter earnings of $444.1 million or 76 cents a share.
05/11/00	WAMU's wholly owned subsidiary, Marion holdings, inc., to engage in new activities: a limited liability company (LLC Op Sub) and a registered Investment Company (the "RIC Op Sub"). The new activities will be conducted through two operating subsidiaries, a limited liability company and a registered investment company. The limited liability company will invest in first mortgage residential and commercial loans, mortgage-backed securities, or ownership interests in lower-tier subsidiaries that own such assets. Approved 06/02/00.
05/16/00	OTS began field visit to WMBFA on 04/24/00, objective of the visit was to assess the status of the corrective actions promised as a result of the examinations of WMBFA and its holding company, Washington Mutual Inc. Overall, OTS concluded that management has been responsive to the issues that were raised at the prior examination.
05/18/00	Information Technology Field Visit for 04/24/00. The scope and objectives of review focused on management's corrective actions related to the findings contained in the OTS IT Report of Examination dated September 7, 1999. Management's corrective efforts on the 1999 OTS IT examination findings progressed according to plan.
05/19/00	Special Compliance Examination field visit for 04/24/00, purpose was to determine progress made in addressing outstanding issues from the prior compliance examination, to determine what changes in structure and procedures have occurred since the prior examination, to gain an understanding of the current compliance structure, and to lay the groundwork for the full-scope compliance examination that will commence in the fourth quarter of this year.

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07/12/00	Capital Distribution (August Dividend) – WMBFA not to exceed $350 million and WMB not to exceed $30 million.
07/19/00	Washington Mutual Inc. reported record second-quarter earnings and raised its dividend by a penny a share. The Seattle-based company, the nation's largest savings institution and one of its largest banking companies, earned $490.8 million, or 92 cents a share, up from $452.7 million or 78 cents a share a year ago. The median of analyst estimates was 83 to 84 cents a share.
08/03/00	WMB to establish an operating subsidiary, Washington Mutual Life Insurance Company (WMLICC), to engage in insurance activities. Approved 06/14/02.
08/04/00	OTS began field visit to WMBFA on 07/17/00, objectives of the visit was to continue OTS assessment of the status of the corrective actions promised as a result of the examinations of WMB FA and its holding company, Washington Mutual Inc. (WMI). Additionally, OTS planned on following up on discussions regarding interest rate risk policy changes that we had during the April 2000 visit. WM management has addressed or continued to address identified issues.
	Information Technology Field Visit for 07/17/00. The scope and objectives of review focused on management's corrective actions related to the findings contained in the OTS IT Report of Examination dated September 7, 1999; assessed the progress of corrective actions taken by management to address those issues disclosed in the OTS IT Report of Examination and the December 6, 1999, Examination Deficiencies and Recommendations supplemental document; and assessed the status of management's follow-up actions on two transactional web sites (eCharge and WM Financial). Overall, management's corrective efforts on the 1999 OTS IT examination findings are considered satisfactory.
08/25/00	Special Examination for 07/24/00. The purpose of this special examination was to continue gathering information about operations and the structure of the organization and to plan logistics for the upcoming compliance examination. One issue that was still outstanding from the prior special examination dealt with variations in the mortgage products available from the two origination channels.
10/06/00	Approved "November Dividend" - WMBFA not to exceed $500 million, WMBFSB not to exceed $7 million, WMB not to exceed $50 million.
10/10/00	WAMU, New American Capital, Inc., and WMBFA filed application to acquire and effect mergers with Bank United Corp. and its subsidiaries, BNKU Holdings, Inc. and Bank United. Approved 01/16/01.
10/17/00	Washington Mutual, Inc. (NYSE:WM) today announced third-quarter earnings of $452.5 million or 86 cents per diluted share, versus third-quarter 1999 earnings of $470.0 million or 83 cents per share. Earnings for the first nine months of 2000 were $1.40 billion or $2.60 per diluted share versus $1.37 billion or $2.37 per diluted share for the same period in 1999.
11/07/00	Information Technology Field Visit for 10/16/00. The scope and objectives of our review focused on preplanning for the IT examination starting November 27, 2000 and management's corrective actions related to the findings contained in the OTS IT Report of Examination dated September 7, 1999. Overall, management's corrective actions on the 1999 OTS IT examination findings are considered satisfactory. Management continue to make progress according to plan.
11/17/00	Recommendation to Close Preliminary Inquiry Involving Washington Mutual Bank. In November 1999, West Enforcement & Litigation opened a preliminary inquiry into matters related to a low document mortgage-lending program used by WAMU in Florida. Two concerns – 1) possible fraud in loan applications submitted by a series of loan brokers to WAMU under the low doc program; disposition – OTS was not able to proceed because the brokers who submitted the applications were neither independent contractors of WAMU nor had sufficient contacts with the institution to bring them

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	within the category of persons participating in the conduct of WAMU's affairs. 2) West Appraiser Darryl Washington determined that a WAMU approved appraiser in Florida had submitted several flawed appraisals that went undetected in the low doc program, disposition – WAMU immediately removed the subject appraiser from approved list, and filed a compliant promptly against the appraiser with the FL BREA.
11/22/00	WMBFA filed notice that the institution intends to acquire five additional subsidiaries from PNC Bank, NA (PNC Mortgage Corp. of America, PNC Mortgage Partners Corp., PNC Mortgage Securities Corp., Fairway Drive Funding Corp., and PNC Mortgage Funding Corp.). OTS issued no objection letter dated 12/19/00.
11/29/00	Establish Three New Lower-Tier Subsidiaries In Connection With The Reorganization Of An Existing Subsidiary, FA California Aircraft Holding Corp.; New Subsidiaries: WM Aircraft Holdings, LLC; Sound Bay Leasing LLC; And Interim Series E LLC. Approved 12/19/00.
01/10/01	WM filed a CRA-related application on 10/10/00, it proposed to acquire Bank United Corp. OTS expressed no objection to the institution's request based on its CRA performance.
01/11/01	Capital Distribution (February Dividend) No Objection Letter – WMBFA intends to pay a cash dividend not to exceed $250 million and WMB intends to pay a dividend not to exceed $95 million, such dividends will be paid on or after 02/15/01.
01/16/01	Washington Mutual Announces Record Fourth-Quarter and Annual Earnings; Increased Cash Dividend.
01/18/01	Capital Distribution - Dividend on Series C and D preferred stock to be issued in connection w/bank united acquisition/tender offer -- $4.6 million.
	Nation's Largest Thrift, Washington Mutual, Selected by Fannie Mae as Delegated Underwriting and Servicing -- DUS – Lender.
01/22/01	Washington Mutual Received Regulatory Approval on Bank United Acquisition; Office of Thrift Supervision Approves Merger.
02/01/01	Washington Mutual Completed Acquisition of PNC Mortgage. On 11/22/00 HellerEhrman Attorneys notified OTS of WMBFA's intention to acquire certain subsidiaries from PNC Bank, NA. OTS issued no objection letter dated 12/19/00.
02/07/01	Washington Mutual Completed Bank United Tender Offer.
02/08/01	Bank United Shareholders Approved Merger with Washington Mutual.
02/09/01	Washington Mutual and Bank United Holding Companies Merged; Banking Subsidiaries Expected to Merge on Tuesday 02/13/01.
02/13/01	Washington Mutual Completed Merger with Bank United.
02/14/01	OTS issued No Objection Letter – WMBFA intends to pay a quarterly cash dividend not to exceed $4.6 million on its outstanding C and D preferred stock. Such dividend will be paid on or after March 30, 2001.
03/16/01	To issue up to $2 billion of sub debt notes over a period of approx 18 months. 8/30/02 - inst requesting six-month ext of time to issue sub debt as part of the bank's global note program; 10/23/02 - request granted until 4/12/03 to issue sub debt. 6/13/03 - request for waiver of certain provisions of OTS securities offering regulation; granted 7/9/03. 8/25/05 - recd ltr re: pricing supplements for WAMU global note program. 5/2/06 - recd copies of preliminary pricing supplements 4/26/06, term sheet, and pricing supplement 4/27/06 - each relating to $1 billion senior floating rate notes due 5/2/09. 8/1/08 - inst has determined that it is unlikely to issue sub debt to be included as supplemental capital under 12 CFR 563.81; application withdrawn.
	Capital Distribution - Cash dividend not to exceed $150 million; will be declared on 4/17/01 and paid on or after 5/15/01.
03/20/01	Transmitted Report of Examination (ROE) Information Technology for 11/27/00, WMBFA and

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	WMBFSB. FDIC and State of Washington participated. Rating: Satisfactory (2) – Audit, Management, Acquisition and Management, and Support and Delivery.
03/31/01	Deloitte & Touche Independent Accountant's Report on WMBFSB. No significant issues.
04/02/01	Washington Mutual to Acquire Fleet Mortgage.
04/05/01	Transmitted Report of Examination (ROE) for 11/27/00, WMBFA ratings 2/222223 as of 11/27/00, 2/222223 as of 09/20/99, and 2/222222 as of 08/24/98. Key issue identified – Interest Rate Risk remained 'Significant'.
04/11/01	No Objection Letter – WMBFA cash dividend not to exceed $150 million, will be declared on 04/17/01 and paid on or after 05/15/01.
04/12/01	OTS issued no objection letter in responds to notice filed by Jacob A. Scholl, Esquire on behalf of WMBFA advising its intent to issue up to $2 billion of subordinated notes over a period of approximately eighteen months as part of a global note program that will include offerings of certain registered and exempt debt instruments by WMBFA and WMB.
04/17/01	Washington Mutual announced record quarterly earnings of $641.0 million or $1.15 per diluted share, up 40 percent from first-quarter 2000 earnings of $458.5 million or 83 cents per diluted share. Earnings for the first quarter of 2001 include partial quarter results from the former mortgage operations of The PNC Financial Services Group, Inc. and Bank United Corp., which were acquired this year by Washington Mutual on Jan. 31 and Feb. 9, respectively.
04/20/01	WM announced that it proposes to sell up to $1 billion of Trust Preferred Income Equity Redeemable securities to qualified institutional buyers pursuant to Rule 144A.
04/26/01	WM announced the company has priced $1 billion of Trust Preferred Income Equity Redeemable Securities (PIERS), and provided the underwriter with a 30-day option to purchase up to an additional $150,000,000. WM announced the company has established a US $15,000,000,000 Global Bank Note Program (the "Program") for its two main banking subsidiaries, Washington Mutual Bank, FA (WMBFA) and Washington Mutual Bank (WMB).
05/16/01	OTS approved Fleet Mortgage Reinsurance Company acquisition. WMBFA intends to acquire four subsidiaries under a stock purchase agreement with Fleet National Bank and FleetBoston Financial Corporation. The subsidiaries to be acquired are Fleet Mortgage Corp., Fleet Securities Corp., Fleet Mortgage Insurance Agency Corp., and Norstar Mortgage Corp.
05/18/01	Capital Distribution - Qtrly dividend not to exceed $4.2 million to be paid on or after June 29, 2001.
05/24/01	WM Director's Report April 2001. Topics – WMI key highlights, management comment, financial highlights and trend analysis. WMBFA and WMB subsidiary highlights.
	OTS issued no objection letter to WM 04/30/01 letter notifying OTS of the intent of WMBFA to acquire Fleet Mortgage Corporation and its subsidiaries expected to close on 06/01/01.
05/31/01	WM provided written response to the 11/27/00 Safety and Soundness Reports of Examination of WMBFA, WMBFSB, and WMB. Examinations were conducted concurrently by OTS, FDIC, and State of Washington, Department of Financial Institutions.
06/01/01	WM announced the company has completed its acquisition of Fleet Mortgage Corp., a unit of FleetBoston Financial Corp. (NYSE:FBF).
06/15/01	Capital Distribution ("August dividend") - $675 million. No objection letter issued on 07/12/01.
06/25/01	WM announced a definitive agreement to merge with Dime Bancorp, Inc. (NYSE: DME - news) in a transaction currently valued at $5.2 billion in stock and cash.
07/17/01	WM announced record quarterly earnings of $798.2 million for the second quarter of 2001, up sharply

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	from second-quarter 2000 earnings of $490.8 million.
07/31/01	ROE Regular Compliance for 10/30/00. Compliance Rating 3 as of 10/30/00, 2 as of 07/20/98 and 2 as of 04/29/96. CRA Rating Outstanding as of 10/30/00, 07/20/98 and as of 04/29/96.
08/17/01	Capital Distribution - Proposed cash dividend: $4.2 million on its outstanding series c and series d preferred stock to be paid in September 2001.
	Report of Compliance Examination for 10/30/00. Compliance Rating 3 as of 10/30/00, 2 – as of 07/20/98, 2 – as of 04/29/96. CRA rating - Outstanding as of 10/30/00, 07/20/98 and 04/29/96. Key recommendation – A plan for implementing a Broad-approved centralized corporate compliance oversight program.
08/27/01	WMBFA to pay quarterly cash dividend not to exceed $4.2 million on its outstanding Series C and D preferred stock, will be paid in September 2001.
09/05/01	Acquisition Of Dime Bancorp, Inc. by Washington Mutual, Inc. and The Merger Of The Dime Savings Bank Of New York, FSB, into Washington Mutual Bank, FA. Comment period extended to 10/31/01. At request of Acorn, NY, in light of the disruptions caused by the Sept. 11 terrorist attack. Comments received 10/01/01 from CRC and fwd. to WAMU for response by 10/31; response recd on 10/31/01; 11/08/01 - processing suspended pending resolution of the protest issues; a formal meeting is scheduled for 11/15/01, 01/04/02 - acquisition of Dime Bancorp, Inc. by Washington Mutual, Inc. 01/07/02 - Merger of the Dime Savings Bank Of New York, Fsb, Into Washington Mutual Bank, FA.
09/06/01	Washington Mutual Home Loans and Insurance Services Group announced today it will offer a new portfolio product, the 5/1 CMT Interest Only loan.
09/14/01	Capital Distributions - November dividend $2 billion.
10/16/01	WM announced record third-quarter earnings of $832.3 million or 94 cents per diluted share. Earnings for third-quarter 2000 were $452.5 million or 57 cents per diluted share.
10/19/01	OTS WM Home Loans and Insurance Services Group: Operations and Risk Management – Pre-qualification and application date proposal. Discussed with OTS current/future control environment, proposed pre-qualification program, application date definition, and next steps.
	OTS five week field visit commenced 09/17/01, objectives were 1) to meet with senior management of various operational groups regarding current structure and status of their departments, 2) to review the status of corrective actions in response to exceptions and recommendation made at the prior examination, and 3) to prepare and present to management the pre-examination package for the upcoming full scope examination in February 2002.
10/29/01	WM Response to October 30, 2000 Compliance ROE. Key issues – Corporate Compliance Program, Fair Lending Program, Flood Disaster Protection Act, Late Payment Fees, Home Mortgage Disclosure Act, Residual Income, Minimum Loan Amounts, OPTIS Prequalification Features, Customer Referrals, Comparative File Reviews, Right of Rescission, ARM Notices, and Customer Complaints.
11/06/01	WM Compliance Update. Objective – To provide an overview of the Home Loans Group's commitment to fair lending in under-served communities.
11/08/01	New Activity - To Establish "WMHLI Transfer Interim LP" As A Subsidiary.

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	OTS performed a field visit at WMBFA during 09/17/01. Accomplished objectives were as follows -
	• Met with senior management of the various operational groups for presentations regarding the current structure and status of their departments. These meetings were significant principally because of the integration of Bank United and PNC subsequent to the conclusion of our 2000 examination. • Reviewed the status of corrective actions in response to exceptions and recommendations made at the prior examination. • Prepared and presented to management the pre-examination package for the upcoming full scope examination in February 2002.
11/16/01	Capital Distribution - $4.2 Million Dividend On Series C and D Preferred Stock.
	Acq/Merger Bif Acq - Washington Mutual Bank, FA Sale Of Its Five Branch Offices located in Midland and Stanton, TX, to Community National Bank. Approved 01/17/02.
12/06/01	OTS Update – WM Home Loans & Insurance Services Group. Topics – Acquisition Overview, Loan Servicing (WM Platform Assessment, Loan Servicing & Consumer Direct Business Integration Plan), and Operations (Bank United & PNC Mortgage, Fleet, Optis, and North American Mortgage).
12/11/01	WM signed a definitive agreement to acquire for cash the operating assets of HomeSide Lending, Inc., the U.S. mortgage unit of the National Australia Bank Limited.
12/13/01	Capital Distribution - Proposed Cash Dividend: $1,200.
12/19/01	Interagency Report Of Examination of Vital Processing Services LLC issued. Federal Reserve Board, FDIC and OCC assisted.
12/21/01	WM to issue up to $1.5 billion in sub debt to be included in WAMU's capital; sole purchaser of the debentures was Washington Mutual Inc. 03/24/03 - Inst requests that the offering period be extended until 04/22/04 and it be permitted to issue sub debt to new American Capital, Inc., as well as to Washington Mutual, Inc. 04/09/03 - request granted. Approved 04/22/02.
	WM announced receipt from the Office of Thrift Supervision (OTS) of approval of the company's acquisition of Dime Bancorp Inc. (NYSE:DME) through the merger of Dime Bancorp with and into Washington Mutual. The merger is scheduled to close on Jan. 4, 2002.
01/07/02	Washington Mutual Completed Acquisition of Dime Bancorp.
01/08/02	WM to acquire a new operating subsidiary, Stockton plaza, inc., in connection with the acquisition of certain assets of HomeSide lending, Inc. OTS issued no objection letter dated 02/05/02.
01/15/02	Washington Mutual Caps Most Profitable Year with Record Quarterly Earnings; Board Increases Cash Dividend.
01/18/02	Quarterly cash dividend not to exceed $4.2 million on its outstanding Series C and D preferred stock.
01/23/02	WM Quarterly Regulatory Meeting. Topics – Strategic Overview, Loan Serving Update, Credit Update, 2002 Business Plan, Acquisition and Integration Update (Fleet Mortgage, Dime Bancorp, Midland Region Divestiture, and HomeSide Lending), and Compliance Update.
	WM's OTS Qtrly Progress Report – Home Mortgage Disclosure Act reengineering project and progress toward implementing a corporate wide compliance program and fair lending program. Corporate Compliance Department ability to complete all targeted tasks was impacted by repercussions of 9/11 tragedy, Dime acquisition, and personnel extensive turnover.
01/24/02	OTS approved establishment of the new operation subsidiary, WMHLI Transfer Interim LP under

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	WMBFA for the sole purpose of facilitating the consolidation of assets of WM Home Loans, Inc. with and into WMBFA.
01/30/02	OTS performed a field visit at WMBFA and WMBFSB during 09/17/01 through 12/14/01. Scope and objectives were focused on management's corrective actions related to the findings contained in the OTS IT ROE dated November 27, 2000 and obtained an update on IT activities to prepare for the 2002 IT examination. Overall management's corrective actions on the 2000 OTS IT examination findings were considered satisfactory. Key issue - The inaccurate transfer of data between service providers after the PNC conversion resulted in unwarranted delinquency notices for unpaid property taxes being issued to approximately 55,000 borrowers. Inadequate vendor oversight by Washington Mutual management and inaccurate data from service providers caused the tax reporting problems. Management has taken appropriate steps to resolve the issue.
02/05/02	Corporate Technology Briefing Book to OTS. Current year business plan, description of lending business philosophy, new businesses entered, significant initiatives and projects, current status of regulatory issues, current budget and operating performance, and listing of all policies and procedures.
02/06/02	Compliance Field Visit. OTS performed a field visit at WMBFSB during 11/05/01; WM has not established a compliance management program and a fair lending program appropriate to its size complexity, and activities.
03/01/02	Washington Mutual Completed Acquisition of HomeSide Lending
03/22/02	Special Compliance Examination. OTS performed compliance field visit for WMB from 02/25/02 through 03/22/02. Reviewed progress in the implementation process of the Corporate Compliance Program as required in the Compliance Report of Examination dated October 30, 2000. OTS was not able to draw a conclusion as to the quality of the programs being developed for Compliance and Fair Lending in response to the OTS request. OTS was able to conclude the implementation process will take a longer period than management anticipated and that there will continue to be compliance weaknesses inherent with a decentralized approach.
04/01/02	CRA Performance Evaluation for 10/30/00. WMB FSB, Lending Test – Outstanding, Investment Test – High Satisfactory, Service Test – Highly Satisfactory, and WMB FA Lending Test – Outstanding, Investment Test – High Satisfactory, Service Test – Outstanding.
04/09/02	Special Compliance Examination. OTS reviewed the progress in the implementation process of the Corporate Compliance Program as required in the Compliance Report of Examination dated October 30, 2000. Field visit performed from 02/25/02 through 03/22/02.
04/16/02	Washington Mutual Announced Record Quarterly Earnings; Board of Directors Increased Cash Dividend.
	WM Compliance and Fair Lending Programs Update provided to OTS. Copies of program statements, executive summary, actions take to -date and status reports with timelines.
04/18/02	WM Quarterly Regulatory Meeting. Topics – Strategic Overview, Market Risk Strategy, Technology Solutions Strategy, Loan Serving Update, Credit Update, Acquisition and Integration Update, and Credit Risk Update.
05/17/02	Capital Distribution not to exceed $4,200,000 on preferred stock Series C and D (June 2002 dividend).
5/24/02	OTS approved the establishment by WMBFA of an operating subsidiary (Washington Mutual Life

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	Insurance Company) that would be a California insurance company acting as a reinsurer for credit life and mortgage.
06/06/02	WM to issue capital distribution of $125 million in sub debt, that were originally issued by the dime savings Bank of New York, FSB.
06/14/02	Capital Distribution - payment of $1.4 billion cash dividend (August cash dividend) on the institution's outstanding common stock.
06/19/02	WM Director's Report May 2002. Topics – WMI key highlights, management comment, financial highlights and trend analysis. WMBFA and WMB subsidiary highlights.
07/16/02	Washington Mutual Announced Record Quarterly Earnings; Board of Directors Increased Cash Dividend.
08/07/02	Transmitted Report of Examination (ROE) Information Technology for 02/25/02. Federal Deposit Insurance Corporation (FDIC) and the State of Washington participated. Satisfactory Rating – Audit; Management; Acquisition and Development; and Support and Delivery.
08/08/02	Transmitted Report of Examination (ROE) for 02/25/02, WMBFA ratings 2/223223. WMBFSB ratings 2/232122. HC Rating S as of 02/25/02, S as of 11/27/00 and S as of 09/20/99. Federal Deposit Insurance Corporation (FDIC) and the Department of Financial Institutions, State of Washington (DFI) participated. WMBFA Key deficiencies and requested corrective actions included: 1) WM growth created significant challenges to management and resulted in substantial increases in a variety of risks; 2) significant number of customer errors and led to a very high level of clearing and suspense items; and 3) lack of implementation of a risk management function for the MSA commensurate with its enhanced size and complexity. WMBFSB Key deficiency was continued deterioration in asset quality; problem asset categories had worsened and asset quality was considered less than satisfactory.
08/12/02	To acquire WM mortgage Reinsurance Company and merge it with WMBFA's PMI reinsurance subsidiary, home loan reinsurance company (formerly Fleet Mortgage Reinsurance Company). Approved 09/30/02.
08/16/02	WAMU capital distribution in an amount not to exceed $4,200,000 September dividend.
08/27/02	OTS WM Risk Management & Operational Update. Topics covered – Compliance Overview; Servicing and Product Operations; Capital Markets/Risk Management; Credit Card Proposal; and WMBFSB 2Q Earnings/Portfolio Changes.
08/29/02	HomeSide acquisition -- 2 op. Subs: Sr investment and HS lending. 10/10/02 - filed an amendment -to establish HomeSide trust as an interim measure to facilitate transfer of assets/ liabilities of SR investment, Inc. And HomeSide Lending, Inc. to WMBFA; 10/23/02 - No Objection.
09/05/02	A Delaware single-member limited liability company "APB LLC Op Sub"; 10/3/02 - recd copy of FDIC's approval letter dated 10/2/02. Washington limited liability company - "APB Development LLC Op Sub"; 10/3/02 - recd copy of FDIC's approval letter dated 10/2/02. Approved 10/08/02.
09/11/02	Information Technology Field Visit Memo. Field visit performed at WMBFA from 07/15/02 through 08/23/02. Objective of review was to review the status of the North American Mortgage Company and HomeSide integration project. Overall, project management and control reports for the aforementioned was considered satisfactory.
09/12/02	Targeted Compliance Examination. Primary purpose of the examination was to review progress management has made in implementing a Corporate Compliance Program, as required in the

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	Compliance Report of Examination dated October 30, 2000, and reinforced in the OTS letter of February 6, 2002, to the Board
09/12/02	Special Compliance Examination. Primary purpose of the field visit was to establish the scope of the upcoming, targeted compliance examination.
09/13/02	Capital Distribution - quarterly cash dividend for the 4th qtr of $1.5 billion.
09/24/02	WM Director's Report August 2002. Topics – WMI key highlights, management comment, financial highlights and trend analysis. WMBFA and WMB subsidiary highlights.
10/01/02	Washington Mutual Completed Acquisition of Remaining Assets of HomeSide Lending, Inc.
10/08/02	OTS approved WMBFA established two wholly owned operating subsidiaries, Second and Union LLC .
10/15/02	Washington Mutual Announced Strong Third Quarter Earnings; Company Continues Steady Growth; Board of Directors Increases Cash Dividend.
10/17/02	WM Quarterly Regulatory Meeting. Topics – Strategic Overview, Banking and Financial Services Review, Loan Serving, Compliance Update, Market Risk, Credit Update, and 3Q02 Financial Performance.
11/15/02	Capital Distribution - cash dividend not to exceed $4.2 million on its outstanding, Series C and D preferred stock to be paid on December 2002.
12/20/02	Capital Distribution - 1st qtr dividend not to exceed $1.5 billion.
12/27/02	WM Compliance Improvement and Fair Lending Program Status Reports. WM call centers issues continued, delinquency performance acceptable, unit cost increased, reconciliations over 90 days within tolerance levels, and taxes paid prior to delinquency date were at 99.7%.
	WM Home Loans & Insurance Services Group OTS Executive Briefing. Key Issues – Longer hold time and abandonment rates in call centers, Acceptable delinquency versus all industry benchmarks, Unit cost increased as a result of several one time charges, Reconciliations over 90 days within WM's tolerance and risk levels, and Taxes paid prior to delinquency date were at 99.7%.
12/31/02	OTS West Region WAMU Risk Assessment - Overall Corporate Risk somewhere between moderate and moderately high; WMBFA risk – moderate; WMBFSB – moderate; HC – moderately high. Strategic risk – moderate; reputation risk – moderately high; credit risk – moderately low; market/IRR risk – moderately high; liquidity risk – moderately low; operational risk – moderately high; and compliance risk – moderately high.
01/14/03	Transmitted Report of Examination (ROE) for 11/12/02. OTS performed a targeted compliance examination of Washington Mutual Bank, FA and Washington Mutual Bank, FSB (Washington Mutual) from November 12, 2002, through December 19, 2002, in Seattle, WA. A primary objective of the field visit was to review progress management has made in implementing a Corporate Compliance Program, as required in the Compliance Report of Examination, dated October 30, 2000, and reinforced in the OTS letter of February 6, 2002, to the Board. OTS found the institution has made satisfactory progress in complying with the February 6, 2002, requests of OTS and has established a process for the continuing implementation of a Regulatory Compliance and Fair Lending Program (compliance program) to ensure compliance with all laws, rules, and regulations applicable to its business.
01/23/03	Washington Mutual's record quarterly EPS driven by record loan volume, strong account and deposit growth; Board of Directors increases cash dividend. Earnings for 2002 were a record $3.90 billion, or $4.05 per diluted share versus $3.11 billion, or $3.59 per diluted share in 2001.
01/23/03	Quarterly Regulators Meeting – topics covered: Strategic Overview, 4th Quarter Financial Update, 2003 Financial Plan, Credit Update, Corporate Governance, Compliance Scorecard, and Enterprise Risk

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	Management.
02/05/03	WAMU 01/13/03 extended field visit memo issued. All issues from the prior examination have been satisfactorily addressed.
03/17/03	Washington Mutual Bank, OTS approved capital distribution not to exceed $1,700,000,000 (2ND QTR 2003) on 04/08/03.
04/15/03	Washington Mutual, Inc. announced record earnings of $1 billion, or $1.07 per diluted share, for the quarter ended March 31, 2003, up 8 percent on a per share basis from $956 million, or 99 cents per diluted share for the same period a year ago.
04/17/03	Quarterly Regulators Meeting – Topics covered: Strategic Overview, 1st Quarter Financial Update, Credit Risk Reports, Technology Solutions Group Update, Customer Service/Loan Servicing Update, Compliance Progress Report, and Enterprise Risk Management Report.
05/29/03	WMBFA filed an application for issuance of subordinate debt securities of up $5.0 billion over a period of approximately twenty-four months. WMBFA's application included a request that OTS waive certain regulatory requirements.
06/02/03	WAMU to issue sub debt up to $5 billion approved on 07/15/03.
06/11/203	Notice filed by Washington Mutual Bank, FA advising that it intends to acquire Washington Mutual Asset Securitization Corp. from its sister bank, Washington Mutual Bank.
06/17/03	Capital distribution of $2,000,000,000 (3rd qtr dividend).
06/27/03	Formal investigation is initiated into the apparent sale of non-public customer information to unaffiliated third parties by at least four, perhaps more, employees of the thrift. The investigation will seek to determine if more employees, in other locations, were involved. Investigation continues as of 08/2004. The formal investigation established the nature and extent of violations and appropriate enforcement actions have been taken against the culpable institution-affiliated parties involved. The investigation was authorized to be closed 04/18/08 (Action Canceled/Terminated).
07/09/03	OTS granted a wavier on Washington Mutual Bank, FA Global Note Program of certain provisions of the OTS Securities Offering Regulation.
07/11/03	Washington Mutual responded to findings relating to WM Mortgage Reinsurance Co.'s non-compliance with the condition of approval issued by OTS on May 16, 2001 for WMBFA's acquisition of Fleet Mortgage Reinsurance Company, Inc. OTS required action: 1) WM Mortgage Reinsurance Company is to immediately cease engagement in the unapproved activity; 2) Quantify the extent of the noncompliant activity, including dollar amount, and an assessment of the risk to WMBFA; 3) provide management's plan to 'undo' the reinsurance of PMI that is not permissible and the status of those plans; and 4) provide management plans to ensure compliance with the approval conditions in the future.
07/15/03	Washington Mutual, Inc. announced record earnings of $1.02 billion, or $1.10 per diluted share, for the quarter ended June 30, 2003, up 9 percent on a per share basis from $990 million, or $1.01 per diluted share for the same period a year ago.
07/15/03	WAMU provided an update to OTS on the actions that management has accomplished and continues to champion in strengthening its Regulatory and Fair Lending Compliance Management Programs at WMBFA and WMBFSB.
07/16/03	OTS approved 05/29/03 WMBFA's application, including waivers noted.
07/17/03	OTS approved WMBFA requested a waiver of Item 15 of Form 1344 relating to Issuance of subordinated debt securities by Washington Mutual Bank, FA approved by OTS on 07/16/03.
08/18/03	Capital Distribution: Not to exceed $4.2 million on its outstanding Series C and D preferred stock.
08/22/03	Transmitted Report of Examination (ROE) for 03/17/03, ratings 2/222223. Federal Deposit Insurance

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	Corporation (FDIC) and the Department of Financial Institutions, State of Washington (DFI) participated. Key deficiencies and requested corrective actions included: (1) Continue to build infrastructure – data, systems, metrics, reporting, staff, organizational structure, and processes – to foster strong risk management structure and culture. Be selective in acquisitions given the potentially severe impact a major acquisition could have on already overtaxed units; (2) Focus extra attention on HLIS activities – especially single-family residential mortgage underwriting, correspondent and wholesale channel management, pipeline and warehouse management, recourse administration, and quality assurance; (3) Continue to dedicate resources to building and strengthening Enterprise Risk Management and Corporate Credit Risk Management – these functions should conduct intensive and frequent reviews of higher risk areas of concern and ensure enterprise-wide risk management standards are in place; and (4) Continue execution of ongoing compliance and risk management initiatives.
08/22/03	Transmitted Regular IT Examination for 03/17/03. Federal Deposit Insurance Corporation (FDIC) and the State of Washington participated. Satisfactory Rating – Audit; Management; Acquisition and Development; and Support and Delivery.
08/26/03	Washington Mutual, the nation's leading retailer of consumer financial services, opened a record-setting 49 retail banking de novo stores in August.
09/19/03	WAMU notified OTS on 3rd qtr anticipated earnings to be between $900 million and $1 billion. The institution has lots of people working on improvements in internal controls over mortgage pipeline and warehouse. Additionally, there is significant risk in the loan documentation at Long Beach Mortgage.
09/22/03	Capital Distribution: Not to exceed $1,500,000,000 4th qtr dividend.
09/25/03	WMBFA and New American Capital Inc., WMBFA holding company requested approval of the acquisition of Washington Mutual Bank FSB through a merger of an interim federal savings association subsidiary (WM 2003 Interim FSB) of WMBFA.
10/03/03	OTS discussed with WAMU in more depth the negative gain on sale of loans to be reported for Q3 2003, including the extent of the loss and the market and operational weaknesses contributing to the loss. Additionally, discussed in more depth WAMU's recent decision to cease securitization activity at Long Beach Mortgage Company (LBMC).
10/08/03	During the first nine months of 2003, the West Region received a total of 2,232 written complaints concerning WAMU. Majority of complaints were in the loan servicing area regarding misapplied loan payments; nonpayment of taxes or insurance from a customer's escrow account; payoff related problems; amounts of escrow collected and escrow accounting related concerns; and foreclosure notices being incorrectly received by customers.
10/08/03	Washington Mutual's (WM) Multi-Family Lending Continues Expansion Eastward. WM will open three new Multi-Family Lending offices by the end of 2003 in Boston, Miami and Washington DC.
10/21/03	Washington Mutual, Inc. announced earnings of $1.03 billion, or $1.12 per diluted share, for the quarter ended Sept. 30, 2003, up 10 percent on a per share basis from $981 million, or $1.02 per diluted share for the same period a year ago.
10/23/03	Quarterly Regulators Meeting – topics covered: Strategic Overview, Retail Consumer Strategy, Long Beach Mortgage Update, 3rd Quarter Financial Review, and Credit Update.
11/03/03	09/03 WAMU Regulatory Performance Objectives Status (WAMU Report)
	1) Improve SFR underwriting and oversight of correspondent & wholesale lending channels – Capability and resources exist; however progress has been slowed or delayed. 2) Improve pipeline and warehouse risk management practices - Capability and resources exist; however progress has been slowed or delayed. 3) Improve market risk management practices – Satisfactory progress toward resolution

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	in a reasonable timeframe. 4) Continue to improve the Compliance & Fair Lending Programs - Satisfactory progress toward resolution in a reasonable timeframe. 5) Improve Long Beach Mortgage Securitization Practices – High probability that current target date will not be met; significant concern may exist; or negative events may have occurred due to lack of reduction.
11/7/03	The OTS approved an H(e)1-S application, whereby WMBFA will acquire WMBfsb. Following the acquisition, WMBFA will contribute approximately $37 billion of investment securities to WMBfsb. The corporate reorganization is being done primarily for tax savings within the Washington Mutual organization. It was anticipated that this transaction would be consummated in the first quarter of 2004.
11/13/03	Washington Mutual, Inc. (NYSE:WM) filed today its Quarterly Report on Form 10-Q with the Securities and Exchange Commission, which included the correction of an error in its accounting for certain components of Bank Owned Life Insurance (BOLI). The adjustment in accounting treatment for BOLI is not expected to have a material effect on earnings in the fourth quarter of 2003 or future periods, according to the company.
11/14/03	Capital distribution: Quarterly cash dividend of $4.2 million on its outstanding Series C and D preferred stock to be paid in December 2003.
12/19/03	Capital distribution: 1st qtr dividend not to exceed $425,000,000 approved.
12/23/03	Notice of Acquisition of Subsidiary – Washington Mutual Bank, FA (the "Association"), Stockton, California, plans to acquire an additional operating subsidiary, Aristar Management, Inc. on or after January 8, 2004.
12/9/03	OTS met with WAMU personnel to discuss findings of the recently completed field visit that commenced on 10/14/03.
12/29/03	Letter from OTS to WAMU reminding them of their obligations to provide information to the examination staff.
1/22/04	Quarterly Regulator's Meeting: discussed (1) findings from the 4th quarter 2003 field visit; (2) reorganization of the "risk management" function; (3) an update on compliance with Sarbanes Oxley; (4) review of financial statements for the 4th quarter of 2003; and, (5) credit risk.
2/1/04	Washington Mutual Bank, fsb, and its subsidiary, WMF Utah Holding Corp., became subordinate organizations of WMBFA through a reorganization (from ROE as of 3/15/04).
2/2/04	Transmitted Report of Examination for the field visit that commenced on 10/14/03 examination. The field visit was conducted concurrently with the FDIC and the State of Washington Department of Financial Institutions. The field visit focused primarily on assessing the impact of certain significant events, planning for the 2004 examination, and following up on Long Beach Mortgage Company (LBMC) securitization process issues from the 2003 examination (at the time, LBMC was a holding company affiliate of WAMU). We focused secondarily on evaluating progress on corrective actions promised in response to the 2003 examination, and on assessing the condition of the OTS-regulated entities to determine if any examination ratings needed to be changed. The examiners concluded that the institutions were basically sound, but expressed concern regarding: (1) the recent organizational realignment; (2) deteriorating earnings; and, (3) capital levels (core and risk-based capital slipped slightly below the internal targets of 5.5 and 11.0 percent, respectively, for WAMU at 9/30/03); and (4) weaknesses with the institution's servicing platform.
3/3/04	Transmitted IT Report of Examination for 10/14/03 examination. The limited IT examination work was conducted concurrently with OTS safety and soundness examiners, and personnel from the FDIC and State of Washington Department of Financial Institutions. The purpose of the on-site field visit was to

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	meet with management to obtain an update on operations and technology, perform a limited review of management corrective actions to the 2003 IT Report of Examination findings, provide input to the risk assessment and supervisory strategy, and plan for the 2004 IT examination. Findings discussed in the examination report included: (1) the discontinuation of the Optis initiative (single-family servicing platform); and (2) certain outsourcing initiatives.
4/22/04	Quarterly Regulator's Meeting: discussed (1) the 1st quarter 2004 financial results; (2) update on compliance and credit; and, (3) an update on compliance with Sarbanes Oxley.
7/1/04	Examination exit meeting (examination begun 3/15/04)
7/22/04	Quarterly Regulator's Meeting: discussed (1) the Bank's proposed five-year plan --- 2005-to-2009; (2) 2nd quarter 2004 financial results; (3) update on the IT environment; (4) ERM update; and, (5) an update on the Fidelity Conversion.
9/13/04	Transmitted Report of Examination (ROE) for comprehensive 3/15/04 examination, rated 2/222223, of WAMU. Compliance was rated "2". IT was rated 2/22232. The examination was performed concurrently with examinations of Washington Mutual Bank, fsb and WMI, the insured institution's top-tier holding company. Additionally, the Federal Deposit Insurance Corporation (FDIC) and the Department of Financial Institutions, State of Washington, performed a concurrent safety and soundness examination of Washington Mutual Bank, a state-chartered, commercial bank subsidiary of WMI. Key findings and corrective actions listed among in the ROE included: (1) infrastructure weaknesses due to past rapid growth and the failure of the institution to fully integrate past acquisitions; (2) continued weaknesses in single-family loan underwriting; (3) the need to develop a high risk/subprime lending strategy for the Bank; (4) weaknesses with market risk management practices, including interest-rate risk modeling and mortgage pipeline and warehouse risk management practices; and, (5) concern regarding the consolidation of the Residential Quality Assurance unit with other functions within Enterprise Risk Management.
9/13/04	Memo closing the 3/15/04 IT Report of Examinations for Washington Mutual. The OTS IT examiners conducted concurrently the IT examinations of Washington Mutual Bank, FA and Washington Mutual Bank, fsb with the OTS safety and soundness / compliance examination report as of 3/15/04.
10/21/04	Quarterly Regulator's Meeting: discussed (1) 3rd quarter 2004 financial results; (2) TSG (Technology Solutions Group) update; and, (4) ERM update.
11/10/04	Transmitted CRA Report of Examination (ROE) as of 7/14/03. CRA was rated "Outstanding". All three tests (the Lending Test, the Investment Test, and the Service Test) were rated "Outstanding".
12/7/04	Closing meetings (12/7/04 and 12/9/04) with senior management pertaining to the field visit that commenced on October 18, 2004.
12/21/04	Mr. Stephen Rotella hired as President and Chief Operating Officer (from 3/13/06 ROE)
1/1/05	The State of Washington chartered Washington Mutual Bank was merged into Washington Mutual Bank, FA. As a result of the merger, the former state-chartered institution ceased to exist as a separate legal entity.
1/20/05	Quarterly Regulator's Meeting: discussed (1) the Bank's proposed strategy; (2) 2004 financial results and 2005 outlook; (3) update on ERM; and, (4) the Bank's retail banking strategy.
2/7/05	Transmitted Report of Examination for the field visit that commenced on 10/18/04 examination. The field visit was conducted concurrently with the FDIC. The State of Washington declined to participate given the impending merger of the state-chartered institution, Washington Mutual Bank, into WAMU. The field visit focused primarily on assessing management's progress in addressing issues noted in the

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	Matters Requiring Board Attention section of the March 15, 2004, Report of Examination. The examiners concluded that the institution had made satisfactory progress in addressing the concerns identified during the previous examination; however, the examiners identified concerns in the following areas: (1) the use of an automated valuation methodology (appraisal finding); (2) the increasing level of credit risk, without adequate oversight; (3) the lack of adequate profitability analysis (specifically Option ARMs); (4) weaknesses with Corporate Credit Risk Oversight;
2/8/05	Transmitted IT Report of Examination for 10/18/04 examination. No material concerns were identified.
2/28/05	Press release: WAMU announces new retail leadership; adds new senior manager to home loans team; Michael Amato and Ken Kido to head retail.
4/12/05	Letter from OTS to WAMU reiterating our understanding that the institution would maintain its core capital ratio above 5.5 percent.
4/21/05	WAMU advised OTS staff that the institution's past due loans would increase significantly as a result of amendments to the institution's TFR (GNMA buy-backs will be required to be reported as past due). Based on March 31, 2005 data, past due loans would increase from $1.2 billion to $2.7 billion as a result of this reclassification.
4/21/05	Quarterly Regulator's Meeting: discussed (1) the overall condition of the Bank; (2) the first quarter 2005 financial results; (3) update on the home loans group; (4) update on ERM; and, (5) an update on TSG (Technology Solutions Group).
6/1/05	Press release: WAMU drops annual fee on personal equity manager product, adds longer-term feature, making it one of the most flexible home equity and mortgage products currently available.
6/6/05	Press release: WAMU announces it will acquire Providian Financial; strategically compelling fit for both companies (three releases that day regarding proposed acquisition).
6/29/05	Examination closing meeting; Report of Examination transmitted 8/29/05
6/30/05	Press release: WAMU announces new president of its Home Loans Group (per 3/13/06 ROE, David Schneider was hired effective 8/8/05).
7/21/05	OTS examiners met with WAMU to discuss the need to resolve our concerns regarding SFR underwriting.
8/4/05	Press release: OTS deems WAMU's application to acquire Providian complete.
8/24/05	Press release: Bank regulator approves Washington Mutual's acquisition of Providian; transaction scheduled to close October 1.
8/29/05	Transmitted IT Report of Examination for 3/14/05 examination. The OTS IT examiners conducted concurrently the IT examinations of Washington Mutual Bank, FA and Washington Mutual Bank, fsb with the OTS melded safety and soundness / compliance examination report as of 3/14/05.
8/29/05	Transmitted Report of Examination (ROE) for comprehensive 3/14/05 examination, rated 2/222222. Compliance was rated "2". The examination was concurrent with examinations of Washington Mutual Bank, fsb, an operating subsidiary of the Bank, and WMI, the insured institution's top-tier holding company. The Federal Deposit Insurance Corporation (FDIC) participated as the back-up regulator. Key findings and corrective actions listed among in the ROE included: (1) the need for strong support of ERM by senior management and the Board of Directors; (2) continued weaknesses in loan underwriting; (3) concerns regarding Corporate Risk Oversight; (4) the need to enhance oversight over the Bank's "High-Risk Lending Strategy", particularly as it relates to the acquisition of Providian; (5) weaknesses with oversight of the Mortgage Banker Finance division; (6) appraisal weaknesses; (7) concern regarding compensation for loan underwriters; (8) concern that the Bank's home equity lending

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	was inconsistent with Interagency Guidance relating to this type of lending; (9) weaknesses with the Bank's fair lending program; and, (10) exceptions with the Loans-to-one-borrower report.
8/31/05	Press release: Washington Mutual's focus on seamless integration of Providian; Providian shareholders approve acquisition.
10/3/05	Press release: WAMU completes acquisition of Providian Financial (effective 10/1/05).
10/20/05	Quarterly Regulator's Meeting: discussed (1) the overall condition of the Bank; (2) the third quarter 2005 financial results; (3) an update by the COO, Steve Rotella (planning regarding the acquisition of Card Services and the introduction of David Schneider); (4) update on home loans; (5) update on the Commercial Group; and, (6) an update on ERM.
10/21/05	Press release: WAMU names John F. Woods Controller.
10/27/05	Press release: WAMU hires new Chief Enterprise Risk Officer (per 3/13/06 ROE, Ronald Cathcart was hired effective 12/1/05, to replace EVP James Vanasek, who retired at the end of 2005).
12/8/05	Transmitted IT Report of Examination for 10/3/05 examination. No material concerns were identified.
12/14/05	OTS met with CEO Kerry Killinger and COO Steve Rotella to discuss the findings of the 10/3/05 field visit.
12/21/05	Press release: WAMU realigns prime and subprime residential lending under one management team; move part of ongoing efforts to serve customers better; improve operating efficiencies.
1/1/06	The Bank transferred the Mortgage Banker Finance Group and holding company affiliate LBMC from the Commercial Group to the Home Loans Group. The reorganization effectively placed all of the Bank's SFR lending operations under one group (see ROE dated 3/13/06, transmitted on 8/30/06).
1/10/06	WAMU advised the OTS that its fourth quarter earnings would be at the low end of (or below some) market analysts' expectations due to higher loss provisions at Long Beach Mortgage and mortgage servicing asset valuation adjustments....Long Beach experienced a sharp rise in early payment defaults during the fourth quarter resulting in an estimated repurchase of $600 million in whole loans that were sold into the secondary market. WAMU switched to whole loan sales, instead of securitizations, in the second half of 2005 for Long Beach and sold an estimated $13.2 billion into the secondary market. By comparison, Long Beach loan repurchases were $100 million in 2003, $30 million in 2004, and $40 million for the first 9 months of 2005 primarily on securitizations that do not have the same early payment default provision found in the whole loan sales.
1/19/06	Quarterly Regulator's Meeting: discussed (1) the overall condition of the Bank; (2) update on Card Services; (3) update on ERM; (4) financial review (4th quarter 2005); and, (5) the Bank's retail banking strategy.
2/1/06	Letter from Darrel Dochow (OTS) to WAMU confirming our agreement that WAMU "super risk weight" certain higher-risk assets.
2/2/06	Transmitted findings of 10/3/05 field visit. The FDIC did not participate. Areas reviewed during the examination included: (1) SFR underwriting; (2) appraisal weaknesses; (3) Corporate Risk Oversight; (4) Fair Lending; (5) Basel II progress, with specific emphasis of the economic capital allocation model; (6) Enterprise Risk Management; and, (7) the integration of Providian into WAMU. Overall, the examiners concluded had made progress in each of the areas reviewed, though further progress was deemed warranted.
2/15/06	Letter from John Robinson (WAMU) confirming our agreement that WAMU "super risk weight" certain higher-risk assets.

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2/15/06	Press release: WAMU consolidates home loan support offices.
2/28/06	8K filed: merger of LBMC into WAMU (from WMI) as of 3/1/06.
3/29/06	Press release: Frank Vella joins WAMU as new division head for small business banking.
4/10/06	8K filed: WAMU named James B. Corcoran Retail Banking President on April 4, 2006, effective may 15, 2006.
4/20/06	Quarterly Regulator's Meeting: discussed (1) the overall condition of the Bank; (2) the first quarter 2006 financial results; (3) economic capital update; and, (4) an update on ERM.
4/23/06	Press release: WAMU to acquire Commercial Capital Bancorp. Inc.; deal to strengthen WAMU's commercial and retail banking businesses.
5/16/06	Press release: WAMU enhances its home equity line of credit product to provide greater payment flexibility; allows consumers to make interest-only payments on a fixed-rate loan option.
6/21/06	Memo from Kerry Killinger regarding a change in the Bank's strategic direction. Points made by Kerry Killinger included: • Our Home Loans Group should complete its repositioning within the next twelve months and will be in position to profitably grow its market share of Option ARM, home equity, sub-prime and Alt-A loans. We should be able to increase our share in each of these categories to over 10%, although Alt-A will take longer because of our low starting market share. • We are refining our Home Loans business model to significantly curtail low-margin Government and conventional fixed rate originations and servicing, and significantly increasing our origination and servicing of high-margin home equity, Alt A, sub-prime and option ARMs. Action steps include merging Long Beach sub-prime and the prime business under common management, merging correspondent activities into our conduit channel, exiting Government lending, curtailing conventional fixed-rate production, expanding distribution of targeted high-margin products through all distribution channels and potentially selling MSRs related to low-margin/high-hedge cost products. • To accomplish our desire to reduce interest-rate risk and to increase credit risk, we are embarking on a gradual remixing of our balance sheet. This remixing will also have the benefit of better utilizing our economic capital. In 1995 *(2005?)*, prime single-family loans represented 36% of our balance sheet. Within three years, we expect this to decline to 26%. Making up the balance will be home equity at 19% versus 15%, sub-prime home loans at 10% versus 6%, credit card receivables at 3% versus 2%, and multi-family at 11% versus 8%.
7/19/06	Press release: WAMU to sell $140 billion in mortgage servicing and Milwaukee servicing operations to Wells Fargo.
7/25/06	Press release: WAMU to sell mutual fund subsidiary to the Principal Financial Group.
8/19/06	Press release: WAMU chairman and chief executive Kerry Killinger says the federal guidance on nontraditional mortgages will have a "limited" effect on its payment-option ARM lending program.
8/23/06	Press release : OTS approves WAMU acquisition of Commercial Capital Corp, Inc.
8/30/06	Transmitted Report of Examination (ROE) for comprehensive 3/13/06 examination, rated 2/222222. Compliance was rated "2". The examination was concurrent with examinations of Washington Mutual Bank, fsb, an operating subsidiary of the Bank, and WMI, the insured institution's top-tier holding company. The Federal Deposit Insurance Corporation (FDIC) participated. Key findings and corrective actions listed among in the ROE included: (1) concern that the number of management changes could pose short-term transition risk; (2) weaknesses with fraud management; (3) weaknesses in subprime

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	underwriting at LBMC (prime underwriting was rated marginally satisfactory); (4) violations of RESPA Section 8 and Reg X, regarding reimbursement of unearned fees; (5) the need to ensure ERM's effectiveness and the adequacy of resources for this department; (6) the need to enhance monitoring of the Bank's high-risk-lending strategy; (7) the need to enhance the credit scoring model development and monitoring processes; (8) errors on the LTOB report; (9) the need to enhance monitoring reports for one-to-four lending, including the mortgage banker finance group; (10) appraisal weaknesses; and, (11) servicing weaknesses.
8/30/06	Transmitted IT Report of Examination for 3/13/06 examination (rating of 2 / 2222). No material concerns were identified.
9/29/06	Press release: Statement from David Schneider, President, Home Loans, regarding interagency guidance on nontraditional mortgages.
10/2/06	Press release: WAMU completes acquisition of Commercial Capital Bancorp.
10/6/06	OTS met with WAMU to discuss REIT preferred stock.
10/12/06	OTS met with WAMU to discuss NTMP guidance.
10/19/06	Quarterly Regulator's Meeting: discussed (1) the overall condition of the Bank; (2) the third quarter 2006 financial results; (3) economic capital update; (4) update on ERM; (5) discussion of retail banking strategy; and, (6) an update on home loans group.
10/19/06	WAMU announcement: "the federal guidance on nontraditional mortgages will have a "limited" effect on its payment-option ARM lending program……based on preliminary analysis and initial discussions with our regulator, the Office of Thrift Supervision, while we expect some changes, the impact on the origination of the option ARM products in our Home Loans group appears limited."
	OTS examination commenced
1/8/07	Approved Dividend Quarter (Q) 1 $3 billion (B)
1/11/07	IT Limited Thrift Examination transmitted: Scope focused on management corrective action to the March 13, 2006, IT Report of Examination. Corrective action found satisfactory, and the timeline for compliance with CEO Memo 228-Interagency Guidance on Authentication in an Internet Banking Environment was on track.
1/23/07	OTS/Treasurers interim meeting
1/23/07	Approved Operating Subsidiary - Thackerey
1/30/07	Discuss Nontraditional Mortgage Guidance Action Plan
2/1/07	Quarterly Treasurers Meeting
2/1/07	Quarterly Regulators Meeting • Q4 06 net income $1.058B, improved NIM offset partially by weak performance by home loans due to subprime loan performance. • Repurchased $3B of common shares in 2006. Projected to repurchase $4.2B in 2007. • 2007 forecast net income of $3.8B • Enterprise Risk Management (ERM) – Consistent with our strategic plan we are increasing credit risk in our 2007 business plan to be monitored and actively managed through the ERM committee. Consumer loans to high risk borrowers 15.2% at 11/06 to increase to 22.9% in 2007 plan; Consumer loans with high LTV 6% at 11/06 to increase to 7.3% in the 2007 plan; • single state concentrations increased from 46.2% to 48/2% and • single MXA from 20.55 to 21.4%.

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	FDIC Supervisory Strategy – FDIC focus on Basel II, Market Risk Amendment and VAR methodology, SFR Lending and Non-traditional Mortgage Guidance, and general interest rate risk.
2/1/07	Approved March Preferred Dividend $4.2 Million (M)
2/21/07	Project Thackeray Update (see Treasurer's meeting)
2/22/07	OTS update meeting; Robinson, Dochow, Carter
3/5/07	Current Litigation Meeting
3/8/07	Exam Exit Meeting
3/15/07	OTS Basel II Schedule meeting
3/21/07	OTS Q1 2007 Exam Exit Meeting
4/17/07	St Stated Income-Reporting, Analytics and Risk Management
4/19/07	Quarterly Regulators Meeting • Q1 2007 Net income $784 million (M) • Improved margin and higher credit card income offset by subprime losses. • $273 M below projected NI for the Quarter • NIM improved 21bps driven by asset repricing and lower interest cost of deposits. • Subprime gain on sale and residual write-down deteriorated due to wider credit spreads and increased delinquencies. • Higher provision expense due to increased charge-offs on sub-prime and HE loans. • Loans HFS declined due to $17.8B hybrid sale, SFR balance decrease in line with decision to hold fewer loans in portfolio in the current flat rate environment. Credit Card on balance shee receivables decreased due to an increase in Q1 07 securitization of $1.2 B. • Increased Cash Dividend to $0.55. • Subprime-Integrating products originated through the sub-prime channel into prime channels. • Dedicated sales force solely focused on retail bank mortgage volume. • Subprime market is experiencing massive market dislocation. • Subprime production; stated income reduced from 52% Jan 06 to 25% March 07. • Nontraditional Mortgage Guidance o Moving towards underwriting at fully indexed, fully amortized rate, including full negative amortization. o Enhancing risk management and disclosures. • Proposed Subprime Statement o Moving away from 2/28 to longer fixed term period o Implementing retention and loan modification programs • ERM top 5 Risk Issues o Housing Market Deterioration o Volatility of Credit Card Markets o Business model stress-shift from portfolio lender to gain on sale o Data Governance and integrity o Increased intensity of regulatory and legislative oversight
4/20/07	OTS/Internal Audit Investigation
4/23/07	OTS/Capital Restructuring Meeting
4/24/07	Monthly OTS Update Meeting, Dochow/Franklin

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4/24/07	Quarterly Basel II Conference Call
4/26/07	BSA/AML Weekly Status Meeting
4/26/07	Exam Update meeting-Deloitte and OTS
5/1/07	Basel II Kickoff Meeting
5/1/07	Approved Q2 Common Dividend $3 B, Preferred Dividend $4.2 M
5/9/07	BSA/AML Weekly Status Meeting

5/14/07	OTS Quarterly Treasurer's meeting (filed paper document)
	• Balance sheet reductions and Project Thackeray reduced Q1 funding needs
	  o Thackeray – complex transaction with Barclay's Bank $6.25B 3 year funding complete 3/27/07
	• Wholesale funding declined from $143B on 12/06 to $116B on 3/07
	• $1B Senior Note issued
	• March covered bond issue postponed
	• WaMu master note trust $1.1B AAA , $150M A, with $700 M Credit Card conduit increase
	• Forecast Q2 funding needs remain limited
	  o No WMI funding needs in 07, next Senior bank debt maturity forecast Q3 07
	  o FHLB advance pay-downs continue
	  o WM master note trust 3yr $875N AAA, $125M BBB Credit Card Securitization to sett Mid May
	  o Brokered Retail deposits likely to remain stable
	• 2007 Funding Outlook
	  o Subordinate debt removed from forecast
	  o $2 to $4B senior debt needs in 2007
	  o FHLB advances expected to decline $15 to $20B by year end
	• Q1 Capital Outlook
	  o Repurchased $2.8B common stock
	  o Exercised call option to retire $400M trust preferred
	  o WMB upstreamed $3B excess Capital by dividenting to WMI
	• Q2 Forecast Capital Activity
	  o Continue to retire inefficient trust preferred
	  o $500M WM Preferred Funding LLC issue in May
	  o Excess Capital available at WMB
	• 07 Capital Strategy
	  o Continue optimizing Tier 1 Capital base
	  o Limited growth makes any new capital issue "nice" but not required

5/14/07	OTS/Rotella Update meeting
5/15/07	Discuss Status of NTM Guidance and Proposed Subprime Lending Guidance
5/15/07	Long Beach Mortgage FPD/EPD Review with OTS
5/16/07	BSA/AML Weekly Status Meeting
5/17/07	OTS Exam Status update ALLL
5/24/07	Compliance Limited Examination Transmitted – Overall we found WaMu had established an effective fair lending risk monitoring and management program for residential lending. Four of 14 comparative review found that corrective action at a transaction level would be appropriate. Management's prompt response in taking corrective action for the affected borrowers is a positive step in limiting the

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	institution's fair lending risk.
5/25/07	Monthly OTS Update Meeting-Dochow/Franklin
6/14/07	BSA/AML update
6/20/07	Follow up Committed Capital Term Sheet
6/20/07	OTS Exit Meeting – C-2, A-2, M-2, E-2, L-1, S-2, Compliance-2, IT-2, WMI-Satisfactory
6/20/07	Monthly OTS Update Meeting-Dochow/Franklin
7/23/07	Approved Operating Subsidiary Pike Holdings
8/1/07	Approved Common Dividend $1B in connection with elimination of North American Capital Inc. (NACI) as a holding company.
8/15/07	Approved 5 new Operating Subsidiaries including 4 foreign entities

8/16/07	Quarterly Treasurer's Meeting
	• Capital Forecast-see below
	• Debt Schedule and Forecast-see below
	• Funding Review
	  o Funding Diversification
	    ▪ FHLB advances declined from $25B to $21B
	    ▪ Brokered CDs declined from $32B to $25B
	    ▪ Covered Bond issue in May 2007 of $2B
	    ▪ WaMu Master Note Trust 3yr, $875M AAA and $125M BBB.
	  o Major Market disruption
	    • Little or no liquidity across most asset classes
	    • Liquidity remains limited and volatile
	    • WaMu has adequate Liquidity
	      o Substantial FHLB capacity-$43B
	      o Repo and Broker CD capacity
	      o Minimal debt maturities, $1.5B in Nov
	      o Credit Card Asset Backed Securitizations expected to issue in Q3
	      o Enhanced monitoring, 12 month liquidity forecast and weekly liquidity reports
	• NACI Elimination Update
	• Pike Street Holdings Update
	• Q3 Capital Strategies
	  o Remove plans for Share Repurchases in Q4 08
	  o Retain Capital in WMB except for that needed by WMI for common dividends

8/27/07	1/8/07 examination concluded
8/27/07	Approved Operating Subsidiary MergeCo
9/10/07	Discuss McKell vs WaMu
9/17/07	1/ 1/8/07 Report of Examination transmitted, with a composite rating of "2", camels ratings of 2,2,2,2,1,3 and compliance 3. The summary highlighted management's long term strategic plan of reducing market risk while reducing reliance on lower yielding SFR first mortgages by replacing those with higher yielding, though higher risk assets such as multifamily, credit card, and home equity loans. The strategy is being pursued more cautiously, particularly with regard to subprime lending, where there has been deterioration. The report highlighted the following Matters Requiring Board Attention (MRBA): • Continued weaknesses in subprime SFR lending which is a repeat MRBA. Board to ensure

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	underwriting deficiencies are reduced to tolerance levels agreed upon in management's to Asset Quality Findings Memo 3. • A Cease and Desist Order (C&D) was issued covering the required Bank Secrecy Act (BSA)/Anti Money Laundering (AML) Corrective Actions and the Board is to ensure the requirements of the C&D are fully complied with. • Civil Money Penalties were imposed for violations of the National Flood Insurance Protection Act. Board to ensure that the management and system deficiencies that resulted in the violations are corrected and the necessary flood insurance is obtained. • Board to ensure that management implements a comprehensive compliance framework, and that the compliance management function receives appropriate support, leadership, and resources. • Continue to monitor and receive reports on the status of Enterprise Risk Management to ensure its effectiveness and that appropriate resources and support are provided to the function. ERM should provide an important check and balance on profit-oriented units and, therefore, warrants strong Board commitment and support.
9/18/07	Discuss Transland MBF
9/18/07	OTS Basel II September Kickoff meeting
9/19/07	Overview of Consumer Complaints
9/20/07	Up to marketing update
9/21/07	Monthly OTS update meeting-Dochow/Franklin
9/21/07	Discussion on new Subprime Report for OTS
9/26/07	Fair Lending Review
10/02/07	1-8-07 IT Examination Completed-Findings transmitted in the type 16 ROE of 9/18/07.
10/16/07	Score Assisted Underwriting Overview meeting
10/13/07	WaMu announces closure of its Mortgage Banker Finance, Conduit, and Correspondence Loan divisions. Residential loan origination will now be concentrated in branch system.
10/14/07	Initiated a formal examination of the appraisal process to assess the validity of a complaint filed by the New York Attorney General's (NYAG) Office. No examination report was issued on this matter.
10/17/07	Assessed $60,445.00 Civil Money Penalties (CMPs) related to violation of flood insurance regulations
10/17/07	OTS/HFI Transfer Valuation Meeting
10/17/07	Ca Card Services Fraud Overview
10/18/07	Quarterly Regulators Meeting • Q3 07 Net Income $210 M $620 M below plan • Reflects accelerated credit pressures and freeze of secondary market • Provision expense increased • $147 M valuation loss on $17 B loans transferred to HFI • $104 M permanent impairment on AFS securities • Widening spreads and credit deterioration also drove write-downs on commercial loan residuals and trading securities • MSR performance improved • Cash increased by $7B to bolster liquidity position, primarily from FHLB • Declared Cash Dividend of $0.56/Share • Residential Portfolio consists of

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		o $19.8B subprime portfolio in run off mode o $58.4B Home Equity high credit quality, largely second lien, o $106.8 SFR Prime High quality primarily option arms and hybrids • Significant changes to guidelines in all segments o Tightened underwriting standards on Prime SFR, Home Equity, Subprime, and for all products. o Prime SFR 90% max Cumulative Loan to Value (CLTV), reduce non-full doc eligibility to loans with CLTV 80%, Fico under 680 require 65% CLTV or lower, No exceptions for borrowers with FICO below 620. o Home Equity max CLTV 85% in CA, FL, AZ, and NV, CLTV>65% requires Fico>680, o Subprime Eliminate Stated Income and Limited Doc Loans, Eliminate 2/28 and 3/27 loans, Max CLTV 90%, Eliminate Piggyback seconds o All Products Enhance declining market policy to include a CLTV reduction by 5% if high risk market • Credit Risk profile of new originations stronger under new guidelines. Sept 07 originations combined with CLTV>80% = 23% vs 28% in Jan and the portfolio avg, Fico <660 =9% vs 14% in January and 22% for portfolio avg, >80%<660 = 3% in Sept vs 6% in Jan. and 7% portfolio. • Customer outreach: Expand relationships with local agencies, dedicate 1-800 number and email box where customers can make direct contact, dedicated leadership team with $100K budget. Establish early loss mitigation department for subprime, create NPA early loss mitigation department for subprime, • BSA/AML Enforcement Action: On 9/25/07 OTS delivered C&D draft with the final order delivered 10/15/07, with 3/31/08 deadline for full compliance. • ERM o Critical Environment Elements: Home Price Appreciation (HPA) indices show dramatic drop in home price year over year change in Jan 07. Subprime Credit Default Swap index shows significant investor sentiment that subprime mortgage holders will suffer increased financial losses from these investments with decline in the index beginning mid June 2007. o Held For Sale (HFS) to Held for Investment Loans (HFI): The balance of HFS assets was reduced from $41.7B (4Q06) to $8.5B (3Q 07) through sales, redirection of originations, and transfers from HFS to HFI. Transfers included $14.4B SFR, $1.4B Subprime, and $1.3B Commercial. o Subsequent to 12/31/05, WaMu reduced its reliance on Federal Home Loan Bank (FHLB) advances in favor of finding through Covered Bonds and retail deposits. FHLB advances declined from 22% of funding sources at 12/31/05, to 7% at 6/30/07 but went back up to 17% at 9/30/07 as Commercial and Escrow Deposits declined. o ERM top 5 Risk Issues have changed since last Quarter o Q3 ERM Top 5 Risks ▪ Housing Market Deterioration

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	▪ Volatility of Credit Card Markets ▪ Business model stress-shift from portfolio lender to gain on sale ▪ Data Governance and integrity ▪ Increased intensity of regulatory and legislative oversight o Q4 ERM Top 5 risks ▪ Accelerated Deterioration of US Markets remains #1 ▪ #2 is now "Withdrawal of liquidity from the secondary markets ▪ #3 is now Compliance Process Deficiencies ▪ #4 is now External Fraud ▪ #5 is now Data Integrity • Overview of WMI consolidated Portfolio o Total NonPerforming Loans (NPL) portfolio has risen from less than 1% at 1/06 to 2.2% at 9/07. Portfolio charge-offs have risen from 0.15% o 0.78% in the same period. o ALLL was \$1.6B at 6/30/07, \$1.9B at 9/30/07
10/25/07	Quarterly Treasurers Meeting Liquidity Update; debt issuance, collateral expansion • Self-imposed liquidity requirements have been established for 1 day, 7 day, 3 month, 6 month, and 12 month periods. Excess liquidity forecast as of 9/30/07 indicated that excess liquidity for 3 month period of \$14 billion was short of target of \$25 billion. The shortfall is expected to be cured by on-going reallocation of collateral to increase FHLB borrowing capacity to \$35 to \$40 billion by yearend. • WMB's stress case scenario projects that its "Total Excess Liquidity" will range between \$32 billion and \$38 billion from Q4-2007 through Q4-2008. Over this time period, total assets are projected to grow from \$322.8 billion at 9/30/2007 to \$357.7 billion at 12/31/2008. Most of the growth is projected to be funded with an increase in FHLB advances. Total FHLB advances are projected to increase from \$53.2 billion at 9/30/07 to \$84.4 billion at 12/31/08. WaMu Preferred Funding and planned future capital activity • WMI successfully priced and issued \$1 billion in a Preferred Funding LLC transaction in October 2007. • Planning \$500 million WMI sub debt in October. The sub debt was priced last week with a 7.25% coupon and will settle next Tuesday. • Planning \$500 million Cayman Preferred Funding in Nov/Dec • Planning \$500 million DRD Preferred in Nov/Dec • NACI will be merged out of existence on November 1, 2007. NACI transaction eliminates \$950 million of subdebt at WMB. WMB's capital will be augmented in Q4-2007 with: (1) up to \$1.465 billion in Tier-1 Capital (consisting of net proceeds from: (a) \$1 billion of WMB preferred stock issued, and (b) potential issuance of \$500 million preferred stock, and (2) \$500 million in Tier 2 capital (subordinated debt). Bagley Phase II • WaMu expects to hand deliver an application to OTS on Monday, 10/29/07 for Project Bagley Phase II. • Will move \$15 billion commercial loans held in a trust from WMB to WMBfsb through a

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	complex transaction. This will increase WMBfsb's QTL from 66% to approximately 88% to 92%. WMBFSB projects a common stock cash dividend of $2.6 billion in Q4-2007 to be paid to WMB in connection with the Bagley II transaction. AFS Investment Securities Portfolio • As of 10/11/2007, the market value of the securities portfolio was $25,197,000, which was $669 million less than the book value. The book yield of the portfolio of 5.64% is 33 basis points below the current market yield of 5.97%. • WMI has been changing the mix of the portfolio toward more positive convexity and long-term call instruments. • By rating, 88% of the investments are rated AAA, 6% are rated AA, 4% are rated A, and 3% are rated BBB. • Nearly 40% of the entire securities portfolio is Agency backed. • The subprime portion of the investment portfolio totals $722 million, or 2.9% of the entire investment portfolio.
10/31/07	Approved Dividend of $1 B
11/07/07	O OTS Flood Update Meeting
11/14/07	M Meeting to Discuss Appraisal Review with OTS
11/15/07	Update on BSA Roadmap
11/16/07	OTS Meeting, HL Business Update and Underwriting Changes
11/20/07	HFS to HFI Transfer Review with OTS and Deloitte
11/20/07	Repurchase Reserves Update
11/26/07	Repurchased Home Loan Valuation, $45.6 million Locom on $5.6 billion portfolio
11/27/07	Monthly Update meeting Dochow/Franklin
11/27/07	Dochow/Franklin Meeting with Rotella
11/27/07	VAR Model Update Miyashiro/Chararat
11/30/07	OTS Basel II Exit Meeting for September 12, 2007 Field Visit • Our reviews to this point have been limited to monitoring the development of the different approaches to measure risk and quantify the required capital to support this risk within the Basel II framework. • From what we've seen, by and large the models developed appear to follow industry-accepted approaches for quantifying operating and market risk and the various parameters required under the AIRB approach. • During our review, we have also shared with you some of our preliminary impressions and suggestions for improving the market risk model. • 2008 Qualification Exam to commence April 7, 2008 - Early review of HELOC/HEL and credit card models to start 2/11/08
12/4/07	Discuss Capital Projections
12/6/07	Meeting discuss adding Home Loan Servicing Transaction Data to Monitoring Environment-Johnson/Franklin/Hendriksen/Fiene/Dick Stephenson
12/14/07	OTS Monthly Update Meeting-Franklin/Dochow
12/31/07	Approved Ops Sub Unified 1st Tier Sub

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1/07/08	Target examination of Home Loans, Commercial lending, and certain aspects of operations commences.
1/17/08	OTS Senior managers, exam team and FDIC representatives attend quarterly regulators meeting with WMB Executive management.
1/24/08	WMB provided OTS a copy of the Simpson Thatcher work plan for the internal review of the NYAG appraisal allegations
	OTS met with Simpson Thatcher, the law firm conducting the internal investigation for Washington Mutual related to appraisal outsourcing by the Bank. Simpson Thatcher acknowledge that both outsource providers raised appraisal independence concerns and that their investigation identified substantive criticisms with the process including the significant input that the production force had on the composition of the WaMu preferred appraisal panel, and subsequent panels, and the inadequate supervision, monitoring and control of the process by appraisal management. Overall however, Simpson Thatcher concluded that there was no merit to the allegations contained in the NYAG complaint and that they found no systematic effort to subvert the independence of the appraisal process, no motive or intent to do so, and finally no opportunity. OTS investigation was still in process.
2/1/08	FDIC informed OTS that they would like to have an FDIC Ombudsman discuss with WMB management what happened to certain deposits of a former customer of failed bank, Columbia Savings and Loan Association. Columbia merged with Washington Mutual Bank, via American Savings Bank, back in 1991. No one at WaMu has been able to assist the customer; therefore, the Ombudsman got involved.
	WR Director instructs exam team to Assess CAMEL ratings and to make any changes necessary by 3/31/08.
2/6/08	Attended Quarterly Treasurer's meeting. Exam and Appraisal review team met with management to discuss broker/borrower provided appraisals
2/19/08	Exam team and WR Director meet to discuss suggested changes to CAMEL Ratings
2/25/08	New York Attorney General, Fannie and Freddie, and OFHEO announced new appraisal guidelines that primarily resulted from the allegation of appraisal misconduct at WMB.
2/26/08	Management agreed to discontinue stated income lending for HELOCs given the obvious deterioration in portfolio quality and because the exam team had indicated that our conclusion would be that the program be discontinued.
	Stephen I. Chazen was elected to the Board of Directors of Washington Mutual Bank (the "Bank") by the unanimous vote of the other members of the Board. The Board also appointed Mr. Chazen to the Audit, Compliance and Finance Committees of the Board.
2/27/08	WR Director issues letter downgrading WMB Composite rating to "3" and requires a Board resolution to address deteriorating conditions. Exam team met with treasury personnel to request that more conservative stress scenarios be added to existing internally derived stress scenarios.
2/28/08	CEO Killinger met with OTS Director to discuss the condition of the Bank, examination concerns, and the prospects of raising capital.
	DOJ contacts WMB in regards to the complaint against WaMu on Soldier/Sailor Relief Act. DOJ subsequently coordinates with OTS on exam procedures on this issue.
	Examiners provided a second request for documents and information related to OTS special investigation into NYAG appraisal allegations.
3/5/08	Examiners met with Home Loans management to provide their view of stated income lending in general. With WR Director's approval, examiners inform management that unless they could provide analytics that supported why remaining stated income products being offered should continue being made, our exam conclusion would indicate that this product should be discontinued.

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3/6/08	WR Director and exam team briefed the DC office (and subsequently FDIC WR management) that ALLL provisions would increase significantly due to a continuing downward trend in home prices and growing delinquencies and charge offs. This also means a loss for 2008 and projected for 2009. Management engaged Lehman and Goldman to explore capital and investor options. OTS DC staff alerted FDIC DC staff which led to coordinating a deposit download request for contingency planning purposes.
3/7/08	Victor Villarreal of the FDIC DRR group arrived at the Bank to make the deposit download request for contingency planning purpose.
3/10/08	In response to communications with DC FRB counterparts, OTS DD Ward instructed WR management and WMB exam team to encourage WMB management to provide the FRB SF with any information that they might need to ensure discount window access.
	After various discussions with the WMB exam team, management issues a new policy eliminating low doc (stated income) lending in all but the GSE saleable "doc relief" loan program.
3/12/08	OTS Director and senior staff met with WMB CEO and senior staff to discuss the Bank's liquidity position, particularly uninsured and other "at risk" deposits.
3/13/08	WMB exam team updated WR and DC management on liquidity and provided the initial series of detailed liquidity monitoring reports and related data. GAO staff requested 2006 and 2007 balance sheet and income statement data for WMB, Citi and AIG in conjunction with their audit activity regarding issues relating to the development of Basel II.
	Moody's Investors Service downgraded the senior unsecured rating of Washington Mutual, Inc. to Baa3 from Baa2. Washington Mutual Bank's long term deposit rating was downgraded to Baa2 from Baa1. Washington Mutual Bank's bank financial strength rating at C- and short term rating at Prime-2 were affirmed. Moody's placed a negative outlook on all Washington Mutual (WaMu) entities.
	Fitch places WM covered bonds program on rating watch negative on downgrade of WMB to 'BBB'.
3/17/08	WMI announced that on March 14, 2008, the United States Court of Federal Claims published its written decision in the case of Anchor Savings Bank, FSB vs. The United States of America, awarding Washington Mutual Bank $382.0 million for damages, and an additional amount for taxes that will be determined by the court.
	WMB board passes resolution to address the Bank's deteriorating financial condition.
3/18/08	WR Director and exam team update DC management on results of 3/17/08 Board meeting discussion.
	COO Polakoff directs other regions to provide the WaMu exam team with examiners to perform a more detailed analysis of Liquidity, including all relevant agreements that could negatively impact liquidity.
	WMB management provides DC management with a listing of the Bank's top 30 depositors per an earlier request.
3/19/08	In light of the failure of Bear Stearns, the WMB exam team provides OTS management information on the Bank's credit exposure to Lehman, Merrill, and Morgan Stanley which approximated $250.0 million.
	OTS formally request mortgage loan servicing data as a part of our ongoing supervisory process to conduct a nationwide horizontal review. The goal is to have a detailed, current, and on-going picture of mortgage loan performance and loan modification efforts.
3/20/08	DC policy staff had a meeting via conference call to discuss proposed changes to Unfair and Deceptive Practices rules.
3/24/08	Out of region examiners begin assisting WMB exam team in doing a detailed analysis and monitoring of Liquidity, including a review of all relevant contracts and agreements that might contain triggers which could negatively impact the Bank's liquidity position.
	WR Director provided DC management the latest info on the Bank capital raising efforts based on an

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	update received from WMB executive team. April 4, 2008, was scheduled for a subsequent update by WMB's board to OTS DC and WR management.
3/26/08	Exam team hold exit meeting for the Commercial Group review, no significant findings.
	Exam team request updated financial projections from management, FDIC in attendance.
3/31/08	FinCen informs OTS that our referral regarding WMB Bank Secrecy Act issues was referred to their Office of Enforcement because they determined that the imposition of civil enforcement remedies under the Bank Secrecy Act may be warranted.
	WR briefed OTS COO on the status of the examination.
4/1/08	OTS COO (Polakoff), Deputy Director (Ward), and WR Director (Dochow) met with the Board to direct them to raise capital given the increasing losses at the Bank.
4/2/08	WR Director informed onsite FDIC examiners that OTS had a telephonic discussion with WMB's Board on 4/1/08 where they heard from OTS that they needed to take action to ensure the safety and soundness of the banks and sufficiency of capital. The board authorized Rotella and Casey to start meeting with a number of large current shareholders who signed confidentiality agreements to obtain additional capital above what the private equity companies proposed. Management appeared confident that capital was available. OTS Wash DC briefed FDIC DC on 4/2/08.
4/3/08	Examiners had mid-exam update meeting with Home Loans management. Discussions included primary findings of recurring concerns regarding stated income lending in all HL portfolios and generally unsatisfactory underwriting overall.
	Examiners requested documents from the Bank to facilitate the FDIC contingency planning efforts.
4/4/08	Examiners requested a deposit download at the request to the FDIC contingency planning group.
	WR provides DC the Bank's revised liquidity stress analysis with additional stress conditions requested by WR management including: a $19 billion deposit run off among retail, custodial and commercial accounts, plus a reduction in Fed Funds capacity and 400 bp increase in the FHLB haircut. Also included was new info on several items such as clarification of what the FHLB's can do upon a "material adverse change" indicating that potential exists for a much worse event should the FHLB of SF triggers an early amortization of outstanding balances or immediate repayment upon default stemming from a material adverse change. Management reports that they are very close to signing a deal to raise additional capital approximating $4.9 billion. OTS encourages management and the Board to raise all that is possible in this transaction. Management agrees with OTS to keep JP Morgan offer open.
4/7/08	WMB announces their exiting the wholesale lending channel including the closure of related loan offices.
4/8/08	WMB announces a $7.0 billion + capital raising.
4/15/08	Annual shareholders meeting – some shareholders and employees were extremely critical of management and the Board for the condition of the bank and suggested a number of changes. Mary Pugh resigned as Finance Committee Chairman.
4/17/08	WR management and examiners attend Quarterly regulators meeting.
	Michella Alban – Home Loans Legal Officer, and Adam Ellis- Home Loans Appraisal Manager. We learned subsequently that Mr. Ellis was retained in a different capacity.
	COO Rotella informs the exam staff that 3 individuals were terminated related to the NYAG appraisal allegations: Cheryl Feltgen - Chief Credit Officer for Home Loans
4/23/08	Exam team requests an appraisal sample related to the appraisal investigation. Discussed the Bank's rights under applicable regulation to cancel HELOC lines of credit with CERO Cathcart and John Robinson, Regulatory Relations Exam team met with HL management to get more detail analysis of the root cause of mounting losses.

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4/24/08	Examiners completed detailed analysis of liquidity related instruments/contracts that could potentially negatively impact the Bank's liquidity position.
	WMB announces the termination of Cheryl Feltgen and Michella Albon from the Home Loans group.
5/5/08	FDIC provides a revised capital analysis indicating that the Bank needed an additional $5 - $7.0 billion in capital
5/8/08	Temporarily discontinued weekly liquidity reports to DC due to recent capital infusion
5/14/08	Examiners and WR management attend quarterly Treasurer's meeting.
5/15/08	Internal reorganization at WMB moves the Compliance and Regulatory Relations functions from ERM to the Legal Department.
5/16/08	Onsite examiners discontinued sending liquidity reports to DC because of the recent capital infusion but continued to monitor liquidity.
5/19/08	FDIC DRD staff informs that the download of WMB deposit data was successful.
5/21/08	Moody's Investors Service (Moody's) downgraded the rating of the Covered Bonds (approximately $6.0 billion) issued by WM Covered Bond Program (the Program) to **A2**, on review, with direction uncertain from **Aa1** under review for possible downgrade. The downgrade of the Covered Bond rating follows the recent downgrades of the long-term deposit ratings of Washington Mutual Bank (the Sponsor) to **Baa2** (stable outlook).
5/28/08	Examiners held general discussion with D&T audit manager. Exam team met with WMB attorneys to discuss internal review of alleged fraud by WMB loan consultants. MOU and ROE required an in depth investigation into the validity of the allegations and extent on any problem.
5/29/08	Onsite FDIC examiner inform OTS examiners that they are classifying all subprime loans "substandard" regardless of payment status and as such, would downgrade the Bank's asset quality component from "3" to "4".
6/2/08	WMB issues a press release indicating that, to further strengthen corporate governance and to listen to corporate shareholders, effective July 1, independent director Stephen E. Frank would assume the role of Board Chair while Kerry Killinger would continue to lead the company as Chief Executive Officer and serve as a Director. The Board also adopted a majority voting standard and made several changes to the composition and leadership of certain of its Board Committees: (1) the Board appointed Orin C. Smith, retired Starbucks CEO, to serve as Chair of the Finance Committee, (2) recently elected director David Bonderman, managing director of TPG Investors, would serve as Vice Chair of the Finance Committee, in addition to being a member of the Corporate Development committee, (3) the Board appointed Thomas C. Leppert, Dallas Mayor and former chairman and CEO of The Turner Corporation, to serve as Chair, and (4) the Board appointed Regina T. Montoya to serve as Chair of the Corporate Relations committee. She also continued in her role as a member of the Finance Committee. In addition, the company launched a search for individuals with extensive financial services and strong leadership experience to further fortify WaMu's Board of Directors as new independent directors.
	WR Director and examiners discuss WMB at high risk briefing
6/4/08	WR Director and exam team held conference call with Director Frank, Chairman of the audit committee to express our concerns and provide examination findings as well as to discuss the effectiveness of the audit committee, ERM, internal audit, and the management team.
6/9/08	Examiners notified that WMB appraisal issue would likely remain a separate investigation; as such, findings and conclusions would likely be handled separately outside of the current comprehensive examination.
	OTS approves application filed April 24, 2008, for payment of a dividend to Washington Mutual, Inc., consisting of the stock of WM Mortgage Reinsurance Company ("Captive"). WM Mortgage Reinsurance Company is considered a non-includable subsidiary of WMB for purposes of determining

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	the bank's regulatory capital. As such, the distribution of Captive to WMI will have no impact upon WMB's regulatory capital.
	WMB reports that its exposure to Fannie and Freddie is limited to equity securities approximating $282.0 million with a mark to market loss approximating $49.0 million
6/10/08	OTS suspends the Basel II qualification exam given that WMB delayed their qualification efforts to be consistent with other institutions that were required to be Basel II compliant.
	Examiners became aware that Management had used approximately $1.4 billion in recent capital proceeds to pay down holding company debt. Management subsequently directed to discontinue this activity.
	Examiners held Sensitivity to Market Risk exam exit with executive responsible for this area; onsite FDIC examiner in attendance.
6/11/08	OTS DC analyst indicates that WMI stock tanking early already down 13.17% trading at $5.82 its lowest level since 1992 and inquired whether upcoming news caused a significant swing from the previous day's late rebound. WR director indicated that it was likely due to rumors about the possibility of an upcoming MOU in that both OTS and WMB were being asked for comment in this regard by the media.
	WMB issues a press release indicating "while it is the policy of Washington Mutual not to comment on speculation and market rumors, the company released the following statement to address recurring speculation about regulatory activity: "Neither our primary federal regulator, the OTS, nor any other bank regulatory agency has taken any enforcement action against WaMu that we have not previously disclosed. Further, the company is not currently in such discussions with any regulatory agency."
	OTS examiners held exit meeting with executive responsible for Enterprise Risk Management; onsite FDIC examiner in attendance.
6/12/08	Held exam exits meetings for Capital, Earnings, and Liquidity as well as for Home Loans for the executives responsible for those areas; onsite FDIC examiner in attendance.
	Management provides the examiners a draft of their new Long Range Forecast, recently approved by the Board
6/16/08	Examiners held Compliance exit meeting
6/18/08	Exam team met with COO Rotella to discuss Operation Restart, initiated in May 2008, wherein Management identified about $1.0 billion in run-rate NIE saves and [5,400+] in headcount reductions. Phase II was initiated in mid May 2008 with the majority of savings centered on Home Loans, Retail Bank, Technology, and Real Estate. WMB issued a press release on 6/19/08 regarding a number of changes intended to improve expense management, increase efficiency, and accelerate return to profitability by: (1) eliminating some positions that don't support mission critical activities, (2) eliminating positions that supported Home Loans functions that were discontinued, and (3) centralizing some support functions such as in Technology, Human Resources, and Enterprise Operations. About 1200 positions would be eliminated
6/20/08	Examiners discuss with COO Steve Rotella our concern that certain MSR hedging personnel were being terminated as a cost cutting measure, particularly since this area was recently a high risk area.
	Examiners with WR Director present discussed their examination findings with CEO Kerry Killinger, COO Steve Rotella and Acting General Counsel Stewart Landefeld today since the CEO would not be available at the formal management exit scheduled July 1, 2008. Examiners disclosed that composite would remain "3" but that Asset Quality and Management ratings were being downgraded (343432). WR Director informed WMB management that additional enforcement action was likely given the condition of the Bank.
6/23/08	Examiners met with Home Loans management to inquire about ongoing hedging of Mortgage Servicing

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	Rights because we received anecdotal information that certain WMB personnel responsible for hedging were being laid off. We expressed concern that management must maintain competent personnel to continue to manage this asset. Management stated that key individuals were being maintained.
6/24/08	Exam team provided the 6/20/08 management meeting agenda to DC management along with all the examination findings memos.
6/25/08	WR Director met with CEO Killinger who agreed to infuse additional capital into WMB but indicated that the Bank was wary of creating a tax issue or rating agency discomfort. Mr. Killinger indicated that the bank would bring in approximately 400 people to clear the backlog of Alerts and SAR filings. He also asked if there was anyway to avoid a MOU given the capital infusion as well as the following actions: a plan to increase liquidity sources to $60.0 billion by June 30th versus $37.0 billion at March 31st, accelerating loan loss provision asked for by examiners, discontinuing many lending areas where underwriting was criticized by examiners, and cutting approximately $1.0 billion in expenses to accelerate return to profitability. WR Director indicated that as a "3" rated institution, enforcement action would be necessary. Mr. Killinger asked about the status of the appraisal review; to which, WR Director indicated that the review was still in process.
6/26/08	WMB applied to issue another $3 billion in sub debt under its Global Note Program over the next two years. They anticipate issuing only $2.25 billion, but applied for $3 to give them additional flexibility. WR Director opined that while some use of the global note program makes sense, the dynamics have changed sufficiently at the company so that we should require a clear indication of ability to service, representation of no adverse impact on rating agency ratings, and have their plan showing attainment of profitability and maintenance of sufficient capital under the credit cost stress scenarios
6/27/08	WMB informs WR Director that they are near a deal to sell about 45 Chicago area branches and all Chicago deposits and all Colorado deposits and branches to U S Bank. This will likely be announced with earnings on July 16. WMB had previously closed about 60 Chicago area branches and with the sale will be out of that market and Colorado in terms of retail presence. They will also close about 100 other stores in other states with the largest number in any one market being about 30 in the west Florida/Tampa area.
	WMB executives meet with OTS DC management to discuss exam findings and to discuss whether enforcement action was necessary. DC management confirmed that enforcement action was necessary.
7/1/08	Examiners conducted the formal management exit meeting to discuss all examination findings with the executive management team.
	WMB management indicated that per their discussion with Moody's, the rating agency was taking no action at this time, and confirmed that assuming earnings are finalized at the level discussed with them the previous day, they would affirm both WMB and WMI ratings and Stable outlook immediately after WMB's earnings release.
	Examiners expressed concern to WMB management about their recent buyback of holding company debt because this depletes capital although debt was repurchased at a discount.
	WR Director discusses with WMB management the need for WMI to infuse at least another $2.0 billion into the Bank.
7/3/08	Exam team asked to provide a list of provisions to be considered for inclusion in the MOU.
7/7/08	Exam team provided suggested requirements to be included in the MOU.
7/10/08	Examiners inform WMB management of conclusion that the Bank failed to comply with certain aspects of the Compliance C&D.
7/11/08	IndyMac Bank is placed in receivership
	WR updates DC on upcoming 2Q08 earnings announcement that WMB would report on July 22, 2008,

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	including a higher loss expectation of $3.3 billion loss versus about $1.1 billion in the first quarter. The difference resulted from a dramatic increase in ALLL provision (approximately $3.5 billion planned amount was increased to $5.9 billion in response to examination plus a little more). Total assets are down to about $309 billion.
7/14/08	Examiners attend earnings update meeting with WMB executives
7/15/08	OTS West Region management and examiners met with Board to present examination findings and conclusions, including the decision to downgrade Capital to "4", Asset Quality to "4", and Management to "3" while maintaining a Composite "3". The FDIC indicated that they considered the Bank a borderline "3" composite. OTS also informed the Board of a pending enforcement action related to the condition of the Bank. IN addition to the significant deterioration in the Bank's financial condition, other significant findings included continuing concerns with respect to underwriting of SFR loans, particularly related to stated income lending, problems in the home loan appraisal process, continuing compliance management concerns, particularly in BSA/Anti Money Laundering concerns; and ineffective enterprise risk management function, deficiencies in ALLL and reserve methodologies, and less that satisfactory Board and management oversight.
	David Bonderman, new director at WAMU representing TPG, asked the WR Director whether TPG's arrangement can be clarified/altered on their rebuttal of control to allow the observer who joins him at board meetings to ask questions and/or participate in discussions but continue to not vote, and whether WAMU management could, if they choose, contact some of the TPG related staff/companies for advice and counsel. This would be solely at WAMU management's initiation.
	DC management requested that the examiners follow up on reports from the FDIC regarding complaints from branch customers that IndyMac official checks are being sent for collection by WaMu which could mean no access by customers to deposited funds for 8 weeks. DC also asked for clarification whether the checks were from the former FSB or the new conservatorship FSB. If from the latter, the holds would appear to be inappropriate. Clarification from WMB was requested.
7/17/08	OTS West Region receives independent complaints regarding WMB holding checks drawn on IndyMac Bank (in receivership) for eight weeks. WMB confirmed that extended holds were in effect due to the receivership. WR Director instructed WMB to honor IndyMac check in accordance with regulatory requirements for check hold procedures. WMB indicated the Bank issued new guidance to branches to comply.
7/18/08	OTS receives a letter explaining the scope of a consulting agreement whereby Mckinsey and Company would provide consulting services, the goal of the project was to build on WMB's initial transformation results achieved in Project Restart to create a go-forward environment where WMB's executives will drive performance through enhanced accountability and decision making while preserving the best elements of WMB's culture and values.
7/19/08	In response to OTS findings that WMB did not comply with terms of certain requirements of the compliance (BSA) C&D, management provided a legal response from Wilmer Hale opining that the Bank was in compliance. OTS disagreed with this response
	Management provided capital projections for WMB that accompany the LRF Income reflecting a $2 billion infusion of capital from WMI to WMB which is expected to occur before the earnings announcement scheduled for the following week.
7/21/08	WMB informed WR Director that their attempt to sell all Chicago deposits and certain offices plus all Colorado branches to US Bank was off. As negotiations neared the end, US Bank upped the anti by asking for a letter of credit given their perception of WMB as being named on a list of banks for possible take over etc. WMB thought that the requirement for a letter of credit, if made public, might cause further headline risk.

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	WMB informs WR Director that WMI infused $2.0 billion into the Bank
	Received FDIC 7/21/08 letter which contained their thoughts on conditions that should be included in any enforcement documents, which included a requirement that WMB needed an additional $5.0 billion in capital.
7/22/08	WR Director responds to FDIC 7/21/08 letter which contained their thoughts on conditions that should be included in any enforcement documents.
	Moody's Investors Service placed the ratings of WMI (senior unsecured rating of Baa3) and WMB (financial strength rating of C-, long term deposit rating of Baa2, and short term rating of Prime-2) under review for downgrade. The review follows WMB's reported $3.3 billion loss for the second quarter of 2008.
	Met with WMB regarding liquidity position given concern that upcoming earnings announcement could cause new deposit outflows on top of post IndyMac outflows. Management reported building cash reserves in anticipation with existing $8 billion cash and expected $13 billion by the end of the week. They are also increasing their collateral at the FED. They currently have $8 billion in borrowing capacity at the FED and will have $15 billion by the end of the week. They ran various deposit decrease scenarios and opined that a $25.0 billion decrease by month end would be serious. Although they have $60 billion in borrowing capacity, the FHLB is not in a position to fund more than about $4 to $5 billion a week which would leave them relying on the FED and Cash Reserves. Ability to draw down FHLB advances also limited by the ability of the FHLB's ability to place large sums of paper in the capital markets in order to fund WMB advance requests.
	WMB has $19.7 billion in what they consider susceptible uninsured deposits.
7/23/08	WR Director and exam team met with management to discuss recent earnings call and recent steps to improve liquidity.
7/24/08	Examiners met with management to discuss the post earnings announcement impact on liquidity and need to shore up deposit outflow.
	"Gimme Credit Research Brief", reports that "many of WaMu's unsecured creditors are quietly reducing their exposure to the troubled bank, increasing its relative reliance on insured deposits and FHLB borrowings". This is being evidenced in the credit default market.
	OTS DC concerned about increasing widening of spreads for credit default swaps related to WMI debt. Management opined that much of this was due to speculators in these instruments
7/25/08	FRB informed WR Director that they would be sending an examiner from their Credit monitoring department to monitor liquidity and related credit/collateral.
	WMB expresses concern about the impact on yield from maintaining higher levels of liquid assets. OTS tells management that it best to maintain excess liquidity in the short term and to take necessary steps to increase deposits to recapture funds lost. Also OTS tells management to ensure that the company implements effective media/press/investor plans as we understand that they have hired firms to advise them in that regard.
	NY Post reports inquires of WMB about whether FHLB- SF has a blanket lien on WMB assets reportedly based on sources within FHLB and WMB's "regulator".
7/28/08	FRB examiner Patrick Loncar arrived to monitor WMB's liquidity.
	WMB looking into restructuring large deposits at WMB by using both the WMB and WMBfsb charters to increase FDIC coverage
7/30/08	Examiners participate in a conference call update with DC senior management regarding exam findings, MOU, financial projections, and liquidity.
7/31/08	WMB reports first positive deposit flow post IndyMac closure.
8/1/08	OTS Director and senior OTS management, FDIC director and senior staff met with CEO Killinger and

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	members of his executive team who presented WMB's long term forecast. Apparently, FDIC indicated to WMB that they put little credence in their plans
	WR Director informed by OTS DC senior management that per FDIC Chairman, FDIC has a ratings difference with OTS. WR Director indicated that per onsite FDIC examiner, the FDIC was only contemplating a ratings difference. WR FDIC director indicated that the region had not yet reached a decision but that the LIDI group was contemplating a downgrade; he also indicated that he thought the FDIC EIC has stated that the FDIC would rate the bank a "4" at the 7/15/08 board meeting; however, WR OTS director indicated that this was not the case. Based on a subsequent discussion between WR Director and WR FDIC Director, the FDIC was still pondering their CAMELS rating so a rating difference did not yet exist between OTS and FDIC.
	FDIC EIC indicated that FDIC DC senior management may have instructed WMB CEO to find a merger partner.
8/4/08	FRB credit examiner Julie Plock joins FRB examiner Patrick Loncar onsite.
	Exam team met with WR Director to discuss WMB rating and info package to be sent to DC.
	Examiners resumed the more extensive Weekly liquidity reports to DC including the most recent asset quality information available (in addition to daily liquidity reports).
8/5/08	The FRB declines WMB for the 84 day TAF borrowing facility that began that week.
8/6/08	WMB reports that FHLB SF would likely implement 400 bp across the board haircuts that would lessen liquidity availability. In addition, given the recent post IndyMac deposit runoff, the 3 and 6 month liquidity projections for the stress scenario fell below the Bank's minimum target levels.
	Discussions with FDIC EIC indicated that he was now thinking of rating Liquidity a "4" based on recent post IndyMac deposit runoff, tightening of lending policy by the FHLBSF, and per him, a call from the Fed to the FDIC Chairman expressing concern about WaMu's liquidity. He acknowledged that his position from a few weeks ago of a "3" rating for Liquidity has changed as a result of these factors. He mentioned that he may also get guidance to rate Capital a "4" and Management a "4", however, his indication seemed to be that he is already backing the "4" liquidity rating, but will go along with "4" Capital and Management ratings if that is the decision of FDIC management.
8/8/08	Executive management update by CFO, Treasurer, and CCO on loss tracking, earnings and post IndyMac deposit runoff. Management indicated that most of the runoff ($6.6B) came from uninsured accounts and approximately a third of that was from accounts over $500.0 million. Deposit losses were heavily concentrated in Southern California which was hardest hit; however, current deposit trends were stable. RD Dochow stressed the need to shore up liquidity and strongly indicated that management should pursue regaining deposits lost in the post IndyMac runoff.
	FRB examiners conclude onsite visit
8/13/08	OTS examiners met with Treasurer and his staff to register concern that the bank was not aggressively increasing liquidity via deposits and the need to bring liquidity back in line with internal targets in stress scenarios. Examiners again reiterated what they and WR Directors had indicated earlier, that management should be less concerned about the effect of excess liquidity on NIM that they should be about the potentially fatal impact that could result from future liquidity runs. Management also expressed concern regarding negative impact that higher rates could have on headline risk but agreed to be more aggressive in deposit gathering.
8/14/08	WMB provides updated LRF showing $2.0 billion capital infusion in July 2008 and no other capital raise necessary through 2010; updated earnings projections indicating return to positive earnings in 2Q09; potential $600M debt for equity swap, and TPG investors agreement term sheet.
	Management provided updated cumulative loss tracking report indicating that losses were tracking within loss projections.

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8/18/08	WR director and exam team update DC management on WMB.
	WMB completes DC's (Sharon Stark) request for option ARM data.
8/19/08	WMB provides positive and negative events that could impact capital in the near future, the impact of which, were essentially neutral.
	WR management and exam team discuss ratings and FDIC suggested ratings.
8/20/08	OTS examiners provide assessment of FDIC's capital analysis to WR Director.
	WMB reports significantly reduction is SFR loan production.
	Deposit runoff post IndyMac approximates $9.3 billion
	OTS examiners provide assessment of FDIC's capital analysis to WR Director
8/21/08	WMB management provides information on office closures related to Hurricane Fay.
	WMB reports minimal exposure to FNMA and FHLMC subsequent to the government takeover of these entities.
	WMB stressed projected earnings by $300 and $500 million per quarter but still indicate compliance with well capitalized standard through 2010
8/22/08	DC Senior management updates OCC Director on WaMu.
	WR Director discussed OTS ratings with WR FDIC management.
8/23/08	Management finally begins the 5 day deposit special that OTS had been strongly encouraging for some time.
8/26/08	WMB management and OTS and FDIC Examiners discuss most recent earnings projections.
8/27/08	Examiners have updated discussion with management on Loss Model.
	Exam team received FDIC's most recent Capital assessment from DC management.
8/28/08	Examiners provide DC and WR management with an update of most recent earnings projections.
	OTS Examiners and WR management participate in a conference call with FDIC examiners and FDIC WR management to discuss FDIC's assessment that Capital is inadequate.
9/3/08	Examiners WR management and FDIC representatives attend Quarterly Treasurer's meeting.
	Provided initial assessment of FDIC's capital analysis to DC per S. Polakoff's request
9/5/08	WR FDIC informs WR OTS that they are proceeding with problem bank memo and OTS informs FDIC that OTS will respond. Also OTS indicates that MOU and Killinger resignation will be announced on 9/8/07.
	WMB provides PERK material for 4Q08 exam work.
9/7/08	WMI/WMB MOU signed by directors, Alan Fishman approved as CEO by directors, and Kerry Killinger resigns as CEO.
	WSJ and Seattle Times reports Mr. Killinger's resignation prior to the public announcement on 9/8/08
9/8 /08	OTS Director informs Secretary Paulson, Director John Dugan, Director Sheila Bair, and Fed Govs Don Kohn and Randy Kroszner that WMB/WMI MOU was effective 9/7/08.
	OTS receives the FDIC's final memo recommending a "4" rating for WMB, the region required to respond in 3 days.
	WMB announces Alan Fishman as WMB as CEO.
	WMB ROE uploaded to system.
9/9/08	Weekly Liquidity report sent to DC.
9/10/08	During FHLB SF presentation at WR managers meeting, it was discussed whether a blanket lien on WMB's assets would give FHLB managers more assurance to continue lending to the Bank. They indicated that it would and in the following week, this was accomplished.
	WMI contributes $500M to WMB increasing pro forma capital ratios to 7.55 percent leverage and 13.19 percent risk based.

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	FRB examiner Loncar requests a copy of the MOU and we indicated he would have to go through official channels.
	Field Examiners provided WR Director with a summary of differences with the FDIC's capital analysis.
9/11/08	Today's liquidity meeting noted: •Anecdotal information from the branches today suggests that deposit withdrawals remain higher than normal; most withdrawals were in increments greater than $50,000. •Post-IndyMac plans have been reinitiated in the branches, which include: emphasis on FDIC insurance education; waiver of penalties if customers restructure deposits to increase insurance coverage (with multiple account owners, etc); waiver of penalties if customers bring back official checks at a later date and redeposit the funds; distribution of flyers outside of downtown Seattle branches advertising the current 5% CD special •An 8 month CD special at 4.25% will replace the current 5% 13 month special beginning on Saturday •The negative headlines have not directly impacted other funding sources so far •Fishman, Rotella, Casey and McMurray are meeting with S&P today. The meeting was scheduled for next week, but was rescheduled because of this week's events. •Management is considering a third quarter pre-earnings announcement next week to attempt to calm the market. They are discussing this with S&P. They expect an earnings announcement to cause Fitch to downgrade the holding company credit rating to BBB-. The bank rating is expected to stay unchanged (BBB), although the outlook will likely change to "Negative." This will be a change from prior practice by Fitch, which has generally given the bank and the HC the same credit rating.
	Moody's downgraded the long-term deposit and issuer ratings of Washington Mutual Bank to Baa3 from Baa2. The bank's financial strength rating was downgraded to D+ from C-, base line credit assessment (BCA) to Ba1 from Baa2, and short term rating to Prime-3 from Prime-2. Washington Mutual Inc.'s senior unsecured rating was downgraded to Ba2 from Baa3. The rating action concludes the review that was initiated on July 22, 2008. The outlook is negative
	Fitch made the following downgrades for WMI: (1) long-term IDR to 'BBB-' from 'BBB' and (2) short-term IDR to 'F3' from 'F2. For WMB Fitch affirmed long-term IDR at 'BBB" but short-term IDR downgraded to 'F3' from 'F2'. The Rating Outlook is Negative.
9/12/08	OTS responds to FDIC's capital assessment.
9/15/08	WMB responds to S&P. The change in Standard & Poor's ratings for Washington Mutual announced today brings S&P's ratings in line with those announced last week by Moody's; however, it's important to note that S&P attributed its action to worsening market conditions, and not to any material change in the evaluation of Washington Mutual's financial condition. S&P's ratings for Washington Mutual Bank remain investment grade.
	Branches in the Midwest and west reported continued higher than normal activity after the market closed today because of increased press and network news coverage of Lehman, AIG, etc.
9/16/08	WMB reported increasing customer traffic in branches due to the frenzied broadcast media. The Suzi Orman segment on the Today show created increased consumer concern. She indicated that she was working with the FDIC to insure accurate information was distributed and then noted that the leading indicator of a bank failure is the stock price declining. • More customers are requesting cash withdrawals and Financial Center Managers are discussing the risk of carrying large amounts of cash and encouraging customers to either accept a cashier's check or a wire for safety. • Management working closely with the retail operations and treasury teams to insure adequate cash levels given market conditions.

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	• Reports received yesterday (Monday) noted that the FDIC Call Center and CNBC questioned whether the language employed in the Master Account Agreement application for WaMu's POD accounts clearly establishes a pay-on-death arrangement as required by FDIC deposit insurance regulations. WMI legal has spoken with the FDIC and the FDIC confirmed that it does indeed meet the requirements. We have been told that the FDIC has provided this clarification to its call centers.
	OTS updates FDIC regional management on current liquidity situation.
	West Region OTS and FDIC present the WMB rating difference to FDIC Board.
	Increasing Deposit Outflows essentially wipe out recent inflows that OTS had strongly encouraged.
9/17/08	FDIC requests WMB's consolidated tax returns.
9/18/08	OTS receives a customer complaint regarding WMB not setting up accounts properly to facilitate insurance of accounts which were discussed with management.
	WMB reports high traffic in branches and continuing branch closings and reported available liquidity at $33.3 billion.
	WMB updated DC Management on Liquidity: Funding Plans - the trajectory of deposit outflows looks like it will be IndyMac ($9.5B) + 70%, or a total outflow $16-$17B over three weeks (including what has already happened). They are borrowing $8.5B from FHLBs over the next two weeks. FHLB SF now has a blanket lien and has assured WMB that they will not have any additional cuts in capacity. WMB will also be getting $2B in proceeds from discount note maturities and sales. Repo market is shut down. Repo collateral is being shifted to SEA FHLB. • Treasury Manager thinks that liquidity at the end of the quarter will be $13B, or $3B in excess cash and $10B in FHLB capacity. • M&A - Casey, Fishman, and a rep from Goldman gave an update on M&A activity. JP Morgan is expected to complete due diligence by today or tomorrow. Citi is expected to complete due diligence tomorrow. Also one other party (missed the name) is looking into acquiring a minority interest. Goldman thinks a deal could be done by Sunday.
	OTS downgrades WMB's composite rating to "4" (343442).
9/19/08	Daily Liquidity report provided to WR and DC senior management.
	John Robinson, Regulatory Relations, request that the FDIC inform OTS of their plans to send in two DRR examiners, Ken Parker and Eric Piscini, to gather IT information.
	Liquidity projected at $29.8 billion by WMB.
	FRB will keep on primary credit with same haircuts and pricing, but prefers that WMB not bid in the Monday 28 day TAF program and instead use the Discount window. Also FRB will use $1.5 billion of the pledged collateral toward intraday transactions.
	FDIC corresponds that Advances still available from the FHLBs and the situation is not dire.
	FHLB -SF reports that their accountants, PWC requires them to follow FAS 157 fair value accounting for the collateral of problem banks and that WAMU was a problem bank. That means they look to observable sales of option arms and they found some at fire sale prices of 35 cents on the dollar that they will have to use. On that basis they are out of collateral and gave advances yesterday only because of the blanket lien. FHLB of SF told management this late last night. FHLB of SF told OTS that they might be able to lend $1 to $2 billion more if it was a bridge to getting a deal done. OTS management encouraged FHLBs to continue lending.
9/20/08	Gail Patelunas, FDIC, informs Scott Polakoff that the FDIC is sending two DRR examiners to WMB.
	Daily Liquidity report provided to WR and DC senior management.
9/22/08	Daily Liquidity report provided to WR and DC senior management.

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	Darrel Dochow asked FDIC to coordinate DRR efforts through onsite OTS examiners.
	Peter Frielinger, Treasury Manager and Robert Williams, Treasurer, met with both the FRB and the FHLB SF.
	In implementing a $1.5 billion daylight overdraft limit for WMB, the FRB incorrectly posted the $2 B discount window repayment against the collected balance, not the ledger balance. And since PSR (Payments System Risk) balance monitoring uses the Collected Balance not the ledger balance, this caused all of the morning's wires to get sent to a rejection cue. Apparently some counterparties were aware of the rejections. The error has been fixed and the wire cue has been cleared out, and all of this morning's wires have been sent out.
	FDIC DRR examiners Ken Parker and Eric Piscini along with OTS IT Manager Sandy Chan met with CIO Deb Horvath to discuss access to WMB systems.
	Management reported a slowing of customer traffic in branches and a slowing of outflows to more normal levels.
	Net FRB collateral determined to be $7.4 billion.
	WMB projected ending available liquidity to be $28.0 billion; however, they estimated $9.4 in FRB availability or $2.0 billion more that estimated by the FRB. FDIC projected $20.8 billion in liquidity because they reduced the amount ($8.5 billion) reportedly available from FHLB-SF to $1.0 billion.
	Onsite examiners provided West Region ERC with an update on WMB's deteriorating liquidity situation.
9/23/08	Daily Liquidity report provided to WR and DC senior management.
	FDIC requested that OTS directs the Bank to only borrow short term advances to avoid prepayment penalties; which we communicated.
	WMI ROE Uploaded to OTS System.
	WMB Treasury personnel respond that the Bank has potential saleable assets, but none that can be sold in short order. Assets potentially include loans, CMBS, corporate and municipal bonds, as well as REIT asset currently in a Special Purpose Entity that could be dissolved under certain supervisory actions.
	Latest FRB projection indicates that WaMu liquidity would reach "0" by 10/9/08 assuming approximately $2.0 billion runoff per day.
	WaMu projects available liquidity at $23.6 billion
	Notified WMI via hand carried letter that the holding company rating was downgraded to "4", which differed from the ROE's "3" rating, based on WMI's condition at 6/30/08.
	Downgraded WMBfsb to "4" based on condition of parent.
9/24/08	Daily Liquidity report provided to WR and DC senior management.
	FDIC reports to OTS that while deposit outflows are declining they are not stabilized and that FHLB-SF is "day to day" with respect to future advances.
	S&P Lowers Washington Mutual Inc's ratings to "B-" from "BB-"; S&P affirms the "BBB-/A-3" rating on Washington Mutual Bank as the breadth of the deposit franchise , the capital position and loss reserve coverage remain adequate in light of the high level of mortgage loan asset quality pressures.
	WaMu submits a presentation on potential recapitalizations options.
	FDIC informs JP Morgan that they had won the bid for WaMu
9/25/08	Daily Liquidity report provided to WR and DC senior management. Available liquidity projected at $13.1 billion (subject to FHLB continuing to fund).
	Total deposit outflow (including commercial) from 9/8/08 to 9/24/08 is $18.7 billion.
	Net consumer noninterest and small business outflows from 7/14/08 to 9/25/08 total $19 billion.
	The FHLB of San Francisco notifies WaMu that it is near its limit on advances. WaMu believed that they had another $5 billion in capacity.

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	The FRB of San Francisco moves the bank into the secondary credit category.
	FHLB-SF limits WMB advance availability to $500.0 million.
	OTS directs WaMu to dissolve the WM preferred Funding REIT.
	At FDIC's Request, OTS examiners directed WMI management to dissolve Preferred Funding REIT (a special purpose entity), forfeit all rights to the approximately $9.0 in loan collateral, and assign the collateral loans to WMB for inclusion in the receivership transaction.
	WaMu placed into receivership; sold to JP Morgan Chase.
	JP Morgan raises $7.0 billion from private investors pursuant to the WaMu purchase.
	FDIC asks if OTS found any violations of law in connection with the Appraisal Investigation. Examiners referred them to West Region Counsel, Jim Hendriksen.
9/26/08	JP Morgan raised an additional $3.5 billon in the open market or $2.5 billion more than planned, related to the WaMu deal. Its stock increased 6.8 percent from 9/24/08 price of $40.50.
	FDIC asks if OTS removed the Board Audit and Finance Committee notebooks from the examiner library and were informed that we had not. It was determined that Regulatory Relations staff had removed them the evening of 9/25/08. They were returned upon our request.

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Washington Mutual
WMBFA, WMBfsb
March 15, 2004
Safety & Soundness Examination
OTS MEMO 5

DATE:	May 12, 2004
TO:	Tony Meola, EVP, Production
	Mark Hillis, Deputy Chief Credit Officer
FROM:	Bill Durbin, OTS
SUBJECT:	SFR Loan Origination Quality
CC:	Deanna Oppenheimer, President WAMU Consumer Group

BACKGROUND INFORMATION

Several of our recent examinations concluded that the Bank's single family loan underwriting was less than satisfactory due to excessive errors in the underwriting process, loan document preparation, and in associated activities. Similar findings noted in internal audits and quality control reports supported our examination conclusion. The overt causes for past underwriting concerns were many, but included: (1) A sales culture focused heavily on market share via loan production, (2) extremely high lending volumes fueled by the low interest rate environment, and (3) a less than optimal organizational structure that included multiple loan origination platforms, in part due to recent merger activity, and a variety of origination procedures that varied by origination office (i.e., loan fulfillment center (LFC)).

During our review period, management began several initiatives aimed at correcting the overt causes of underwriting deficiencies discussed above. Specifically, initiatives are underway to simplify the origination structure by reducing origination platforms from nine to two while developing a single origination model to be implemented in all LFCs. Other current initiatives to improve underwriting quality include: (1) de-emphasizing the Bank's position as the pricing leader with more emphasis on maintaining manageable capacity and originating higher quality loans, and (2) installing Credit Risk Teams in LFCs aimed at increasing the credit risk management group's influence over underwriting while reducing the influence of production management. Since these and other management initiatives are in process, we cannot yet opine on their effectiveness; however, the steps taken are considered appropriate and should eventually have a positive impact on underwriting. Given the breadth of changes being made such as:,(1) computer system changes (loan origination platforms and termination of OPTIS.2) and (2) restructuring and consolidation of the loan fulfillment centers, with its attendant relocations and staff reductions, the near term result may be an environment where other types of errors may become prevalent. As such, we encourage heightened management oversight of all ongoing initiatives and careful consideration of findings discussed in this memorandum.

Our past reviews concentrated on assessing underwriting analysis documented in loan files. Since prior examinations and internal reports have already established that underwriting concerns exist, we decided to forego some file review at this examination to instead concentrate on reviewing and improving internal processes that may contribute to underwriting concerns. The following discussions relay our findings with respect to these processes.

EXAM FINDINGS DEFINITIONS

Observation:	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation:	A secondary concern for which immediate corrective action is left to management's discretion. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and are generally mentioned in Exit and Board Meetings. Examiners will usually request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations to assess any changes in risk exposure.
Criticism:	A primary concern that if left uncorrected, the Agencies may consider stronger action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and typically require a written response. They are subject to formal follow-up by examiners.

Last Revised: 06/10/2004 10:24 AM

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #648

OTSWME04-0000004883

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OTS MEMO 5

EXAM FINDING 1	☐ Observation* ☑ Recommendation* ☐ Criticism*
Topic:	Consumer Group Goals
Finding:	The Consumer Group's overall goals do not expressly state a goal with respect to the desired quality of loan originations/acquisitions. We believe that this issue is of sufficient materiality, complexity, and duration that it should be clearly stated as a goal with quantified expectations of those involved in the origination process.
Action:	Establish and quantify a Consumer Group goal with respect to desired asset quality and communicate this expectation to those involved in the production process.
☐ Repeat Finding	Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [9/30/04]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees it is important to have specific goals and targets for portfolio performance. Consumer Group Credit Risk Management has established a target Non-performing Loan/Total Loan ratio of less than 1% as a target performance level. Management needs to communicate this target broadly as part of the overall Consumer Group strategic objectives/goals.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Management will establish, quantify, and communicate a Consumer Group goal with respect to desired asset quality as part of the overall strategic objectives/goals.
   a. Manager Accountable: Mark Hillis, Chief Credit Officer, Consumer Group
   b. Target Date: 9/30/04

OTSWME04-0000004884

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Footnote Exhibits - Page 0304

OTS MEMO 5

EXAM FINDING 2	☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: Metrics used to monitor performance in the loan fulfillment centers.

Finding: There are 16 measures of performance in the Home Loans Production Scorecard (11 for the Correspondent channel). Only one of these, the Optimal Performance Score, measures overall quality. (The Optimum Performance score is obtained quarterly for most LFCs but is not available for the Correspondent channel.) In addition, the measurement of Home Mortgage Disclosure Act (HMDA) performance is not measured by LFC; rather, this is measured only by loan channel. The current performance measurements do not appear to be either sufficiently detailed or sufficiently frequent to effectively monitor and promote desirable loan origination and acquisition quality.

Action: Track performance with sufficient detail and frequency to effect the desired change in underwriting. Ideally, performance measures should be provided monthly and in sufficient detail to trace problems to the specific channel, and LFC.

☐ Repeat Finding Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [9/30/04]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

The Risk Oversight team will work with the Home Loans team, to further refine risk metrics that are used to evaluate and manage: Credit, Compliance and Data Integrity risk elements in conjunction with ongoing process refinements. Management is supportive and has requested continuous feedback to support business execution and risk management activities. The Risk Oversight Group is in process of developing testing capabilities to provide monthly feedback for all LFC's.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Identification of risk metrics will be performed in collaboration with Home Loans.
   a. Manager Accountable: Melissa Martinez, Risk Oversight & Compliance
   b. Target Date: 7/30/04
2. Establishment of risk tolerance and performance standards will be developed in collaboration with Home Loans.
   a. Manager Accountable: Melissa Martinez, Risk Oversight & Compliance
   b. Target Date: 7/30/04
3. Full implementation of revised performance measurement standards will be implemented no later than September 30, 2004.
   a. Manager Accountable: Melissa Martinez, Risk Oversight & Compliance
   b. Target Date: 9/30/04

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OTS MEMO 5

EXAM FINDING 3 ☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: Incentive compensation for loan fulfillment centers

Background:

The incentive compensation plan with respect to managers incorporates four performance measures including: (1) productivity, (2) customer service, (3) management objectives, and (4) quality. This discussion primarily focuses on the quality measure that generally accounts for 20.0 to 40.0 percent of incentive compensation. Within the quality measure, there are four components: (1) HMDA results, (2) Optimum Performance review results [1], (3) RQA review results, and (4) percentage of unsaleable loans. The plan indicates that one or two of these components may be used in determining the quality portion of incentive compensation; however, in practice, only two measures are used: HMDA and Optimum Performance review results. Both components are currently used for each consumer direct, wholesale and retail LFC. As expressed in the plan, the program can generate the following compensation for various levels of achievement in the Optimum Performance reviews.

RPI Category	RPI Score	Minimum Incentive Award as a % of Salary	Maximum Incentive Award as a % of Salary
Unsatisfactory	Below 60%	0%	0%
Unsatisfactory	60% to 69%	1.1%	2.6%
Marginal	70% to 79%	1.3%	3.0%
Satisfactory	80% to 89%	1.5%	3.4%
Commendable	90% to 100%	1.7%	3.8%

The foregoing assumes: (1) the quality portion of the incentive compensation plan ranges from 20% of the total (the minimum incentive assumption) to 40% (the maximum incentive assumption), (2) an Optimum Performance score of 80% equates to achieving 100% of the goal, and (3) two measures are used for quality, HMDA and Optimum Performance score.

In practice, we were informed that some channels use a minimum standard of 70.0 percent for the quality portion of an incentive award, notwithstanding the provisions in the plan. One channel augments the core results with a portion of the Management Objective component of the incentive plan.

Finding: We do not believe that the current incentive compensation program for SFR loan underwriting provides effective incentive to maximize satisfactory or superior loan quality. This results in part from the fact that credit and underwriting quality does not appear to be sufficiently weighted in determining incentive compensation. In addition, the plan allows for significant tailoring by LFC management and is not consistently applied across channels and LFCs. Further, current methodology makes it difficult to trace responsibility and appropriately affect incentive compensation. These findings pertain primarily to the LFC manager position, but are generally applicable to other positions in the LFC.

The Optimum Performance or RPI score is an average of the score for three components: compliance, underwriting, and process. An LFC could perform at an unacceptable level in one component but qualify for an incentive compensation award because performance in the other components is better. (For example, one LFC scored 65 for credit but received an 82 overall and would thus have earned more than 100% of its incentive plan target for quality even though its credit quality performance was unsatisfactory.)

The HMDA quality measure is not available by LFC; instead, the incentive compensation for the LFCs is based on the performance for the entire channel. As a consequence, the LFC managers can influence, but not control, their ability to meet the incentive compensation standard for HMDA quality.

Action: Management should consider enhancing the incentive compensation plan with respect to the loan fulfillment center manager position to more heavily emphasize credit quality concerns. Our recommendations include: (1) Revising the incentive compensation plan to track quality performance using only items that can be measured at the LFC level; (2) Measuring performance based on four criteria: quality of compliance, documentation, underwriting, and data quality, including rate lock quality; (3) Working with the Consumer Risk Oversight Group to obtain performance measures in the four categories; (4) Establishing minimums in each category that reflect an acceptable level of quality, or that temporarily

[1] Optimum Performance results are also referred to internally as a Risk Performance Indicator (RPI) score. This score is determined as a result of file reviews conducted by one of the quality control functions within the Bank (separate from RQA). The score is a composite measure of file review results that assess compliance, processes, and credit quality.

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OTS MEMO 5

EXAM FINDING 3 ☐ Observation* ☑ Recommendation* ☐ Criticism*

accept a lesser level but reward progress toward an acceptable level; (5) Establishing a level and range of reward that provides a meaningful incentive to achieve excellent quality in loan origination and acquisition, and disincentives for poor quality; and (6). Centrally administering or overseeing the quality portion of the incentive compensation to ensure the objectives of the program are being met in all channels and LFCs.

In addition, review the quality aspects of the incentive compensation plans with respect to other positions affecting loan quality and, where appropriate, revise the plans to serve as an effective incentive to improve performance.

☐ Repeat Finding   Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [1/01/05]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Washington Mutual management is in agreement with the recommendations for Exam Finding 3 and will take steps as defined below to comply with actions as stated. Target implementation dates are defined below.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Identify existing credit quality performance measure(s) to be used within the LFC Incentive Plan management plan as part of the management objective component of the plan.
   a. Manager Accountable: Mark Hillis, Consumer Credit Risk Oversight
   b. Target Date: 8/31/04

2. Utilize the management objective component of LFC management plan to focus on credit quality measure (Measure as identified in corrective action #1). This will result in 6.3% of management pay linked to credit quality.
   a. Manager Accountable: John Schleck, Kim Yezbak and Arleen Scavone, LFC Sr. Leaders
   b. Target Date: 10/1/04

3. Increase incentive weight of existing quality measures for LFC management from 25% to 35%. This coupled with corrective action #2 will result in 15% of LFC management pay linked to quality.
   a. Manager Accountable: Peggy Ohlhaver, Consumer Rewards
   b. Target Date: 10/1/04

4. Risk weight the Optimum Performance or RPI components: compliance, underwriting, and process to better reflect impact of achievement.
   a. Manager Accountable: Peggy Ohlhaver, Consumer Rewards
   b. Target Date: 7/1/04

5. Working with Consumer Credit Risk Oversight, establish agreed upon achievement thresholds for existing quality measures within the LFC plan and revise incentive tables.
   a. Manager Accountable: Peggy Ohlhaver, Consumer Rewards
   b. Target Date: 10/1/04

6. Establish strategy for identifying credit quality metric accountability, tracking and incentive link for the four areas identified within the exam findings: quality of compliance, documentation, underwriting and data quality, including rate lock quality.
   a. Manager Accountable: Mark Hillis, Consumer Credit Risk Oversight & Tony Meola, Production (for rate lock quality)
   b. Target Date: 1/1/05

7. Launch study to identify drivers and accountability of quality excellence in loan origination and acquisition and determine appropriate incentive link.
   a. Manager Accountable: Peggy Ohlhaver, Consumer Rewards
   b. Target Date: 7/1/04

8. Centralize oversight of LFC quality metrics to the Consumer Credit Risk Oversight function.
   a. Manager Accountable: Mark Hillis, Consumer Credit Risk Oversight
   b. Target Date: 8/31/04

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OTS MEMO 5

EXAM FINDING 4 ☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: Management Support for the Loan Fulfillment Centers

Finding: LFCs are inundated with changes in loan origination procedures and policies, to the extent that they have difficulty complying with the changes.

Action: Management should provide additional support to the LFCs to help them implement policy and procedure changes as expected. One suggestion is to write model desk procedures for each position in the loan fulfillment centers and to revise these desk procedures concurrently with each notice of a procedural or policy change. When the LFC receives notice of a new policy or procedure, it should also receive a revised desk procedure for each affected position in the LFC. This will improve compliance with standards in the LFC and promote consistency among the LFCs, a stated management expectation. The timeliness and adequacy of training should also be reviewed.

☐ Repeat Finding Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☐ Agree ☑ Partially Agree ☐ Disagree **Enter Target Date: [7/31/04]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Partially Agree: Although we agree that there has been a large amount of changes in policies and procedures and it is difficult at times to comply/keep up with changes, we do feel that change is relative to the nature and the core of our business. In addition, there are several techniques in place to lessen the impact of changes to both LFC management and staff, including following up large impact changes with meetings and training to ensure the changes are communicated to all applicable levels.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Continue to work with Policy Administration to ensure all policies are rolled out with as much notice as possible, and channel managers will ensure that LFC management has input on policy changes as needed.
   a. Manager Accountable: Arleen Scavone, John Schleck, Kim Yezbak
   b. Target Date: 7/31/04

2. Utilize Loan Fulfillment Center management facilitate twice daily/weekly team meetings to review and train on new policies and procedures.
   a. Manager Accountable: Arleen Scavone, John Schleck, Kim Yezbak
   b. Target Date: 7/31/04

3. Continue to issue HLPAs developed by the Policy Administration group weekly (each Friday) with a two week implementation window prior to effective date of a change.
   a. Manager Accountable: Arleen Scavone, John Schleck, Kim Yezbak
   b. Target Date: 7/31/04

4. Utilize channel management communication avenues to refresh and re-enforce policy communications on a monthly basis.
   a. Manager Accountable: Arleen Scavone, John Schleck, Kim Yezbak
   b. Target Date: 7/31/04

OTSWME04-0000004888

Footnote Exhibits - Page 0308

Washington Mutual

WMB
March 15, 2004
Safety & Soundness Examination
FDIC-DFI MEMO 3

DATE: May 20, 2004
TO: Mark Hillis, Deputy Chief Credit Officer
Tony Meola, EVP, Production
FROM: Trina Dong, FDIC and Erin Burr, DFI
SUBJECT: Single Family Residential Review
CC:

BACKGROUND INFORMATION

FDIC and State examiners reviewed a sample selection of 220 loans during this examination, primarily loans originated in 2003: 75 brokered loans, 65 loans originated in house, 20 subprime/niche loans, 20 low doc, 20 custom construction, 10 residential lot loans, and 10 advantage 90/high LTV loans. **The loan file review reflected inconsistencies in underwriting and documentation practices, particularly in the brokered channel. Additionally, examiners noted that Washington Mutual's SFR portfolio has an elevated level of risk due to a significant volume of potential negative amortization loans, high delinquency and exception rates, and a substantial volume of loans with higher risk characteristics, such as low FICO scores** (see Joint Memo #8).

EXAM FINDINGS DEFINITIONS

Observation: A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.

Recommendation: A secondary concern for which immediate corrective action is left to management's discretion. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and are generally mentioned in Exit and Board Meetings. Examiners will usually request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations to assess any changes in risk exposure.

Criticism: A primary concern that if left uncorrected, the Agencies may consider stronger action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and typically require a written response. They are subject to formal follow-up by examiners.

EXAM FINDING 1 ☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: Inconsistent Underwriting and Documentation Practices

Finding: The loan file review of WMB's portfolio revealed the following inconsistencies.

- A substantial number of loans (17 of 75 brokered loans, 9 of 65 originated in house, and 8 of 20 low doc loans) granted to borrowers with derogatory credit ratings or with higher risk characteristics were graded a "0" or "prime." The assigned credit classification is inconsistent with the bank's policy and credit grading guidelines. As a result, these loans were not accurately priced for risk as loans with 2-4 credit codes (niche loans) which are priced at a premium rate. Additionally, the inconsistency in credit grading resulted in an inaccurate level of loan loss reserve for the niche portfolio.
- The full doc loans in the brokered portfolio (21 of 75 loans reviewed) were not fully documented and did not meet the criteria for appropriate verifications. Missing employment, asset, and income verifications were noted in the review.
- FICO scores were not consistently reported on the Loan Approval Summary Sheet for a majority of the loans reviewed. The underwriting guidelines specify which score to use when multiple credit reports were obtained, but it has not been applied uniformly.
- There is often lack of support for income calculations in the underwriting analysis, especially when multiple credit applications are in the file.
- Some of the title policies for the NegAm loans have the insurance amount of 110% of the original loan

Last Revised: 06/04/2004 3:00 PM

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #649

OTSWME04-0000004889

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FDIC-DFI MEMO 3

EXAM FINDING 1 ☐ Observation* ☑ Recommendation* ☐ Criticism*

balance and some have 100% of the loan amount.

During the examination, management began several initiatives to enhance the credit culture and correct underwriting deficiencies through the implementation of minimum credit standards, Credit Risk Teams, and a proprietary credit scoring model (version 2). However, examiners cannot yet opine on the effectiveness of these initiatives.

Action: Develop a process and system to ensure that underwriting guidelines are consistently applied.

☐ Repeat Finding — Management Response Requested ☑ Yes ☐ No

MANAGEMENT RESPONSE ☑ Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [12/31/04]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the Recommendation. As noted above, Consumer Credit Risk Management, in collaboration with the Consumer Group Production channels, have developed and begun several initiatives to enhance credit culture and correct underwriting deficiencies. In addition, the credit class 2-4 program has been eliminated effectively Q3 '04. This coupled with Credit Risk Team (CRT) monitoring, training, and control should also add to the improvement of these processes and overall quality. Please Note: FICO score discrepancies are predominantly caused by inefficiencies in our loan origination systems which cause loans to be manually boarded and may, in some cases, result in a new credit score to be drawn which could conflict with the score used at origination and underwriting.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. MINIMUM CREDIT STANDARDS PROJECT: Consumer Credit Risk Management implemented the new Minimum Credit Standards, which supplements the existing underwriting process for loans that receive a WaMu AUS-Refer. These Standards include a FICO/LTV-CLTV Matrix that determines which underwriting path a loan will follow. Loans falling below the matrix that may present an unacceptable level of risk will be quickly passed on to a credit approver with the appropriate level of authority and experience to explore all options prior to a decision being rendered. All AUS-Referred loans, however, will be reviewed in accordance with manual underwriting credit guidelines, regardless of the FICO score. This policy is currently in effect and applies to all loan applications or loan submissions made on or after April 1, 2004.

2. CREDIT RISK TEAMS (CRTs): These teams of senior underwriters who are managed outside the fulfillment operation are being deployed in all Loan Fulfillment Centers (LFCs). Four pilot sites have been operating since May 17 and CRTs will be operational in all LFCs by July 31 and fully implemented by the end of the third quarter. These teams in addition to handling more complex and high risk transactions will also monitor the performance of all credit approvers in the centers. A new Residential Lending Authority Policy and Performance Improvement Plan will be introduced in June and all credit grantors will be re-certified by year end. **Responsible Manager: Barry Wolfgram, Consumer Credit Risk Management. Target Date: 12/31/2004**

3. PROPRIETARY CREDIT SCORING MODEL (version 2): The Enterprise Modeling and Decision Systems group is currently redeveloping the Home Loans Proprietary Model (PM2). The PM2 is expected to be significantly more robust in risk prediction than the Transitional Proprietary Model (TPM) that is currently in place and will be much more reliant on credit file information than its predecessors. The development is based on WaMu's new credit file attribute superset, which consists of approximately 490 different credit attributes in addition to the added incremental predictivity of application attributes, loan purpose, and other significant characteristics. The PM2 is scheduled to be completed in 3rd quarter 2004.

   As a result, enhanced services should be able to be offered more confidently to lower-risk borrowers, improving service and pull-through rates for more desirable risk profiles. At the higher risk end of the spectrum, more accurate identification of risky loans and associated automation to achieve "quicker no's" on these loans will assist in fewer opportunities for errors associated with manual processes. **Responsible Manager: Tim Bates, Corporate Credit Risk Management. Target Date: 9/30/2004**

OTSWME04-0000004890

Footnote Exhibits - Page 0310

FDIC-DFI MEMO 3

EXAM FINDING 2 ☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: Underwriting for Low Documentation Loans

Finding: The bank's underwriting guidelines indicate that the low doc loan program is designed to expedite processing of low risk loans. **Eight of the 20 low doc loans reviewed were to borrowers with credit scores lower than 660 who had major derogatory ratings or current past due problems listed on their credit reports. Granting loans to these borrowers would appear contrary to the low risk characteristics.** Additionally, no compensating factors were noted in the underwriting analysis when approving such loans.

Limited income or employment verification within this loan program was also noted, as verification is not required for low doc loans according to the bank's underwriting guidelines. The applicants may qualify using stated income and verify their own employment. However, such guidelines appear contradictory to the low risk criteria.

Action: Reevaluate the documentation and underwriting guidelines and establish acceptable credit quality and underwriting parameters for the low doc loan program that are consistent with the low risk characteristics.

☐ **Repeat Finding** **Management Response Requested** ☑ **Yes** ☐ **No**

MANAGEMENT RESPONSE ☑ **Agree** ☐ **Partially Agree** ☐ **Disagree** **Enter Target Date: [12/31/04]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the Recommendation. In order to further drive credit quality consistency and acceptable level of risks on Low Doc transactions we will monitor their performance and reevaluate the documentation and underwriting guidelines and establish acceptable credit quality and underwriting parameters for the Low Doc Loan Program that are consistent with the low risk characteristics.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Thus far all of our analyses conclude that Low Doc loans significantly outperform Full Doc loans. This is also seen when comparing the other Low Doc qualifying criteria (CLTV, DTI, etc.). These loans are sent through our predictive models (LPRM) which show these to have lower loss expectations. Overall NPL rate from Low Doc loans with FICOs less than 660 is 1.00% compared to Full Docs with FICOs less than 660 which have a rate of 1.64%. The Credit Information and Analytics team will continue to monitor these through regular audit reports that screen for high risk Low Doc loans. The results will then be communicated to National Underwriting for review and to implement necessary corrective actions. **Responsible Manager: Alan Newstead, Consumer Credit Risk Management. Target Date: 09/30/04**

2. National Underwriting will use these reports to evaluate, control, and improve the underwriting process for Low Doc loans. Consumer Credit Policy will review and revise the applicable sections of the Conventional Underwriting Guideline, the Home Loans Online Lending Manual, and the Product and Pricing Guide to ensure all areas of evaluating the applicant are addressed. Also included in this review will be the overall credit review process, income and asset analysis, and the documenting of the risk decision. In addition, the sections regarding Verbal Verifications of Employment will be reviewed to ensure that they provide clear and concise direction when verbally verifying self employed applicants, as well as those borrowers with unusual income sources.

   Following the review and necessary revision, National Underwriting will drive the operational execution with the new Credit Risk Teams (CRTs) who will oversee and monitor the implementation of the new policy and training. **Responsible Manager: Barry Wolfgram, Consumer Credit Risk Management. Target Date: 12/31/04**

OTSWME04-0000004891

Footnote Exhibits - Page 0311

FDIC-DFI MEMO 3

EXAM FINDING 3	☑ Observation*	☐ Recommendation*	☐ Criticism*

Topic: Risk in SFR Portfolio

Finding: **Our review, as well as that of Corporate Credit Review identified that Washington Mutual's held-for-investment SFR portfolio has an above average risk profile: higher delinquencies and exception rates, 69% of WMI's SFR portfolio has the potential to negatively amortize; and 17% of WMI's SFR portfolio, or 135% of Tier 1 Capital, reflects current FICO scores less than 620.**

WMB's SFR loans with the potential NegAm feature represent 96% of the Option ARM loans or 74% of the SFR portfolio in 2003, an increase from 88% of the Option ARM loans or 38% of the SFR portfolio in 2002. These loans increase credit risk in a rising interest rate environment due to borrowers' uncertain ability to service a higher monthly payment, a potential increase in principal balance, and potential LTV concerns. The September 2003 internal analysis concluded that NegAm loans make up a significantly larger proportion of loans in the lower FICO bands, have higher delinquencies, and higher current LTVs than the loans in the rest of the portfolio.

WMI's loans with FICO scores less than 620 totaled approximately $19 billion, or 135% of WMI's Tier 1 Capital. Loans in this category show a higher delinquency rate compared to the rest of the portfolio. Of the $19 billion, approximately $1.98 billion is currently more than 30 days past due, which represents 85% of the $2.33 billion delinquent loans for the entire SFR portfolio.

The June 2003 Credit Review Report concluded that the level of Washington Mutual's non-performing loans is considered high and the probability of improvement in overall performance is not likely. Additionally, the review identified excessive error rates in documentation.

Action: Monitor the effectiveness of management's new initiatives: the establishment of minimum credit standards, formation of Credit Risk Teams, and launching of a new proprietary credit scoring model. Measure the underwriting quality that results from the above initiatives and take corrective action if necessary to enhance the process.

☐ Repeat Finding — Management Response Requested ☐ Yes ☑ No

MANAGEMENT RESPONSE	☑ Agree	☐ Partially Agree	☐ Disagree	Enter Target Date: [N/A]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees with the Observation and is carefully monitoring the progress and effectiveness of the noted initiatives. As discussed in the Management Response for Finding 1, the establishment of Minimum Credit Standards, the formation and implementation of the Credit Risk Teams, and the launch of the new proprietary credit scoring model are currently in progress and should result in overall underwriting quality improvements.

Regarding the SFR loans with the potential NegAm feature, the Credit Information and Analytics group currently runs stress testing for NegAm and potential NegAm loans. The greatest risk to the organization is not a rising rate environment, but a declining housing price environment. The multiple stress tests that are performed, however, indicate that while the losses could be much greater than what we currently are experiencing, our loan loss reserve is adequate to cover those possible losses.

For the proportion of the total HFI population mentioned with FICOs less than 620, about $1 billion (or 5%) were originated by acquired institutions and about $3 billion (or 15%) have LTVs less than 60 percent. A small amount of the acquired is less than 60 CLTV (about $127 million). Thus, of the population:

- 4% Acquired and >60 LTV
- 14% Not Acquired and < 60 LTV
- 1% Acquired and <60 LTV

Please note that the establishment of the Minimum Credit Standards will sharply reduce the highest risk tail, in addition to assisting in the improvement of underwriting quality, as will the elimination of credit classification codes 2-4.

With regard to the section of the June Credit Review Report stating that the probability of improvement is not likely; the reference is misleading. Without the changes to the front-end, CRT implementation and active portfolio management

OTSWME04-0000004892

Footnote Exhibits - Page 0312
FDIC-DFI MEMO 3

EXAM FINDING 3	☑ Observation* ☐ Recommendation* ☐ Criticism*

(loan sales), this would be true. There has been significant improvement in default servicing management and oversight. In early 2004, Consumer Credit Risk Management began working with the Default Servicing group to focus on improving and reducing the outstanding balance of Non-Performing Loans (NPLs). The reduction in NPLs has been principally achieved with the quarterly sale of Non-Performing and Sub-Performing loans; this is not the long-term strategy for managing NPLs. The Default Collections team has implemented a focused calling campaign on the asset portfolio. Delinquent loans are called on by the fifth business day of the month, the right party contact rate is improving, and we are seeing deeper penetration within the portfolio. Performance is monitored and measured each month with a comparison to prior year's performance. Considerable improvement has shown in the following areas with an overall reduction in delinquency:

- Cure Ratio of 4+ Payment DQ – As of April 2004 Cure Rate was 12.2% in comparison to the average cure rate of 6.3% in 2003.
- 3 – 4 Payment Roll Rates - The level of loans rolling from 3 to 4 payments delinquent was 41.4% in April 2004 in comparison to the 2003 average of 55.1%.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

As stated in Finding 1, the following are the corrective actions as they relate to Minimum Credit Standards Project, Credit Risk Teams, and proprietary credit scoring model (version 2):

1. MINIMUM CREDIT STANDARDS: This policy is currently in effect and applies to all loan applications or loan submissions made on or after April 1, 2004.

2. CREDIT RISK TEAMS: Four pilot sites have been operating since May 17 and additional expansion to more sites will take place through June 14. CRTs will be operational in all fulfillment centers by the end of July and fully implemented by the end of the third quarter. A new Residential Lending Authority Policy and Performance Improvement Plan will be introduced in June and all credit grantors will be re-certified by year end. **Responsible Manager: Barry Wolfgram, Consumer Credit Risk Management. Target Date: 12/31/2004**

3. PROPRIETARY CREDIT SCORING MODEL (version 2): The Enterprise Modeling and Decision Systems group is currently redeveloping the Home Loans Proprietary Model (PM2). **Responsible Manager: Tim Bates, Corporate Credit Risk Management. Target Date: 9/30/2004**

OTSWME04-0000004893

Footnote Exhibits - Page 0313

WASHINGTON MUTUAL BANK FA/FSB
OTS# 08551 & 11905
March 15, 2004

Date: 5/04
Prepared By: OTS/FDIC DFI
Reviewed By:
Index #: 202a 4

SFR ORIGINATION MEMOS
OTS 5, FDIC/DFI 3

OTSWME04-0000004894

WaMu

This presentation was posted to BoardVantage on March 18, 2008, and replaces and supplants all prior versions.

Summary of Management's Action to Address OTS Concerns

March 11, 2008

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #686

Footnote Exhibits - Page 0315

[redacted]

OTS Concerns:

- Rapidly increasing levels of Nonperforming and Classified assets.
- Potentially Insufficient ALLL

WaMu Response:

- In recent quarters, we have been provisioning at twice the rate of charge-offs and anticipate doing so as necessary to ensure an adequate ALLL. This is resulting in a significant build-up of ALLL.
- Project Olympic anticipates either strategic options or a $3 to $4 billion increase in capital during early 2Q08, resulting in capital levels sufficient to absorb expected provisioning and losses during 2008/2009.

Footnote Exhibits - Page 0316

[redacted]

OTS Concerns:

- Substantial loan loss provisions caused earnings losses in 2007 and will result in continued losses in 2008.

WaMu Response:

- Continued actions to reduce expenses
- Project Olympic anticipates $3 to $4 billion increase in capital during early 2Q08. An increase in capital permits Company to remain above well-capitalized even with earning losses during 2008 and 2009.
- Expected return to profitability in 2009 with adequate provisions in place.

3/19/2008 Internal Use Only 3

Confidential Treatment Requested by JPMC

JPM_WM0102232(

573231.114

Footnote Exhibits - Page 0317

[redacted]

OTS Concerns:

- Liquidity has become more stressed due to market disruption, deteriorating financial condition and rating agency downgrades.
- Increasing funding costs and contraction of available funding sources.

WaMu Response:

- Project Olympic anticipates $3 to $4 billion increase in capital during early 2Q08. An increase in capital will strengthen balance sheet for counterparties.
- Active management of balance sheet expected to result in modest balance sheet shrinkage in 2008/2009.
- Temporary dividend reduction until earnings and capital levels recover.
- Collateral initiatives
- Stress tests indicate continued excess liquidity even in face of 2-notch downgrade from current position.

3/19/2008 Internal Use Only 4

Footnote Exhibits - Page 0318

[redacted]

OTS Concerns:

- Ineffective BSA program due to internally identified weaknesses in several required program elements. OTS issued a Consent Order.
- Need a more disciplined framework for the identification and management of compliance risks.
- Ineffective monitoring processes on Commercial serviced loans resulting in properties with inadequate insurance.

WaMu Response:

- Management is executing a comprehensive program to strengthen the Bank Secrecy Act program and address the Consent Order. Board has been monitoring action plans in response to Matters Requiring Board Attention and Consent Order.
- Corporate Compliance initiated a significant effort to improve the program. On track to meet committed timeframes.
- Management implemented actions to address flood compliance issues and secured appropriate coverage for all inadequately insured loans.

3/19/2008 Internal Use Only 5

Confidential Treatment Requested by JPMC JPM_WM01022326

Footnote Exhibits - Page 0319

Washington Mutual

WMBFA
March 14, 2005
Safety & Soundness Examination
OTS MEMO 4

DATE:	May 20, 2005
TO:	Michelle White, Appraisal and Performance Engineering
FROM:	Bruce Thorvig, Regional Appraiser, OTS
SUBJECT:	Residential Real Estate Appraisal Operations
CC:	Mark Hillis, Chief Credit Officer
	Ken Kroemer, FDIC

BACKGROUND INFORMATION

The primary focus of the review of the Residential Appraisal Department included following-up on prior examination findings, review of one-to four-family residential appraisals and evaluations, appraiser assisted automated valuation model (AAAVM), and policy and procedures. Single-family residential appraisals and evaluations have been reviewed for reasonableness of value and compliance with Uniform Standards of Professional Appraisal Practice (USPAP), Part 564 of the OTS Regulations, and the bank's written appraisal policy and procedures.

Two criticisms have been identified. The first criticism, which is a repeat finding (Exam Finding 3 in Joint Memo #3), addresses the Appraisal Assignment/Engagement Request form, which includes the owner's estimate of market value. The second criticism addresses weaknesses identified in the AAAVM process. During a meeting held on May 10, 2005, appraisal management agreed to delete the owner's estimate of market value from the Appraisal Assignment/Engagement Request form and to address the weaknesses identified in the AAAVM process.

EXAM FINDINGS DEFINITIONS

Observation:	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation:	A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.
Criticism:	A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

FINAL: 06/28/2005 3:37 PM

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #691

Printed: 03/22/2006 5:43 PM

OTSWME06-039 0000214

Footnote Exhibits - Page 0320

OTS MEMO 4

EXAM FINDING 1	☐ Observation	☐ Recommendation	☑ Criticism

Topic: Appraisal Assignment/Engagement Request Form

Finding: The review of single-family appraisals and evaluations noted that numerous Appraisal Assignment/Engagement Request forms continue to provide the appraiser with the owner's estimate of market value. **The owner's estimate of market value should be eliminated from the request form in order to ensure that appraiser independence is not compromised.**

Recent guidance on this issue is included in the "Interagency Statement on Independent Appraisal and Evaluation Functions" dated March 22, 2005. The statement reaffirms, "the information provided by the regulated institution should not unduly influence the appraiser or in any way suggest the property's value." In addition, this issue is addressed in the May 16, 2005, interagency guidance on "Credit Risk Management Guidance for Home Equity Lending." The guidance on collateral evaluation management states that management should "Ensure that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation."

This represents a repeat finding from the prior examination. This matter was an incorrectly closed issue that had not been adequately corrected (Issue 04-SS-0011).

Action: The owner's estimate of market value should be eliminated from the Appraiser Assignment/Engagement Request form. Andy LaPlante, Regulatory & Investor Liaison, indicated at our May 10, 2005, meeting that by May 20, 2005, the owner's estimate of market value would be blocked out on the request form.

We request that Quality Assurance follow up after May 20, 2005, to ensure that Appraiser Assignment/Engagement Request forms actually sent to appraisers no longer provide the owner's estimate of value. Documentation of this follow-up should either be provided to examiners while still on-site or kept available for future examiner review.

☑ **Repeat Finding** **Management Response Requested** ☑ **Yes** ☐ **No**

MANAGEMENT RESPONSE	☑ **Agree**	☐ **Partially Agree**	☐ **Disagree**	**Enter Target Date: [N/A]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees that this issue was incorrectly closed as it had not been adequately corrected as previously committed to. The "Owner's Estimate of Value" field was not removed from the Appraiser Assignment/Engagement request form by the time this issue was initially closed. Management was unable to implement the appropriate OptisValue updates to correct this issue during 2004 due to a mandatory OptisValue systems freeze between June and October, followed almost immediately by the annual, end of year Sarbanes-Oxley (SOX) required systems freeze.

On 5/20/05 the "Owner's Estimate of Value" field was successfully removed from the "Appraisal Assignment" form and is no longer viewable by the appraiser, therefore ensuring the appraiser independence is not compromised going forward.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. The field in question was eliminated on 5/20/05. Documentation demonstrating completion has been provided to examiners. **Responsible Manager: Michelle White, Target Date: N/A**

Footnote Exhibits - Page 0321

OTS MEMO 4

EXAM FINDING 2 ☐ **Observation*** ☐ **Recommendation*** ☑ **Criticism***

Topic: Appraiser Assisted Automated Valuation Model (Desktop Evaluation Report)

Finding: **Our review of appraisals completed using Appraiser Assisted Automated Valuation Models (AAAVMs) or Desktop Evaluation Reports noted significant technical documentation weaknesses in the process.** The AAAVM process needs improvement to address material appraisal documentation deficiencies in order to comply with Uniform Standards of Professional Appraisal Practice (USPAP). In 2004, staff appraisers completed over 44,000 AAAVMs. None of the 18 appraisals sampled were fully USPAP compliant. Of the 11 AAAVMs that may involve value issues, WMBFA responded that 2 represented significant risk, 4 may or may not represent significant risk and the remaining 5 represented no risk.

The quality assurance review of AAAVMs was inadequate. Appraisal management agreed that quality assurance procedures did not include the review of AAAVMs. Reviews by the quality assurance group may have identified the documentation deficiencies noted during the examination.

Action: Management must review the AAAVM process and address the appraisal documentation deficiencies. The Desktop Evaluation Report form will require some modification. Staff appraisers must be provided with additional training on the appraisal development and reporting standards of USPAP. Most importantly, the AAAVM process must be monitored and the quality assurance function must be expanded to include an on-going review of Desktop Evaluation Reports.

During a May 10, 2005, meeting with appraisal management, Michelle White, Appraisal and Performance Engineering, agreed that documentation weaknesses existed and that the appraisal department will address them. Future reviews by the quality assurance teams will include AAAVMs in their review.

☐ **Repeat Finding** **Management Response Requested** ☑ **Yes** ☐ **No**

MANAGEMENT RESPONSE ☑ **Agree** ☐ **Partially Agree** ☐ **Disagree** **Enter Target Date: [3/31/06]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

After additional investigation, management concludes that while not achieving complete compliance with USPAP, none of the AAAVMs sampled posed a significant risk.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. Appraisers will be provided with additional training on the appraisal development and reporting standards of USPAP. **Responsible Manager: Michelle White**
   a. A communication will be issued to all Appraisers completing AAAVMs with instruction to include the source of the definition of market value and the correct, USPAP compliant wording regarding the use of extraordinary assumptions on all AAAVM assignments. **Target Date: 6/30/05**
   b. Develop training material content for all applicable employees on the appraisal development and reporting standards of USPAP, with special emphasis on USPAP as it applies to AAAVM. **Target Date: 7/31/05.**
   c. Rollout training through Breeze; include automated tracking of employee completion. **Target Date: 8/31/05**
   d. All applicable Appraisers will complete this new training by end of October and documentation will be compiled to demonstrate all applicable Appraisers have completed the training. **Target Date: 11/30/05**

2. Residential Appraisal Quality Assurance will be expanded to include a quarterly review of the AAAVM product. **Responsible Manager: Michelle White**
   a. Develop a checklist for the QA review of AAAVMs. **Target Date: 6/30/05**
   b. The first sample of AAAVM appraisals will be pulled for QA review in August. **Target Date: 8/31/05.**
   c. Incorporate AAAVM sampling into standard quarterly sampling query. **Target Date: 10/31/05**
   d. AAAVM sample will be analyzed following the October quarterly sampling query with the results of the QA Analysis published and issued to Appraisal Production by end of year 2005. This ongoing process will continue with a sample of AAAVMs being drawn every quarter thereafter and the results communicated to Appraisal Production within 90 days of quarter's end. **Target Date: 12/31/05**

3. The AAAVM/Desktop Evaluation form will be reviewed and revised for enhanced USPAP compliance. **Responsible Manager: Michelle White**

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OTS MEMO 4

EXAM FINDING 2	☐ Observation* ☐ Recommendation* ☑ Criticism*
a.	Revised form will require appraisers to manually add precise statements regarding 1) the source definition of market value, 2) use of extraordinary assumptions, and 3) the inclusion of thorough analysis and appraisal methods to support the final estimated appraised value within the completed AAAVM assignment (See related item #1 above). **Target Date: 6/30/05**
b.	Development of business requirements for the automated form revision. **Target Date: 9/30/05**
c.	Development of implementation plan with TSG. **Target Date: 01/31/06**
d.	Programming, implementation, and roll out of new form to Appraisers. **Target Date: 3/31/06**

Footnote Exhibits - Page 0323

WMB
March 13, 2006
Safety & Soundness Examination
OTS MEMO 2

DATE: May 23, 2006
TO: Michelle White, Mortgage Appraisal
FROM: Bruce Thorvig, Regional Appraiser, OTS
SUBJECT: Residential Real Estate Appraisal Operations
CC: Hugh Boyle, Chief Credit Officer
Cathy Doperalski, Regulatory Relations
Steve Funaro, FDIC

BACKGROUND INFORMATION

The primary focus of the review of the Mortgage Appraisal Department (Residential Appraisal Oversight, Production and Administration) included following-up on prior examination findings, review of one-to-four-family residential appraisals and evaluations, sample review of Desktop Evaluations (Appraiser Assisted Automated Valuation Model – AAAVM), policy and procedures, and appraiser independence. Samples of single-family residential appraisals and evaluations were reviewed for reasonableness of value and compliance with Uniform Standards of Professional Appraisal Practice (USPAP), Part 564 of the OTS Appraisal Regulations, and the bank's written appraisal policy and procedures.

Appraisal Quality Assurance estimates that WMB performs approximately 60,000 AAAVM services in a typical year. WMB performs these appraisal services using a Desktop Evaluation. The Desktop Evaluation is an appraisal that, when completed by a licensed appraiser, must comply with USPAP standards and OTS appraisal regulations.

One criticism has been identified. While OTS recognizes appraisal management's ongoing improvements to the AAAVM (Desktop Evaluation) process since the prior exam, weaknesses were identified in compliance with USPAP standards and the bank's procedures for using Desktop Evaluations. The examination findings were discussed with Mortgage Appraisal management and Regulatory Relations on May 9, 2006. Appraisal management concurred with OTS findings and agreed to address the identified weaknesses.

EXAM FINDINGS DEFINITIONS

Observation: A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.

Recommendation: A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.

Criticism: A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

EXAM FINDING 1 ☐ Observation ☐ Recommendation ☑ Criticism

Topic: Appraiser Assisted Automated Valuation Model (AAAVM) Services

Finding: Appraisal deficiencies identified included non-compliance with both USPAP standards and the bank's procedures for using Desktop Evaluations. During the prior examination, we also identified significant technical USPAP documentation issues in all Desktop Evaluations sampled.

Although our current review noted that process improvements were made to address our prior examination concerns, the **AAAVM process is still not at a satisfactory level. While value conclusions were generally within a reasonable range of value, none of the currently reviewed Desktop Evaluations**

FINAL: 06/27/2006 2:42 PM
Revised FINAL MEMO

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #694

Printed: 06/29/2006 11:46 AM

OTSWME06-039 0000205

Footnote Exhibits - Page 0324

OTS MEMO S-2

EXAM FINDING 1	☐ Observation	☐ Recommendation	☑ Criticism

were in full technical compliance with USPAP because the Desktop Evaluation forms were revised since the prior examination to a format that is not USPAP compliant.

We believe a fully effective internal control and appraisal quality assurance process would have prevented a noncompliant form from being disseminated to appraisers.

Our review of twenty-five Desktop Evaluations (AAAVMs) identified the following weaknesses:

(1) Inconsistencies were found in the entire sample of 25 desktop evaluations (form content deficiencies) related to identifying the type of appraisal and reporting option (a Desktop Evaluation cannot be both a "Restricted Use Appraisal Report" and a "Summary Appraisal Report"),
(2) Use of a Restricted Use Appraisal Report option for loans greater than $250,000. This report generally does not contain sufficient information to enable the intended users of the appraisal to understand the report properly or contain sufficient information and analysis to support the institution's decision to engage in the transaction,
(3) Appraisers not completing the Desktop Evaluation in compliance with the bank's Desktop Evaluation procedures (also identified by AQA),
(4) Instances of inadequate support for value conclusions or differences between a recent sale of the subject property and the appraised value, (also identified by AQA) and
(5) Four instances of the appraiser not signing the certification page in compliance with USPAP (also identified by AQA).

Action: Management must address the weakness identified and continually review the AAAVM process:

(1) The Desktop Evaluation form will require modification to ensure compliance with USPAP and to clarify which appraisal option (Summary Appraisal Report or Restricted Use Appraisal Report) is being used. Restricted Use Appraisal Reports will generally not be appropriate for a federally related transaction with a loan amount greater than $250,000.
(2) Staff appraisers must be continuously trained and counseled as to the proper use of the Desktop Evaluation to achieve reasonable value conclusions that are supported by an appraisal that complies with all USPAP standards and OTS appraisal regulations.
(3) AQA must continue to evaluate the AAAVM process during their monthly quality assurance review process. Quality Assurance must ensure that Desktop Evaluations meets all USPAP development and reporting requirements (Refer to USPAP Standards 1 and 2 for specific standards). We expect self-identification of documentation and value issues. AQA must also ensure that the appraiser feedback process is effective in reducing documentation exceptions.

We expect the AAAVM process to improve to the point that technical documentation exceptions and deficiencies are reduced to an acceptable level.

☐ Repeat Finding — Management Response Requested ☑ Yes ☐ No

Washington Mutual

MANAGEMENT RESPONSE ☐ Agree ☒ Partially Agree ☐ Disagree **Enter Target Date: [10/31/06]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

Management agrees that the Desktop Evaluation form currently in use is not in full technical compliance with the USPAP standards for a "Restricted Use Appraisal Report" and would require modification to resolve the three (3) noted inconsistent statements within the form, should Washington Mutual choose to continue offering the AAAVM service. Management does not agree that the Restricted Use Appraisal Report is inadequate as it has been used, or do the relatively minor inconsistencies within the form indicate an ineffective internal control or quality assurance process. This is clearly evidenced by the following:

- *The staff-prepared AAAVMs adequately support the lending decisions*: The AAAVM is adequate in those limited circumstances where it was relied upon for lending decisions because reports are completed only by staff appraisers, staff appraiser files are the property of Washington Mutual, and are available for review should any additional information be necessary to support the lending decision. Washington Mutual staff appraisers have completed AAAVM training and are subject to continuous evaluation, training and performance counseling.

Footnote Exhibits - Page 0325

OTS MEMO S-2

EXAM FINDING 1	☐ **Observation**	☐ **Recommendation**	☑ **Criticism**

- *Self identification of errors*: With the exception of the form inconsistency, all deficiencies noted by the OTS in the individual Appraisal Reports had already been identified by Washington Mutual's internal quality control process. Additionally, both the Internal Quality Assurance and OTS reviews concluded that the AAAVM values were within a reasonable range.
- *Relative risk of the AAAVM product*: In 2005, the AAAVM represented 3.2 percent of all completed appraisal service orders, and is predominately used for transactions at or below $250,000 (the "de minimis"). For March 2006, 90 percent of the AAAVM orders were at or under the de minimis level. Further, the appraisal transition history for 2005 shows that approximately 43 percent of all AAAVM services required an upgrade to a traditional appraisal service in order to close the loan; therefore the AAAVM product had a limited impact on credit decisions as a whole. Given the inefficiency of the product as an alternative appraisal service, its 2006 volume has declined by 50% when compared to 2005 levels.

In the interest of efficiency, Washington Mutual has decided to discontinue the use of the AAAVM Service. It is scheduled to be discontinued, first by the Retail Banking/Consumer Lending area (which uses 99% of the total AAAVM products) in July 2006, then by the entire organization in October 2006.

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1. The use of AAAVMs will be discontinued in the Retail Banking/Consumer Lending division in July 2006. **Responsible Manager: Michelle White, Target Date: [7/31/06]**
2. As of 7/17/06, any AAAVM order to support a lending decision for a loan of $250,000 or more will be modified to an order for a 2055 (exterior inspection). **Responsible Manager: Michelle White, Target Date: [7/17/06]**
3. The AAAVM will be discontinued entirely in October, 2006. **Responsible Manager: Michelle White, Target Date: [10/31/06]**

Footnote Exhibits - Page 0326

Sent: Monday, May 22, 2006 11:06:37 PM

From: Feltgen, Cheryl A.
To: Bull, Sushuma R.
Cc:
Subject: FW: Meeting with the OTS regarding residential appraisal services at Washington Mutual

Forgive me for not copying you. Hope the meetings are going well with the vendor. When. will be ready to have a definitive discussion about our internal org structure?

Cheryl

From: Feltgen, Cheryl A.
Sent: Monday, May 22, 2006 7:35 PM
To: Schneider, David C.; Cathcart, Ron
Cc: White, Michelle; Ludlow, Diane L.; Boyle, Hugh F.; Fierling, Jennifer; Domer, Jake; Zarro, Michael R.; Doperalski, Cathy L.
Subject: Meeting with the OTS regarding residential appraisal services at Washington Mutual

Michelle White and I attended a meeting last week with OTS representatives, Bruce Thorvig (appraisal expert) and Ben Franklin. Bruce had specifically requested the meeting as part of the OTS review now in process to get an update on Project Cornerstone. We provided an update on our current plan to outsource the residential appraisal function to two large national firms, First American and LSI. It was a very positive meeting. Bruce had helpful and appropriate items for us to consider as we take the next steps. He encouraged us to have a contingency backup. He inquired as to how we would select the appraisers for a given region. He emphasized that the appraisal review and quality assurance functions are critical. He encouraged us to have continuous due diligence with the vendors to be certain that they are meeting our service level agreements.

We promised to spend further time with Bruce and others as the details of our plan regarding oversight, controls and service levels are more precisely defined. Bruce's concluding remark was: "How could I not be supportive of your plans? Everyone is outsourcing." There are still many details we appropriately should review with the OTS, but I believe that we have endorsement of our direction.

Not discussed at this specific meeting, but identified during the OTS review of appraisal services, the OTS will likely issue a "criticism" for the new version of the AAAVM form which is not USPAP compliant.

Cheryl

Ms. Cheryl A. Feltgen
Senior Vice President
Chief Risk Officer, Home Loans Division
Washington Mutual
1201 Third Avenue
WMT2026

EXHIBIT
WE-07-010
99

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #700

OTSWMEN-0000020983

Seattle, WA 98101
Phone: 206.377.2336
Fax: 206.490.3437
Email: cheryl.feltgen@wamu.net

OTSWMEN-0000020984

Washington Mutual

Residential Appraisal Department Review
CCVRM: February 2007

Introduction

The Corporate Collateral Valuation Risk Management (CCVRM) department reviewed the structure and operating policies, standards, and guidelines of the Appraisal Business Oversight (ABO) department to identify valuation and compliance risks and familiarize themselves with changes in operations progress on updating policies and procedures. This initial review did not involve comprehensive file reviews or a detailed analysis of existing processing controls. It relied on the stated processes, procedures, and interviews with management and observable trends in appraisal activity.

The areas of concern have not been fully vetted with business line management. They will be the focus of CCVRM department follow-up on the higher risk areas.

Contents

Based on this initial review, there are XXX areas of concern. Embedded within these areas are observations, which are offered to assist with productivity and efficiency:

- Changes in the third-party review processes increased collateral risk dramatically over the last six months.
- Appraisal standards and processes, despite full outsourcing of the function remain undefined.
- Vendor management requirements remain loosely defined
- Sales force influence over the appraisal function is unreasonable and imprudent.
- Appraisal quality reporting, remains closely held information with little in the way of action plans to improve quality or monitor adverse trends.

The primary function of the Appraisal Business Oversight Department is to provide oversight of all appraisal services processed through WaMu's Collateral Management System (CMS), OptisValue, and provided by two national appraisal management companies. Additional vendors are under consideration. Expansion to REO, Servicing appraisal needs is a natural extension of the process. This extension is under discussion.

The Appraisal Business Oversight Department took over complete appraisal operations during the third quarter of 2006, when all management, staff, and coordination functions within the Appraisal Production Department were outsourced through the Cornerstone project. The department's mission started as a "work in progress" with sales focused forces challenging prudent credit risk for control. A large number of the department's practices were not developed and tested in advance, but were created on the fly in response to complaints from loan consultants and channel managers swelled. Further, some current department processes were created or agreed to by the Vendor Management team to assure sales approval, and were not created in the best longer term interests of WaMu.

To the credit of ABO department managers, they appreciate this issue and are working define in actual department processes in writing, and to resolve any conflicts between policies and actual processes. Some of the new processes were instituted by leaders outside of the department, without a full assessment of the risks. The ABO managers will have to work diligently to unwind the damage done and re-establish appropriate controls and processes.

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #703

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ABO has three primary customers and consumers represent an indirect customer these groups often have competing interests.

Sales: Timely completion of low cost appraisal services that facilities rapid credit decisions. Valuations should be reasonable and reliable. Illegitimately, Sales also desires: 1) high valuations and the delivery of values that meet its and the customers' expectations, 2) problematic property characteristics should be ignored to facilitate rapid credit decisions, and 3) appraiser selection to ensure they can influence items 1 and 2.

Underwriting : Expects reasonably credible valuations with specific property characteristics or appraisal content effectively disclosed to prevent underwriting and securitization errors, and improving product selection. Underwriting at WaMu, with the exception of sub-prime lending does not review the appraisal for concerns, unless they are triggered to do so. Effectively calling out these property concerns allows them to be addressed. Legitimately, underwriters may second guess the appraisal and require additional comparables or appraisal services to resolve poor quality appraisals. This can also occur illegitimately, if the underwriter is not qualified to conduct the evaluation.

Credit Risk: Sufficient appraisal quality controls to assure an appropriate risk of repurchase liability, loss severity, and maintenance of WaMu's positive reputation in the secondary market with its associated premium pricing. Illegitimately, credit risk could require excessive risk mitigation controls, or neglect their responsibility to safeguard the bank's capital and shareholder value. Credit risk must strike a balance of control vs. efficient high volume growth.

Consumers : Desire high valuations, but deserve reasonably credible valuations with an accurate presentation of their property's condition. This is important to prevent equity stripping, fraud activity and the decimating of neighborhood property values by illegal flipping and the high foreclosure rates associated with targeted fraud activities. The appraisal is a check against the reasonableness of the negotiated sales price and helps borrowers objectively evaluate their equity position.

You will also see certain words highlighted throughout this report (i.e. organizational chart). Clicking on the highlighted word will link you to an additional supportive document.

We have given each issue a "rating" to identify the magnitude or risk involved in each item.

Level 1 (high risk) – These issues are of the utmost of concern. They involve additional risk to the bank and provide definite indications of compromising safety and soundness.

Level 2 (medium risk) – These issues are of moderate concern, individually. They involve internal policy contradictions and possible appraiser influence issues.

Level 3 (low risk) – These are minor exceptions issues.

Level 4 (observation) – These are business suggestions.

(See full rating definitions within the appendix on page XX.)

Third Party Appraisal Risk Control Process

Current processes to mitigate the risk from third party provided appraisals deliver poor mitigation for the collateral risks entering the loan application process.

- Value cuts and rejections are weakly are clearly below historical trends.
- Contractual requirements for within state licensing of reviewers have been suppressed to meet business Service Level Agreements (SLAs) demands.
- Number of field reviews has fallen to extremely low levels to meet business turn time demands and reduce value cuts or rejections, which also impair origination rates.

This broken process may be contributing to the increasing incidence of mortgage fraud within the bank.

Appraisals from brokers represent one of the highest collateral risks the bank faces because the broker controls the ordering process and can use appraisers who only deliver the values and appraisal content they need to complete the loan request. This circumvents appraiser independence controls that are typically stronger for retail lending production at insured financial institutions.

The Third Party Originated appraisal review process seeks to strike an efficient balance between the costly alternative of 100% desk or field review on all appraisals vs. no review at all. The bank is placed at a disadvantage for obtaining the loan if it delays its approval or cuts the value on the appraisal. The broker will simply take the application elsewhere. The key is an efficient process that flags the appraisals needing more scrutiny and adjusts their values or rejects them out right, allowing the low risk appraisals to flow through for an automatic approval. An efficient system will monitor and minimize through a feedback loop:

- False positives where appraisal approval is slowed down unnecessarily do to an inaccurate risk assessment.
- False negatives where an appraisal is auto approved, but the overvaluation risk is intolerable.

Field reviews are used as the final word to confirm false positive and false negative rates. The level of field reviews, the percentage of value cuts and appraisal rejections is a mark of the health and effectiveness of the third party appraisal control practices, particularly when risk has remained at, or risen slightly from historical levels.

The cost of false positives is typically a lost business opportunity to originate a loan. The cost of a false negative can be increased loan repurchases from investors, fraud events, and eventually higher loss severity. The bank can also jeopardize its reputation by becoming an unwitting facilitator of mortgage fraud and the adverse impacts that practice can have on neighborhoods, typically those that are already economically disadvantaged.

Previously, false positive risk was mitigated with low cost administrative reviews performed typically by local staff appraisers who considered the risk report generated by the screening process. This allowed the false positives to be manually approved quickly increasing response time (4 hours on average). Those, which required additional scrutiny, were sent for a more in-depth review by a local appraiser. Appraisal Field Analysts could assess the risk and needs based on their local knowledge or phone calls to local peer appraisers to 1) assign a desk or field review, 2) reject the appraisal outright, or 3) conduct a review themselves to correct deficiencies depending upon what was expedient and prudent.

The risk presented by the new process can be seen in the dramatic shift in value cuts and rejections. Based on the emerging trends CCVRM conducted small-targeted reviews of the highest risk appraisals to ensure the fraud tools remained effective predictors of risk and assess the extent of overvaluation if any.

The charts on the following page show the trends in collateral risk mitigation efforts. The degree of mitigating value cuts and rejections has fallen considerably.

Footnote Exhibits - Page 0331

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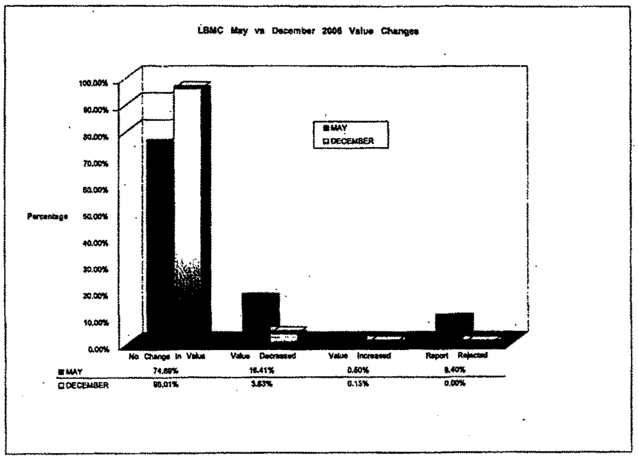
For Long Beach the sub-prime lending operation and the highest risk wholesale channel, the percent by number receiving a value cut or a rejection was 4% in December 2006 vs. 25% in May 2006 before the outsourcing.



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Footnote Exhibits - Page 0332

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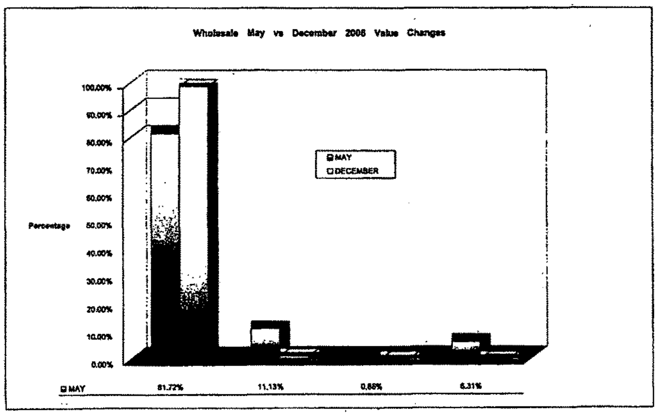
For Wholesale Prime the percentage by number receiving a value cut or rejection decision was 1% vs. 17% for the same period.



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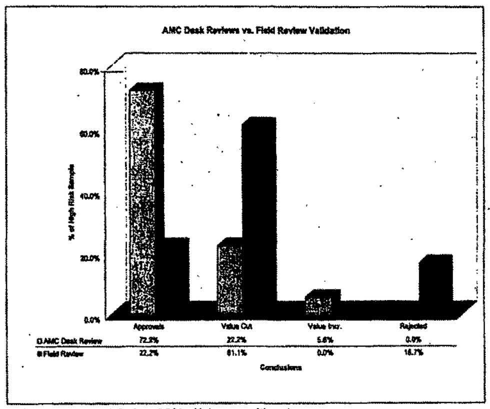
Targeted testing by CCVRM on the highest risk Long Beach appraisals showed the ineffectiveness of the out-of-state desk review process. Two small samples were drawn to investigate the disturbing trends: 1) Eighteen of the highest risk appraisals approved in October 2006 were subjected to field reviews; and 2) 37 randomly selected high risk appraisals with F Score¢â of 11-25 were reviewed by CCVRM appraisal staff.

The field review validation sample was selected to dramatize the risk. It is only reflective of the risk in the higher risk appraisals. The opposing AMC completed 10 of the new field reviews. To keep costs down CCVRM staff local to the markets completed the other eight and the sample was concentrated on the highest risk appraisals from known appraisal fraud areas. Nearly, 78% were scored highest risk by CoreLogic, a "25"; which implies a 47% chance of a 20% overvaluation. This risk level is known prior to assigning the appraisal for review.



The results are highlighted below:

- AMC Desk Review process approved or increased the value of the appraisals 78% of the time.
- Comparatively, field reviews concluded, "approved " for 22% (false positives).
- None of the desk reviews recommended rejection and 17% of field reviews did.
- Value cuts from the field reviews ranged from 12%-50% with an average decrease of 25%.

For the 37 high-risk appraisals, CCVRM reviewers concluded that 78% of the approved appraisals were unacceptable. Comparatively, all but 1 of the 37 appraisals (98%) was approved unchanged by the AMC based review processes.

Fraud rings seek the least controlled environments to operate in. The lack of effective controls will mark the bank as an easier target and escalate the fraud volumes. Regulatory guidance requires prudent assessment and management of the risks present in wholesale mortgage operations.

High-risk appraisal approval orders coming through are a relatively small portion of the population to the population of orders coming through. Those scored 7-25 represent just slightly more than 2% and 8% of requests for wholesale prime and sub-prime (LB), respectively. False positives are less common in the high-risk appraisal scores, but do occur. Case in point the 22% approved above by field reviews, above. The risk profile has remained stable between the 2nd and 4th quarter of the year yet value cuts and rejections have fallen dramatically. This risk profile can be viewed on page X of the appendix.

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Issue 1 Level 1 maintenance of an effective and efficient appraisal review and approval function: Based on the lack of value cuts and rejections, the decline in field reviews and the dramatized risk being allowed through the system, a more effective process needs to be built that balances quick response with prudent controls.

Recommendation : Many different approaches to resolving the risk problem may exist. The ABO team needs to develop a product or process with the vendors to ensure reviews are effective at identifying the risk and rejecting or cutting valuations as appropriate. Success in resolving this issue should be measured by value cuts and rejections meeting or exceeding pre-outsourcing levels. Analysis should include the depth of cuts and the correlation between appraisal risk scores and results. Conclusive assessment will require periodic testing of the rates for false positives and false negatives and the appropriateness of review decisions.

The revised TPO process must address the effectiveness of reviews both desk and field. It needs to ensure appraisers with local expertise, resources are engaged to review moderate or higher risk appraisals, and that these reviews are effective. Local reviews may adversely affect turn time and business origination goals. To mitigate this impact the strategy should involve either

1) Additional risk screening tools that leverage LTV, FICO, Broker rating, an evaluation of the appropriateness of comparable sales or subject sales history;
2) Administrative style reviews from the vendors to route appraisals to desk or field review and pass along areas of concern as necessary; Or
3) A combination of both of these strategies.

The following are the sub-issues to the larger goal of an effective review and approval process for TPO appraisals.

Issue 2 Level 1 An effective risk screening and routing process is needed. A replacement service for the "administrative reviews" was not developed during the cornerstone project. Therefore, all appraisals hitting the risk trigger were routed to desk technical reviews. Out-of-state appraisers typically perform these reviews. Out-of-state appraisers lack geographic competency and local data sources to verify information in the appraisal. Out-of-state appraisers defer heavily to the subject appraiser's work having limited tools or knowledge to question the information.

Recommendation : The administrative review service should be reconsidered as a tool to ensure proper ordering and routing of review assignments. At a minimum, transactions of moderate or high risk should receive desk or field reviews by competent appraisers with sufficient resources to question, evaluate, and re-appraise the subject property as may be necessary.

Issue 3 Level 1 Geographic Competency: ABO suspended the requirement for appraiser geographic competency to ensure business expectations for turn time could be met.

The table to the right shows the volume of out-of-state appraisers completing desk reviews. As the vendors add staff, the percentage is declining, slowly from its high of 95%.

The out-of-state reviewers make extraordinary assumptions that they can rely on the work of the subject appraiser and that they do not have the data sources or local market knowledge to question the appraiser's conclusions. This discredits the review. The dramatic rise in out-of-state reviews coincides with the drop in value cuts and rejections presented earlier. Fees for the reviews remain the standard desk review rates although their scope and effectiveness is significantly reduced. The table that follows presents the trend in out-of-state reviews for TPO and non-TPO appraisals

Standard 3 technical desk reviews are being submitted where the appraiser is not licensed in the state in which the property is located. The appraisers do not have geographic competency to produce these reviews (violation of USPAP ethics provision) and they are attempting to limit the scope of the review below that of a standard 3, thus giving the bank a false level of security.

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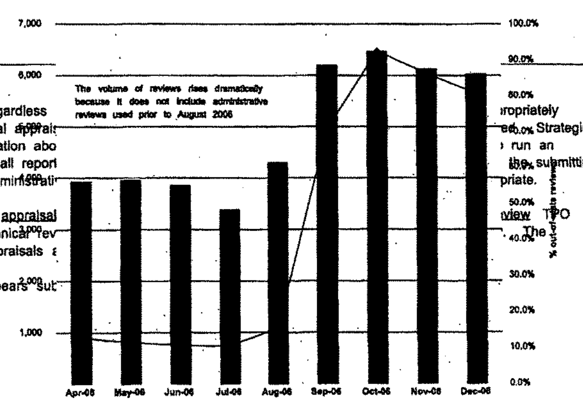
Pre-funding reviews of appraisal services trend in out-of-state reviews



	Apr-06	May-06	Jun-06	Jul-06	Aug-06	Sep-06	Oct-06	Nov-06	Dec-06
DESK REVIEWS	3,923	3,956	3,856	3,381	4,286	6,182	6,467	6,122	6,019
Out of State Desk Reviews	12.7%	11.5%	10.7%	10.5%	15.4%	70.5%	92.5%	86.2%	80.7%

Recommendation : Regardless ... ropriately assigning reviews to local apprai ... ed. Strategies listed in the recommendation abo ... run an additional risk check on all repor ... the submitting appraiser 's license. Administrat ... priate.

Issue X Level TPO appraisal ... view TPO appraisals require a technical rev ... The following volumes of appraisals a

Need data here.—It appears sub

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Issue 4 Level 2 Appraisal risk information is not available to the reviewers. Currently, the appraisal risk scores and reports generated to route the appraisals for review are not passed to the appraisers evaluating the review, nor are they used to route the appraisal beyond ordering a review. To assign reviews to desk or field inspection the vendors do not run their own fraud or risk screens. The reviewers have no insight into the risk already identified by the bank.

The risk screen vendor has resisted training AMC staff in their tool and the information is not passed with the order.

Recommendation : The risk screen information should be shared with the reviewers and operational obstacles between the vendors and the risk screen providers broken down. The bank may be held accountable for knowing of the flaws, yet facilitating the lending transaction anyway. Risk screen information needs to be used proactively to reduce risk.

Issue 5 Level 2 Field reviews occur below historical rates and do not reflect the risk in the transaction. Field reviews are appropriately reserved for the highest risk transactions. For the 2nd Quarter of 2006, field reviews were applied to xx% of the TPO generated appraisals and XX% of these resulted in value cuts or appraisal rejections. For the 4th quarter, less than xx% of TPO generated appraisals receive field reviews and these xxx field reviews have cut values or rejected the appraisal x times or x%.

Appraisal Quality Assurance, or the ABO management team at large, have not adequately addressed the lack of credible results from these reviews. It appears that sales demands to reduce value cuts and rejections and to speed response time have been met at the expense of appraisal quality and collateral valuation risk.

Issue 6 Level 2 Threshold review services should be effective. While the higher risk lies in the reviews of third party appraisals, threshold reviews, similarly suffer from a lack of meaningful mitigation for the risk. High loan amount appraisals from retail or banking channels are not risk scored, but similarly require a meaningful review of the appraisal. The chart above covers reviews conducted for the retail mortgage lending channels for 1st and 2nd lien mortgages.

Recommendation : To the extent possible, the revised review process for third party appraisals should be extended to threshold reviews to make them more effective and meaningful.

According to XXXXXXX, Appraisal Business Oversight (ABO) recognizes this risk. They have been working to create alternatives for the wholesale process. The deficient process has operated since September 2006 with an average monthly flow of around *25,000* appraisal approvals. CCVRM has not reviewed the proposal. Timing of deployment or the effectiveness of the strategy is not vetted with CCVRM.

Issue 8 Level 2 / Level 3 —Depends on results RFTs should be subject to Compliance and TPO like risk assessment : Although a small portion of the completed appraisal orders (3-4%) are reviews for transfer (RFTs), they represent appraisals from third parties, as well. They also carry additional regulatory requirements because they are appraisals performed for others. Formal instructions to vendors on how to address the added RFT compliance considerations have not been issued. RFTs required both a valuation risk assessment and a compliance assessment.

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FIRREA requirements for accepting appraisals prepared for other regulated financial institutions and financial services institution include:

1. the appraiser was directly engaged by the financial service company or regulated financial institution
2. the appraiser has no direct or indirect interest in the property or transaction
3. the existing appraisal remains valid
4. the appraisal conforms to the institution's and regulatory requirements and guidelines

The regulatory commentary suggests that the engagement letter serves as evidence that the appraisal was not ordered directly. WaMu has traditionally used the listing of the client in the certification section of the appraisal to validate direct ordering. WaMu also relies upon the appraiser certifications regarding their interest in the property. Since USPAP will allow a financial interest if the appraiser discloses it, the process for accepting a transferred appraisal should include looking for a statement of interest or no interest in the appraisal. These two practices should continue to be acceptable, especially if heightened risk assessment processes are used.

For compliance purposes the bank should ensure, the RFT is not used by the sales force to directly order an appraisal.

The following are the testing results based on a random 300 Appraisal sample of completed December 2006 RFT services:

Percent with in FIRREA compliance XX%
Ineligible appraisers
Evidence of Direct ordering
Percent with no compliance concerns:

Comparatively the RFT risk profile from HistoryPro and History Pro Review is presented below along side that of Wholesale Prime and Sub-prime appraisals. [remove if not available, by time of publishing.]

	RFTs	Prime	Sub-prime
% Very high risk 11-25			
% High Risk 7-10			
% Moderately High Risk 2-6			
% No hit			
Subtotal Pecent			
Extrapolated Average Monthly volume			

Clearly the RFTs represent less risk than the direct wholesale prime or sub-prime populations, however the risk exists and a rational process to address it should be adapted along side revisions to the existing TPO review process. If an administrative review service is offered or even just a hierarchy of local desk and field reviews, it can increase the response to loan consultants and make their sales efforts more effective on good quality applications.

Recommendation : The same risk tools used for broker provided appraisal should be applied to RFTs. At a minimum, instructions to AMCs and their reviewers should include the FIRREA requirements in specific common language instructions. Periodic testing for direct ordering concerns will need to follow this minimum requirement.

1. ensure Washington Mutual is not listed as the client,
2. ensure that there is no disclosure of a financial interest direct or indirect in the subject property by the appraiser,
3. ensure that the appraisal under review is no older than policy allows (provide actual days per channel credit policy).
4. Confirm the appraisal is not completed by an appraiser on the ineligible appraiser list. (If more than 2-4 are found in sample)

Periodic targeted testing to ensure the RFT was not directly ordered by sales or fulfillment personnel should be conducted. Timing of the reviews should be driven by the risk identified at the last testing and the abnormal rise in RFT use by individual loan consultants. The compliance or FIRREA review requirements do not need to be completed by a credentialed appraiser.

Lastly, RFTs should be considered in the TPO review process and existing tools leveraged to increase the speed to approval and the effectiveness of reviews.

Appraisal standards, guidelines, and processes

Issue 8 Level 2 The residential appraisal manuals and policies have not been updated for the change in appraisal operations. With the transition from a staffed appraisal production department to a completely outsourced operation, the February 2006 Residential Appraisal Manual, located on the Residential Appraisal SharePoint , is outdated. Therefore, currently, there is not a single document defining the roles and responsibilities of ABO and the AMCs. Any procedural changes made today are distributed as "operational guidelines " and go through the same approval process as the CUG and HLPAs. According to Jill Petersen, a new procedures manual is in draft form. Effort on this revision is stalled with the anticipated revised corporate policies, standards and governance process.

Recommendation : Establish new Business Unit Standards & Guidelines to document new processes and requirements. These will facilitate discussions and development of the corporate level policies, standards, and metrics to be used to measure business line adherence to the new policy. It will provide a structure to help the ABO team resist the pressures from the business lines to curb quality standards in favor of short term loan origination gains.

The Business Unit Guidelines should include:

- Appraisal ordering process
- Process for the selection of Appraisal Management Companies and/or individual appraisers
- Validation process for selecting new vendors, due diligence procedures
- Appraiser Trainees' appropriate use
- How geographic competency is assured beyond state licensing
- Guidelines regarding the service level types ordered and changes permitted after the service has been placed with a vendor
- Process for using a prior service
- Statements as to how appraisal fees are handled and monitored
- Guidelines regarding the process for value arbitrations (ROVs)
- Guidelines for reviewing appraisal services not *ordered* by WAMU (RFTs, Wholesale)
- Guidelines for evaluating Vendor performance for Service, Quality, and Process adherence
- Guidelines for appraisal quality assessment (acceptable/unacceptable definitions and examples, sub-criteria for evaluating the appraisal
- Audit process of the following vendor management functions
    - Appraiser Independence
    - Fee changes
    - Service type changes
    - Appraisal product quality
    - Multiple Appraisal Service orders
    - Appraiser competency (geographic, complexity, market value)

Page X of the Appendix contains more detailed recommendations for these areas

Vendor Expectations and Monitoring

A strong vendor oversight process requires clearly defined expectations, monitoring of those expectations and negative consequences for not meeting expectations and as appropriate positive consequences for exceeding expectations. ABO was placed at the mercy of its two vendors at the start of the outsourcing with limited leverage to establish strong, objective criteria. ABO was further embattled internally by vendor relations and strategic sourcing which failed to respect their credit risk authority or expertise in the field. ABO is recovering from the assaults on its authority, and inappropriate demands of sales. Recognizing the difficult position the new department was immediately thrust. The following issues should be addressed to regain its authority and protect the banks asset quality.

Issue 9 Level 1 Vendor quality and procedure expectations are not clearly defined after nearly 6 months of outsourcing, this is in spite of a search for a third or replacement vendor, currently underway.

Examples of minimal expectations include the following:

Quality guidelines

- Reasonable range of valuation cuts and rejections over all and by channel and risk level
- Reasonable range of appraisals submitted in a non-IA ready format.
- Expected level of unacceptable appraisals, 3%
- Expected level of individual appraisal characteristics that are unacceptable, for example:
  - inadequate subject sales price, sales history, or reconciliation, should not exceed 5-10% or
  - inadequate comparable selection or reconcilement with the appraised value should not exceed 10-20%
- Tolerance level for appraisers without geographic competency for the appraisals they complete (FNC monitoring tools needed to establish or at a minimum a list of appraisers and their geographic areas of coverage from the vendors.)
- Tolerance for manufactured homes processed as site built or modular homes
- Tolerance for failure to identify and message ineligible collateral types
- Tolerance for appraisals using trainees and to what extent they may be used.

Procedure expectations

- All appraisals should be locked from editing between appraiser and AMC as well as from AMC to WaMu.
- Ineligible appraisers should be blocked from providing work, tolerable error rate 0.25%
- No inappropriate messages should be passed to appraisers.
- Use of trainees to complete specified portions of the appraisal should be clearly documented
- Expected deviations from contracted fees 1-3% over all orders per month.
- Expected appraisal upgrades.
- Tolerable volume of duplicate appraisal orders for the same loan number and property address
- Tolerable volume for assigning appraisers specifically requested by WaMu sales or fulfillment team to the 0%
- Provision of appraisals in non-AI ready format 2-3%
- Appropriate upgrading of reviews to higher levels based on risk and complexities of the property

Other guidelines specifically associated with the revised processes, message log maintenance, adherence to escalation procedures or any other features that ABO needs to ensure the vendor follows

This high level monitoring of vendor performance is required under Thrift Bulletin 82a. How the monitoring is to be conducted is not specified, it should be effective.

Recommendation : Develop an effective vendor monitoring and management process that balances production, quality and processes.

Issue 1X Level 1 Assigning work to vendors needs to consider SLA performance, Quality, and Process compliance, not merely SLA performance. Assigning work to vendors has been based upon that vendor's SLA performance or turn time, complaints from the loan originators and requests for special arrangements have influenced which vendors are engaged and to whom they assign work. Quality has not been a ranking factor for vendors.

Recommendation : The process needs to be balanced with SLA, quality and meeting procedural expectations. It also needs to be objective, so it can have the best motivational and control power. A matrix approach may provide a good 1-2 page scorecard that can clearly show how the vendor is performing. Formal processes for considering and effecting corrective action for substandard behavior need to be established. Under the old staff and fee panel based system the appraisal department was criticized for measuring and tracking SLA performance, but failing to provide measures of quality. Reports concerning fee changes, appraisal quality and were under development prior to the outsourcing.

Issue 1X Level 1 Fee Exception Controls. OptisValue automatically prompts payment for a specific transaction as soon as the order has been completed. The payment system is automated. Work is delivered and queued for payment. Fees are set based on tables within OptisValue and these are based on the negotiated rates. However, since the outsourcing the vendors have been given the ability to raise their own fees on a transactional level.

The appraisal management companies are free to increase their fees for appraisals without any Bank staff approval. The vendor is required to place a message in the message log to inform the lending office/processing of the change in fee and reason. This provides an opportunity to stop the fee increase at the discretion of lending. It also provides notice to correct the good faith estimate GFE and prep borrower expectations. Invoices are reconciled by a group under Jill Peterson, the appraiser profile team (Teri Jackson). Legitimate reasons for fee increases include:

- Hard to reach property;
- Complex properties;
- Nonstandard addenda required.

Non-standard addenda are such items as a rent schedule, or property operating income statement. These are required for certain loan programs.

The message log/e-mail systems require expensive manual review to extract the reasons for the adjustments. No process is established to extract this information.

The vendors are not subject to set limits on fee exceptions, accptable ranges or expected results. Fee variance and monitoring reports are developed on an adhoc basis. There is no efficient data collection around the reasons for fee increases, if adverse trends with minority groups are economically disadvantaged areas emerged, the investigation of the reasons we would be highly mannual. No validation of the appropriateness of th increase or the reason for it has been noted.

Recommendation : In the short term fee variance reports should be generated by property type, adenda requirements, value ranges, location (state, county, city or zip code) to gain a sense of expected results and set expectations for the vendors. Other legitimate reasons for exceptions may exist and the list should be expanded to capture all scenarios.

Longer term, reasons for fee changes need to be coded within OptisValue to facilitate 1) post completion and payment analsys and 2) automated exception processing and approval by ABO staff for fees outside of the normal or expected ranges. ABO current staffing may not facilitate 100% review of fees changes during processing and still meet the high service levels expected for the allow prompt completion of appraisal services. If this is the case, post completion analysis must be more robust to compensate for the weaker front-end controls.

To the degree the appraisal service fee was charged to the borrower at closing and reimbursed to WaMu, any credits or fees from the vendor to compensate for errors need to be paid to the borrower. Establishing a process to ensure these payments are prompt and accurate is critical to maintaining RESPA compliance.

ABO plans to include fee audits in the Appraisal Quality assessment. Given the limited volume transactions reviewed for quality assessment, this control is an ineffective alternative to more robust post completion monitoring. Targeted testing of a sample of transactions with fee changes may provide a more meaningful result and be consistent with the weaker front end controls.

Issue 1X Level 2 Secure Submission of Appraisers' Work: When an appraisal report is submitted into OptisValue, it is currently running automated critical checks (i.e. a search for missing fields on the appraisal; incorrect form type submitted) and risk checks (business defined rules increasing the risk of the transaction). These checks are based on the ability to accurately capture the data from the submitted appraisal. Both Appraisal Management Companies are currently submitting their appraisal reports in multiple formats (i.e. AI ready vs. .pdf). This does have an adverse affect on the integrity of the data captured, therefore increasing the risk to the Bank, as pdfs go through our OCR (optical character recognition) process, which is not only an added expense for WaMu; however is not as accurate or complete as it is a manual extraction of data with limited fields extracted.

- Appraisals sent into OptisValue from the AMC are in a locked format and cannot be altered; however currently not all appraisals sent to the AMC by the individual appraiser are in a secured format. According to Jill Petersen, ABO has already identified some appraisals that appear to have been altered by the AMC rather than the signing appraiser. Appraisal industry blogs and watch groups have also identified the practice.
- AMCs are submitting their reports in multiple formats, which results in a loss of data integrity and increasing costs.

Recommendation : Require AMCs to submit their appraisal reports in AI format or in another electronic data stream that could capture and analyze all data submitted. If appraisals are provided in non AI format the vendor should be required to update the missing data with an electronic update to OptisValue at their expense. Vendors should be given a tolerance for this behavior and compliance within that tolerance monitored.

Issue 1X Level 4 AMC indemnification was a cornerstone of the outsourcing project. A process for collecting reimbursements for poor quality appraisals in loans that are repurchased and resold, processed through foreclosure and REO loss has not been developed.

Recommendation : A method for acquiring these indemnifications should be developed.

Excessive Sales Force Influence Over Appraisal Production

The prohibitions regarding undue pressure on appraisers and the appraisal management company need to be reiterated through the process to the vendors and the sales force, with violations of independence recorded, tracked and corrected through the managers overseeing those employees. Support from senior channel management, the Chief Risk Officer, and AMC management is needed to communicate a consistent and compliant message. Vendor management and strategic sourcing recommendations should receive review and approved by the Appraisal Business Oversight manager or her designee.

These forces have placed pressure on the ABO staff and they need organizational support to send a message of appropriate behavior and practices.

Issue 1X Level 1 Value shopping and duplicate order processing: Previously, when a duplicate order was placed in OptisValue, the order was halted in an exception queue that was manually researched by the appraisal staff coordination team, resulting in either a manual cancellation of the order or a manual push to process the order. This control minimized the practice of placing multiple orders in attempts to gain higher values. There are legitimate reasons for duplicate orders to be placed however, the control to objectively distinguish theses was eliminated and control over duplicate ordering was granted to lenders and loan processing personnel.

The ordering process now consists of OptisValue running an "existing appraisal" search for all new orders by both property address and loan number. If the system finds any current appraisal service previously completed, the originator/processor is prompted with a pop up message indicating a duplicate order was found including all pertinent information (service type, effective date, value, previous CVR, etc.) After reviewing the previous service, the originator receives three options that they must choose from:

"Accept Existing Order" "Cancel New Order" "Submit New Order"

If "submit new order" is chosen, the order is processed and is automatically assigned to the original AMC, if applicable. Each AMC does run a duplicate screening on their end and if they have concerns as to why a new order was placed; it is the AMC's responsibility to contact Lending with questions. No monitoring or performance indicators are established to assess the vendor's effective management of the process, they are fee to process duplicate orders and receive duplicate payment.

The appraisal order will proceed through an automated path without intervention from ABO. ABO does not police this process during production. Effectively, this allows for an unlimited number of new orders to attain a desired value.

According to Jill Petersen, it appears the number of multiple services being placed is significantly rising. The Risk Analytics Manager is currently running reporting to check the number and type of multiple services that are ordered, along with the outcome.

Recommendation : The revised controls are considerably weaker since they can be abused by the sales force. Robust monitoring is needed to identify value shopping behavior and minimize over valuation risk, particularly in a declining value environment.

1. Assuming staffing to prevent duplicate ordering is not available through the bank, the vendor's behavior must be monitored and evaluated to ensure they overcome their natural incentives to process duplicate orders. Vendor guidelines on this issue need to be established, performance needs to be monitored, and performance outside of tolerance should incur penalties.
2. The full control of ordering now provided to the lenders and loan processing personnel should be curtailed with improved business rules to disallow certain transactions that may be indicative of value shopping and force ABO approval. Examples of orders that raise the most concern include:
   - Ordering of an equal service value, for example a second 2055 exterior or second 1004w/cost interior appraisal. If both are completed two competing CVRs will be issued and there are no

controls to ensure the highest quality appraisal is used. Processors and loan consultants can use their discretion regarding which should be used, selecting the highest value or the CVR with less conditions requiring underwriter review.

- ROV requests on exterior only appraisals should normally be rejected and an order for a higher level appraisal service placed. These decisions should be automated or default to the ABO Vendor Relationship Managers.

- More than 1 completed ROV service. Although not established in policy, the ABO team would like to limit ROV services to 1. Therefore approval to proceed would be a prudent control.

- RFTs ordered after another type of appraisal service was completed. It is suspicious that the appraisal done by another lender would materialize after an internally derived service failed to meet the value expectation.

These orders should trigger closer scrutiny and require ABO approval to proceed. The person placing the order should be informed that the order has exceeded one of these limits and requires ABO approval. It should fall to a queue that is monitored and manually cancelled or pushed to the vendors as appropriate.

Monitoring of multiple orders is challenged by weak controls over the loan numbers provided manually through OptisValue please see related data stewardship concerns.

Issue 1x Level 2 /Level 3 Missed sales price / value cut revisions during processing at the vendors is not efficiently monitored. When a value comes in below sales price or a review cuts the appraised value of the subject property it is reviewed by the vendor business managers. The VBM will review the report with the appraiser and either the appraiser or the VBM will amend the value if appropriate. These activities can occur prior to submission of the final work product in OptisValue. The vendors may have tracking of these interations, but aside from notifying the loan consultant of an issue no record of the discussion is created.

As this process has developed, it is common to see within OptisValue two identical services completed by the same appraiser, one at the original value and one at a revised value. This contributes to the escalation of multiple services. The vendor business managers turn to the appraiser first for corrections, but are licensed appraisers who will issue a technical review to conclude at the purchase price if the value can be reasonably supported.

The E-flash outlining this process was issued by Rich Perry, Mgr-Channel Strategic Support - Retail Production on October 20, 2006 In addition, Sushuma Bull further clarified that the vendor hired business managers would also attempt to resolve value reductions in a similar manner in her October 20, 2006 announcement of the vendors business managers and ABO Vendor Relationship Managers. [To Donnie-pdf of Eflashs for embedding]

Appraisers are provided the sales contract and price negotiated between the two parties. Since, normally this contract is negotiated between a willing buyer and seller and are normally arms length transactions, without contrary evidence and contradictory comparable properties, it would be uncommon for the concluded appraised value to be less than the sales contract price. It can occur and appraisers must feel comfortable turning in objective, substantiated opinions.

Recommendation : To assess the appropriateness of the process and prevent excessive abuse of appraisers monitoring of results is necessary. Training on appropriate behavior and discussions by the VBMs and ABO VRMs need to be instituted to prevent undue influence upon appraisers. Concerns are mitigated by the high caliber of the ABO VRM appraisers and several of the VBMs are former WaMu staff appraisers who were well versed in appropriate and inappropriate behavior. That said training and monitoring remain important to protect WaMu 's reputation and the reliability of appraisal reviews. As Fair Lending seeks to develop a risk assessment for appraisal, monitoring of these interactions will become increasingly important.

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Issue 1x Level 2 /Level 3 Sales personnel are encouraged to contact the vendors to arrange a reassignment of the appraisal to another appraiser. Several HLPA's issued at the start of the outsourcing process recommended that vendors be contacted directly concerning an appraiser reassignment. The reassignment was left to the vendors discretion. These HLPA's were 06-197, 06-249

Recommendation : Appraiser selection by sales personnel is forbidden under regulatory guidance. There are few scenarios where re-assignment is appropriate from sales personnel. 1) a reconsideration of value to isolate the initial appraiser from perceived pressure, 2) Appraiser / borrower relationships that would appear improper or invite unprofessional conflicts. Each case should be rare handling these events through WaMu appraisal business oversight would be ideal. However, if ABO staffing will not support this function vendors must be trained in the appropriate scenarios and courses of action to address these requests and provided a means to track them and report them back to ABO for corrective action with the WaMu lending personnel. The HLPA should be corrected with a broader communication concerning appropriate and inappropriate requests to AMCs and the appraisers.

Issue 1X Level 3 Special instructions passed to appraisers: During the appraisal order process, lending personnel can provide free form text comments regarding how the appraisal should be processed, special contact information, or special loan program requirements for the appraisal. This information is passed to the vendors and may be passed on to the appraisers. LSI has represented that it does not pass the comments along if they are prohibited by regulatory guidance. EAppraiseIT has not offered such screening services. Historically, appraiser pressure has been high through this method of communication, requests for a specific value, requests for a specific appraiser, or now a specific vendor. With the addition of pre-structured comments for the most common legitimate messages the use of the field and the abuse of the field have both fallen. Pressuring comments are now less than 1%.

The vendors also represent that requested appraisers are not considered when assigning the appraisal.

In depth monthly/Quarterly reviews would not be necessary if the vendors agreed to block inappropriate messages as originally planned in the outsourcing project. Then all that would be required is monitoring of the vendors and ensuring they properly screened the comments.

Recommendation : Require all vendors to monitor and block inappropriate information from the special instructions field or any other free form text that may be passed to the vendors through the order system. Conduct at least semi annual targeted testing to verify the vendor's representations. To the degree that prohibited information can be sent to the vendor and used, such as a request for a specific appraiser, semi-annual targeted testing should include verification that such a request disqualified the use of that appraiser and this fact was communicated back to the lender overstepping the bounds.

OTSWMEN-0000000290

Appraisal Quality Reporting

Currently, the QA process has not changed from the way it was managed prior to the outsourcing. Per Jill Petersen, the QA process will be moved under the management of Pam Jarnigan and the procedures, roles and responsibilities will be defined by 2nd quarter 2007. The team is conducting baseline reviews on a limited volume of appraisals and is developing base line samples for wholesale, retail, and technical reviews. Expansion of their review role to cover some process expectations such as fee exceptions, special instructions, and appraisal processing have been under development.

The QA process prior to outsourcing lacked effective reporting and tracking of results, baseline sampling and trends, performance metrics, and accountability for results. It was plagued with adhoc requests and diversions which prevented it from providing a clear and trendable report on appraisal quality. In the interim, the QA team continues to audit for appraisal quality only. The outsourcing function has only increased the importance of quality assurance monitoring and reporting. QA results and monitoring is critical to meeting outsourcing requirements under Thrift Bbulletin 82a.

It is clearly a department in transition and these recommendations are intended to guide its development.

- Appraisal quality assurance reviews exceptions with the vendors, but action plans are not published or available to show proactive identification and remediation of risk.
- A formal sampling plan has not been developed that covers the most significant risk areas. Sampling and testing continue based on low volumes of appraisals and evidence of comprehensive coverage has not been provided.
- No quality reports have been issued to corporate credit and vendor efforts to improve quality are not tracked.
- Vendor expectations and ranking have not been established based on appraisal quality results.
- Additions to the ineligible appraiser list have slowed as the appraisal quality assurance team has been re-building its processes.
- Appraisal quality definitions for acceptable and unacceptable appraisals and review criteria should be formally approved by Corporate Credit Risk. This is similar to how Corporate Credit Review provides minimum standards to the Commercial Chief Risk Officer and the Commercial Business Line.
- These criterial also are not alligned with the activities of the loan review functions in the bank an effort to align these criteria

The pre-outsourcing definitions are attached in the appendix for reference on page x

Issue 1X Level 1 Currently, QA procedures specifically relating to the new business model and working with Appraisal Management companies have not yet been defined.

Recommendation: A Quality Control Plan needs to be developed, along with specific audit/review procedures, which would include the plan for onsite audits of the vendors.

Level 2 Quality Assurance reports through Jill Petersen, who has 4 relationship managers also reporting to her. While the volume of transactions these relationship managers sheppard through to completion should be low, they are the escalated transactions, presumably containing the highest collateral risk. Relationship managers are empowered to change values and complete appraisal services as needed. The quality assurance team reports to Jim Dillon and Pam Jarnigan and would have occasion to report on the adequacy of the relationship manager's work.

In addition, the ABO team is significantly vested in maintaining sufficient vendor capacity to meet business SLA requirements. This focus can create bias to create or enforce quality standards. It places the entire ABO team in a conflict of interest, one that can be overcome with established vendor quality and performance expectations and monitoring of these metrics.

Recommendation: ABO and the Chief Risk Officer should review its reporting structure and look to align the appraisal review expertise with other review function units giving them a degree of separation from appraisal production. If appraisal quality assurance is retained within ABO, it should at least report to a manager that does not oversee production.

However, currently, there are limited managerial choices for switching the reporting structure to be more independent. In addition, needed changes are being planned and executed under Jill Petersen's direction these changes may be critical to producing the reporting and transparency into appraisal quality. The conflict should be recognized and tempered with additional controls, oversight, or re-assignment of production oriented ABO personnel.

Issue 1X Level 4 Criteria for reporting is inconsistent with the Credit Risk Oversight Events (Corporate Credit Review (CCR). See a sample of criteria in the appendix on page x.

Recommendation : These should be aligned to facilitate broader publication of results and a clear understanding of the appraisal quality trends. It would help alleviate misconceptions from the other review groups and communicate efforts to improve the problems observed by the other review groups.

Washington Mutual Residential Appraisal Department Review
CCVRM: February 2007

HERE Starts what has not yet been moved to the new headings above.

Residential Appraisal Department Overview

The primary function of the Appraisal Business Oversight Department is to provide oversight of all appraisal services processed through WaMu's Collateral Management System (CMS), OptisValue, and provided by two national appraisal management companies.

The Appraisal Business Oversight Department took over complete appraisal operations during the third quarter of 2006, when all management, staff, and coordination functions within the Appraisal Production Department were outsourced through the Cornerstone project. However, for a full understanding on the department, it is critical to appreciate that the mission of the department started as a "work in progress" and continues largely with that legacy at present. But that is meant that a large number of the departments practices weren't developed and tested in advance, but were created on the fly in response to complaints from lenders as to the issues related to the outsource plan. Further, some current department processes were created or agreed to by the Vendor Management group to assure customer approval, and were not created in the best interests of the profession.

To the credit of ABO department managers, they appreciate this issue and are working to define in writing department processes, and to resolve any conflicts between policies and actual processes. Nevertheless, this will take some time and quite a diligent effort. Consequently, the actual performance of the department cannot be compared to written policies, since so many items will have to be addressed in arrears now that leaders outside the department have already instituted them, sometimes. Any ABO analysis should therefore be considered a "work in progress," given the situation.

The ABO department includes a total of 30 employees. Based on an organization chart dated 11/01/06, the employee breakdown is as follows:

- 1 Senior Manager Appraisal Oversight
  - 1 Business Ops Analyst
- 1 Manager Appraisal Operations
  - 4 Relationship Managers
  - 2 Credit Policy Specialists
  - 2 Credit Policy Analysts.
  - 1 Manager Credit Operations Strategy
    - 7 Appraiser Review Analysts
  - Manager of Credit Policy
- 1 Manager Credit Operations Strategy
  - 1 Credit Ops Strategy Analyst
  - 1 Business Data Analyst
- 1 Manager of Technology
  - 1 Credit Ops Strategy Analyst
  - 1 Credit Systems Manager
    - 1 Business Data Analyst
    - 2 Technology Analysts

1 Manager of Risk Analytics

Summary of Concerns

OLD LIST

- As stated early is this report, ABO is a group operating as a start-up unit, but from a distinct disadvantage. That is, they did not actively manage the transition process from internal staff to Vendors. This management was mainly done by the Vendor Management group, often without documentation, nor with any consideration of appraisal quality or professional requirements. The motivation of Vendor Management was solely "noise reduction" for concerns of lenders during the transition. Now, ABO is in the process of backtracking to try to document what they had little involvement with. Unfortunately, any changes at this point would not be supported by lending since they would be viewed as hindering the speed of the process. Therefore, ABO operates in a very informal environment with few document able processes, and less oversight of the vendors.

- **Issue Level 1**
  - Correspondent lending, SMF, and the REO/Loss Mitigation department are not following the residential ordering process via OptisValue.
  - It appears the number of multiple services being placed is raising, significantly. According to Jill Petersen, Lending is really pushing on completing a new appraisal in search of a higher value vs. ordering an ROV with the AMCs.
  - Standard 3 technical desk reviews are being submitted where the appraiser is not licensed in the state in which the property is located.
  - CoreLogic 's report/recommendation is being transmitted from OptisValue to the AMC; however, the AMC is not passing this information along to their individual assigned appraiser. Therefore, CoreLogic is not fully being utilized and those high-risk transactions that indicate a field review is necessary are not taken into consideration when determining the level of review being completed.
- **Issue Level 2**
  - The current Residential Appraisal Manual is outdated and has not been updated since the outsourcing project. Therefore, there is not a single document defining the roles and responsibilities of ABO and the AMC.
  - The Quality Assurance Employees, along with the four production related Relationship Managers, are all reporting to the same individual.
  - Without specific guidelines for fee increases, the Bank is not ensuring compliance with Fair Lending issues. There is no check in place to ensure what is being requested/reason for increase is what actually matches the characteristics of the submitted appraisal.
  - Currently not all appraisals sent to the AMC by the individual appraiser are in a secured format and could potentially be altered.
  - ABO is currently not completing any upfront-added checks on reports submitted by trainees.
  - There is a lack of geographic competency in the standard 3 desk reviews being completed today. Reviews are being performed outside of the reviewer's typical service area, many of which are completed by an out-of-state appraiser, not actually licensed in that area
  - Currently, QA procedures specifically relating to the new business model and working with Appraisal Management companies have not yet been defined.
- **Issue Level 3**
  - The current ABO work structure does not align with HR guidelines stating Manager Titles should have a minimum of four direct reports. There is a very uneven balance of direct reports within their structure.
  - Although assigning of all appraisal orders is an automated process, it is based on a manually set up profile within OptisValue.
  - Lending does still have the ability to enter free form text and request a specific appraiser for a transaction, risking appraiser independence.
  - The responsibility of all fee increases and due date extensions is that of the AMC providing the service.
  - AMCs are submitting their reports in multiple formats, which results in a loss of data integrity and increasing OCR costs.
  - ABO is not auditing fees to ensure payment is correct and due to the automated payment system, we have no upfront way of preventing incorrect payments.

Washington Mutual

Residential Appraisal Department Review
CCVRM: February 2007

Review Process

INCOMPLETE, JUST MOVED PROCESS ITEMS
The Corporate Collateral Valuation Risk Management (CCVRM) department was created in early October. At that time, a team was formed within CCVRM to collaborate with ABO. The first task given to this team was to garner knowledge about the ABO division. The goal was to gather information pertaining to:

- ABO organization structure
- ABO policies and procedures
- Operational guidelines
- Appraisal process
- Review guidelines
- Quality Assurance (QA) process

In order to fulfill these tasks, we took a variety of steps including several phone meetings with ABO. We started with an initial conference call on December 11, which included Tom Westerfield, Donnie Gill, and Jill Petersen of ABO. This meeting was used to introduce the new CCVRM department, explain our roles and responsibilities, and begin to gather documentation such as the organizational charts and policies. The second meeting took place by conference call on December 15 and included the same three individuals. The goal of this meeting was to capture the remainder of the process information for the department. The last call took place on January 2 and was between Tom Westerfield and Pam Jarnigan. This meeting was scheduled to garner information around the current and planned changes in the appraisal oversight and quality assurance processes.

Footnote Exhibits - Page 0350

WMB, WMBfsb
January 8, 2007
Safety & Soundness Examination
OTS ASSET QUALITY MEMO 2

DATE:	April 5, 2007
TO:	David Schneider, EVP, President – Home Loans Cheryl Feltgen, SVP, Chief Risk Officer – Home Loans
FROM:	Bruce Thorvig, Regional Appraiser Scott Shambaugh, Examiner
SUBJECT:	Appraisal Operations
CC:	Cathy Doperalski, FVP, Regulatory Relations Tina Tran, Regulatory Relations

BACKGROUND INFORMATION

Office of Thrift Supervision (OTS) appraisal regulations are included in 12 CFR Part 564 – Appraisals. The regulation prescribes minimum standards for the performance of real estate appraisals in connection with federally related transactions under the jurisdiction of the OTS. Appraisals must conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP). In addition, the regulation sets forth the responsibilities of management to develop, implement and maintain appraisal policies to ensure that appraisals reflect professional competence and to facilitate the reporting of estimates of market value upon which the institution may rely on to make lending decisions. Management must develop written appraisal policies that will ensure that adequate appraisals are obtained and proper appraisal procedures are followed consistent with the requirements of part 564.

Appraisal Business Oversight (ABO) is in the process of updating the department's appraisal policy and procedures following the reorganization of the appraisal operations and the final phase of the Appraisal Outsourcing Initiative, which was completed on November 6, 2006. During the interim, ABO has continued to provide documentation to the vendors through various means, including weekly Ops Meetings, on requirements and other WaMu standards that will be incorporated into the Vendor Procedures Manual.

During the examination, twenty appraisals from LBMC and thirty-four appraisals from WaMu Home Loans were reviewed in detail for reasonableness of the value conclusions and compliance with OTS appraisal regulations, USPAP, secondary market appraisal guidelines, and the bank's internal appraisal policies and procedures. We have identified certain areas of the appraisal and review process in need of improvement. Primary appraisal issues (red flags requiring attention by the underwriter or review appraiser) included seller paid closing costs and concession, misstatements/contradictions, inadequate/incomplete explanations and support for the value conclusion, reconciliation of the sales comparison approach, and weakness in the appraisal review process. Two memorandums were provided to ABO management detailing the results or the OTS appraisal review. Findings were discussed with ABO management and regulatory relations on April 4, 2007.

EXAM FINDINGS DEFINITIONS

Observation:	A weakness identified that is not of regulatory concern, but which may improve the bank's operating effectiveness if addressed. *Observations* are made in a consultative role. They may be presented to management either verbally or in writing, but will generally not be included in the Report of Examination. Examiners will rarely request a written response during the examination. *Observations* may or may not be reviewed during subsequent examinations.
Recommendation:	A secondary concern requiring corrective action. A *Recommendation* can become a *Criticism* in future examinations should risk exposure increase significantly or other circumstances warrant. They may be included in the Report of Examination and mentioned in Exit and Board Meetings. Examiners will request a written response from Management during the examination. Management's actions to address *Recommendations* are reviewed at subsequent or follow-up examinations.
Criticism:	A primary concern requiring corrective action. *Criticisms* are often summarized in the "Matters Requiring Board Attention" or "Examination Conclusion and Comments" section of the Report of Examination; warrant increased attention by Senior Management and the Board of Directors; and require a written response. They are subject to formal follow-up by examiners and, if left uncorrected, may result in stronger action.

OTS Final as of April 10, 2007 Printed: 04/23/2007 2:15 PM

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #704

OTSWME07-067 0001082

Footnote Exhibits - Page 0351

EXAM FINDING 1	☐ Observation ☑ Recommendation ☐ Criticism
Topic:	Updating and revision of appraisal policy and procedures
Finding:	Appraisal Business Oversight has not completed updating and revising the operation's appraisal policy and procedures and on-line appraiser guidance following the reorganization of the appraisal operations and the final phase of the Appraisal Outsourcing Initiative.
Action:	Policies, procedures and controls must be updated and revised to ensure that appraisals reflect professional competence and to facilitate the reporting of estimates of market value upon which the institution may rely on to make lending decisions. Management must develop written appraisal policies that will ensure that adequate appraisals are obtained and proper appraisal procedures are followed consistent with the requirements of part 564. The appraisal manual (dated 2/21/06) and other information located on the appraisal website www.wamuappraisal.com should also be updated to reflect current policy and procedures.
	Management Response Requested ☑ Yes ☐ No

WaMu

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree Enter Target Date: [ ]

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.
Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.
Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

Washington Mutual, Inc. – Confidential

OTSWME07-067 0001083

EXAM FINDING 2 ☐ Observation* ☑ Recommendation* ☐ Criticism*

Topic: Appraisal issues (red flags) requiring further attention by the underwriter or review appraiser

Finding: Certain areas of the appraisal and review process are in need of improvement. Primary appraisal issues (red flags requiring further attention by the underwriter or review appraiser) identified included: incomplete analysis or explanation of seller paid closing costs and concessions; misstatements/contradictions regarding property descriptions, market trends, correct selling price of the subject property, property address and taxes, and rental information; inadequate/incomplete explanations and support for the value conclusions, inadequate reconciliation of the sales comparison approach; and weakness in the appraisal review process such as: an inadequate appraisal review checklist for LBMC underwriters, vendor quality assurance not adequately identifying appraisal issues/weaknesses, not elevating an administrative review by underwriters to a higher level of review by an appraiser when appropriate, not obtaining a field review when a review required a value change, and inappropriate geographical selection of review appraisers.

Action: Complete the process of updating and revising the appraisal policy and procedures and develop controls to better ensure that the appraisal and appraisal review process are effective in identifying primary appraisal issues, inadequate/weak appraisals, and unsupported value conclusions. Also, ensure that procedures are implemented to strengthen and improve the appraisal review process of LBMC and WaMu Home Loans in identifying and preventing the noted weaknesses.

Management Response Requested ☑ Yes ☐ No

WaMu

MANAGEMENT RESPONSE ☐ Agree ☐ Partially Agree ☐ Disagree **Enter Target Date: [ ]**

Management Response: Indicate whether you agree, partially agree, or disagree. If you agree, provide an anticipated target date for implementation.

Partially Agree: The response should clearly define that portion of the finding or recommended action disagreed with as well as the portion agreed to.

Disagree: The response should clearly define WHY there is disagreement with the finding or recommended action, and outline any mitigating circumstances or alternative course of action to be pursued.

RESPONSE (succinct response to finding / action)

CORRECTIVE ACTION (provide specific action steps planned, the assigned responsible manager, and target dates for each)

1.
2.
3.

Washington Mutual, Inc. – Confidential

OTSWME07-067 0001084

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

THE PEOPLE OF THE STATE OF NEW YORK by ANDREW M. CUOMO, Attorney General of the State of New York,		
Plaintiff,	:	**COMPLAINT**
-against-	:	Index No.
FIRST AMERICAN CORPORATION and FIRST AMERICAN EAPPRAISEIT,		
Defendants.	:	

1. This action is brought by Plaintiff, the People of the State of New York, by Andrew M. Cuomo, Attorney General of the State of New York ("Attorney General"), based upon the Attorney General's authority under Article 22-A of the General Business Law, Section 63(12) of the Executive Law, and the common law of the State of New York.

2. Plaintiff, complaining of the above-named defendants, alleges upon information and belief as follows.

THE RELEVANT ENTITIES

3. First American Corporation ("First American") is, according to its 2006 annual report, "America's largest provider of business information." It earned $8.5 billion in revenues in 2006. First American operates in five primary business sectors: Title Insurance and Services, Specialty Insurance, Mortgage Information (including real estate appraisal services), Property Information, and Risk Mitigation and Business Services. It does business in New York both directly and through its subsidiaries.

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #707

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4. First American provides real estate appraisal services to savings and loans, banks, and other lending professionals through its wholly owned subsidiary, First American eAppraiseIT ("eAppraiseIT"), an appraisal management company headquartered in California and Massachusetts. eAppraiseIT conducts business and appraises real estate in the state of New York.

5. Washington Mutual, Inc. ("WaMu") is the country's largest savings and loan, with assets totaling $346 billion. In the first three quarters of 2007, WaMu originated $116 billion in residential mortgage loans. WaMu is eAppraiseIT's largest client.

PRELIMINARY STATEMENT

6. In this era of widespread mortgage loan defaults and home foreclosures, the independence and integrity of the real estate appraisers who determine the value of home loan collateral is of enormous importance. Real estate appraisals are intended to provide borrowers and lenders with an independent and accurate assessment of the value of a home. This ensures that a mortgage or home equity loan is not under-collateralized, which in turn protects borrowers from being over-extended financially and lenders and investors from loss of value in a foreclosure proceeding.

7. First American recognizes and touts the central role it plays, through its appraisal management company eAppraiseIT, in protecting homeowners, business customers, and the entire financial market. As First American explains in its 2006 Annual Report:

> Appraisals are used to establish a property's market value; therefore, inaccurate or fraudulent appraisals damage the entire market and have negative economic effects that are far reaching. First American's third-party, unbiased valuations – including insured valuations – are a resource real estate and lending professionals can turn to for accuracy that benefits not only the homeowner and lender, but our nation's

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economy.

> *Value to Consumers*: Homeowners, who place a large investment in their property, can be particularly victimized by appraisal fraud. First American's warranted valuations, which are supported by our third-party perspective and backed by more than a century of integrity, virtually eliminate risk from this type of fraud.
>
> *Value to our Business Customers*: Inaccurately appraised properties that make their way into lender portfolios increase the opportunity for foreclosures. Our national services provide our mortgage lender customers with a welcomed resource for unbiased appraisals that satisfy increased regulatory concerns, help to accurately determine value, and mitigate default risk.

8. Despite these representations, First American and eAppraiseIT have abdicated their role in providing "third-party, unbiased valuations" for eAppraiseIT's largest client, WaMu. Instead, eAppraiseIT improperly allows WaMu's loan production staff to hand-pick appraisers who bring in appraisal values high enough to permit WaMu's loans to close, and improperly permits WaMu to pressure eAppraiseIT appraisers to change appraisal values that are too low to permit loans to close. eAppraiseIT compromises its independence even while publicly touting that independence, and despite myriad warnings from its senior management team about the illegal collusion inherent in the compromises it is making. Instead of preserving its independence, which would have protected consumers and business customers alike, eAppraiseIT chose to protect only itself. And senior executives at First American, though warned by eAppraiseIT's senior management of its compromised independence, nonetheless directed eAppraiseIT to continue its wrongful conduct.

9. This wrongful conduct constitutes a deceptive, fraudulent, and illegal business practice. It violates New York law as well as federal law and regulations.

JURISDICTION

10. The State of New York has an interest in the economic health and well-being of those who reside or transact business within its borders. The State also has an interest in assuring the presence of an honest marketplace in which economic activity is conducted in a competitive manner, without fraud, deception, or collusion, for the benefit of marketplace participants. The State also has an interest in upholding the rule of law generally. The conduct of First American and eAppraiseIT injured these interests.

11. Thus, the State of New York sues in its sovereign and quasi-sovereign capacities, as *parens patriae*, and pursuant to Executive Law § 63(12), General Business Law §§ 349 *et seq.* and New York common law. The State sues to redress injury to the State, and to its general economy and residents, as well as on behalf of: (1) persons who obtained mortgages, home equity loans, or refinanced their homes with WaMu and as to whose homes eAppraiseIT conducted the real estate appraisal; and (2) persons who bought WaMu loans secured by mortgages that were improperly appraised by defendants. The State seeks disgorgement, restitution, damages including costs, and equitable relief with respect to defendants' fraudulent, deceptive, and otherwise unlawful conduct.

FACTUAL ALLEGATIONS

I. <u>The Real Estate Mortgage Industry</u>

A. Background

12. Most people interested in purchasing or refinancing a home ("borrowers") seek a financial institution (a "lender") to lend them money on the most favorable repayment terms available. Traditionally the lender, as part of agreeing to loan the funds, wanted to ensure that the borrower was able to repay the loan and that the loan was adequately collateralized in case

the borrower defaulted. The borrower and the lender had a common interest in accurately valuing the underlying collateral because both wanted to be sure the borrower was not paying too much for the property and would be able to meet the repayment terms, or that – in the event of default and foreclosure – the property value could support the loan.

13. Today, the landscape of the mortgage industry is quite different from this traditional model. Rather than holding the mortgage loans, lenders now regularly sell these mortgages in the financial markets, either directly or to investment banks or Government Sponsored Enterprises ("GSEs"), such as the Federal National Mortgage Association ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac"). The loans are then pooled together, securitized, and sold to the general public as mortgage backed securities. The money that the lender receives for the sale of the mortgage loans or bonds is then used to finance new mortgages, increasing the lender's profits and aiding its stock price. Today, the vast majority of mortgage loans are sold to investment banks or GSEs, leaving the original lender holding far fewer mortgages in its portfolio.

14. This reconfiguration of the way that mortgages are held has transformed the incentives in the industry. Specifically, it has the effect of making the lender less vigilant against risky loans since any risk is quickly transferred to the purchasers of the loans. Moreover, as the lender does not hold many of its loans in its portfolio, the lender's interest in ensuring the accuracy of the appraisal backing the loan is severely diminished. Even worse, because lenders' profits are determined by the quantity of loans they successfully close, and not the quality of those loans, there is an incentive for a lender to pressure appraisers to reach values that will allow the loan to close, whether or not the appraisal accurately reflects the home value.

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15. Further jeopardizing the process, mortgage brokers and the lenders' loan production staff (also known as "loan origination staff") are almost always paid on commission. Thus, the income of these individuals depends on whether a loan closes and on the size of the loan. Accordingly, brokers and loan production staff have strong personal incentives to pressure appraisers to value a home at the maximum possible amount, so that loans will close and generate maximum commissions. For these reasons, mortgage brokers and lenders frequently subject real estate appraisers to intense pressure to change values in appraisal reports.

16. The investment banks and GSEs also have an interest in inflating (or at least in not questioning) the value of the pooled loans. The values of these loans serve as a basis for the value of their securities. As such, the higher the value of the loans closed, the greater the value for which the securities are sold on the secondary market.

17. Thus, the only parties under the current system who want an accurate appraisal are the borrowers and the investors in the asset-backed securities market. Neither of these parties, however, has any contact with, or control over, the appraisal process.

B. Federal and State Laws Require Appraisal Independence

18. Because of the importance of appraisals in the home lending market, state and federal statutes and regulations require that appraisals be accurate and independent. The Uniform Standards of Professional Appraisal Practice ("USPAP") are incorporated into federal and New York law. See 12 C.F.R. § 34.44; 19 NYCRR § 1106.1. USPAP requires appraisers to conduct their appraisals independently: "An appraiser must perform assignments with impartiality, objectivity, and independence, and without accommodation of personal interests. In appraisal practice, an appraiser must not perform as an advocate for any party or issue." USPAP

Ethics Rule (Conduct).

19. Federal law sets independence standards for appraisers involved in federally-regulated transactions. <u>See</u> 12 U.S.C. §§ 3331 *et seq.* The Code of Federal Regulations provides that an in-house or "staff" appraiser at a bank "must be independent of the lending, investment, and collection functions and not involved, except as an appraiser, in the federally related transaction, and have no direct or indirect interest, financial or otherwise, in the property." 12 C.F.R. § 34.45. For appraisers who are independent contractors or "fee" appraisers, the regulation states that "the appraiser shall be engaged directly by the regulated institution or its agent, and have no direct or indirect interest, financial or otherwise, in the property transaction." 12 C.F.R. § 34.45.

20. In 2005, federal regulators including the OTS [Office of Thrift Supervision] published "Frequently Asked Questions on the Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions." With regard to appraisal independence, the document provides:

> 3. *Who should be considered the loan production staff for purposes of achieving appraiser independence? Could loan production staff select an appraiser?*
>
> *Answer:* The loan production staff consists of those responsible for generating loan volume or approving loans, as well as their subordinates. This would include any employee whose compensation is based on loan volume. Employees responsible for the credit administration function or credit risk management are not considered loan production staff. **Loan production staff should not select appraisers.**
>
> * * *
>
> 5. *When selecting residential appraisers, may loan production staff use a revolving pre-approved appraiser list, provided the*

list is not under their control?

Answer: Yes, loan production staff may use a revolving, board-approved list to select a residential appraiser, provided the development and maintenance of the list is not under their control. **Staff responsible for the development and maintenance of the list should be independent of the loan production process. . . . Further, there should be periodic internal review of the appraiser selection process to ensure that appropriate procedures are being followed and that controls exist to ensure independence.** (Emphasis added).

21. New York law incorporates USPAP and requires that a State-certified or State-licensed appraiser may not accept a fee for an appraisal assignment "that is contingent upon the appraiser reporting a predetermined estimate, analysis, or opinion or is contingent upon the opinion, conclusion or valuation reached, or upon the consequences resulting from the appraisal assignment." N.Y. Exec. Law § 160-y; 19 NYCRR § 1106.1.

II. Appraisal Management Companies Create the Appearance of Appraiser Independence

22. In response to these rules and the threat of stricter federal enforcement, in Spring 2006, WaMu attempted to insulate itself by hiring two Appraisal Management Companies ("AMCs") – eAppraiseIT and its top competitor Lender's Service, Inc. ("LSI") – to oversee the appraisal process. These companies provide the appearance of a structural buffer between the banks and the appraisers that eliminates potential pressure or conflicts of interest. In theory, an AMC selects appraisers independently, serves as the appraisers' sole contact, and communicates the unbiased results to the lending institution. In this way, structurally, a lending institution would be much less able to improperly influence an appraisal.

23. eAppraiseIT publicly claims on its website that it provides just such a firewall

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between lenders and appraisers, and that "customers can be assured that Uniform Standards of Professional Appraisal Practice (USPAP) and Financial Institutions Reform Recovery and Enforcement Act (FIRREA) guidelines are followed and that each appraisal is audited for compliance."

III. First American and eAppraiseIT Violate Appraiser Independence Requirements by Permitting WaMu's Loan Origination Staff <u>To Select Appraisers Who Provide Higher Appraised Values</u>

24. Despite their claims of independence from their lender clients, First American and eAppraiseIT violate federal and state independence requirements with regard to appraisals performed for WaMu, and in doing so deceive borrowers and investors who rely on their proclaimed independence.

25. WaMu retained eAppraiseIT in Spring 2006, after WaMu decided to close its internal appraisal office and terminate its staff appraisers. WaMu quickly became eAppraiseIT's largest client, providing nearly 30 percent of its business in New York. Over the course of the business relationship, eAppraiseIT conducted more than 260,000 appraisals for WaMu, receiving over $50 million from WaMu.

26. Initially, eAppraiseIT employed a combination of in-house staff and third-party fee appraisers, including some "preferred appraisers" identified by WaMu, to conduct appraisals of residential property for WaMu. eAppraiseIT also hired approximately 50 former WaMu employees as staff appraisers and Appraisal Business Managers ("ABMs") and – at WaMu's request – gave the ABMs the authority to override and revise the values reached by third-party appraisers. One-third of eAppraiseIT's staff appraisers are former WaMu employees, and all of the ABMs are former WaMu employees. eAppraiseIT's President advised the leadership of First

American that "we have hired and on boarded many of Wamu's regional mangers and appraisers last week. They will be instrumental in our relational and operational success with the sales force."

27. Under contractual arrangements between WaMu and eAppraiseIT, WaMu can challenge an appraiser's conclusions by requesting a "reconsideration of value" ("ROV") when WaMu disagrees with an appraised home value set forth in an appraisal report. Practically speaking, this permits WaMu to ask eAppraiseIT to reconsider and raise the value assigned to a home. Throughout the business relationship, WaMu has frequently ordered ROVs from eAppraiseIT.

28. By email dated September 29, 2006, a WaMu executive wrote to eAppraiseIT's senior executives to define the responsibilities of eAppraiseIT's ABMs as to ROVs and value disputes:

> . . . the four appraisers/reviewers would be directly involved in escalations dealing with: ROVs, Valuation issues where the purchase price and appraised value differ with no reconciliations/justifications by the appraiser, Value cuts which we continue to receive from your third party reviewers (Wholesale), **proactively making a decision to override and correct the third party appraiser's value or reviewer's value cut**, when considered appropriate and supported . . .

In this way, from the outset, WaMu sought to use eAppraiseIT to ensure that appraisals did not come in lower than WaMu wanted.

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A. Summer - Fall 2006: WaMu is Dissatisfied with the Values Provided by eAppraiseIT's Independent Appraisers; First American and eAppraiseIT Try to Satisfy WaMu's Concerns

29. Almost immediately after WaMu retained eAppraiseIT to provide appraisals in early Summer 2006, WaMu's loan production staff began complaining that the appraisal values provided by eAppraiseIT's appraisers were too low. It was clear, and eAppraiseIT well understood, that WaMu's dissatisfaction was largely due to the fact that eAppraiseIT's staff and fee appraisers were not "hitting value," that is, were appraising homes at a value too low to permit loans to close.

30. For example, on August 9, 2006, eAppraiseIT's President told WaMu executives that "We need to address the ROV issue . . . . Many lenders in today's environment . . . have no ROV issue. The value is the value. I don't know if WAMU production will go for that . . . . The Wamu internal staff we are speaking with admonish us to be certain we solve the ROV issue quickly or we will all be in for some pretty rough seas."

31. A week later, on August 15, 2006, eAppraiseIT's Executive Vice President advised eAppraiseIT's President that WaMu's loan officers would often pressure WaMu's internal appraisal field managers for an "extra few thousand," or "tell[] them specifically what they needed," or would "ask for several ROVs on the same property." eAppraiseIT's Executive Vice President explained that "[h]aving loan officers ask for a few thousand dollars because it is within the range is something we do not currently do for any client. . . . It is also direct pressure on the appraiser for a higher value without any additional information."

32. Yet only a month later, on September 14, 2006, eAppraiseIT's Executive Vice President proposed a solution that appeared to capitulate to these demands for an "extra few

thousand": he wrote "it looks like our potential 'raise the value' policy by [an eAppraiseIT manager's] group might help a lot on the small value changes. . . . [W]e are studying allowing [the manager's] group a little flexibility to raise the value 5% with a cap of $50k if it is fully justified."

33. Complaints and pressure from WaMu's loan origination staff were not empty threats. On October 5, 2006, in response to "complaints from the WaMu production team – particularly in Northern California," eAppraiseIT prepared a "WaMu Improvement Implementation Plan." The plan was unsuccessful, however. By December 2006, WaMu had reassigned all of its Northern California appraisal work to LSI.

34. During this period, First American was seeking additional business from WaMu in other areas. But WaMu expressly conditioned giving any future business to First American on success with eAppraiseIT. By email dated September 27, 2006, a First American senior executive advised other senior executives at First American and eAppraiseIT about a conversation he had with the President of WaMu Mortgage about long-term business prospects. The First American executive explained that:

> [WaMu] and I discussed our long-term relationship including the money we have on deposit there and our other current business relationships. I told him we would like to expand those relationships. And in exact terms, we would like one half of their flood business, which they currently give 100% to [Corporation A] and their tax business is divided 3 ways among [3 corporations] and that we would like to take [Corporation A's] tax business.

According to the First American executive, WaMu responded as follows:

> He said that if the appraisal issues are resolved and things are working well he would welcome conversations about expanding our relationship including tax and flood.

Thus, First American knew that WaMu would provide it with new business only if the "appraisal issues" – including WaMu's complaints that eAppraiseIT's appraisers did not provide high enough values – were "resolved."

35. By December 2, 2006, eAppraiseIT noted internally that ". . . we know [WaMu is] going to complain about the excessive number of low values because the majority of orders are not going to [WaMu's] preferred appraisers."

36. On December 18, 2006, one eAppraiseIT executive told others that WaMu had advised him that its criticism was based on the fact that "values are coming in lower with EA [eAppraiseIT]" than with LSI, the competitor appraisal management company that WaMu had also retained to provide appraisals. According to this executive, WaMu maintained that "They also see more Wamu preferred appraisers doing work for LSI and they think that is why they aren't having as many value issues with them. . . . The [WaMu] managers indicated that if the loan consultants had a choice they would prefer to use LSI over eAppraiseIT because they feel they will have less problem with the values."

B. Winter 2007: First American and eAppraiseIT Agree to "Roll Over and Just Do It" and Accept WaMu's Corrupt Proven Appraiser List

37. In February 2007, WaMu directed eAppraiseIT to stop using its usual panels of staff and fee appraisers to perform WaMu appraisals. Instead, WaMu's loan origination staff demanded that eAppraiseIT use a Proven Panel of appraisers selected by the loan origination staff, who were chosen because they provided high values.

38. By email dated February 22, 2007, eAppraiseIT's President explained to senior executives at First American WaMu's motives for demanding the Proven Panel:

> We had a joint call with Wamu and LSI today. The attached document

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> outlines the new appraiser assigning process. In short, we will now assign all Wamu's work to Wamu's "Proven Appraisers" . . . . We will pay their appraisers whatever they demand. **Performance ratings to retain position as a Wamu Proven Appraiser will be based on how many come in on value, negating a need for an ROV.** (Emphasis added).

39. eAppraiseIT's senior management was well aware of the threats to appraiser independence inherent in allowing WaMu's loan production staff to select the appraisers on the Proven Panel based on whether the appraiser "came in on value," and raised these concerns with First American's senior management. eAppraiseIT executives warned of their "concern regarding the proven list" and "concerns about over-valued properties."

40. These concerns were warranted. eAppraiseIT knew that WaMu's Proven Appraiser List would be composed of appraisers who had been hand-picked by the loan origination staff because they brought in high appraisal values. Indeed, when eAppraiseIT received email requests to add particular appraisers to the panel, the email chains often showed that the requests came directly from WaMu's loan origination staff. Further, a WaMu Vice President in the Appraisal Oversight group explained, in an email to eAppraiseIT about an ROV for a "low value," that "This is an example of the issue that has caused sales pushing for a 'proven appraiser' process."

41. In February 2007, eAppraiseIT simply capitulated to WaMu's demands. In an email on February 22, 2007, eAppraiseIT's President told senior executives at First American "we have agreed to roll over and just do it." He explained that "we were willing to live with the change if they would back us up with the appraisers and tell them that simply because they are rated as Gold Preferred does not mean that they can grab all the fees. They agreed." In other words, for the right price in fees, eAppraiseIT was willing to go along with the Proven Panel.

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Indeed, eAppraiseIT's President suggested to WaMu

> that if this the case we should have Wamu write the introduction letters to their appraisers, set the stage and let us do our magic . . . . I assured her the noise from retail will stop . . . . She brought up the fact that Wamu knows this means little money to no money for EA and LSI and they will fix that in the near future. But for now they need to stop the noise or none of us will be around. I believe her.

42. eAppraiseIT agreed to the Proven Panel with full knowledge that WaMu's loan production staff was selecting appraisers that would "hit value" and provide higher appraisals. In an email dated March 1, 2007, eAppraiseIT's President told WaMu executives:

> Recently, we have been notified that Lending would like us to use more of their "Proven Appraisers" versus appraisers off our pre-selected appraiser panel. It seems the amount of Reconsideration of Value (ROV) requests associated with our appraisers far exceeds those initiated when a WaMu proven appraiser completes a file. Said differently, **Wamu proven appraisers bring the value in a greater majority of the time** with minimal involvement of the vendor, sales and Appraisal Oversight. **I am fine with that, of course, and will happily assign Wamu orders to Wamu proven appraisers instead of eAppraiseIT's approved panel appraiser whenever possible.** (Emphasis added).

With this email, eAppraiseIT's President "happily" agreed to compromise the company's independence and violate the laws governing appraiser independence.

43. On March 5, 2007, WaMu confirmed the primary role of its loan origination staff in picking appraisers in a follow-up email, in which it explained that the

> Proven Appraiser List is being created. This will replace the WaMu preferred list. **The initial list of names will be provided by lending** with a minimum of two appraisers per area/county. The list will then be reviewed and approved by the Appraisal Business Oversight Team and will be checked against our most recent ineligible list. Final list will be provided to VMC's [vendor management companies]. Majority of work must be assigned to the appraisers on the Proven Appraiser List on a Priority Basis. (Emphasis added).

44. eAppraiseIT knew that the "review and approval" role of WaMu's Appraisal Oversight team described above was a fig leaf, because WaMu's Appraisal Oversight team deferred to WaMu's loan production staff. For example, in March 2007, upon learning that WaMu's loan production officers were pressuring eAppraiseIT to reach a predetermined value for a particular appraisal, the Appraisal Oversight Vendor Relations Manager told eAppraiseIT to "stop coming to me for approval" and to work the issue out with the lending staff. In other words, WaMu's Appraisal Oversight group provided no oversight at all.

C. Spring 2007: First American and eAppraiseIT Knew That The Proven Appraiser List Was Illegal

45. As it became increasingly apparent to eAppraiseIT that WaMu's loan production staff was hand-picking the appraisers that eAppraiseIT was required to use based on the values the appraisers provided, eAppraiseIT began to consider the legal implications of this arrangement. eAppraiseIT's Executive Vice President analyzed the federal guidelines and regulations on appraiser independence and selection of appraisers by loan production staff, and advised eAppraiseIT's President that "Based on this, I think WAMU's new initiative is way over the line. It is even possible that the current arrangement crosses the line." In response, eAppraiseIT's President wrote: "Bingo!" and explained that since the federal government enforced appraiser independence rules variably in different regions of the United States, and that "it boils down to who has juice with whom at the regulatory level." In response, the Executive Vice President warned "it may be that the OTS [federal Office of Thrift Supervision] is OK with WAMU's current way (maybe) but the new way seems to be quite a stretch."

46. On April 4, 2007, eAppraiseIT's Executive Vice President wrote an email to senior eAppraiseIT executives regarding eAppraiseIT's legal liability for using WaMu's Proven

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List. He explained that appraiser independence is initially

> the lender's responsibility since the OCC [Office of the Comptroller of the Currency]/OTS only pertain to lenders. **However, we as an AMC need to retain our independence from the lender or it will look like collusion. Imagine a simple mortgage broker saying he will give us the work if we use his "proven" appraiser. We say no. This is very similar to that except they are very big. . . .**
>
> So the push back to WAMU needs to be (assuming we want to do this some day), eAppraiseIT needs to choose the appraisers, not WAMU. Where it gets really clear that eAppraiseIT is NOT choosing is the proven idea because they always go first and MUST be selected unless there is a specific reason why not. **eAppraiseIT is clearly being directed who to select. The reasoning that there are fewer ROVs is bogus for many reasons including the most obvious – the proven appraisers bring in the values.**
>
> Fun, eh?? (Emphasis added).

47. Yet, despite this clear articulation of what eAppraiseIT should do, by one of the company's most senior executives, eAppraiseIT did not "push back." It agreed to use the WaMu Proven Appraiser Panel, acceding to WaMu's demands for complete control over the Proven Panel and the reconsideration of value process.

48. On April 17, 2007, eAppraiseIT's President wrote to senior executives at First American, describing the issues with WaMu as follows:

> In short, the issues are using their designated appraisers as mandated by the WaMu production force at 20% gross margin and bypassing our panel. **We view this as a violation of the OCC, OTS, FDIC and USPAP influencing regulation.** (Emphasis added).

49. In support of his conclusion that using the WaMu panel violated federal regulations and USPAP, eAppraiseIT's President attached to his email a memorandum to WaMu that was prepared by eAppraiseIT's Executive Vice President. At the outset of the memorandum, eAppraiseIT summarized the guidelines regarding appraiser independence,

stating:

> The various regulatory boards including OTS, OCC, FDIC and others prepared a list of frequently asked questions on Independent Appraisal and Evaluation Functions on March 21, 2005. These FAQs should be reviewed in conjunction with prior guidelines published in 1994 and 2003. I have included the 2005 FAQs at the end of this document. We assume that you are very familiar with these documents.
>
> We want to focus on appraiser independence. All three documents address and re-address this issue. In the section titled Independence of the Appraisal and Evaluation Function, the 1994 and 2003 document states, "Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institutions's loan production process." This is reinforced in the Selecting Individuals to Perform Appraisals or Evaluations section from the 2003 document. It states that it is important to ensure that the program is safeguarded from internal influence and interference from an institution's loan production staff. Individuals independent from the loan production area should oversee the selection of appraisers and individuals providing evaluation services.

50. eAppraiseIT's memorandum then applied the appraiser independence guidelines to the WaMu Proven Panel and concluded that:

> Based on our conversations we have had with the WAMU oversight as well as the questions and answers initiated by our competitor LSI, **it is our interpretation that the loan production staff has a great deal to do with selecting appraisers. The PAL [Proven Appraiser List] has been selected by the loan production staff and the continued use of these appraisers is being monitored by the loan production staff.** For example, on the LSI question #1 "Does WAMU want to be updated transactionally on every order we can not assign to a PAL?", WAMU's answer is "Yes, we need a short sentence in the message log so that we can monitor, – AND most important - lending can see why you didn't assign to a PAL service provider. Not using a PAL appraiser will be an issue so we need to ensure we've covered our bases as to why they're not utilized." **This appears to be directly in contradiction to the interagency guidelines unless you have a different interpretation.**
>
> * * *
>
> This produces the following challenge – eAppraiseIT is operating

> under what appears to be a mandate from WAMU in utilizing PAL selected appraisers (and this selection is coming from the loan production staff). We are then asked to rep and warrant this work. We are concerned about this arrangement from a risk perspective . . . ." (Emphasis added).

51. As demonstrated by this memorandum, First American and eAppraiseIT knew that complying with the WaMu Proven Panel violated appraiser independence regulations. However, eAppraiseIT did not stop conducting appraisals for WaMu using the tainted Proven Panel. To the contrary, First American's Chief Operating Officer, who sits on First American's Compliance Committee, testified under oath that his reaction to the April 17 email and the attached memorandum was that "I don't recall anything unique about this email."

52. Again, on April 17, 2007, eAppraiseIT's Executive Vice President wrote to eAppraiseIT's President and Chief Operating Officer regarding eAppraiseIT's legal liability:

> OTS and OCC only control lenders. However, there is the legal concern about collusion. For example, let's say it is discovered that a lender (loan officer at a lender) is being collusive with an appraiser that is on OUR (WAMU) panel. That is, our reps and warrants apply. Then we are liable I would say because we have gone along with it. . . .
>
> In addition, I think it will tarnish our reputation in the appraisal community because we are allowing WAMU to pick appraisers based on their loan officers. It makes us look complicit. So [it] may not be actionable legally but would hurt our reputation. So those are two bad things off the cuff. There may be more if we think about it and use creative paranoia.

53. On April 17, 2007, eAppraiseIT emailed its staff appraisers to explain why the staff appraisers had been removed from the WaMu Proven List. In these messages, eAppraiseIT's ABMs acknowledged that WaMu loan origination staff were now choosing the appraisers for their loans:

> I thought I [sic] pass on my thoughts regards the recent message that we all received for [sic] Peter last weekend. I will be glad to tell you what I know. I have been told that the lending folks at Wamu and [sic] were unhappy with the AMC's and felt they were not receiving a good level of appraisal work. They therefore decided to construct their own appraisal panel, now known as the wamu proven panel, and instructed the AMC's to utilize appraisers from this panel whenever possible. The end result is that if you are not on this proven panel it is very unlikely you will receive wamu work.

No independent appraiser could misread this message: if you want to do work for WaMu, you will have to satisfy the "lending folks at Wamu."

54. Even beyond picking the Proven Panel, WaMu's loan officers at times also directly selected specific individual appraisers on the panel to conduct their appraisals. On April 19, 2007, eAppraiseIT's Chief Operating Officer wrote in an email to eAppraiseIT's President and Executive Vice President:

> Evidently, we do get calls/emails from the WaMu Oversight Group to select a specific appraiser for an order. Now, normally, this would not be a concern since the group is separate from [WaMu] lending. However, Vicky [at eAppraiseIT] is also receiving a copy of an email from the LC [WaMu Loan Consultants] to Oversight requesting the appraiser selection – then the subsequent email from Oversight directing the assignment change."

55. By April 2007, WaMu had complete control over eAppraiseIT's appraiser panel. On April 26, 2007, eAppraiseIT's President wrote an email to senior management at First American regarding WaMu. In the email, eAppraiseIT's President discussed the Proven Panel and eAppraiseIT's reputational risk:

> Sales is the driving force behind the Proven Appraiser List (PAL) which is questionable from regulatory perspective. We are required to use these appraisers at 80/20% fee splits. This is dilutive to our P&L. Even with the implementation of such, we are still finding that we are being questioned surrounding what appraiser was assigned the order. **We feel our reputation in the industry is being tarnished by the**

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> **implementation of the Proven List since Production selects the appraiser.** (Emphasis Added).

56. Yet First American and eAppraiseIT continued to comply with WaMu's demands and agreed to use the Proven Panel selected by WaMu loan production staff.

57. On May 11, 2007, eAppraiseIT's Executive Vice President wrote to eAppraiseIT's President that "currently WAMU is controlling the appraiser panel. They are selecting the appraisers and calling them 'proven' appraisers. These appraisers are being chosen by their sales force. First American eAppraiseIT (FA eAppraiseIT) is obligated to use these appraisers." According to eAppraiseIT's Executive Vice President, WaMu was using a Proven Panel because of the "low values" from eAppraiseIT's appraisers.

D. Spring 2007: First American and eAppraiseIT Attempt to Stop Warranting WaMu's Appraisals Because They Know They Have Illegally Compromised Appraiser Independence

58. On April 26, 2007, eAppraiseIT informed WaMu that effective May 1, 2007, it would no longer "be warranting appraisals as performed by the Wamu selected Proven Appraiser List (PAL) appraiser on originations. . . . The new, verbal requirements to utilize Wamu's panelists falls outside the spirit and letter of our agreement as it relates to Warranties. . . ."

59. This was a dramatic departure from eAppraiseIT's regular practices. On its website, eAppraiseIT claims that: "All of First American eAppraiseIT's traditional appraisal products come standard with one of the industry's strongest warranties. Our warranty coverage includes foreclosure loss incurred due to fraud or gross negligence. First American eAppraiseIT's commitment to appraisal quality means our customers don't need to go through the lengthy and difficult process of filing a claim against our Errors and Omissions policy, in the event they suffer a loss due to appraisal error. Of course, the policy is there for that purpose, but

our warranty presents a much simpler way to recover losses due to appraisal fraud or gross negligence."

60. eAppraiseIT threatened to stop warranting WaMu appraisals because eAppraiseIT's management knew that it had compromised its appraiser independence by using the WaMu Proven Appraiser List. eAppraiseIT's Chief Appraiser has testified that the threat to stop warranting was based on the risks inherent with WaMu's choice of such a "limited" panel.

61. eAppraiseIT's senior managers acknowledged these risks internally to one another. As eAppraiseIT's Executive Vice President explained in an email to other members of senior management while discussing a particular reconsideration of value: "The original appraiser was a WAMU proven appraiser coming in $750,000 higher than the eAppraiseIT review appraiser. This is a good example of why we currently have stopped rep and warrants and our concerns about over-valued properties."

62. In response to the above email, eAppraiseIT's Chief Operating Officer wrote that "In addition to this example, we are also seeing what appears to be a higher incidence of Threshold Reviews [mandated for properties worth over $1 million] coming in with a lower value than the original appraisal. I think this supports our concern regarding the proven list."

63. On April 30, 3007, eAppraiseIT's President wrote to his Chief Operating Officer, regarding the warranting of appraisals from WaMu's Proven Panel:

> I have given serious thought to your suggestion on Friday regarding an addendum to section B of the contract striking our quality control efforts and warranty coverage on appraisals performed by an appraiser off the Wamu Proven Appraiser List (PAL). Would you draft something that stipulates this? Again, this new requirement violates the spirit of our agreement where we agreed to aggressively QC and warrant appraisals as performed by our own panel. **Using Loan Officer's favorite appraiser is obviously something we will not**

> **stand behind from a quality and risk perspective.** (Emphasis added).

64. Nevertheless, eAppraiseIT continued to perform appraisals for WaMu, and continued to tout its independence.

65. The New York Attorney General issued a subpoena to First American on May 5, 2007.

66. On May 15, 2007, eAppraiseIT's Chief Operating Officer in an email wrote to eAppraiseIT's President regarding WaMu's Appraisal Oversight group: "I think this proves the point that . . . Oversight continues to buckle when confronted with direct and unrelenting pressure from lending."

67. Although eAppraiseIT repeatedly told First American that WaMu's loan origination staff illegally selected and controlled its Proven Appraiser List and that, in some instances, loan officers were directly selecting specific appraisers, First American instructed eAppraiseIT to continue the business relationship with WaMu. By email dated May 17, 2007, First American's Chief Operating Officer instructed eAppraiseIT's President and Executive Vice President to continue the relationship with WaMu and to "design a model that predominantly leverages their panel but doesn't violate our independence **which is probably easier said than done but there should be a way to figure it out.**" (Emphasis added).

68. On May 29, 2007, eAppraiseIT's Executive Vice President summarized the problems in the eAppraiseIT/WaMu business relationship in a letter to a senior executive at WaMu as follows:

> In the first quarter of 2007, the sales group of WAMU began to insist they choose the appraisers mostly due to their concerns about 'low values.' eAppraiseIT encouraged WAMU to resist these pressures if

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> possible. However, WAMU decided to go with what came to be called the "proven" list of appraisers recommended by sales. . . .
>
> The use of the "proven panel is challenging for eAppraiseIT in two ways: A. Financially – The proven panel is paid a minimal of 20% more than the eAppraiseIT panel. B. Risk Management – the possibility of collusion between the loan officers and appraisers is increased when eAppraiseIT does not control the selection. In addition, eAppraiseIT is concerned with any possible lender pressure or perception of lender pressure when the only way to get on the WAMU "proven" panel is through the loan officer.

69. Despite this articulation of the "possibility of collusion," nothing changed between the parties, except cosmetically, and they continued in this corrupt business relationship. On June 7, 2007, a WaMu executive directed eAppraiseIT to change the name of the Proven List for the following reasons: "Name change from "proven appraiser" and/or use of the moniker "PAL" list is discontinued, under direction of the WaMu legal department. We are utilizing a more generic term acceptable w/in regulatory guidelines and industry standards." The Proven Appraiser Panel was renamed the "WaMu Select" panel, and eAppraiseIT accepted the name change while doing nothing to solve the regulatory violations.

IV. First American and eAppraiseIT Permit WaMu's Loan Origination Staff to Remove Appraisers From the Proven Appraiser Panel and to Improperly Communicate Directly With eAppraiseIT Appraisal Business Managers

70. As discussed above, First American and eAppraiseIT permitted WaMu's loan origination staff to select a Proven Appraiser List of appraisers and to control the Proven Panel. In addition, First American and eAppraiseIT permitted WaMu's loan origination staff to remove appraisers from the Proven Panel on the grounds that such appraisers consistently valued properties lower than WaMu's desired target amount, had a high rate of reconsideration of value requests, or performed desk reviews that reduced another appraiser's value for a given property.

71. In one specific example, in or about December 2006, a particular appraiser ("Appraiser A") was approved to be an appraiser on the Proven Panel. From January 25, 2007 through May 7, 2007, Appraiser A conducted five appraisals for eAppraiseIT with respect to WaMu properties. For each appraisal, WaMu requested a reconsideration of value. In each instance, Appraiser A refused to increase the value.

72. Shortly thereafter, Appraiser A was removed from the Proven List and placed on the WaMu inactive list. He was then told by a WaMu sales assistant that he was removed from the panel because he did not increase values in response to these reconsiderations of value. This same WaMu sales assistant told Appraiser A that many appraisers who had previously been removed from WaMu's list of active appraisers for conducting fraudulent appraisals were being reinstated on WaMu's Proven List in order to help ensure that appraisals would come in at sufficiently high value to permit the loans to close.

73. On May 30, 2007, Appraiser A wrote to eAppraiseIT regarding the WaMu Proven Panel. In the email, Appraiser A wrote that: "We continued to provide this high level of service when eAppraiseIT took over as appraisal management. With no explanation or warning, I was removed from the assignment rotation in mid April of this year. I respectfully ask to be re-instated as an active preferred appraiser."

74. Following receipt of Appraiser A's email, on May 30, 2007, an eAppraiseIT Appraisal Specialist wrote to eAppraiseIT's Executive Vice President, Chief Operating Officer and Chief Appraiser:

> I was working with two good, solid long-time wonderful appraisers in NY and CT until right after the WaMu Proven Panel was formed. They were both removed very soon after for no apparent reason. **We were having value issues, however, I felt their work was very**

> **defendable and supportable, and kept copious notes on our dealings.** They have continued to keep in touch with me, in order to find out why they were removed from the panel. (Emphasis added).

75. On May 31, 2007, eAppraiseIT's Chief Appraiser replied:

> First he was on the Master List so put on WAMU Proven and then as the list went around he was REMOVED. The probability that a loan officer requested him to be removed is pretty high I think because that is what they did with the Master List; they sent it out to Lending to choose.

76. To date, Appraiser A remains off the Proven Panel.

77. Another appraiser ("Appraiser B") conducted hundreds of appraisals for WaMu loans through eAppraiseIT from January 2007 through April 2007. During this period, Appraiser B received 102 Reconsideration of Value requests.

78. On April 3, 2007, in an email Appraiser B wrote to eAppraiseIT the following:

> I WAS JUST MADE AWARE FROM ONE OF YOUR COMPETITORS (LSI) THAT I MAY BE ON A BLOCKED LIST FROM WAMU. THIS MAY HAVE SOMETHING TO DO WITH THIS APPRAISAL IN QUESTION FOR WHICH I THOUGHT WAS BEING TAKEN CARE OF AND IN PROCESS OF BEING RESOLVED. CAN SOMEONE HELP ME OUT HERE AS THIS IS IMPORTANT TO US TO KEEP THE RELATIONSHIP WITH WAMU THROUGH EAPPRAISEIT. WHAT IS GOING ON AND WHAT CAN I DO TO CLEAR THIS FILE UP????? (Capitals in original).

79. A senior appraiser employed by Appraiser B argued to eAppraiseIT that he was removed because WaMu did not like it when he reduced appraisal values after desk reviews. He wrote: "After reviewing appraisals over the past few months, many of which are fraudulent, with inflated unsupported values, it is disturbing that WaMu's focus and concern is misplaced with the review process."

80. To date, Appraiser B is still on the WaMu removed list.

81. Similarly, on April 17, 2007, a third appraiser ("Appraiser C") wrote to eAppraiseIT that:

> This is the second Wamu Appraisal quality assurance issue I have received from Wamu in the past 2 months. Both as a result of an appraisal I completed that did not come in to their predetermined value for a "valued" Wamu client. **I was pressured for 2 weeks to change both my value and the conditions of my appraisal report . . . both of which were violations of USPAP, FANNIE MAE and the Supplemental Standards I am required to observe and am bound by my license to complete.** Since that time, I have been singled out by WaMu and have been pressured on every appraisal I have completed that did not reach a pre-determined value. I feel that Wamu is in process of "blacklisting" me as an approved Wamu appraiser by going after each appraisal I complete and looking for violations." (Emphasis added).

82. Appraiser C wrote this email after having been pressured and harassed to increase values on two appraisals, after WaMu had requested ROVs and she had declined to increase the values. Shortly after her refusal to increase these values, she received two "Unacceptable Appraisal Notifications" from WaMu. After having been harassed and targeted with "unacceptable" strikes, she withdrew from WaMu's panel in order to avoid being removed against her will.

83. Senior executives at eAppraiseIT acknowledged that WaMu was targeting their appraisers. On May 23, 2007, eAppraiseIT's Chief Operating Officer wrote to eAppraiseIT's Executive Vice President that " It was disturbing to find out from [WaMu] that we receive three times the number of strike letters as LSI – and we're getting less volume. This indicates to me that they have targeted our "non-proven" appraisers – and are somewhat biased against EA in their work."

84. Further, eAppraiseIT permitted loan officers at WaMu to communicate directly

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with eAppraiseIT's ABMs and Appraisal Specialists by telephone and email, to discuss appraisal values. Indeed, eAppraiseIT permitted loan officers at WaMu to pressure eAppraiseIT ABMs and Appraisal Specialists about appraisal values even after an initial appraiser has considered a value reconsideration request and refused to change the value.

85. eAppraiseIT permitted these improper practices because WaMu is a large client that demanded the right to have these contacts. And eAppraiseIT's ABMs had the authority to change a final appraisal value only because WaMu had demanded, in September, 2006, that ABMs be permitted to "proactively mak[e] a decision to override and correct the third party appraiser's value or reviewer's value cut."

86. Further, email exchanges between WaMu and eAppraiseIT show that WaMu repeatedly pushed eAppraiseIT's ABMs to increase appraised values so that loans could close. For example, in one exchange with an eAppraiseIT review appraiser, a WaMu loan officer wrote that "Basically, if we don't get at least the appraised value of $3,650,000 . . . we lose the deal." (Ellipses in original). Earlier that day, this loan officer told eAppraiseIT that "if we don't have a definitive $$ appraised value then the borrower will go to another lender with a higher appraised value of $4mm. Please . . . at least . . . keep this value at the original appraised value of $3,650,000." (Ellipses in original).

87. On May 23, 2007, eAppraiseIT's Chief Appraiser described these comments as "a clear picture of Lender Pressure on behalf of WaMu."

88. eAppraiseIT received other communications from WaMu in which WaMu attempted to influence the appraised values of specific properties. For example, on May 24, 2007, eAppraiseIT's Chief Operating Officer wrote to eAppraiseIT's President that: "We have

received in the past, and now most recently with the Sag Harbor event (which incidentally just happens to be a New York property), communications where it could be viewed that EA did experience some level of influence to increase a value beyond that which we concluded in our own analysis was not supported."

89. eAppraiseIT's internal appraisal log entries indicate that its Review Appraisers and ABMs increased property values on appraisal reports after being told by WaMu loan origination staff that such increases would help loans to close. For the period of November 2006 to May 2007, there were 8 desk reviews performed by ABMs and 1 desk review performed by the Appraisal Specialist relating to properties in New York, all of which were for WaMu. The appraised values were increased in each of the 9 desk reviews completed, as follows: from $825,000 to $850,000, $230,000 to $240,000, $415,000 to $420,000, $1,550,000 to $2,270,000, $720,000 to $730,000, $535,000 to $556,000, $580,000 to $587,000, $500,000 to $525,000.

90. This level of contact between WaMu's loan production staff and eAppraiseIT's ABMs is prohibited by USPAP's independence requirements and by state and federal law.

FIRST CAUSE OF ACTION
(Fraudulent or Illegal Business Practices – Executive Law § 63(12))

91. The acts and practices alleged herein constitute conduct proscribed by § 63(12) of the Executive Law, in that defendants engaged in repeated fraudulent or illegal acts or otherwise demonstrated persistent fraud or illegality in the carrying on, conducting on transaction or a business.

SECOND CAUSE OF ACTION
(Deceptive Acts or Practices – General Business Law § 349)

92. The acts and practices alleged herein constitute conduct proscribed by § 349 of

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the General Business Law, in that defendants engaged in repeated deceptive acts or practices in the conduct of its business.

THIRD CAUSE OF ACTION
(Unjust Enrichment)

93. By engaging in the acts and conduct described above, defendants unjustly enriched themselves by receiving payment for independent, accurate, and legal appraisals, but failing to provide such appraisals.

WHEREFORE, plaintiff demands judgment against the defendants as follows:

A. Enjoining and restraining First American and eAppraiseIT, their affiliates, assignees, subsidiaries, successors and transferees, their officers, directors, partners, agents and employees, and all other persons acting or claiming to act on their behalf or in concert with them, from engaging in any conduct, conspiracy, contract, agreement, arrangement or combination, and from adopting or following any practice, plan, program, scheme, artifice or device similar to, or having a purpose and effect similar to, the conduct complained of above.

B. Directing that First American and eAppraiseIT, pursuant to Article 22-A of the General Business Law, § 63(12) of the Executive Law and the common law of the State of New York, disgorge all profits obtained, including fees collected, and pay all restitution, and damages caused, directly or indirectly by the fraudulent and deceptive acts complained of herein;

C. Directing that First American and eAppraiseIT pay plaintiff's costs, including attorneys' fees as provided by law;

D. Directing such other equitable relief as may be necessary to redress First American and eAppraiseIT's violations of New York law; and

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E. Granting such other and further relief as may be just and proper.

Dated: New York, New York
November 1, 2007

ANDREW M. CUOMO
Attorney General of the State of New York
Attorney for Plaintiff
120 Broadway, 25th Floor
New York, New York 10271
(212) 416-6053

By: ______________________________
Nicole Gueron
Deputy Chief Trial Counsel

Of Counsel:
Christopher Mulvihill
Assistant Attorney General

Footnote Exhibits - Page 0384

Chow, Edwin L

From:	Dochow, Darrel W
Sent:	Wednesday, November 07, 2007 11:02 AM
To:	Dochow, Darrel W; Thomas, Randy W; Chomicz, Susan L; Hendriksen, James A; Franklin, Benjamin D; Johnson, Mark W
Cc:	Polakoff, Scott M; Ward, Timothy T; Bowman, John E; Chow, Edwin L; Petrasic, Kevin; Quigley, Lori G; Messett, Brian C
Subject:	RE: Assertion

Hello All:

Given the new news this morning, I believe that OTS needs to open up its own special investigation.

WAMU executives have talked with both Freddie and Fannie today and both GSEs have confirmed they will continue to buy loans from WAMU. The GSEs have also agreed to have a special examiner review the appraisal issue in their conversations with NYAG Cuomo. The GSEs have not seen the subpoena yet.

WAMU started their own special investigation a few days ago when this broke by the special unit under Chief Counsel Faye Chapman using some internal audit staff.

Darrel

From:	Dochow, Darrel W
Sent:	Wednesday, November 07, 2007 7:40 AM
To:	Thomas, Randy W; Chomicz, Susan L; Hendriksen, James A; Franklin, Benjamin D; Johnson, Mark W
Cc:	Polakoff, Scott M; Ward, Timothy T; Bowman, John E; Chow, Edwin L
Subject:	RE: Assertion

Jim Hendriksen, Mark Johnson and Ben Franklin:

The OTS has received a similar allegation as to the one by NYAG Cuomo relating to LSI and WAMU in Arizona. I am thinking that we ask for a formal investigation by the WAMU special investigative unit of this and the NYAG allegations and have the investigation report(s) shared with us and we meet with the investigators. We simultaneously open up a special investigation so that we can interview folks directly etc if necessary. As you recall, the special investigation unit reports to the Chief Counsel and the Board, so independence is good. This is similar to how we have handled some previous situations.

Lets discuss today between meeting breaks

Darrel

From:	Thomas, Randy W
Sent:	Wednesday, November 07, 2007 7:09 AM
To:	Dochow, Darrel W; Chomicz, Susan L
Cc:	Polakoff, Scott M; Ward, Timothy T; Bowman, John E
Subject:	Assertion

Darrel and Susan: Below this introduction, I have cut and pasted from 2 emails that I received yesterday as Ombudsman from an individual who asserts that he has knowledge of "massive mortgage fraud" in connection with appraisals performed on behalf of Wamu. He has consented to me using his name and passing his information on to Supervision and Enforcement. I am expecting to receive at least another email from him with additional details when he returns to his office.

I initially advised him to contact the FBI. He emailed back and said that he has been in contact with the FBI, but there seems to be no action taken and no communication back from the FBI.

I will keep you posted as I receive additional information from him.
Randy

****

1

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #708

OTSWMS07-011 000129

Footnote Exhibits - Page 0385

From:	Polakoff, Scott M
Sent:	Saturday, November 17, 2007 1:22 PM
To:	Reich, John M <reichjm@office of thrift supervision.com>
Subject:	Re: Draft of Proposed Action Plan for Washington Mutual, eAppraiseIT, and LSI Special Examination

John - I'll take a good look at the plan and give you my thoughts. Also, I have learned that the next FFIEC meeting occurs at the same time as our all-managers conference. I haven't seen an agenda for the ffiec meeting yet but the timing is identical to our Gallup briefing. We have been unsuccessful in trying to move Gallup.

Would you like me to represent you at the ffiec? If not, who would you want to accompany you as I need to let the ffiec folks know.

Thanks

Scott

Scott Polakoff

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Reich, John M
To: Polakoff, Scott M
Sent: Fri Nov 16 22:27:53 2007
Subject: Fw: Draft of Proposed Action Plan for Washington Mutual, eAppraiseIT, and LSI Special Examination

Scott,

This appears to be a comprehensive (and impressive) review schedule. It doesn't appear, on the surface anyway, to leverage off of WaMu's own review. Do you think we might be totally reinventing the wheel and possibly taking too long to complete our review?

John

Sent using BlackBerry

----- Original Message -----
From: Chow, Edwin L
To: Polakoff, Scott M; Ward, Timothy T; Bowman, John E; Quigley, Lori G; Chomicz, Susan L
Cc: Reich, John M; Russell, Robert W; Dochow, Darrel W; Johnson, Mark W; Hendriksen, James A; Franklin, Benjamin D; Thorvig, Bruce L; Archibald, Robert D; Henry, David R; Shambaugh, Scott E

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #710

Reich_John-00040045_001

Footnote Exhibits - Page 0386

Sent: Fri Nov 16 19:05:26 2007
Subject: Draft of Proposed Action Plan for Washington Mutual, eAppraiseIT, and LSI Special Examination

Hello everyone,

Darrel asked that we share with you the latest draft of the proposed action plan for the WaMu special examination for your review and input.

We welcome your suggestions and any available staff resources from Washington DC and/or the other regions that may have specialized appraisal expertise. To date, the West has committed Bruce Thorvig (Examiner, MAI Appraiser, and national appraisal expert) and Scott Shambaugh (examiner and former appraiser) to this assignment under the coordination of Assistant Director Mark Johnson , WaMu EIC Ben Franklin, WaMu LPM Bob Archibald, and Regional Enforcement Counsel Jim Hendriksen (who will be in charge of the special 407m investigation and legal/enforcement work). The proposed scope of work in this draft plan is very extensive and we are still in the process of refining it, as well as estimating the additional resources and timeline that will be necessary to complete this work.

On-site work on this special examination began earlier this week at WaMu, and Jim Hendriksen has also started a review of the eAppraiseIT and LSI documents.

Let us know if you have questions or comments.

Thanks, Edwin

<<Appraisal Review Final Draft.doc>>

Reich_John-00040045_002

Footnote Exhibits - Page 0387

OTS ENFORCEMENT
Status of Formal Investigations
(as of 12/15/2008)

Name of Institution	Location	OTS #	Authorized	Prima Facie Case Memorandum	Current Status

Redacted by the Permanent Subcommittee on Investigations

Quigley_Lori-00231631_001

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #716

Footnote Exhibits - Page 0388

Redacted by the
Permanent Subcommittee on Investigations

Washington Mutual Bank	Henderson, NV	08551	11/27/2007 WE-07-010	10/03/2008	Investigation completed; examination focused on the issue of whether thrift personnel improperly exerted pressure or otherwise acted to compromise the independence or results of residential mortgage appraisals provided to the institution by third-party contract appraisal management companies; institution placed into receivership and acquired by JP Morgan Chase on 09/25/2008; draft recommendation memorandum submitted to Deputy Director and Chief Counsel Bowman on 10/03/2008 (recommendation prepared while WAMU was an open institution); meeting held with Chief Counsel Bowman to discuss memorandum; Enforcement attorney Ellett will be setting up meeting with OCC to discuss OTS investigation.

Redacted by the
Permanent Subcommittee on Investigations

Quigley_Lori-00231631_002

Footnote Exhibits - Page 0389

Redacted by the
Permanent Subcommittee on Investigations

Quigley_Lori-00231631_003

Footnote Exhibits - Page 0390

Federal Deposit Insurance Corporation
Division of Supervision and Consumer Protection
San Francisco Regional Office
25 Ecker Street Suite 2300
San Francisco, California 94105
415.546.0160

State of Washington
Department of Financial Institutions
Division of Banks
PO Box 41200
Olympia, Washington 98504-1200
360.902-8704

Board of Directors
Washington Mutual Bank
1201 Third Avenue
Seattle, Washington 98101

Subject: Joint Visitation Dated October 14, 2003

Members of the Board:

We enclose the October 14, 2003, joint visitation report of Washington Mutual Bank. FDIC Examiner Kenneth J. Kroemer and State Examiner John Ransom prepared the visitation report. The purpose of the visitation was to review management's progress towards addressing examination findings resulting from the March 17, 2003, safety and soundness and information technology Reports of Examination and to prepare for the upcoming examinations that are scheduled to begin on March 15, 2004. In addition, three issues that arose since the examination were explored and discussed with management. These issues included the unanticipated negative gain on loan sale incurred by the company's consolidated mortgage banking operation during the third quarter of 2003, the disclosure of unsatisfactory underwriting practices at affiliate Long Beach Mortgage Company, and the realignment of management and the business units.

The examiners concluded that:

- Management's progress toward addressing safety and soundness and information technology examination findings is satisfactory.
- Financial performance was marred by problems during the third quarter, but the bank's financial condition remains satisfactory.
- Issues in the mortgage banking operation impacted the quality of earnings and the effectiveness of management.
- The culture, practices, and systems at Long Beach Mortgage Company are inconsistent with the lending activity of the bank.
- The abandonment of Optis 0.2 represents a significant management/technology failure.

We understand that a major corporate reorganization is in process and plans are being or have been implemented to address mortgage banking weaknesses, practices at Long Beach Mortgage Company, and information technology strategies.

The Board is encouraged to review the visitation report, although no formal response is requested. If you have any questions, please contact Assistant Regional Director J. George Doerr or Senior Examiner Stephen P. Funaro of the FDIC at (206) 284-1112 or Program Manager Michael Abe of the State of Washington Department of Financial Institutions at (360) 902-8704.

Sincerely,

Nancy E. Hall Regional Director Federal Deposit Insurance Corporation	David G. Kroeger Director of Banks State of Washington Department of Financial Institutions

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #719

LETTER

OTSWME04-0000029592

Report of Visitation	**09576**

Background

The FDIC and Washington State Department of Financial Institutions (DFI or State) visited Washington Mutual Bank (WMB) from 10/14/2003 to 12/11/2003. The visitation was conducted concurrently with representatives of the Office of Thrift Supervision (OTS). The purpose of the visitation was to perform an interim assessment of WMB's financial condition and performance, follow up on outstanding issues from the 3/17/2003 examinations, and prepare for the 3/15/2004 examination. In addition, three issues that arose since the examination were discussed with management:

- The unanticipated negative gain on loan sale incurred by Washington Mutual Inc.'s (WMI) consolidated mortgage banking operation during the third quarter of 2003;
- The disclosure of unsatisfactory underwriting practices at sub prime lending affiliate Long Beach Mortgage Company, Inc. (LBMC); and
- The resultant realignment of management and the business units.

Summary

Like WMI, WMB's financial performance during the third quarter of 2003 was marred by problems, but the bank's condition remains satisfactory. Issues in WMI's mortgage banking operation and at LBMC impacted the quality of earnings, adequacy of capital, contingent liquidity, and the effectiveness of management throughout the entire organization. A major corporate reorganization is in process that is intended to address outstanding issues.

Management's progress toward addressing Examination Findings from the 3/17/2003 examination was reviewed and found to be satisfactory.

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REPORT

Report of Visitation (Continued)	09576

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Permanent Subcommittee
on Investigations

OTSWME04-0000029594

Redacted By The Permanent Subcommittee on Investigations

LONG BEACH MORTGAGE COMPANY
LBMC is a non-bank affiliate of WMB and WMBFA. It securitizes and sells sub prime residential loans originated through brokers.

An internal residential quality assurance (RQA) report for LBMC's first quarter 2003 sub prime lending product was issued as of 7/31/2003. It concluded that 40% (109 of 271) of loans reviewed were considered unacceptable due to one or more critical errors. This raised concerns over LBMC's ability to meet the representations and warranty's made to facilitate sales of loan securitizations, and management halted securitization activity. A separate credit review report was completed by Corporate Credit Review on 8/29/2003 that reached similar conclusions and disclosed that LBMC's credit management and portfolio oversight practices were unsatisfactory.

The inability to securitize and sell new loan production caused LBMC's warehouse to increase by approximately $1 billion per month to $5 billion at the end of November 2003. The increase was funded through borrowing lines from affiliates and other creditors. LBMC President Troy Gotshall stated that he hoped a $3 billion securitization and sale transaction could occur during January. Unless a sale transpires soon, liquidity will be strained. One element of LBMC's contingent liquidity plan includes the potential sale of warehouse loans to the insured institutions.

A review of loans in the mortgage pipeline and warehouse commenced under the direction of EVP and Senior Legal Counsel Fay Chapman to determine the extent of the problems. Approximately 4,000 of the 13,000 loans in the warehouse had been reviewed by the end of November 2003; of these, approximately 950 were deemed saleable, 800 were deemed unsaleable (saleable as scratch and dent with a haircut), and the remainder contained deficiencies requiring remediation prior to sale.

Report of Visitation (Continued)	09576

It was reported separately that of 4,500 securitized loans eligible for foreclosure, 10% could not be foreclosed due to documentation issues.

President Gotshall stated that the problems were largely attributable to management's decision to integrate LBMC's sub prime loan origination and servicing operations into WMI's prime home lending program. This integration began in 2000 and continued through 2002. It now appears that some loans originated and securitized during that period may not have meet the representations and warranties made in the pooling and servicing agreements and therefore are contingent liabilities to LBMC since they could be put back by the investors. EVP Fay Chapman acknowledged the potential contingent liability, but stated that management has not quantified the exposure. The outstanding principal balances of loans securitized and sold during this time period totals approximately $11 billion.

Senior Vice President (SVP) John Robinson was appointed to LBMC's three member board of directors in December 2003. The other members are Chief Financial Officer Tom Casey and EVP Craig Chapman. The board met on 12/05/2003; the prior meeting was back in July. SVP Robinson acknowledged that oversight of LBMC had been inadequate. The culture, practices, and systems at LBMC are inconsistent with the lending activity of WMB, and it remains to be seen if LBMC can be effectively assimilated into WMI.

Status of Findings from Prior Examinations

Management continues to monitor examination findings and responses through a "findings matrix" which is also used as the response to the Report of Examinations. Internal Audit reviews the responses to determine if the responses are sufficient to "close" the issue. We worked jointly with the OTS to review management's progress in addressing the findings.

Management has implemented action plans to address the Examination Findings from the 3/17/2003 examination. Satisfactory progress was noted, although many action plans are still in process. Internal Audit had not yet assessed the status of all of management's responses; this should be completed in the first quarter of 2004 and will be reviewed during the 2004 examination.

2004 Safety and Soundness Examination

The 2004 examination is scheduled to commence on 3/15/2004, and the onsite planning phase will begin on 2/17/2004. Coordinating efforts are underway for the joint examination of WMB and concurrent examinations by the OTS of WMI, WMBFA, and Washington Mutual Bank, fsb. In addition, joint Information Technology and concurrent Compliance examinations will be conducted.

A joint entry request package, or PERK, was presented to the bank in December 2003. The FDIC, State, and OTS continue to work together to present a joint request package to eliminate duplications and ease the burden of data collection.

Information Technology
The visitation included an Information Technology (IT) component. WMI's IT environment includes over 200 application systems, many of which were not integrated after acquisition. Many of these systems are relatively unique to WMI and operate in diverse locations with a variety of operating systems, application systems, and disaster recovery plans.

This visitation disclosed that management has made notable progress in addressing the Examination Findings from the 2003 IT examination. However, the issues encountered in the mortgage banking operation during the third quarter had a clear IT component and demonstrated the potential impacts of the current IT environment. Management announced its decision to abandon Optis 0.2 at the end of the visitation. The abandonment of Optis 0.2 represents a significant management/technology failure. Management has a plan to address mortgage technology needs, but until the plan is implemented, IT exposure will remain high.

Visitation Findings

Visitation findings were discussed with SVP Robinson and Vice President Wedell on 12/9/03, and will be presented to executive management at the 1/22/04 Quarterly Regulators Meeting.

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WMB, FA/fsb (08551/11905)
Field Visit 10/14/03

FOIC WRITEUP/LETTER DRAFTS

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OTSWME04-0000029598

Footnote Exhibits - Page 0397

Marshall, Penny D

From: Dochow, Darrel W
Sent: Monday, February 13, 2006 8:38 AM
To: Marshall, Penny D
Subject: FW: LBMC EDP Impact

Sensitivity: Private

This has the numbers for LBMC repurchases.

-----Original Message-----
From: Dochow, Darrel W
Sent: Friday, January 20, 2006 8:27 AM
To: Finn, Michael E
Cc: Carter, Lawrence D; Franklin, Benjamin D; Kuczek, Richard A
Subject: LBMC EDP Impact
Sensitivity: Private

Mike:

Attached is the one page table highlighting the financial impact of the LBMC repurchase matter. See particularly the box toward the bottom labeled "Summary". It shows that a $20 million earnings hit came from a net settlement with Bear Sterns where WAMU decided to not repurchase the loans, but let Bear Sterns keep them at a reduced price. These were primarily 2nd lien loans where the servicing had already been transferred to Bear Sterns. The second line item is a $12.8 million LOCOM adjustment from a repurchase in December. The third line is an additional reserve of $39.5 million, but actually approximately $4 million already existed, so the total additional income impact was $35.5 million, for a total $68 to $69 million actual income impact net of the approximate $4 million reserve, or $72.3 million gross. Additional reserves are expected in January when the last two whole loan sales work through their EDP recourse period.

Of the loans repurchased so far, we were told that approximately 60% have cured.

The primary reasons for the problem were as discussed at yesterday's quarterly meeting:

- Servicing lapse in not focusing on having the first payment after sale be current
- Rise in interest rates during this time period that motivated purchasers to put back all they could
- General lower quality 2005 production due to economy and lowered standards up to time of the exam
- WAMU divisions not communicating well enough between themselves on implication of whole loan sales vs securitizations

The $4.749 billion in loans on LBMC books at 12/31/05 are largely comprised of the same 2005 vintage production that was sold in the whole loan sales and are now subject to the increased repurchases. One difference, however, is that loans going into the HFI portfolio must meet the same screens as loans acquired through the Specialty Mortgage Finance channel. Thus, they tend to have somewhat better performance. Management is balancing the probability that these loans will perform worse than expected and priced for, versus the increased income they generate, (plus portfolio taint considerations) in considering whether to sale some or all of the portfolio.

Total higher risk loans (1st with FICO below 620 and 2nds, credit cards and HELOCs with FICO below 660, plus all LBMC and Specialty Mortgage Finance loans, aggregated $34.832 billion at 12/31/05 or 133% of consolidated WMI total risk based capital. Their internal limit is 200%.

WAMU scan - IMC EDP Impact.pd

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Permanent Subcommittee on Investigations
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Report Footnote #729

OTSWMS06-007 0001020

Footnote Exhibits - Page 0398

Q4 2005 EPD Financial Impacts

Long Beach Mortgage Company Q4, 2005 Repurchase Horizon

$ in millions

Investor Name	WaMu Deal Name	Lien	EPD Measurement Date	Deal UPB	Repurchase UPB	Repurchase Rate	Estimated Write-down Price (bps)	Estimated Reserve Impact
EMC - Bear Sterns				$1,531.8	$33.1	2.2%	45.02	($20.0)
Lehman High LTV	WLS LB_0510	1st	10/31/2005	$629.1	$46.7	7.4%	92.56	($3.7)
CSFB	WLS LB_0508	1st	09/30/2005		$40.6		80.46	($8.2)
CSFB	LBMLT 2005-WL2	1st	09/30/2005		$30.7		89.50	($3.8)
				$2,768.2	$71.3	2.6%	83.24	($11.9)
CSFB	WLS LB_0513	1st	12/31/2006		$10.7		93.30	($0.8)
CSFB	WL3	1st	12/31/2005		$61.4		85.00	($9.8)
				$2,233.8	$72.1	3.2%	85.20	($10.7)
Goldman Sachs	WLS LB_0512	2nd	10/31/2005	$382.8	$20.8	5.3%	65.00	($7.3)
Goldman Sachs	WLS LB_0514	2nd	11/30/2006	$250.6	$15.2	6.1%	84.00	($2.6)
Goldman Sachs	WLS LB_0515	1st	12/31/2005	$1,999.2	$125.6	6.3%	97.00	($5.0)
Lehman	WLS LB_0517	2nd	01/31/2006	$309.7	$18.8	6.1%	84.00	($3.2)
Lehman	WLS LB_0516	1st	01/31/2006	$3,100.0	$195.1	6.3%	97.00	($7.6)
Total 2005 Estimated Impact				$13,236.3	$596.8	4.5%	84.41	($72.3)

Summary

($20.0)	12/05 Loss on sale - EMC deal
($12.8)	repurchase complete in 12/05
($39.5)	additional reserve required @12/31/05
($72.3)	Total Q4, 2005 financial impact

Note: Repurchase estimates for measurement dates later than 12/31/05, were based upon assumptions from recent repurchase activity

- Total Income Statement impact, as of 12/31/05 was approximately $69M, comprised of the following:
  - $20M loss on sale related to sale of NPA's to EMC
  - $13M mark to market on WLS LB_0510, WLS LB_0508 and WLS LB_0513, which were repurchased and in the warehouse at 12/31/05
  - $36M increase in repurchase reserve for EPD's, net of partial use of existing reserve of $4M, for remaining estimated liability as of 12/31/05.
- Total Repurchase Reserve, as of 12/31/05 consists of the following:
  - $40M reserve for EPD's
  - $16M reserve for breaches of reps and warrants

OTSWMS06-007 0001021

Coordination of Expanded Supervisory Information Sharing and Special Examinations

Objectives

- Establish fundamental expectations for enhanced coordination and cooperation of supervisory efforts by the Federal banking agencies (Agencies) to ensure that the FDIC is able to fulfill its responsibilities to protect the deposit insurance funds in the most efficient and least burdensome manner possible.
- Confirm the understanding of the Agencies as to the examinations, reports, meetings, examination personnel, and other supervisory information the FDIC will have access to relating to the FDIC's responsibilities.
- Confirm the understanding of the Agencies as to the general circumstances in which the FDIC will conduct Special Examinations of insured depository institutions (IDIs) under 12 U.S.C. § 1820(b)(3).

Key Principles

- Consistent with fundamental principles of safety and soundness, the Agencies are committed to promoting the most effective and efficient bank supervision process possible, minimizing the duplication of effort, ensuring consistent regulatory conclusions or communications to IDIs, and reducing overall costs associated with bank supervision.
- The OCC, FRB and OTS are committed to providing the FDIC information on and access to IDIs that represent a heightened risk to the deposit insurance funds and selected Large IDIs. For the purposes of this document, Large IDIs are defined as selected IDIs within the OCC's Large Bank Program, selected IDIs that are part of the FRB's Large Complex Banking Organization program, and certain identified large thrifts supervised by OTS.
- To the fullest extent possible, the FDIC should continue to rely on the results of the work performed by the primary bank supervisors in assessing the condition of individual institutions.

IDIs Coordination Components

<u>IDIs that Represent a Heightened Risk</u>

- The FDIC is authorized to conduct "Special Examinations" of IDIs under 12 U.S.C. § 1820(b)(3) that represent a heightened risk to the deposit insurance funds when the Board of Directors of the FDIC deems such an examination necessary to determine the condition of the IDI for insurance purposes. The FDIC's Board of Directors' will delegate this responsibility to the FDIC Division of Supervision for IDIs that represent a heightened risk to the deposit insurance funds.
- On a quarterly basis, representatives of the OCC, FRB and OTS will meet with representatives of the FDIC to discuss the risk profile, current condition, and status of identified supervisory matters requiring attention of IDIs that represent a heightened risk to the deposit insurance funds.
- For purposes of this document, the following institutions will be assumed to represent a heightened risk to the deposit insurance funds under 12 U.S.C. § 1820(b)(3):

- IDIs with a composite rating of 3, 4 or 5; and
- IDIs that are undercapitalized as defined under Prompt Corrective Action.

- The following principles underlie the exercise of this "Special Examination" authority:
  - All Special Examination activities will be conducted in a manner to minimize costs to the industry, regulatory burden and duplication of effort;
  - FDIC staff will meet and coordinate with the appropriate Agency prior to engaging in any Special Examination activity. The FDIC shall, to the fullest extent possible, conduct Special Examination activities concurrently with the appropriate Agency's regularly scheduled examinations; and
  - The FDIC will not prepare a separate Report of Examination, or other similar report to bank management, except where an enforcement action by the FDIC is anticipated.

<u>All IDIs</u>

- On an ongoing basis, the OCC, FRB and OTS will provide the FDIC with access to supervisory information, including risk assessments, supervisory plans, reports of examination and other documents related to selected IDIs. Similarly, the FDIC will provide access to the same types of supervisory information, if any, to the OCC, FRB and OTS.
- In addition to the situations falling under the Special Examination authority discussed above, the FDIC may seek participation in examinations or meetings with senior bank management of IDIs that exhibit material deteriorating conditions or other adverse developments that could result in the institution becoming troubled in the near term. In the event the staffs of the FDIC and the appropriate Agency cannot agree, the two agencies' representatives to the FFIEC Supervision Task Force will determine whether such a material deteriorating condition or adverse development exists within a given IDI. In the event the two representatives cannot agree, the Chairman of the FDIC and the principal of the relevant Agency (or the Governor that is a member of the FFIEC in the case of the FRB) will determine whether such a material deteriorating condition or adverse development exists.
- Differences in CAMELS ratings between the FDIC and the appropriate Agency will be communicated consistent with current procedures. For all ratings differences, any final decision by the FDIC to depart from the appropriate Agency's assigned rating will be made by senior management of the FDIC's Division of Supervision after discussion with and consideration of information supplied by the appropriate Agency's senior supervisory management.

<u>Large IDIs</u>

- On an ongoing basis, the OCC, FRB and OTS will provide the FDIC with access to supervisory personnel and information, including risk assessments, supervisory plans, reports of examination and other documents related to Large IDIs. Similarly, the FDIC will provide access to the same types of supervisory information, if any, to the OCC, FRB and OTS.
- On at least a quarterly basis, representatives of the OCC, FRB and OTS will meet with representatives of the FDIC to discuss the risk profile, current condition, and status of identified supervisory matters requiring attention of all Large IDIs.
- In addition, the FDIC will establish a dedicated examiner program with respect to the eight largest banking organizations (collectively as "Largest Banks," individually as an "Assigned Institution"). The dedicated examiner program will work within existing supervisory

programs of the appropriate Agencies so as to avoid, to the fullest extent possible, any increase in regulatory burden or duplication of effort.

- The person designated as dedicated examiner will be the FDIC's primary point of contact with Agency supervisory personnel as it relates to the supervision of the Assigned Institution. Agency supervisory personnel are expected to keep the dedicated examiner informed of all material developments in the supervision of the Assigned Institution and will invite the dedicated examiner to observe and participate in certain examination activities to ensure the FDIC has an understanding of the supervisory issues and risk management structure of the Assigned Institution.
- The FDIC will fully participate in the review and assessment of the risk of the credits within the Shared National Credit Program in Large IDIs and other depository institutions.
- When the Agencies agree that participation by the FDIC is appropriate to evaluate the risk of a particular banking activity to the deposit insurance funds, the FDIC dedicated examiner and other staff, as appropriate, should participate with the appropriate Federal banking agency in selected supervisory reviews of that activity, including meetings with bank management relating to those reviews. In the event Agencies' staff cannot agree, the respective Agencies' representatives to the FFIEC Supervision Task Force will determine whether FDIC participation is appropriate. In the event the two representatives cannot agree, the Chairman of the FDIC and the principal of the relevant Agency (or the Governor that is a member of the FFIEC in the case of the FRB) will resolve the dispute.

Washington Mutual

David C. Schneider
President,
Home Loans

March 29, 2006

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G. Street, NW
Washington, DC 20552
Attention: Docket Number 2005-56
Regs.comments@ots.treas.gov

Re: Proposed Guidance – Interagency Guidance on Nontraditional Mortgage Products
70 FR 77249 (December 29, 2005)

Dear Sir or Madam:

Washington Mutual Bank appreciates the opportunity to comment on the Interagency Guidance on Nontraditional Mortgage Products (the "Guidance") that has been proposed by the federal banking and credit union agencies (the "Agencies"). Our comments on the Guidance are based upon the experience that we have gained from providing alternative mortgage products such as our "Option ARM" for over twenty years. They are presented below in two parts. First, we provide general comments regarding the application, interpretation and possible implementation of the Guidance. These comments track the outline of the three specific areas that are the focus of the Guidance. Second, we respond to specific questions asked in the preamble to the Guidance with regard to comprehensive debt service qualification standards.

I. General Comments:

Washington Mutual Bank agrees that different mortgage products pose different risks for lenders and that lenders should have appropriate robust underwriting and risk management standards to address these different risks. Washington Mutual Bank also agrees that lenders should provide timely and clear disclosure to consumers of the terms of the mortgage products that they offer. We support the Guidance to the extent that it will advance these principles in an effective manner and without unnecessarily harming the mortgage markets.

We are concerned that some parts of the Guidance as proposed will discourage or prevent responsible lenders from continuing to offer important mortgage products that have provided consumers the substantial economic and personal benefits of homeownership.

Washington Mutual Tower
1201 Third Ave.
Seattle, WA 98101
phone 260.490.3859

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #824

We also believe that the Agencies' concerns with respect to consumer protection would be more effectively advanced by amending Regulation Z and other regulations that apply to all mortgage lenders.

A. Overview of Guidance

Guidance Should Not Cover Home Equity Lending

The Agencies should make clear that the Guidance does not amend the recent guidance on home equity lending. Home equity lines of credit and junior lien home equity loans should be specifically excluded from the guidance.

Guidance Should Not Disfavor Alternative Mortgages

We are concerned that the Guidance's focus on interest-only ("IO") and payment option mortgage products and the use of the term "non-traditional mortgages" to describe these products reflect a concern by the Agencies that these products are more risky or less consumer friendly than other mortgage loans. Washington Mutual Bank and other institutions have been successfully offering payment option mortgages for more than 20 years through different interest-rate and economic cycles. Contrary to the Guidance's assertion, these mortgages have been tested in a "stressed environment." In fact, these mortgages have been considered more safe and sound for portfolio lenders than many fixed rate mortgages.

In addition, these mortgage products, when prudently underwritten, have provided substantial economic benefits to consumers by allowing borrowers to manage their cash flow by, e.g., using funds that might otherwise go to their mortgage payment to pay down other debt or to make other investments. Prudently underwritten alternative mortgage products have also allowed some borrowers who might otherwise have been precluded from participating in the housing market to purchase homes.

The need for lenders to develop such products and the benefit to consumers of such products were recognized by Congress in enacting the Alternative Mortgage Transaction Parity Act of 1982. In proposing the Guidance, the Agencies have not cited any past problems with these products to challenge this Congressional support for payment option or IO mortgages. While we understand the Agencies' heightened interest in these products as they take on new features and are offered by a broader array of lenders to a broader population, we are concerned that the worst-case scenarios assumed by the Agencies in the Guidance will cause examiners to discourage institutions from offering such products. To address these concerns, we recommend that the Guidance 1) not discourage lenders from offering these products; 2) refer to such products as "alternative mortgages," the term used in federal law and hereafter in this letter; and 3) not be based on theoretical worst-case scenarios.

Guidance Should Not Be Prescriptive

The Guidance appears to impose new specific mandates on federally regulated institutions offering these products, as opposed to providing general guidance to examiners and their regulated entities on how such products can be offered in a safe and sound manner. We recommend that the Guidance not prescribe certain practices and that the use of "should" in the Guidance does not mean "must," especially in the Guidance's discussion of "Recommended Practices."

Guidance Should Allow For Flexible Implementation

In addition, the statement in the Guidance calling for its consistent implementation is contrary to the notion of regulatory guidance and could mean that experienced providers of alternative mortgages would be subject to the same examination scrutiny as institutions that have not offered these products in the past. The risk with such a dictate is that valuable products offered by experienced lenders that have not posed safety and soundness problems will be taken away from the consumer. The Guidance should explicitly recognize that experienced institutions' proven safety and soundness practices are "best practices" and will not need to be changed or modified because of the Guidance.

We understand that the Agencies may have concerns that new entrants to the alternative mortgage market may not have the underwriting or portfolio and risk management expertise that experienced lenders may have. Such concerns are best addressed on an institution-specific basis as a supervisory matter, not by imposing new restrictions on all regulated entities and their affiliates as if the Guidance were a regulation. At the end of the day, the case-by-case evaluation by examiners is critical. Examiners should understand the need to apply the Guidance flexibly and with good judgment.

Guidance Does Not Cover All Lenders

The call for consistent application also is not possible given that the Guidance would apply only to federally regulated entities and their affiliates. Consumer finance companies, mortgage banks, and other state-regulated lenders and brokers not affiliated with federally regulated entities, many of which are new to offering alternative mortgages, would not be subject to the Guidance. If the Guidance unnecessarily restricts federally regulated entities from offering these products, it will place such entities at a competitive disadvantage in a very competitive mortgage marketplace. Thus, unnecessary restrictions actually do a disservice to safety and soundness.

New Types of Controls for Monitoring Third Parties Should Not Be Required

We are also concerned that the Guidance requires a lender to impose additional controls regarding its loan consultants and third party originators that are specific to alternative mortgages to ensure that the loan originators' practices are consistent with the lender's policies and procedures. While a lender is responsible for the acts of its own employee loan consultants, it is virtually impossible for a lender to control the practices of mortgage brokers or correspondent lenders. A large lender may deal with literally thousands of mortgage brokers and hundreds of correspondent lenders each year and any single broker or correspondent may deliver only a small number of loans to the lender. Although such a lender may re-underwrite a broker originated loan and provide its own program disclosures to the broker's customer if the loan will close in the lender's name, the lender cannot effectively or economically monitor the sales practices of each of the brokers with whom it does business.

The lender is even further removed from a correspondent lender's practices. A correspondent sells a loan that it has closed in its own name and with its own funds to a lender/purchaser. In some cases, the correspondent will underwrite the loan to the lender/purchaser's guidelines and in other cases the correspondent will underwrite the loan to general investor guidelines. A lender/purchaser will confirm that the loans it purchases are acceptable to it from an underwriting perspective, but it is impossible for a lender/purchaser effectively or economically to monitor the sales practices of all of the correspondents from which it purchases loans. While lenders can provide training and materials explaining their products to mortgage brokers and correspondents, lenders should not be expected to monitor the interaction between a third party and its customer.

B. Loan Terms and Underwriting Standards

Underwriting Should Not Be Based on Future Scenarios

We agree that when a loan is underwritten, the borrower must have a demonstrated capacity to repay based upon information available at that time. Washington Mutual's Responsible Mortgage Lending Principles provide that we only make and purchase mortgage loans where the borrower has a demonstrated ability to repay. With such underwriting, a well-informed consumer is in the best position to make the decision regarding which mortgage product best suits his or her needs and to assess the risks associated with his or her situation in the future, not banks or regulators.

The Guidance, however, could be read to require lenders to forecast a borrower's capacity to repay based on information unknown about a borrower at the time of origination, such as a borrower's payment patterns, a borrower's future income, a borrower's ability to refinance the loan, and interest rate projections. Such scenario-based underwriting is not a best practice used by experienced lenders of these loans. Not only is such underwriting highly speculative, but it could unnecessarily exclude qualified borrowers. Such a practice also imposes an additional level of subjectivity to the underwriting process. Underwriting should only use information available at the present time and not be based on forecasts or possible future scenarios.

Specific Underwriting Criteria Should Not Be Prescribed

The Guidance recognizes that lenders use a number of factors in underwriting alternative mortgages. Experienced underwriters of such products use a borrower's credit score in combination with other key underwriting criteria, such as the loan's loan-to-value ratio ("LTV"), the borrower's debt-to-income ratio ("DTI"), the loan's purpose, the amount of loan documentation, and the type of loan appraisal. The Guidance should avoid prescribing specific criteria for different loans types and purposes, and would better capture industry practices and promote responsible innovations if it addressed the broader issue of borrower ability and willingness to pay (which we discuss in further detail below). In other words, the Guidance should not affect an institution's business model and pricing strategy with regard to such products as long as the products are fairly offered to consumers and are safe and sound.

C. Portfolio and Risk Management Practices

Concentration Limits Should Not Be Prescribed

We also oppose the Guidance's insistence that concentration limits be set for certain loan types, for loans with certain characteristics, and for loans acquired through third parties. We agree that concentrations should be monitored for riskier exposures and that some level of portfolio diversification is necessary. This monitoring can be done in the form of concentration triggers that result in a management response, rather than limits set down as part of board policy. These concentration triggers should be based on each institution's portfolio and business model. The goal should be risk diversification in areas where pricing may not compensate for risk in stressed scenarios. The key point is to set up controls so that portfolio concentrations are monitored.

D. Consumer Protection Issues

We agree that it is important that consumers understand the terms and features of the mortgages that they are considering. We also agree that consumers find it beneficial to have such information early in their search for the appropriate mortgage loan. Alternative mortgage loans are already subject to disclosure requirements under Regulation Z which applies to all individuals or businesses that regularly extend consumer credit that is subject to a finance charge. The Guidance calls for only regulated lenders to provide information specific to alternative mortgages that is similar but not identical to the disclosures required under Regulation Z. The different disclosure standards may very well cause more consumer confusion at the time of application rather than less. We believe that any new disclosure requirements should be addressed within the framework of the existing regulatory requirements so that consumers receive consistent disclosures from as many types of lenders as possible.

While we comply with the current legal requirements, we also want to ensure that our mortgage customers understand the features of the loan products that they are considering when they are shopping for a mortgage. To that end, we and other lenders have developed disclosures for specific types of alternative mortgage products beyond the disclosures required by law.

We support the recommendation in the Guidance encouraging lenders to "provide consumers with information at a time that will help consumers make product selection." To effectuate this goal, we recommend that the Federal Reserve Board update its *Consumer Handbook of Adjustable Rate Mortgages* ("CHARM") booklet to include a discussion of alternative mortgage products. The CHARM booklet is provided to the consumer at the time the consumer begins shopping for a mortgage loan. A revised CHARM booklet would provide some consistency in the description of the advantages and risks of alternative mortgage products that would help the consumer shop for a mortgage loan.

We are concerned that including recommended consumer practices in the Guidance, along with a discussion of laws that prohibit unfair or deceptive acts or practices, could have unintended consequences. Some people could interpret the recommendations to mean that lenders who have not been following the Guidance's practices have engaged in unlawful activities. We do not believe that this would be a correct interpretation of the law or that the Agencies intend such an interpretation. If the Agencies do include a discussion of consumer protection issues in the Guidance, then the Guidance should be explicit that failure by a lender to follow the recommended practices does not mean that the institution is engaging in unfair or deceptive acts or practices.

II. Responses to the specific questions posed by the Agencies:

Our comments in Part I above touched on many of our concerns with the Guidance. In Part II of our letter, we provide specific answers to the questions posed by the Agencies in the preamble to the Guidance.

(1a) ***Should lenders analyze each borrower's capacity to repay the loan under comprehensive debt service qualification standards that assume the borrower makes only minimum payments?***

No. As noted above, we strongly disagree with the use of any scenario-based analyses in underwriting as the result would be inconsistent underwriting standards over time. In addition, the modeled relationship among losses and certain factors may change with different scenarios. Forecasting models based on future scenarios may conflict with forecasting models based on historical performance, resulting in dissonance in the qualification and pricing determinations at the underwriting stage.

The Guidance suggests three scenarios for calculating payment behavior (of increasing conservatism). More conservative scenarios could be prudent for determining portfolio management strategies and for evaluating portfolio risk under stressed conditions (e.g., capital adequacy). However, to underwrite using a measurement of payment capacity based upon a worst-case scenario of significant negative amortization restricts credit to consumers that could realize tangible economic benefits from these more affordable loan products.

(1b) ***What are current underwriting practices and how would they change if such prescriptive guidance is adopted?***

A borrower is able to qualify for a loan based upon several determinants of the borrower's ability and willingness to pay. Factors such as credit score, LTV, and DTI are predictive of a borrower's ability to pay, with credit score and LTV factors historically being much stronger predictors than DTI. An assessment of willingness or incentives to pay based upon personal credit history and loan type is also an important factor that is considered in the underwriting process.

Industry practice for calculating DTI on nontraditional mortgage products is as follows: For IO loans, a DTI is calculated for borrowers based upon the IO loan payments at the starting interest rate (fixed for a specified time period, usually 5 years). For payment option loans, a borrower's DTI is calculated based upon the fully indexed rate assuming that payments are fully amortizing. These types of mortgages do introduce greater uncertainty about the borrower's ability to make increased monthly payments, say at the expiration of an IO period or the recast of a payment option loan. It is important to note, though, that the borrower's capacity to repay is analyzed based upon information available at origination.

For a payment option loan, the calculation of DTI based on the potential payment shock from negative amortization would be highly speculative. This would require a long-term forecast of interest rates to calculate the negative amortization resulting from a borrower making only minimum payments. While such an analysis is important for portfolio management and determining capital adequacy, it is inappropriate to use in lending decisions. Such underwriting could exclude otherwise qualified borrowers, especially if the forecasts are conservative with respect to credit risk.

It is also generally recognized that certain loan purposes do not provide strong incentives for repayment when compared to a first lien on a primary residence. Examples of loan purposes with lower repayment incentives mentioned in the Guidance include loans for non owner-occupied investor loans and simultaneous second-lien loans with high combined LTVs.

Finally, underwriting payment option mortgages with a reduced initial interest rate spread for riskier borrowers is recognized as a sound practice. This underwriting decision is made at the transaction level using policies that are part of risk-based pricing. However, such policies cannot be made uniform across institutions, as different features of a product may be used to mitigate risk.

(2a) What specific circumstances would support the use of the reduced documentation feature commonly referred to as "stated income" as being appropriate in underwriting nontraditional mortgage loans?

For "stated income" loans, other compensating factors such as a lower LTV, a high FICO score, or good liquidity are used to mitigate the risk. Advertised low-doc programs such as stated income loans provide homeownership opportunities for borrowers who might have difficulty verifying income (such as business owners or borrowers with commissioned, seasonal, or non-documented incomes). The increased risk with such loans is recognized and compensated for with other factors and possibly increased pricing.

However, low documentation does not imply increased risk in the case of "efficiency process programs" where borrowers have income or asset verification waived due to the quality of their credit, presence of sufficient cash reserves, or other compensating factors. Such recommendations are often the output of automated underwriting models that are standard in the industry, such as Desktop Underwriter (Fannie Mae), Loan Prospector (Freddie Mac) or DAX (S&P).

(2b) What other forms of reduced documentation would be appropriate in underwriting nontraditional mortgage loans and under what circumstances?

The mortgage industry offers various forms of low-doc options, such as stated income verified assets ("SIVA"), stated income stated assets ("SISA"), or no income no assets ("NINA") where no income or asset information is provide in writing or verbally. The appropriateness of such low-doc programs in conjunction with alternative mortgages would depend upon the individual circumstances of each borrower and whether the low-doc option was offered to the borrower for efficiency based upon their excellent credit standing or sought by the borrower.

(2c) Please include specific comment on whether and under what circumstances "stated income" and other forms of reduced documentation would be appropriate for subprime borrowers.

If a subprime channel were to offer reduced documentation mortgage loans, then these loans should be priced and offered according to the assessed credit risk of each borrower and transaction. Such mortgages are not necessarily inappropriate or predatory for subprime borrowers. The offering of such loans to subprime borrowers should be recognized as risk-layering and underwritten accordingly.

(3) Should the Guidance address the consideration of future income in the qualification standards for nontraditional mortgage loans with deferred principal and, sometimes, interest payments? If so, how could this be done on a consistent basis? Also, if future events such as income growth are considered, should other potential events also be considered, such as increases in interest rates for adjustable rate mortgage products?

Future events such as projected income growth or interest rate forecasts should not be included in the underwriting or loan approval decision. As noted above, basing DTI on forecasted interest rates brings in an unnecessary level of subjectivity into the underwriting process and may disqualify otherwise qualified borrowers. Allowing for the consideration of future income, say for a new graduate that may realize a substantial increase in income versus an individual with a steady but constant income, could also open an institution to uncertain legal risk.

Instead, the projection of future income is a factor the borrower may want to consider in choosing a loan. Borrowers must decide based on their expectations of future income and other factors, such as the planned length of stay in their homes, whether a loan product is appropriate for them. If after a borrower takes an IO or payment option loan, he or she realizes that this choice provides an uncomfortable level of uncertainty in payments, then the borrower will likely have options to refinance at a fixed rate to mitigate this risk. It is a best practice for institutions to monitor payment patterns and negative amortization and to offer constructive options to borrowers as a part of active account management.

This concludes our comments on the Guidance. Again, we appreciate the Agencies providing us the opportunity to present our concerns and to provide information on how we offer alternative mortgages. If you have any questions regarding our comments, please feel free to contact me at 206-490-3859.

Sincerely,

David Schneider

David C. Schneider
President
Home Loans

Since maintaining a sufficient level of capital is critical for an association to maintain operations, you should appropriately weigh the importance of capital on the viability of the association when formulating the composite rating. You should also consider the association's dividend payout policy and practice. You should rate an association's capital adequacy considering all criteria cited in the UFIRS statement.

PCA Levels

In general, an association in any of the three lower-tier Prompt Corrective Action (PCA) categories warrants a 4 or 5 Capital component rating. A capital rating of 4 is appropriate if the association is undercapitalized or significantly undercapitalized but asset quality, earnings, or interest rate risk problems will not cause the association to become critically undercapitalized in the next 12 months. Also, a capital rating of 4 may be appropriate for an association that does not have sufficient capital based on its capital level compared with the risks present in its operations, even though the association may meet the minimum regulatory requirements.

An association warrants a 5 rating if it is "critically undercapitalized," or has significant asset quality problems, negative earning trends, or high interest rate risk exposure that will cause the association to become critically undercapitalized within the next 12 months.

See the Capital Chapter of this Handbook for more detailed instructions for reviewing capital adequacy.

Asset Quality

An accurate evaluation of an association's asset quality can be one of the most important products of the examination. The asset quality rating reflects the extent of credit risk associated with the loan and investment portfolios, real estate owned, other assets, and off-balance-sheet risks as well as the association's ability to manage those risks. The evaluation of an association's asset quality is dependent on the association's policies and procedures relating to loan underwriting and asset procurement, the proper monitoring and classification of assets, the nature of the risk inherent in the association's portfolios, and the adequacy of the association's valuation allowances.

When asset quality is in doubt because of excessive or inadequately controlled risk, the association's asset quality component rating should reflect this concern. In order to attain a 1 or 2 Asset Quality component rating, an association must fully control its credit risk. If an association has a high exposure to credit risk, it is not sufficient to demonstrate that the loans are profitable or that the association has not experienced significant losses in the near term. Management must demonstrate that it has identified credit risks, measured the potential exposure to loss, established systems to monitor such risk on an ongoing basis, and has taken adequate steps to limit and control those risks. Otherwise, a significant supervisory concern will exist relative to the association's asset quality.

Management

This rating reflects the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial

Review of Securitization
WAMU Examination of March 5, 2007

Scope of Review

Our review of the bank's securitization activities in 2006 (WMB, WMB-FSB, and Long Beach Mortgage Corporation) included the following (credit card securitization activity was not part of the scope of this review):

- Existing internal controls over the securitization process.
- Best execution procedures.
- Monitoring of Counterparty Risk.
- Monitoring of performance and triggers of issued securities
- Valuation of residuals retained by the bank.
- Validation of assumptions and models used in the valuation of residual pieces (Intex and WSA).
- Policies and procedures for the securitization process including cleanup call options.
- Internal Audit of the securitization processes.
- Review of Basis Floater Interest Only (BFIO) instruments retained by the bank. Review of hedging strategies will be performed under the Hedging Program (R. Miyashiro).
- Follow up on 2006 Examination Findings Memo 17.
- Certification of loan pools (GNMA) was not included in the scope of this review due to low activity in 2006.
- Loan repurchase activity, recourse on securitizations, and profitability was performed by examiner S. Bielik – refer to *Programs 572.* & 575

Overall Conclusions

- For the year ended December 31, 2006, the bank securitized mortgage loans with an aggregate UPB of $110.0 billion, a $20.8 billion decline when compared to the $130.8 billion securitized in 2005. Mortgage loans sold with recourse during the same periods totaled $959 million and $2.02 billion, respectively. The bank realized pre-tax gains of $1.0 billion[1] on mortgage loans securitization; slightly higher gain than the $949 million reported in 2005.
- The level of repurchased loans was low relative to the overall volume of mortgage loan securitization. The low level of repurchases and/or losses from repurchasing prime → activities is attributable to management's success in remitting loans repurchased from the investors to the originating mortgage broker/correspondent institution.

[1] Source: 10-k as of March 01, 2007(page 107).

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- Oversight of the securitization process is adequate. The Market Risk Committee (MRC) replaced the ASOC as the committee ultimately responsible for the oversight of the securitization area. The MRC has delegated to the Valuation Committee (VC) the responsibility of monitoring the valuation methodology used for retained interests (models and assumptions). All securitization channels report to the MRC on a monthly basis on securitization activity and any noteworthy governance/compliance, market, credit, and operational risks.
- Management implemented the recommendations made by the examiners during the prior examination and securitization reporting is currently satisfactory and consistent across the three divisions engaged in securitization of mortgage loans (WMMSC, LBMC, and Commercial Real Estate).
- The market value of WMB's consolidated holdings of residual interests totaled $2.3 billion, or 12.37 percent of WMI Tier I capital at March 31, 2007. Of this total, $383.4 million pertain to the securitization of mortgage loans and the remaining amount pertains to the securitization of credit card receivables. Noteworthy is the 44.6 percent decline in residual interests at the LBMC. The decline is attributable primarily to higher delinquencies and adjustments to prepayment and home price appreciation (HPA) assumptions used in the Intex model to derive fair market value.

in value of

- At March 31, 2007, the Basis Floater Interest Only (BFIO) portfolio had an estimated fair value of $201 million, a 60.0 percent decline over the $502 million reported at December 31, 2005. The decline is attributable to changes in market conditions as well as in the internal valuation methodology. The decline in the BFIO asset and; consequently, the bank's lower exposure to this asset is consistent with management's strategy. Management had indicated during the prior examination its willingness to reduce the bank's exposure to BFIO primarily due to the difficulty in hedging and managing this asset.

portfolio runoff

- The overall system of internal controls for the loan securitization area is generally satisfactory. Based on our review, management has implemented appropriate processes to ensure that the securitization activity complies with internal policies, procedures, and regulatory requirements.
- Policies and procedures governing this area are adequate. During the examination, management revised the Loan Purchase, Sale, and Securitization Standard to incorporate examiner recommendations pertaining to cleanup call options.
- A perceived weakness in the system of internal controls is the out-of-cycle condition of the internal audit of the Loan Purchase, Sale, and Securitization area. Audit Services indicated that the out-of-cycle condition is due to the department's modification of its annual audit process (risk approach versus cycle methodology) but that there were mitigating circumstances for the cycle override of this area. These included the satisfactory audit of this area in February of 2005, the experience level of the staff involved in this process, the absence of known issues in this area since the last audit, and the stability of the processes for this area since the last audit date.

referred to IAD review

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Overview

Washington Mutual Bank (WMB) has three divisions that engage in securitization activities: Washington Mutual Mortgage Securities Corp. (WMMSC), Long Beach Mortgage Corporation (LBMC) and the Commercial Group. The following is a synopsis of these units/divisions.

WMMSC is the division[2] responsible for the securitization of mortgage loans originated and sold into the securitization by WMB and Washington Mutual Bank, FSB (WMB-FSB). Within WMMSC there is the Conduit Unit that is charged with the purchase, typically in bulk, of subprime and Alt-A mortgage loans from brokers and correspondent entities. Furthermore, WMMSC serves as the master-servicer for the majority of the loan pools supporting the securities sold.

Long Beach Mortgage Corporation (LBMC) is the division responsible for the origination and securitization of sub-prime mortgage loans under the shelf registration of LBMC. Mortgage loans originated under the LBMC name are acquired through its broker network. Beginning in 2007, Wamu will securitize all loans originated through LBMC using the Wamu Asset Acceptance Corp. (WAAC) shelf registration. The new trusts are designated as Wamu Asset-E Certificates, Wamu Series 200X-HEX Trust. The first transaction using the new designation closed in January 2007 and used the ticker 2007-HE1. This will also be used for Wamu conduit and sub-prime conduit securitizations. The changes are a result of the consolidation of Long Beach Mortgage Corp. into WMB.

The Commercial Group securitizes commercial real estate loans originated through the bank's retail channel (no delegated underwriting). The group sells its securitizations to both private and government sponsored entities (GSE). Sales to GSE are done primarily to Fannie Mae and it involves an exchange of whole loans for MBS. Under certain programs (WamuPlus), the bank is liable for losses up to 3% of the principal balance of loans sold. On sales to private investors, the bank may retain unrated residual interests and/or portions of the B tranche.

Securitization Oversight

The Market Risk Committee (MRC) is responsible for establishing guidelines, procedures, and limitations for the securitization activities of Washington Mutual Inc. (WMI) and its subsidiaries. Additionally, the committee is responsible for ongoing transaction monitoring to ensure that securitization activities comply with established parameters. The MRC has delegated to the Valuation Committee (VC) the responsibility of monitoring the valuation methodology (models and assumptions) used for retained interests.

All securitization channels (prime, subprime, and commercial real estate) report to the MRC on a monthly basis on securitization activity for the prior month. Information provided include: securitization volumes, delinquency status by portfolio segment, losses, rating agency actions on outstanding issues, outstanding classes that fail loss-severity test (predicts

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2 Both WMMSC and LBMC ceased existing as separate legal entities when these WMI subsidiaries were integrated into Washington Mutual Bank (WMB).

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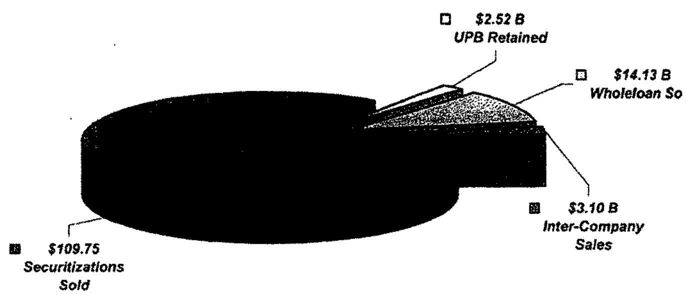
downgrades), and outstanding repurchase demands. The channels also discuss with the committee any noteworthy governance/compliance, market, credit, and operational risks.

Mortgage Loan Lending Activity

The following graph depicts mortgage loan lending activity and securitization activity in 2006.



Source: PERK Response Q101-105

In 2006, WMB, WMB-FSB, and LBMC originated mortgage loans with an aggregate unpaid principal balance (UPB) of approximately $129.7 billion. As shown in the graph above, the majority of the mortgage loan production (approximately $110 billion) was securitized and sold to government sponsored entities (GSE) and private investors, whereas $3.1 billion was sold inter-company. The fair market value of the mortgage servicing receivable asset (MSR) booked associated with the retained servicing rights amounted to $2.2 billion.

Securitization Activity

For the year ended December 31, 2006, the bank securitized mortgage loans with an aggregate UPB totaling $110.0 billion, a $20.8 billion decline when compared to the $130.8 billion for 2005. Mortgage loans sold with recourse during the same periods totaled $959 million and $2.02 billion, respectively. The bank realized pre-tax gains of $1.0 billion[3] on mortgage loans securitization; slightly higher gain than the $949 million reported in 2005.

[3] Source: 10-k as of March 01, 2007(page 107).

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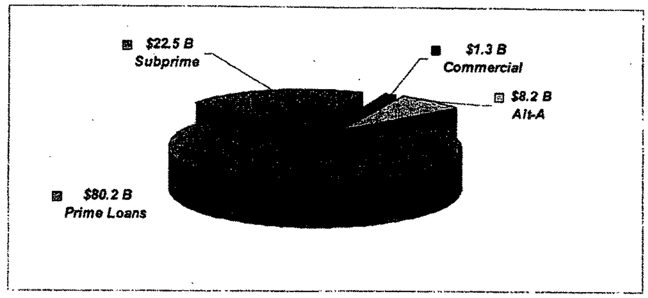

As shown in the graph above, prime 1-4 single-family mortgage loans accounted for the majority of the securitized loans at approximately $80.2 billion, or 71.47% of total securitization in 2006. Non-traditional mortgage loans such as subprime and Alt-A represented 20.05% and 7.30% of total securitizations, respectively. Commercial real estate securitization totaled $1.3 billion, or 1.18% of total securitization volume in 2006. Of the total amount securitized, WMB retained $2.52 billion (2.24% of total securitizations), of which only $187 million were subprime loans.

The following tables provide details for prime, subprime, and commercial real estate securitizations in 2006:

	Prime				
Data	FHLMC	FNMA	GNMA	Private	Grand Total
Sum of UPB Sold	30,011,081,003	9,840,988,799	2,508,641,181	44,380,288,006	86,740,998,988
Sum of UPB Retained	**1,087,811,289**	**-**	**-**	**590,935,664**	**1,678,746,953**
Sum of Loans/MBS BV-Sold	29,852,208,325	9,784,424,714	2,518,348,991	44,164,750,937	86,319,732,968
Sum of Loans/MBS BV-Retained	1,086,869,595	-	-	586,458,498	1,673,328,094
Sum of Gain/(Loss)	161,852,087	38,696,417	17,691,129	346,108,126	564,345,759
Sum of Gain/(Loss) 316	11,179,825	3,605,488	-	(12,342,370)	2,442,943

WMB sold approximately 49% of the production of prime mortgage loans to government sponsored entities and the remaining 51% to private investors. WMB booked MSR with a total FMV of $1.8 billion. Gain on sale amounted to $566.8 million (does not reflect impact of hedging gains and/or losses).

In 2006, there were 128 securities reviewed by Fitch, Moody's, and S&P. Upgraded classes totaled 164, affirmed 965, ratings watch negative classes 9, and only 4 classes were downgraded. Class downgrades are generally anticipated by management as it monitors performance and conducts stress-scenario analyses to determine which classes may be in line for downgrades.

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Sub-Prime					
Data	FHLMC	FNMA	GNMA	Private	Grand Total
Sum of UPB Sold				22,526,363,992	22,526,363,992
Sum of UPB Retained				-	-
Sum of Loans/MBS BV-Sold				22,447,651,221	22,447,651,221
Sum of Loans/MBS BV-Retained				186,581,539	186,581,539
Sum of Gain/(Loss)				271,358,159	271,358,159
Sum of Gain/(Loss) 316				11,141,373	11,141,373

Production and securitization of subprime loans totaling $22.5 billion was sold in its entirety to private investors with WMB retaining approximately $187 million in subordinated and/or residual pieces. Gain on sale amounted to $282.5 million, not taking into account the impact of hedging activities.

In the first quarter of 2007, management transferred approximately $1.7 billion of originated subprime loans in the Held for Investment (HFI) portfolio. Management indicated that due to the uncertainty in the subprime market at the time, the sales execution would have been poor. Subsequently, management sold the loans in question. The transfer of he loans into HFI received OTS approval.

In the first quarter of 2007, Fitch downgraded 23, affirmed 91 and upgraded three classes from the 21 Long Beach RMBS issues. The downgrades affected approximately $213.7 million of outstanding certificates and reflected the continued deterioration in the relationship between credit enhancement and loss expectations. The monthly losses in the downgraded issues exceed the available excess spread; thus, resulting in substantial deterioration of the Over Collateralization (OC). In the most severe examples (2001 vintage), the OC has been depleted and the subordinate certificates have incurred principal write-downs.

In 2006, there were 223 rating agency determinations for Long Beach issues/deals: 70 downgrades, 137 affirmed and 16 upgraded classes. Class downgrades are generally anticipated by management since it monitors performance and conducts stress-scenario analyses to determine which classes may be in line for downgrades.

Commercial R.E.					
Data	FHLMC	FNMA	GNMA	Private	Grand Total
Sum of UPB Sold		-		484,513,001	484,513,001
Sum of UPB Retained		810,309,344		26,847,300	837,156,644
Sum of Loans/MBS BV-Sold		-		496,231,582	496,231,582
Sum of Loans/MBS BV-Retained		795,370,392		17,523,207	812,893,599
Sum of Gain/(Loss)				15,270,161	15,270,161
Sum of Gain/(Loss) 316		-		-	-

During 2006, the bank, through its commercial real estate loan group, originated approximately $1.3 billion in commercial real estate. The loan production consisted overwhelmingly of loans secured by multi-family properties. The majority of these loans were originated by the bank's retail channel, although the bank purchased approximately $200 million from third parties. Dick

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Fisher, SVP Commercial Loan Group, indicated that purchased loans were re-underwritten pursuant to Wamu's standards for these loan types.

The overall production of commercial real estate loans declined precipitously in 2006 from a $9.9 billion production in the prior year due primarily to the lack of demand in the market for the type of product that the bank was willing to originate. According to SVP Dick Fisher, Commercial Real Estate Group, management projects a $8.3 billion securitization volume of 2007: $7.0 billion in Private Label securities, $1.1 billion under the WAMU Plus program, and $200 million under the FNMA DUS program.

During 2006, no commercial real estate security was downgraded by the rating agencies. For the same period, S&P, Fitch, and Moody's upgraded 7, 15, and 13 securities, respectively.

I/O and Option ARM

In 2006, the bank originated approximately $20.1 billion in Option ARM loans, issued 18 securities and sold $11.8 billion to private investors and $5.5 billion to GSE. The bank sold the remainder loans on a whole-loan basis to both private investors and GSE. For the same period, the bank originated $20.2 billion in mortgage loans with interest-only features. Securitization of this loan type sold to private investors amounted to $9.4 billion while the remainder was sold on a whole-loan basis to private investors and GSE.

While securities may have unique features, each structure has senior and subordinate pieces. Typically, the senior structure has several levels of Class A certificates, which are AAA rated, and are supported by the subordinate Class B certificates. The latter certificates are rated AA to BBB. Additionally, each issue may have an interest-only class or interest- and principal-only components (identified as Class X). Furthermore, each securitization has a residual class identified as the R Class that is intended for cleanup calls (not traded)

Wamu occasionally retains the basis I/Os (X Class) and the subordinate B Class certificates associated with option ARM securities. The bank refers to these pieces retained as "residual interests."

Residual Interests

(Millions)	12/31/05	12/31/06	3/31/07
Reserve Accts. (CC)	$10,372	$434,442	$448,027
Credit Enhan. (CC)	$1,803,413	$1,464,511	$1,432,333
LBMC[4]	**$71,496**	**$149,155**	**$82,657**
WMMSC NIM (sub)	$0	$34,161	$36,142
Providian Master Note	$85,100	$85,419	$85,290
Credit Enhancements	**$216,404**	**$138,114**	**$215,491**
Other Reserve Accts.	$19,889	$20,657	$38,861
WMB Consolidated	**$2,135,249**	**$2,326,460**	**$2,338,799**

[4] LBMC's residual interests and NIM pieces are held in the "trading" portfolio.

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The bank typically provides some form of credit enhancement when issuing securities for sale to private investors. These credit enhancements may include spread accounts, over-collateralization, interest-only strips, and retained subordinated interests. Collectively, these credit enhancements are referred to as "residual interests." Current bank policy limits residual interests to 25.0% of Tier 1 Capital. At March 31, 2007, total residual interests represented 12.37% of WMI's Tier 1 capital, well below the 25% internal policy limit.

This reviews focused on the residual interests held by the WMB and its affiliates and associated with the securitization of mortgage loans. The review of residual interests pertaining to the securitization of credit card receivables was performed separately.

As shown in the table above, the market value of WMB's consolidated holdings of residual interests totaled $2.3 billion at March 31, 2007. Of this total, only $383.4 million pertain to the securitization of mortgage loans. The remaining amount pertains to the securitization of credit card receivables. Noteworthy is the 44.6 percent decline in residual interests at the LBMC level from $149.2 million to $82.7 million. The decline is due primarily to the $88.0 million write-down on subprime residuals due to higher delinquencies, adjustments to prepayment and home price appreciation (HPA) assumptions used in the Intex model to derive fair market value.

Basis Floater Interest Only (BFIO)

BFIO is a byproduct of Option ARM securitization created by structuring the security in a way that, for a designated tranche (or tranches), WMB pays the investors 1-month LIBOR while collecting from the borrower an interest rate coupon based on MTA plus a margin. This cash flow mismatch creates significant basis risk. The BFIO is also highly susceptible to prepayment risk. Management hedging strategies to mitigate exposure to interest rates and basis risk include the buying and selling of Eurodollar futures. Management has acknowledged the difficulty in hedging this asset due the low predictability of Option ARM prepayments and the illiquidity of the basis swaps market. Refer to workpaper ***221P-63* through *221P-78*** for a more detailed discussion of BFIO.

The following table shows the changes in the BFIO portfolio in terms of Fair Value and the underlying notional unpaid principal balance (UPB):

BFIO ($MM)	Value	Change	Notional UPB	Change
12/31/2005	$502		$24,809	
12/31/2006	$238	($264)	$14,994	($9.815)
03/31/2007	$201	($37)	$13,061	($1,932)

At March 31, 2007, the BFIO had an estimated fair value of $201 million. This represents a 60.0 percent decline over the $502 million reported at December 31, 2005. During 2006, the fair value declined by $264 million, or 53.0 percent. Changes in the valuation methodology during 2006 resulted in a negative impact of $117 million, of which, $115 million was due the implementation of the new prepayment model that resulted in increased prepayment projection. The remaining $2 million impact resulted from the change in the 1-year CMT curve model based on constant spread to LIBOR.

The decline in the BFIO asset and; consequently, the lesser exposure to this asset is consistent with management's strategy. The reduction was accomplished by changing the structure of Option ARM deals to be MTA based instead of LIBOR based. During the prior examination, management indicated that the bank planned to reduce exposure BFIO due primarily to the difficulty in hedging and managing this asset.

On a quarterly basis (the first month end of each quarter), management surveys brokers for price indications on the BFIO portfolio. The Retained Interests Valuation group sends an email request to each broker that was a co-lead in the deal at issuance. Washington Mutual Capital Corp. ("WCC") was the lead broker-dealer on all deals, but since WMB owns WCC, the latter is excluded from the price indication process. Because of this fact, each deal typically only has 1 to 2 broker indications.

Brokers send back dollar price indications and management compiles and reviews the information and unreasonable changes from month to month or absolute levels discussed with the brokers. Management averages the final prices and compare on a deal by deal basis, as well as total portfolio value. The final BFIO Attribution Report is compiled and distributed daily.

Securitization Process/Internal Controls

Refer to workpaper ***221P-8*** for a discussion of the bank's internal controls surrounding securitization activities. These include compliance with Reg AB, Data Verification Process, Best Execution Analysis, Counterparty Risk, and Residual Valuation Process.

Counterparty Risk

John Morris, OTS Examiner, performed a review of counter-party risk, ~~was performed by examiner John Morris~~. Based on conversations with Mr. Morris and Wamu personnel, there are not any material concerns in this area. Monitoring of counter-party risk by management is adequate. See ***221P-29***.

Internal Audit

On April 26, 2007, the examiners met with Audit Services (AS) to discuss the 23-month out-of-cycle condition of the Loan Sales and Securitization area. The Loan Sales and Securitization area was last audited in May of 2005 and the next audit is scheduled for March 31, 2008. The three-year period between internal audits is outside the required interval under the cycling approach used by the internal audit department for units, such as the one in question, with **high-risk** ratings. Erin Dunlap, Audit Division Manager, and John Vandermeulen, Senior Audit Manager, provided the responses to the examiners' inquiry.

AS's explained the out-of-cycle status by indicating that the department had modified its annual audit process in accordance with its new audit plan cycle methodology (implemented January 1, 2007). Under the new methodology, the area in question is to be audit in March of 2008, a three-year cycle versus the 15-month interval required for high-risk areas. The AS

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indicated that the new policy allows for sufficiently justified and approved cycle overrides and that, as communicated to the Audit Committee, a transition period is required to fully implement the new three-year risk based audit cycle methodology.

The AS pointed out some mitigating circumstances for the cycle override of this area including: (1) the satisfactory audit of this area in February of 2005 and the experience level of the staff involved in this process, (2) the absence of known issues in this area since the last audit, and (3) the stability of the processes for this area since the last audit date. Moreover, the AS indicated, several peripheral areas have been or are in the process of being audited and no material concerns were noted.

The examiners believe that a three-year interval between internal audits may be inappropriate given the high volume activity in the securitization area (in excess of $100 billion/year) and the high-risk nature of this operation. The need for timely audits is further accentuated by the findings of our review of the MRC minutes of December 2006 and January 2007, which seem to indicate that there were data integrity issues surrounding the creation of securitization trusts, resulting in loan repurchases from those securitization trusts. According to Tom Lehman, root causes stemmed from the relocation of the transaction management group (Project Scarlet) and the simultaneous replacement of key systems (Sporty and Conduit database). Another concern arises from the lack of internal audit review of WMMSC Master Servicing operation, which provides servicing for all the loans sold into the securitization Trusts. The untimely internal audit of this area was pointed out as a concern Fitch's report as of August 14, 2006 (see Program 576).

The examiner communicated these concerns to the examiner responsible for the review of the internal audit area. (John Morris)

Clean-up Call Options

Regulation 12C.F.R.567.1 establishes certain requirements for clean-up calls on securitizations in order for institutions to avoid implicit recourse treatment. In general terms, clean-up calls are recourse for regulatory purposes unless it involves 10% or less of the original pool balance and are exercisable at the option of the bank/affiliates. The fact that the bank holds the residual piece(s) does not insulate the bank from implicit recourse determination if the bank provides post-sale credit support (although it plays a role determining under which circumstances purchasing assets from a trust at greater than FMV may not constitute implicit recourse). Further, the bank must exercise the cleanup call for legitimate business reasons other than to provide credit support to third party investors (key criterion for determining implicit recourse). Non-compliance with regulatory requirements could taint other existing securitizations and the bank could be required to bring back onto its books said securitizations and; consequently, have an impact on capital requirements.

In 2006 and the early part of 2007 WaMu requested and obtained a waiver from the OTS to exercise clean-up call options on three LBMC securitization deals. The OTS cleared WaMu's request for the agency's concurrence that the exercise of those cleanup calls in a securitization under the set of established facts provided by WaMu in its letters of December

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21, 2006 and February 13, 2007 and subsequent conversations. The OTS concluded that the deals in question did not constitute implicit recourse and did not trigger recourse treatment for other securitizations under the same shelf registration. This supervision policy decision was consistent with the supervisory determination by the West Region on this matter.

Subsequently, management requested from the OTS a blanket waiver for these types of transactions and the OTS agreed[5] to grant a blanket waiver if the bank would commit to revise the Loan Purchase, Sale and Securitization Standard in order for the standard to incorporate clear and precise guidance for the exercise of clean-up call options. The OTS's concurrence assumes that the economic valuations that support the fair market value calculations are economically sound that these valuations are scrutinized during the examination process to ensure that, in exercising the calls, WaMu has not provided additional credit support to third-party investors. If examiners conclude that the valuations are not economically sound or are not adequately documented and supported, the OTS may revisit this concurrence, conclude that WaMu has provided implicit recourse and require WaMu to bring the assets in outstanding securitizations back onto its balance sheets and hold risk based capital for those assets.

The examiners reviewed the language that WaMu plans to include in the Loan Purchase, Sale and Securitization Policy with regard to securitization clean-up calls. The language satisfies OTS requirements.

Profitability

In 2006, WMB's mortgage banking division incurred losses totaling $89.2 million. The poor performance derives primarily from the losses incurred by three business segments: Retail ($146.8 million), LBMC ($132.9 million), and Servicing ($106.8 million). Profitability is discussed under the Mortgage Banking: Profitability Program 572.

Reporting/Findings Memo 17

During the 2006 examination, the examiners issued a findings memo (OTS Memo 17) stating that (1) management was not reporting to oversight committees as required by policy and (2) there were inconsistencies in reporting by the three main loan groups (single-family, subprime, and commercial real estate). Our review disclosed that management has taken appropriate corrective actions. See ***221P-17***.

Policies and Procedures

The Loan Purchase, Sale, and Securitization Standard governs the securitization activities. This Standard is contained within the ALM Policy. During the examination, management revised this standard to include certain language pertaining to cleanup calls as recommended by the examiners. Overall, this Standard provides adequate guidance to the securitization process.

[5] Blanket waiver provided via letter from Darrel Dochow, DRD.

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Footnote Exhibits - Page 0423

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Summary of Review

OTSWME07-075 0000791

JOHN M. McCOY, III, Cal. Bar No. 166244
Email: mccoyj@sec.gov
SPENCER E. BENDELL, Cal. Bar No. 181220
Email: bendells@sec.gov
LYNN M. DEAN, Cal. Bar. No. 205562
Email: deanl@sec.gov
SAM PUATHASNANON, Cal. Bar No. 198430
Email: puathasnanons@sec.gov
PARIS WYNN, Cal. Bar No. 224418
Email: wynnp@sec.gov

Attorneys for Plaintiff
Securities and Exchange Commission
Rosalind R. Tyson, Regional Director
Michele Wein Layne, Associate Regional Director
5670 Wilshire Boulevard, 11th Floor
Los Angeles, California 90036
Telephone: (323) 965-3998
Facsimile: (323) 965-3908

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CLERK U.S. DISTRICT COURT
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BY:

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, vs. ANGELO MOZILO, DAVID SAMBOL, AND ERIC SIERACKI, Defendants.	Case No. CV09-03994 VBF AJWx **COMPLAINT FOR VIOLATIONS OF THE FEDERAL SECURITIES LAWS** **DEMAND FOR JURY TRIAL**

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #884

Plaintiff Securities and Exchange Commission ("Commission") alleges as follows:

JURISDICTION AND VENUE

1. This Court has jurisdiction over this action pursuant to Sections 20(b), 20(d)(1), 20(e) and 22(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§ 77t(b), 77t(d)(1), 77t(e), and 77v(a), and Sections 21(d)(1), 21(d)(2), 21(d)(3)(A), 21(e), and 27 of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§ 78u(d)(1), 78u(d)(2), 78u(d)(3)(A), 78u(e) & 78aa. Defendants have directly or indirectly made use of the means or instrumentalities of interstate commerce, of the mails, or of the facilities of a national securities exchange in connection with the transactions, acts, practices and courses of business alleged in this complaint.

2. Venue is proper in this district pursuant to Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a), and Section 27 of the Exchange Act, 15 U.S.C. § 78aa, because defendants reside and transact business within this district and certain of the transactions, acts, practices and courses of conduct constituting violations of the federal securities laws alleged in this complaint occurred within this district.

SUMMARY

3. This matter involves a disclosure fraud by the three most senior executives of Countrywide Financial Corporation, a mortgage lender formerly based in Calabasas, California, and insider trading by Countrywide's former chairman of the board and chief executive officer, Angelo Mozilo.

4. From 2005 through 2007, Mozilo, along with David Sambol, chief operating officer and president, and Eric Sieracki, chief financial officer, held Countrywide out as primarily a maker of prime quality mortgage loans, qualitatively different from competitors who engaged primarily in riskier lending. To support this false characterization, Mozilo, Sieracki, and Sambol hid from

investors that Countrywide, in an effort to increase market share, engaged in an unprecedented expansion of its underwriting guidelines from 2005 and into 2007. Specifically, Countrywide developed what was referred to as a "supermarket" strategy, where it attempted to offer any product that was offered by any competitor. By the end of 2006, Countrywide's underwriting guidelines were as wide as they had ever been, and Countrywide was writing riskier and riskier loans. Even these expansive underwriting guidelines were not sufficient to support Countrywide's desired growth, so Countrywide wrote an increasing number of loans as "exceptions" that failed to meet its already wide underwriting guidelines even though exception loans had a higher rate of default.

5. Countrywide was more dependent than many of its competitors on selling loans it originated into the secondary mortgage market, an important fact it disclosed to investors. But Mozilo expected that the deteriorating quality of the loans that Countrywide was writing, and the poor performance over time of those loans, would ultimately curtail the company's ability to sell those loans in the secondary mortgage market. Mozilo and the company's chief risk officer warned Sambol and Sieracki about the increased risk that Countrywide was assuming. Thus, each of the defendants was aware, but failed to disclose, that Countrywide's current business model was unsustainable.

6. Mozilo, Sambol, and Sieracki were responsible for Countrywide's fraudulent disclosures. From 2005 through 2007, these senior executives misled the market by falsely assuring investors that Countrywide was primarily a prime quality mortgage lender which had avoided the excesses of its competitors. Countrywide's Forms 10-K for 2005, 2006, and 2007 falsely represented that Countrywide "manage[d] credit risk through credit policy, underwriting, quality control and surveillance activities," and the 2005 and 2006 Forms 10-K falsely stated that Countrywide ensured its continuing access to the mortgage backed securities market by "consistently producing quality mortgages."

7. In fact, the credit risk that Countrywide was taking was so alarming to Mozilo that he internally issued a series of increasingly dire assessments of various Countrywide loan products and the risks to Countrywide in continuing to offer or hold those loans, while at the same time he, Sambol, and Sieracki continued to make public statements obscuring Countrywide's risk profile and attempting to differentiate it from other lenders. In one internal email, Mozilo referred to a particularly profitable subprime product as "toxic," and in another he stated that the company was "flying blind," and had "no way" to predict the performance of its heralded product, the Pay-Option ARM loan. Mozilo believed that the risk was so high and that the secondary market had so mispriced Pay-Option ARM loans that he repeatedly urged that Countrywide sell its entire portfolio of those loans. Despite their awareness of, and Mozilo's severe concerns about, the increasing risk Countrywide was undertaking, Mozilo, Sambol, and Sieracki hid these risks from the investing public.

8. Defendants misled investors by failing to disclose substantial negative information regarding Countrywide's loan products, including:

- the increasingly lax underwriting guidelines used by the company in originating loans;
- the company's pursuit of a "matching strategy" in which it matched the terms of any loan being offered in the market, even loans offered by primarily subprime originators;
- the high percentage of loans it originated that were outside its own already widened underwriting guidelines due to loans made as exceptions to guidelines;
- Countrywide's definition of "prime" loans included loans made to borrowers with FICO scores well below any industry standard definition of prime credit quality;
- the high percentage of Countrywide's subprime originations that had a loan to value ratio of 100%, for example, 62% in the second quarter of 2006; and

- Countrywide's subprime loans had significant additional risk factors, beyond the subprime credit history of the borrower, associated with increased default rates, including reduced documentation, stated income, piggyback second liens, and LTVs in excess of 95%.

Mozilo, Sambol, and Sieracki knew this negative information from numerous reports they regularly received and from emails and presentations prepared by the company's chief credit risk officer. Defendants nevertheless hid this negative information from investors.

9. During the course of this fraud, Mozilo engaged in insider trading in Countrywide's securities. Mozilo established four sales plans pursuant to Rule 10b5-1 of the Securities Exchange Act in October, November, and December 2006 while in possession of material, non-public information concerning Countrywide's increasing credit risk and the risk that the poor expected performance of Countrywide-originated loans would prevent Countrywide from continuing its business model of selling the majority of the loans it originated into the secondary mortgage market. From November 2006 through August 2007, Mozilo exercised over 5.1 million stock options and sold the underlying shares for total proceeds of over $139 million, pursuant to 10b5-1 plans adopted in late 2006 and amended in early 2007.

DEFENDANTS

10. **Angelo Mozilo**, age 70, is a resident of Thousand Oaks, California. Mozilo was a founder of Countrywide and was its chairman and chief executive officer ("CEO") from its formation in 1969 until Countrywide was acquired by Bank of America in 2008.

11. **David Sambol**, age 49, is a resident of Hidden Hills, California. He was Countrywide's president and chief operating officer ("COO") from September 2006 until its acquisition by Bank of America in 2008. Sambol was Countrywide's executive managing director, business segment operations from April 2006 until September 2006, and executive managing director and chief of mortgage banking

and capital markets from January 2004 until April 2006. Sambol was a member of the Countrywide board of directors from 2007 until July 2008. Sambol also held executive positions at certain Countrywide subsidiaries, including Countrywide Bank.

12. **Eric Sieracki**, age 52, is a resident of Lake Sherwood, California. Sieracki was Countrywide's chief financial officer ("CFO") from the first quarter of 2005 until its acquisition by Bank of America in 2008.

RELATED PARTY

13. **Countrywide Financial Corporation**, a Delaware corporation, was a mortgage lender based in Calabasas, California. During all times relevant to this complaint, its stock was registered pursuant to Section 12(b) of the Exchange Act and was listed on the New York Stock Exchange, and, until the demise of the Pacific Stock Exchange, it was listed on that Exchange as well. On July 1, 2008, Countrywide merged with Bank of America and is now a wholly owned subsidiary of Bank of America. Countrywide's remaining operations and employees have been transferred to Bank of America, and Bank of America ceased using the Countrywide name in April 2009. On July 1, 2008, the NYSE filed a Form 25 to deregister and delist Countrywide's common stock, and on July 22, 2008 Countrywide filed a Form 15 deregistering its common stock under Section 12(g) of the Exchange Act.

FACTS

14. From 2005 through 2007, in Countrywide's periodic filings with the Commission and in other public statements, Mozilo, Sambol, and Sieracki held Countrywide out as primarily a maker of prime quality mortgage loans, qualitatively different from competitors who engaged primarily in riskier lending. To support this false characterization, the proposed defendants hid from investors that Countrywide was engaged in an effort to increase market share and sustain

revenue generation through unprecedented expansions of its underwriting guidelines, taking on ever-increasing credit risk.

A. **Countrywide's Business**

15. Countrywide originated, sold, and serviced both prime and subprime (which Countrywide's periodic filings referred to as "nonprime") mortgage loans. By 2005, Countrywide was the largest U.S. mortgage lender in the United States, originating over $490 billion in mortgage loans in 2005, over $450 billion in 2006, and over $408 billion in 2007. Countrywide recognized pre-tax earnings of $2.4 billion and $2 billion in its loan production divisions in 2005 and 2006, respectively, and a pre-tax loss of $1.5 billion in its loan production division in 2007.

16. Countrywide pooled most of the loans it originated and sold them in secondary mortgage market transactions. Countrywide sold the pooled loans either through whole loan sales or securitization. In whole loan sales, Countrywide sold the loans to investors and recorded gains on the sales. In securitizations, Countrywide sold interests in the pooled loans, i.e., mortgage-backed securities. Countrywide's loan sales were run out of its capital markets division. In 2005, Countrywide reported $451.6 million in pre-tax earnings from capital market sales, representing 10.9% of its pre-tax earnings; in 2006, it recognized $553.5 million in pre-tax earnings from that division, representing 12.8% of its pre-tax earnings, and in 2007 it recognized a mere $14.9 million in pre-tax earnings from that division, reporting a pre-tax loss overall.

17. Historically, Countrywide's primary business had been originating prime conforming loans that were saleable to the Government Sponsored Entities ("GSEs"). In the fiscal years 2001, 2002, and 2003, Countrywide's prime conforming originations were 50%, 59.6%, and 54.2% of its total loan originations, respectively. In 2003, United States residential mortgage production reached a record level of $3.8 trillion. Countrywide experienced record earnings in that year,

with net earnings of $2.4 billion, an increase of $1.5 billion, or 182%, over 2002. In 2004, in a market where originations were declining overall, Countrywide maintained net earnings of $2.1 billion, and increased its market share from 11.4% to 12.7%.

18. Countrywide achieved this result in large part by moving away from its historical core business of prime mortgage underwriting to aggressively matching loan programs being offered by other lenders, even monoline subprime lenders. As a result, as reported in Countrywide's periodic filings and reflected in the chart below, in 2004, 2005, and 2006, Countrywide wrote more non-conforming, subprime, and home equity loans than in any prior period:

	2001	2002	2003	2004	2005	2006
Prime Conforming	50%	59.6%	54.2%	38.2%	32%	31.9%
Prime Non-Conforming	16.5%	24.5%	31.4%	38.7%	47.2%	45.2%
Home Equity	6.8%	4.6%	4.2%	8.5%	9.0%	10.2%
Nonprime (Subprime)	7.8%	3.7%	4.6%	11.0%	8.9%	8.7%
FHA/VA	18.9%	7.6%	5.6%	3.6%	2.1%	2.8%
Commercial	0.0%	0.0%	0.0%	0.0%	0.8%	1.2%

19. In 2004, Countrywide's reported production of conventional conforming loans dropped to 38.2%, its production of subprime loans had risen to 11%, its production of home equity loans had risen to 8.5%, and its production of conventional non-conforming loans had risen to 38.7%. By 2006, Countrywide had turned its prior business model on its head: a mere 31.9% of its originations were conforming, 45.2% were non-conforming, 8.7% were subprime, and 10.2% were home equity.

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B. **Countrywide's Deceptive Description of Its Loans**

20. Countrywide's Form 10-Ks deceptively described the types of loans upon which the Company's business depended. While Countrywide provided statistics about its originations which reported the percentage of loans in various categories, such as those noted in the table in paragraph 18, the information was misleading because its descriptions of "prime non-conforming" and "nonprime" loans in its periodic filings were insufficient to inform investors what types of loans were included in those categories. "Prime" loans were described in Countrywide's 2005, 2006, and 2007 Forms 10-K as follows:

> Prime Mortgage Loans include conventional mortgage loans, loans insured by the Federal Housing Administration ("FHA") and loans guaranteed by the Veterans Administration ("VA"). A significant portion of the conventional loans we produce qualify for inclusion in guaranteed mortgage securities backed by Fannie Mae or Freddie Mac ("conforming loans"). Some of the conventional loans we produce either have an original loan amount in excess of the Fannie Mae and Freddie Mac loan limit for single-family loans ($417,000 for 2006) or otherwise do not meet Fannie Mae or Freddie Mac guidelines. Loans that do not meet Fannie Mae or Freddie Mac guidelines are referred to as "nonconforming loans."

21. Nothing in that description informed investors that Countrywide's "prime non-conforming" category included loan products with increasing amounts of credit risk. While guidance issued by the banking regulators referenced a credit score ("FICO score") at 660 or below as being an indicator of a subprime loan, some within the banking industry drew the distinction at a score of 620 or below. Countrywide, however, did not consider **any** FICO score to be too low to be categorized within "prime." Nor did Countrywide's definition of "prime" inform

investors that its "prime non-conforming" category included so-called "Alt-A" loan products with increasing amounts of credit risk, such as (1) reduced or no documentation loans; (2) stated income loans; and (3) loans with loan to value or combined loan to value ratios of 95% and higher. Finally, it did not disclose that Pay-Option ARM loans, including reduced documentation Pay-Option ARM loans, were included in the category of prime loans. Moreover, to the extent these extremely risky loans were below the loan limits established by the government sponsored entities that purchased these loans ("GSEs"), they would have been reported by Countrywide as prime conforming loans. In 2005 and 2006, Countrywide's Pay-Option ARMs ranged between 17% and 21% of its total loan originations. It maintained the majority of these loans in the held for investment portfolio at Countrywide Bank.

22. Significantly, the Countrywide periodic filings do not define "nonprime" in any way, and Countrywide's periodic filings failed to disclose that loans in the category of subprime were not merely issued to borrowers with blemished credit, but that this category included loans with significant additional layered risk factors, such as (1) subprime piggyback seconds, also known as 80/20 loans; (2) reduced or no documentation loans; (3) stated income loans; (4) loans with loan to value or combined loan to value ratios of 95% and higher; and (5) loans made to borrowers with recent bankruptcies and late mortgage payments.

23. By increasing its origination of non-conforming and subprime loans between 2003 and 2006, Countrywide was able to originate many more loans in those years and increase its market share, even as the residential real estate market declined in the United States. As of December 31, 2003, based on its own internal estimates, Countrywide had an 11.4% share of the United States mortgage market. By September 30, 2006, it had a 15.7% share of the market. While Countrywide boasted to investors that its market share was increasing, company executives did not disclose that its market share increase came at the expense of prudent

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underwriting guidelines. As a result, Countrywide's share price rose from $25.28 on December 31, 2003 to $42.45 on December 29, 2006, the last trading day of that year.

C. Countrywide's Market Strategy Caused it To Take On Increasing Credit Risk

1. Countrywide's Undisclosed Expansion of Underwriting Guidelines and the Matching Strategy

24. By the end of 2006, Countrywide's underwriting guidelines were wider and more aggressive than they had ever been. The company's aggressive guideline expansion was deliberate, and began as early as 2003. Indeed, from January 2003 until well into 2006, Countrywide's credit risk management department ("Risk Management") spent approximately 90% of its time processing requests for expansions of Countrywide's underwriting guidelines.

25. Countrywide's "matching strategy," also known as the "supermarket strategy," was a key driver of the company's aggressive expansion of underwriting guidelines. The strategy committed the company to offering any product and/or underwriting guideline available from at least one "competitor," which included subprime lenders. Thus, if Countrywide did not offer a product offered by a competitor, Countrywide's production division invoked the matching strategy to add the product to Countrywide's menu. For example, if Countrywide's minimum FICO score for a product was 600, but a competitor's minimum score was 560, the production division invoked the matching strategy to reduce the minimum required FICO score at Countrywide to 560.

26. The impact of the matching strategy was intensified by Countrywide's "no-brokering" policy, which precluded Countrywide's loan officers from referring loan applicants to other brokers and/or institutions. Prior to its implementation, loan officers could engage in a practice known as "brokering," in which the loan officer would refer those borrowers deemed too risky for Countrywide to another

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lender, which in turn paid a commission to the Countrywide loan officer. The no-brokering policy increased the incentives for Countrywide's retail sales force to be aggressive in finding ways for Countrywide to underwrite a loan, regardless of whether the loan satisfied the underwriting guidelines Countrywide repeatedly touted to investors.

27. Mozilo, Sambol, and Sieracki knew that the company was taking on increased risk of defaults and delinquencies as a result of its widened underwriting guidelines and matching strategy, yet Countrywide's periodic filings concealed the unprecedented expansion of underwriting guidelines and the attendant increased credit risk.

2. <u>Exception Loans Magnified Countrywide's Credit Risk</u>

28. Though Countrywide proclaimed in its Forms 10-K for 2005, 2006, and 2007 that it managed credit risk through its loan underwriting, the company's increasingly wide underwriting guidelines and exceptions process materially increased Countrywide's credit risk during that time. Countrywide used an automated underwriting system known as "CLUES" to actually underwrite loans. The CLUES system applied the principles and variables set forth in the Countrywide underwriting manuals and its loan program guide. CLUES applied a device known as the "underwriting scorecard," which assessed borrower credit quality by analyzing several variables, such as FICO scores, loan to value ratios, documentation type (*e.g.*, full, reduced, stated) and debt-to-income ratios. These variables were weighted differently within the scorecard, depending upon their perceived strength in predicting credit performance. In underwriting a loan, Countrywide loan officers entered an applicant's information into CLUES, which would (1) approve the loan; (2) approve the loan with caveats; or (3) "refer" the loan to a loan officer for further consideration and/or manual underwriting.

29. The CLUES program typically did not "reject" a loan if a requirement of Countrywide's guidelines had not been met or if CLUES calculated that the loan

presented an excessive layering of risk. Instead, CLUES "referred" the loan, indicating that the loan application would have to be reviewed manually prior to approval. In these circumstances, to proceed with the loan, the loan officer would request an "exception" from the guidelines from more senior underwriters at Countrywide's structured lending desk ("SLD"). Countrywide's level of exceptions was higher than that of other mortgage lenders. The elevated number of exceptions resulted largely from Countrywide's use of exceptions as part of its matching strategy to introduce new guidelines and product changes.

30. Further, the actual underwriting of exceptions was severely compromised. According to Countrywide's official underwriting guidelines, exceptions were only proper where "compensating factors" were identified which offset the risks caused by the loan being outside of guidelines. In practice, however, **Countrywide used as "compensating factors" variables such as FICO and loan to value, <u>which had already been assessed by CLUES in issuing a "refer" finding</u>**. Countrywide underwriting manuals were amended to explicitly prohibit this practice in mid-2007, but this serious deficiency was in place from early 2006 through early 2007, when a large volume of obviously deficient exception loans were originated by Countrywide.

D. <u>Countrywide's Business Model Became Unsustainable</u>

31. As described above, Countrywide depended on its sales of mortgages into the secondary market as an important source of revenue and liquidity. As a result, Countrywide was not only directly exposed to credit risk through the mortgage-related assets on its balance sheet, but also indirectly exposed to the risk that the increasingly poor quality of its loans would prevent their continued profitable sale into the secondary mortgage market and impair Countrywide's liquidity. Rather than disclosing this increasing risk, Mozilo, Sambol, and Sieracki gave false comfort, again touting Countrywide's loan quality. For example, Countrywide stated in its 2005 Form 10-K: "We ensure our ongoing access to the

secondary mortgage market by consistently producing quality mortgages. . . . We make significant investments in personnel and technology to ensure the quality of our mortgage loan production." A virtually identical representation appears in Countrywide's 2006 Form 10-K. Accordingly, Countrywide's failure to disclose its widening underwriting guidelines and the prevalence of exceptions to those guidelines in 2005 and 2006 constituted material omissions from Countrywide's periodic reports.

E. Mozilo, Sambol, and Sieracki Were Aware of the Increased Credit Risk Created By Expanded Underwriting Guidelines and Exception Loans

32. Countrywide's increasingly wide underwriting guidelines materially increased the company's credit risk from 2004 through 2007, but this increased risk was not disclosed to investors. In 2007, as housing prices declined, Countrywide began to suffer extensive credit problems as the inherent credit risks manifested themselves.

1. The September 2004 Warning

33. The credit losses experienced by Countrywide in 2007 not only were **foreseeable** by the proposed defendants, they were in fact **foreseen** at least as early as September 2004. Risk Management warned Countrywide's senior officers that several aggressive features of Countrywide's guidelines (*e.g.*, high loan to value programs, ARM loans, interest only loans, reduced documentation loans, and loans with layered risk factors) significantly increased Countrywide's credit risk.

34. Countrywide was taking on more risk as a direct result of the lower credit quality of the loans it was originating. Countrywide's strategy of reducing risk through loan sales was being frustrated as the company produced smaller percentages of loans eligible for sale on a nonrecourse basis (e.g., FHA, VA and conforming loans), and larger percentages of loans (e.g., subprime and

nonconforming loans) where it retained credit risk in the form of residual interests. By September 2004, defendants knew the following trends:

- 66% of Countrywide's production was conforming in July 2003, but conforming originations **had fallen** to 35% by July 2004;
- 21% of Countrywide's production was nonconforming in July 2003, but non-conforming originations **had risen** to 40% by July 2004; and
- 2% of Countrywide's July 2003 production was subprime, but subprime originations **had risen** to 10% by July 2004.

35. The credit risk described in the September 2004 warning **worsened** from September 2004 to August 2007. Risk Management continuously had discussions with Countrywide's loan production division, which reported to Sambol, about the credit concerns identified in the September 2004 warning. In fact, Risk Management conducted studies to identify relationships among certain credit variables and their effect upon the probability that a loan would go into serious delinquency or default. One finding of these studies, the results of which were shared with Sambol and Sieracki, was that the less documentation associated with a loan, the higher the probability of default. Nevertheless, Countrywide continued to expand its underwriting guidelines, and to liberally make exceptions to those guidelines, through the end of 2006. These facts were never disclosed to investors.

2. <u>Credit Risk Management Repeatedly Alerted the Defendants to Increases in Credit Risk</u>

36. Both Sambol and Sieracki were members of the Countrywide credit risk committee. The credit risk committee had quarterly meetings. At these meetings, the members were provided with detailed presentations highlighting Countrywide's increased credit risk. For example, at an April 6, 2005 meeting of the credit risk committee attended by Sambol, McMurray reported that (1)

Countrywide non-conforming loans originated in May 2002 were twice as likely to default as loans originated in January 2000; (2) the risk of home equity lines of credit defaulting had doubled over the past year, mainly due to the prevalence of reduced documentation in those loans; and (3) Countrywide was now a leader in the subprime market in four of six categories, whereas in December 2004 Countrywide had only been a leader in two of six categories.

37. Similarly, Sieracki attended a June 28, 2005 meeting at which the chief operating officer noted that Countrywide was taking on "too much" balance sheet risk in home equity lines of credit ("HELOCs") and subprime loans, and had taken on "unacceptable risk" from non-owner occupied loans made at 95% combined loan to value ratios, which were an exception to Countrywide's then-existing underwriting guidelines. Risk Management also reported at that meeting that non-conforming loan programs accounted for 40% of Countrywide's loan originations and that subprime production had tripled, rising from 4% to 14% of total production. Finally, at that same meeting, Risk Management reported to the committee on evidence of borrowers misrepresenting their income and occupation on reduced documentation loan applications, and the increasing credit risks associated with Pay-Option ARM loans, for example, negative amortization, payment shock, and the necessity of raising the initial interest rate to reduce the speed of negative amortization on the loans.

38. Sambol and Sieracki also learned of the risks associated with the company's aggressive guideline expansion in meetings of other company committees. For example, Sieracki was a member of the asset and liability committee, and Sambol attended certain of its meetings. If a proposed guideline expansion had a modeled expected default rate in excess of 8%, the proposal had to be submitted to this committee for approval. All proposed expansions to Countrywide's subprime menu from late 2005 through 2006 presented an expected default rate in excess of 8% and required approval of that committee. In June

2005, Sambol and McMurray engaged in a lengthy email exchange regarding the impact of Countrywide's underwriting guideline expansion related to requests for subprime product expansions that had been taken up by the asset and liability committee in the first and second quarters of 2005. In that exchange, McMurray warned Sambol that "as a consequence of [Countrywide's] strategy to have the widest product line in the industry, we are clearly out on the 'frontier' in many areas." McMurray went on to note that the frontier had "high expected default rates and losses."

39. Additionally, proposals with high expected defaults or that were otherwise controversial were referred to the Countrywide responsible conduct committee for approval. Sambol was a member of this committee, which had repeatedly approved guideline expansions. For instance, in late 2006 Countrywide's production divisions proposed expanding Countrywide's guidelines to match certain guidelines offered by Bear Stearns and Lehman Brothers, programs that were known within Countrywide as "Extreme Alt-A." Risk Management was concerned about the risks associated with these guidelines, and referred the request to the responsible conduct committee. Sambol, in his capacity as a member of that committee, approved the expansion.

40. Finally, both Mozilo and Sambol were aware as early as June 2006 that a significant percentage of borrowers who were taking out stated income loans were engaged in mortgage fraud. On June 1, 2006, Mozilo advised Sambol in an email that he had become aware that the Pay-Option ARM portfolio was largely underwritten on a reduced documentation basis and that there was evidence that borrowers were lying about their income in the application process. On June 2, 2006, Sambol received an email reporting on the results of a quality control audit at Countrywide Bank that showed that 50% of the stated income loans audited by the bank showed a variance in income from the borrowers' IRS filings of greater

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than 10%. Of those, 69% had an income variance of greater than 50%. These material facts were never disclosed to investors.

3. **Warnings Regarding the Matching Strategy**

41. McMurray repeatedly provided explicit and ominous warnings about Countrywide's matching strategy. In a June 25, 2005 email to Sambol concerning guideline expansion and the company's growing credit risks, McMurray addressed the matching strategy and explained that "because the matching process includes comparisons to a variety of lenders, our [guidelines] will be a composite of the outer boundaries across multiple lenders[,]" and that because comparisons are only made to competitor guidelines where they are more aggressive and not used where they are less aggressive, **Countrywide's "composite guides [sic] are likely among the most aggressive in the industry."** (emphasis added.)

42. On November 2, 2006, McMurray sent an email to Countrywide's chief investment officer ("CIO"), which the CIO forwarded to Sambol, stating that the matching strategy had caused Countrywide to cede its underwriting standards to the most aggressive lenders in the market. In the email, McMurray asked: "**Do we want to effectively cede our policy and is this approach "saleable" from a risk perspective to those constituents who may worry about our risk profile?**" (emphasis added.)

43. In a November 16, 2006 email to Sambol, McMurray complained about guidelines and products being introduced in contravention of credit policy. As an example, McMurray cited the fact that Extreme Alt-A loans were being offered by the loan production divisions, even though that program had not been officially approved in the guideline review process. The proposed guidelines would have permitted 100% financing, layered with additional credit risk factors such as stated income, lower than average FICO scores, or non-owner occupied investment properties.

44. In a February 11, 2007 email to Sambol, McMurray noted that the production divisions continued to advocate for, and operated pursuant to, an approach based upon the matching strategy alone, and repeated his concern that the strategy would cause Countrywide's guidelines to be a composite of the riskiest offerings the market. Additionally, McMurray warned that, "**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.**" (emphasis added.)

4. Warnings Regarding Guideline Expansion and Disruptions in the Secondary Market

45. By no later than 2006, Mozilo and Sambol were on notice that Countrywide's exotic loan products might not continue to be saleable into the secondary market, yet this material risk was not disclosed in Countrywide's periodic filings.

46. In September 2006 Mozilo wrote an email to Sambol warning that he believed that the Pay-Option loan was "mispriced" in the secondary market and that the pricing spread could disappear quickly if there were a negative event in the market. On February 2, 2007, Risk Management warned Sambol that guideline expansions could disrupt the secondary market for subprime mortgage backed securities ("MBS"). Later in that quarter, the MBS market for subprime loans experienced a disruption that forced Countrywide to write down loans that it had previously intended to sell into that market. Then, in August 2007, the entire market for MBS experienced a severe disruption, which effectively crippled the ability of Countrywide, as well as other mortgage lenders, to sell non-GSE securitizations into the secondary markets and contributed to Countrywide's liquidity problems.

5. <u>Warnings Regarding 100% (a.k.a. 80/20 loans) Financing</u>

47. The seriousness of Risk Management's warnings on guideline expansion and the consequences of Countrywide's failure to heed such warnings are vividly demonstrated by the company's experience with "80/20" subprime loans. An 80/20 subprime loan is a loan where a borrower with a subprime FICO score simultaneously takes out two loans to purchase a home: a first lien loan (typically 80% of the purchase price), and a second lien loan (typically 20% of the purchase price). As a result of having 100% financed the purchase, the borrower has no initial equity in the home. Pursuant to Risk Management's "Policy on High Risk Products," subprime 80/20 loans could not be originated via the exceptions process, and could only be originated if Countrywide could totally extinguish the credit risks (*e.g.*, residual interests or corporate guarantees) resulting from such loans. But the policy was ignored by the production divisions.

48. Mozilo knew of the risks Countrywide incurred by originating subprime 80/20 loans and repeatedly questioned the wisdom of continuing to offer the product. Mozilo became concerned about the loans in the first quarter of 2006, when HSBC, a purchaser of Countrywide's 80/20 loans, began to contractually force Countrywide to "buy back" certain of these loans that HSBC contended were defective. On March 28, 2006, Mozilo sent an e-mail to Sambol and others, directing them to implement a series of corrective measures to "avoid the errors of both judgment and protocol that have led to the issues that we face today caused by the buybacks mandated by HSBC." Mozilo further stated that the 100% loan-to-value (also known as 80/20) subprime product is "**the most dangerous product in existence and there can be nothing more toxic** and therefore requires that no deviation from guidelines be permitted irrespective of the circumstances."

49. Then, in an April 13, 2006 email, Mozilo informed Sambol, Sieracki, and others that there were numerous issues that they must address relating to the 100% subprime second business in light of the losses associated with the HSBC

buyback. One issue in particular that Mozilo identified was the fact that the loans had been originated "through our channels with disregard for process [and] compliance with guidelines." Mozilo went on to write that he had **"personally observed a serious lack of compliance within our origination system as it relates to documentation and generally a deterioration in the quality of loans originated** versus the pricing of those loan [sic]." Mozilo noted that, **"[i]n my conversations with Sambol he calls the 100% sub prime seconds as the 'milk' of the business. <u>Frankly, I consider that product line to be the poison of ours</u>."** (emphasis added.)

50. Furthermore, in an April 17, 2006 email to Sambol concerning Countrywide's subprime 80/20 loans, Mozilo fumed:

> In all my years in the business I have never seen a more toxic prduct. [sic] It's not only subordinated to the first, but the first is subprime. In addition, the FICOs are below 600, below 500 and some below 400[.] With real estate values coming down...the product will become increasingly worse. There has [sic] to be major changes in this program, including substantial increases in the minimum FICO.... Whether you consider the business milk or not, I am prepared to go without milk irrespective of the consequences to our production.

51. Echoing Mozilo's criticisms of the 80/20 product, in April 2006 Risk Management recommended increasing the minimum FICO score on the product by 20 points. Sambol, then still the head of the production divisions, opposed this recommendation, and noted that such an increase would make Countrywide uncompetitive with subprime lenders such as New Century, Option One, and Argent.

52. On December 7, 2006, Mozilo circulated a memorandum drafted for him by McMurray to the board of directors and all Countrywide managing

directors, including Sambol and Sieracki. In the memorandum, Mozilo made the following observations, among others:

- Countrywide had expanded its subprime underwriting guidelines in every conceivable area, lowering minimum FICOs, raising maximum loan size and LTV, and making interest only, stated income, and piggyback second loans available to subprime borrowers;
- Countrywide expected that subprime loans originated in 2006 (the "2006 Vintage") would be the worst performing on record, driven by wider guidelines and the worsening economic environment, which included rising interest rates and declining home values;
- the percentage of 60- and 90-day delinquencies in the 2006 Vintage (at 8.11% and 4.03% respectively), exceeded the percentages from each of the previous six years, and the company expected these percentages to rise; and
- 62% of Countrywide's subprime originations in the second quarter of 2006 had a loan to value ratio of 100%.

53. In April 2006, Mozilo wrote that no premium, no matter how high, could justify underwriting a loan for a borrower whose FICO score was below 600. Yet Countrywide failed to disclose to investors the serious deficiencies in its underwriting of these "toxic" loans.

6. <u>Warnings Regarding Exception Loans</u>

54. Mozilo, Sambol, and Sieracki were aware of significant lapses in Countrywide's underwriting processes and the resulting risk to Countrywide. On May 22, 2005, McMurray warned Sambol of the likelihood of significantly higher default rates in loans made on an exception basis: "[t]he main issue is to make sure everyone's aware that we will see higher default rates." McMurray explained that

"exceptions are generally done at terms more aggressive than our guidelines," and continued that **"[g]iven the expansion in guidelines and the growing likelihood that the real estate market will cool, this seems like an appropriate juncture to revisit our approach to exceptions."** (emphasis added.) McMurray also warned that increased defaults would cause repurchase and indemnification requests to rise and the performance of Countrywide-issued MBS to deteriorate.

55. The poor quality of the loans originated through the exception process became even more obvious in the first quarter of 2007. In fact, in materials distributed at a March 12, 2007 meeting of the credit risk committee attended by Sambol and Sieracki, Risk Management reported that nearly 12% of the loans reviewed by Countrywide in an internal quality control process were rated "severely unsatisfactory" or "high risk." The causes for such a rating included findings that such loans had debt-to-income, loan to value, or FICO scores outside of Countrywide's already wide underwriting guidelines. By the second quarter of 2007, Risk Management began to report a serious deterioration in the performance of exception loans.

56. In a December 13, 2007 memo that was sent to Mozilo in his capacity as Countrywide's chairman of the board, Countrywide's enterprise risk assessment officer noted that:

> Countrywide had reviewed limited samples of first- and second-trust-deed mortgages originated by Countrywide Bank during the fourth quarter of 2006 and the first quarter of 2007 in order to get a sense of the quality of file documentation and underwriting practices, and to assess compliance with internal policies and procedures. The review resulted in . . . the finding that **borrower repayment capacity was not adequately assessed by the bank during the underwriting process** for home

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> equity loans. More specifically, **debt-to-income (DTI) ratios did not consider the impact of principal [negative] amortization or an increase in interest.** (emphasis added)

57. These material deficiencies in Countrywide's underwriting were never disclosed to investors in Countrywide's Forms 10-Q or 10-K for 2005 through 2007.

F. Pay-Option Arms and the Discrepancy Between the Internal and External Portrayals of Credit Risk

1. The External Story

58. Countrywide began originating Pay-Option ARM loans in 2004; by the second quarter of 2005 21% of Countrywide's loan production was Pay-Option ARMS. Pay-Option ARMs allowed borrowers to choose between four payment options: (1) a minimum payment which was insufficient to cover accruing interest; (2) an interest-only payment; (3) a fully amortizing payment with a 30 year pay-off; and (4) a fully amortizing payment with a 20 year pay-off. If the minimum payment was selected, then the accruing interest would be added to the loan's principal balance, a phenomenon known as negative amortization. Countrywide's Pay-Option ARM loans typically allowed for negative amortization until the principal balance reached 115% of the original loan balance, at which time the payment would reset to the amount necessary to repay principal and interest in the term remaining on the loan. This resulted in a much higher monthly payment and "payment shock" to many borrowers. Even if the borrower never reached the 115% threshold, the loan would typically reset after five years to a fully amortizing payment. Because Countrywide began to offer Pay-Option loans in 2004, Countrywide's first wave of automatic resets were scheduled to occur in 2009. Unlike many other loans that Countrywide originated, most of the Pay-Option loans were held for investment by Countrywide Bank.

59. Countrywide publicly heralded Pay-Option loans as a safe product offering. For instance, in its 2006 Form 10-K, Countrywide proclaimed that it had "prudently underwritten" its Pay-Option ARMs. On May 31, 2006, Mozilo gave a speech in which he stated, "Pay-Option loans represent the best whole loan type available for portfolio investment from an overall risk and return perspective," that, "[t]he performance profile of this product is well understood because of its twenty year history, which includes stress tests in difficult environments[,]" and that Countrywide "actively manages credit risk through prudent program guidelines...and sound underwriting."

2. The Internal View

60. Contrary to such public statements extolling the virtues of the Pay-Option ARM product, Mozilo, along with several of Countrywide's senior executives, had concluded that the product's risks to the company were severe, and they were scrambling to identify ways to mitigate them. Sambol and Sieracki were aware of these concerns.

a. Negative Amortization and Payment Shock

61. In June 2005, Risk Management warned senior executives, including Sieracki, that action was needed to address the increasing pace of negative amortization and the potential for payment shock associated with Pay-Option ARMs. Specifically, in a June 28, 2005 meeting of the credit risk committee, which was attended by Sieracki, Risk Management recommended that the rate used to calculate the minimum payment on Pay-Option ARMs ("start rate") be raised to reduce negative amortization and the severity of payment shock. Risk Management explained that while the start rate remained constant at 1%, short term rates (upon which borrowers' fully amortizing payments were based) had risen steadily, thereby increasing the pace of negative amortization and the severity of the resulting payment shock.

62. At a June 22, 2006 credit risk committee meeting, attended by Sambol and Sieracki, Risk Management noted that the median time to reset on the pay option loans was getting shorter as negative amortization was accruing at a faster than expected pace.

b. **Mozilo's Pointed Concerns About Pay-Option ARMs**

63. On April 4, 2006, Mozilo received an e-mail regarding Pay-Option loans which informed him that "72% of [Pay-Option] customers chose Minimum Payment selection in February 06, up from 60% in August 05." In response to this information Mozilo sent an email to Sambol that reflected how well he understood the negative ramifications of the information for Countrywide: "Since over 70% have opted to make the lower payment it appears that **it is just a matter of time that we will be faced with much higher resets and therefore much higher delinquencies.**"

64. About six weeks later, on May 18, 2006, Mozilo sent another e-mail to Sambol and Sieracki again sounding the alarm about the Pay-Option portfolio. Stating that "the Bank faces potential unexpected losses because higher [interest] rates will cause the loans to reset much earlier than anticipated and as a result causing mortgagors to default due to the substantial increase in their payments," Mozilo directed the management team to reduce "balance sheet risk" by refinancing Pay-Options into interest-only loans and improving consumer education about the consequences of resets. Mozilo concluded his e-mail by stating that "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 payoptions." The very next day, May 19, 2006, Mozilo wrote another email to Sambol and Sieracki, noting that Pay-Options loans presented a long term problem "unless [interest] rates are reduced dramatically from this level and there are no indications, absent another terrorist attack, that this will happen."

c. <u>Mozilo's Concerns Mount</u>

65. Mozilo received more dire news regarding the Pay-Option loan portfolio in June 2006. On June 1, 2006, **one day** after he gave a speech publicly praising Pay-Option ARMs, Mozilo sent an email to Sambol and other executives, in which he expressed concern that the majority of the Pay-Option ARM loans were originated based upon stated income, and that there was evidence of borrowers misrepresenting their income. Mozilo viewed stated income as a factor that increased credit risk and the risk of default. In his email, Mozilo reiterated his concern that in an environment of rising interest rates, resets were going to occur much sooner than scheduled, and because at least 20% of the Pay-Option borrowers had FICO scores less than 700, **borrowers "are going to experience a payment shock which is going to be <u>difficult if not impossible</u> for them to manage."** Mozilo concluded that the company needed to act quickly to address these issues because "[w]e know or can reliably predict what's going to happen in the next couple of years." Mozilo directed Countrywide Bank to (1) stop accumulating loans with FICO scores below 680 unless the loan-to-value ratio was 75% or lower, (2) assess the risks that the Bank faced on loans with FICO scores below 700 and determine if they could be sold out of the Bank and replaced with higher quality loans, and (3) take a careful look at the reserves and "begin to assume the worst."

66. On July 10, 2006, Mozilo received an internal monthly report, called a "flash report," that tracked the delinquencies in the Pay-Option portfolio, as well as the percentage of borrowers electing to make the minimum payment and the amount of accumulated negative amortization on each loan. Mozilo learned that from September 2005 through June 2006, the percentage of Pay-Option borrowers choosing to make the minimum payment had nearly doubled, from 37% to 71%. Mozilo believed that these statistics were significant enough that he requested that the company include a letter in bold type with every new Pay-Option loan to

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inform borrowers of the dangers of negative amortization and to encourage full payment.

67. About a month later, on August 16, 2006, Mozilo received an e-mail from a fellow member of Countrywide's board of directors, asking whether the company anticipated any significant problems with the Pay-Option portfolio. Mozilo responded by reiterating the ongoing concerns he had shared with senior management earlier in 2006. By this point in time, over 75% of the Pay-Options borrowers were opting for the minimum payment, which, along with rising interest rates, continued to accelerate negative amortization. Mozilo explained that, as a result, the loans would reset much faster than the borrowers expected with accompanying payment shock. The only solution, Mozilo wrote, was to refinance the loans before reset, but this would be difficult in light of decreasing home values and rising interest rates. Mozilo wrote that only "unlikely" events, such as a dramatic rise in home values or a dramatic drop in interest rates, would alleviate future payment shock.

d. Internally, Mozilo Urges Selling the Pay-Option Portfolio

68. Mozilo met with Sambol the morning of September 25, 2006 to discuss the Pay-Option ARM loan portfolio. The next day Mozilo sent an e-mail to Sambol and Sieracki expressing even greater concern about the portfolio. In that e-mail, Mozilo wrote:

> **[w]e 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 our focus is fico. In my judgement, as a long time lender, I would always trade off fico

for equity. The bottom line is that **<u>we are flying blind</u>** on how these loans will perform in a stressed environment of higher unemployment, reduced values and slowing home sales. (emphasis added)

69. In his September 26, 2006 email Mozilo further stated that "**pay options are currently mispriced in the secondary market, and that spread could disappear quickly** if there is an foreseen [sic] headline event such as another lender getting into deep trouble with this product or because of negative investor occurance [sic]." (emphasis added.) He urged that the "timing [wa]s right" to sell Countrywide Bank's portfolio of loans. To mitigate these anticipated losses, Mozilo proposed that the Bank "sell all newly originated pay options and begin rolling off the bank balance sheet, in an orderly manner, pay options currently in their port[folio]."

70. McMurray responded to Mozilo's September 26, 2006 email, agreeing that Countrywide "should be shedding rather than adding Pay Option risk to the portfolio." In the fall of 2006, Countrywide's CIO went further, and recommended to Mozilo, Sambol, Sieracki, and others that <u>all</u> Pay-Option ARMs be sold from Countrywide Bank because Countrywide was not receiving sufficient compensation on these loans to offset the risk of retaining them on its balance sheet.

71. Mozilo never became comfortable with the risk presented by the Pay-Option loan. Indeed, on January 29, 2007, Mozilo wrote an email in which he instructed the president of Countrywide Bank to "to explore with KPMG the potential of selling out (one time transaction because of the tarred reputation of Payoptions) the bulk to the Payoptions on the Bank's balance sheet and replace them with HELOCS." Then, on November 3, 2007, Mozilo instructed the president of the Bank and Sambol that he did not "want any more Pay Options originated for the Bank. I also question whether we should touch this product

going forward because of **our inability to properly underwrite these** combined with the fact that these loans are inherently unsound unless they are full doc, no more than 75% LTV and no piggys" (emphasis added). Finally, on November 4, 2007, Mozilo advised the president of the Bank and Sambol that "[p]ay options have hurt the company and the Bank badly. . . . World Savings culture permits them to make these loans in a sound manner and our culture does not . . . . fico scores are no indication of how these loans will perform."

72. Despite the repeated warnings of Mozilo, McMurray, and the CIO, the Pay-Option ARMs were never sold, and the clearly identified risks to Countrywide were not disclosed to investors. Mozilo recognized as early as August 2006 that Pay-Option ARM loans were one of the "only products left with margins [profit]."

G. <u>Mozilo, Sambol, and Sieracki Were Responsible for Countrywide's Periodic Filings</u>

73. Mozilo, Sambol, and Sieracki each bore responsibility for Countrywide's periodic filings. In April 2004, Countrywide promulgated a set of written "Disclosure Controls and Procedures ("Disclosure Guidelines")" which established the procedures governing the preparation of the company's periodic reports. The Disclosure Guidelines were revised in December 2005 and again in September 2006. The Disclosure Guidelines established a disclosure committee at Countrywide, which Sieracki joined at least as early as December 2005. The Disclosure Guidelines required Countrywide "to disclose on a timely basis any information that would be expected to affect the investment decision of a reasonable investor or to alter the market price of the Company's securities." Countrywide's financial reporting staff was required to:

> seek input from and discuss with the Divisional Officers information pertaining to the past and current performance and prospects for their business unit, known trends and uncertainties related to the business

> unit, [and] significant risks and contingencies that may affect the business unit. . .

The Disclosure Guidelines also required that Countrywide's accounting division, among others, assist the officers involved in the preparation of the company's periodic reports in gaining a reasonable understanding of the applicable rules and regulations, including the disclosure requirements set forth in Regulation S-K and the relevant SEC staff guidance and interpretive materials.

74. The preparation of the periodic reports at Countrywide began with a review of the pertinent report from the prior period. The senior vice president for financial reporting circulated to the head of each Countrywide division (1) a memorandum setting forth Countrywide's disclosure obligations and (2) a template ("MD&A Questionnaire") that contained questions concerning the applicable officer's division and that portion of the prior period's filing that concerned the officer's division.

75. Starting in the first quarter of 2006, the MD&A Questionnaire for credit risk management was sent to McMurray and solicited information pertaining to a number of topics related to credit risk, including (1) changes in the management of credit risks, (2) environmental risks and uncertainties, (3) deterioration in loan quality and (4) changes in underwriting guidelines.

76. After circulating the draft MD&A Questionnaires to the divisions, the financial reporting group compiled them and generated the first draft of the periodic report, which was reviewed and edited by the chief accounting officer and the deputy CFO. The revised draft then went to the legal department and the senior managing directors responsible for signing sub-certifications, as well as Sieracki, Sambol, and Mozilo.

77. From the certifiers and the senior officers, the draft went to the board of directors. When all of the certifications had been compiled, Sieracki and Mozilo were notified and they signed Sarbanes-Oxley certifications. Sieracki also signed

all of the Forms 10-Q and 10-K starting in the first quarter of 2005 and throughout 2007. Sambol signed the Forms 10-Q for the third quarter of 2006 and all of the quarters in 2007, as well as the Form 10-K for the year ended 2007. Mozilo signed the Forms 10-K for the years ended 2005, 2006, and 2007.

H. Sambol and Sieracki Refused Suggestions to Disclose Countrywide's Increased Credit Risk

78. Sambol and Sieracki actively participated in decisions to exclude disclosures regarding Countrywide's widened underwriting guidelines in the periodic filings. Throughout 2006, McMurray unsuccessfully lobbied to the financial reporting department that Countrywide disclose more information about its increasing credit risk, but these disclosures were not made.

79. In January 2007, McMurray sent an email to Sieracki, which he subsequently incorporated by reference in his MD&A questionnaire, explaining that Countrywide's delinquencies would increase in the future due to a weakening real estate market and what McMurray characterized as credit guidelines that were "wider than they have ever been." On January 29, 2007 McMurray provided Sambol and others with an outline of where credit items impacted Countrywide's balance sheet. McMurray then forwarded the email to the financial reporting staff, and specifically requested that a version of the outline be included in the 2006 Form 10-K. The information was not included in the 2006 Form 10-K.

80. In August 2007, McMurray exchanged a series of emails with the managing director of financial reporting suggesting revisions to the Form 10-Q for the second quarter of 2007. McMurray again specifically asked financial reporting to include information regarding widened underwriting guidelines in the prospective trends section of the Form 10-Q for the second quarter of 2007. In response, the managing director of financial reporting wrote back to McMurray, stating that he did not make McMurray's changes because he "**expect[ed] those**

changes to be <u>trumped</u> by certain reviewers." One of those reviewers was Sambol.

81. When McMurray's request that Countrywide disclose its widened underwriting guidelines was not included in the draft filing, he sent a "qualified" certification to the company's Sarbanes-Oxley officer, along with an email articulating his concerns. That email was forwarded to the deputy CFO, who then spoke with McMurray about his concerns. She took his suggestions to Sieracki and Sambol, who directed her not to include them in the Form 10-Q.

82. Despite McMurray's repeated requests, Countrywide never made any disclosures in its Forms 10-Q or 10-K for 2005, 2006, or 2007 about the unprecedented expansion of its underwriting guidelines.

I. <u>Mozilo, Sambol, and Sieracki Made Affirmative Misrepresentations to Investors</u>

83. As set forth in detail above, Mozilo, Sambol, and Sieracki were all aware that Countrywide had increasingly widened its underwriting guidelines year after year from 2004 through 2006, and that Countrywide Bank's held for investment portfolio included loans that were underwritten based on reduced documentation, with loan to value ratios above 95%, and with subprime FICO scores. Despite that knowledge, Mozilo, Sambol, and Sieracki failed to include these material facts in Countrywide's Forms 10-K and 10-Q for 2005, 2006, and 2007. Indeed, Mozilo, Sieracki, and Sambol each made public statements from 2005 through 2007 that were intended to mislead investors about the increasingly aggressive underwriting at Countrywide and the financial consequences of those widened underwriting guidelines.

1. <u>Misrepresentations in Countrywide's Periodic Reports</u>

84. From 2005 through 2007, all of the proposed defendants participated in preparing Countrywide's periodic reports. These documents contained misrepresentations as follows:

85. First, Countrywide's Forms 10-K for 2005, 2006, and 2007 stated that Countrywide "manage[d] credit risk through credit policy, underwriting, quality control and surveillance activities" and touted the Company's "proprietary underwriting systems . . . that improve the consistency of underwriting standards, assess collateral adequacy and help to prevent fraud." These statements were false, because defendants knew that a significant portion of Countrywide's loans were being made as exceptions to Countrywide's already extremely broad underwriting guidelines.

86. Second, Countrywide stated in its 2005 Form 10-K: "We ensure our ongoing access to the secondary mortgage market by consistently producing quality mortgages. . . . We make significant investments in personnel and technology to ensure the quality of our mortgage loan production." A virtually identical representation appears in Countrywide's 2006 Form 10-K. These statements were false, because, as set forth in detail above, Mozilo, Sambol, and Sieracki were aware that Countrywide was originating increasing percentages of poor quality loans that did not comply with Countrywide's underwriting guidelines.

87. Third, the descriptions of "prime non-conforming" and "subprime" loans in Countrywide's Forms 10-K were misleading because they failed to disclose what types of loans were included in those categories. The definition of "prime" loans in Countrywide's 2005, 2006, and 2007 Forms 10-K was:

> Prime Mortgage Loans include conventional mortgage loans, loans insured by the Federal Housing Administration ("FHA") and loans guaranteed by the Veterans Administration ("VA"). A significant portion of the conventional loans we produce qualify for inclusion in guaranteed mortgage securities backed by Fannie Mae or Freddie Mac ("conforming loans"). Some of the conventional loans we produce either have an original loan

> amount in excess of the Fannie Mae and Freddie Mac loan limit for single-family loans ($417,000 for 2006) or otherwise do not meet Fannie Mae or Freddie Mac guidelines. Loans that do not meet Fannie Mae or Freddie Mac guidelines are referred to as "nonconforming loans.

88. Nothing in that definition informed investors that Countrywide included in its prime category loans with FICO scores below 620. Nor did the definition inform investors that the "prime non-conforming" category included loan products with increasing amounts of credit risk, such as (1) reduced and/or no documentation loans; (2) stated income loans; or (3) loans with loan to value or combined loan to value ratios of 95% and higher. Finally, it did not disclose that Countrywide's riskiest loan product, the Pay-Option ARM, was classified as a "prime loan," and to the extent that the loan amount was below the loan limits established by the GSEs, would have been reported in Countrywide's Forms 10-K as a prime conforming loan. Significantly, in 2005 and 2006, Countrywide's Pay-Option ARMs ranged between 17% and 21% of its total loan originations, the majority of which were held for investment at Countrywide Bank.

89. Fourth, the Countrywide periodic filings noted that Countrywide originated "non-prime" loans, but failed to disclose that these loans were not merely issued to borrowers with blemished credit, but also included significant additional risk factors, such as (1) subprime piggyback seconds, also known as 80/20 loans; (2) reduced documentation loans; (3) stated income loans; (4) loans with loan to value or combined loan to value ratios of 95% and higher; or (5) loans made to borrowers with recent bankruptcies and late mortgage payments.

90. Finally, Countrywide's 2006 Form 10-K contained the misrepresentation that "[w]e believe we have prudently underwritten" Pay-Option ARM loans -- despite Mozilo's resounding internal alarms regarding these loans

and his and Sambol's knowledge that a significant percentage of borrowers were misstating their incomes on stated income loans.

2. Mozilo and Sambol Made Additional Affirmative Misstatements to Investors

91. Mozilo and Sambol made affirmative misleading public statements in addition to those in the periodic filings that were designed to falsely reassure investors about the nature and quality of Countrywide's underwriting.

92. Mozilo repeatedly emphasized Countrywide's underwriting quality in public statements from 2005 through 2007. For example, in an April 26, 2005 earnings call, Mozilo falsely stated that Countrywide's Pay-Option portfolio at the bank was "all high FICO." In that same call, in response to a question about whether the company had changed its underwriting practices, Mozilo stated, "We don't see any change in our protocol relative to the quality of loans that we're originating."

93. In the July 26, 2005 earnings call, Mozilo claimed that he was "not aware of any change of substance in [Countrywide's] underwriting policies" and that Countrywide had not "taken any steps to reduce the quality of its underwriting regimen." In that same call, Mozilo touted the high quality of Countrywide's Pay-Option ARM loans by stating that "[t]his product has a FICO score exceeding 700. . . . the people that Countrywide is accepting under this program . . . are of much higher quality. . . that [sic] you may be seeing . . . for some other lender." On January 31, 2006, Mozilo stated in an earnings call "It is important to note that [Countrywide's] loan quality remains extremely high."

94. On April 27, 2006, Mozilo stated in an earnings call that Countrywide's "pay option loan quality remains extremely high" and that Countrywide's "origination activities [we]re such that, the consumer is underwritten at the fully adjusted rate of the mortgage and is capable of making a higher payment, should that be required, when they reach their reset period."

These statements were false when made, because on April 4, 2006, Mozilo wrote of the bank's pay-option portfolio, "[s]ince over 70% [of borrowers] have opted to make the lower payment it appears that **it is just a matter of time that we will be faced with much higher resets and therefore much higher delinquencies.**"

95. Then, on May 31, 2006, at the Sanford C. Bernstein Strategic Decisions Conference, Mozilo addressed investors and analysts and made additional false statements that directly contradicted the statements he was making internally within Countrywide. Specifically addressing Pay-Option loans, Mozilo told the audience that despite recent scrutiny of Pay-Option loans, "Countrywide views the product as a sound investment for our Bank and a sound financial management tool for consumers." At the May 31 conference, Mozilo added that the "performance profile of this product is well-understood because of its 20-year history, which includes 'stress tests' in difficult environments."

96. Mozilo's statements at the Sanford Bernstein Conference were false, because at the time that he made them he had just written to Sambol and Sieracki in a May 19, 2006 email that **Pay-Option loans would continue to present a long-term problem "unless rates are reduced dramatically from this level and there are no indications, absent another terrorist attack, that this will happen.**" Moreover, on June 1, 2006, Mozilo advised Sambol in an email that he knew that the Pay-Option portfolio was largely underwritten on a reduced documentation basis, and believed there was evidence that borrowers were lying about their income in the application process. Mozilo concluded: (1) in an environment of rising interest rates, borrowers would reach the 115% negative amortization cap sooner than they expected; (2) **borrowers would suffer payment shock because of the substantially higher payments upon reset, particularly those with FICO scores below 700 who "are going to experience a payment shock which is going to be difficult if not impossible for them to manage"; and (3) "we know or can reliably predict what's going to happen in the next couple**

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of years" so the company must act quickly to address these issues. In addition, Mozilo failed to disclose that by the time he made the statement about the 20-year history of pay-options, the history that he was referring to, that of World Savings, no longer provided him any comfort about the future performance of the portfolio.

97. At a Fixed Income Investor Forum on September 13, 2006, Mozilo upheld Countrywide as a "role model to others in terms of responsible lending." He went on to remark that "[t]o help protect our bond holder customers, we engage in prudent underwriting guidelines" with respect to Pay-Option loans. These statements were false when made because:

- On July 10, 2006, after reviewing data on an internal flash report, Mozilo learned that, from September 2005 through June 2006, the percentage of Pay-Option borrowers choosing to make the minimum payment had nearly doubled, from 37% to 71%. This was the key metric by which Mozilo measured the performance of the Pay-Option portfolio;
- On August 16, 2006 Mozilo received an e-mail asking whether the company anticipated any significant problems with the Pay-Option portfolio. Mozilo responded that rising interest rates would cause the loans to reset much faster than the borrowers expected with accompanying payment shock. The only solution, Mozilo wrote, was to refinance the loans before reset, but this would be difficult, in light of decreasing home values and rising interest rates. Only unlikely events, such as a dramatic rise in home values or a dramatic drop in interest rates, would alleviate future payment shock; and
- On September 26, 2006 Mozilo advised Sambol and Sieracki in an email that "[w]e have no way, with any reasonable certainty, to assess the real risk of holding [Pay-Option] 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 our focus is fico. In my judgement, [sic] as a long time lender, I would always trade off fico for equity. The bottom line is that **we are flying blind** on how these loans will perform in a stressed environment of higher unemployment, reduced values and slowing home sales." (emphasis added)

98. In the January 30, 2007 earnings conference call, Mozilo attempted to distinguish Countrywide from other lenders by stating "we backed away from the subprime area because of our concern over credit quality." On March 13, 2007, in an interview with Maria Bartiromo on CNBC, Mozilo said that it would be a "mistake" to compare monoline subprime lenders to Countrywide. He then went on to state that the subprime market disruption in the first quarter of 2007 would "be great for Countrywide at the end of the day because all of the irrational competitors will be gone."

99. Sambol also made misleading statements that were designed to reassure investors. For example, at a May 24, 2005 investor day presentation, Sambol reassured analysts that Countrywide addressed the higher credit risk associated with adjustable rate mortgage programs by requiring different underwriting criteria such as "higher credit scores or lower loan to value ratios." At the September 13, 2006 Fixed Income Investor Forum, Sambol downplayed Countrywide's participation in originating subprime loans by falsely stating that Countrywide had been "on the sidelines" of the risky subprime market.

100. The statements in Countrywide's periodic filings and statements by its chief executives were materially false when made, because Mozilo and Sambol were well aware that Countrywide had increasingly widened its underwriting guidelines year over year from 2004 through 2006, and Countrywide's loan quality had deteriorated as a result.

J. **Countrywide's Collapse**

101. In the first quarter of 2007, subprime 80/20s experienced high levels of defaults and delinquencies, which caused severe disruptions in the secondary market for subprime loans. On January 31, 2007, two members of Countrywide's Risk Management participated in the annual meeting of the American Securitization Forum ("ASF"), which was attended by sophisticated investors who purchased mortgage backed securities in the secondary market. They reported

back in a February 2, 2007 email, which was forwarded to Sambol, and noted that, "[t]he obvious big topic of concern was 2006 vintage performance, both prime and nonprime. **All recognize that 80/20's (and the layered risk on top of them) are definitely the main culprit** and are concerned that the rating agencies sized it wrong. All want to know when we are pulling back guidelines...and why we haven't already." (emphasis added.) They went on to note that, "**[i]nvestors believed that 100% financing and layered risk is the driver.**" (emphasis added.)

102. One of the Countrywide employees attending the conference observed that higher than expected losses on 80/20 loans caused investors to fear increasingly high losses and the possibility that their investments, which, in many cases, had received AAA ratings, would be downgraded. The secondary market for 80/20 loans essentially evaporated after the conference. In 2007, as a result of the increasingly risky loans that it had been underwriting, Countrywide began to report extensive credit problems. In May 2007, Countrywide disclosed in its Form 10-Q for the first quarter of 2007 that its consolidated net earnings for the quarter were $434 million, a 37% **decrease** from net earnings in the first quarter of 2006. Countrywide indicated that its first quarter results had been negatively impacted by higher delinquencies related to its subprime lending, which had caused the company to (1) take a write down of $217.8 million due to its inability to sell certain of its subprime loans into the secondary market; (2) reduce the estimated value of its retained servicing rights by $429.6 million; and (3) increase its allowance for loan losses on loans held for investment by $95.9 million.

103. Then, on August 9, 2007, Countrywide disclosed in its Form 10-Q for the second quarter of 2007 that its consolidated net earnings for the quarter were $485 million, a 33% net decrease from the second quarter of 2006. Countrywide attributed the decline to credit-related costs, specifically, a $417.2 million impairment loss on its retained interests, including $388.1 million related to home

equity loans, and a $231 million increase in its allowance for loan losses. On July 24, 2007, in the earnings release teleconference, Countrywide disclosed for the first time that its definition of "prime" loans included loans made to borrowers with FICO scores as low as 500, and that 80% of its portfolio of Pay-Option loans held for investment were underwritten based upon reduced documentation. After the disclosures regarding its credit risk on July 24, 2007, Countrywide's share price dropped from the previous day's close of $34.06 to $30.50 on July 24, an 11% decline.

104. Concurrent with its rising credit losses, Countrywide experienced a liquidity crisis in August 2007. Revenues from Countrywide's capital markets loan sales and securitizations had dropped from $553.5 million in pre-tax earnings in 2006 to $14.9 million in 2007, and Countrywide found itself unable to access the short term credit markets by issuing commercial paper. As a result, on August 16, 2007, Countrywide announced that it had drawn down its entire $11.5 billion credit facility to supplement its cash position. Following that announcement, the ratings agencies downgraded Countrywide's securities, and Countrywide's stock declined from $21.29 per share to $18.95, another approximately 11% decline.

105. On August 23, 2007, Countrywide announced that Bank of America had invested $2 billion in Countrywide in exchange for non-voting preferred securities.

106. On October 26, 2007, Countrywide reported a quarterly loss of $1.2 billion. The company's Form 10-Q, filed on November 9, 2007, disclosed that Countrywide had taken a $1 billion impairment loss on its loans held for sale and mortgage backed securities, and had taken $1.9 billion in credit charges related to its allowance for loan losses and its provision for representations and warranties on loans it had securitized and sold. In the October earnings call, Mozilo nevertheless assured investors that the company would return to profitability in the fourth quarter of 2007 - a representation that caused Countrywide's share price to rise from its

previous day's close of $13.07 to $17.30 after the call, despite its poor performance in that quarter.

107. Thereafter, Countrywide's share price continued to trend downward, driven in part by bankruptcy rumors, until it closed at $8.94 on December 31, 2007. Then, on January 8, 2008, Countrywide's shares dropped 28%, from $7.64 to $5.47, again on rumors that the company intended to file for bankruptcy. On January 11, 2008, prior to reporting its year-end 2007 results, Countrywide announced that it was being acquired by Bank of America in an all stock transaction estimated to have an approximate value of $4 billion.

108. On March 29, 2008, in its Form 10-K for the year ended December 31, 2007, Countrywide disclosed that the contraction of the secondary market for its loans had increased its financing needs because it was required to hold loans for longer periods pending sale and certain loans had become unmarketable and had to be held for investment. In response to these funding needs, Countrywide disclosed that it had: (1) speeded integration of mortgage banking activities into Countrywide Bank to reduce its dependency on the secondary markets; (2) taken a $2 billion infusion from Bank of America in exchange for shares of preferred stock; (3) drawn down an $11.5 billion credit line to maintain liquidity; and (4) revised its product offerings and underwriting guidelines, such that the majority of its loan production was again eligible for sale to the government sponsored entities.

K. <u>Stock Sales of Mozilo and Sambol</u>

109. Both Mozilo and Sambol realized profits on sales of Countrywide stock in 2005, 2006, and 2007, through stock sales pursuant to various 10b5-1 plans. From May 9, 2005, when the Form 10-Q for the first quarter of 2005 was filed, through the end of 2007, Mozilo exercised stock options and sold the underlying shares for total proceeds of at least $260 million, and Sambol exercised stock options and sold the underlying shares for total proceeds of at least $40 million.

L. Mozilo, Sambol, and Sieracki Participated in Several Offerings of Countrywide Securities While the Misleading Periodic Reports Were Outstanding

110. On February 9, 2006, Countrywide filed a registration statement on Form S-3ASR that registered a then indeterminate amount of common stock, preferred stock, stock purchase contracts, stock purchase units, and debt securities of Countrywide. Thereafter, Countrywide filed 180 prospectus supplements identifying the securities it was offering for sale, including a Post-Effective Amendment to that Form S-3ASR dated October 30, 2006. On November 16, 2007, Countrywide filed a registration statement on Form S-3ASR that registered $2 billion worth of Series A Floating Rate Convertible Senior Debentures and $2 billion worth of Series B Floating Rate Convertible Senior Debentures. Sieracki, Sambol and Mozilo signed all of these offerings, each of which incorporated one of the false Form 10-Ks by reference.

M. Insider Trading By Mozilo

111. Mozilo also engaged in insider trading in Countrywide securities. Mozilo established four sales plans pursuant to Rule 10b5-1 of the Exchange Act in October, November, and December 2006 while in possession of material, non-public information concerning the operations and financial condition of Countrywide.

C. Countrywide's Insider Trading Policy

112. During the relevant period, Countrywide had an insider trading policy in effect, dated as of June 24, 2005, which prohibited trading in Countrywide securities on the basis of material non-public information. The policy included a section entitled "Material Information" that stated:

> 3.2 Material Information
>
> U.S. federal securities laws prohibit transactions while aware of material nonpublic information. "Material" information means information relating to the

> company with publicly traded securities, which, if publicly disseminated, would likely affect the market price of any of its securities, or which would likely be considered important by a reasonable investor in determining whether to buy, sell, or hold such securities.

In addition, the policy included a section regarding 10b5-1 sales plans that stated:

> 4.3 <u>10b5-1 Trading Arrangements</u>
>
> A. Section 10b5-1 of the Exchange Act creates an exception to the prohibition against trading while in the possession of material nonpublic information. In order to take advantage of the exception set forth in Section 10b5-1 of the Exchange Act, Directors and Executives Officers must enter into a 10b5-1 Trading Plan; provided that such Trading Plan:
>
> i. specifies the amount of shares to be purchased or sold and the price at which and the date on which the shares are to be purchased or sold; <u>or</u>
>
> ii. includes a written formula or algorithm, or computer program, for determining the amount of shares to be purchased or sold and the price at which and the date on which the shares are to be purchased or sold; <u>or</u>
>
> iii. does not permit the individual to exercise any subsequent influence over how, when or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not be aware of the material nonpublic information when doing so; <u>and</u>
>
> iv. was acknowledged by Countrywide in writing and pre-cleared by the Office of the Chief Legal Officer.

113. Mozilo knew about and understood the Countrywide insider trading policy. In addition, prior to the execution of each 10b5-1 sales plan, Countrywide's legal department was required to review and approve the sales plan

and Mozilo was required to orally represent to Countrywide's general counsel that he was not in possession of material non-public information.

2. **Mozilo Established His 2006 10b5-1 Sales Plans While In Possession of Material, Nonpublic Information**

114. As set forth in section E. above, in 2006, Mozilo possessed material non-public information regarding the characteristics and performance of Pay-Option ARM loans as well as increasing credit risks associated with this product. None of this information was disclosed to the public prior to the establishment of Mozilo's sales plans in October, November, and December 2006.

115. As set forth in section F. above, in 2006, Mozilo learned of red flags concerning Countrywide's expanded underwriting guidelines and concluded that certain of Countrywide's mortgage loans would have a future detrimental financial impact on the company. In response to this information, beginning in early 2006, Mozilo raised his concerns with other members of senior management and instructed them to take action to mitigate risks associated with lower quality loans.

116. While in possession of this material, non-public information, Mozilo established four different Rule 10b5-1 plans.

117. On October 27, 2006, Mozilo established a sales plan that directed his broker to exercise 3,989,588 stock options and sell the underlying shares on specific days set forth in the plan beginning on November 1, 2006 and ending no later than October 5, 2007 (the "October 2006 Plan").

118. Mozilo gave final approval to create the October 2006 Plan during a meeting with his financial advisor on September 25, 2006, one day before sending an e-mail to Sambol and Sieracki, as described in paragraphs 68 and 69 above, that stated among other things, that **"we are flying blind on how these loans will perform in a stressed environment of higher unemployment, reduced values and slowing home sales."** (emphasis added).

119. Also on October 27, 2006, Mozilo established a sales plan in the name of the Mozilo Family Foundation, a charitable organization that he chaired, that directed the broker to sell 91,999 shares of Countrywide stock held by the Foundation: 23,000 shares to be sold on November 1, 6, and 16, 2006 and 22,999 shares to be sold on November 21, 2006 (the "Foundation Plan").

120. On November 13, 2006, Mozilo established a sales plan for the Mozilo Living Trust, a revocable trust created for the benefit of his family, that directed the broker to sell 100,000 shares of Countrywide stock in lots of 25,000 shares on November 16, 21, 29, and December 4, 2006 (the "Trust Plan").

121. On December 12, 2006, Mozilo established a sales plan that directed his broker to exercise 1,389,580 stock options and sell the underlying shares on specific days set forth in the plan beginning on January 5, 2007 and ending no later than December 14, 2007 (the "December 2006 Plan").

122. Mozilo executed the December 2006 Sales Plan five days after he circulated a memorandum, described in paragraph 52 above, to all managing directors and the board of directors that analyzed subprime mortgages.

123. On February 2, 2007, Mozilo amended the December 2006 Plan ("February Amendment") by directing the exercise of an additional 2,467,777 stock options and selling the underlying shares on the schedule already set forth in the December 2006 Plan.

124. From November 2006 through October 2007, Mozilo exercised over five million stock options and sold the underlying shares pursuant to the four sales plans, realizing gains of over $139 million.

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FIRST CLAIM FOR RELIEF

FRAUD IN THE OFFER OR SALE OF SECURITIES

Violations of Section 17(a) of the Securities Act

(Against All Defendants)

125. The Commission realleges and incorporates by reference ¶¶ 1 through 124 above.

126. Defendants, and each of them, by engaging in the conduct described above, directly or indirectly, in the offer or sale of securities by the use of means or instruments of transportation or communication in interstate commerce or by the use of the mails:

a. with scienter, employed devices, schemes, or artifices to defraud;

b. obtained money or property by means of untrue statements of a material fact or by omitting to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

c. engaged in transactions, practices, or courses of business which operated or would operate as a fraud or deceit upon the purchaser.

127. By engaging in the conduct described above, Defendants violated, and unless restrained and enjoined will continue to violate, Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a).

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SECOND CLAIM FOR RELIEF

FRAUD IN CONNECTION WITH THE PURCHASE OR SALE OF SECURITIES

Violations and Aiding and Abetting Violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder

(Against All Defendants)

128. The Commission realleges and incorporates by reference ¶¶ 1 through 124 above.

129. Defendants, and each of them, by engaging in the conduct described above, directly or indirectly, in connection with the purchase or sale of a security, by the use of means or instrumentalities of interstate commerce, of the mails, or of the facilities of a national securities exchange, with scienter:

a. employed devices, schemes, or artifices to defraud;

b. made untrue statements of a material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

c. engaged in acts, practices, or courses of business which operated or would operate as a fraud or deceit upon other persons.

130. By engaging in the conduct described above, Defendants violated, and unless restrained and enjoined will continue to violate, Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5.

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THIRD CLAIM FOR RELIEF

VIOLATIONS OF COMMISSION PERIODIC REPORTING REQUIREMENTS

Aiding and Abetting Violations of Section 13(a) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 thereunder

(Against All Defendants)

131. The Commission realleges and incorporates by reference ¶¶ 1 through 124 above.

132. Countrywide violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder, by filing with the Commission annual reports on Form 10-K for fiscal years 2005, 2006, and 2007 and quarterly reports on Form 10-Q for each quarter in 2005, 2006, and 2007 that were materially false and failed to include material information necessary to make the required statements, in light of the circumstances under which they were made, not misleading.

133. Mozilo, Sambol, and Sieracki knowingly provided substantial assistance to Countrywide in its violation of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder in connection with Countrywide's annual reports for fiscal years 2005, 2006, and 2007 and its quarterly reports for each quarter in 2005, 2006, and 2007.

134. By engaging in the conduct described above and pursuant to Section 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), Mozilo, Sambol, and Sieracki aided and abetted Countrywide's violations, and unless restrained and enjoined will continue to aid and abet violations, of Section 13(a) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 thereunder.

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FOURTH CLAIM FOR RELIEF

CERTIFICATION VIOLATIONS

Violations of Rule 13a-14 of the Exchange Act

(Against Defendants Mozilo and Sieracki)

135. The Commission realleges and incorporates by reference ¶¶ 1 through 124 above.

136. Mozilo and Sieracki violated Rule 13a-14 by signing the certifications included with Countrywide fiscal year 2005, 2006, and 2007 Forms 10-K, certifying, among other things, that the forms fully complied with the requirements of the Exchange Act and fairly presented, in all material respects, the financial condition and results of operations of the company, when, in fact, the reports contained untrue statements of material fact and omitted material information necessary to make the reports not misleading.

137. By engaging in the conduct described above, defendants Mozilo and Sieracki violated Exchange Act Rule 13a-14, 17 C.F.R. § 240.13a-14. Unless restrained and enjoined, defendants Mozilo and Sieracki will continue to violate Rule 13a-14, 17 C.F.R. § 240.13a-14.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that the Court:

I.

Issue findings of fact and conclusions of law that the defendants committed the alleged violations.

II.

Issue judgments, in a form consistent with Fed. R. Civ. P. 65(d), permanently enjoining Defendant Mozilo and his agents, servants, employees, attorneys, and those persons in active concert or participation with any of them, who receive actual notice of the order by personal service or otherwise, from violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rules 10b-5 and 13a-14 thereunder, and from aiding and abetting violations of Section 13(a) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 thereunder.

III.

Issue judgments, in a form consistent with Fed. R. Civ. P. 65(d), permanently enjoining Defendant Sambol and his agents, servants, employees, attorneys, and those persons in active concert or participation with any of them, who receive actual notice of the order by personal service or otherwise, from violating Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, and from aiding and abetting violations of Section 13(a) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 thereunder.

IV.

Issue judgments, in a form consistent with Fed. R. Civ. P. 65(d), permanently enjoining Defendant Sieracki and his agents, servants, employees, attorneys, and those persons in active concert or participation with any of them, who receive actual notice of the order by personal service or otherwise, from violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rules 10b-5 and 13a-14 thereunder, and from aiding and abetting violations of Section 13(a) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 thereunder.

V.

Enter an order, pursuant to Section 21(d)(2) of the Exchange Act, 15 U.S.C. § 78u(d)(2), prohibiting defendants Mozilo, Sambol, and Sieracki from acting as officers or directors of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act, 15 U.S.C. § 78l, or that is required to file reports pursuant to Section 15(d) of the Exchange Act, 15 U.S.C. § 78o(d).

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VI.

Order defendants Mozilo and Sambol to disgorge all ill-gotten gains from their illegal conduct, together with prejudgment interest thereon.

VII.

Order defendants Mozilo, Sambol, and Sieracki to pay civil penalties under Section 21(d)(3) of the Exchange Act, 15 U.S.C. § 78u(d)(3).

VIII.

Order defendant Mozilo to pay a civil penalty under Section 21A(a) of the Exchange Act, 15 U.S.C. § 78u-1(a).

IX.

Retain jurisdiction of this action in accordance with the principles of equity and the Federal Rules of Civil Procedure in order to implement and carry out the terms of all orders and decrees that may be entered, or to entertain any suitable application or motion for additional relief within the jurisdiction of this Court.

X.

Grant such other and further relief as this Court may determine to be just and necessary.

DATED: June 4, 2009

Lynn M. Dean
JOHN M. McCOY, III
SPENCER E. BENDELL
LYNN M. DEAN
SAM PUATHASNANON
PARIS WYNN
Attorneys for Plaintiff
Securities and Exchange Commission

DEMAND FOR JURY TRIAL

Plaintiff hereby demands trial by jury.

DATED: June 4, 2009

Lynn M. Dean

JOHN M. McCOY, III
SPENCER E. BENDELL
LYNN M. DEAN
SAM PUATHASNANON
PARIS WYNN
Attorneys for Plaintiff
Securities and Exchange Commission

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

SHEILA C. BAIR
CHAIRMAN

September 17, 2010

Honorable Carl Levin
Chairman
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed please find a signed copy of a revised and much-strengthened memorandum of understanding among the FDIC and other bank regulators which will greatly enhance our ability to continually access and monitor information related to our risks as deposit insurer. I believe this is a very strong agreement and one which we accomplished due in no small part to the work of your Subcommittee in identifying weaknesses in the supervisory processes leading up to the failure of Washington Mutual. I appreciate and applaud your leadership and support for a strengthened MOU.

Best Regards,

Sheila

Sheila C. Bair

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #947

PSI-FDIC-13-000001

Board of Governors of the Federal Reserve System | Federal Deposit Insurance Corporation | Office of the Comptroller of the Currency | Office of Thrift Supervision

Interagency Memorandum of Understanding on Special Examinations

This Memorandum of Understanding ("MOU"), dated as of July 14, 2010, is made and entered into by and among The Federal Deposit Insurance Corporation ("FDIC" or the "Corporation"), the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), and the Office of Thrift Supervision ("OTS") (the OCC, FRB and OTS collectively, the "Agencies;" and separately, the "PFR") This MOU concerns the implementation of Section 10(b)(3) of the Federal Deposit Insurance Act that provides that examiners appointed by the Board of Directors of the Corporation "shall have power, on behalf of the Corporation, to make any special examination of any insured depository institution whenever the Board of Directors determines a special examination of any such depository institution is necessary to determine the condition of such depository institution for insurance purposes."

I. Objectives

The Objectives of this MOU are to:

(1) Facilitate the FDIC's implementation of its special examination authority under Section 10(b)(3) of the Federal Deposit Insurance Act ("FDI Act");

(2) Establish arrangements for coordination and cooperation between the Agencies and the FDIC, consistent with the respective authorities of each.

(3) Avoid unnecessary duplication of effort; and

(4) Facilitate the ability of the FDIC and each of the Agencies to effectively and efficiently carry out their respective responsibilities.

II. IDI Coverage

Under this MOU, Special Examinations may be made by the FDIC with respect to the insured depository institutions ("IDIs") defined in this Part II of this MOU ("Covered IDIs"):

(1) IDIs with composite PFR ratings of "3", "4" or "5", and IDIs that are undercapitalized under Prompt Corrective Action standards ("Problem IDIs").

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(2) IDIs that have a heightened risk to the Deposit Insurance Funds defined as follows: (a) CAMELS 1- or 2-rated institutions that fall under FDIC's large bank deposit insurance pricing method if their initial assessment rate ("IAR") is in the top 66 percent of the IAR range;[1] and (b) small institutions that are CAMELS 2-rated and the FDIC's Statistical CAMELS off-site Rating ("SCOR") indicates their probability of downgrade is 50 percent or greater or their rank according to the FDIC's Growth Monitoring System ("GMS") is in the 98 percentile. ("Heightened Insurance Risk IDIs"). For the purposes of this section II(2), "Large Institutions" are IDIs with assets of $10 billion or more, and "Small Institutions" are IDIs with assets of less than $10 billion. The FDIC will provide the PFR access to SCOR and GMS.[2]

(3) Large, complex IDIs, consisting of (a) mandatory Basel II "Advanced Approach" institutions as may be determined from time to time, and (b) IDI subsidiaries of any non-bank financial company or large interconnected bank holding company that are subject to heightened prudential standards recommended by the Council under Section 115(a)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 as may be agreed upon from time to time by the FDIC and the relevant PFR ("Large IDIs").

(4) IDIs that are affiliated with entities that have had greater than $5 billion of borrowings under the FDIC TLGP program ("TLGP-IDIs").

III. Guidelines for the Conduct of Special Examinations

(1) In making Special Examinations, the FDIC's focus will be on gathering and evaluating information obtained by the FDIC from the Agencies, State banking regulators, IDIs, and other sources that is necessary for insurance purposes, namely information to determine the risk that is presented to the Deposit Insurance Fund (DIF), price deposit insurance, assess the probability of default, estimate any potential loss to the DIF, develop contingent resolution plans, and such other matters that are necessary for deposit insurance purposes.

(2) In making Special Examinations, the FDIC shall use the reports of examination made by the PFR and any appropriate State regulator, other information available from the PFR and State regulator, and information provided by other Federal or State agencies to the fullest extent possible, without limiting the authority of the FDIC referenced in section III(4) to make Special Examinations of IDIs both covered and uncovered by this MOU. The FDIC will notify the PFR before the FDIC obtains any information directly

[1] The IAR range contemplated under this MOU is 10 basis points to 50 basis points. Under this formula an IDI is a Covered IDI for two calendar quarters following the last calendar quarter in which the IDI was a Covered IDI as determined under section II(2)(a) above. Should the FDIC modify the IAR range in the future the Agencies and FDIC will jointly confirm that the top percentage of the IAR range stated in section II(2) remains appropriate.

[2] The FDIC will provided advanced notice of any modifications of the SCOR and GMS models affecting the thresholds in section II(3) and confirm that the thresholds remain appropriate.

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from an IDI, explaining why additional information beyond what is currently available from the PFR is needed.

(3) At Large IDIs and TLGP-IDIs, the FDIC will establish a continuous on-site full-time Staff presence with the number of staffers depending on the size of the IDIs. To meet its staffing needs, it is the intention of the FDIC to assign up to no more than (a) five full-time on-site staffers at IDIs with U,S holding companies that have total assets of $750 billion or more, and (b) three full time on-site staffers for Large, Complex IDIs with U.S. holding companies that have total assets of less than $750 billion. Additional full-time on-site staffing shall be subject to mutual agreement between the FDIC and the PFR. The FDIC also may determine, based on particular events or specific circumstances, that required information is not available from the PFR, and that it is necessary to be on-site to gather such information, and that additional staff is temporarily needed on-site in order to obtain such information.

(4) The Agencies recognize that the FDIC Board of Directors has the authority under Section 10(b)(3) of the FDI Act to direct the making of Special Examinations in situations covered and not covered by this MOU.

IV. Coordination and Information Sharing

(1) FDIC will, to the fullest extent possible, without limiting the authority of the FDIC referenced in section III(4) to make Special Examinations of IDIs both covered and uncovered by this MOU, conduct special examinations of any covered IDI in accordance with this MOU, provide the PFR with reasonable prior notice of any proposed Special Examination activities, coordinate its work with the relevant PFR, and avoid unnecessary duplication of activities. The FDIC will notify the relevant PFR prior to conducting a Special Examination under Section 10(b)(3) of the FDI Act of a covered or uncovered IDI outside of the provisions of this MOU explaining the reasons for such a Special Examination. In the case of such a Special Examination, the FDIC and the PFR will use their best efforts to coordinate, cooperate, share and use information in accordance with Section IV of this MOU.

(2) One FDIC on-site examiner will be identified as the point of contact for the PFR. ("FDIC Contact")

(3) One PFR on-site examiner will be identified as the point of contact for the FDIC. ("PFR Contact")

(4) The FDIC will inform the PFR Contact on an on-going basis of the FDIC's special examination planning and scoping activities, as well as any significant changes thereto, and will provide reasonable prior notice to the PFR Contact of any unscheduled special examinations of the IDI and of meetings with the Board of Directors and board committees of the IDI. The FDIC Contact and the PFR Contact may also agree on other types of meetings for which notice would be provided. The FDIC will also provide the PFR on an ongoing basis, through the PFR Contact, with access to results of FDIC Special Examinations, including material deposit insurance related issues and risk assessments, and other FDIC Special Examination information prepared by the FDIC.

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(5) The PFR will inform the FDIC Contact on an on-going basis of the PFR's examination planning and scoping activities, as well as any significant changes thereto, and will provide reasonable prior notice to the FDIC Contact of any unscheduled special examinations of the IDI and of meetings with the Board of Directors and board committees of the IDI. The PFR Contact and the FDIC Contact may also agree on other types of meetings for which notice would be provided. The PFR will also provide the FDIC on an ongoing basis, through the FDIC Contact, with access to supervisory information prepared by the PFR, including risk assessments, supervisory plans, and reports of examination prepared by the PFR.

(6) The FDIC Contact may request to participate in examinations and meetings with IDI personnel conducted by the PFR. The PFR Contact and FDIC Contact shall consult regarding such requests. In the event the PFR declines the request, the FDIC Contact shall provide reasonable prior notice to the PFR Contact before proceeding separately to conduct any Special Examination activities or meetings.

(7) The PFR Contact may request to participate in examinations and meetings with IDI personnel conducted by the FDIC. The FDIC Contact and the PFR Contact shall consult regarding such requests.

(8) On an on-going basis, no less frequently than quarterly, representatives of the FDIC will meet with appropriate representatives of the PFR to discuss the risk profile, current condition, identified supervisory matters, and material deposit insurance related issues and risk assessments with respect to Covered Institutions. On a quarterly basis, FDIC will share lists of all IDIs meeting the criteria specified in II(1)-II(4), above.

V. CAMELS Rating Differences

Differences in CAMELS ratings between the FDIC and the appropriate PFR will be communicated by the FDIC Contact to the PFR Contact in writing, including an explanation of the basis for the FDIC's position. In the event those officials are unable to resolve the ratings disagreement, the matter shall be referred to the Director of the FDIC Division of Supervision and Consumer Protection (the "Director") (or other officer of the Corporation designated by the Chairman of the FDIC) and the appropriate senior-most supervision official of the PFR for resolution. Any decision by the FDIC to depart from the appropriate PFR's assigned rating will be made by the Director of the FDIC Division of Supervision and Consumer Protection (or other officer of the Corporation designated by the Chairman of the FDIC) after consultation with the Chairman of the FDIC.

Federal Deposit Insurance Corporation

BY: Sheila C Bair

Board of Governors of the Federal Reserve System

BY: David K Jones

Office of the Comptroller of the Currency

BY: John C Dugan

Office of Thrift Supervision

BY: John C Bowman

PSI-FDIC-13-000005

TESTIMONY OF VICKIE A. TILLMAN,
EXECUTIVE VICE PRESIDENT,
STANDARD & POOR'S CREDIT MARKET SERVICES,
BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
UNITED STATES HOUSE OF REPRESENTATIVES

SEPTEMBER 27, 2007

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #962

S&P SEN-PSI 0001945

Mr. Chairman, Members of the Subcommittee, good afternoon. I am Vickie A. Tillman, Executive Vice President of Standard & Poor's ("S&P") Credit Market Services, and head of Ratings Services, our nationally recognized statistical rating organization ("NRSRO"). I appreciate the opportunity to appear before you today. I especially appreciate your invitation because I believe it is important to clarify the role of rating agencies such as S&P in the financial markets, the rigor S&P applies in fulfilling that role, and our overall record of delivering unbiased opinions on creditworthiness. To that end, I also welcome the opportunity to address some questions that have been raised about how we have served the market in the midst of unprecedented conditions in the subprime mortgage market and the credit crunch and pressure on the economy that have followed.

I want to assure you at the start of my testimony that we have learned hard lessons from the recent difficulties in the subprime mortgage area. While we fully agree with Secretary Paulson's observation last week that "the subprime mortgage market improved access to credit and homeownership for millions of Americans," it appears that abuses may have occurred in the origination process. We support Congress' efforts to investigate those abuses and to prevent their recurrence. For our part, we are taking steps to ensure that our ratings — and the assumptions that underlie them — are analytically sound in light of shifting circumstances. As I am sure you know, and as my testimony will set forth in some detail, S&P began downgrading some of its ratings in this area towards the end of last year and had warned of deterioration in the subprime sector long before that. Nonetheless, we are fully aware that, for all our reliance on our analysis of historically rooted data that sometimes went as far back as the Great Depression, some of that data has proved no longer to be as useful or reliable as it has historically been. Additionally, the collapse of the housing market itself has been both more severe and more precipitous than we had anticipated. As I will describe in more detail later, we have taken a number of steps in response to enhance our analytics and process and continue to look for ways in which to do still more.

Our reputation and our track record are the core of our business, and when they come into question, we listen and learn. We take our work seriously, very seriously, and at no time in our history more than now, as I speak to you.

In my testimony I would like to address four broad topics:

- First, the nature of S&P's ratings and their role in the capital markets;
- Second, S&P's approach to rating residential mortgage-backed securities ("RMBS"), including mortgage securities backed by subprime mortgage loans;
- Third, a number of the questions that have been raised in the press and elsewhere related to ratings, including:
    - Questions as to whether payment of fees by issuers presents a conflict of interest that could compromise analytical independence;
    - Questions as to whether S&P is somehow involved in "structuring" RMBS and other structured finance transactions;
    - Questions about the appropriateness of our ratings because securities backed by subprime collateral sometimes receive 'AAA' ratings; and
    - Questions about whether S&P has acted too slowly in responding to the deterioration of the subprime mortgage market.

- Fourth, steps we have taken in light of the Credit Rating Agency Reform Act passed by this body in 2006.

Ratings and Their Role In The Capital Markets

I would like to begin today by discussing the nature of our credit ratings, as it appears from numerous press reports that this matter is sometimes misunderstood. At their core, S&P's credit ratings represent our opinion of the likelihood that a particular obligor or financial obligation will timely repay owed principal and interest. Put another way, we assess the likelihood, and in some situations the consequences, of default — nothing more or less.

When we issue a rating on a particular security we are expressing our view that the security shares similar credit characteristics to those securities that have, in the past, represented a particular range of credit risk. A bond that we rate as 'BBB' has received the lowest of our so-called "investment grade" ratings; one rated 'BB' has received the highest non-investment grade rating. "Investment grade" securities are those securities that certain regulated investors may legally purchase. On S&P's ratings scale, such securities are those rated at the 'BBB' level or higher. Since we began rating RMBS in the late 1970's, only 1.09% of those securities rated by us 'BBB' have ever defaulted. For 'BBs' this number is 2.11%. Thus, when we rate securities, we are *not* saying that they are "guaranteed" to repay but the opposite: that some of them *will* likely default. Even our highest rating — 'AAA' — is not a guarantee or promise of performance. 'AAAs' do default and have defaulted, although rarely.

Another misconception about ratings relates to their purpose and use. Ratings speak to one topic and one topic only — credit risk. As we have repeatedly made clear in public statements, including statements to the SEC, testimony before Congress, and innumerable press releases, ratings do *not* speak to the likely market performance of a security. Thus, ratings clearly do not address:

- o Whether investors should "buy", "sell" or "hold" rated securities;
- o Whether any particular rated securities are suitable investments for a particular investor or group of investors;
- o Whether the expected return of a particular investment is adequate compensation for the risk;
- o Whether a rated security is in line with the investor's risk appetite;
- o Whether the price of the security is appropriate or even commensurate with its credit risk; or
- o Whether factors other than credit risk should influence that market price, and to what extent.

I want to be clear. Ratings matter; as the individual who oversees S&P's ratings business I would be the last person to suggest to you that they do not. But in the current climate, it is especially important to bear in mind just what it is we do and that other developments also affect market perceptions and behavior. The current credit crunch is very real, but we certainly have not witnessed widespread defaults of mortgage-backed securities. This dynamic and its relationship to the nature of ratings was recently recognized by one of Europe's top regulators, Mr. Eddy Wymeersch, Chairman of the Committee of European Securities Regulators and also Chairman of Belgium's Banking and Financial Commission. According to Mr. Wymeersch:

> "[t]he press and general opinion is saying it's the fault of the credit rating agencies . . . Sorry, the ratings are just about the probability of default. Nothing more. Now we have a liquidity crisis and not a solvency crisis."

Though they may move more slowly than market prices, ratings are not designed to be static. Our view of an RMBS transaction evolves as facts and circumstances develop, often in ways that are difficult to foresee. We issue ratings and, as new information becomes available with the passage of time, we either affirm those ratings — *i.e.,* leave them unchanged — upgrade them, downgrade them, or put them on CreditWatch, which is a warning to the market that the rating is subject to change after a pending review. To make such decisions, we perform surveillance on our ratings. I will discuss our surveillance process in greater detail a little later on, but the three important points here are:

- That we have a team and process in place whose responsibility it is to monitor developments and bring about ratings changes to reflect those developments as appropriate;
- Changes in RMBS ratings are not based on speculation or market sentiment; and
- Such changes are often based upon events which were not predictable.

To cite only a few recent examples on this last point, the level of early payment default trends in recent subprime loans is unprecedented; so is the fact that, while individuals who purchased homes have generally paid their mortgages before paying off their credit cards, that now appears no longer to be true to the extent it once was; so is the reality that, while individuals who live in homes they purchase historically repay the mortgages on these homes more regularly than those who live elsewhere, that long-standing pattern now appears of questionable validity in a striking number of cases. These are ahistorical behavioral modes, ones of particular import at a time of a substantial fall in real estate prices, and ones that, together with other factors, required downgrading some RMBS ratings even though no substantial amount of pool losses have occurred.

I said earlier that we have made repeated statements about the nature and role of ratings. To the extent those efforts have failed to communicate sufficiently clearly about that topic, we view this hearing, and this process overall, as an opportunity to begin to rectify that. We recognize that we bear primary responsibility for getting the message out. We are making, and will continue to make, every effort to do so.

S&P's Rating of Securities Backed By Mortgage Loans, Including Subprime Loans

Our ratings of residential mortgage-backed securities, particularly RMBS backed by pools containing subprime mortgage assets, have recently received a significant amount of attention. S&P has been rating RMBS for thirty years and has developed industry-leading processes and models for evaluating the creditworthiness of these transactions. As a result, S&P has an excellent track record of assessing RMBS credit quality. For example, S&P's cumulative U.S. RMBS default rate by original rating class (through September 15, 2007) is as follows:

Initial Rating	% of Default
AAA	0.04
AA	0.24
A	0.33
BBB	1.09
BB	2.11
B	3.34

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Default statistics are the critical measure of ratings analytics because, as I explained earlier, at their core ratings speak to the likelihood of timely repayment, not other market factors, such as supply and demand, that may go into the pricing of securities. Moreover, these default numbers for our RMBS ratings are lower, in some cases materially lower, than the long-term default rates for similar ratings issued on corporate bonds.

While evaluating the credit characteristics of the underlying mortgage pool is part of our RMBS ratings process, S&P does not rate the underlying mortgage loans made to homeowners or evaluate whether making those loans was a good idea in the first place. Originators make loans and verify information provided by borrowers. They also appraise homes and make underwriting decisions. In turn, issuers and arrangers of mortgage-backed securities bundle those loans and perform due diligence. They similarly set transaction structures, identify potential buyers for the securities, and underwrite those securities. For the system to function properly, S&P relies, as it must, on these participants to fulfill their roles and obligations to verify and validate information before they pass it on to others, including S&P. Our role in the process is reaching an opinion as to how much cash we believe the underlying loans are likely to generate towards paying off the securities eventually issued by the pool. That is the relevant issue for assessing the creditworthiness of those securities.

As a practical matter, S&P's analysis of an RMBS transaction breaks down into the following categories:

The LEVELS® Model The first step in our analysis is evaluating the overall creditworthiness of a pool of mortgage loans by conducting loan level analysis using our Loan Evaluation and Estimate of Loss System (LEVELS®) Model. This model is built on, and

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reflects, our analytical assumptions and criteria. S&P's criteria do not dictate the terms of the mortgage loans; those terms are set by the originator in the underwriting process. S&P collects up to seventy different types of inputs, including, but not limited to: the amount of equity a borrower has in the home; the loan type; the extent of income verification; whether the borrower occupies the home; and the purpose of the loan. This analysis allows us to quantify multiple risk factors, or the layered risk, and allows us to assess the increased default probability that is associated with each factor. Based on the individual loan characteristics, the LEVELS® model calculates probabilities of default and loss realized upon default. The assumptions and analysis embedded in the LEVELS® model are under regular review and are updated as appropriate to reflect our current thinking about rating residential mortgages.

As part of our commitment to transparency, S&P makes its LEVELS® model available to investors who wish to license it. The vast majority of those involved in issuing RMBS have access to LEVELS® and use it regularly. We also publicly announce any changes to our LEVELS® model in a timely manner. In other words, our basic criteria is out there every day, subject to criticism and comment.

The SPIRE® Model Another important aspect of our rating process is assessing the availability of cash flow, which comes from the monthly payments generated by the mortgage loans, to timely pay principal and interest. To do this, we use our Standard & Poor's Interest Rate Evaluator (SPIRE®) Model. The model uses the S&P mortgage default and loss assumptions (generated by the LEVELS® model) as well as interest rate assumptions. Like the LEVELS® model, our SPIRE® model reflects our analysis and assumptions and is regularly reviewed and updated as warranted.

Also like our LEVELS® model, our SPIRE® model is publicly available, used extensively by market participants, and subject to market comment and review every day.

Review of Originator and Servicer Operational Procedures S&P also reviews the practices, polices, and procedures of the originators and servicers primarily to gain comfort with the ongoing orderly performance of the transaction. For an originator, the topics we review include, but are not limited to: loan production practices; loan underwriting; and quality control practices and findings. S&P may adjust its credit support calculation based on the underwriting employed at origination.

Review of Legal Documents S&P also reviews, with the assistance of internal and external counsel, the legal documents of the securities to be issued, and, where appropriate, opinions of third-party counsel that address transfer of the assets and insolvency of the transferor, as well as security interest and other legal or structural issues. S&P reviews the underlying documentation in order to understand the payment and servicing structure of the transaction.

Credit Enhancement Any description of our ratings of RMBS would be incomplete without discussing the critical concept of credit enhancement. Credit enhancement is the protection (*i.e.*, additional assets or funds) needed to cover losses in deteriorating economic conditions, sometimes referred to as "stress". Sufficient credit enhancement allows securities backed by a pool of subprime collateral to receive what might otherwise be considered high ratings. One form of credit enhancement, although there are several, would occur if the pool has more in collateral than it issues in securities, thereby creating a cushion in the pool. We refer to this form of credit enhancement as "overcollaterization," and it is a key component in our ratings analysis. It provides protection against defaults in the underlying securities. That is, if the pool ends up experiencing losses, it should still generate enough cash from which to pay the holders of the securities. I will discuss credit enhancement in more detail later in my testimony.

The Rating Committee After reviewing the relevant information about a transaction, including information related to credit enhancement, the lead analyst then takes the transaction to a rating committee. As with all S&P ratings, structured finance ratings are assigned by committee. Committees are comprised of S&P personnel who bring to bear particular credit experience and/or structured finance expertise relevant to the rating. The qualitative judgments of committee members at all stages of the process are an integral part of the rating process as they provide for consideration of asset and transaction specific factors, as well as changes in the market and environment. Personnel responsible for fee negotiations and other business-related activities are not permitted to vote in ratings committees and vice versa.

Notification and Dissemination Once a rating is determined by the rating committee, S&P notifies the issuer and disseminates the rating to the public for free by, among other ways, posting it on our Web site, www.standardandpoors.com. Along with the rating, we frequently publish a short narrative rationale authored by the lead analyst. The purpose of this rationale is to inform the public of the basis for S&P's analysis and enhance transparency to the marketplace.

Surveillance After a rating has been issued, S&P monitors or "surveils" the rating to review developments that could alter the original rating. The surveillance process seeks to identify those issues that should be reviewed for either an upgrade or a downgrade because of asset pool performance that may differ from original assumptions. The surveillance function also monitors the credit quality of entities that may be supporting parties to the transaction, such as liquidity providers. Analysts review performance data periodically during the course of the transaction, and as appropriate present that analysis to a rating committee for review of whether to take a rating action. The rating committee then decides whether the rating change is warranted. For changes to public ratings, a press release is normally disseminated.

S&P's Commitment to Constant Improvement

While our ratings process is the product of three decades of analytical experience and excellence, we are always looking for ways to enhance that process and our analytics. This is a hallmark S&P principle and is especially true when, as with recent subprime loans, developments indicate that historically-rooted behavioral patterns that have served as solid foundations for analysis may lack their prior value.

By now there is no doubt that subprime loans made from late 2005 through at least early 2007 are behaving very differently from loans in prior periods, even when the loans share the same basic credit characteristics. For example, for years a primary indicator of a borrower's credit has been so-called FICO credit scores. FICO scores are provided by another independent market participant and are an industry standard. In recent loans, we are seeing borrowers with high FICO scores behaving in a manner consistent with how materially lower FICO borrowers have historically behaved. Similarly, as I observed earlier, there are a number of other ahistorical anomalies that make more problematic applying a number of historically-rooted assumptions about the behavior of borrowers. At the same time, these behaviorial shifts appear *not* to be occurring in loans generated in 2004 and most of 2005, which include many of the same type of subprime characteristics present in the more recent loans. We are still gathering data to analyze the causes for these inconsistent market dynamics.

In response to these developments, and as part of our constant commitment to enhancing our analytical processes, S&P has already initiated a number of steps:

- We have significantly heightened the stress levels at which we rate and surveil transactions to account for deteriorating performance as evidenced by data we have received. We have also increased the frequency of our review of rated transactions;
- We are modifying (and will soon be releasing) our LEVELS® model to incorporate these new stress levels and other changes recently made to our ratings assumptions, as announced in our July 10, 2007 press release;
- We recently acquired IMAKE consulting and ABSXchange. These services have long provided data, analytics and modeling software to the structured finance community and we feel they will further enhance our in-depth surveillance process;
- We have also undertaken a survey of originators and their practices, particularly with respect to issues of data integrity. We are in the process of compiling the results of this survey and will publish those results when finalized; and

- We have hired a Chief Compliance Officer to augment our internal control procedures.

In addition to these steps, we continue to look at areas in which we can further enhance our analysis and processes. Some of the areas include:

- Our policies and procedures to protect against conflicts of interest;
- The quantity and quality of data available to us; and
- Modification of our analytics to reflect changing credit behaviors.

S&P's Response To Various Questions

Some have raised questions about ratings and the ratings process in recent months in light of the turmoil in the subprime mortgage market. As I have previously said, we are well aware that certain historically-rooted assumptions we made in determining which RMBS ratings to issue do not, in retrospect, appear to have remained as relevant as they previously have been. Whether that is because of factors unique to the period immediately prior to and after 2006 or whether we must change those assumptions on a long-term basis is a subject of robust and continuing examination and re-examination at S&P.

At the same time, some of the questions recently put to S&P reflect a fundamental misunderstanding of what ratings are or are based on inaccurate or, in some cases, incomplete information. Let me now address those questions.

The "Issuer Pays" Model Does Not Compromise the Independence and Objectivity of Our Ratings

A number of commentators have asked whether payment of fees by issuers and/or their representatives presents a conflict of interest that compromises the independence and objectivity of ratings. Skeptics question whether, in pursuit of fees, S&P and other major rating agencies may give higher ratings than they otherwise would. Not only is this not true at S&P, but this line of questioning ignores the significant benefits of the "issuer pays" model to the market.

S&P currently makes all of its public ratings available to the market free of charge in real time. When a rating is assigned or changed, the announcement is made on our Web sites — www.sandp.com and www.ratingsdirect.com — and a press release is provided to news outlets and other media. Today there are approximately 9 million current and historical ratings available on RatingsDirect. In addition, as many as 1.3 million active ratings are available for free on www.sandp.com. The benefits to the market are obvious: any and all interested market participants can access the same information at the same time. It creates a level playing field and a common basis for analyzing risk. It also leads to higher quality ratings as our analysis is subject to market scrutiny and reaction every day from every corner of the capital markets.

This type of free, public disclosure and transparency is only possible under the "issuer pays" model. Developing and maintaining models and hiring experienced and skilled analytical talent is costly. Without payment by issuers, those costs would have to be covered by subscription fees, an approach with several insurmountable problems. A subscription model would severely limit the transparency and broad (and free) dissemination of ratings, as access would necessarily be expensive and exclusive to subscribers. Not only would this result in less, not more, information in the market, but it would also take away an important check on ratings quality — the constant scrutiny of a broad market. Moreover, because subscription fees would necessarily be significant (given the breadth of our ratings coverage

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and the depth of our analysis), many investors, including the vast majority of individual investors, simply would not be able to afford access to ratings information. The likely result would be one of two equally harmful outcomes: either (i) these investors would have no meaningful access to ratings information; or (ii) a ratings black market would develop in which S&P's intellectual property — its ratings analysis — would be misused or resold in a manner all too consistent with the pervasive misuse of other intellectual property and with the same destructive impact.

As noted, some have questioned whether the "issuer pays" model has led S&P and others to issue higher, or less rigorously analyzed, ratings so as to garner more business. First and foremost, there is no evidence — none at all — to support this contention with respect to S&P. This is not surprising since it would be clearly against S&P's self-interest as well as its cornerstone principles.

Indeed, what evidence there is on the subject shows the opposite.

1. Consider, for instance, the performance of our RMBS ratings. As reflected in the chart below, in every year from 1994 through 2006, upgrades of U.S. RMBS ratings significantly outpaced downgrades by multiple factors — about 7:1 on average. The ratio was even higher from 2001-2006. That is to say, after S&P initially provided its ratings in this area, actual performance of the rated transactions led to upgrades far more often than downgrades as time passed.

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	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
% of Ratings Upgraded	6.81	2.54	1.38	2.54	2.20	2.78	10.08	10.21	9.24	12.82	10.74	7.91	3.79
% of Ratings Downgraded	2.21	1.70	1.18	1.25	1.28	0.54	1.93	1.05	0.98	0.85	0.45	0.64	1.04

If, as some claim, S&P deliberately issued high ratings to please those who paid for them, one would expect that the initial (allegedly inflated) ratings would require downward adjustment to reflect actual performance. Similarly, one would expect default rates on our RMBS ratings to be higher — indeed, materially higher — than the statistics I cited earlier. But, over the years, the opposite has emphatically been the case.

2. Similarly, if S&P put revenue ahead of analytical rigor, we would not refuse to rate, as we have, transactions that do not meet our criteria. A recent highly publicized example occurred in Canada where significant amounts of asset-backed commercial paper became illiquid. The paper had not met S&P's minimum criteria and so we did not rate it. These are not the actions of an agency that would rate every deal that reaches our door.

3. The primacy of our reputation has been recognized by independent sources. A report prepared by two Federal Reserve Board economists found "no evidence" that rating agencies acted in the interest of issuers due to a conflict of interest. After detailed study, the report concluded that "rating agencies appear to be relatively responsive to reputation concerns and so protect the interests of investors." *See* Daniel M. Covitz & Paul Harrison, *Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate* (Dec. 2003) at

http://www.federalreserve.gov/pubs/feds/2003/200368/200368pap.pdf.

The real question is not whether there are potential conflicts of interest in the "issuer pays" model, but whether they can be effectively managed by S&P and other credit rating agencies. Mr. Erik Sirri, director of the SEC's Division of Market Regulations, recently testified at a congressional hearing that the conflicts raised by this long-standing business model are indeed manageable. As Mr. Sirri testified:

> "Typically, [rating agencies] are paid by the underwriter or the issuer. That presents a conflict. But we believe that conflict is manageable. Credit rating agencies should have polices and procedures in place, and they should adhere to those policies and procedures when they evaluate deals."

S&P maintains rigorous policies and procedures designed to ensure the integrity of our analytical processes. For example, analysts are not compensated based upon the amount of revenue they generate. Nor are analysts involved in negotiating fees. Similarly, individuals responsible for our commercial relationships with issuers are not allowed to vote at rating committees. These policies, and others, have helped ensure our long-standing track record of excellence. As previously noted, our track record speaks for itself. Moreover, the Credit Rating Agency Reform Act of 2006, and the SEC's implementing regulations, give greater assurance that those policies will be enforced.

S&P Does Not "Structure" Transactions

Similar misunderstandings have led some to question whether rating agencies "structure" transactions, thereby threatening ratings independence. These questions are particularly troubling as they give false and negative impressions about a practice that benefits the markets — the open dialogue between issuers and ratings agencies.

It is true that our analysts talk to issuers of RMBS transactions as part of the ratings process, as they have traditionally had discussions with corporate issuers with respect to rating their non-structured securities. This dialogue provides benefits to the marketplace. Critical to our ability to rate transactions is a robust understanding of those transactions. Reading documents and reviewing the results of modeling are important, of course, but so is communication with the people responsible for the transaction itself. Through dialogue with issuers and their representatives our analysts gain greater insight into transactions to be rated, including any modifications to those transactions that may occur as the process goes forward. This dialogue promotes transparency into our ratings process, a virtue we believe in, and one that regulators have consistently espoused.

Nor does the dialogue amount to "structuring" by S&P, even in cases where the discussion is about the effect different structures may have on ratings. S&P does not tell issuers what they should or should not do. Our role is reactive. Using our models with set publicly available criteria, issuers provide us with information and we respond with our considered view of the ratings implications. In the process, and as part of our commitment to transparency, we also may discuss the reasoning behind our analysis. Those who question this practice ignore that the ratings process is not and should not be a guessing game. Without informed discussion, issuers would be proposing structure upon structure until they stumbled upon the structure that best matches with their goals. That certainly would not make the markets more transparent and efficient.

Nor should anyone view as suspicious the fact that some issuers structure transactions so as to achieve a specific rating result. Indeed, a variety of potential structures could merit a

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particular result. Our role is to come to a view as to the structures presented, but not to choose among them. Again, we do not compromise our criteria to meet a particular issuer's goals. As noted, we make criteria publicly available. If we were not applying our criteria to particular transactions, it would be readily apparent to the market and would immediately diminish the credibility — and thus the value — of our ratings business.

Credit Enhancement — How Securities Backed By Subprime Mortgages Can Receive, and Merit, Investment Grade Ratings

A potentially incomplete understanding of the ratings process has also led to questions about how a pool of subprime mortgage loans can support securities with investment grade, even 'AAA' ratings. The answer lies in the concept of credit enhancement.

As discussed earlier, credit enhancement — additional assets or funds — affords protection against losses in deteriorating conditions. When an issuer comes to us with a pool of subprime loans to be used as collateral for an RMBS transaction, S&P is well aware, of course, that all of this collateral is not likely to perform from a default perspective like 'AAA' securities. Nonetheless, the pool of collateral loans *will* yield *some* amount of cash, even under the most stressful of economic circumstances.

A key component of our analysis is looking at the pool of collateral to determine how much credit enhancement — extra collateral, for example — would be needed to support a particular rating on the securities to be backed by that collateral. To do this, we analyze the expected performance of the collateral in stressful economic conditions. To determine the amount of credit enhancement that could support an 'AAA' rating, we use our most stressful economic scenario, including economic conditions from the Great Depression. The stress scenarios are then adjusted for each rating category. Thus, if our analysis of a particular collateral pool's expected performance indicates that the pool would need 30% credit enhancement to support an 'AAA' rating, the issuer would have to have 30% additional collateral above and beyond the value of the securities issued in order for the securities issued by the pool to have enough credit enhancement for an 'AAA' rating. To put it in more concrete terms, if the pool was comprised of, for example, $1.3 million in collateral, it could only issue $1 million in 'AAA' rated securities in this scenario. This way, if the collateral performs poorly — and thirty percent in losses is very poor performance — there will still be sufficient collateral to cover losses incurred upon loan defaults. This credit enhancement figure would, of course, be lower for ratings other than 'AAA', as those ratings address the likelihood of repayment in less stressful economic environments. For example, the issuer might be able to issue $1.2 million in 'BBB' rated securities backed by the same collateral pool. Thus, it is not the case that through securitization, poor credit assets magically become solid investments. Rather, it is because, in our example, a pool has $1.3 million in collateral to support $1 million in securities that it may receive an entirely appropriate 'AAA' rating on those securities.

S&P Has Been Warning the Market, and Taking Action, in Response to Deterioration in the Subprime Market Since Early 2006

Others have questioned whether S&P has acted quickly enough in response to the deteriorating subprime market. Again, we believe these questions result from an incomplete understanding of the facts. S&P has spoken out — and taken action — early and often on subprime issues.

For some time S&P has been through our publications repeatedly and consistently informing the market of its concerns about the deteriorating credit quality of RMBS transactions. For example:

- In a January 19, 2006 article entitled *U.S. RMBS Market Still Robust, But Risks Are Increasing And Growth Drivers Are Softening*, we said: "Standard & Poor's expects that some of the factors that drove growth in 2005 will begin to soften in 2006 . . . . Furthermore, Standard & Poor's believes that there are increasing risks that may contribute to deteriorating credit quality in U.S. RMBS transactions; it is probable that these risks will be triggered in 2006."

- On May 15, 2006, in an article entitled *A More Stressful Test Of A Housing Market Decline On U.S. RMBS*, we reported on the results of our follow-up analysis to our September 2005 housing-bubble simulation. We stated: "[t]he earlier simulation had concluded that most investment-grade RMBS would weather a housing downturn without suffering a credit-rating downgrade, while speculative-grade RMBS might not fare so well . . . . In the updated simulation . . . [S&P used] more stressful macroeconomic assumptions [which] lead to some downgrades in lower-rated investment-grade bonds."

- On July 10, 2006, in an article entitled *Sector Report Card: The Heat Is On For Subprime Mortgages*, we noted that downgrades of subprime RMBS ratings were outpacing upgrades due to "collateral and transaction performance." The article also identifies "mortgage delinquencies" as a "potential hot button," and notes that such delinquencies "may become a greater concern for lenders and servicers."

- On July 17, 2006, we noted a 38% increase in downgrades in U.S. RMBS, a significant number of which came from the subprime market. *Structured Finance Global Ratings Roundup Quarterly: Second-Quarter 2006 Performance Trends.*

- On Oct. 16, 2006, in our *Ratings Roundup: Third-Quarter 2006 Global Structured Finance Performance Trends*, we reported a 15% decline in upgrades for U.S. RMBS while the number of downgrades more than tripled compared to the same period in 2005. We also noted that the quarter's ratings actions among RMBS transactions had set a record for the most performance-related downgrades.

- Then on December 8, 2006, in an article entitled *Credit Trends: 2007 Global Credit Strategy: Asset Class Outlook*, we informed the market of our view that "[c]redit quality in the RMBS sub-prime market has been under scrutiny this year. Standard & Poor's RMBS surveillance group sees the environment ahead as portending greater downgrade potential along with lower upgrade potential." We also stated that "the jump in third-quarter downgrade activity for the sub-prime market raises some risk flags for this segment; with 87 third-quarter downgrades adding to the 46 downgrades of the second quarter and 34 in the first."

- On January 16, 2007, in an article entitled *Ratings Roundup: Fourth-Quarter 2006 Global Structured Finance Performance Trends*, we stated: "Rating activity among subprime transactions has started to shift to being predominantly negative from being predominantly positive. . . . We expect this trend in subprime rating performance to continue during 2007."

- Ten days later on January 26, 2007, in our *Transition Study: U.S. RMBS Upgrades Are Down And Downgrades Are Up In 2006*, we reported that for 2006 "[d]owngrades overwhelmed upgrades for subprime mortgage collateral" and that we expected "losses and, therefore, negative rating actions to continue increasing during the next few months relative to previous years."

- Our statements to the market continued throughout the first half of 2007. On March 22, 2007, in an article entitled *A Comparison Of 2000 and 2006 Subprime RMBS Vintages Sheds Light On Expected Performance*, we stated: "[w]hile subprime mortgages issued in 2000 have the distinction of being the worst-performing residential loans in recent memory, a good deal of speculation in the marketplace suggests that the 2006 vintage will soon take over this unenviable position."

- In an April 27, 2007 article entitled *Special Report: Subprime Lending: Measuring the Impact*, we stated: "The consequences of the U.S. housing market's excesses, a topic of speculation for the past couple of years, finally have begun to surface. . . . Recent-vintage loans continue to pay the price for loosened underwriting standards and risk-layering in a declining home price appreciation market, as shown by early payment defaults and rising delinquencies."

- Then on June 26, 2007, in an article entitled *Performance of U.S. RMBS Alt-A Loans Continues To Deteriorate*, we reported: "The most disconcerting trend is how quickly the performance of these delinquent borrowers has deteriorated. We continue to see migration from 60-plus-day to 90-plus-day delinquencies within the 2006 vintage, suggesting that homeowners who experience early delinquencies are finding it increasingly difficult to refinance or work out problems, as opposed to being able to 'cure' falling behind on payments."

None of these warnings were hidden by S&P and I will gladly provide the Subcommittee with these documents. In addition to these warnings, we also took action in response to subprime deterioration. For example:

- On June 1, 2006, almost sixteen months ago, we tightened our criteria through changes in our LEVELS® model targeted to increase the credit enhancement requirements for pools with subprime loans. In announcing these changes to the market, we specifically identified subprime loans, such as "[l]oans with simultaneous second liens (especially those with very low FICO scores)", as loans "much more likely to default than non-second-lien loans with similar FICO scores."
- Then in February 2007, we took the unprecedented step of placing on CreditWatch negative (and ultimately downgrading) transactions that had closed as recently as 2006. As we informed the market in the accompanying release: "Many of the 2006 transactions may be showing weakness because of origination issues, such as aggressive residential mortgage loan underwriting, first-time home-buyer programs, piggyback second-lien mortgages, speculative borrowing for investor properties, and the concentration of affordability loans." In a February 16, 2007 Los Angeles Times article, S&P's announcement was described as "'a watershed event' because it means S&P is now actively considering downgrading bonds within their first year." *See S&P to Speed Mortgage Warnings*, Los Angeles Times, Feb. 16, 2007.
- We continued taking downward action through the Spring. In May we announced that "Standard & Poor's Ratings Services took 103 rating actions affecting 103 classes of residential mortgage-backed securities (RMBS) transactions backed by subprime, closed-end second-lien, and Alt-A loan collateral originated in 2005 and 2006; we lowered 92 ratings . . . and placed 103 ratings on CreditWatch negative . . . . These rating actions were due to collateral performance." We also noted that "[m]ost of the transactions affected by CreditWatch placements (and no downgrades) have not experienced significant losses. The placement of our ratings on CreditWatch when a transaction has not experienced significant losses represents a new methodology derived from our normal surveillance practice."
- On June 22, 2007, we announced further ratings actions in an article entitled *133 Subordinate Second-Lien, Subprime Ratings From 2006, 2005-Vintage RMBS On Watch Neg, Cut.* We explained that "[t]he downgrades and CreditWatch placements reflect early signs of poor performance of the collateral backing these transactions."
- Then in July of this year, we again took action in response to increasingly bad performance data, including loss levels that continued to exceed historical precedents and our initial expectations. Specifically:

- We increased the severity of the surveillance assumptions we use to evaluate the ongoing creditworthiness for RMBS transactions issued during the fourth quarter of 2005 through the fourth quarter of 2006 and downgraded those classes that did not pass our heightened stress test scenario within given time frames.
- In addition, we modified our approach for ratings on senior classes in transactions in which subordinate classes have been downgraded.
- We also announced that, with respect to transactions closing after July 10, 2007, we would implement changes that would result in greater levels of credit protection for rated transactions and would increase our review of lenders' fraud-detection capabilities.

No one can see the future. The point of these articles and actions, however, is to highlight our reaction to increasing subprime deterioration — looking, as we always do, to historical or paradigm-shifting behaviors to help analyze long-term performance. Consistent with our commitment to transparency we repeatedly informed the market of our view that the credit quality of subprime loans was deteriorating and putting negative pressure on RMBS backed by those loans. And, consistent with our commitment to analytical rigor, we revised our models, took action when we believed action was appropriate, and continue to look for ways to make our analytics as strong as they can be.

Impact of The Credit Rating Agency Reform Act of 2006

Earlier this year, the Credit Rating Agency Reform Act of 2006 took effect. As a result, over the past few months, S&P has been actively engaged in the process of implementing the requirements of the Commission's new Rules regulating NRSROs under the Act.

On June 25, 2007 we filed our application to register as an NRSRO. The application includes, among other things, our procedures and methodologies for determining ratings;

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credit ratings performance measurement statistics; and information related to our ratings analysts and the largest users of our credit ratings. In addition, the application includes a description of our policies for preventing the misuse of material, non-public information and addressing and managing potential conflicts of interest. We also hired a Chief Compliance Officer who is responsible for administering and overseeing these policies and procedures and ensuring compliance with applicable securities laws.

Additionally, S&P has continued its ongoing efforts to develop and streamline internal record-keeping policies and procedures in order both to ensure the integrity of the ratings process and to satisfy Commission requirements that records be available for inspection. We recently received a notice of examination from the Commission seeking the production of a substantial amount of documents that may relate to the issue of the potential conflict of interest discussed above. We are in the process of complying with this notice.

S&P supported final passage of the Credit Rating Agency Reform Act and remains committed to that Act's stated goal of improving ratings quality for the protection of investors and fostering oversight, transparency and competition in the credit rating industry. Given that we are relatively early in the process of seeing this new law fully implemented, we would respectfully urge you to allow the Commission to proceed with its task of enforcing the provisions of the new law and the regulations so recently adopted before Congress proposes any further actions.

Conclusion

I thank you for the opportunity to participate in this hearing. Over the past several decades, S&P's consistent approach has been to evolve our analytics, criteria, and review processes when appropriate, and you can expect that same approach in light of new consumer credit behaviors in all markets, including residential mortgages. Let me also assure you again of our commitment to analytical excellence and our desire to continue to work with the Subcommittee as it explores developments effecting the subprime market. I would be happy to answer any questions you may have.

Footnote Exhibits - Page 0509

From: GREG LIPPMANN (DEUTSCHE BANK SECURI) <GREGLIP@BBOTG>
Sent: Tuesday, August 29, 2006 2:12 PM
To: PAOLO.PELLEGRINI <paolo.pellegrini@paulsonco.com>; NLOBACCARO <nlobaccaro@gweiss.com>; EKOSNIK <ekosnik@hginvestors.com>; MARC <MARC@JANAPARTNERS.COM>; RICHARD BARRERA (GLENVIEW CAPITAL MAN) <RBARRERA2@BBOTG>; PAOLO PELLEGRINI (PAULSON & CO. INC.) <PPELLEGRINI3@BBOTG>; DAVID MACKNIGHT (MASON CAPITAL MANAGE) <DMACKNIGHT@BBOTG>; ALAN FOURNIER (PENNANT CAPITAL) <AFOURNIER@BBOTG>; MICHAEL PENDY (DUQUESNE CAPITAL MAN) <GMPENDY@BBOTG>; NICK LOBACCARO (GEORGE WEISS ASSOCIA) <NLOBA@BBOTG>; EDWARD KOSNIK (HUNTER GLOBAL INVEST) <EKOSNIK@BBOTG>; JEREMY COON (PASSPORT MANAGEMENT,) <JMCPASSPORT@BBOTG>; JAMES DIDDEN (GSO CAPITAL PARTNERS) <JDIDDEN2@BBOTG>; GREGORY PAPPAJOHN (VARA CAPITAL LLC) <GPAPPAJOHN4@BBOTG>; BRADLEY WICKENS (SPINNAKER CAPITAL LT) <BWICKENS1@BBOTG>; MICHELLE BORRE (OPPENHEIMERFUNDS, IN) <MBORRE1@BBOTG>; CEMIL URGANCI (ASHMORE GROUP LIMITE) <CURGANCI1@BBOTG>; PAUL TWITCHELL (WHITEBOX ADVISORS, L) <PTWITCH@BBOTG>; SHAILESH VASUNDHRA (DEEPHAVEN CAPITAL MA) <SVASUND@BBOTG>; ANTHONY BOZZA (SAB CAPITAL MANAGEME) <ABOZZA@BBOTG>; BRAD ROSENBERG (PAULSON & CO. INC.) <BSROSENBERG@BBOTG>; TYLER DUNCAN (WAYZATA INVESTMENT P) <TJDUNCAN@BBOTG>; STEVE ROTH (GLG PARTNERS LP) <WOODY2@BBOTG>; DAVID GERSZEWSKI (AUTONOMY CAPITAL RES) <DAVIDG@BBOTG>; LEV MIKHEEV (MOORE EUROPE CAPITAL) <LVMIKHEEV@BBOTG>; STEFAN TSONEV (UBS LIMITED) <TSONEVS@BBOTG>; WYATT WACHTEL (YORK CAPITAL MANAGEM) <WJWACHTEL@BBOTG>; RENE HO (MORGAN (J.P.)) <RENEHO@BBOTG>; JOHN GISBORNE (TORONTO DOMINION BAN) <JGISBORNE@BBOTG>; MATTHEW J KEEGAN (OSPRAIE MANAGEMENT L) <MAKEEGAN@BBOTG>; PHILIP GUTFLEISH (ELM RIDGE VALUE ADVI) <PGUTFLEISH2@BBOTG>; JEFF MOSKOWITZ (MORGAN STANLEY) <JMOSK@BBOTG>; KENNETH COE (TALEK INVESTMENTS LL) <KCOE1@BBOTG>; MATTHEW BASS (GSO CAPITAL PARTNERS) <MBASS1@BBOTG>; ROPER STRYPE (RUBICON FUND MANAGEM) <RSTRYPE1@BBOTG>; ROBERT NEMETH (ELM RIDGE VALUE ADVI) <RNEMETH1@BBOTG>; MARC LEHMANN (JANA PARTNERS LLC.) <MARCLEHMANN@BBOTG>; JEREMY SCHIFFMAN (TPG-AXON CAPITAL MAN) <JSCHIFFMAN@BBOTG>; JORIS HOEDEMAEKERS (OASIS CAPITAL (UK) L) <JORIS1@BBOTG>; NEIL JOSHI (DEEPHAVEN CAPITAL MA) <NJOSHI@BBOTG>; DANIEL DONOVAN (GDG) <DDONOVAN5@BBOTG>; RAGHU RAGHAVENDRA (MOORE EUROPE CAPITAL) <RAGHAVENDRA@BBOTG>; CHAD KLINGHOFFER (GLENVIEW CAPITAL MAN) <CKLINGHOFFER@BBOTG>; JOSH ADAM (GLG INC.) <JOSHADAM@BBOTG>; JEREMY SIMON (TPG-AXON CAPITAL MAN) <JSIMONTPG@BBOTG>; BRIAN VAHEY (KING STREET CAPITAL) <BVAHEY@BBOTG>; DEAN CARLSON (SUSQUEHANNA INVESTME) <DCARL@BBOTG>; JEAN FAU (DARBY CAPITAL IRELAN) <JFAU@BBOTG>; VARUN GOSAIN (CONSTELLATION CAPITA) <VGOSAIN1@BBOTG>; MAULIN SHAH (POLYGON INVESTMENT P) <MAULIN_SHAH@BBOTG>; HARRY MAMAYSKY (OLD LANE, LP) <H MAMAYSKY@BBOTG>
Subject: Fwd: Two Jim Grant articles on CDOs
Attach: 15664357.htm

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #963

Message Sent: 08/29/2006 09:12:02
From: GREGLIP@BBOTG|GREG LIPPMANN|DEUTSCHE BANK SECURI|1726|328663
To: paolo.pellegrini@paulsonco.com|PAOLO.PELLEGRINI| | |
To: nlobaccaro@gweiss.com|NLOBACCARO| | |
To: ekosnik@hginvestors.com|EKOSNIK| | |
To: MARC@JANAPARTNERS.COM|MARC| | |
To: RBARRERA2@BBOTG|RICHARD BARRERA|GLENVIEW CAPITAL MAN| |
To: PPELLEGRINI3@BBOTG|PAOLO PELLEGRINI|PAULSON & CO. INC.| |
To: DMACKNIGHT@BBOTG|DAVID MACKNIGHT|MASON CAPITAL MANAGE| |
To: AFOURNIER@BBOTG|ALAN FOURNIER|PENNANT CAPITAL| |
To: GMPENDY@BBOTG|MICHAEL PENDY|DUQUESNE CAPITAL MAN| |
To: NLOBA@BBOTG|NICK LOBACCARO|GEORGE WEISS ASSOCIA| |
To: EKOSNIK@BBOTG|EDWARD KOSNIK|HUNTER GLOBAL INVEST| |
To: JMCPASSPORT@BBOTG|JEREMY COON|PASSPORT MANAGEMENT,| |
To: JDIDDEN2@BBOTG|JAMES DIDDEN|GSO CAPITAL PARTNERS| |
To: GPAPPAJOHN4@BBOTG|GREGORY PAPPAJOHN|VARA CAPITAL LLC| |
To: BWICKENS1@BBOTG|BRADLEY WICKENS|SPINNAKER CAPITAL LT| |
To: MBORRE1@BBOTG|MICHELLE BORRE|OPPENHEIMERFUNDS, IN| |
To: CURGANCI1@BBOTG|CEMIL URGANCI|ASHMORE GROUP LIMITE| |
To: PTWITCH@BBOTG|PAUL TWITCHELL|WHITEBOX ADVISORS, L| |
To: SVASUND@BBOTG|SHAILESH VASUNDHRA|DEEPHAVEN CAPITAL MA| |
To: ABOZZA@BBOTG|ANTHONY BOZZA|SAB CAPITAL MANAGEME| |
To: BSROSENBERG@BBOTG|BRAD ROSENBERG|PAULSON & CO. INC.| |
To: TJDUNCAN@BBOTG|TYLER DUNCAN|WAYZATA INVESTMENT P| |
To: WOODY2@BBOTG|STEVE ROTH|GLG PARTNERS LP| |
To: DAVIDG@BBOTG|DAVID GERSZEWSKI|AUTONOMY CAPITAL RES| |
To: LVMIKHEEV@BBOTG|LEV MIKHEEV|MOORE EUROPE CAPITAL| |
To: TSONEVS@BBOTG|STEFAN TSONEV|UBS LIMITED| |
To: WJWACHTEL@BBOTG|WYATT WACHTEL|YORK CAPITAL MANAGEM| |
To: RENEHO@BBOTG|RENE HO|MORGAN (J.P.)| |
To: JGISBORNE@BBOTG|JOHN GISBORNE|TORONTO DOMINION BAN| |
To: MAKEEGAN@BBOTG|MATTHEW J KEEGAN|OSPRAIE MANAGEMENT L| |
To: PGUTFLEISH2@BBOTG|PHILIP GUTFLEISH|ELM RIDGE VALUE ADVI| |
To: JMOSK@BBOTG|JEFF MOSKOWITZ|MORGAN STANLEY| |
To: KCOE1@BBOTG|KENNETH COE|TALEK INVESTMENTS LL| |
To: MBASS1@BBOTG|MATTHEW BASS|GSO CAPITAL PARTNERS| |
To: RSTRYPE1@BBOTG|ROPER STRYPE|RUBICON FUND MANAGEM| |
To: RNEMETH1@BBOTG|ROBERT NEMETH|ELM RIDGE VALUE ADVI| |
To: MARCLEHMANN@BBOTG|MARC LEHMANN|JANA PARTNERS LLC.| |
To: JSCHIFFMAN@BBOTG|JEREMY SCHIFFMAN|TPG-AXON CAPITAL MAN| |
To: JORIS1@BBOTG|JORIS HOEDEMAEKERS|OASIS CAPITAL (UK) L| |
To: NJOSHI@BBOTG|NEIL JOSHI|DEEPHAVEN CAPITAL MA| |
To: DDONOVAN5@BBOTG|DANIEL DONOVAN|GDG| |
To: RAGHAVENDRA@BBOTG|RAGHU RAGHAVENDRA|MOORE EUROPE CAPITAL| |
To: CKLINGHOFFER@BBOTG|CHAD KLINGHOFFER|GLENVIEW CAPITAL MAN| |
To: JOSHADAM@BBOTG|JOSH ADAM|GLG INC.| |
To: JSIMONTPG@BBOTG|JEREMY SIMON|TPG-AXON CAPITAL MAN| |
To: BVAHEY@BBOTG|BRIAN VAHEY|KING STREET CAPITAL| |
To: DCARL@BBOTG|DEAN CARLSON|SUSQUEHANNA INVESTME| |
To: JFAU@BBOTG|JEAN FAU|DARBY CAPITAL IRELAN| |
To: VGOSAIN1@BBOTG|VARUN GOSAIN|CONSTELLATION CAPITA| |
To: MAULIN_SHAH@BBOTG|MAULIN SHAH|POLYGON INVESTMENT P| |
To: H.MAMAYSKY@BBOTG|HARRY MAMAYSKY|OLD LANE, LP| |

----- Original Message -----

From: Greg Lippmann <greg.lippmann@db.com>

At: 8/28 17:32:17

Structured Complacency

Credit markets are sanguine. Structured credit is proliferating. Could the first fact be related to the second?

Yes, we say. There?s no end of explanation for the mysterious willingness of bond buyers and bank-loan investors to accept persistently modest returns over riskless government yields. Liquidity has been superabundant, hedge-fund assets are on the prowl, yield thirst goes unslaked?all these causes are put forward. We are about to suggest another explanation for the bewildering complacency of lenders. Spreads are tight in part because of the growing number of collateralized debt obligations (CDOs). What these entities share is a strong propensity to buy and a low propensity to sell. A new fact commands the attention of lenders and borrowers: Financial engineering is displacing credit analysis.

Definitions are in order. A CDO is a debt-acquisition enterprise. It raises money from investors. It acquires assets with the proceeds?bonds, bank loans, mortgages, asset-backed securities, etc. It can buy floating-rate assets or fixed-, senior claims or subordinated. In 2005, no less than $250 billion of CDOs came into the world, 59% more than in analysis, we venture the following capsule distinction: financial engineering is the science of structuring cash flows; credit analysis is the art of getting paid.

The liabilities side of a CDO balance sheet is what gives the structure its distinctive investment personality. The liabilities are layered. Field-strip a typical $100 million CDO and you find, first, a large swath of ?senior? liabilities, say $70 million worth, rated triple-A; a $20 million ?junior? slice rated single- or double-A; a $3 million mezzanine piece rated triple-B; and $7 million of unrated equity.

The top-rated assets are not inherently triple-A. Their strength derives rather from the vulnerability of the assets underneath. The equity tranche is most exposed; to it goes the first loss. When it has borne all it can bear (i.e., $7 million), the next loss goes to the mezzanine tranche and the next to the junior slice. Only after all of these levees are breached--$30 million worth?do losses cut into the value of the senior segment.

The various segments are priced according to their risk, with the senior-most yielding a few dozen basis points over Libor and the equity segment returning 1,000 basis points over (or more). The cost to create such a structure runs to about 1.5% of the balance-sheet footings. Included are legal, rating and origination expenses. Annual management fees may run to 50 basis points. Although some CDOs are ?static??the assets with which they are seeded are the ones they keep?some latitude for the managers is increasingly the norm.

Our ?typical? CDO is known as a ?cash? CDO. It is not to be confused with a ?synthetic? CDO. Like the cash variety, a synthetic CDO raises money from investors. Then it sells credit protection to other investors, in the shape of credit default swaps (CDS). The cash CDO earns income from the securities it holds. The synthetic CDO earns income from the premium it writes.

In a few short years, these derivative structures have marginalized the vast corporate bond market. Companies still issue public debt, but Wall Street is trading less and less of it. The charm of the old corporate arena?with its generously separated bids and offers and its personable, richly compensated sales people?proved its undoing. The advent of price transparency through the TRACE reporting system bathed the marketplace in sunlight. Blinking, the salespeople watched quotations tighten and commission income dwindle.

?Banks that trade corporate bonds have been required to report transactions to TRACE since 2002,? Bloomberg noted in a May 9 report on the historic shift from cash transactions to derivative ones (?Derivatives Make Nich Carraway, Corporate Bond Traders Obsolete,? is the headline). ?The system now provides prices and the amount of bonds exchanged in each trade on 29,000 securities with in 15 minutes of a deal, according to NASD. With the data available, there?s little need for guidance from analysts or salespeople.?

Observe, please, the analytical leap implied in the final three words of the quotation: ?analysts or salespeople.? Why should price transparency make analysts obsolete? Hypothesis No. 1: Because, in an efficient market, a security?s price is the unfailing measure of its value. Hypothesis No. 2: Because, on Wall Street, the analysts are paid out of the big fat commission pot. We lean toward No. 2.

Credit risk is ever present. Where it resides is the timely question. Once upon a time, before ?disintermediation,? the risk of default or nonpayment lay with the banks. It was the banks? business to know more about their borrowers than anyone else. Come the junk-bond revolution, the risk migrated out of the banks and into the securities markets. Now comes the derivatives boom. Who are the keepers of the flame of credit analysis in 2006?

We?re not sure?and neither is the International Monetary Fund. ?[R]ating agencies have played a significant role in the acceptance of new products by investors, with the analysis and rating of structured products heavily reliant on sophisticated quantitative modeling,? says IMF?s 2006 Global Financial Stability Report (see Chapter 2, ?The Influence of Credit Derivative and Structured Credit Markets on Financial Stability?). ?Not surprisingly. The development of structured credit markets has coincided with the increasing involvement of people with advanced financial engineering skills required to measure and manage these often complex risks. In fact, for many market participants, the application of such skills may have become more important than fundamental credit analysis.? This provocative thought is developed in a one-sentence footnote, as follows: ?Discussions with market participants raised questions as to whether the increased focus on ?structuring? skills, relative to ?credit? analysis, may itself present a concern.?

Emphatically, the rating agencies are on the job. Since a CDO without a triple-A-rated senior tranche would be unmarketable, their imprimatur is indispensable. For Moody?s Corp., the sole publicly traded rating business, derivatives are the wave of the future?and of the present, besides. In the first quarter, structured finance generated revenues of $176 million, nearly double the contribution of old0line corporate debt ratings.

Colleague Ian McCulley was unable to elicit from any agency just what this booming business entails. But he did catch up with a junior analyst at one ratings shop, who described his work in monitoring as many as 20 CDOs a day. (Both the analyst?s name and his employer?s are being withheld to protect the innocent.) ?Basically,? says our source, ?I go through what they buy and sell each month. And I go through all of their ratios. And I check to see if they have synthetics,? e.g., credit default swaps. It?s all in an Excel model. The CDOs he checks are actively managed. Interestingly, some of them invest in the tranches of other CDOs, and they are called ?CDO squared.? It?s no easy matter to rate these exotica, even with the help of a complex model developed for the purpose by Moody?s. Our admittedly green contact says he doubts that many people really understand what these structures own, how their assets are correlated or what might happen to them in the liquidation portion of a credit cycle.

A skeptical friend of ours applauds the bank-loan-holding CDOs. Michael Lewitt, president of Harch Capital Management, Boca Raton, Fla., is the manager of 150 bank loans (which constitute a collateralized loan obligation, or CLO, a species of CDO). He contends that the loan structures do work?and Lewitt, in his professional capacity, is a hard man to please. Yes, he readily acknowledges, credit spreads are too tight, but ?even if a loan defaults, you still get recoveries of 95 cents on the dollar, or even over par, so you are OK.? Lewitt is here referring to senior loans. Beware, he says, the second-lien kind, which are really ?just bonds, and that?s where you will have some real capital impairment.?

Our investigation leads usto the same conclusion, though most lenders and borrowers are wondering less about capital impairment than about what took them so long to see the beauty of junior bank claims. Among these merits is the east of early call (at the borrower?s behest and

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with fewer of the costs and restrictions typically associated with calling a corporate bond) and the fact that they pay a floating, not a fixed, rate of interest. Their issuance is soaring. According to Steven Miller, manageing director of S&P?s Leveraged Commentary and Data Group, $16 billion of second-lien paper came to market in 2005, 35%more than in 2004. And while junk-bond issuance last year totaled $75 billion, less will be sold this year. ?Furthermore,? colleague McCulley observes, ?second liens are tailor-made for the current state of the financial world; hedge funds absorb 37% and CLOs 48% of second lien issuance nowadays. Libbey Inc., the Toledo, Ohio, glassmaker profiled in the April 21 issue of Grant?s, is among the companies that has recently forsaken the junk market for the second-lien market; it expects to tap it any day.?

What?s there to be afraid of? a practitioner we know rhetorically asks: ?For a deal that has locked in its liability costs for in the market that would bring back credit spreads to more natural levels.?

Be careful what you wish for, we say. The financial engineers are up in the driver?s seat of credit, a fact that ought to worry everyone except distressed investors. ?[F]or some mezzanine structured credit products,? the aforementioned IMF paper speculates, ?zero recovery rates are much more likely than on similarly rated corporate bonds, yet the resulting default probabilities and expected losses are mapped into traditional corporate bond ratings that tend to be in the 40%-60% range.?

No default epidemic is imminent, our friend Lewitt asserts. Yet, he points out, something is bound to interrupt the present idyll. Something ?systemic? is his nomination. ?These hedge funds are not a sign of health and this equity day trading is not a sign of health. And having a credit market priced on a non-credit basis?meaning priced off quantitative and arbitrage bases and not on credit fundamentals?is not a healthy thing.?

Credit markets ought to be priced on the basis of credit, of course?and, one day, most assuredly, they will be again.

English Majors? Revenge

Collateralized debt obligations are only baffling most of the time. Gibberish, the technical literature may be, but a determined reader can make out the occasional familiar English word or phrase. One such word is ?assumption.? It turns out to be of critical importance to understanding how these complex structures are designed, priced and sold.

Now begins another voyage of discovery. The destination: The land of the CDOs. The missions: Understanding. We write on behalf of all who stand suspicious but mute before the mathematical guardians of this $1 trillion market. Do you, Mr. or Ms. Former English Major, suspect that there is a fly in the derivatives ointment but are afraid to express a doubt in the company of quants? We are going to arm you with the facts.

By way of background, the housing market is only as strong as the mortgage market. And the mortgage market, these days, is only as strong as the CDOs into which are packed hundreds of billions of dollars of housing-related debt (prime and subprime, ?cap corridor bonds,? Alt-A-pass-through hybrids and others you may not want to ask about just now). And the CDOs are only as viable as their equity base.

In previous issues, Grant?s has described these securities and the risks that unsuspecting investors may run in holding them. This time out, the focus is on the junior-most portion of the CDO liability structure, i.e., the equity tranche. It?s the equity that bears the first loss or, if all goes according to plan, earns the highest return. You can?t sell a CDO without some sliver of equity?and sliver is the word. High-grade deals are leveraged at 100:1 on up. Buyers of this derivatives dynamite are said to include hedge funds as well as institutions in Japan, South Korea and Southeast Asia.

In March, Moody?s performed the signal public service of compiling actual returns on equity portions of 66 ?terminated? CDOs (i.e., entities that, for one reason or another, had reached the end of their useful lives). It found that returns ranged from a negative 82% to a positive 99% and that the median return was very close to zero. The

Moody?s analysts were not dogmatic, however, because they could not be sure what investors had paid for the securities they were examining: ?Unfortunately, the pricingof equity is the result of a highly private, sometimes complex negotiation.? In a follow-up study of the equity tranches of 10 terminated structured-finance CDOs, Moody?s last month found that returns had ranged from a negative 59.1% to a positive 70.1%, with the average at a negative 8.4%.

A curious layman will now begin to appreciate the significance of the word ?assumptions? in the context of expected CDO returns (especially when pricing is as transparent as a curtain of lead). With enough of the right kind of assumptions, the equity-tranche buyer can sleep the sleep of the confidently misinformed.

But such self-delusion will be a little harder to achieve since publication of a July 26 report by Deutsche Bank entitled, ?High Grade ABS CDOs? (in which ABS stands for ?asset-backed securities?). The analysis calls into question the premises on which such derivatives are built and sold. ?Modeling assumptions that simplify actual cash flows are commonplace in the world of structured finance,? the authors note. ?However, while these adjustments are unlikely to significantly impact the debt, they can have significant consequences on equity returns?especially within a structure that is leveraged 100 to 200 times.?

And what might these dubious assumptions be? Asset and liability cash-flow mismatch, is one. Something having to do with a five- to seven-day ?trustee period? at the time of issuance is another, and ?risk mismatch in 2004 CDOs? is a third. A fourth involves the universal impulse to reach for yield: ?In the current relatively tight spread environment,? the report says, ?collateral managers have increasingly turned to higher yielding alternative prime mortgage products to add additional yield to the CDO portfolio.?

These are, or have been, the best of times for housing, the Deutsche Bank authors observe. Drawing comfort from past performance, investors have come to regard ?the structures and the various modeling assumptions that are embedded within them? with unwarranted confidence.

Especially is confidence unwarranted at a time of elevated leverage.

?I don?t want to suggest that anything malicious and underhanded is going on here,? Anthony Thompson, managing director and head of U.S. asset-backed security and CDO research for Deutsche Bank, tells colleague Dan Gertner. ?I think the reality is that a lot of the CDO architecture and technology was created 10 to 15 years ago when spreads were wider, leverage was lower and where you didn?t have to be so meticulous with your assumptions.? Buyers of these equity pieces are not necessarily the world?s most sophisticated modelers of structured finance securities, Thompson adds. ?I would make the point that mortgages are complicated still to most of the world. Mortgages levered 200 times are even more complicated.?

By tweaking some standard assumptions to make them conform with the 2006 marketplace, the Deutsche Bank study adjusts an ?idealized? expected return of 19% to a more realistic 10.2% return. Note well, however, as the authors add, that CDOs are built on many assumptions. They acknowledge that they examined ?but a few pieces of the complex CDO puzzle.?

Come the next bear market in mortgage debt, many more assumptions will certainly come in for reappraisal. Knowing only this much, the detached and calculating English major might well be able to sweep up astonishing bargains.

Examination Report for
Moody's Investor Services, Inc.
("Moody's")

1. Introduction

On August 31, 2007, the Staff in the Commission's Office of Compliance Inspections and Examinations ("OCIE"), Division of Trading and Markets ("Trading & Markets") and Office of Economic Analysis ("OEA") (collectively "the Staff") initiated an examination of Moody's, and two other credit rating agencies. The focus of the examinations was Moody's activities in rating subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") linked to subprime RMBS.[1] Specifically, key areas of review included:

- the NRSROs' ratings policies, procedures, and practices, including gaining an understanding of ratings models, assumptions, criteria and protocols;
- the adequacy of the disclosure of the ratings process and methodologies used by the NRSROs;
- whether the NRSROs complied with their ratings policies and procedures for initial ratings and ongoing surveillance;
- the efficacy of the NRSROs' conflict of interest procedures; and
- whether ratings were unduly influenced by conflicts of interest related to the NRSROs' role in bringing issues to market and the compensation they receive from issuers and underwriters.

The examinations also included a review of whether there were any errors in ratings issued as a result of flaws in ratings models used as a result of a press report indicating errors in one firm's model.[2] Initial observations as a result of this aspect of the examinations are included in this report.

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1 Beginning in 2007, delinquency and foreclosure rates for subprime mortgage loans in the United States dramatically increased, creating turmoil in the markets for RMBS backed by such loans and CDOs linked to such loans. As the performance of these securities continued to deteriorate, the three NRSROs most active in rating these instruments downgraded a significant number of their ratings. The NRSROs' performance in rating these structured finance products raised questions about the accuracy of their credit ratings generally as well as the integrity of the ratings process as a whole.

2 See Sam Jones, Gillian Tett, and Paul J. Davies, *Moody's Error Gave Top Ratings to Debt Products,* Financial Times, May 20, 2008, at 1.

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The examination review period generally covered January 2004 through the present. The firms under examination became subject to the provisions of the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act"), which amended the Securities Exchange Act of 1934 ("Exchange Act"), and the Commission's rules when they registered with the Commission as NRSROs in September 2007. Although Moody's was not subject to legal obligations applicable to NRSRO during most of the review period, the Staff nonetheless sought to make relevant factual findings and observations with respect to the activities of Moody's in rating subprime RMBS and CDOs during the period, as well as to identify possible areas for improvement in their practices going forward.

Over 50 Commission Staff participated in the examinations of Moody's, and two other credit rating agencies. The examinations included extensive on-site interviews with the rating agencies' staff, including senior and mid-level managers, initial ratings analysts and surveillance analysts, internal compliance personnel and auditors, personnel responsible for building, maintaining and upgrading the ratings models and methods used in the ratings process, and other relevant rating agency staff.

In addition, the Staff reviewed a large quantity of the rating agencies' internal records, including the written policies, procedures and other such documents related to initial ratings, the ongoing surveillance of ratings, and the management of conflicts of interest, and the public disclosures of the procedures and methodologies for determining credit ratings. The Staff also reviewed deal files for subprime RMBS and CDO ratings, internal audit reports and records, and other internal records, including a large quantity of email communications records (the rating agencies' produced over two million emails and instant messages that were sorted, analyzed and reviewed using software filtering tools). Finally, the Staff reviewed the rating agencies' public disclosures, filings with the Commission and other public documents.

2. The Ratings Process

The Rating Agency Act expressly states that the Commission has no authority to regulate the "the substance of the credit ratings or the procedures and methodologies" by which any NRSRO determines credit ratings.[3] As part of this examination, however, the Staff necessarily sought to develop an understanding of the quantitative analysis used to rate the RMBS and CDOs that have been subject to such dramatic and widespread change.

Moody's rates RMBS and CDO transactions by first assessing the underlying collateral and then assessing the deal structure. For RMBS collateral assessment, Moody's uses the Moody's Mortgage Metrics Model ("M3") to quantitatively arrive at initial loss coverage numbers.[4] Moody's then looks at qualitative factors, such as the originator and servicer,

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3 15 U.S.C. 78o-7(c)(2).

4 Presently, Moody's evaluates over 50 different characteristics of each loan in a pool, through its M3 model, examples of which are: credit bureau scores, which is an indicator of a borrower's past credit performance; loan-to-value ratio, which reflects the amount of equity borrowers have in

and makes adjustments to the initial loss coverage numbers to arrive at the final loss coverage numbers.[5] For CDOs, Moody's uses its proprietary CDOROM model for projecting expected loss. For cash flow CDOs, the results of the CDOROM model runs are processed by Moodys' proprietary CDOEdge model in order to assess the portfolio.[6] In this second stage, Moody's arrives at an estimate of credit enhancement for excess spread through models which project cash flows for the proposed capital structure. Results from the collateral and cash flow models are reviewed through the rating committee approval process before a final rating is issued.

M3 was not available to rate subprime securities until December 2006. Prior to that date, Moody's used a system of "benchmarking" to rate subprime RMBS wherein a subprime mortgage pool currently being evaluated was compared to several subprime pools previously rated by Moody's.[7] This process resulted in an initial rating number after which several "hits" or adjustments could be applied, depending on the pools characteristics, to arrive at the final loss coverage numbers.[8]

As part of the ratings process during this period, Moody's will on occasion revise its ratings methodology. Many of the changes Moody's made were incremental and did not affect the overall rating. Moody's transitioned incremental changes over a short period of time. If a deal was in-house and had been priced, the old methodology would apply, and the deal would be rated under the former methodology. When a change to the methodology would affect a rating, Moody's generally published a Request for Comment notifying the market of the potential change and indicating that it would implement the change at a later date.

3. Increase in Number and Complexity of RMBS and CDO Deals

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their homes; how fully buyers have documented their income and assets; whether the property will be owner occupied; and, whether the loan is for purchase or refinance.

5 Moody's review of the originator, servicer, and master servicer is a significant element of Moody's rating process as each can greatly influence loss levels depending on their relative strength or weakness. The originator or servicer can increase or decrease loss levels separately by up to a total of 20%.

6 For synthetic CDOs, Moody's analysts employ the CDOROM model, a simulation tool designed to determine the expected loss for each tranche. The CDOROM model runs a minimum of one million Monte Carlo simulations using the potential asset pools allowed under a CDO's covenants. For cash CDOs, the CDOROM model is generally employed to generate expected loss figures for potential collateral pools, which are then run through the firm's CDOEdge model, which applies a correlated binomial method (incorporating default correlation assumptions) to a proposed deal structure in order to generate projected payment waterfalls, in order to generate cash flow models for various scenarios.

7 The subprime pools had either the same originator or a comparable originator.

8 For example, if a bucket in a pool had a high percentage of interest only loans a hit would be applied to the expected loss number for that bucket.

From 2002 to 2006, the volume of structured finance deals rated by Moody's increased substantially, as did the revenues Moody's received from rating those deals. The structured products Moody's was asked to evaluate became increasingly complex, with many employing derivatives such as credit default swaps to replicate the performance of mortgage backed securities. Further, the loans made to retail borrowers being securitized evolved from 30-year fixed rate instruments to newer products such as second lien and adjustable rate mortgages. The increasing number and complexity of deals may have compromised various aspects of Moody's ratings operations for structured finance, as discussed in greater detail below.

a. Revenue, Deal, and Staffing Levels

From 2002 to 2006 the volume of RMBS deals rated by Moody's increased by 137%, and the number of CDO deals rated by Moody's increased by 700%. Correspondingly, the revenue Moody's derived from RMBS deals increased from $61.8 million in 2002 to $168.9 million in 2006 and CDO revenue increased from $11.7 million in 2003[9] to $91.2 million in 2006.

For the RMBS group, contemporaneous staffing increases appear roughly in line with volume increases (Moody's increased RMBS staff by 114% as volume increased by 137%).[10] For CDOs, however, Moody's staffing increases do not appear to have kept pace with volume increases (Moody's increased CDO staff by 24% as volume increased by 700%).[11]

b. Impact on the Ratings Process

The Staff believes that the deal and staffing levels during the review period may have impacted various aspects of the ratings process. For instance, several CDO memoranda reviewed by the Staff indicate that ratings were issued notwithstanding one or more unresolved issues. For example, the rating committee memorandum for the Costa Bella CDO, Ltd. deal stated that for one issue involving the collateral manager, "We didn't ha [sic] time to discuss this in detail at the committee, so they dropped the issue for this deal due to timing. We will need to revisit in the future."[12] Another potentially unresolved issue was described as "poorly addressed – needs to be checked in the next deal"[13] and "WARR- don't ask ☺)".[14]

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9 Moody's was unable to produce CDO revenue for 2002 due to a transition of accounting systems.

10 In 2002 RMBS lead analysts were responsible for monitoring their rated transactions. See MIS-OCIE-RMBS-28799. The tabulation of Moody's RMBS personnel for 2002 does not include the Group Managing Director or Senior Managing Director and the tabulation for 2006 does not include the Group Managing Director.

11 In 2002, CDO lead analysts were responsible for monitoring their rated transactions. Senior Associates, of which there were nine, provided monitoring support.

12 See MIS-OCIE-RMBS-26801.

13 Id.

The Staff believes that the increase in the number and complexity of deals may have impacted Moody's subprime RMBS and CDO ratings operations, as is discussed in more detail below.

The Staff recommends that Moody's periodically evaluate if it has sufficient staff and resources to manage its volume of business and meet its obligations under the Rating Agency Act.

Moody's Response: Moody's agrees with the Staff's recommendation and will periodically evaluate staffing levels.

4. Disclosure of the Rating Process

The requirements of the Rating Agency Act specifically address the importance of disclosure. An NRSRO is required to disclose publicly the procedures and methodologies it uses in determining credit ratings.[15] Form NRSRO requires that this disclosure be a general description; but sufficiently detailed to provide users of credit ratings with an understanding of the processes employed in determining credit ratings, including among other things, the quantitative and qualitative models and metrics used to determine credit ratings. Moody's explained to the Staff that, prior to being registered as an NRSRO, it disclosed its ratings process during the review period. It appears, however, that certain significant aspects of the rating processes and the methodologies used to rate RMBS and CDOs were not always disclosed, or were not fully disclosed, as summarized below.

New or revised rating methodologies and policies that are deemed material are often first approved internally and then published as a Request for Comment from the market before being implemented.[16] In the RMBS group incremental changes to the ratings methodology or process are approved through RMBS chair meetings. Moody's states that it uses press releases and web postings to publicly disclose modifications to its rating methodologies and related practices, procedures and processes.[17] However, Moody's does not consolidate its methodologies for rating subprime RMBS or CDO transactions in one location.

As such, the Staff had difficulty locating the disclosure of certain aspects of Moody's ratings process. Moreover, Moody's does not publish (or publish before implementation) all incremental changes to its methodology. For example, the Staff found emails where

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14 "WARR" stands for weighted average rate of return. See MIS-OCIE-RMBS-26798.

15 Section 4(a)(1)(B)(ii) of the Exchange Act.

16 Moody's Report on the Code of Professional Conduct, April 2006.

17 Moody's Code of Professional Conduct, June 2005.

Moody's made changes to assumptions before the market was notified of the changes.[18] Additionally, the Staff found emails evidencing Moody's analysts utilizing an unpublished model to assess data.[19]

The Staff recommends that Moody's conduct a review of its current disclosures of its processes and methodologies for rating RMBS and CDOs to assess whether it is fully disclosing its ratings methodologies and meeting the requirements of the Rating Agency Act and Form NRSRO. Further, the Staff recommends that Moody's review whether its policies governing the timing of disclosure of a significant change to a process or methodology are reasonably designed to comply with these requirements.

Moody's Response: Moody's generally agrees with the Staff's recommendations and is currently taking steps to improve disclosure of the ratings process, including the drafting of unified methodologies.

5. Written Policies and Procedures for Rating RMBS and CDOs

As of September 2007, NRSROs are subject to a requirement to make and retain certain internal documents relating to its business, including procedures and methodologies used to determine credit ratings.[20] Prior to this, Moody's ratings policies are described in its Code of Professional Conduct, Report on the Code of Professional Conduct, Analyst Handbook – Rating Practices and Procedures, and Moody's Best Practices for the Conduct of Moody's Structured Finance Rating Committees. While these documents, taken as a whole, provide a general guideline for an analyst to follow when rating structured finance products, they were not specific to any type of structured finance product, such as RMBS or CDOs.

The Staff recommends that Moody's conduct a review to determine whether its written policies and procedures used to determine credit ratings for RMBS and CDOs are fully documented in accordance with the requirements of Commission Rule 17g-2.

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18 Email chain ending with email from Ariel Weil, Associate Vice President/Analyst, Term RMBS, Moody's, to Kelly Slicklein, Associate Director, Investor Services Group, Moody's (Nov. 29, 2007, 20:08 GMT). See also email chain ending with email from Yuri Yoshizawa, Group Managing Director, US Derivatives, Moody's, to Yvonne Fu, Team Managing Director, US Derivatives, Moody's (Apr. 24, 2007, 18:50 GMT). See also email from Ariel Weil, Associate Vice President/Analyst, Term RMBS, Moody's, to Mark DiRienz, Team Managing Director, Term ABS, Moody's (Feb. 7, 2007, 20:54 GMT). See also email form Karen Ramallo, Associate Analyst, Term RMBS, Moody's, to Odile Grisard Boucher, Associate Analyst, Term RMBS, Moody's (Nov. 15, 2006, 19:10 GMT).

19 Email chain ending with email from Karen Ramallo-Rodriguez, Associate Analyst, Term RMBS, Moody's, to Denise Person, Vice President/Senior Criteria Officer, Term RMBS, Moody's (Sept. 24, 2007, 18:26 GMT). Moody's states that it does not publish all criteria changes, particularly those they consider incremental or non-material.

20 Rule 17g-2 under The Exchange Act. 17 CFR 240.17g-2.

Moody's Response: Moody's generally agrees with the Staff's recommendation and will conduct a review to ensure that its policies and procedures are properly documented in accordance with the Commission's rules.

As a result of a May 20, 2008, Financial Times article detailing a coding error in the model Moody's utilized to rate constant proportion debt obligations ("CPDOs")[21] the Staff expanded the scope of its exam to review Moody's policies and procedures for addressing the discovery of errors in its models and methodologies.[22] The Staff found that while Moody's does have policies and procedures that emphasize the importance of providing accurate ratings with integrity, it does not have policies and procedures that provide guidance on the process that should be followed when errors are discovered in its models, methodologies, or other aspects of the ratings process.

The Staff recommends that Moody's develop policies and procedures to address the detection of errors with its models, methodologies, or other aspects of the ratings process. The Staff also recommends that Moody's develop policies and procedures for the reporting of discovered errors in its models, methodologies, or other aspects of the ratings process.

Moody's Response: Moody's responded that it has instituted numerous remedial measures to address this issue, including implementing new policies and procedures, and establishing a taskforce to initiate a thorough review of all existing structured finance models.

6. Integrity and Accuracy of the Information Provided to Moody's

There is no requirement under the federal securities laws that an NRSRO verify the information contained in RMBS loan portfolios presented to it for rating. Additionally, NRSROs are not required to insist that issuers perform due diligence, and they are not required to obtain reports concerning the level of due diligence performed by issuers.

The Staff notes that pursuant to its policies, procedures, and public pronouncements, Moody's did not engage in any due diligence or otherwise seek to verify the accuracy and quality of the loan data underlying the RMBS pools it rated during the review period. In fact, the Code of Ethics for Moody's clearly states that Moody's is under no obligation to perform, and does not perform, due diligence.[23] Moreover, it states that the assignment of a rating is not a guarantee of the accuracy, completeness, or timeliness of the

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21 CPDOs are a type of credit derivative sold to investors looking for long term exposure to credit risk on a highly rated note. Investors buy notes issued by a special purpose vehicle ("SPV").

22 The Staff also noted potential conflicts of interest with respect to this issue. These are addressed more fully below.

23 See Moody's Code of Conduct, p 7, dated June 2005 and updated October 2007 (stating Moody's has no obligation to perform, and does not perform, due diligence with respect to the accuracy o f the information it receives or obtains in connection with the rating process).

information relied on in connection with the rating.[24] Moody's solely performed loss and cash flow analyses on the data presented to it. Moody's generally did not verify the integrity and accuracy of such information as, in Moody's view, due diligence duties belonged to the other parties in the process. Moody's also did not seek representations from sponsors that due diligence was performed.

Moody's has taken, or announced, measures designed to improve the integrity and accuracy of the loan data they receive on underlying RMBS pools:

- Moody's announced that it was considering enhancements to its RMBS securitizations that would include the engagement by issuers of independent third parties to randomly sample, for due diligence, the greater of 10% or 200 loans for all subprime transactions.

- In addition, in an agreement with the New York State Attorney General, Moody's agreed to develop and publicly disclose due diligence criteria to be performed by underwriters on all mortgages comprising RMBS, and to review those results prior to issuing ratings.[25]

7. Documentation of Significant Steps and Participants in the Rating Process

a. Documentation of Significant Steps in the Ratings Process

An NRSRO is required to retain internal records, including non-public information and workpapers, used to form the basis of a credit rating it issued (Exchange Act Rule 17g-2(b)(2)). Prior to implementation of this requirement, Moody's policy was to retain records related to the credit analysis and rating process for certain time periods as identified in its record retention schedule.[26]

The Staff reviewed 50 RMBS and 51 CDO deals to determine if Moody's followed the policies and procedures for rating RMBS and CDOs and its file maintenance and recordkeeping policy. Moody's policies and procedures call for a rating committee memorandum and addendum to be produced for each transaction rated by Moody's. The information required in the rating committee memorandum and addendum includes the date the rating committee convened; the names of the rating committee attendees; the name of the committee chair; the type of rating action and type of instrument under consideration; the rating recommendation and rationale; the rating committee outcome and vote tally; quantitative analysis, and supporting materials.[27]

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24 Id.

25 http://www.oag.state.ny.us/press/2008/june/june5a_08.html

26 Moody's record retention policy did not apply to procedural or methodological policies governing the credit ratings process as a whole. MIS-OCIE-RMBS-28424-28483.

27 See Moody's Best Practices for the Conduct of Moody's Structured Finance Rating Committees, at 5 (May 2006). See MIS-OCIE-RMBS-312, 397, 430. In May of 2006 Moody's added the

For RMBS transactions, most of the ratings memoranda and addenda contained the minimum required information under Moody's policy. However, the Staff found that the level of detail provided as to how the committee arrived at its rating levels was inconsistent.[28] Often boxes on the addendum were checked without explanation despite fields requiring explanation, contained an inadequate explanation, or in some cases were not checked at all.[29]

The level of documentation of Moody's CDO ratings process varied widely across the deals reviewed by the Staff. Only 15 included all of the four basic required pieces of documentation: a rating committee memorandum, a rating committee addendum, a monitoring committee memorandum, and a monitoring committee addendum. For 16 of the deals reviewed, no monitoring documentation was produced.[30] Additionally, the rating committee memoranda featured significant variation in the topics covered and amount of information presented. For instance, over half of the rating committee memoranda included a section on the collateral manager, however, the level of detail provided in this section varied greatly.[31] Almost all of the rating committee memoranda included a modeling assumptions section, however, the level of detail provided varied greatly. While a small number of memoranda had detailed discussions of the collateral manager, the majority of memoranda including this section either contained a very brief summary or essentially included the section only as a placeholder (i.e., the section included the name of the collateral manager followed by blank fields for items such as "location," "contact," "key personnel," etc.). The majority of the ratings committee memoranda also included an "Issues" section. The level of detail in this section also varied greatly, ranging from detailed listings of rating committee concerns and issuer/underwriter responses to short lists without any indication of resolutions. To the extent that they were provided to the Staff, the surveillance and monitoring memoranda,

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requirement that the committee chair be identified in all memoranda as well as the committee outcome. Compare MIS-OCIE-RMBS-312, with MIS-OCIE-RMBS-397, and 430.

28 For instance, one initial rating committee memorandum contained only three sentences that merely state a base description of the loan pool and there is no way to discern how the rating committee arrived at its results, GSAMP 2006-S1, MIS-OCIE-RMBS-28730; others did not discuss the rating rationale in sufficient detail. See e.g. Long Beach Mortgage Loan Trust 2006-2, MIS-OCIE-RMBS-28621-28625.

29 For example, the "Key variable(s) voted upon" sections of the addenda were often left blank or contained a generic term like "ratings."

30 These numbers are based on the Staff's review of the documentation provided by Moody's. Approximately three months after the delivery of the majority of the requested transaction materials, Moody's provided an index that confirmed the Staff's findings as to the extent of documentation. See MIS-OCIE-RMBS-32168-32171.

31 While a small number of memoranda had detailed discussions of the collateral manager, the majority of memoranda including this section either contained a very brief summary or essentially included the section only as a placeholder (i.e., the section included the name of the collateral manager followed by blank fields for items such as "location," "contact," "key personnel," etc.).

like the rating committee memoranda, also varied in the amount of information provided, with sections of some memoranda essentially serving as placeholders. Finally, many of the rating committee or monitoring memoranda did not contain a narrative discussing the ratings committee decision or underlying rationale.[32]

The Staff's findings with respect to deal files it reviewed are corroborated by other internal discussion by Moody's. For example, the Derivatives Group was aware that "delinquencies on adherence to the document retention policy had increased" and sent out an email to the Derivatives Group noting this issue.[33] Moody's, however, has subsequently stated that it is in the process of implementing automated committee memorandum and other document retention procedures which will address these issues.

Ultimately, the Staff found that Moody's failed to retain or document certain significant steps in the rating process, which made it difficult for the Staff to assess compliance with its rating policies and procedures, and to identify the factors that were considered in developing a particular rating. This lack of documentation would similarly make it difficult for the Moody's internal compliance staff or internal audit staff to assess compliance with the firm's policies and procedures.

b. Documentation of Participants in the Ratings Process

An NRSRO is also required to make and retain records of the identity of any credit analyst that participated in determining the rating and any person that approved the rating before it was issued (Exchange Act Rule 17g-2). This requirement is intended to assist the Commission in monitoring whether the NRSRO is following its procedures and methodologies for determining credit ratings and whether the NRSRO is complying with procedures designed to prevent the misuse of material nonpublic information by identifying the persons with the best information as to how the credit rating was determined. Prior to this, Moody's policy required that the rating committee attendees and rating rationale be a part of the rating committee memorandum.[34]

For the subprime RMBS and CDO transactions reviewed by the Staff, the Staff found that, at times, in both the initial ratings memoranda and addenda the vote tally was incomplete with either a generic "agreed with levels" type comment in the field for "Key variable(s) voted on" accompanying the vote tally or no indication of the vote tally at

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32 In many cases, the sole documentation of the decision-making process is in the addenda section labeled "RC Outcome," with checkboxes for "RC Recommendation accepted" and "RC Outcome differed from Recommendation." In several cases where the latter box was checked, no explanatory narrative was provided.

33 Email from Gus Harris, Senior Managing Director, New Products Group, Moody's, to 'SFG/Derivatives – US' listserv, Moody's (May 18, 2007, 22:16 GMT).

34 <u>See</u> Moody's Best Practices for the Conduct of Moody's Structured Finance Rating Committees, at 5 (May 2006). <u>See</u> MIS-OCIE-RMBS-312, 397, 430.

all.[35] The Staff also found that like the initial rating committee memoranda, the majority of surveillance memoranda failed to record the voting results.

The Staff recommends that Moody's conduct a review of its current policies and practices for documenting the credit rating process to review whether they are reasonably designed to ensure compliance with Rule 17g-2 and to address weaknesses in the policies or in adherence to existing policies that result in gaps in recording the voting in the credit rating process.

Moody's Response: Moody's generally agrees with the Staff's recommendation and will continue to monitor to ensure compliance with its recordkeeping requirements.

8. Surveillance Practices

Under the Rating Agency Act, an NRSRO is required to disclose publicly the procedures and methodologies it uses in determining credit ratings. In addition, Section 4(d) of the Rating Agency Act states that an NRSRO must maintain adequate financial and managerial resources to produce credit ratings with integrity.

Moody's does not have written policies and procedures for the surveillance of subprime RMBS and CDO bonds, although it publishes criteria that describe the methodologies under which such bonds are monitored.[36] For both RMBS and CDO Moody's uses automated surveillance tools that on a monthly basis flag for review securities whose performance indicates that their current credit rating may not be consistent with the current estimated expected loss.[37] Aside from its monthly outlier screening, Moody's also regularly performs ratings sweeps by issuer and/or origination year, where Moody's looks at each outstanding deal individually.

Once a rated instrument is selected based on the automated surveillance tools, a Moody's surveillance analyst will further investigate the status of the transaction and present findings to a ratings committee. If the rating committee believes that a rating may need to be adjusted, then the securities are placed on review for a potential downgrade or upgrade.[38]

It appears that Moody's regularly performed RMBS and CDO surveillance during the exam time period. However, while Moody's publishes criteria that describe its

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35 See e.g. Long Beach Mortgage Loan Trust 2006-2, MIS-OCIE-RMBS-28621-28631.

36 From 2003-2007, Moody's released three comprehensive publications that detail how Moody's monitors RMBS transactions.

37 For RMBS the surveillance process is based on a review of collateral performance, for CDO it is based on the ratings of the individual assets comprising the collateral pool.

38 For CDO Moody's follows a very similar process; however, surveillance analyst analyze different metrics.

methodology for the surveillance of RMBS and CDO bonds, Moody's does not have internal written procedures documenting the steps staff should undertake for surveillance of RMBS and CDO bonds.

The Staff recommends that Moody's develop RMBS and CDO surveillance policies and procedures. The Staff also recommends that Moody's conduct a review to determine if adequate resources are devoted to surveillance of outstanding RMBS and CDO ratings.

Moody's Response: Moody's agrees with the Staff's recommendations and informed the Staff that it is implementing, or has implemented, global procedural and structural changes that address the Staff's recommendations. Among these policies and changes is the building out of its compliance function to facilitate surveillance policy development.

9. Management of Conflicts of Interest

a. "Issuer Pay Model"/Fee Discussions

Moody's uses the "issuer pays" model, in which the sponsor or other entity that issues the security is also seeking the rating. Under Exchange Act Rule 17g-5(b)(1), it is a conflict of interest for an NRSRO being paid by issuers or underwriters to determine credit ratings with respect to securities they issue or underwrite. Section 15E(h) of the Exchange Act requires an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed to address and manage conflicts of interest. Such policies and procedures are intended to maintain the integrity of the NRSRO's judgment. Avoiding a conflict of interest prevents an NRSRO from being influenced to issue a more favorable credit rating in order to obtain or retain business of the issuer or underwriter.[39]

In order to manage this conflict of interest, in October of 2007 Moody's established a policy to restrict analysts and their immediate managers from participating in fee discussion with issuers.[40] Moody's has also organized its rating group as a separate organization within a larger company.[41] However, Moody's does not actively monitor employees' compliance with the prohibition against analysts from participating in fee discussions.

The Staff found multiple communications that indicate that analysts are aware of the firm's fee schedules, and actual (negotiated) fees. There does not appear to be any internal effort to shield analysts from emails and other communications that discuss fees and revenue from individual issuers. In some instances, analysts discuss fees for a rating. For instance, one analyst wrote to his manager "in the past it took us 2 – 3 months to rate one [a type of deal], so I assume fees should be much higher than for typical

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39 See Release No. 34-55857 and Exchange Act Rule 17g-5.

40 Moody's Code of Professional Conduct (October 2007).

41 In 2007, Moody's Corporation effected a separation at the corporate level between its credit rating business, Moody's, and its non-ratings product and service business, Moody's Analytics.

reperforming deal."[42] Another analyst wrote to his manager asking about whether the firm would be charging a fee for a particular service, and what the fee schedule would be.[43] In addition, there were indications that analysts were involved in fee discussions with employees of the firm's billing department.[44] The Staff is concerned that analysts could be influenced in their ratings by their awareness of the amount of fees charged to issuers.

b. Business considerations in the Ratings Process

As a result of a May 20, 2008, Financial Times article detailing a coding error in the model Moody's utilized to rate CPDOs, Moody's began a review by outside counsel surrounding the issue. As a result of that investigation, Moody's reported to the Staff that a European CPDO rating/surveillance committee had knowledge that Moody's had issued ratings on certain CPDO securities in 2006 using a model that contained a coding error.[45] The coding error resulted in most of those securities receiving a rating several notches higher than if the model had not contained the coding error. In January of 2007, a CPDO committee first became aware that the ratings were several notches higher than they should have been. Despite this fact, the committee agreed to continue to maintain the higher unwarranted ratings for several months until the securities were eventually downgraded for performance reasons. Members of the committee, all analysts or analytical managers, considered the rating agency's reputation when deciding not to downgrade the securities and make the coding error public.

Moody's recently informed the Staff that as a result of these findings, it has implemented, or plans to implement several global procedural and structural changes that address the issues identified. The Staff is still reviewing the facts related to the CPDO ratings.

The Staff recommends that Moody's continue to review its practices, policies and procedures to further mitigate and manage the "issuer pays" conflict of interest. In particular, the Staff recommended that Moody's consider steps that would insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria.

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42 Email from Gulmira Karaguisiyeva, Analyst, Term RMBS, Moody's, to David Teicher, Team Managing Director, Term RMBS, Moody's (May 9, 2007, 13:46 GMT).

43 Email from Zhiqin (James) Huang, Analyst, Term RMBS, Moody's, to Mark DiRienz, Team Managing Director, Term ABS, Moody's (May 7, 2006, 13:38 GMT).

44 Email from Gulmira Karaguisiyeva, Analyst, Term RMBS, Moody's, to Joy Mayo, Manager, Middle Office, Moody's (Aug. 23, 2007, 23:10 GMT).

45 The Staff met with Moody's and outside counsel conducting the investigation on June 27, 2008, to discuss the CPDO coding error and the progress of the investigation. Moody's represented that the investigation into this matter will be completed in mid-July 2008.

Moody's Response: Moody's agrees with the Staff's recommendation and will continue to review its practices and procedures to further mitigate and manage the "issuer pays" conflict of interest.

c. Analyst Compensation

Moody's has a policy that generally provides that an analyst may not be compensated or evaluated based upon the amount of revenue that the rating agency derives from issuers or issues that the analyst rates or with which the analyst regularly interacts.[46] While Moody's does not compensate its analysts based on the deals they rate or the ratings provided, like all employees, the amount of an analyst's bonus is tied to the overall success of the company.

d. Securities Transactions by Employees

Moody's has adopted a policy to prohibit employees and their immediate family members from owning any security that is subject to a credit rating of a team on which such employees are members to guard against potential insider trading.[47] Furthermore, Moody's has implemented procedures to monitor employees' ownership of securities of issuers or obligors rated by groups within the company with whom an employee is not affiliated.[48] Managers are required to review all trades of Moody's employees that report directly to them and raise all potential conflicts of interest or violations with the Legal department or Ratings Compliance department.[49] The Staff found Moody's employee securities transaction program to be adequate.

The Staff has recommended that Moody's conduct a review of its policies and procedures for managing the securities ownership conflict of interest to determine whether they are reasonably designed to ensure that its employees' personal trading is appropriate and does not violate Rule 17g-5.

Moody's Response: Moody's agrees with the Staff's recommendation and will continue to review its policies and procedures for securities trading and ownership to ensure compliance with Rule 17g-5.

10. Internal Audit

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[46] See Section 2.11 of the Moody's Code of Professional Conduct.

[47] See Moody's Revised Securities Trading Policy and Reporting Procedures (November 2005).

[48] Moody's employees must report all the securities holdings of the employee and/or members of his/her immediate family, upon initiation of employment and periodically thereafter, as well as records of securities transactions that the employee and immediate family members engage in. An employee's compliance with the transaction reporting requirement can be achieved by ensuring that his/her employer receives duplicate copes of brokerage statements and trade confirmations.

[49] Section 3 of Appendix A to the Revised Securities Trading Policy and Reporting Procedures (November 2005).

Historically, Moody's employed an outside firm, KPMG, to perform its audits. In addition, at least since 2006, Moody's has performed internal audits to evaluate ratings group's compliance with its best practices, its electronic storage requirements, securities trading restrictions, and the Moody's Code of Conduct.[50] The auditors evaluate the adequacy of implementation of internal controls designed to address these areas. The auditors perform a risk assessment to determine where to perform their audits based upon a number of factors, including the type of debt and geographic location of the group within Moody's responsible for rating an issue. For example, RMBS securities in Europe may be audited in one year, in the U.S. in the next, and in Asia in the year after that, meaning that a specific group in a particular geographic area is audited once every three years.

During the period reviewed by the Staff, Moody's conducted three internal audits related to the RMBS and CDO rating process.[51] The internal audit reviews discovered, among other things, certain non-compliance with document retention policies, over-reliance upon individuals for technological expertise to test software, and lack of adherence to the rating committee guidelines (inquiries about committee member conflicts, no documentation of majority vote, lack of rating committee memo, missing rating letter, empty electronic document management system ["EDMS"] folder, two models not filed on EDMS or CDO Edge, and a lack of documented re-prioritization of deal monitoring). In the Staff's opinion, the most significant finding arising out of the internal audit performed in 2006 for the U.S. Derivatives Team in Structured Finance revealed that derivative models are not formally reviewed and/or validated by management before they are posted for general use. For one deal, the analyst used a banker's proprietary model, without any form of review of the model to determine whether it was reliable or consistent with Moody's methodology. The auditors recommended that management implement a review process to periodically assess the integrity of the models used in support of the rating. Moody's was unable to demonstrate evidence of its management's follow-up on the recommendations of the auditors. The Staff believes that Moody's should be able to provide records of such follow-up as part of an examination of the internal audit record.

The Staff recommends that Moody's review whether its internal audit functions, particularly in the RMBS and CDO ratings areas, are adequate, and whether it provides for proper management follow-up.

Moody's Response: Moody's agrees with the Staff's recommendation and will review the adequacy of its internal audit functions and will develop procedures that address management follow-up.

11. Conclusion

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50 Moody's provided no records of any audits performed prior to 2006.

51 See 2006 U.S. Derivatives Monitoring Internal Audits; 2006 U.S. RMBS Internal Audit; and 2006 U.S. Derivatives Team Structured Finance Internal Audit.

The Staff intends to send a deficiency letter to Moody's outlining its findings and recommendations. The Staff will request that Moody's provide a written response within 30 days outlining any remedial action planned or already taken to address the findings and recommendations in the letter. Moody's will be asked to include in its response a timetable for implementing the proposed remedial action. The letter will also request that Moody's send OCIE a written confirmation in 12 months detailing the status of implementation of each remedial action.

SULLIVAN & CROMWELL LLP

TELEPHONE: 1-212-558-4000
FACSIMILE: 1-212-558-3588
WWW.SULLCROM.COM

125 Broad Street
New York, NY 10004-2498

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FOIA CONFIDENTIAL TREATMENT REQUESTED BY MOODY'S INVESTORS SERVICE

March 11, 2008

By Federal Express

Matthew Daugherty,
Office of Compliance Inspections and Examinations,
United States Securities and Exchange Commission,
100 F Street, N.E.,
Washington, D.C. 20549.

Re: Moody's Investors Service

Dear Mr. Daugherty:

I write on behalf of Moody's Investors Service ("Moody's") in response to the Staff's letter to Raymond W. McDaniel dated February 20, 2008. Moody's understands that the Staff's requests are being made pursuant to the Staff's authority under the Credit Rating Agency Reform Act of 2006. Enclosed is a CD-ROM, bearing bates number MIS-OCIE-RMBS 0028537, containing a spreadsheet comprised of twelve worksheets that respond to Requests 1, 2, and 4-9. The name of each worksheet indicates the Request to which it responds. The information contained in the spreadsheet was compiled by Moody's employees for the purpose of responding to this request. Moody's is preparing a response to a portion of Requests 8 and 9 relating to RMBS rating and surveillance personnel, and Request 10.

For its response to Request 3, Moody's refers the Staff to Moody's Form 10-K for the fiscal years 2004 through 2007 at pages 79, 74, 63, and 76 respectively. Moody's Form 10-K reports revenue by business unit for a three year period, including Structured Finance, Corporate Finance, Financial institutions and Sovereign Risk, and Public Finance.

Moody's is producing these documents in compliance with the Credit Rating Agency Reform Act of 2006 and applicable rules promulgated thereunder. Under 15 U.S.C. § 78o-7(m)(1), Moody's production of these documents "does not constitute a waiver of, or otherwise diminish, any right, privilege, or defense" that Moody's "may

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otherwise have under any provision of State or Federal law, including any rule, regulation, or order thereunder."

The enclosed documents contain confidential and proprietary commercial and financial information concerning Moody's and its affiliates, as well as confidential information concerning the clients and employees of Moody's. Accordingly, Moody's hereby requests, pursuant to Rule 83 of the SEC's Rules on Information and Requests, 17 C.F.R. § 200.83, and for reasons of business confidentiality and personal privacy, that the enclosed documents, and this letter, not be disclosed in response to any request made under the Freedom of Information Act, 5 U.S.C. § 552 (1994) ("FOIA"). The foregoing request also applies to any transcripts, notes, memoranda, tapes or other materials of any sort that are made by, or at the request of, the SEC and incorporate, refer or relate to any of the matters contained in the enclosed documents or this letter.

If the enclosed documents or this letter become the subject of a FOIA request, please call the undersigned at (212) 558-3269 and we will provide further information in support of Moody's request for confidential treatment. Although we make this request in the name of Moody's, we do not intend to waive the right of any client or employee of Moody's separately to request such confidential treatment. We also request that at the conclusion of this investigation, all copies be returned to me at the above address.

Very truly yours,

Stephen Ehrenberg

(Enclosure)

cc: Freedom of Information Act Officer
(United States Securities and Exchange Commission)
(without enclosures)

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Moody's Investors Service

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Annual Gross Revenue - RMBS Ratings

Year		Gross Revenue
FY02*	$	61,801,000
FY03	$	75,964,289
FY04	$	109,121,344
FY05	$	167,509,541
FY06	$	168,916,978
FY07	$	114,381,512

* 2002 Gross Revenue includes revenue from Servicer Quality Ratings ("SQR") which is not likely to exceed 2003 SQR revenue of $643,356.

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Annual Gross Revenue - ABS CDO Ratings*

Year		Gross Revenue
FY02**	$	-
FY03	$	11,730,234
FY04	$	22,210,695
FY05	$	40,332,909
FY06	$	91,285,905
FY07	$	94,666,014

* Revenue figures provided are for CDOs containing Asset Backed Securities, which may include RMBS.
** Revenue figures are not readily available for 2002 due to transition of accounting systems.

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Number of RMBS Rated 2002-2007

Month	RMBS Rated
Jan-02	33
Feb-02	36
Mar-02	60
Apr-02	43
May-02	37
Jun-02	57
Jul-02	40
Aug-02	42
Sep-02	63
Oct-02	45
Nov-02	39
Dec-02	49
Jan-03	41
Feb-03	50
Mar-03	57
Apr-03	62
May-03	60
Jun-03	63
Jul-03	51
Aug-03	64
Sep-03	70
Oct-03	67
Nov-03	61
Dec-03	77
Jan-04	50
Feb-04	66
Mar-04	94
Apr-04	79
May-04	82
Jun-04	106
Jul-04	80
Aug-04	99
Sep-04	103
Oct-04	82
Nov-04	85
Dec-04	104
Jan-05	72
Feb-05	76
Mar-05	101
Apr-05	87
May-05	109
Jun-05	112
Jul-05	87
Aug-05	120
Sep-05	128
Oct-05	93
Nov-05	112
Dec-05	128
Jan-06	79

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Feb-06	110
Mar-06	124
Apr-06	99
May-06	107
Jun-06	144
Jul-06	82
Aug-06	97
Sep-06	134
Oct-06	96
Nov-06	102
Dec-06	115
Jan-07	82
Feb-07	108
Mar-07	121
Apr-07	88
May-07	96
Jun-07	98
Jul-07	52
Aug-07	27
Sep-07	21
Oct-07	24
Nov-07	11
Dec-07	16

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Number of ABS CDOs Rated 2002-2007*

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Month	CDOs Rated
Jan-02	0
Feb-02	4
Mar-02	4
Apr-02	2
May-02	7
Jun-02	6
Jul-02	1
Aug-02	2
Sep-02	3
Oct-02	4
Nov-02	4
Dec-02	8
Jan-03	2
Feb-03	3
Mar-03	3
Apr-03	2
May-03	7
Jun-03	3
Jul-03	9
Aug-03	7
Sep-03	3
Oct-03	6
Nov-03	7
Dec-03	5
Jan-04	3
Feb-04	4
Mar-04	9
Apr-04	7
May-04	5
Jun-04	4
Jul-04	6
Aug-04	6
Sep-04	4
Oct-04	13
Nov-04	12
Dec-04	16
Jan-05	5
Feb-05	2
Mar-05	11
Apr-05	16
May-05	9
Jun-05	14
Jul-05	21
Aug-05	12
Sep-05	6
Oct-05	8
Nov-05	14
Dec-05	23
Jan-06	13

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Feb-06	5
Mar-06	21
Apr-06	11
May-06	34
Jun-06	29
Jul-06	33
Aug-06	28
Sep-06	35
Oct-06	54
Nov-06	39
Dec-06	58
Jan-07	20
Feb-07	34
Mar-07	73
Apr-07	39
May-07	34
Jun-07	35
Jul-07	24
Aug-07	13
Sep-07	2
Oct-07	5
Nov-07	3
Dec-07	0

* Figures provided are for CDOs containing Asset Backed Securities, which may include RMBS.

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Derivatives Rating and Surveillance Analysts 2007

Employee Name	Job Title	Primary Responsibility*
Ang,Kai C	Associate Analyst	Ratings
Araya,Rodrigo	Senior Vice President	Ratings
Beauchesne,Herve-Pierre	AVP-Analyst	Ratings
Bharwani,Pooja	VP-Senior Analyst	Ratings
Brennan,James	VP-Senior Analyst	Ratings
Bunja,Rudolph	Senior Vice President	Ratings
Burger,David	VP-Senior Analyst	Ratings
Cai,Gong	Senior Associate	Surveillance
Chan,Caroline	Senior Associate	Surveillance
Chen,Alena	Associate Analyst	Ratings
Chen,Karie	Analyst	Surveillance
Choi,Eun J	Senior Vice President	Ratings
Crousillat,Cesar	VP-Sr Credit Officer	Ratings
Espinoza,Oswald	Senior Associate	Surveillance
Fan,Hui	Associate Analyst	Ratings
Forster,Yehudah	VP-Senior Analyst	Ratings
Fratantaro,Annette C	Senior Associate	Surveillance
Fu,Yvonne F	Team Managing Director	Ratings
Gollins,Karen E	Associate Analyst	Surveillance
Gottesman,Craig J	Senior Associate	Surveillance
Green,Claudia N	VP-Senior Analyst	Ratings
Grossmann,Philip S	Senior Associate	Surveillance
Hallenbeck,Peter W	AVP-Analyst	Ratings
Ham,David	VP-Sr Credit Officer	Ratings
Harrington,William J	Senior Vice President	Ratings
Hart,Joy N	Associate Analyst	Ratings
Hu,Jian	SVP-Issuer Relations	Ratings
Jiang,Ivan X	VP-Senior Analyst	Ratings
Kaltsas,Dimitri	Associate Analyst	Surveillance
Kharnak,Elina	VP-Senior Analyst	Ratings
Kim,Jun P	AVP-Analyst	Ratings
Koller,Ainat	Senior Associate	Surveillance
Kolmanovskaya,Elina	VP-Senior Analyst	Ratings
Kumar,Harsh	Associate Analyst	Ratings
Lai,Shan	Associate Analyst	Surveillance
Lama,Sange	Senior Associate	Surveillance
Lasseron,Arnaud H	VP-Senior Analyst	Ratings
Leibholz,Maria	VP-Sr Credit Officer	Ratings
Li,Carissa H	Associate Analyst	Ratings
Li,Connie H	Senior Associate	Surveillance
Lioce,Stephen G	VP-Sr Credit Officer	Ratings
Mahdavi,Yasmine	AVP-Analyst	Ratings
May,William	Team Managing Director	Ratings
Miagkova,Maria V	VP-Senior Analyst	Ratings
Mogunov,Leonid	VP-Senior Analyst	Ratings
Nazarian,Danielle	Senior Vice President	Ratings
Nikulin,Evgeny	Analyst	Ratings
Olson,Ruth E	VP-Senior Analyst	Ratings
Ouzidane,Rachid	Analyst	Surveillance

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Park,John	Senior Vice President	Surveillance
Paroda,Prashant	AVP-Analyst	Ratings
Patel,Rahil	Senior Associate	Surveillance
Polansky,Jonathan	Team Managing Director	Surveillance
Putney,Abraham B	AVP-Analyst	Ratings
Remeza,Algis	VP-Sr Credit Officer	Ratings
Sam,Shiou Lin	Associate Analyst	Ratings
Sava,Suzanna	AVP-Analyst	Ratings
Schoellig,Gregory	Statistical Analyst	Surveillance
Sethi,Shana	Associate Analyst	Surveillance
Shrestha,Abiskar	Associate Analyst	Surveillance
Sieczkowski,Christopher R	Associate Analyst	Surveillance
Sieler,Julien	AVP-Analyst	Ratings
Sun,Yu	VP-Senior Analyst	Ratings
Tepper,Evan	Analyst	Surveillance
Torres,Ramon O	VP-Sr Credit Officer	Ratings
Tzianetopoulou,Theodora	Associate Analyst	Ratings
Veliev,Oktay	Associate Analyst	Ratings
Veluri,Sindhu M	Associate Analyst	Ratings
Wang,Fei Fem	AVP-Analyst	Ratings
Wang,Qi	Analyst	Surveillance
Wyszomierski,Teresa	VP-Sr Credit Officer	Ratings
Xu,Min	AVP-Analyst	Ratings
Yerynovska,Oksana	VP-Senior Analyst	Ratings
Yoshizawa,Clara	Group Managing Director	Ratings
Yu,Wai-Yin A	AVP-Analyst	Ratings
Zhang,Hongfei	Senior Associate	Surveillance
Zhu,Qian	AVP-Analyst	Ratings

* This list includes all analysts assigned to the U.S. Derivatives Group. Analysts are not dedicated to rating or monitoring ABS CDOs in particular. Analyst responsibilities have been temporarily shifted to rating or surveillance as needs arise.

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RMBS Rating and Surveillance Analysts 2007

Employee Name	Job Title	Primary Responsibility
Agarwal,Navneet	VP-Senior Analyst	Surveillance
Bains,Karandeep S	Associate Analyst	Surveillance
Bekiroglu,Arif K	Analyst	Ratings
Bergman,Aron	Analyst	Surveillance
Bessermann,Gregory Elie	Analyst	Surveillance
Branton,Mark K	Senior Associate	Surveillance
Chang,Kai-Ling	Associate Analyst	Ratings
Chatterjee,Debashish	VP-Senior Analyst	Ratings
Dang,JingJing	Associate Analyst	Surveillance
De Gaetano Polverosi,Maria I	AVP-Analyst	Surveillance
Drucker,Michael P	AVP-Analyst	Ratings
Fabrikant,Bruce D	Senior Vice President	Ratings
Fellows,Eric	VP-Sr Credit Officer	Ratings
Fried,Ilana J	Senior Associate	Surveillance
Fustar,Stephanie E	Analyst	Ratings
Gemson,Gregory	AVP-Analyst	Ratings
Genis,Peter	Associate Analyst	Ratings
Grisard Boucher,Odile	Analyst	Surveillance
Hannoun-Costa,Ola	Senior Associate	Surveillance
Huang,Zhiqin	Analyst	Ratings
Joseph,Jayesh	Associate Analyst	Surveillance
Kanef,Michael	Group Managing Director	
Karaguishiyeva,Gulmira N	Analyst	Ratings
Kelbaugh,Kathryn E	VP-Senior Analyst	Ratings
Kornfeld,Warren	Team Managing Director	Ratings
Kothari,Deepika	AVP-Analyst	Ratings
Liu,Qingyu	Analyst	Ratings
Lynn,Alexandra	Associate Analyst	Ratings
Markowitz,Murray R	VP-Senior Analyst	Ratings
Peng,Rui-Dan	AVP-Analyst	Ratings
Ramallo,Karen A	Analyst	Surveillance
Riggi,Marjan	VP-Sr Credit Officer	Ratings
Rocco,Joseph	Associate Analyst	Surveillance
Sanchez,Alda Fiorella	Associate Analyst	Surveillance
Shrivastava,Amita	Analyst	Ratings
Singhania,Gaurav	Analyst	Ratings
Swanson,Todd	Analyst	Ratings
Teicher,David L	Team Managing Director	Ratings
Tobey,Amelia	VP-Senior Analyst	Surveillance
Weil,Ariel	AVP-Analyst	Ratings
Zhang,Yi	VP-Senior Analyst	Ratings

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Mari Maloney
Chief Compliance Officer
Ratings Services
Global Regulatory Affairs

55 Water Street
New York, NY 10004-0003
212.438.7219 Tel
212.438.5673 Fax
mari_maloney@sandp.com

March 14, 2008

Via E-Mail and Federal Express

Matthew Daugherty
Office of Compliance Inspections and Examinations
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-8041

Dear Mr. Daugherty,

I write in response to Mr. Meehan's letter of February 20, 2008 to provide the information requested therein in connection with your office's ongoing examination of Standard & Poor's (S&P). The text of those questions is reproduced below, along with our responses. Per our discussions, and consistent with our prior submissions in this examination, the following information reflects our information for U.S. ratings. The data has been provided as it is maintained in the ordinary course, where possible, and, where not, it has been derived from S&P's records.

1. The annual total gross revenue for providing credit ratings on RMBS transactions for the period 2002-2007.

Table 1
U.S. RMBS - Gross Rating Revenues
($ thousands)

	2002	2003	2004	2005	2006	2007
Initial Rating[1]	55,147	90,606	128,073	158,598	176,995	127,726
Surveillance[2]	1,938	8,081	8,982	10,350	13,757	10,175
Total Revenue	57,085	98,687	137,055	168,948	190,752	137,901

1 Gross amount billed for new ratings of RMBS.
2 Gross amount billed for surveillance of ratings of RMBS after their first year of issuance. These figures include surveillance of pre-2002 ratings. From 2003 forward, this amount includes pre-paid surveillance fees for subsequent years.

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2. The annual total gross revenue for providing credit ratings on RMBS CDO transactions for the period 2002-2007.

Table 2
U.S. CDOs of RMBS - Gross Rating Revenues
($ thousands)

	2002	2003	2004	2005	2006	2007
Initial Rating[3]	9,296	12,621	24,829	41,008	88,934	74,231
Surveillance[4]	888	2,095	3,520	6,444	9,864	16,427
Total Revenue	10,184	14,716	28,349	47,452	98,798	90,658

3. The annual total gross revenue for providing credit ratings on all transactions for the period 2002-2007.

Table 3
U.S. Ratings and U.S. Structured Finance Ratings
Annual Net Revenues Earned and Reported[5]
($ thousands)

	2002	2003	2004	2005	2006	2007
Structured Finance	183,955	237,958	311,773	410,322	614,960	561,400
All Ratings[6]	516,856	640,871	742,108	884,257	1,121,678	1,157,043

3 Gross amount billed for new ratings of CDOs that are generally backed by RMBS collateral.
4 Gross amount billed for surveillance of ratings of CDOs of RMBS after their first year of issuance. These figures include surveillance of pre-2002 ratings. From 2003 forward, this amount includes pre-paid surveillance fees for subsequent years.
5 Represents net revenue (including surveillance) reported on an earned basis.
6 Represents U.S. ratings services included in the NRSRO.

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4. The total numbe ÅMBS transactions for which S&P p d a credit rating for each month during the period 2002-2007.

Table 4
Number of U.S. RMBS Transactions Rated

	2002	2003	2004	2005	2006	2007
January	48	56	69	93	96	106
February	43	71	86	106	146	147
March	66	86	123	115	168	149
April	56	84	99	103	116	128
May	53	78	106	129	131	141
June	60	89	140	144	180	131
July	47	79	106	98	98	67
August	57	96	116	143	110	53
September	87	115	141	165	175	44
October	58	88	126	120	149	53
November	60	90	99	149	130	24
December	78	108	133	181	140	22

5. The total number of RMBS CDO transactions for which S&P provided a credit rating for each month during the period 2002-2007.

Table 5
Number of U.S. CDO of RMBS Transactions Rated

	2002	2003	2004	2005	2006	2007
January	0	2	1	6	14	16
February	4	3	4	2	5	23
March	2	1	5	18	23	67
April	0	1	8	11	14	40
May	3	5	4	8	36	36
June	7	2	4	11	24	31
July	1	6	6	14	32	24
August	1	4	4	12	26	16
September	2	1	3	6	29	10
October	3	4	14	11	42	7
November	3	5	7	19	33	6
December	8	6	19	21	65	0

6. The total numbe ..MBS transactions under surveillanc S&P at the end of each month during the period 2002-2007.

Table 6
Number of RMBS Transactions Under Surveillance

	2002	2003	2004	2005	2006	2007
January	3,707	4,050	4,291	4,688	5,673	6,710
February	3,736	4,102	4,355	4,730	5,796	6,847
March	3,791	4,167	4,245	4,799	5,915	6,961
April	3,839	4,216	4,203	4,806	6,025	7,064
May	3,850	4,093	4,272	4,920	6,125	7,142
June	3,851	4,146	4,280	4,980	6,212	7,254
July	3,845	4,172	4,314	5,058	6,273	7,285
August	3,877	4,224	4,367	5,167	6,268	7,286
September	3,930	4,119	4,418	5,263	6,411	7,328
October	3,954	4,182	4,519	5,368	6,487	7,367
November	3,969	4,240	4,549	5,422	6,587	7,314
December	4,021	4,327	4,646	5,588	6,647	7,317

7. The total number of RMBS CDO transactions under surveillance by S&P at the end of each month during the period 2002-2007.

Table 7
Number of CDO of RMBS Transactions Under Surveillance

	2002	2003	2004	2005	2006	2007
January	37	71	110	191	326	661
February	38	75	113	192	332	672
March	43	75	119	209	351	725
April	43	76	125	221	365	765
May	45	79	128	230	398	813
June	51	84	133	236	419	844
July	53	86	139	249	452	864
August	55	94	143	263	477	887
September	56	95	146	270	498	902
October	60	99	155	282	529	913
November	62	103	164	290	569	918
December	70	108	183	315	641	921

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8. Total number of . onnel, identified by name and title, as d to providing initial credit ratings of RMBS and RMBS CDO transactions at year end for the period 2002-2007.

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2007	
RMBS Analysts	
Name	Title
Ahn (Liu), Laura	Associate Director
Albergo, Leslie	Senior Director
Alizadeh, Rasool	Rating Analyst
Arne, Errol	Director
Barash, Henry	Rating Specialist
Barnes, Susan	Managing Director
Bartl, Timothy	Research Assistant
Beauchamp, Kyle	Associate Director
Bergeland, Regina	Associate Director
Bergey, Kent	Associate Director
Bergman, Matthew	Associate
Bliss, Brendan	Senior Research Assistant
Boardman, Jeremy	Senior Research Assistant
Bruzese, Frank	Senior Research Assistant
Cao, Becky Hui	Director
Christensen, Peter	Rating Analyst
Conon, Jonathan	Rating Analyst
Consul, Manish	Associate
Deasy, Christopher	Director
Dougherty, Michael	Associate
Epstein, Ken	Associate Director
Fitter, Jenine	Director
Ghose, Ryan	Senior Research Assistant
Gleeson, Michael	Associate Director
Glehan, David	Director
Goldenberg, Mark	Director
Graham, Peter	Rating Analyst
Grow, Brian	Senior Director
Grundy, James	Associate
Guinyard, Anthony	Associate

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Footnote Exhibits - Page 0553

Name	Title
Hahn, Song	Associate
Hall, Daniel	Rating Specialist
Hansen, Justin	Director
Hierl, Jonathan	Senior Research Assistant
Hinman, Carissa	Rating Analyst
Hopkins, Amanda	Rating Specialist
Huang, Peng	Research Assistant
Johnson, Kimberly	Associate
Kahan, Jack	Rating Analyst
Kennedy, Martin	Senior Director
Kim, Jong Wan	Associate
Kimmel, George	Director
Koniowka, Gregory	Associate Director
Kostiw, Karen	Director
Kramer, Andrew	Research Assistant
Kumar, Rohit	Associate Director
Larkin, Daniel	Rating Analyst
Lim, Kwang Yi	Associate Director
Listner, Michael	Associate Director
Losice, Abraham S.	Managing Director
Lukacsko, Eric	Director
Mahdavian, Sharif	Director
Manasseh, Rani	Rating Analyst
Mason, Scott	Senior Director
McDermott, Gail	Managing Director
Morrison(Clements), Julia	Associate
Neary, Rebecca	Associate
Niemy, Todd	Director
Osterweil, Terry	Senior Director
Parker, Samuel	Director
Perelmuter, Monica	Director
Polizzotto, John	Director
Reiss, Nancy	Senior research Assistant
Ren, Chuye	Associate
Rossman, Ann	Associate
Samuels, Amy	Associate Director
Sang, John	Rating Analyst
Schneider, Jeremy	Associate
Shaikh, Waqas	Director
Sharma, Sudhir	Associate
Siber, Matthew	Senior Research Assistant
Skuthan, Natalia	Associate
Smith, Kevin	Research Assistant
Solar, Mona	Director
Steers, Bridget	Associate Director
Stock, Michael	Senior Director
Tegan, Daniel	Associate
Tencer, Steven	Director
Tillen, Bonnie	Managing Director

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Footnote Exhibits - Page 0554

Name	Title
Tillis, Lisa	Associate
Uppuluri, Sai	Director
Valente, Michael	Associate Director
VanKirk, Spencer	Senior Research Assistant
Vonderhorst, Brian	Senior Director
Wang, David	Associate Director
Wang, Elaine	Research Assistant
Warrack, Thomas	Managing Director
Watson, Jeff	Director
Weller, Brian	Rating Specialist
Wray, Michael	Rating Analyst
Yioupis, Leonidas	Associate
Zimmerman, Allen	Associate
Criteria	
Name	**Title**
Gillis, Thomas	Managing Director
Parisi, Frank	Managing Director
Additional Resources From Structured Finance	
Name	**Title**
Anagnostos, Helen	Associate Director
Maciaszek, Matthew	Associate Director
McGinnis, Peter	Director
Long, Russell	Managing Director
Fazio, Angelo	Senior Director
Legal	
Name	**Title**
Abrams, Natalie	Associate General Counsel
Byrnes, Bernard C.	Assistant General Counsel
Coleman, Maureen N.	Associate General Counsel.
Dawson, Petrina R.	Sr. Managing Director & General Counsel
IT Group	
Name	**Title**
Blaivas, Victoria	Senior Consultant
Garg, Anoop	Senior Consultant
Gimpelevich, Svetlana	Analyst-Systems/Sr
Hager, Aaron	Analyst-Systems/Sr
Karkhanova, Lyudmila	Mgr- Systems
Momin, Naushad M	Mgr- Systems
Rassadzin, Ilia A	Analyst-Systems/Sr
Saftoiu, Elena	Senior Director-Application Development
Ungureanu, Victoria	Analyst-Systems/Sr

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Footnote Exhibits - Page 0556

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2007	
CDO Analysts	
Name	**Title**
Albulescu, Henry	Managing Director
Bentham, Milbert	Director
Berrouet, Louis-Daniel	Associate
Billick, Nicole	Associate Director
Bruslanova, Natalia	Director
Bryan, Andrea	Managing Director
Carelus, Jean-Baptiste	Director
Chang, Jenny	Associate
Chay, Kyu	Director
Cheng, Loming (Lois)	Rating Specialist
Cheng, Kenneth	Director
Chery, Sulexan	Senior Research Assistant
Chinn, Vanessa	Rating Analyst
Chiriani, Robert Jr.	Senior Director
Cho, Jai Ho	Director
Cilento, Jenna	Research Assistant
Compton, Adrian	Associate Director
Cuddy, Daniel	Research Assistant
DeDiego Arozamena, Alfredo	Senior Director
Dennis, Alex	Research Assistant
Detweiler, John	Director
Fink, Gwen	Associate
Galgano, Philip	Managing Director
Gatmaitan, Joshua	Associate Director
Ghetti, Belinda	Senior Director
Guarnuccio, Keith	Senior Director
Halprin, James	Senior Director
Harris, John	Director
Hennessey, Julia John	Research Assistant
Horn, Carol	Associate Director
Hu, Bujiang	Director
Jordan, Pat	Managing Director
Kalinauskus, Paul	Associate
Kambeseles, Peter	Managing Director
Kato, Clara Akiko	Associate
Kaur, Manjeet	Senior Director
Khakee, Nik	Managing Director

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Footnote Exhibits - Page 0557

Name	Title
Kim, Jeong	Director
Kurtas, Erozan	Associate Director
Lam, Jonathan (Chifai)	Director
Lee, David	Rating Analyst
Leong, William	Associate
Llanos, Michael	Rating Analyst
Loken, Andrew	Rating Specialist
Long, Russell	Managing Director
MacDonald, Benjamin	Associate
Maciaszek, Matthew	Associate Director
Martin, John Trevor	Research Assistant
McCarthy, John	Director
McCutcheon, Erin	Associate
Mejia-Barros, Griselda	Rating Analyst
Meng, Jerry	Director
Meyer, R. Christopher	Director
Mooney, Shannon	Rating Specialist
Moy, Edward	Director
Neilson, Francesca	Director
Newman, Debroah	Associate
Nicholson, Boris	Senior Research Assistant
Nolan, Katarzyna	Associate Director
O'Brien, John	Director
O'Keefe, Brian	Managing Director
Omer, Farooq	Director
Parchment, James	Associate Director
Pedvis, Andrew	Senior Director
Radziul, Robert	Senior Director
Richards, Tara	Rating Specialist
Sachse, Sarah	Rating Specialist
Scaturro, Peter	Research Assistant
Schiller, Ross	Associate Director
Sehnert, M. Scott	Director
Sprinkle, Lauren	Rating Analyst
Sriram, Jag	Associate Director
Tagliaferro, John	Research Assistant
Tang, Ming	Associate Director
Tesher, David	Managing Director
Trant, Brian	Rating Analyst
Upton, Daniel	Research Assistant
Volpe, Ryan	Research Assistant
Widernik, Anna	Director
Wolf, Zackary	Associate Director
Wong, Eileen	Associate Director
Wong, Elwyn	Managing Director
Yagoda, Brian	Associate
Yang, Julia (Tingli)	Associate Director
Zhao, Bruce	Associate Director

Criteria	
Name	**Title**
Gillis, Thomas	Managing Director
Quantitative Group	
Name	**Title**
Bassignani, William C	Managing Director - Proj Execution
Morokoff, William J	Managing Director - Quant
Polizu, Cristina	Managing Director - COE
Sargsyan, Eduard	Director - COE
Watson, Robert	Director - COE Quant
Legal	
Name	**Title**
Coleman, Maureen N	Associate General Counsel
Dawson, Petrina R	Sr. Managing Director & General Counsel
Kirschner, Rhonda G	Assistant General Counsel
Manzi, Rosaleen M	Managing Director and Assoc. General Counsel
Silverberg, Michael	Assistant General Counsel

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2007	
RMBS Surveillance	
Name	**Title**
Avant-Koger, Paula	Rating Analyst

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11 Supported data collection efforts for surveillance.

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Footnote Exhibits - Page 0561

Name	Title
Boccanfuso, Francesca	Research Assistant
Bruzzese, Peter	Associate Director
Chin, Jimmy	Associate - COE Data
Davey, Scott	Associate Director
Elder, James	Associate
Giudici, Andrew	Director
Graffeo, Michael	Rating Analyst
Hyun, Catherine	Associate
Joyce, Kristy Marie	Research Assistant
Keenan, Matthew	Associate
Mahabir, Lal	Director
Pollsen, Robert	Director
Rao, Asha	Senior Research Assistant
Rivera, Jessica	Rating Specialist
Rivera, John	Associate Director
Romero, Cesar	Associate
Rozek, Aleksandra	Associate
Sawyer, Ola	Associate
Schuk, John	Associate
Warner, Ernestine	Senior Director
Young, Steven	Research Assistant
Criteria	
Name	**Title**
Gillis, Thomas	Managing Director
RMBS New Issue[12]	
Name	**Title**
Bartl, Timothy	Research Assistant
Bliss, Brendan	Senior Research Assistant
Ghose, Ryan	Senior Research Assistant
Graham, Peter	Senior Research Assistant
Hinman, Carissa	Rating Analyst
Huang, Peng	Research Assistant
Kramer, Andrew	Research Assistant
Smith, Kevin	Research Assistant
Wang, Elaine	Research Assistant
SF Information Tech	
Name	**Title**
Aptekar, Yeugene	Developer - Applications
Blaivas, Victoria	Senior Consultant
Saftoiu, Elena	Senior Director-Application Development
Data[13]	
Name	**Title**
Dunn, James	Associate - COE Data
Houston, Gail	Manager

[12] Additional resources from this group assisted with RMBS Surveillance during peak periods.
[13] In addition to the personnel listed above, 8 people employed by an affiliate assisted in data management efforts for RMBS surveillance in 2007.

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Name	Title
Li, Eric	Temp - Assistant
Lopez, Yasmin	Data Manager
Thornton, James	Manager

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2007	
CDO Surveillance Group	
Name	**Title**
Anderberg, Stephen	Senior Director
Cullen, Brian	Rating Analyst
Davis, Christopher	Associate
Gutierrez-Pagaduan, Heidi	Senior Research Assistant
Hu, Daniel	Senior Research Assistant
Joy, Sampson	Rating Analyst
Kobylinski, James	Associate Director
Lewison, Martin	Associate Director
Maglia, Anthony	Associate (Program)
Miraj, Nikhil	Associate (Program)

21 In addition to the personnel listed above, 39 people employed by an affiliate assisted in data management efforts for CDO surveillance in 2006.

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Name	Title
Mistry, Samir	Associate (Program)
Muthukrishan, Ramki	Director
Rajan, K.P.	Associate Director
Scanlin, Kate	Associate Director
Shah, Niyati	Rating Analyst
Stewart, Ian	Rating Analyst
Subramanian, Jay	Associate
Walsh, Tim	Associate
Zhang, Jennifer	Associate
CDO Group	
Name	**Title**
Chay, Kyu	Director
Compton, Adrian	Associate Director
Kalinauskas, Paul	Associate
Kato, Akiko	Associate
Loken, Andrew	Rating Specialist
Mooney, Shannon	Rating Specialist
Song, Helena	Associate Director
Sprinkle, Lauren	Rating Analyst
Trant, Bo	Rating Analyst
DeDiego Arozamena, Alfredo	Senior Director
Ghetti, Belinda	Senior Director
Guarnuccio, Keith	Senior Director
Hu, Bujiang	Senior Director
Radziul, Robert	Senior Director
Criteria	
Name	**Title**
Gillis, Thomas	Managing Director
Data[11]	
Name	**Title**
Damiano, Salvatore S	Assoc Director-COE Data
Jarvis, Arnold	Research Analyst
Laino, Bobby	Research Analyst
Notarstefano, Robert	Director-COE Data
Serrano, Julio A	VP-COE Data
Proj. Mgmt.	
Name	**Title**
Adams, Latoya S	Analyst-Business Sr COE
Liu Myers, Alice T	Assoc Director-COE Strgy & Pmo
Tomlinson, Sandra L	VP-COE Strgy & Pmo
Quantitative Group	
Name	**Title**
Sargsyan, Eduard	Director-COE

[11] In addition to the personnel listed above, 67 people employed by an affiliate assisted in data management efforts for CDO surveillance in 2007.

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SF Information Tech	
Name	**Title**
Balagurusamy, Srinivasan	Analyst-Systems/Sr
Blaivas, Victoria	Senior Consultant
Chen, John I	Senior Director-Application Development
Kostiw, Jeff	Senior Director, Structured Fin Tech
Moloksher, Nikolay	Senior Consultant
Momin, Inayat	Director-Application Development
Qian, Guoliang	Senior Consultant
Saftoiu, Elena	Senior Director-Application Development
Subramanyam, Tirunelveli K	Developer-Application Lead
Thangaraj, Solomon	Director-Application Development
Vega, Juan C	Senior Director-Structured Fin App

10. All current written policies and procedures, and any supporting documentation of reviews, audits or surveillance related to Rule 17g-5(c)(1), prohibiting an NRSRO from issuing a credit rating where the person soliciting the credit rating was the source of 10% or more of the total revenue of the NRSRO during the most recently ended fiscal year.

Rule 17g-5(c)(1) became effective as of June 18, 2007. As of December 31, 2006, the then-most recently ended fiscal year, no issuer was the source of more than 2.68% of the total revenue for the NRSRO. As of December 31, 2007, no issuer was the source of more than 2.74% of the total revenue for the NRSRO. Because there is no issuer that even approaches the threshold set forth in the rule, no written policies are currently in place. At the conclusion of this fiscal year, this issue will be revisited and appropriate written policies and/or procedures will be adopted if necessary.

* * *

Standard & Poor's requests confidential treatment of all information and/or documents that S&P provides to the Securities and Exchange Commission (the "SEC") in connection with this examination, including this letter and all of the information submitted herewith. This confidential treatment request is made under the SEC's confidential treatment procedures (17 C.F.R. § 200,83), under the Freedom of Information Act (5 U.S.C. § 552), and for reasons of privacy and business confidentiality, among others.

S&P expects this confidential treatment request to cover all information and/or documents that S&P may provide to the SEC in connection with the examination, as well as any subsequent requests that the SEC or any employee of the SEC (or any other government agency) may make in connection with the examination, together with any memoranda, notes, transcripts or other writings of any sort whatsoever that are made by, or at the request of, any employee of the SEC (or any other government agency) that incorporate, include or relate to any such information or documents (collectively, the "Confidential Information").

In accordance with 17 C.F.R. §200.83 and other applicable laws and regulations, S&P requests that all such Confidential Information be kept in a non-public file and that only members of the SEC or its staff have access to it. Should the SEC receive any request for the Confidential Information, under FOIA or otherwise, S&P requests that the undersigned immediately be notified of such request, and be furnished with a copy of all written materials pertaining to such request (including, but not limited to, the request and any agency determination relating thereto).

S&P expects to be given . portunity to submit written substantiati. the request for confidential treatment, if such substantiation is deemed necessary, as provided for in 17 C.F.R. §200.83(d). S&P further expects that, if the preliminary decision of the SEC is that confidential treatment is not warranted, in whole or in part, it will be given ten (10) calendar days from the date of the preliminary decision to submit supplemental arguments in support of the confidential treatment request, as provided for in 17 C.F.R. §200.83(e) (1). In addition, S&P expects that it will be given ten (10) calendar days from the date of the SEC's final decision to release all or part of the Confidential Information to enable S&P to pursue any remedies that may be available to it, as provided for in 17 C.F.R. §200.83(e)(1). For either a preliminary decision or final decision, S&P requests that you telephone the undersigned and send the decision by facsimile rather than relying upon the United States mail for the required notice.

In producing the enclosed information, S&P does not intend to waive any objections to the scope of the examination nor in any way to waive any applicable privileges or protections, including, but not limited to, those arising under the attorney-client privilege, the attorney work-product doctrine, the self-evaluative privilege, and any privileges and protections that may apply under the First Amendment of the United States Constitution or any similar state-law protections and privileges.

Sincerely,

/s/ Mari B. Maloney

Mari B. Maloney

55 Water Street
New York, NY 10041
877-727-8647 Tel
212-438-5153 Fax

The McGraw-Hill Companies

STANDARD
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U.S. STRUCTURED RATINGS FEE SCHEDULE

RESIDENTIAL MORTGAGE-BACKED FINANCINGS AND RESIDENTIAL SERVICER EVALUATIONS

OVERVIEW

This fee schedule applies to both insured and uninsured Residential Mortgage-Backed Financings issued by corporations and financial institutions domiciled in the United States and collateralized by mortgages on U.S. properties as well as ranking for Residential Mortgage Loan Servicers. Separate fee schedules are available for the following types of structured financings:

- Asset Backed Obligations
- Commercial Mortgage-Backed Financings
- Real Estate Companies
- Collateralized Debt Obligations

Please note that in the case of unique structures or securitizations involving new issuers and new product types, Standard & Poor's reserves the right to quote a fee for the analytical work performed. In addition, legal fees are charged for special research associated with such new issuers, products or structures are in addition to Standard & Poor's fees and will be billed separately.

Standard & Poor's performs an independent and objective analysis. The rating, which results from the analytical process may or may not be consistent with the expectations of the issuer. The fee for services is not contingent upon the issuer's acceptance of the assigned rating.

FEE QUOTATIONS

If you have any questions about this fee schedule or require additional information, please contact:

General Fee Inquiries	Ratings Fee Services	(877) 727-8647
Susan Barnes	Managing Director	(212) 438-2579
Thomas Warrack	Managing Director	(212) 438-2634
Brian Vonderhorst	Director	(212) 438-8457
Leslie Albergo	Director	(212) 438-2381
Peter D'Erchia	Managing Director, Global Practice Leader, Surveillance	(212) 438-2438

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FEE SCHEDULES

RESIDENTIAL MORTGAGE-BACKED FINANCINGS

Initial Rating Fee

The initial rating fee is based on the collateral and structure, i.e. senior/subordinated pass-throughs or excess spread and subordination structures. The fees below apply to public issues and private placements with pool balances below $1 billion.

	Basic Fee	Minimum Fee	Maximum Fee
Pass-Throughs:			
First-Lien Prime Jumbo & Alt. A Senior/Sub. Structure	3.0 basis points	$ 40,000	$ 100,000
First-Lien Prime Jumbo & Alt. A Sr./Sub., Excess Spread Structure	3.25 basis points	$ 40,000	$135,000
First-Lien Subprime	3.25 basis points	$ 40,000	$135,000
2nd-Lien: CES, HELOC, High CLTV	3.25 basis points	$ 40,000	$135,000
Agency CMOs	3.0 basis points	$25,000	$85,000

Deals with Multiple Credit Supported Structures will be charged a surcharge of $25,000, per additional structure.

Other:			
Reverse Mortgages	4.0 basis points	$ 75,000	$ 135,000
Tax Liens	4.0 basis points	$ 75,000	$ 135,000
Servicer Advances	4.0 basis points	$ 75,000	$ 135,000
Construction Loans	4.0 basis points	$75,000	$135,000
Scratch -n- Dent –			
Re-performing	4.0 basis points	$ 75,000	$135,000
Document Deficient	4.0 basis points	$ 75,000	$135,000
Outside of the Guidelines	3.25 basis points	$ 50,000	$135,000
Non-Performing	4.0 basis points	$ 75,000	$135,000
Net Interest Margin (NIM)	One S&P Rated U/L	$ 60,000	
Net Interest Margin (NIM)	One S&P Non-Rated U/L	$100,000	

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Large Balance Transactions:

First-Lien Prime Jumbo & Alt. A Senior/Sub. Structure

\$1.0 billion ≤ rated amount < \$1.5 billion	\$108,000 cap
\$1.5 billion ≤ rated amount < \$2.0 billion	\$123,000 cap
\$2.0 billion ≤ rated amount < \$2.5 billion	\$148,000 cap
\$2.5 billion ≤ rated amount < \$3.0 billion	\$158,000 cap
\$3.0 billion ≤ rated amount < \$3.5 billion	\$173,000 cap
\$3.5 billion ≤ rated amount < \$4.0 billion	\$183,000 cap
\$4.0 billion ≤ rated amount < \$4.5 billion	\$198,000 cap
\$4.5 billion ≤ rated amount < \$5.0 billion	\$223,000 cap

\$5 billion ≤ rated amount -- \$248,000 cap

First & Second- Lien, Jumbo, ALT A & Subprime structures requiring Excess Spread analysis.

\$1.0 billion ≤ rated amount < \$1.5 billion	\$143,000 cap
\$1.5 billion ≤ rated amount < \$2.0 billion	\$148,000 cap
\$2.0 billion ≤ rated amount < \$2.5 billion	\$158,000 cap
\$2.5 billion ≤ rated amount < \$3.0 billion	\$163,000 cap
\$3.0 billion ≤ rated amount < \$3.5 billion	\$178,000 cap
\$3.5 billion ≤ rated amount < \$4.0 billion	\$183,000 cap
\$4.0 billion ≤ rated amount < \$4.5 billion	\$198,000 cap
\$4.5 billion ≤ rated amount < \$5.0 billion	\$223,000 cap

\$5 billion ≤ rated amount -- \$248,000 cap

Complex Net Interest Margin (NIM) Transaction

Seasoned Collateral

Fees to rate NIMS supported by seasoned transactions:

Generally a fee of $10,000 to $15,000 per S&P rated underlying deal or $20,000 to $30,000 per S&P non-rated deal is charged, plus a fee of $75,000 for the new NIMS rating.

NIMS with Multiple U/L Deals

In additional to the standard fee of $60,000 for one underlying deal, deals with multiple underlying deals will be billed as follows:

The 2nd and 3rd deal will be billed at an additional $25,000 per deal.
The 4th and 5th deal will be billed at an additional $15,000 per deal.
Deals with greater than 5 underlying deals will be determined on a case-by-case basis.

NIMS with Multiple Rated Classes
For the standard $60,000 NIM fee, S&P will rate deals with up to 2 different rating categories. For deals with 3 or more rating categories S&P will charge an additional $10,000 fee per additional rating category.

SECONDARY MARKET RATING FEES

Wrapped Transactions

The fee to analyze the insurance capital charge for wrapping an existing Standard & Poor's rated certificate is $2,500. In the case of tranches or transactions that have not previously been rated by Standard & Poor's, a fee of three (3.0) basis points is charged for analyzing capital charge requirements, with a minimum fee of $15,000.

Subordinated Class Ratings

In the case where subordinated classes are rated subsequent to the initial rating of the senior classes, an additional fee is assessed. Fees generally are in the range of three (3.0) basis points with minimums dependent on size and timing of transactions.

Re-REMIC Transactions

Currently, Re-REMICs consist of three distinct types of transactions each with a different structure, rating methodology and fees.

(1) Traditional Re-REMICs involve the rating on a pool of outstanding Standard & Poor's rated single-family mortgage certificates all of which have the same rating. The fees for traditional Re-REMICs are three (3.0) basis points on the total dollar amount of certificates issued with a minimum fee of $25,000 and a maximum fee of $150,000 with a break-up charge equal to 50% of the fee.

(2) Re-REMICS consisting of certificates that are non-rated by Standard & Poor's or are a mix of ratings (i.e. "AAA", "AA", or "A" etc) can only be rated by the RMBS group based on a current collateral tape with current (no more than 90 days old) FICO scores. Fees for this type of Re-REMIC are three (3.0) basis points on the total collateral analyzed with a minimum fee of $50,000 and a maximum fee of $250,000 for pools of $2.0 billion or less with a break-up charge equal to 50% of the fee. Fees for larger transactions are determined on a case-by-case basis.

(3) Re-REMICS or mixed certificates similar to (2) above that do not have current tapes available must be submitted to Standard & Poor's CDO group for rating.

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RMBS SURVEILLANCE FEES:

Standard & Poor's surveillance fees for all transactions, including those that utilize bond insurance, and except for U.S. Reverse Mortgages, Tax Lien Transaction and other types of transactions listed below, are charged at the time of the initial rating based on the term of the collateral. The schedules are presented below.

Up front Surveillance Fee Schedule:

Less than or equal to 15-year term (1 loan group):	$ 6,000
Greater than 15-year term (1 loan group):	$ 8,000
Multiple Loan Groups (regardless of term):	$10,000
NIMS	$ 4,000

Annual Surveillance Fee Schedule:

U.S. Reverse Mortgages	$2,500
Tax Lien Transactions	$2,500

Fees for the surveillance of the following types of transactions are negotiated on a case-by-case basis. These include:

- Advance Backed Notes
- Construction Loan Backed Notes
- Mortgage Risk Transfers
- Re-REMICs (underlying transactions not previously rated by S&P)

Amendment Fees:

A fee is charged for the review of certain types of amendments or changes to existing transactions. Generally, the fee ranges from $ $1,500 to $10,000, but is not limited to these amounts. The following is an example of such changes and the related fee:

Replacement of existing deal participants with successors such as the trustee, servicer, depository institution, liquidity provider, credit support provider, etc.	$1,500
Changes to definitions or clauses	$2,500
Substitution of form of credit support, changing to newly assessed credit support amount or minor changes or corrections needed to obtain intended structure.	$5,000
Restructuring of security	$10,000

Generally the fee is applied per deal. The fee is negotiable for a series of transactions where the amendment or change is the same.

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RMBS SERVICER EVALUATIONS

Standard & Poor's Residential Servicer Evaluation provides a comprehensive assessment of a firm's operational capabilities as a residential servicer. Standard & Poor's requires a periodic review and ranking of servicers. A servicer must be included in Standard & Poor's Select Servicer List in order to participate in a Standard & Poor's rated transaction. In order to do so a servicer must achieve a minimal ranking of Average with a Stable outlook. The initial fee for this evaluation is $35,000 to $45,000 plus reimbursement of actual travel expenses incurred, plus printing expenses if copies of the report are requested.

An evaluation assessment fee $35,000 to $45,000 (plus any applicable printing expenses if copies of the report are requested) will be charged annually thereafter on each anniversary of the initial evaluation.

The McGraw-Hill Companies

STANDARD
&POOR'S

55 Water Street
New York, NY 10041
877-727-8647 Tel
212-438-5153 Fax

U.S. STRUCTURED RATINGS FEE SCHEDULE

COLLATERALIZED DEBT OBLIGATIONS
Amended 3/7/07

OVERVIEW

This fee schedule applies to both insured and uninsured Collateralized Debt Obligations rated in the United States. Separate fee schedules are available for the following types of structured financings:

- Asset Backed Obligations
- Residential Mortgage-Backed Financings
- Commercial Mortgage-Backed Financings
- Real Estate Companies
- New Assets

Please note that in the case of unique structures or securitizations involving new issuers and new product types, Standard & Poor's reserves the right to quote a fee for the analytical work performed. In addition, legal fees are charged for special research associated with such new issuers, products or structures are in addition to Standard & Poor's fees and will be billed separately.

Standard & Poor's performs an independent and objective analysis. The rating that results from the analytical process may or may not be consistent with the expectations of the issuer or arranger. The fee for services is not contingent upon the issuer's or arranger's acceptance of the assigned rating.

PRIMARY CONTACTS

Patrice Jordan	Managing Director	Global Practice Leader, Global CDOs	(212) 438-2501
David Tesher	Managing Director	Cash Flow and Market Value CDOs	(212) 438-2618
Andrea Bryan	Managing Director	Synthetic CDOs	(212) 438-2409
Nik Khakee	Director	Operating Companies and SIVs	(212) 438-2473
Peter Kambeseles	Managing Director	Client Value Manager	(212) 438-1168
Elwyn Wong	Managing Director	Client Value Manager	(212) 438-2460
Peter D'Erchia	Managing Director	Global Practice Leader, Surveillance	(212) 438-2438

If you have any questions about this fee schedule or require additional information, please contact the Client Value Managers.

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CASH FLOWS CDOs

Initial Rating Fee

The initial rating fee for CBO/CLOs is 3.5 basis points of the Commercial Paper issuance plus basis points for each term issuance based on the principal amount rated. Costs for direct expenses and legal review (external legal fees will be up to $25,000) will be charged in addition to the rating fee. Minimum and maximum fees are as follows:

Basic Fee	3.5 basis points of the CP issuance plus 7 basis points of the term notes
Minimum Fee	$ 150,000
Maximum Fee	$ 500,000

A surcharge may be imposed on "first time" deals and deals that are unusual/new from a criteria perspective. Additional analysis for credit estimates, credit estimate surveillance, correlation analysis, etc., will be charged separately and are not included in the above fees.

Standard & Poor's reserves the right to charge a fee upon commencing each phase of the rating process. The three major phases are as follows:

Phase I	Preliminary review of the structure, manager and credit.
Phase II	Structural, cash flow, credit and legal review. Convene ratings committee. On-site sponsor/manager review.
Phase III	Final structural, cash flow, credit and legal review. Decision made on transaction ratings.

Annual Surveillance Fee

Standard & Poor's charges an annual surveillance fee of $35,000 to $50,000 annually or an up-front fee representing the present value of such fee.

Amendment Fees

A fee will be charged for amendments that require significant review of documentation, cash flow or collateral analysis.

Cancellation/Break-up Fee

Standard & Poor's charges a minimum break-up fee of $25,000. Additional fees will be assessed based on the interim fee for each phase detailed above. Each phase may be assessed at 33% of the overall transaction fee.

COMMERCIAL REAL ESTATE CDOs and ReREMICS (EXCLUDING SYNTHETIC CDOs)

Initial Rating Fee

The initial rating fees for Commercial Real Estate CDOs (excluding Synthetic CDOs) and ReREMICs is 7 – 10 basis points for each issuance based on the total ramped-up pool balance.

Basic Fee	7 – 10 basis points
Minimum Fee	$ 250,000
Maximum Fee	$1,750,000

In addition to the initial rating fee, costs for determining credit assessments for real estate collateral not possessing a Standard & Poor's credit rating or credit estimate will be charged and vary depending on collateral complexity.

Costs for legal review (external legal fees) will be charged in addition to the rating fee and vary depending on deal complexity.

A surcharge may be imposed on "first time" deals and deals that are unusual/new from a criteria perspective. Additional analysis for credit estimates, credit estimate surveillance, correlation analysis, etc., will be charged separately and are not included in the above fees.

Standard & Poor's reserves the right to charge a fee upon commencing each phase of the rating process. The three major phases are as follows:

Phase I	Preliminary review of the structure, manager and credit.
Phase II	Structural, cash flow, credit and legal review. Convene ratings committee. On-site sponsor/manager review.
Phase III	Final structural, cash flow, credit and legal review. Decision made on transaction ratings.

Annual Surveillance Fee

Standard & Poor's charges and annual surveillance fee of $20,000 - $50,000 annually or an up-front fee representing the present value of such fee.

Cancellation/Break-up Fee

Standard & Poor's charges a minimum break-up fee of $25,000, plus any work performed on credit estimates. Additional fees will be assessed based on the interim fee for each phase detailed above. Each phase may be assessed at 33% of the overall transaction fee.

Amendment Fees

A fee will be charged for amendments that require significant review of documentation, cash flow or collateral analysis.

CMBS SERVICER EVALUATIONS

Standard & Poor's Commercial Servicer Evaluation provides an objective assessment of a firm's operational capabilities as a commercial servicer. Standard & Poor's requires a periodic review and ranking of servicers. A servicer must be included in Standard & Poor's Select Servicer List in order to participate in Standard & Poor's rated transaction. In order to do so a servicer must achieve a minimal ranking of Average with a Stable outlook. The initial fee for this evaluation is $35,000 -$55,000 plus reimbursement of actual travel expenses incurred, plus printing expenses if copies of the report are requested.

An evaluation assessment fee of $35,000 - $55,000 (plus any applicable printing expenses if copies of the report are requested) will be charged annually thereafter on each anniversary of the initial evaluation.

COMMERCIAL REAL ESTATE CDO ASSET MANAGER EVALUATION

Standard & Poor's Commercial Real Estate CDO Asset Manager Evaluation provides an objective assessment of a CDO asset manager's operational capabilities as a commercial asset manager for select commercial real estate CDOs. A Commercial Real Estate CDO Asset Manager must be qualified in order to participate in a Standard & Poor's rated transaction.

The initial fee for this evaluation is $10,000, plus reimbursement of actual travel expenses incurred. An evaluation assessment fee of $10,000 will be charged annually thereafter on each anniversary of the initial evaluation.

SYNTHETIC CDOs

Initial Rating Fee

The initial rating fee for each issuance of Synthetic CDOs depends on the following factors, among other; rated volume, type of collateral, liability rating and tenor, portfolio turnover, etc. Costs for direct expenses and legal review will be charged in addition to the rating fee. Minimum and maximum fees are as follows:

Minimum Fee	$ 30,000
Maximum Fee	$750,000

A surcharge may be imposed on "first time" deals and deals that are unusual/new from a criteria perspective. Additional requirements such as credit estimates, credit estimate surveillance, correlation analysis, etc., will be charged separately, and are not included in the above fees.

Standard & Poor's reserves the right to charge a fee upon completion of each phase of the rating process. The three major phases are as follows:

Phase I	Preliminary review of the structure, manager and credit.
Phase II	Structural, cash flow, credit and legal review. Convene ratings committee. On-site sponsor/manager review.
Phase III	Final structural, cash flow, credit and legal review. Decision made on transaction ratings.

Annual Surveillance Fee

For static pools, Standard & Poor's charges an annual surveillance fee of up to $15,000, or an up-front fee representing the present value of such fee. For managed pools, Standard & Poor's charges an annual surveillance fee that ranges from $10,000 to $50,000, or an up-front fee representing the present value of such fee.

Amendment Fees

A fee will be charged for amendments that require significant review of documentation, cash flow or collateral analysis.

Cancellation/Break-up Fee

Standard & Poor's charges a minimum break-up fee of $25,000. Additional fees will be assessed based on the interim fee for each phase detailed above. Each phase may be assessed at 33% of the overall transaction fee.

PROGRAM SET-UP FEE FOR MULTI-ISSUANCE VEHICLES

A Program Set-Up fee of $50,000 will be charged at the time of set-up for new synthetic vehicles.

Amendment Fees

A fee will be charged for amendments and collateral additions/removals that require significant review of documentation and/or collateral analysis.

MARKET VALUE CDOs

Initial Rating Fee

The initial rating fee for Market Value CDOs is 7 - 8 basis points for each issuance based on the total issuance amount. Costs for direct expenses and legal review (external legal fees will be $25,000) will be charged in addition to the rating fee. Minimum and maximum fees are as follows:

Basic Fee	7 - 8 basis points
Minimum Fee	$150,000
Maximum Fee	$500,000

A surcharge may be imposed on "first time" deals and deals that are unusual/new from a criteria perspective. Additional requirements such as credit estimates and credit estimate surveillance, correlation analysis, recovery analysis, etc., will be charged separately, and are not included in the above fees.

Standard & Poor's reserves the right to charge a fee upon completion of each phase of the rating process. The three major phases are as follows:

Phase I	Preliminary review of the structure, manager and credit.
Phase II	Structural, cash flow, credit and legal review. Convene ratings committee. On-site sponsor/manager review.
Phase III	Final structural, cash flow, credit and legal review. Decision made on transaction ratings.

Annual Surveillance Fee

Standard & Poor's will assess an annual surveillance fee of $35,000 or an up-front fee representing the present value of such fee. Standard & Poor's reserves the right to negotiate significantly higher fees for certain structures.

Amendment Fees

A fee will be charged for amendments that require significant review of documentation, cash flow or collateral analysis.

Cancellation/Break-up Fee

Standard & Poor's charges a minimum break-up fee of $25,000. Additional fees will be assessed based on the interim fee for each phase detailed above. Each phase may be assessed at 33% of the overall transaction fee.

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S&P-PSI 0000042 —— S&P-PSI 0000050

DATE: 04/27/2007
TIME: 18:44:24 GMT
AUTHOR: Yoshizawa, Yuri
RECEIPIENT: Kimon, Noel
CC: Harris, Gus
SUBJECT: TMD Comp

[redacted] = Redacted by the Permanent Subcommittee on Investigations

Noel,

I've attached a comparison of US Derivatives TMD comp (with each other and with [redacted]). After the planned increase for Rudy, the difference in Base/Target compensation between [redacted] and [redacted] shrinks from $42k to $20k. That said, including the equity that they received for this past year, the difference is really $139k.

In the spreadsheet, I have a proposal that I've already discussed with Gus, for a slight ($15k) increase to total comp for [redacted] that will increase the gap between him and [redacted] but only to the point where there is still a gap between him and [redacted], which we believe is appropriate. Gus and I spoke with [redacted] earlier this week regarding the transition of HG ABS CDOs to [redacted] and regarding our expectations of what he needs to work on (i.e., efficiency, delegation of responsibilities and knowledge transfer to team leaders, interaction with bankers, flexibility, etc.). We would propose that if we agree to give him the increase, that we wait for a few months to see whether he shows improveme

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Permanent Subcommittee on Investigations

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Current

Name	Title	Base as of 4/26/2007	Target as of 4/26/2007	Total Comp 4/26/2007	[redacted]	Base as of 07/1/2007	Target as of 7/1/2007	Total Comp 7/1/2007	[redacted]	2007 Equity - Total Grant Value	Total Comp Including 2007 Equity	[redacted]
[redacted]	SVP	235,597	107,641	343,238	[redacted]	255,000	109,794	364,794	[redacted]	192,259	557,052	[redacted]
[redacted]	TMD	265,000	120,000	385,000	[redacted]	265,000	120,000	385,000	[redacted]	310,834	695,834	[redacted]
[redacted]	TMD	286,140	131,250	417,390	[redacted]	286,140	131,250	417,390	[redacted]	396,747	814,137	[redacted]
[redacted]	TMD	291,200	131,250	422,450	[redacted]	291,200	131,250	422,450	[redacted]	430,766	853,216	[redacted]
[redacted]	TMD	305,550	155,800	461,350	[redacted]	305,550	155,800	461,350	[redacted]	476,125	937,475	[redacted]

Proposal

Name	Title	Base	Target	Total Comp	[redacted]	2007 Equity - Total Grant Value	Total Comp Including 2007 Equity	[redacted]
[redacted]	SVP	255,000	109,794	364,794	[redacted]	192,259	557,052	[redacted]
[redacted]	TMD	275,000	125,000	400,000	[redacted]	310,834	710,834	[redacted]
[redacted]	TMD	290,000	131,250	421,250	[redacted]	396,747	817,997	[redacted]
[redacted]	TMD	291,200	131,250	422,450	[redacted]	430,766	853,216	[redacted]
[redacted]	TMD	305,550	155,800	461,350	[redacted]	476,125	937,475	[redacted]

Additional Funds: ###### 5,000.00 ######

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Standard & Poor's Global Compensation Guidelines 2007/2008

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S&P-SEC 067708

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Standard & Poor's Compensation Guidelines 2007/2008

S&P Senior Analytical Incentive Plan ("SAIP") for Ratings Analytical Personnel

SAIP Objectives:
- Attract, motivate and retain superior analytical talent.
- Encourage individual and collective performance towards the achievement of specific, measurable goals.
- Provide appropriate compensation levels to maintain the highest standards of analytical quality.

Eligibility is limited to:
Senior credit rating analytical staff in Structured Finance, C&G and the Quants: Managing Directors, Directors, Associate Directors, Associates, Associate General Counsels and Assistant General Counsels of Standard & Poor's Ratings Services, provided they are employed as such by September 30th.

SAIP Global Guidelines for Performance Year 2007 (as a % of the employee's base salary as of December 31st)

Level	Breakthrough	Exceptional	Target	Requires Improvement
A24	0% to 120%	0% to 90%	0% to 60%	0%
A23	0% to 110%	0% to 83%	0% to 55%	
A22	0% to 100%	0% to 75%	0% to 50%	
A21	0% to 70%	0% to 55%	0% to 35%	
A20	0% to 60%	0% to 45%	0% to 30%	

The guidelines are broad to provide flexibility for managers to ensure that incentive payouts appropriately reflect distinctions in employee performance and contribution to business unit, department and company success.

Overall, Breakthrough performers are expected to earn at least 1/3 more than Exceptional Performers, and Exceptional Performers are expected to earn at least 1/3 more than Target Performers.

Employees who receive an overall PMP rating of Requires Improvement are not eligible to receive an incentive payout for that performance year.

Any exception requests must be submitted to the S&P Compensation Council by the global unit head during the first week of February. Requests for adjustments post-process will not be accepted.

All payout recommendations require the approval of the S&P Compensation Council and by McGraw-Hill senior management.

Standard & Poor's Compensation Guidelines 2007/2008

Long-Term Stock Incentives: Executives

Recommend Values: Managers are to recommend 2008 long-term incentive awards in terms of US-dollar values. On the April 1st award date, McGraw-Hill's Executive Compensation specialists will convert the dollars to stock option grants and RPS/PSU Awards based on the stock price, option fair value, and on the mix of equity vehicles at each grade level.

- Rounding: Recommendations should be made in increments of US$1,000.
- Currency Rates: Recommended LTI amounts made in US$ will be converted to local currency in SPECS to facilitate Total Direct Compensation comparisons.

Fair Value: The McGraw-Hill Controller's Office will utilize an option valuation model to determine the "Fair Value" of a stock option on the grant date. The option exercise price, and the RPS/PSU award date value, will be the closing fair market value on the award date.

2008 LONG-TERM INCENTIVE GUIDELINES BY PERFORMANCE RATING

- ***Awards for Grade Level 23 through 27 will be delivered as 25% options and 75% RPS/PSU.***
- Compensation Decision Makers are to make recommendations in terms of values; McGraw-Hill Executive Compensation will calculate the conversion on the award date.

Grade Level	Target Achievement	Exceptional Achievement	Breakthrough Achievement
24	up to $75,000	up to $105,000	up to $135,000
23	up to $55,000	up to $77,000	up to $100,000

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Standard & Poor's Compensation Guidelines 2007/2008

Standard & Poor's Ratings Services

S&P US
2008 Base Salary Ranges
Ratings Services Analytical Positions Only

Job Title	Grade Level	Minimum	Midpoint	Maximum
Managing Director	A24	$154,500	$225,800	$297,300
Sr Director	A23	$133,700	$199,100	$264,500
Director	A22	$113,000	$172,300	$231,800
Associate Director	A21	$95,100	$136,800	$178,500
Associate	A20	$71,200	$106,900	$142,700

The salary ranges above are to be referenced for analytical positions in Ratings Services only (i.e., Structured Finance and C&G). If your positions are not covered by the salary ranges for Ratings Services roles please reference your merit increase budget, each employee's relative performance, and local market insights.

PAULSON & CO. INC.

"The Subprime Mortgage / Credit Crisis"

John Paulson
President

Investment Management

1251 Avenue of the Americas
50th Floor
New York, NY 10020
Phone: (212) 956-2221 Fax: (212) 977-9505

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January 25, 2010

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #1011

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This document does not constitute an offer to sell or a solicitation of an offer to buy any securities, and may not be relied upon in connection with any offer or sale of securities. This document should be read in conjunction with, and is qualified in its entirety by, information appearing in the Confidential Private Offering Memorandum (and a Limited Partnership Agreement for domestic partnerships), which should be carefully reviewed prior to investing. Past performance is not necessarily indicative of future performance, and although the Advantage Funds may invest in some of the same securities as the Merger Funds, the broader strategy may result in performance that is different from that of the Merger Funds.

An investment in a hedge fund is speculative and involves a high degree of risk, which each investor must carefully consider. An investor in hedge funds could lose all or a substantial amount of his or her investment. Returns generated from an investment in a hedge fund may not adequately compensate investors for the business and financial risks assumed. While hedge funds are subject to market risks common to other types of investments, including market volatility, hedge funds employ certain trading techniques, such as the use of leveraging and other speculative investment practices that may increase the risk of investment loss. Products may involve above-average risk. Risks associated with hedge fund investments include, but are not limited to, the fact that hedge funds can be highly illiquid; they are not required to provide periodic pricing or valuation information to investors; they may involve complex tax structures and delays in distributing important tax information; they are not subject to the same regulatory requirements as mutual funds; they often charge higher fees and the high fees may offset the funds' trading profits; they may have a limited operating history; they can have performance that is volatile; they may have a fund manager who has total trading authority over the fund and the use of a single adviser applying generally similar trading programs could mean a lack of diversification, and consequentially, higher risk; they may not have a secondary market for an investor's interest in the fund and none may be expected to develop; they may have restrictions on transferring interests in the fund; and may effect a substantial portion of their trades on foreign exchanges.

All material is compiled from sources believed to be reliable, but accuracy cannot be guaranteed.

PAULSON & CO. INC.

PSI-Paulson&Co-02-00002

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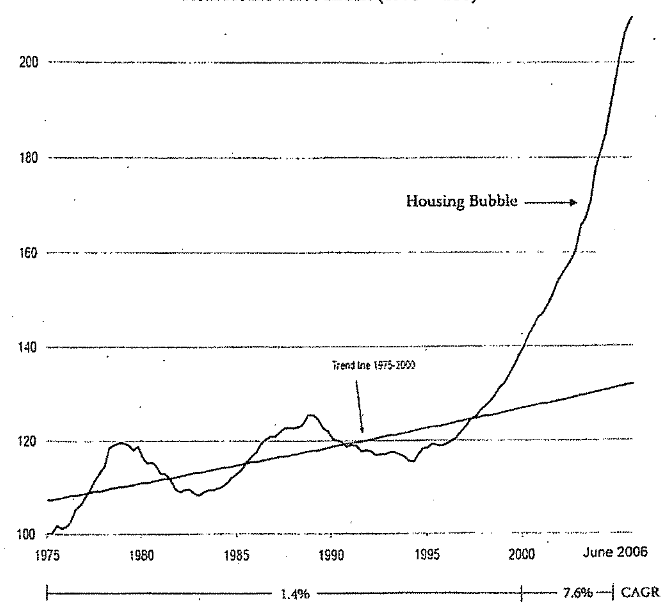
ESTIMATION OF HOUSING BUBBLE: Comparison of Recent Appreciation vs. Historical Trends

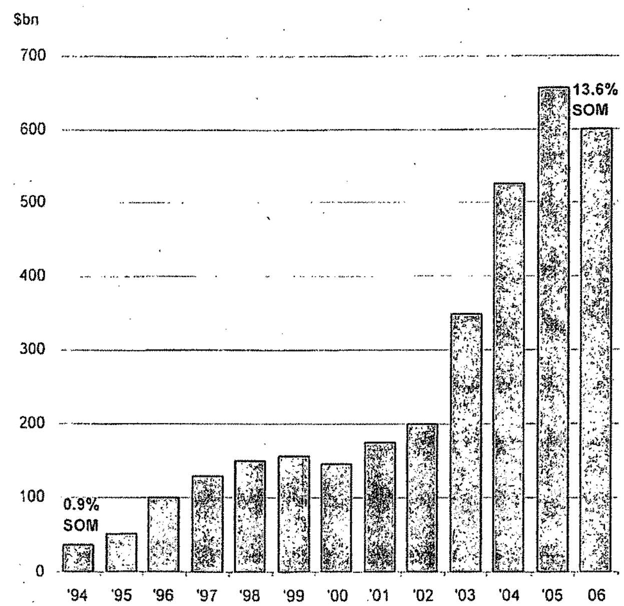
Real Home Price Index (1975 = 100)



Source: Office of Federal Housing Enterprise Oversight, Bureau of Economic Analysis

PSI-Paulson&Co-02-00003

MORTGAGE SUBPRIME ORIGINATION



Source: Lehman Brothers

PSI-Paulson&Co-02-00004

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60 DAY+DELINQUENCY AND FORECLOSURE

	2006	2007	% Change YoY
January	5.6%	9.4%	68.6%
February	5.8%	9.9%	71.9%
March	5.8%	10.4%	79.0%
April	5.6%	10.7%	91.3%
May	5.9%	11.3%	92.0%
June	5.8%	12.2%	109.7%
July	6.0%	13.4%	121.7%
August	6.5%	14.8%	127.4%
September	6.8%	16.3%	139.3%
October	7.4%	18.1%	145.3%
November	8.0%	19.9%	150.5%
December	**8.6%**	**22.0%**	**155.2%**

Source: LoanPerformance

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PAULSON & CO. INC.

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Fact Sheet for Three Examples of Failed AAA Ratings

		Vertical ABS CDO 2007-1	Fremont (GSAMP Trust 2007-FM2)	Delphinus CDO 2007-1, Ltd.
Type		Hybrid CDO	RMBS	Hybrid CDO
Size		$1.5 billion	$1 billion	$1.6 billion
Underwriter		UBS	Goldman Sachs	Mizuho
Initial Rating Date;	S&P	4/10/2007	02/28/2007	08/02/2007
	Moody's	4/26/2007	03/08/2007	07/31/2007
# AAA tranches		3	5	7
First downgrade;	S&P	11/14/2007	10/17/2007	12/21/2007
	Moody's	10/25/2007	12/04/2007	11/07/2007
First downgrade AAA;	S&P	11/14/2007	08/20/2008	12/21/2007
	Moody's	10/25/2007	10/23/2008	01/18/2008
Current rating of AAA;	S&P	Withdrawn	4 out of 5: CCC	Withdrawn
	Moody's	Withdrawn	4 out 5: Caa3 and below	Withdrawn

Source: Prepared by the Subcommittee based on information from S&P and Moody's websites, February 22, 2011. The sizes are all approximations.

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #1034

From: Gutierrez, Michael
Sent: Sunday, October 01, 2006 12:04 PM
To: Mackey, Robert
Subject: RE: REO DATA

I agree

-----Original Message-----
From: Mackey, Robert
Sent: Saturday, September 30, 2006 2:10 PM
To: Gutierrez, Michael
Subject: RE: REO DATA

may I also recommend that if we bring Anne on board we could have her do some of this important data collecting and analysis for us while we get her up to speed.

-----Original Message-----
From: Gutierrez, Michael
Sent: Saturday, September 30, 2006 2:07 PM
To: Mackey, Robert; Koch, Richard; Highland, Edward; Frie, Steven
Subject: RE: REO DATA

Good questions all of which we should discuss further

-----Original Message-----
From: Mackey, Robert
Sent: Saturday, September 30, 2006 11:06 AM
To: Gutierrez, Michael; Koch, Richard; Highland, Edward; Frie, Steven
Subject: RE: REO DATA

The numbers are alarming, yet very consistent (gross, net, and loss severity). Is there a way we could dig a little deeper into several of the clients responses to determine liquidation costs, REO, handling costs etc. to "back into" potential *overzealousness* on the front end? Should the loss severity percentage become more important in our analysis?

-----Original Message-----
From: Gutierrez, Michael
Sent: Friday, September 29, 2006 4:48 PM
To: Koch, Richard; Highland, Edward; Frie, Steven; Mackey, Robert
Subject: RE: REO DATA

You hit it right on the head - Ernestine told me that broken down to loan level what she is seeing in losses is as bad as high 40s -low 50s % I'd love to be able to publish a commentary with this data but maybe too much of a powder keg

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I'm still at a loss over what to talk about at the RMBS Hot Pockets in October

-----Original Message-----
From: Koch, Richard
Sent: Friday, September 29, 2006 3:50 PM
To: Highland, Edward; Gutierrez, Michael; Frie, Steven; Mackey, Robert
Subject: RE: REO DATA

No, I think it is telling us that underwriting fraud; appraisal fraud and the general appetite for new product among originators is resulting in loans being made that shouldn't be made.

Hey Mike, if Spitzer could prove coercion this could be a RICO offense!

-----Original Message-----
From: Highland, Edward
Sent: Friday, September 29, 2006 2:40 PM
To: Gutierrez, Michael; Frie, Steven; Koch, Richard; Mackey, Robert
Subject: RE: REO DATA

Is this telling us the foreclosure expense, winterizing, etc. is running at 40%?

Edward B. Highland, Jr.
Director
Standard and Poor's
55 Water Street
42nd Floor
New York, NY 10041-0003

Tel 212-438-1287
Fax 212-438-2662

Edward_Highland@sandp.com
www.stardardandpoors.com

-----Original Message-----
From: Gutierrez, Michael
Sent: Friday, September 29, 2006 12:20 PM
To: Frie, Steven; Koch, Richard; Mackey, Robert; Highland, Edward
Subject: FW: REO DATA

Gents:

PSI-S&P-RFN-000030

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Take a look at these stats - I find them most interesting!!

-----Original Message-----
From: Moskowitz, Gregg
Sent: Friday, September 29, 2006 10:52 AM
To: Gutierrez, Michael
Subject: REO DATA

<< File: lossseverity.xls >>

Gregg Moskowitz
Senior Research Assistant, Structured Finance Ratings
Standard & Poor's
55 Water Street (42nd Floor)
New York, NY 10041-0003
(212)438-1838
(212)438-2662
Gregg_Moskowitz@standardandpoors.com

PSI-S&P-RFN-000031

From: Pollsen, Robert
Sent: Tuesday, February 14, 2006 11:13 AM
To: Agbabiaka, Taoheed; Avant-Koger, Paula; Clarke, Lisa; Davey, Scott; Giudici, Andrew; Graffeo, Michael; Joyce, Kristymarie; Liu, Shawn; Mahabir, Lal; Rao, Asha; Recentes, Darwin; Rivera, Jessica; Rivera, John; Rocha, Martha; Warner, Ernestine; Young, Steven 2/13/2006; Albergo, Leslie; Kostiw, Karen; Mcdermott, Gail; Osterweil, Terry; Stock, Michael; Warrack, Thomas

Subject: U.S. HOUSING MARKET - Looming "reset problem" - article in Barron's 2/13/2006...

Coming Home to Roost By JONATHAN R. LAING (from ***Barron's*** 2/13/2006)
THE RED-HOT U.S. HOUSING MARKET MAY be fast approaching its date with destiny. Indeed, inside the mortgage trade, much anxiety is being focused on a *looming "reset problem." Over the next two years, monthly payments on an estimated $600 billion of mortgages to borrowers with checkered or no credit histories -- the "sub-prime" market -- may zoom as much as 50% higher, as the two-year teaser rates on hybrid adjustable-rate loans expire and interest payments hit their fully indexed levels.*
In the past, such resets caused little disruption. For one thing, the sub-prime market was strikingly smaller. Only $97 billion of such mortgages were originated in 1996, compared with a mammoth $628 billion last year and $540 billion in 2004, according to the trade publication Inside B&C Lending. Sub-prime loans outstanding now account for more than 10% of the total U.S. mortgage debt of $8.4 trillion.
Moreover, the reset triggers on sub-prime mortgages have dramatically shortened, with the loosening in underwriting standards. ***During the past two years, "affordability" products, as the industry has dubbed them, have migrated from prime to sub-prime borrowers***. Sub-prime borrowers used a variety of products, including:
Hybrid ARMs, with low teaser rates in the early years.
"IO Mortgages," which, in their early years, charge interest only and require no repayment or amortization of principal.
"Stated Income" or **"No Doc" Loans**, requiring no verification of a borrower's income.
Option ARMs, which give borrowers the option of making smaller than normally required monthly payments, with the unpaid portion being added to principal.
Piggy-Back Mortgages, in which the borrower received a first mortgage of, say, 80% of a home's value, plus a credit line to cover his down payment on a new home.
Surging property values in much of the country in the past four years helped bail out many sub-prime borrowers, letting them refinance their loans as painful resets loomed. Many borrowers not only refinanced old debt at attractive teaser rates, but also sucked additional equity out of their homes with cash-out refinancings, to pay off higher-rate credit-card debt. Meanwhile, delinquency rates and credit losses remained artificially low. A tapped-out borrower always could sell his home into a soaring real-estate market to pay off his mortgage debt and regroup.

But now *the refi window may be closing for the sub-prime crowd*. The Fed's hikes in short-term interest rates have pushed up fully indexed ARM rates. At the same time, evidence is mounting that home-price appreciation is slowing or, in a few areas, reversing. And the secondary market in mortgage-backed securities, which provides some 90% of the liquidity in the sub-prime market, is starting to balk at the easy lending practices in this sector.

Various doomsday scenarios are being posited. A New York hedge-fund manager heavily playing the short side of sub-prime mortgage securities foresees a coming spiral in delinquencies, foreclosures and credit losses from tapped-out sub-prime borrowers facing monthly payments they can't meet. A deadly feedback loop impends in which forced home sales will diminish collateral values, which, in turn, will foster yet more delinquencies and forced sales. Before the crisis runs its course, the deflationary contagion will infect all manner of homes, from high-end to starters, says this bear.

To be sure, this prediction is both apocalyptic and self-serving. Market shifts usually tend to unfold slowly enough to let players adjust. "I just don't see any coming collapse in the sub-prime market as long as the U.S. economy and job growth stays strong and interest-rate increases remain subdued," insists Doug Duncan, chief economist of the Mortgage Bankers Association in Washington. Echoes Guy Cecala, publisher of Inside B&C Lending: "People have been crying wolf about the looming sub-prime reset crisis for two years and nothing has happened. Lending standards are now being tightened up, so I expect we'll muddle through."

Perhaps so. But significant sticker shock impends for sub-prime borrowers. Say they are paying a fixed teaser rate of 7% (typical of what the 2004 and 2005 cohort of sub-prime borrowers had to pay while borrowers with good credit got fixed rates of 5%). Come reset, typical contracts call for a floating rate of 600 basis points, or six full percentage points over the six-month London interbank offered rate, a money-market benchmark. Six-month LIBOR has risen to around 4.7%, which means that *the borrower would face more than a 50% jump in mortgage interest expense to 10.7%*, subject to certain temporary caps on the permissible jump in interest rates.

The shock will be even greater for the sub-prime borrowers who are facing not only a jump from a fixed to a floating rate, but also the burden of amortizing principal after two years of interest-only payments. And for many, the interest- rate reset and IO expiration will occur on the same day -- a reflection of the "risk layering" prevalent in the sub-prime market over the past two years.

Of course, if sub-prime borrowers have enough untapped equity in their homes, they will be able to refinance their loans on somewhat similar terms -- the new teaser rates have risen to only 7.5% -- and roll the dice for another two years.

But Glenn Costello of Fitch Ratings estimates that at least a quarter of all sub-prime borrowers facing resets may have precious little equity left, even with the huge surge in home prices in the past two years. Many piggy-backed loans to borrow the down payment on their homes, in addition to taking on a conventional mortgage. "For some borrowers, there will just be no loan-to-value gap left," Costello contends.

In recent months, mortgage underwriting standards have indeed begun to tighten, mostly at the instigation of the secondary market, where the bulk of all sub-prime mortgages trade as securities. Investors seem to have lost much of their zest for IOs and hybrid ARMs. Risk layering

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is also being discouraged. Reset periods are also being extended out to five years to avoid future refinance jam-ups like what now looms in the next two years.

Even more ominous for the sub-prime borrowers with more than $600 billion or mortgages resetting in the next two years would be new standards for "nontraditional" mortgage products that have been jointly proposed by a number of federal regulators (the Office of the Comptroller of the Currency, the Federal Reserve, the FDIC, the Office of Thrift Supervision and the National Credit Union Administration).

The regulators want lenders to qualify borrowers, based on the full payments they will incur once teaser rates expire or full principal amortization on the loans begin. The prevailing practice in the sub-prime industry, however, considers only initial monthly payment levels.

Deutsche Bank Securities analyst Eugene Xu illustrates the impact such standards, if eventually implemented, would have on sub-prime borrowers hitting the refi window.

A household making $60,000 a year, with a total debt-to-income ratio of 40%, currently could qualify for a $288,000 hybrid ARM, paying a fixed interest-only rate of 7.5% for the first two years, followed by 28 years of floating rates. But if the underwriting standard were based on the current fully indexed 10.7% rate, the applicant would qualify for a loan of just $192,000.

These days, many sub-prime lenders are offering 40-year fixed-rate mortgages to reduce monthly payments. But even under this scenario, our hypothetical borrower would be able to obtain only a $234,000 loan at the prevailing sub-prime rate of 9% , says Xu. "The implication of all this is that many sub-prime borrowers who took out loans in recent years may not be able to refinance unless their income increases or interest rates drop significantly," he observes dryly. In other words, the American Dream of home ownership could turn into a Roach Motel nightmare.

Of course, the proposed standards are likely to be watered down. And if U.S. home prices keep rising smartly, the refinance crisis in the sub-prime market could be largely avoided. Industry economists from Freddie Mac to the National Association of Realtors all think that a 5% to 7% rise in housing prices is easily doable this year, if not the double-digit surge of 2005.

SOME SIGNS OF PRICE WEAKNESS are already apparent. Inventories of unsold homes are building in areas that led the recent price boom, such as Southern California and the East Coast. In many areas, affordability indexes (which measure the ability of a family with the median income for that area to buy a home selling at the median price there) are at two-decade lows. Sales of used or "existing" homes have sunk for three consecutive months, according to the National Association of Realtors, even though that trade group's national figures showed that home prices in December were an extraordinary 12.7% above the year-earlier level.

Richard DeKaser, senior vice president and chief economist of Cleveland-based National City (ticker: NCC), has more than an academic interest in what's happening in housing. National City is not only a top-10 originator and servicer of prime mortgages, but it also owns a major sub-prime lending concern, First Franklin. These days, his attention is riveted on National City's quarterly survey "Home Prices in America." As of 2005's third quarter, the latest period for which data are available, it showed 38% of the U.S. housing market at an "extreme" overvaluation level of 30% or higher. The champ, or chump: Naples, Fla., where National City believes homes are 84% overvalued.

Experience in the 299 metropolitan areas covered in the survey shows that such levels of overvaluation are typically followed by price declines of about 15% that take an average of three years to unfold. If systemic and not merely localized, he asserts, any correction this time around could have nasty side-effects: "Individuals will suffer a wealth decline and spend less freely. Lenders will suffer elevated loans losses and credit conditions will tighten. Mortgage-backed securities will lose value and consumer confidence and home building will decline."

The survey's models and methodology are more sophisticated than many such valuation studies. Home-price-to-local-income ratios are only one element examined. The survey also makes adjustments for such factors as population density (in- or out-migration from an area can have a big impact of home prices), mortgage rates, relative income levels (rich folks will allocate more of their income to luxury homes as real income rises). The study also uses a local adjustment factor for home-price-to-income ratios. For example, Santa Barbara, Calif., and Honolulu always boast higher ratios than other metro areas, presumably because of such pluses as their stunning climes.

One ray of hope: The level of overvaluation is so high and has been for so long that DeKaser is beginning to doubt his models' current relevance and predictive value. "I worry that the massive secular shift from fixed-rate loans to ARMs and the greater purchasing power that homebuyers consequently have may have skewed our findings some," he says.

Another positive: Delinquency and foreclosure rates in the sub-prime market certainly evidence few signs of stress. According to Loan Performance, a San Francisco statistical service, just 2.43% of homes bought with sub-prime loans were in foreclosure in November. That was materially lower than the 4.38% reported three years earlier. Serious sub-prime delinquencies had likewise fallen over the three years through November, to 5.3% from 8.16%.

But these figures ignore several important realities. First, nearly all the $1 trillion in outstanding sub-prime loans were made in the past two years, to buy homes or refinance older debt. Such loans typically must age a year or more before repayment problems crop up.

Likewise, the low interest rates and looser lending standards available in the past two years have afforded all but the most busted-out sub-prime borrowers the ability to refinance on easy terms.

Of course, the huge levitation in home prices in 2004 and 2005 also did wonders for default and delinquency levels. Borrowers who couldn't afford their monthly payments were able to resolve their debt problems by merely selling their homes, sometimes even booking a profit in the process. This was especially true in overheated markets like California, which accounts for about 30% of sub-prime mortgage debt.

Deutsche Bank's Eugene Xu looked at mortgage-loss severity rates provided by Loan Performance on a range of loans between prime and sub-prime loans that defaulted over the past three years. All had first liens on the underlying properties and had original loan-to-value ratios of 75% to 85%. They were of superior quality, in other words, to many of the sub-prime mortgages outstanding today.

What he found was revelatory. In areas with moderate home-price gains over the past five years, such as Jackson, Tenn., Memphis and Indianapolis, which had compound price appreciation of less than 4%, loan-loss severity clocked in at more than 35% of the outstanding balance.

In contrast, areas such as Santa Barbara and San Diego, which saw huge annual price growth of over 16.4%, showed minimal loan losses of under 3%. "Sure other factors enter into loss severities such as closing costs and loan size, but previous price appreciation is the primary determinant," he asserts. "Thus, loss severities in key, overheated markets like California and New York could skyrocket by eight-to-10 fold even if home prices growth just moderates markedly rather goes negative."

Modern-day sub-prime lending burst onto the scene only in the mid-'Nineties, pushed by upstart lenders enticed by wide margins and fat fee income. Industry growth surged until a liquidity crisis erupted in 1998 in the U.S. credit markets, following the Russian ruble crisis and the collapse of the Long Term Capital Management hedge fund. Dozens of sub-prime lenders were driven out of business and hideous loan performance made road kill of outfits like the Money Store.

But the industry has roared back, riding the tidal wave of home-price appreciation that sub-prime loans have, in turn, helped foster. In recent years, a number of blue-chip companies such as Citigroup (C), General Electric (GE), Wells Fargo (WFC), H&R Block (HRB), Countrywide Financial (CFC) and HSBC (HBC) have muscled into the industry, mostly by buying existing players and letting them operate independently.

The sub-prime lending crowd has been rocked by more than its share of scandals since the turn of the millennium. Just last month, privately held Ameriquest settled with 49 states for $325 million. Among other things, it had been charged with systematically abusing customers by steering them into higher-cost loans and leaning on appraisers to inflate home appraisals so it could make larger loans.

Shortly after they're originated, nearly all sub-prime loans are packaged into securitizations and sold to public investors. As result, sub-prime offers the best of all worlds in most credit environments. Borrowers assume the bulk of the interest- rate risk by taking out ARMs and can be a source of fat fee income. Meantime, all or most of the credit risk on the loans is shifted to the investors in securitizations.

Obviously, any smash-up in the sub-prime market would hurt lenders. Some such as New Century Financial (NEW) are set up as real-estate investment trusts and, as such, retain some of their securitizations and those of other players. Origination volume is also likely to drop, which would hurt lenders with costly infrastructures that can't be downsized easily in the face of lower volumes. Still, most of the major sub-prime lenders are small cogs in much larger corporate structures. And industry giant Ameriquest is privately held.

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In a bad market, most of the blood would spilled in the lower-ranking tranches of sub-prime mortgage-backed securities, bonds rated triple-B minus and below. That's because the overcollateralization and excess interest margin (the difference between the interest thrown off by the pool and the interest promised the holders of the different tranches in the securitization) afford only about 7% to 8% loss protection to triple-B holders.

Any shortfall in interest payments and mortgage-principal loss above that level would eat away at their returns. In these securitizations, interest and principal payments cascade down from the higher to lower tranches. Priority of losses moves in the opposite direction from residual tranches and double-B bonds upward.

The aforementioned New York hedge-fund manager is busily shorting triple-B and triple-B-minus tranches in sub-prime securitizations by buying credit protection on them in the credit-default-swap market. The fund is also short various collateralized debt obligations, an estimated $50 billion or so invested mostly in the junior tranches of sub-prime securitizations. "These CDOs...could get completely wiped," the manager says. The cascade on interest and principal repayments from the securitizations above them might slow to a trickle.

The liquidity of the sub-prime market depends on continued purchases by CDOs of the randier tranches of sub-prime securitizations. Should this funding dry up, the sector's financing structure could seize up. And that would spell big trouble not only for sub-prime borrowers, but for the entire U.S. housing market...and economy.

PSI-S&P-RFN-000043

From: Seeking Alpha [account@seekingalpha.com]
Sent: Sunday, March 25, 2007 2:50 PM
To: james_grundy@sandp.com
Subject: Asset Manager Sy Jacob's Subprime Longs and Shorts
Asset Manager Sy Jacob's Subprime Longs and Shorts

Judy Weil submits: Annotated article summary from this weekend's Barron's. Receive all our Barron's summaries by **signing up here**:

Slow-Motion Train Wreck Picks Up Speed by Sandra Ward

Summary: Barron's interviews Sy Jacobs, founder and investment manager of Jacobs Asset Management, whose annual returns have averaged 16.4% since the fund's inception in 1995. Jacobs predicted the subprime breakdown in 2005, and cautions that subprime problems are not contained, and will strike all credit classes. His longs and shorts:

- NovaStar Financial (NFI) and New Century Financial (NEWC.PK) -- he's still short. Jacobs expects Fremont General (FMT) to be flayed by regulators due to its lax standards and incompetence.
- Bankrate (RATE) -- short. Its client base of mortgage brokers and backers are rapidly disappearing.
- Credit-rating agencies like Moody's (MCO) and McGraw-Hill (MHP) [owner of Standard & Poor] have high collateralized debt obligations, residential mortgage-backed securities and subprime holdings that account for 30-40% of their operating profits. Congress could come down hard on agencies who should have been more vigilant.
- He's long on financials that are sensitive to short-term interest rates but not to credit, because he believes the Fed will start cutting rates as the housing crisis deepens. One example: Annaly Capital Management (NLY).
- Residential mortgage REIT Anworth Mortgage (ANH) should rise from $9 to $16 as funding costs shrink while ARM assets rise.
- Opteum (OPX) -- ALT-A fears have made this stock oversold. Book value is $7.85/share, while shares are at $4.50. Citibank (C) took a 7.5% stake for 150% of book at year-end 2006.
- Origen Financial (ORGN) -- the only remaining player in manufactured-housing finance. With the end of the housing boom and a possible decline in home ownership, manufactured housing should benefit.

Related Links: Seeking Alpha's Housing Bubble and Real Estate Market Tracker * It's Time To Regulate the Subprime Loan Business * Subprime Mortgage Bust Could Create Ad Trouble for Google

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DATE: 03/26/2007
TIME: 14:34:26 GMT
AUTHOR: Brennan, James
RECEIPIENT: Patrick Brennan
CC:
SUBJECT: RE: barron's article; deacon, not sure if you saw this but this guy talks about short on moody's and s&p

Lovely, with the UNC loss yesterday and this crap below, the only thing that could make me feel better is a massive round of layoffs in the Lehman investment banking division.

Jim

James M Brennan
Moody's Investors Service
Phone: 212-553-1407
Fax: 212-298-6735

-----Original Message-----
From: Patrick Brennan [mailto:patrick@boyarvalue.com]
Sent: Monday, March 26, 2007 10:09 AM
To: Brennan, James
Subject: barron's article; deacon, not sure if you saw this but this guy talks about short on moody's and s&p

Slow-Motion Train Wreck Picks Up Speed

Interview With Sy Jacobs, Founder and Investment Manager, Jacobs Asset Management

By SANDRA WARD

PEOPLE WHO READ OUR FOURTH OF JULY 2005 interview with Sy Jacobs would hardly be surprised by the current meltdown in the subprime loan market. And it should come as no surprise that Jacobs, with a 23-year history of covering the financial markets, predicted the debacle. He has also shined as the principal of the $222 million Jacobs Asset Management in Manhattan, which includes a $45 million private-equity fund. Last year, his market-neutral financial fund gained 16.8% after fees, compared with 13.8% for the S&P 500. Since the fund's start nearly 12 years ago, it has returned 16.4%, on average, versus 11% for the S&P. He sees the debacle deepening, but spies opportunities, as well, in the adversity.

Barron's: Nearly two years ago, you saw the day of reckoning coming for subprime mortgage lenders.

Jacobs: When we spoke in 2005, I was worried about what was brewing in subprime, given the loosening in underwriting standards and the extension of credit to those with little equity and the

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inability to pay the loans back unless housing prices continued to rise. I'm surprised how long it has taken to unravel, but it has. Michael Farrell at Annaly Capital Management has been calling it the slow-motion train wreck, and the fact that it went on for another year or two since we spoke only makes it worse because the credit markets accepted more and more risk and got thinner and thinner margins while the party was still going on. The events of the past two weeks would tell you that the train wreck is accelerating and is turning into a contagion. Subprime will bring down mortgage lending, housing and, in turn, the economy and the market.

Some insist the problems in the subprime market are manageable.

The problems in subprime are not self-contained. It is a pinprick to a larger problem, and it needs to be looked at that way. The notion that subprime home-equity lending is somehow ring-fenced because it is only 12% of total mortgage loans outstanding and won't affect the rest of the mortgage and housing market is absurd. First of all, subprime lending was over 20% of 2006's volume. That tells you it was growing rapidly as a percentage of the mortgage business when it hit the wall.

Sy Jacobs

It also tells you that the subprime borrower was increasingly the marginal buyer of housing and tilted the supply and demand of housing that resulted in such big increases in home prices until late last year.

How will the problems spread?

Mostly through housing. This year is going to be much worse than 2006 for mortgage and housing credit, and 2006 already laid the mortgage industry low. Nearly $700 billion of

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mortgages reset this year and nearly half of that is subprime. Remember 2004, when our esteemed former Federal Reserve chairman, Alan Greenspan, was exhorting us to take out adjustable-rate mortgages, the federal-funds rate was only 1% and had nowhere to go but up? Prime refinancing volume peaked in 2004, and the most popular loan product at that time was a 3/1 adjustable-rate mortgage, three years fixed and adjustable every year after that. Those are resetting this year after 17 quarter-point increases in the fed-funds rate. The subprime home-equity market peaked in 2005, and the most popular product from that year was a two-year-fixed, 28-year-floating mortgage. It resets this year, and now credit spreads are widening, Freddie Mac [ticker: FRE] is going to stop buying as much subprime, as are the capital markets in general, and a lot of capacity is exiting through bankruptcy courts.

The remaining players left standing are raising credit standards and cutting loan products and raising coupons on the products they continue to make. Housing hasn't bottomed, and it is just getting going to the downside.

How bad is the credit crunch?

It is spilling into the secondary market in the sense that credit spreads in the secondary market have widened in the past few weeks. We're seeing a reversal in the appetite for risk that we've seen for the past several years. Credit will get more expensive across asset classes, and that's another way in which the subprime contagion will spread.

Are you hanging on to your subprime shorts, or have you moved on?

In subprime, the decline has been vicious already, and we are starting to look elsewhere for that kind of juicy downside. NovaStar Financial [NFI] is down from 39 to 6 since we last spoke, and we are still short. We are still short some others, and I think New Century Financial [NEW] is very likely going to zero. Another that has more downside is Fremont General [FMT], which we've been short for two to three years already. Fremont is a little more complicated, but if you read the cease-and-desist order that the regulators issued to them two weeks ago, and which started its stock crashing, it is hard to see how they don't eventually seize the bank. They as much as call Fremont's management incompetent and order them to stop doing business in subprime. Their losses from the loans they've made -- and they made $31 billion last year -- are going to be huge. Another part of their business is condo and construction lending, and the regulators criticized them for lax controls in this area and inadequate reserves, as well. By the time they take proper reserves on those loans and because of the losses they'll experience getting out of subprime, we see them as capital-deficient. Given the criticism of management by the regulators in this cease-and- desist order and the probable desire to make an example of someone, I don't see the regulators being lenient with them, and I don't see how they will avoid getting seized and wiping out equity holders.

Some of these names have been bouncing back on capital infusions. Does that throw a wrench into your thinking at all?

No. People are bottom-fishing.

Where else do you see opportunities from the fallout in subprime?

We are still short Bankrate [RATE]. We were painfully early on Bankrate, judging from the fact the stock went from 20 at the time we spoke two years ago to 39 now. But we actually think our original thesis is unfolding now and see Bankrate as a play on mortgage velocity, which is

PSI-MOODYS-RFN-000005

coming down: Organic growth has all but stopped; as you can see from the deceleration of their page-view growth, but they have made some acquisitions. They've surprised on the upside with earnings expectations because they raised prices aggressively for advertising on their site with Internet banner ads and click-throughs. We think the price increases on ad rates are unsustainable. Their customers are mortgage brokers and mortgage bankers. These mortgage bankers and brokers will go out of business in droves in 2007. You could see big revenue disappointments at Bankrate, which won't go over well with the stock trading at 30 times 2007 estimates.

Slow-Motion Train Wreck Picks Up Speed -- Part II

Interview -- Part I <http://online.barrons.com/article/SB117469260899347441.html?mod=article-outset-box>1

Where else do you see trouble brewing?

A secondary way we've found to play the demise of subprime and its fallout is by shorting the credit-rating agencies: Moody's [MCO] and McGraw-Hill [MHP], which owns Standard & Poor's. Standard & Poor's is 44% of McGraw-Hill's revenue and 76% of their operating profits. By our calculations, Standard & Poor's is over 100% of McGraw-Hill's profit growth because the rest of their businesses haven't been growing. Moody's and Standard & Poor's have been major beneficiaries of the wild growth in the structured-finance business such as CDOs [collateralized debt obligations] and RMBS [residential mortgage-backed securities] and subprime. The bulls would say that only 7% of their business is subprime. But when you add CDOs and RMBS and subprime together, all of which we think is driven by the home-equity business, the number jumps to roughly 20% of the rating agencies' revenue.

Revenues per deal on these three segments -- CDO, RMBS and subprime -- are three to four times that of the rating agencies' lower-growth and lower-margin corporate-finance business, which is rating corporate bond offerings. The areas we are focused on are contributing more like 30% to 40% of operating profits at Moody's and Standard & Poor's, and most of the growth in earnings. Subprime issuance is going to shrink dramatically this year, and a big chunk of CDO volume is backed by subprime assets, and so the rating agencies' entire structured-finance operations should see a big drop in growth this year, especially in their high-margin areas, and that's underappreciated by the stock market.

In light of the fact that Moody's is trading at 25 times estimates of 14% earnings growth and McGraw-Hill is trading at 22 times estimates of 16% earnings growth, and we see both missing their estimates this year and possibly showing little if any earnings growth, those multiples could get hurt badly. Besides the earnings risk, there is great regulatory and legislative risk here. When Barney Frank and

PSI-MOODYS-RFN-000006

DATE: 10/19/2006
TIME: 13:37:00
AUTHOR: Ben Katzburg
RECEIPIENT: Grant Bailey, Vadim Verkhoglyad
CC:
SUBJECT:

More Home Loans Go Sour — Though New Data Show Rising Delinquencies, Lenders Continue to Loosen Mortgage Standards

By Ruth Simon
1155 words
19 October 2006

The Wall Street Journal
D1
English

MORTGAGE lenders are making it easier to get loans even as the housing market cools -- and as the number of borrowers struggling to make their payments continues to rise, new studies show.
In the latest sign that a cooling housing market and weaker credit standards are beginning to take their toll on borrowers and lenders, the number of past-due mortgages continued to rise in the three months ended Sept. 30, according to data from Equifax Inc. and Moody's Economy.com Inc.
The increase is particularly notable because bad loans normally climb when the economy weakens and job losses rise, leaving more borrowers unable to make their monthly payments. By contrast, the latest increase appears to be more closely tied to looser lending standards, borrowers tapping their equity and slowing home-price growth.
"We're seeing rises in delinquencies and loan losses that are unrelated to what's going on in the job market," says Mark Zandi, chief economist of Moody's Economy.com. "It's very unusual."
Some 2.33% of mortgages were delinquent at the end of the third quarter, the highest level since 2003, according to Equifax and Moody's Economy.com. Among the areas that saw the biggest jump in the delinquency rate since the end of last year were Stockton and Merced, Calif., and Las Vegas-Paradise, Nev. Delinquency rates were highest in McAllen-Edinburg-Mission, Texas; Brownsville-Harlingen, Texas; and Detroit-Livonia-Dearborn, Mich.
A separate report released yesterday by the federal Office of the Comptroller of the Currency found that lenders continued to ease credit standards over the past year.
To be sure, mortgage delinquencies have been at low levels in recent years, and the recent uptick only brings them closer to historical averages. The seasonally adjusted mortgage-delinquency rate reached its most-recent peak of 2.53% in the first quarter of 2002, according to Equifax and Moody's Economy.com.
The latest news comes amid increasing concerns that lenders have been loosening their standards in an effort to boost loan volume as refinancings and home purchases wane. In a speech to the American Bankers Association this week, Comptroller of the Currency John Dugan noted that bank regulators have seen a "significant easing" of mortgage lending standards this year, even though banks normally tighten standards when the housing market cools. "We don't want to see the lending decisions bankers make today result in excessive foreclosures -- and reduced affordable housing credit -- tomorrow," he said.
The Comptroller's report found that competitive pressures are driving many banks to further loosen their credit standards. More than one-third of the lenders relaxed their standards for home-equity loans in the 12 months ended this March, according to bank examiners, while less than 5% tightened their

PSI-MOODYS-RFN-000009

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standards.

Over the same period, 26% eased their mortgage-lending standards, most often by increasing the use of nontraditional mortgage products. These include loans that allow borrowers to pay interest and no principal in the early years or make a minimum payment that can lead to a rising loan balance. Yesterday, regulators released a booklet designed to help consumers understand these exotic mortgage products.

"We have reason to believe that the amount of easing we saw back in March is continuing," says Kathryn Dick, deputy comptroller for credit and market risk at the OCC. Federal bank regulators have been stepping up their scrutiny of residential mortgage lending by large banks, she says, with a particular focus on banks that lend heavily in cooling housing markets.

There are signs that some lenders are beginning to pull back. Last week, New Century Financial Corp. said it would begin tightening lending guidelines for adjustable-rate mortgages sold to "at-risk"

PSI-MOODYS-RFN-000010

DATE: 09/06/2006
TIME: 20:40:46
AUTHOR: Markowitz, Murray
RECEIPIENT: Moody's - SFG/Mortgage Pass Through
CC:
SUBJECT: Article re: NegAms & Origination Practices

For your reference, this Barron's piece from last weekend is a predecessor/sort-of companion piece to much-traveled Jesse Eisinger piece from last Wednesday's WSJ:
===================================

Monday, August 21, 2006

The No-Money-Down Disaster
By LON WITTER

A HOUSING CRISIS APPROACHES: According to the Commerce Department's estimates, the national median price of new homes has dropped almost 3% since January. New-home inventories hit a record in April and are only slightly off those all-time highs. Existing-home inventories are 39% higher than they were just one year ago. Meanwhile, sales are down more than 10%.

Although the stocks of new-home builders are down substantially, the stock market and many analysts are ignoring other implications of the housing news. In the latest Barron's Big Money Poll of institutional investors, not a single money manager ranked problems in the housing market among the factors likely to lead to a sharp selloff in stocks in the next 12 months (see "Headed for Dow 12,0001," May 1, 2006). Most experts still predict a 2%-6% rise in housing prices for the year.

These experts and analysts are basing their predictions on a possible increase in wages, inflation and GDP growth. They are overlooking the fact that by any rational valuation there has been no support for the run-up in housing prices since 2001, when the wealth of the middle class was battered by a bear market. Since then, inflation has been low, and wages practically stagnant. Housing prices, on the other hand, are through the roof.

Extrapolating housing prices from their current level based on wages and inflation is like saying a $100 Internet stock with no cash flow and negative earnings will rise as long as it is able to narrow the loss. The analysis ignores the fact that the stock never should have been trading at $100 in the first place.

By any traditional valuation, housing prices at the end of 2005 were 30% to 50% too high. Others have pointed this out, but few have had the nerve to state the obvious: Even if wages and GDP grow, the national median price of housing will probably fall by close to 30% in the next three years. That's simple reversion to the mean.

A careful look at the reasons for the rise in housing will give a good indication of the impact this drop will have on the stock market. They include, in chronological order: The collapse of the Internet bubble, which chased hot money out of the stock market; rock-bottom interest rates; 50 years of economic history that suggested housing never goes down, and creative financing.

The first three factors might not be enough to cause a crash, except that together they led to the fourth factor. Irresponsible financing causes bubbles. It causes individuals to buy houses they can't afford. It causes speculation to run wild by lowering the bar to entry. Finally, it leads individuals who bought houses years ago at reasonable prices into the speculative borrowing trap. The home-equity credit line has supported American consumer spending, but at a steep price: Families that tapped into their home equity with creative loans are now in the same trap as those who bought homes they couldn't afford at the top of the market.

The cost and risk of adjustable-rate financing can be devastating. Consider a typical $250,000 three-year adjustable-rate mortgage with a 2% rate-hike cap. If the monthly payment now is $1,123, after the first adjustment, the monthly payment is $1,419. After the second adjustment, the monthly payment is $1,748, a $625-per-month increase. That's $7,500 more per year just to maintain the same mortgage. If you think high gas prices are biting the consumer, consider the cost of mortgage adjustments.

Some more numbers:

• 32.6% of new mortgages and home-equity loans in 2005 were interest only, up from 0.6% in 2000

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- 43% of first-time home buyers in 2005 put no money down
- 15.2% of 2005 buyers owe at least 10% more than their home is worth
- 10% of all home owners with mortgages have no equity in their homes
- $2.7 trillion dollars in loans will adjust to higher rates in 2006 and 2007.

These numbers sound preposterous, but the reasoning behind them is worse. Lenders have encouraged people to use the appreciation in value of their houses as collateral for an unaffordable loan, an idea similar to the junk bonds being pushed in the late 1980s. The concept was to use the company you were taking over

PSI-MOODYS-RFN-000002

DATE: 03/19/2000
TIME: 18:52:38
AUTHOR: Gerst, Catherine
RECEIPIENT: Clarkson, Brian
CC:
SUBJECT: TR: my departure

Just so you know.

-----Message d'origine-----
De: Gerst, Catherine
Date: dimanche 19 mars 2000 19:51
À: Perry, Debra (Moody's)
Objet: my departure
Critère de diffusion: Confidentiel

Dear Debra,

as per your suggestion I sent you this morning a series of e-mails illustrating some of the daily difficulties I may have experienced as the manager of the Paris Office. However those were just small examples, and I believe it is important to give you the big picture.

The big picture is as follows. I'm leaving Moody's because I am incomfortable with:
the lack of a strategy I can clearly understand, other than maximize the market share and the gross margin with insufficient ressources;
the lack of definition of the local MDs role: does Moody's want executants of policies decided in London or NY (which is fine, but then the MDs should not be neither responsible neither accountable for any result or replication of those strategies), or MDs participating to the strategy and decision process and having a certain degree of autonomy (and would therefore be legitimately responsable in their markets)? I several times raised this issue because I needed to understand what the company was expecting from me. But I could never get an answer.
the structural lack of ressources in any place of Moody's, that renders the daily life extremely difficult;
the lack of an adequate chain of decisions, that makes any move extremely long and painful, and generally results in losses of any kind (it took 1 year to implement the RoR policy, 9 months to put in place a new product -the custodian rating-, 8 months to obtain an authorization to sign a contract for Cades, resulting in th loss of a big and recurrent amount of monney for Moody's, etc....). I consider Moody's can not afford such delays in an extremely rapidly moving world, where competition goes much quicker.
the lack of transparency in the decision process, particularly from a budget standpoint.
the lack of real integration

PSI-MOODYS-RFN-000039

From: Warrack, Thomas
Sent: Saturday, May 07, 2005 8:44 AM
To: Deasy, Chris; Osterweil, Terry; Barnes, Susan
Cc: Vonderhorst, Brian; Solar, Mona; Stock, Michael
Subject: RE: 2005-S2

Chris thanks very much for quick analysis.
Mona as Terry states, this certainly highlights issues with our multiples.
Thanks, Tom

-----Original Message-----
From: Deasy, Chris
Sent: Friday, May 06, 2005 4:18 PM
To: Osterweil, Terry; Warrack, Thomas; Barnes, Susan
Cc: Vonderhorst, Brian; Solar, Mona; Stock, Michael
Subject: RE: 2005-S2

If there are any objections, please let me know by 10:30 Monday morning or I will approve the structure.

-----Original Message-----
From: Osterweil, Terry
Sent: Friday, May 06, 2005 3:56 PM
To: Deasy, Chris; Warrack, Thomas; Barnes, Susan
Cc: Vonderhorst, Brian; Solar, Mona; Stock, Michael
Subject: RE: 2005-S2

Considering that the shortfalls that occur when we use 8.25 and the associated multiples are not outrageous and that when we use 8.01 and the same multiples it works, I would recommend approving their structure.

P.S. Using a higher multiple with a lower "B" and getting a worse structure (because the other levels are higher) is ridiculous. And ridiculous is my tempered word. This shows that we are not truly assessing the risks correctly.

-----Original Message-----
From: Deasy, Chris
Sent: Friday, May 06, 2005 3:14 PM
To: Osterweil, Terry; Warrack, Thomas; Barnes, Susan
Cc: Vonderhorst, Brian; Solar, Mona
Subject: RE: 2005-S2

If I use 8.00 this is what I get (keep in mind that 8.00 moves us to a new column on the multiples sheet and due to the way the multiples sheet works we are actually worse off than we were at 8.25):

Rating	OC %	Int shortfall	Prn shortfall	Def Crv

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AAA	-0.14%	424,437	258,546	PASS
AA	-2.37%	7,077,245	4,309,949	PASS
A	-2.36%	6,999,251	4,284,821	PASS
BBB	-1.66%	5,132,060	3,017,173	PASS
BBB-	-1.10%	3,586,782	2,005,871	PASS
BB	1.08%	-	-	PASS

If I only go down to 8.01 to keep us in the same column on the multiples sheet, it passes:

Rating	OC %	Int shortfall	Prn shortfall	Def Crv
AAA	0.15%	-	-	PASS
AA	0.29%	-	-	PASS
A	0.48%	-	-	PASS
BBB	0.37%	-	-	PASS
BBB-	0.41%	-	-	PASS
BB	1.58%	-	-	PASS

So, a 'B' number somewhere between 8.01 and 8.25 works. Please let me know what you want me to tell Nomura.

-----Original Message-----
From: Deasy, Chris
Sent: Friday, May 06, 2005 2:58 PM
To: Osterweil, Terry; Warrack, Thomas; Barnes, Susan
Cc: Vonderhorst, Brian; Solar, Mona
Subject: RE: 2005-S2

using 8.25 we get the following shortfalls with their proposed structure:

Rating	OC %	Int shortfall	Prn shortfall	Def Crv
AAA	0.08%	-	-	PASS
AA	-0.04%	112,683	77,761	PASS
A	-0.35%	985,728	643,587	PASS
BBB	-0.30%	883,464	549,812	PASS
BBB-	-0.27%	845,359	487,518	PASS
BB	1.20%	-	-	PASS

-----Original Message-----
From: Osterweil, Terry
Sent: Friday, May 06, 2005 2:16 PM
To: Warrack, Thomas; Barnes, Susan
Cc: Vonderhorst, Brian; Deasy, Chris; Solar, Mona
Subject: RE: 2005-S2

I would approve the structure they are proposing. This structure is basically taking <1.00% from the "BB" class and 1.00% from the "AA" class and putting that in the

PSI-S&P-RFN-000025

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"AAA" instead. There will be more excess now with lower class rates. If we want to satisfy our curiosity, why don't we go down 75 bps. on the single "B", use the same multiples to get the other rating levels, and see if the proposed structure works or is at least close.

Does Mike have any initial results from his groups analysis to possibly justify an interim approval on this deal prior to a new second lien methodology being approved.

-----Original Message-----
From: Warrack, Thomas
Sent: Friday, May 06, 2005 1:52 PM
To: Barnes, Susan; Osterweil, Terry
Cc: Vonderhorst, Brian; Deasy, Chris; Solar, Mona
Subject: FW: 2005-S2

Terry & Susan,

Rob, makes some good points below and clearly would like to have us on the deal but the difference is still significant.
At a minimum since he claims the numbers got 76 bp better in the LEVELS model we could have gone down a bit further.

Do you want this deal to be re-reviewed or are we going to live with not rating it?

Thanks, Tom

-----Original Message-----
From: Gartner, Robert [mailto:rgartner@us.nomura.com]
Sent: Friday, May 06, 2005 1:21 PM
To: Warrack, Thomas
Subject: 2005-S2

Good afternoon Tom. We have been trying to work with Chris Deasy to get to a structure which works for us but without much success. Mona called me about a week ago and told me that, while S&P is working on it, the new model will not be ready for this deal. The S2 is a significantly better collateral pool than the S1 and I do not feel we are getting proper credit for it under the current approach.

	S1	S2
FICO	681	690
CLTV	96.4	95.8
Stated/stated	11.7%	5.1%
No Doc	7.4%	8.2%
Investor	14.3%	14.9%
3&4 family	10.7%	6.8%
<620 FICO	6.1%	5.4%
621-640 FICO	13.8%	8.5%

PSI-S&P-RFN-000026

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Using the existing S&P levels model, the single B loss coverage improved by 0.76% between S1 and S2. By Nomura's model, it improved by 1.10%. The levels we received from Chris improved by just 0.50%. The loss coverages are shown below.

	S1	S2
AAA	40.50	38.25
AA	29.25	27.75
A	23.25	21.75
BBB	17.75	16.75
BBB-	16.00	15.25
BB	12.50	11.90
B	9.00	8.50

Below is another set of data we provided to Chris as well. As I mentioned in our discussions, I have been focusing on reducing layered risk. Not only does the S2 have a lower percentage of risky loans but the layered risk has been significantly lowered in those loans as well. As you can see in the table below, the S2 loans, in every risk category, have higher FICO, lower CLTV and less common risk factors.

		FICO	CLTV	>95	<640	Stated/stated	No Doc	3&4 family	Investor
Investor	S1	707	93.8	25.7	3.3	17.5	8.5	37.2	100.0
	S2	715	91.0	3.0	3.2	8.0	7.0	21.1	100.0
2-4 family	S1	696	95.0	41.7	8.9	18.0	8.4	55.0	36.5
	S2	702	94.4	32.7	6.4	10.1	6.1	40.9	30.8
Stated/stated	S1	687	94.6	43.7	9.4	100.0	0.0	14.3	21.5
	S2	699	93.8	36.0	3.6	100.0	0.0	8.9	23.5
NINA	S1	709	93.5	31.8	0.0	0.0	100.0	12.6	16.7
	S2	719	92.5	32.2	3.2	0.0	100.0	5.3	12.6

Unfortunately, the structure which has been approved by S&P is significantly worse than the ones approved by Moody's and Fitch. I have provided the approved S&P and Moody's/Fitch structures below.

	S&P	Moody's/Fitch
AAA	70.00	79.25
AA	13.10	6.50
A	6.60	5.50
BBB	4.70	5.25
BBB-	1.30	1.25
BB	4.30	2.25
OC target	2.65	2.95

The 2.95 target was from Fitch (Moody's approved 2.65). Our analyst here seemed confident Fitch would do 2.65 as well but we haven't asked yet. Fitch did not rate our initial deal but Moody's did. Their levels have clearly improved dramatically from the first deal.

PSI-S&P-RFN-000027

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The difference in economics to Nomura is between 3/8 and 1/2 point so it is a significant amount. It is difficult for me to justify to my management why I would include S&P if it means that much to our bottom line. Based on levels we have seen, we asked Chris if S&P could approve the following structure. It would only gain back about 40% of the difference in economics but would allow me to convince my management that we are supposed to keep S&P on the deal. Based on my calculations, this improvement would require less than 0.50 improvement in the base case loss coverage. Chris has told me this structure is not possible.

AAA	72.10
AA	12.00
A	6.50
BBB	4.60
BBB-	1.30
BB	3.50

OC Target 2.65

My desire is to keep S&P on all of my deals. I would rather not drop S&P from the upcoming deal, particularly if it ends up being for only a single deal until the new model is in place. Can you please review the approval process on this deal? If you are comfortable that the approved structure is the best S&P can do at this time, I will live by that decision. Thanks for your time and effort. I look forward to speaking with you soon.

Rob

PSI-S&P-RFN-000028

DATE: 04/13/2007
TIME: 15:45:45 GMT
AUTHOR: Karaguishiyeva, Gulmira
RECEIPIENT: Grisard Boucher, Odile; Agarwal, Navneet; Weil, Ariel;
CC: Ramallo, Karen; Milano,Christopher
SUBJECT: RE: Call for tomorrow and Loan Level 1st Lien Data

New Century has an Alt-A platform but we never seen their ALt-A CES

60/20 is for subprime CES.

My recomendation would be to apply new Joe's approach and hit 15% for NC. We use 15% originator factor for NC.

Gulmira Karaguishiyeva, CFA
Structured Finance
Moody's Investors Service
Harborside Financial Plaza 5, Suite 2400
Jersey City, NJ 07311-3988
Ph: 201-395-6354
Fax: 212-298-6329

-----Original Message-----
From: Grisard Boucher, Odile
Sent: Friday, April 13, 2007 10:26 AM
To: Agarwal, Navneet
Cc: Karaguishiyeva, Gulmira; Ramallo, Karen; Milano, Christopher
Subject: FW: Call for tomorrow and Loan Level 1st Lien Data

FYI, follow-up on committee last night. We are running the pool per Joe's instructions and also based on the first lien information we received late last night. If New Century collateral is in effect prime, should we drop the levels of 60/20 on that subpool?

We should receive information on EPD later today.

-----Original Message-----
From: DellaValle.Patrick [mailto:Patrick.DellaValle@SunTrust.com]
Sent: Thursday, April 12, 2007 9:04 PM
To: Grisard Boucher, Odile; Ramallo, Karen; Teicher, David
Cc: Scalzetti.David; Brian Haklisch
Subject: Call for tomorrow and Loan Level 1st Lien Data

Odile and David,

Attached please find loan level 1st lien Information.

SunTrust is disconcerted by the dramatic increase in Moody's loss coverage levels given initial indications and the positive feedback received from you, Karen, and David after the STICS presentation: These levels indicate that this program has not received credit for the collateral selection and due diligence process. Our entire team is extremely concerned, and we would like to set up a call first thing tomorrow morning with you as well as David to discuss the situation. Each of the other agencies reduced their initial levels, and the material divergence between Moody's levels and the other agencies seems unreasonable and unwarranted given our superior collateral and minimal tail risk. Attached also please find the levels from S&P. We would like to discuss the bond sizes for our structure on tomorrow's call along with the following topics:

1. Ratings on other Second Lien Transaction of weaker collateral

2. Wealth of Data provided

3. MBIA attachment of A.

4. Enhanced level of diligence

5. 44% remaining EPD

6. SunTrust making all reps and warrants

7. New Century collateral is from their Home123 channel: Prime

8. Significant less barbelled pool compared to market

Please let me as soon as soon as you can coordinate your colleagues' schedules, as we would like to discuss these issues as early as possible.

Thank You,

Patrick

Patrick DellaValle

SunTrust Capital Markets

303 Peachtree Street, MC 3950

PSI-MOODYS-RFN-000033

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Atlanta, GA 30309

404.813.0013 [office]

404.813.0000 [fax]

Patrick.DellaValle@suntrust.com <mailto:Patrick.DellaValle@suntrust.com>

PSI-MOODYS-RFN-000034

DATE: 02/20/2007
TIME: 23:22:23 GMT
AUTHOR: DiRienz, Mark
RECEIPIENT: Robert.B.Miller
CC:
SUBJECT: Re: Thanks for your help

Hi Bob. Sorry I missed you - I did not want to bother you on your cel during your dinner meeting. I spoke to Osmin earlier and confirmed that Jason is looking into some adjustments to his methodology that should be a benefit to you folks. I would expect that he has spoken to his counterpart on your side by now with his progress. I think he is going to committee it tomorrow morning.

-----Original Message-----
From: Robert.B.Miller@chase.com <Robert.B.Miller@chase.com>
To: DiRienz, Mark
CC: raj.m.kothari@jpmchase.com <raj.m.kothari@jpmchase.com>
Sent: Tue Feb 20 16:58:45 2007
Subject: Thanks for your help

Appreciate your help with the Chase seasoned collateral dilemma. Like i said, normally wouldn't bother you, but the optics here are difficult. There's going to be a three notch difference when we print the deal if it goes out as is. I'm already having agita about the investor calls I'm going to get.

If you get a chance to call back tonite, please call the desk at 212-834-2050 and ask for me or Raj. Just in case, my cell is 845-641-1313 - but I have an event this evening and may have a tough time taking calls.

Bob Miller
Home Equity Trading
212-834-2428

DATE: 05/23/2007
TIME: 09:40:36
AUTHOR: Lasseron, Arnaud
RECEIPIENT: Fu, Yvonne
CC: Chen, Karie; Kolchinsky, Eric
SUBJECT: Re: Lancer II: (partial) feefback from committee

On the 1st point note though that they have 3 other deals under way (incl one closing Friday) that they are cloning on this deal so will be hard to resist on the other ones if we give up on this one. Given that, pls confirm.

-----Original Message-----
From: Fu, Yvonne
To: Lasseron, Arnaud
CC: Chen, Karie; Kolchinsky, Eric
Sent: Wed May 23 09:31:36 2007
Subject: Re: Lancer II: (partial) feefback from committee

Arnaud, both Bill's articles only address IR and currency swaps. I agree that what the committee was asking is reasonable, but given the other modeling related issues and the time line for closing, I propose we let them go with the CDS Cp criteria for this deal.

Karie, on the modeling side, what is the difference between current and covenant levels? If they are passing with 1.5x and current level, the most we should as is for them to move the covenant levels closer to current levels.

I might be able to get out for a few mins if you need me to be on the call. Thanks.

-----Original Message-----
From: Lasseron, Arnaud
CC: Chen, Karie; Kolchinsky, Eric; Fu, Yvonne
Sent: Tue May 22 22:35:24 2007
Subject: Re: Lancer II: (partial) feefback from committee

Eric and Yvonne:

Before you reply to Vab's email below, just to clarify, the committee has asked that the downgrade trigger rating levels in his CDS Schedule comply with Bill Harrington's paper dated 2002 and Vab is opposing to us that he doesn't need to b/c, according to him, such paper was superseded by Bill Harrington's paper dated May 2006. Our understanding and what we have replied to him is that the May 2006 paper applies to hedges such as interest rate, currency or cash flow swaps not to CDS but he doesn't agree. Pls let us know should we be wrong. Thanks.

-----Original Message-----
From: Vaibhav-V.Kumar@ubs.com <Vaibhav-V.Kumar@ubs.com>
To: Lasseron, Arnaud
CC: Chen, Karie; Kolchinsky, Eric; Fu, Yvonne; Lirenn.Tsai@ubs.com <Lirenn.Tsai@ubs.com>; Phillip.Azzollini@srz.com <Phillip.Azzollini@srz.com>; rvillani@tpw.com <rvillani@tpw.com>; Leahy, Jim
Sent: Tue May 22 22:14:48 2007
Subject: RE: Lancer II: (partial) feefback from committee

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this makes no sense - we comply with your criteria published in May 2006

bottom of the page it says

As such, it will supplant Moody's current framework, as contained in "Swaps in

European Term Securitisations", May 21, 2002 and "Moody's Approach for Rating

Thresholds of Hedge Counterparties in CDO Transactions", October 23, 2002.

Yvonne / Eric - you need to discuss this ASAP with our external counsel (Rob @ Thatcher), deal counsel (Phil @ SRZ), and Lirenn if Moodys is going to make us comply with criteria from 2002 for this transaction when you have published criteria from 2006 that supplants this.

We are closing a transaction on Thursday and need to print a final OM.

From: Lasseron, Arnaud [mailto:Arnaud.Lasseron@moodys.com]
Sent: Tuesday, May 22, 2007 10:07 PM
To: Kumar, Vaibhav-V
Cc: Chen, Karie
Subject: Re: Lancer II: (partial) feefback from committee

It's not ok. The rating levels in the schedule need to comply with the published criteria that we emailed to you. This is a comment from the committee.

-----Original Message-----
From: Vaibhav-V.Kumar@ubs.com <Vaibhav-V.Kumar@ubs.com>
To: Lasseron, Arnaud
CC: Chen, Karie
Sent: Tue May 22 21:44:47 2007
Subject: RE: Lancer II: (partial) feefback from committee

please call me 212-713-4972 re: this issue or tell me if you are ok with the below: We are waiting on these to print our OM tonight

---

From: Kumar, Vaibhav-V
Sent: Tuesday, May 22, 2007 9:43 PM
To: 'Lasseron, Arnaud'
Cc: 'Chen, Karie'
Subject: RE: Lancer II: (partial) feefback from committee

here's Moodys paper from 2006

page 13 is the table

PSI-MOODYS-RFN-000014

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"Second Trigger" - Baa1 or below

The language as is complies with your criteria

From: Kumar, Vaibhav-V
Sent: Tuesday, May 22, 2007 9:40 PM
To: Lasseron, Arnaud
Cc: Chen, Karie
Subject: RE: Lancer II: (partial) feefback from committee

this is from 2002 - this can't be the latest criteria?

From: Lasseron, Arnaud [mailto:Arnaud.Lasseron@moodys.com]
Sent: Tuesday, May 22, 2007 9:36 PM
To: Kumar, Vaibhav-V
Cc: Chen, Karie
Subject: RE: Lancer II: (partial) feefback from committee

What question is your answer below trying to reply to? If it is replying to our request that the schedule "is drafted so that actions need to be taken when failing the above ratings" and should be changed to when reaching the ratings, our comment still stands. Please see attached paper summarizing our criteria thereon.

-----Original Message-----
From: Vaibhav-V.Kumar@ubs.com [mailto:Vaibhav-V.Kumar@ubs.com]
Sent: Tuesday, May 22, 2007 6:55 PM
To: Lasseron, Arnaud
Cc: Chen, Karie
Subject: RE: Lancer II: (partial) feefback from committee

updated Schedule attached which should take care of this

CDS, page 21 of the Schedule:
- the second level says P2 or A3, it should be "AND".
- we will send you our published paper, so far it is drafted so that actions need to be taken when failing the above ratings. Whereas it should be when they reach these ratings.

IF UBS DOESN'T HAVE THE REQUIRED RATINGS AND DOES NOT TAKE ONE OF THE REQUIRED ACTIONS, IT IS A DOWNGRADE EVENT, WHICH IS AN ATE.

PSI-MOODYS-RFN-000015

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- as discussed, please make sure to add "and not on watch for downgrade" next to the Aa3 rating in the 1st level.
- as discussed, please make sure to delete "any other action that satisfy the RAC".
- ATE: as discussed with Yvonne last week, pls remove "or such other action as shall satisfy the RAC".

From: Lasseron, Arnaud [mailto:Arnaud.Lasseron@moodys.com]
Sent: Tuesday, May 22, 2007 4:36 PM
To: Kumar, Vaibhav-V
Cc: Chen, Karie
Subject: Lancer II: (partial) feefback from committee

Vab:

Please find below partial feedback from the committee:

- Deep Discount securities:
. The committee is fine with the definition you sent over, except that you need to specify that there should be no upfront payments under the unhedged Long CDS for the Matrix to be used, if there were any upfront payments under the unhedged Long CDS, one must look directly to the FMV of the Reference Obligation.

. The committee re-confirmed that the A1-A3 column must be conformed to our criteria (and the deal you copied it from): 3.00%, 3.00% and 2.00%.

- please add language in the Indenture to the effect that whenever there is a public rating from Moody's required, it has to address the full amount of principal and interest promise.

- Securities managed by the CM, your request for 2.5%, FOR THIS DEAL, the committee is fine with this provided that any reinvestment with optional redemption proceeds must comply with the 2% limitation (and of course the 6 months). Please revise the definition to specify accordingly.

- VFN: the eligible investments that are used in the Class A1S Prepayment Account must mature overnight as the need for the VFN cash related to the CDS payments is not tied to the distribution date as in the Indenture. Please revise the VFN, particularly section 2.7(c) and (e) accordingly.

- VFN:
As per our prior comments dated 5/2/07, "reimbursements must go back to the source (i.e., if PP was used then reimbursements must go back to PP and not Interest Proceeds)." The committee confirms that Phil's answer is not addressing their concern which is the Interest Shortfall Reimbursements.

- TRS: we are still discussing and we'll get back to you later on the below:
"-under the Schedule for the TRS, make sure default under TRS does not subordinate payments to the CDO under TRS
-are there downgrade triggers and replacement requirements for MLI (TRS Counterparty)?
-if MLI defaults/CDS terminates, MLI will still be on the hook and this shall not be an Additional Termination Event (ATE)."

PSI-MOODYS-RFN-000016

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CDS, page 21 of the Schedule:
- the second level says P2 or A3, it should be "AND".
- we will send you our published paper, so far it is drafted so that actions need to be taken when failing the above ratings. Whereas it should be when they reach these ratings.

- as discussed, please make sure to add "and not on watch for downgrade" next to the Aa3 rating in the 1st level.
- as discussed, please make sure to delete "any other action that satisfy the RAC".
- ATE: as discussed with Yvonne last week, pls remove "or such other action as shall satisfy the RAC".

Cash Flow Swap documents:
- in what circumstances can the CPTY walk away?
- we're continuing to review the blacklines you sent yesterday.

Indenture:
- use of the Ramp-Up Par Amount for purposes of calculating compliance with the EC: committee is fine with this provided that you specify in the document that this is only for reporting purposes and not when determining compliance when reinvesting proceeds of an Optional Redemption (which should use current par).

We'll get back to you on a couple of other points once the committee has reached a decision.

Note that in addition to the above, we will continue to review the revised drafts of the documents that we haven't yet commented on and therefore may have further comments.

When sending the next draft of the Indenture, could you make it cumulative against the 4/19/07 draft please.

Thanks.

The information contained in this e-mail message, and any attachment thereto, is confidential and may not be disclosed without our express permission. If you are not the intended recipient or an employee or agent responsible for delivering this message to the intended recipient, you are hereby notified that you have received this message in error and that any review, dissemination, distribution or copying of this message, or any attachment thereto, in whole or in part, is strictly prohibited. If you have received this message in error, please immediately notify us by telephone, fax or e-mail and delete the message and all of its attachments. Thank you. Every effort is made to keep our network free from viruses. You should, however, review this e-mail message, as well as any attachment thereto, for viruses. We take no responsibility and have no liability for any computer virus which may be transferred via this e-mail message.

PSI-MOODYS-RFN-000017

From: Arne, Errol
Sent: Thursday, February 23, 2006 9:43 AM
To: Kennedy, Martin; Mason, Scott; Osterweil, Terry
Cc: ResidentialPools; Mahdavian, Sharif; Uppuluri, Sai; Cao, Becky; Alizadeh, Rasool
Subject: Request for prioritization

Gentlemen,

Bear Stearns is currently closing three deals this month which has 40 year mortgages (negam) which will have a 30 year bond maturity. On all 3 deals they have already sent us cashflows last week for us to review (as Spire is not ready for this pertaining to negam). There was some discrepancy in that they were giving some more credit to recoveries than we would like to see. After a conference call with Becky Cao and Jeff Maggard and Jenn Schneider it was agreed that for the deals this month we were OK and they would address this issue for deals going forward.

(the deals are SAMI 2006-AR1-me; SAMI 2006-AR2-Sharif; and GP 2006-AR1-Sai).

Bear, and I know they are very late in the process, have sent over the final collateral tapes for each deal so that we can 'confirm' original levels we gave out. They are waiting for us to get back to them and they will turn over cashflows 'in an hour'. My question to you is can we move this up the priority flag pole as they will need to send over these flows and we need to sign-off by tomorrow.

If the analyst is running the levels and they see that the levels are not going to change, does this need to go to committee or can they take it to a chair, even off committee hours, so that we may let Bear know the levels are confirmed and they can get started on sending over flows for our review. If levels have changed- different story- needs to be taken back to committee but the analyst assigned should contact me (on any of the deals) so that this way I can give Bear a heads up that levels will be changing. Thanks.

Please advise as the timetable is very short. Thanks again.

Errol

Errol Arne
Standard & Poor's
55 Water Street
New York, NY 10041
Phone: (212) 438-2089
Fax: (212) 438-2661
Errol_Arne@standardandpoors.com

DATE: 06/28/2007
TIME: 17:43:16 GMT
AUTHOR: Bharwani, Pooja
RECEIPIENT: Li, Frank; Kolchinsky, Eric; Fu, Yvonne
CC: Awasthi, Maneesh; Hersch, Jessica
SUBJECT: RE: CV4 - Post Reinvestment

Frank,

This is an issue we feel strongly about and it is a published Moody's criteria.

We are making an exception for this deal only. As we understand the manager will covenant to the Class B Effective Date level - 1%. Going forward this has to be effective date level.

I would urge you to let your colleagues know as well since we will not be in a position to give in on this issue in future deals.

Regards,
Pooja

-----Original Message-----
From: Li, Frank [mailto:frank.li@citi.com]
Sent: Thursday, June 28, 2007 12:27 PM
To: Bharwani, Pooja; Kolchinsky, Eric; Fu, Yvonne
Cc: Awasthi, Maneesh ; Hersch, Jessica
Subject: RE: CV4 - Post Reinvestment

I just spoke to Yvonne. She will check with you and Eric to see if the latest proposal is acceptable to you. That's Effective Date Level - 1%.

Please let us know. Thanks.

-----Original Message-----
From: Bharwani, Pooja [mailto:Pooja.Bharwani@moodys.com]
Sent: Thursday, June 28, 2007 12:21 PM
To: Li, Frank [CMB-GFICC]; Kolchinsky, Eric; Fu, Yvonne; Natcharian, Matthew; Kraez, Kathleen
Cc: Awasthi, Maneesh [CMB-GFICC]; Hersch, Jessica [CMB-GFICC]
Subject: RE: CV4 - Post Reinvestment

Will dial-in in 5 minutes.

Pooja Bharwani
VP-Senior Analyst
Moody's Investors Service | 99 Church Street | New York, NY 10007
Tel: 212 553 7135 | Fax: 212 298 6462
pooja.bharwani@moodys.com

-----Original Message-----
From: Li, Frank [mailto:frank.li@citi.com]
Sent: Thursday, June 28, 2007 12:16 PM
To: Bharwani, Pooja; Kolchinsky, Eric; Fu, Yvonne; Natcharian, Matthew; Kraez, Kathleen

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Cc: Awasthi, Maneesh ; Hersch, Jessica
Subject: RE: CV4 - Post Reinvestment

Conference Dial-in Numbers
Toll free: 1-866-548-4717
Toll: 1-719-785-9434
Participant Passcode: 654061

Please call in now. Both Citi and Babson are available now to talk about this.

-----Original Message-----
From: Bharwani, Pooja [mailto:Pooja.Bharwani@moodys.com]
Sent: Thursday, June 28, 2007 12:13 PM
To: Li, Frank [CMB-GFICC]; Kolchinsky, Eric; Fu, Yvonne
Cc: Awasthi, Maneesh [CMB-GFICC]
Subject: RE: CV4 - Post Reinvestment

Can we get a dial-in?

Thanks.

-----Original Message-----
From: Li, Frank [mailto:frank.li@citi.com]
Sent: Thursday, June 28, 2007 11:56 AM
To: Kolchinsky, Eric; Bharwani, Pooja; Fu, Yvonne
Cc: Li, Frank ; Awasthi, Maneesh
Subject: CV4 - Post Reinvestment

Eric, Pooja,

I went back to Babson and effective date level is still totally unacceptable to them as they don't understand the rationale behind the criteria. We have run the model and showed you the results that are passing. Please give a call to Matt at Babson directly to discuss this:

Matt: mnatcharian@babsoncapital.com
Tel: 413-226-1672.

You can call me and I can loop Matt in. As we are printing Offering Circular shortly, your immediate attention is greatly appreciated.

Thank you.

Frank Li, CFA
Global Structured Credit Products
Citigroup Global Capital Markets, Inc.
390 Greenwich Street, 4th Floor
New York, NY 10013
Tel: (212) 723-6173
Fax: (646) 291-5391
frank.li@citigroup.com

PSI-MOODYS-RFN-000020

From: Meyer, Chris
Sent: Sunday, April 23, 2006 6:52 PM
To: Williams, Geoffrey; Gerst, David
Cc: Egol, Jonathan; Tourre, Fabrice; Yukawa, Shin; Ghetti, Belinda; Guarnuccio, Keith
Subject: RE: ABACUS 2006-12 - Writedowns immediately prior to Stated Maturity

Geoff,

This language is actually one of the areas that we felt failed to meet our counterparty criteria. For example, setting aside the amount being posted, the rating trigger is not even remotely correct and it only pertains to CDO Reference Obligations. I understand from my colleagues that they are unaware of this type of language (i.e., taking into account market pricing) being approved. This is especially surprising given that Belinda, a Team Leader regarding criteria as it relates to Synthetic CDOs, probably should have been involved in the approval of languge that would result in a deviation from our core criteria.

Chris

-----Original Message-----
From: Williams, Geoffrey [mailto:Geoffrey.Williams@gs.com]
Sent: Sun 4/23/2006 6:23 PM
To: Meyer, Chris; Gerst, David
Cc: Egol, Jonathan; Tourre, Fabrice; Yukawa, Shin; Ghetti, Belinda; Guarnuccio, Keith
Subject: RE: ABACUS 2006-12 - Writedowns immediately prior to Stated Maturity

See 10.3(f) of the Indenture of this transaction. This was negotiated with S&P in connection with our last transaction, ABACUS 2006-8.

From: Meyer, Chris [mailto:christopher_meyer@standardandpoors.com]
Sent: Sunday, April 23, 2006 6:18 PM
To: Williams, Geoffrey; Gerst, David
Cc: Egol, Jonathan; Tourre, Fabrice; Yukawa, Shin; Ghetti, Belinda; Guarnuccio, Keith
Subject: RE: ABACUS 2006-12 - Writedowns immediately prior to Stated Maturity

Geoff,

I'm unaware of market related information ever being used to determine the amount that should be posted in connection with Writedowns of any kind. Given that Belinda, Keith Guarnuccio and I are highly involved with issues relating to PAYGOs, we'd be most interested in knowing where we've approved this type of language -- since this would be a significant departure from our current criteria. As you point out, it is a conservative position for S&P to take, but it is one we've taken with all Dealers. Since time is of the essence, this may be another issue that we table for 2006-12, but would have to be addressed in future trades.

Regards,
Chris

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-----Original Message-----
From: Williams, Geoffrey [mailto:Geoffrey.Williams@gs.com]
Sent: Sun 4/23/2006 3:25 PM
To: Meyer, Chris; Gerst, David
Cc: Egol, Jonathan; Tourre, Fabrice; Yukawa, Shin; Ghetti, Belinda
Subject: RE: ABACUS 2006-12 - Writedowns immediately prior to Stated Maturity

Chris -- we're happy to build in the appropriate 1 year / 3 year CDO language that you describe in your first point below. However, we are not going to be able to accommodate your second request. We drafted this language in the spirit of the clause that we recently incorporated (and had approved by both you and Moody's) into our cds confirm which governs the amount that must be posted given an implied writedown of a CDO reference obligation. The premise is that market information is very relevant in determining whether or not a reference obligation that has sustained writedowns is expected to write back up and I do not see why this methodology is relevant only in determining the amount that should be posted under the cds.

I would add that this scenario is very different from an optional redemption as you point out below since the optional redemption is at Goldman's option and a stated maturity is not. We therefore cannot settle for the most conservative alternative as I believe you are suggesting.

David -- can you please point Chris to language he is looking for on his third point?

Let us know if you have any questions. Thanks. Geoff.

From: Meyer, Chris [mailto:christopher_meyer@standardandpoors.com]
Sent: Saturday, April 22, 2006 6:03 PM
To: Gerst, David
Cc: Egol, Jonathan; Tourre, Fabrice; Williams, Geoffrey; Yukawa, Shin; Ghetti, Belinda
Subject: RE: ABACUS 2006-12 - Writedowns immediately prior to Stated Maturity

David,

I've had an opportunity to review the proposed language this afternoon.

1. Clause (b) -- the one calendar year "cure period" is only applicable to non-CDO Reference Obligations in this case, the RMBS and CMBS Reference Obligations). For CDO Reference Obligations, our criteria is that we'll deem a Reference Obligation, which has experienced a Writedown, to be "defaulted" (a) after one year if the Reference Obligation is undercollateralized by more than 25% and (b) after three years if the Reference Obligation is undercollateralized by 25% or less.

2. Clause (A) -- I'm a little confused. I thought the proposal put forth on Wednesday was that to the extent there was any Writedown which (per our tests) hadn't been deemed permanent, then Goldman would reimburse the full amount of the Writedown. The current formula suggests Goldman may pay an amount less that the full amount of the Writedown. I was expecting to see language similar to the Optional Redemption Reimbursement Amount, which addresses the exact same concern in the context of when Notes are optionally redeemed.

If you can direct me to the specific location in the Schedules of the Basis Swap and Put that contain the identical language to Part 1.3(v) of the CDS Schedule, I would appreciate it.

Chris

PSI-S&P-RFN-000003

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-----Original Message-----
From: Gerst, David [mailto:David.Gerst@gs.com]
Sent: Fri 4/21/2006 9:30 AM
To: Meyer, Chris
Cc: Egol, Jonathan; Tourre, Fabrice; Williams, Geoffrey; Yukawa, Shin
Subject: ABACUS 2006-12 - Writedowns immediately prior to Stated Maturity

Chris,

Below is our proposed language to determine how much Goldman has to pay the Issuer if a writedown occurred shortly before maturity of the Notes.

On the Stated Maturity for any Series of Notes, if (i) any such Series of Notes maturing on such date has an ICE Currency Adjusted Aggregate Outstanding Amount Differential greater than zero and (ii) an ICE Reference Obligation Notional Amount Differential is greater than zero with respect to one or more Reference Obligations (a) that remain in the Reference Portfolio at such time of determination, (b) with respect to which the ICE Reference Obligation Notional Amount Differential was equal to zero on the day that was one calendar year prior to such Stated Maturity, (c) that, at the time of such Stated Maturity, has an Actual Rating above (1) if rated by Moody's, "Ca" (2) if rated by S&P, "CC" or (3) if rated by Fitch, "CC" and (d) with respect to which no Credit Event (other than a Writedown) has occurred at any time on or prior to such Stated Maturity, Goldman will pay to Counterparty an amount, if greater than zero, equal to the lesser of (A) the aggregate of the difference, determined for each such Reference Obligation, of (i) the ICE Reference Obligation Notional Amount Differential of such Reference Obligation and (ii) if greater than zero, the ICE Reference Obligation Notional Amount of such Reference Obligation less the related Current Dollar Price and (B) the ICE Currency Adjusted Aggregate Outstanding Amount Differential of each Series of Notes for which the Stated Maturity is such date.

Also, please note that Section 7.10 of the Indenture (issuing ordinary shares) and the Basis Swap and Put Schedules (regarding Bankruptcy) address your concerns as previously drafted. Let me know if you need me to point you to the appropriate provisions.

Thanks,

David

PSI-S&P-RFN-000004

From: O'Brien, John
Sent: Wednesday, May 03, 2006 9:01 AM
To: Rashid, Malik
Subject: RE: Broadwick Funding.

Sure. Call me when you're free.

John

-----Original Message-----
From: Rashid, Malik
Sent: Tuesday, May 02, 2006 9:32 PM
To: O'Brien, John
Subject: RE: Broadwick Funding.

John,

Let's re-group on this tomorrow at a time that suits you; I realize that the closing date is coming soon. I apologize for not being able to partake in the call today; issues cropped up in nearly every transaction I'm currently staffed on.

Malik

-----Original Message-----
From: Meyer, Chris
Sent: Monday, May 01, 2006 9:08 PM
To: O'Brien, John
Cc: Rashid, Malik
Subject: RE: Broadwick Funding.

John,

I'm not sure what they are talking about in terms of the modeling based solution, but I'm not sure how you can model the counterparty risk with respect to Writedown Reimbursement Amounts. In addition, you can tell them that if the are referring to ABACUS 2006-12, which closed lastThursday, that is the last trade that will not be required to post Writedowns (unless they can demonstrate conclusively that our concern is otherwise dealt with in the structure). It was a known flaw not only in that particular ABACUS trade, but in pretty much all ABACUS trades (which between the three of us were all rated by the same person...who neglected to catch other important criteria issues...or ignored them after being told to correct them by Team Leaders and business managers). The ABS desk at Goldman has already been told that the all of the de-linking criteria would need to be addressed in future ABACUS trades, and this includes posting of Writedown Amounts.

In terms of the CSA and opinion language, they do have a point...if we indeed have RAC. Nevertheless, I always copy and past the description of the opinion from the counterparty criteria

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article and ask why they can't include the language. It's very generic and doesn't ask them to speak to any details.

It looks like swap termination payments to the swap counterparty are netted senior out of the Synthetic Security Counterparty Account. Is this the case?

I'm not sure if this helps. At this point, I'm not thinking all that clearly.

Regards,
Chris

-----Original Message-----
From: O'Brien, John
Sent: Mon 5/1/2006 5:55 PM
To: Meyer, Chris
Cc: Rashid, Malik
Subject: FW: Broadwick Funding.

Chris - Would really appreciate any/all guidance on this you can offer. Trying to wrap this up as soon as possible.

Thanks,
John

-----Original Message-----
From: Bieber, Matthew G. [mailto:matthew.bieber@gs.com]
Sent: Monday, May 01, 2006 5:23 PM
To: Rashid, Malik
Cc: O'Brien, John; Kim, Jeong-A
Subject: RE: Broadwick Funding.

Malik thanks for the feedback -

1. GS has not agreed to this hold back provision in any of our previous transactions (including the ABACUS deal that just closed last week) - and we cannot agree to it in this deal. We'd discussed the modeling based solution with respect to this counterparty risk back on April 13th - and it was ultimately communicated to us the following week there would be no changes in this transaction on this point.

2. I agreed with your long term rating comment (BBB+) as well as the 10 day delivery of the opinion. I thought this was reflected in the document - but I assure you it will be so in the next deal.

3. In terms of timeliness - the CDO holds the collateral and as soon as there is a termination and the appropriate termination payments have been made - the lien that the synthetic security counterparty has on the collateral is released to the trustee. this is outlined in section 12.2 of the indenture. Is there specific language you'd like to see here? if so, I'd be happy to review and try and incorporate, where appropriate.

4. Given that the CSA is will be subject to RAC, S&P will have ability to refview the opinion and to the extent it is not satisfactory, act accordingly. We cannot agree to specifically enumerate the carve outs at this time, due to the fact that there may be changes in case law, market practice, etc. that would have an impact on the opinion between now and the time when any opinion would be required.

PSI-S&P-RFN-000009

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From: Rashid, Malik [mailto:malik_rashid@standardandpoors.com]
Sent: Monday, May 01, 2006 4:53 PM
To: Bieber, Matthew G.
Cc: O'Brien, John; Kim, Jeong-A
Subject: RE: Broadwick Funding.

Matt,

I realize that GS abd the CDO group have differences in opinion over certain provisions, but I understand from conversations on Friday and today that the group reiterates their view. Below are our comments from our review of the revised CDS documents circulated on 4/21. This reflects the latest feedback from the CDO group related to the downgrade/posting provisions for this specific transaction, and you'll find that these are repetitive from our last set of comments on the CDS.

Malik

-->

1. To de-link GS's counterparty risk with respect to reimbursements, Writedown amounts need to be posted for one year as long as its rating is below AA- or A-1+. This posting for one year should remain and should not be extinguished if the swap terminates early as a result of GS being the defaulting/affected party. Writedowns can be considered permanent after the expiration of one year.

2. On p.5 of the Schedule:

- the second level rating trigger should be A-2 or BBB+, not BBB-.

- It looks like GS is choosing to remain in the swap by posting when its rating falls below the second level rating trigger. The opinion with respect to the collateral should be delivered within 10 days, not 30.

- Re: my earlier comment on the opinion addressing the timeliness issue - because this is a situation where Party A's credit rating is low, there is greater concern over the CDO's ability to avoid loss arising from exposure to Party A credit risk. While the CSA does speak to Party B's rights as Secured Party, we need more comfort that the CDO terminate the CDS (when the need arises) and liquidate the collateral to make itself whole in a timely manner without undue delay.

- Also on the opinion, we are not certain as to what "customary and usual assumptions, carveouts, and exceptions" mean. Our concern is whether such language limits the opinion's scope. We're trying to de-link GS's credit risk so it can choose to remain in the CDS regardless of what its rating is, so we'd like to make sure that the opinion's description today does not limit its scope.

-----Original Message-----
From: Bieber, Matthew G. [mailto:matthew.bieber@gs.com]
Sent: Monday, May 01, 2006 3:14 PM
To: O'Brien, John
Cc: Kim, Jeong-A
Subject: RE: Broadwick Funding.

ok. the sooner the better. just a reminder - we cannot agree to holding write downs in the deal for a year or any short term rating triggers.

PSI-S&P-RFN-000010

Footnote Exhibits - Page 0639

From: O'Brien, John [mailto:john_o'brien@standardandpoors.com]
Sent: Monday, May 01, 2006 2:58 PM
To: Bieber, Matthew G.
Cc: Kim, Jeong-A
Subject: RE: Broadwick Funding.

Matt - Malik will be sending you comments to the last draft of the swap later today.

Regards,
John O'Brien

-----Original Message-----
From: Bieber, Matthew G. [mailto:matthew.bieber@gs.com]
Sent: Monday, May 01, 2006 9:48 AM
To: O'Brien, John; Kim, Jeong-A
Cc: Mangalgiri, Vickram S.; Mishra, Deva R.
Subject: Broadwick Funding.

John and Jeong-A

Hope the weekend and vacation was enjoyable. As discussed last week, I'd like to finalize all outstanding points on Broadwick Funding by the end of the day this Wednesday. To that end, would you please let me know when its most convenient for you to discuss any remaining comments you have to the documents over the next day or so? Additionally, it appears we'll be slightly increasing the size of the S Note in the transaction by approx. $1.5mm. Look forward to hearing from you.

Best Regards,
Matt

PSI-S&P-RFN-000011

DATE: 05/20/2007
TIME: 15:15:39 GMT
AUTHOR: Kolchinsky, Eric
RECEIPIENT: Fu, Yvonne; Yoshizawa, Yuri
CC:
SUBJECT: Re: Paper on inter-CDO correlations - update from ABS Steering Committee

Ok, but I'm not sure this will solve the communication problem. In the UBS case, the analysts were informed about the look through by the new deal staffing email and Yuri's email, below (in addition to the numerous discussions in sterring comm).

Unfortunately, our analysts are owerwhelmed and I'm concerned that the communication to the bankers will "2x and one notch" without any of the subtelties which we ascribe to the approach. I still get routinely asked for which tranches do we use the sequential life...

Thank you
Eric

-----Original Message-----
From: Fu, Yvonne
To: Kolchinsky, Eric; Yoshizawa, Yuri
Sent: Wed May 23 08:08:53 2007
Subject: RE: Paper on inter-CDO correlations - update from ABS Steering Committee

I think it should still be mentioned in the internal communication to give analysts better guidance. The current practtice is quite varied as the analysts do not seem to know what to do even in the cases for which you have communicated with the banks,i.e. UBS. I will send a revised one to both of you.

-----Original Message-----
From: Kolchinsky, Eric
Sent: Wednesday, May 23, 2007 7:56 AM
To: Yoshizawa, Yuri; Fu, Yvonne
Subject: Re: Paper on inter-CDO correlations - update from ABS Steering Committee

Yuri/Yvonne

In that case, should we exclude any mention of the one notch rule from the general communication? Instead, we should give comm chairs the discretion to apply the rule as they see fit. In this way, there is less of a chance of it getting back to the bankers as a "general rule". They are more likely to know it as something that only applies, as a concession, on the deal that they are working on.

Thank you very much
Eric

-----Original Message-----
From: Yoshizawa, Yuri
To: Kolchinsky, Eric; Fu, Yvonne
Sent: Tue May 22 23:02:49 2007
Subject: Re: Paper on inter-CDO correlations - update from ABS Steering Committee

We need to find a way of positioning the 1 notch as our way of "grandfathering"

Yuri Yoshizawa
Moody's Investors Service
(212) 553-1939

Sent From My Blackberry

Footnote Exhibits - Page 0641

-----Original Message-----
From: Kolchinsky, Eric
To: Fu, Yvonne; Yoshizawa, Yuri
Sent: Tue May 22 23:00:12 2007
Subject: Re: Paper on inter-CDO correlations - update from ABS Steering Committee

Yvonne

Looks good generally, two comments however.

1. The one notch rule. I understand the impetus, but it may be problematic in the long term. I think that any stress levels that we implement now will be percieved by the market as being close to the final. They have been asking for certainty in their ability to ramp and structure deals.

If we give a one notch leeway with 2x now and end up with 2x in the long term without the extra room -- I think that bankers will be upset. Instead of dealing with the problem now, we will have to deal with it when we implement the final methodology. I think that we would be better off doing 2.5x with one notch now and go to 2x without. That way we can at least give them a trade-off.

2. We should be clear that the 2x should apply to the underlying vs the MAC.

3. Could you add that this should apply to cdo buckets in abs cdos as well?

Thank you very much
Eric

-----Original Message-----
From: Fu, Yvonne
To: Kolchinsky, Eric; Yoshizawa, Yuri
Sent: Tue May 22 22:16:56 2007
Subject: Fw: Paper on inter-CDO correlations - update from ABS Steering Committee

I am planing on sending this to the group. Please let me know if you are ok with it - don't worry about spelling errors as I will do a spell check before sending!

PSI-MOODYS-RFN-000012

DRAFT

2007 Operating Plan

Public Finance, Global Structured Finance and Investor Services

Brian Clarkson
February 20, 2007

Moody's Investors Service

1:19 AM

Confidential Treatment Requested
by Moody's Investors Service

MIS-OCIE-RMBS-0419014

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #1113

2006 Overview

- 2006 was a record year in Global SFG & PFG (including ISG and KIS) with combined revenues of $1,036.4B
  - Global SFG revenues were $860.4MM exceeding prior year by 25% and budget by 18%
  - PFG revenues were $112.5MM a drop from prior year by 4% but exceeding budget by 2%
  - Global ISG Products & Research exceeded prior year by 12% and was flat compared to budget
- Contribution margin for the group was 83%, equal to prior year and exceeding budget of 80%
- Issuance exceeded our expectations in almost all sectors especially in US RMBS (HE), Global CDOs, US CMBS and EMEA Securitisation
- New ratings products introduced in the market are estimated to have generated $78.6MM in revenues
- Our non-ratings new products generated $7.4MM of revenues
- For 2007, we are forecasting **13%** revenue growth (12% Pre-FX)

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2007 Operating Plan

Moody's Investors Service

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MIS-OCIE-RMBS-0419023 — MIS-OCIE-RMBS-0419024

Challenges for 2007 - Downside

- Interest rate increases in the US
- Price pressure, particularly in AFG, PFG, synthetic CDO's, and in emerging markets as more and more deals become commoditized. Additional pressure from issuers such as JP Morgan, Morgan Stanley, CSFB, Deutsche Bank
- Managing customers' expectations and demand for real-time data in external PFG products (QRate, MFRA
- Competitive issues (ex. Rating inflation, successful rating shopping, notching below investment grade for mono-line insured deals, etc.)
- Managing customers' expectations and demand for real-time data
- Greater than expected decline in RMBS issuance due to expansion of GSE activity, declining home values which may limit refinancing activity, and issuer consolidation
- Increased "rating shopping" by market participants
- Past and future issuer consolidations
- Financial stability of the "Big 3" automakers may reduce issuance
- ABCP programs from the same sponsor are combined into larger programs capping fees
- Credit stress or greater than anticipated issuance decline in US RMBS or US corporate loan sectors leads to decreased US CDO issuance or greater issuance of synthetic transactions
- Leveraged loan issuance declines significantly reducing supply of assets for EMEA CDOs
- Higher than expected rating transition in Home Equity and RMBS
- Technology constrains growth of new ratings and non-ratings products and does not keep pace with business growth, resourcing, business lines

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Footnote Exhibits - Page 0648

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MIS-OCIE-RMBS-0419026 — MIS-OCIE-RMBS-0419034

Operating Risks

- Under resourced growth in new and existing businesses
- Intermediary Rating Shopping
- Market Pricing Pressure and Issuer Consolidation
- Turnover and Retention
- Credit Quality Shifts/Monitoring Challenges
- Competition
- Technology limitations

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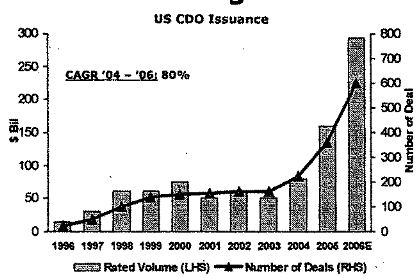
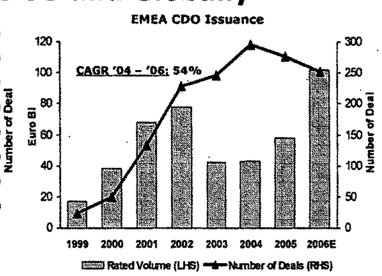
CDO Issuance Volumes for 2006 Continued to be Strong both in the US and Globally



Source: Moody's. Represents volume rated by Moody's alone. Excludes CRE CDOs



Source: Moody's. Represents all volume rated by Moody's and other publicly rated deals.

- Strong historical performance by CLOs and record issuance of RMBS and Home Equity into Resecuritization CDOs were the main drivers of the growth in these two leading CDO sectors
- Issuance driven by demand for and development of new types of structures in the market, increased liquidity and the application of the CDO technology to new asset classes
- Moody's has kept its market coverage in the mid- to high-90's

Moody's Investors Service

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2007 Outlook for Global Derivatives Market

- Moody's is well-positioned to capture global CDO issuance business and we expect momentum to continue into 2007
- The continued need of investors, issuers, intermediaries, and regulators to mitigate and transfer risk will fuel expansion; and create new investment products
- Credit derivatives growth will moderate, but remain robust.
  - Market outlook for US CDOs range from 10% to 26% growth in 2007
  - Market outlook for Cash EMEA CDOs is for 25% growth in 2007
- The market's rapid growth does suggest the possibility of a correction.
  - A correction would slow growth more than anticipated, and for a longer period. However, increasing liquidity and innovation should support longer term growth.

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Potential Risks to the Derivatives Business

- Ability to attract and **retain** skilled analytical resources to support volume and innovation is increasingly difficult given competitive pressures in the market. Derivative analysts are contacted frequently by the market
- Downturn in housing market could effect growth for Resecuritization CDOs, which currently represent approx. 55% of the U.S. CDO business. Downturn in corporate credit quality would also have an impact on CLO, the second largest CDO business
- Increased scrutiny by press and regulators as spotlight is focused on the global CDO market. Underperformance of underlying securities and resulting underperformance of CDOs would have a material negative impact
- As transactions become increasingly complex, Moody's is faced with the challenge of keeping its technology current to meet demands of the business (e.g., computing capacity, speed, other tools

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MIS-OCIE-RMBS-0419039 — MIS-OCIE-RMBS-0419053

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Division of Insurance and Research

June 4, 2007

TO: Stephen P. Funaro, Dedicated Examiner

CC: Paul H. Kupiec, Associate Director, DIR
John H. Corston, Associate Director, DSC

FROM: Daniel A. Nuxoll, DIR

SUBJECT: ALLL Modeling at Washington Mutual

Summary

Washington Mutual does not currently have data that permit to track charge-offs back to individual loans.

Consequently, Washington Mutual uses the Loan Performance Risk Model to establish reserves for its single family housing loans. The model was developed by a vendor on data for mortgages that were part of private-label securitizations, and Washington Mutual has calibrated the model to reflect its own experience. The calibrations for the various portfolios are based on very limited data usually the portfolio at a single date. These exercises attempt to produce forecasts of key aspects of portfolio performance at horizons from 18 to 36 months. Recently, Washington Mutual decided to set reserves sufficient to cover losses that occur within the next 36 months.

Despite the calibration, the model does not fit some aspects of the data. Probably the most significant problem is that the model estimates prepayment rates for option ARMs that are much too high. The dataset used to develop the model does not include any significant data on option ARMs, so there is reason to believe that the model might not adequately measure the risk of option ARMs. These mortgages constitute over half of the prime mortgage portfolio held for investment.

Details

Overview

Washington Mutual (Wamu) uses different methods for reserving for different parts of their portfolio. I focused on the single family mortgage models which are adaptations of the Loan Performance Risk Model (LPRM). Wamu uses the prime version of that model for its prime portfolios (single family mortgages, home equity loans, and home equity lines of credit) and the subprime version for Long Beach Mortgage Company (LBCM) and the Specialty Mortgage Finance (SMF). These models are designated by the bank[1] as Tier 1 models because

[1] Throughout this memo, the institution is referred to as bank, although all data refers to the parent of the two thrifts.

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #1119

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they are used for portions of the portfolio that were responsible for more than $50 million of reserves. There are two additional Tier 1 models—credit cards and multifamily housing loans.

As shown in Table 1, the Tier 1 models account for over $200 billion (95%) of the balances in the held for investment portfolio and almost $1.2 billion (92%) of the reserves. The mortgage models for single family mortgages account for over $170 billion (78%) of the portfolio and $700 million (55%) of the reserves.

Table 1

Portfolio	Balance $billion	Reserve $million
Single Family Residential	97.3	199
Specialty Mortgage Finance	14.2	196
Long Beach Mortgage Company	4.1	84
Home Equity Loans	21.3	106
Home Equity Lines of Credit	33.2	126
Multifamily Lending	29.8	84
Credit Cards	9.4	399
Other	10.2	107
Total	219.5	1,301

Source: Calculated from the March 2007 ALLL/Provision Recommendation and Q1 2007 Summary, Exhibits 1 and 2.[2]

In addition to the numbers for these model-driven (allocated) reserves, the bank also holds an additional (unallocated) reserve of 14% of the allocated reserves. Unallocated reserves are driven by a scorecard of macroeconomic factors. For example, one factor in the scorecard is the "Market/Industry/Financial Services Sector Conditions." These are identified as being a moderate concern mostly because of decelerating pace of house price appreciation. According to the scorecard, if this factor is a moderate concern, the bank holds an additional 5% unallocated reserves. Other factors in the scorecard account for another 9%.

These numbers are for the consolidated entity. The vast majority of the reserves are held by the two insured entities, but this memo focuses on the consolidated entity because the most detailed reporting is available on this level.

<u>**General Methodology for the Mortgage Portfolio**</u>

Wamu does not have a good clean database of charge-offs. A validation study of LPRM observed,

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[2] The numbers in exhibits 1 and 2 of this memo do not agree with the text of the memo, although they agree with the other exhibits in the memo.

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> However, the available data does not include separate measurement of actual losses on such static pools; net charge-off historical data is available only in more aggregate form, with commingling of losses from pools outstanding at the beginning of any given period with losses from loans subsequently acquired into the portfolio.
>
> Furthermore, portfolio management activities for SFR and SMF loans have changed substantially over the last several years... Since the end of 2002, SFR loans that have entered non-performing loan (NPL) status have been reviewed for possible sale, and about $1-1/2 billion were sold. These NPL sales have markedly transformed the timing and magnitude of actual net charge-offs in the period from their initiation to now. Given management plans for less NPL sales activity in the future, a structural change in charge-off patterns is anticipated.[3]

The validation study noted that these complications prevented the bank from computing a clean database to validate the LPRM. The same considerations would clearly prevent the bank from developing its own charge-off model based on the internal data.

Portfolio Defense, a consulting company hired by Wamu to evaluate its methodology recommended,

> Ultimately, if more extensive and better quality Bank mortgage account-level loss data becomes available, we would recommend considering a migration from an LPRM-based process to an internally developed process, using Bank data. At the least, such an approach could be tested and the results compared.[4]

The use of LPRM to set reserves must be interpreted in the light of these data limitations.

The bank recognizes that LPRM data might not be representative of its current mortgage portfolio, so the bank has calibrated LPRM to its own internal data. That calibration is discussed more extensively after the more general discussion of the model. After the model has been calibrated, the model is validated again. Wamu staff has also assured us that the bank tracks the performance of the model; we requested a copy of the regular tracking report but have not received it yet.

Calibration, validation, and performance tracking are all complicated by the issue of the relevant horizon. The bank has commissioned studies by Portfolio Management Associates, a consulting firm, that examine the timing of losses. I received copies of the studies on home equity and subprime lending.

These studies explicitly recognize that "impairment events" such as the loss of a job or a medical problem might not be observable to the bank. These events eventually are discovered, often when the loans become delinquent. In order to analyze the timing of losses, the studies examined all loans that became were sold out of REO and their status prior to entering REO.[5] There are multiple observations of the loan's status prior to the loss, so each observation is weighted by the number of total observations for each loan. There is also a problem of

[3] "Validation of LPRM for SFR and SMF," April 2005. Two bullets have been combined in this quotation.
[4] Portfolio Defense, "Review of ALLL Estimation Methodology and LPRM Calibration Process," January 2006.
[5] The studies on home equity and subprime use slightly different definitions of the final loss confirmation. The subprime study uses the date of sale out of REO, and the home equity study uses the date that property entered REO which typically four months before the sale of the property.

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truncation because newer loans have not had sufficient time to suffer losses. Consequently, the two studies consider older vintages and give more credence to the oldest vintage.

Based on these studies, Wamu has decided to use a 36-month horizon for both types of loans. The data suggest that over 90% of the losses in the home equity portfolio occur within that horizon, and almost 90% of the losses in the subprime horizon occur within that horizon.[6] The studies show that the timing of losses differs significantly by delinquency status; there is some variability for different products and vintages, but that is relatively small compared to the variability by delinquency status. Wamu decided that using different horizons based on delinquency status would introduce "operational complexity that would increase operational risk."[7]

Wamu currently uses a four-year horizon for the SFR (prime mortgage) portfolio, a one-year horizon for cards, and a three-year horizon for subprime mortgages, home equity loans, and multifamily housing loans.

Loan Performance Risk Model

There are four versions of the LPRM: prime, subprime, alt-A, and seconds. The LPRM was developed on data from securitizations of mortgages originated by a wide variety of lenders. Over 90% of the data for each of the four models are for mortgages originated between 1997 and 2003. Two components of the LPRM are relevant to the Wamu ALLL process. One component is the transition component and the second is the loss given default component.

The Transition Component

The transition component uses a Monte Carlo simulation of interest rates and house price appreciation to estimate the possible outcomes for a portfolio of mortgages within a specific horizon. The model estimates the delinquency status of the mortgage (current, 30 days past due, 60 days past due, 90 days past due as well as whether the mortgage has been paid off (prepaid), foreclosed or gone to REO. The model also considers the possibility that the house has been short sold or sold out of REO. It does not consider partial prepayments. Each of these possible statuses is a function of the current status, so the model essentially estimates a roll-rate matrix which reports the probability that a mortgage with a specific status will migrate to another status.

The model was built using data on mortgages that were part of private-label securitizations.[8] The prime version of the model has been built on a dataset of approximately 1.1 million mortgages, while the subprime version uses data from approximately 3 million mortgages. Over the 90% of the mortgages used for both models were originated between 1997 and 2003.

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[6] The timing difference discussed in the previous note means the studies are not completely comparable.
[7] The same phrase is used in "Use of a 3 Year LoSWss Horizon for Subprime ALLL: Recommended Response to Results of the Loss Materialization Timing Study," August 2006, and "Loss Horizon for Home Equity ALLL: Recommended Response to Results of the Loss Materialization Timing Study," February 2007.
[8] Private-label securitizations are those not done by Fannie Mae or Freddie Mac.

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The model uses loan level data and includes most variables that are widely used in the mortgage industry, including original loan-to-value, FICO score, documentation type, and occupancy status.

Several variables are noteworthy. LPS uses only the FICO score at origination. Wamu follows LPS and does not use a refreshed FICO score.

LPS does update estimates of loan to value using the housing price appreciation index from OFHEO. The model assumes that the future changes in house price appreciation are uncorrelated with past changes, so it assumes that large increases in house prices are equally likely to be followed by above average increase in prices as a below average increase in house prices.[9] This means that sustained periods of above average house appreciation are improbable. In fact, these periods are clearly evident in the OFHEO data.[10]

Wamu apparently recognizes this problem and has augmented the LPS model by using a mixture model of house price appreciation. The bank has estimated a logit model for sustained downturns in the housing market. (Staff was not sure, but they thought that the model specified a severe downturn as a 15% decline in prices in a two-year period.) The model is run on the CBSA/MSA level and the key variables are unemployment rates relative to the long run average, changes in payroll employment, and past house price acceleration. The model has two different means—one for a period of normal behavior in house prices and the other for the severe declines.

It should also be noted that most of the sample is from 1997 and later. Virtually none of the data is drawn from an episode of severe house price depreciation. Even introductory statistics textbooks caution against drawing conclusions about possibilities that are outside the data. A model based on data from a relatively benign period in the housing market cannot produce reliable inferences about the effects of a housing price collapse.

LPS also includes a payment shock variable which equals the percentage increase in payments. Less than 25% of the loans used to construct the model were adjustable rate mortgages (ARMs), and some of those were hybrid ARMs. However, few, if any, were option ARMs. For hybrid ARMs, payments are determined by a fixed interest rate for an initial period ranging from two to seven years. After the initial period, interest rates are adjustable, and payment shocks can approach 30%. In contrast, option ARMs generally have a minimum payment that is insufficient not only to repay principle but also insufficient to pay all the interest. At the recast date, payments must cover both, and payments can escalate much more than 100%.[11] Consequently, the model was developed on data that did not include payment shocks as large as those that could be faced by option ARM borrowers.

The same issue discussed above with respect to house price appreciation also affects the estimation of the effects of payment shock. The model cannot reliably estimate the effects of 100% payment shocks based on data in which virtually none of shocks exceed 30%.[12]

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[9] The model uses a five-factor model of house price appreciation to capture correlations across regions. Each area has its own mean, and changes in the five factors are assumed to be i.i.d.

[10] The autocorrelation in the index for the national index is 0.64; the autocorrelation in the California data exceeds 0.80. LPS staff stated that the next version of LPRM will deal with this issue.

[11] These loans typically include caps on payment increases that spread the payment shocks out.

[12] This definition of payment shock is not documented; but LPS staff confirmed this definition during the course of a phone meeting conducted for another examination. During that conversation, LPS staff also confirmed that the

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The Loss Given Default Component

There are two versions of the LPRM loss given default (severity) component—one is an accounting model and the other is a statistical model. Wamu is using the statistical model but is not considering interest lost because of delays in recoveries. The model estimates severity as a function of a number of variables including original combined loan to value, loan characteristics, and original FICO. The model updates the estimated collateral value based on the simulated house price index. The model includes idiosyncratic movements in house prices so it does not assume that prices move in lockstep with regional indices.

Calibration and Validation

The LPRM is calibrated for different mortgage portfolios. Most of the work has been done on the transition component of the model, but some work has been on the severity component. At this point, there is a separate calibration for Option ARMs, for prime mortgages that are not Option ARMs, for home equity loans (HELs) originated by the bank, purchased home equity loans, home equity lines of credit (HELOCs), and for LBCM 1st liens and SMF 1st liens.

Table 2 reports the studies on LPRM that were available. Most of these studies reported the results for the loans held for investment as of a specific date over a defined horizon. The table reports that most the horizons in these studies were shorter than the horizons which are used for reserving purposes which are either 36 or 48 months. Wamu has only recently adopted these horizons used for reserving, and the bank should consider redoing its calibration and validation studies for these longer horizons.

The studies on the single family residential portfolio use data from 1999, occasionally presenting results from 2003 as well. The bank uses data from this period because this is the latest period for which there is data with 24 months of performance history. After 2001, the bank began a program of actively selling non-performing loans, so the timing and magnitude of losses were considerably different than they were for earlier periods. That program has been modified, and the bank believes that the performance of the 1999 sample is more comparable to that of the present portfolio.

Table 2

Portfolio	Study	Sample	Horizon
Single Family Residential	Phase 1 Calibration	January 1999*	24 months
Single Family Residential	Phase 1 Validation	January 1999 January 2003	24 months
Option ARMs (SFR)	Phase 2 Calibration	January 1999	24 months
Other Mortgages (SFR)	Phase 2 Calibration	January 1999	24 months
Specialty Mortgage Finance	Phase 1 Calibration	January 2003	24 months
Specialty Mortgage Finance	Phase 2 Calibration	January 2003	36 months

development data included virtually no option ARMs or payment shocks in excess of 100%. They also agreed that inferences about the model did not produce reliable estimates of the effects of very large payment shocks.

Long Beach Mortgage Company	Phase 2 Calibration	January 2003**	36 months
Home Equity Loans	Validation	November 2003	18 months
Home Equity Lines of Credit	Validation	November 2003	18 months

* The document refers to calibrations done on January 2003 data, although no results are reported.

** Securitized loans

The Transition Component

The LPRM has a number of "dials" that can be set to match the forecasts to the actual data. The calibration documents generally compare the calibrated to the uncalibrated version of the model, and there are some clear differences. For example, the phase 2 calibration study on prime mortgages reports that the roll rate from current to 30 days past due is decreased for all prime loans. That study reports that calibration reduces the roll-rate from current to 30 days past due from 1.12% to 0.52%.[13]

These documents are vague about the procedures used to set these dials, although they state that the dials were set to improve measures of goodness of fit. The studies consider the differences between the forecasted and the actual values of:

1. the sum of the percentages of loans resolved by sales out of foreclosure or REO
2. the sum of the percentages of loans that 90 or more days delinquent, loans that are in foreclosure or REO, and loans that have been resolved by sales out of foreclosure or REO (90+ day or worse).

The studies seem to concentrate most heavily on the squared value of the second criteria, although the studies discuss almost the entire roll rate matrix.

The studies include results based on a Monte Carlo simulation of these time series of house prices and interest rates. However, the model was consistently evaluated with the forecasts based on the actual historical values of house price appreciation and interest rates. This approach produces forecast errors result that do not result from unexpected changes in economic conditions, but rather from the strengths or weaknesses of the model.

The studies revealed a number of anomalies that were not eliminated by calibration. First, in all the studies, loans that were delinquent were much more likely to be 90+ days delinquent at the end of horizon than forecast. For example, in the phase 1 calibration study for single family mortgages, the LPRM forecasted that 0.6% of the loans that were past due 30 days in January 1999 would be 90+ days delinquent two years later; the actual number is 2.5%. Almost all the actual rates are at least twice as large as the forecasted rates. However, because delinquent loans are a small part of the portfolio (the forecasts are dominated by the current part of the portfolio), the aggregate forecasts of the percentage of loans that will be 90+ days delinquent are fairly accurate.

Second, the first calibration study of the prime mortgage portfolio showed that the LPRM forecasts of prepayments are much larger than the actual prepayments. According to the LPRM, over 52% of the current loans would have prepaid within two years, but in fact, only 31%

[13] The roll-rates reported in this paragraph are for 24 months, so the rate represents the percentage of mortgages that are current that will become 30 days past due in 24 months. This is not the usual roll-rate which uses a one-month horizon.

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prepaid. The errors for delinquent loans were similar. The second calibration study located the problem in the option ARM portion of the portfolio. According to the LPRM, 66% of the option ARMs that were current should have prepaid within two years, but only 32% did. In contrast, LPRM forecasted that about 30% of the other prime mortgages that were current would prepay within two years, and 35% did. Again, the errors for delinquent loans were similar. The prepayment rates in other portfolios do not match exactly, but they are much more accurate than that for the option ARM mortgages. Again, these exercises compare calibrated models to actual data.

One can only conjecture about the reasons for the large difference between actual and forecasted prepayments for option ARMs. As discussed above, the data used to develop the LPRM contains virtually no option ARMs so the estimates of option ARM behavior are not statistically reliable. This might be a concern if the borrowers for option ARMs differ from the borrowers for other loans. If people choose to use an option ARM because they face severe financial constraints, then these borrowers could be more risky. FICO scores, CLTV values, and the other conventional measures used by the LPRM might reflect some of that difference, but there is no reason to believe that these data capture all the differences.

The differences between the forecasted and actual prepayments might indicate that the borrowers who utilize this particular type of loan are less able to refinance than those that choose other loans. Possibly, they cannot afford the payments that would be required if they were to refinance to another loan.

There is some other evidence on whether option ARM borrowers are more financially constrained. First, option ARMs were marketed as "affordability product." Wamu's own website states a number of reasons that borrowers should consider an option ARM; two of the first three are "To minimize your house payment to pay off other debt" and "To maximize your buying power." Second, the percentage of loans that negatively amortize is high and has been increasing. The rate has steadily increased from 69.7% of the eligible loans in March 2006 to 83.9% in March 2007.

In addition, phase 2 of the calibration for prime loans provided some evidence. As part of that exercise, Wamu reported the results of using the option ARM calibration and the calibration for other loans on the same data which happened to be the non-option ARM portfolio. The calibration for Option ARMs estimated 1.20% would become 90+ days past due or worse, while the calibration for other loans forecasted 0.80%. (The actual percentage was 0.81%.) The difference suggests that for this portfolio, the estimated rate of 90+ days past due or worse would be 40 b.p. higher if the loans were option ARMs.

Again, this explanation is conjectural, but there is some evidence consistent with it.

The evidence does suggest that Wamu should be cautious about using the model to evaluate the risks of option ARMs. Moreover, the evidence suggests that these loans are relatively risky.

As of March 2007, Wamu had $57 billion of option ARMs in a $95 billion portfolio of held for investment prime mortgages.

The validation exercises also compared the accuracy of the model by segmentation. The bank considered loans going to REO and segmented four different variables: initial delinquency status, initial FICO score, estimated combined LTV, and initial loan age. As a result of this exercise, the bank did not identify any issues. There are differences, but it is difficult to assess the significance of these differences. For example, over 8% of the loans that were 25 months or older eventually went into REO, but the model estimates that less than 7% would have gone into REO.

The Loss Given Default Component

In general, the calibration and validation exercises offer little detail about the actual severity numbers, so the adequacy of the loss given default component of the model is difficult to assess. The Phase 2 calibration study for prime loans does include a chart that compares actual losses to forecast losses for about 3500 loans. The Phase 2 calibration study for subprime loans shows that the model generally produces forecasted severities that are higher than those actually observed. The LPRM estimated severities do not depend heavily on the horizon, but the actual severities are increasing with time. The validation study for HELs and HELOCs does not show a consistent relationship between the historical data and the LPRM forecasts. The forecasts for HEL 1st and HELOC 2nd liens are higher than the actual severities, while LPRM generally forecasted lower losses given default than were actually realized for HEL 2nd and HELOC 1st liens. These differences can be large; for example, the projected severity at 18 months for 1st lien HELs is 35%, but the actual loss given default is 13%.

On the whole, the various studies do not suggest that the bank believes there is any urgency to recalibrate the severity component. The studies were done on sales out of REO, so they omit the other available methods of collecting on foreclosed loans. In addition, for some of these portfolios, there is very little data—the validation exercise for 1st lien HELs based its severity estimates on only 13 observations.

Documentation Used in this Memorandum

This list includes only that documentation that provided the information in this memorandum. It does not include background information or other documents.

Meeting

Meeting with a Washington Mutual team led by Joe Mattey, Chief Risk Officer, Washington Mutual Home Loans, May 9, 2007

Validation and Calibration Documents

Calibration of LPRM v3.1 for SFR and SMF, April 2005
Validation of LPRM v3.1 for SFR and SMF, April 2005
Validation of LPRM v3.1 for HEL and HELOC Loan Portfolios, after July 2005
Phase II Calibration of LPRM for Prime Portfolios, after April 2006
Calibration of LPRM for Subprime Portfolios, after April 2006

Other Documents

Use of a 3 Year Loss Horizon for Subprime ALLL: Recommended Response to Results of the Loss Materialization Timing Study, August 2006

FDIC_WAMU_00000375

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Loss Horizon for Home Equity ALLL: Recommended Response to Results Loss Materialization Timing Study, February 2007
Negative Amortization Snapshot: March 2007
Credit Risk Review: March 2007
Untitled charts showing balance, loss factors, and net charge-offs

Consultant Documents
Review of ALLL Estimation Methodology and LPRM Calibration Process—Portfolio Defense, January 2006
Loss Materialization Timing Study Final Report [for subprime mortgages]—Portfolio Management Associates, August 2006
Home Equity Loss Materialization Timing Study Final Report—Portfolio Management Associates, February 2007

Loan Performance Documents
Risk Model 3.1.5 Technical Document, August 2005

FDIC_WAMU_00000375

AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

STEVEN R. ROSS
202.887.4343/fax: 202.887.4288
sross@akingump.com

February 24, 2011

VIA HAND DELIVERY
The Honorable Carl Levin
Chairman
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
199 Russell Senate Office Building
Washington, DC 20510

Re: Moody's Investors Service: Response to Follow-Up Questions

Dear Chairman Levin:

On behalf of our client, Moody's Investors Service ("Moody's"), we respectfully submit this letter in response to the Committee's recent follow-up questions.

In response to the Committee's question about certain RMBS transactions, from April 2007 through the first week of July 2007, Moody's rated 284 deals containing the following number of RMBS tranches:

	Tranches	Deals
April 2007	1,386	88
May 2007	1,511	96
June 2007	1,379	98
July 1, 2007 – July 6, 2007	29	2

In addition, your staff asked to be further informed regarding Moody's acquisition of underlying loan data that was used to create its model. Moody's obtained data for the purpose of model development through the operation of a consortium, rather than by purchase. Moody's was developing a unique version of its Moody's Mortgage Metrics model for use with respect to the subprime market ("M3 Subprime"). For the purpose of obtaining loan level data to use in M3 Subprime, Moody's, during 2006, formed a consortium of a number of banks and mortgage institutions. The participating institutions, which included the most active participants in the market, agreed to and did, submit to Moody's loan level data concerning mortgages they had originated. Throughout 2006 Moody's received data from the participating institutions.

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AKIN GUMP
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Attorneys at Law

February 24, 2011
Page 2

Moody's utilized a number of these data collections in the development of M3 Subprime, which Moody's began to use as an input to the rating process in late 2006.

The acquisition of these databases was in addition to the data obtained on a regular basis by Moody's for the purposes of RMBS surveillance (which included loan level performance data).

As we described in our February 17, 2011 response, models are tools sometimes used in the process of analyzing credit risk, but Moody's ratings reflect the collective opinion of a rating committee as to the relative creditworthiness of the issuer or obligation.

The information provided today is confidential and proprietary in nature, and therefore we ask that it be kept confidential by the Committee and its staff. We also ask that the Committee staff provide us with notice and an opportunity to be heard before the Committee discloses any non-public information from this letter to third parties. Please let us know if you have any questions.

Sincerely,

Steven R. Ross
Counsel for Moody's Investors Service

cc: The Honorable Tom Coburn, Ranking Minority Member

DATE: 11/13/2000
TIME: 16:03:32 GMT
AUTHOR: Siegel, Jay
RECEIPIENT: Clarkson, Brian
CC:
SUBJECT: RE: MIC analytic software + Investment in analytics

Just got back today, here are some initial thoughts, I might want to follow-up in a few days when I've slept on it.

As you know, I don't think we need to spend a lot of $ or resources to improve the model from an analytic perspective; but I'd need to defer to people more in the loop (looks like you're that person) on whether the marketing component mandates some announcement of model and data improvement.

1. I think the 3 key issues on the "A" market are credibility of analytics (with the threshold for credibility being a lot lower than the need to out-do the MIs' and GSEs' models and certainly lower than the need to improve on FICO as a borrower quality tool (I assume you heard that this was one of the original objectives, right? else I can fill you in)), transparency, and either ease of use (if we share the model with the outside) or prompt and intelligent response (if we continue to have a reason to run the pools ourselves). I don't think these objectives require a huge expenditure if properly staffed and managed.

2. We need to decide again a key issue -- whether pools that are the same to our model will get different credit support levels based on subjective analysis of originators. If yes, this is another reason not to try to further refine the modelling - it would all wash out in the subjective adjustment. If no, we ought to share the model with the bankers and originators and reassign staff to other product types.

3. Make sure you talk to Noel and maybe Fons about the decision to buy the data; I was invited to the original meeting so that the powers that be (at the time) could understand the data originally used. I felt that the arguments for buying the data and re-inventing the model were not persuasive, and left that meeting believing that Noel and Jerry F. felt the same way. The most convincing argument for buying the data was that it would be a cornerstone for marketing, that S&P touted the size of their database as a competitive advantage and that this was why they had the market share advantage. HOWEVER:

a. Your market participant intelligence seems much better than what I believe was just anecdotal presumption for S&P's market share.

b. There are at least a dozen players out there (Fannie& Freddie, the large originators, the seven large Mortgage Insurers) who will always be able to outspend and "out-data" us, our ability to create a market-necessary model is very limited. Our sole advantage is our objectivity (hence the FHLBs use S&P's system and not the originators').

c. The data in question likely does not reflect a major stress situation (in contrast to what we had the last time), not sure that our Aaa levels would be much helped by slicing and dicing the performance of mortgages during a real estate boom.

4. The issue of whether people leave committees understanding the rating conclusions and being able to defend them is an issue you and I discussed in the past; your criticism is on point.

-----Original Message-----
From: Clarkson, Brian
Sent: Friday, November 03, 2000 9:46 AM
To: Zhai, David; Stesney, Linda
Cc: Gupta, Pramila; Silver, Andrew; Bankole, Ed; Kanef, Michael; Kimon, Noel; Adler, Michelle; Eisbruck, Jay; O'Connor, Michael; Siegel, Jay (MOODY'S)
Subject: RE: MIC analytic software + Investment in analytics

I have a wild thought also -- lets not even consider BUYING anymore data, programs, software or companies until we figure out what we have and what we intend to do with what we have. From what I have heard and read so far we have approaches (MBS, Tranching and Spread) few use or understand (let alone being able to explain it to the outside) and new data that we are unable to use. We want more data when most of the time we rate MBS deals using arbitrary rule of thumb?!! (i.e. earthquake coverage and hard floors made up by one person). And from what I have heard from market participants during the last few weeks the reason(s) we are not viewed as a player in the MBS market have little to do with anything set forth below. The reason the competition spends more is because they have a larger revenue base to absorb the expense. I suggest we spend less time asking for more data and software

PSI-MOODYS-RFN-000007

(I have not seen anything that sets forth the gains in revenue from such spending -- it is easy to ask for $$ -- much harder to justify it against competing projects) and more time figuring out how to utilize what we have by way of good analysis, a solid approach to this market a proper staffing model. I look forward to hearing all of your thoughts on how to resolve the issues in this market.

-----Original Message-----
From: Zhai, David
Sent: Wednesday, November 01, 2000 3:10 PM
To: Stesney, Linda
Cc: Gupta, Pramila; Silver, Andrew; Adelson, Mark; Bankole, Ed; Kanef, Michael; Kimon, Noel; Clarkson, Brian; Adler, Michelle
Subject: MIC analytic software + Investment in analytics

(1) MIC Software

There is a software called LPS by MIC selling for about $70,000 per year. We considered the option to buy it a few months back. This again was the money issue that Noel/Mark decided not to buy the piece prior to the spin-off. Therefore we only bought the raw data just for the re-modeling purpose.

In addition, The current functionality of the software is not as comprehensive as we desire, e.g., a black/closed box with no flexibility in getting loan-level statistics. Customization of it will cost us more money. In fact, even MIC's sales manager did not recommend that we buy the software because she thinks it was still premature.

I think the should add some value to our rating process if money is not an issue anymore. It will help our regular research, i.e., comparing pool performances. In addition, maybe we should consider INTEX software platform as well since it will boost ou

PSI-MOODYS-RFN-000008

AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

STEVEN R. ROSS
202 887.4343/fax: 202.887.4288
sross@akingump.com

February 17, 2011

VIA HAND DELIVERY
The Honorable Carl Levin
Chairman
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
199 Russell Senate Office Building
Washington, DC 20510

Re: Moody's Investors Service: Response to Follow-Up Question

Dear Chairman Levin:

On behalf of our client, Moody's Investors Service ("Moody's"), we respectfully submit this letter in response to the Committee's recent follow-up question about Moody's use of models. Specifically, your staff asked to be informed how underlying loan data has been used with respect to models.

Over the years, Moody's has developed a number of quantitative models which may be used as one of several inputs in the rating process for a wide variety of structured finance products. It is important to emphasize that Moody's credit ratings themselves are not derived solely from application of a mathematical process, or a "model." Models are tools sometimes used in the process of analyzing credit risk, but the credit rating process always involves much more, including the exercise of independent judgment by the members of the rating committee. Each rating reflects the collective opinion of a rating committee, and not the opinion of an individual analyst, as to the relative creditworthiness of the issuer or obligation.

Moody's ratings take into account qualitative as well as quantitative factors and are intended to reflect the exercise of the rating committee members' judgment about the expected creditworthiness of an obligation or entity. One quantitative factor considered by rating committee members includes historical, both recent and longer-term, performance of similar assets. Models, based on historic performance of the same or similar asset class, are one such input. The predicted impact of newer asset formulations and more recent market performance are elements that are brought to bear in the individual and collective exercise of judgment by the members of a rating committee.

AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

February 17, 2011
Page 2

With respect to previously-rated RMBS, Moody's generally receives, as part of the surveillance process, updated loan performance statistics on a monthly basis for the collateral pools of the transactions it has rated. As loan performance reflected by the monthly surveillance data began to deteriorate, Moody's sought to include an awareness of that information in the ratings process for newly-issued structured finance products. For example, the lead analyst for a particular transaction is often invited to participate in surveillance rating committees for that transaction to provide added perspective on the deal, and to gain an understanding of developing performance trends. This coordination between the surveillance and original rating functions facilitates a broad internal understanding and the best possible use of the most relevant performance data.

In addition, the actual recalibration of a statistical model requires a significant quantum of data. In constructing and estimating a model, a large amount of data representing a significant time period is assembled, cleaned and prepared. Loan performance information from new loan product types may be taken into consideration once there is sufficient history available that meets all necessary requirements, including the quality and breadth of the data. Until such time as reliable performance data becomes available and can be incorporated into a quantitative model, Moody's rating committees account for new loan product types through analyst judgment about the likely impact of such products on a given loan pool. This is but one of the reasons that rating committees utilize the output from a model as only one of many factors to consider when exercising their judgment. Rating committee members were aware of what was being seen in the data collected as part of the surveillance process and could incorporate that knowledge in the committees' considerations.

The information provided today is confidential and proprietary in nature, and therefore we ask that it be kept confidential by the Committee and its staff. We also ask that the Committee staff provide us with notice and an opportunity to be heard before the Committee discloses any non-public information from this letter to third parties. Please let us know if you have any questions.

Sincerely,

Steven R. Ross
Counsel for Moody's Investors Service

AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

February 17, 2011
Page 3

cc: The Honorable Tom Coburn, Ranking Minority Member

CAHILL GORDON & REINDEL LLP
EIGHTY PINE STREET
NEW YORK, NY 10005-1703

TELEPHONE: (212) 701-3000
FACSIMILE: (212) 269-5420

1990 K STREET, N.W.
WASHINGTON, DC 20006-1181
(202) 862-8900
FAX: (202) 862-8958

AUGUSTINE HOUSE
6A AUSTIN FRIARS
LONDON, ENGLAND EC2N 2HA
(011) 44.20.7920.9800
FAX: (011) 44.20.7920.9825

WRITER'S DIRECT NUMBER

(212) 701-3693

February 10, 2011

Re: Standard & Poor's

Dear Laura:

I write regarding your request for a summary of the data that Standard & Poor's purchased in connection with the development of its RMBS collateral model (known as LEVELS). I understand that the Subcommittee is preparing a final memorandum following up on the Chairman's April 23, 2010 memorandum to the members of the Subcommittee, and that you are seeking to verify information concerning the data that S&P purchased regarding RMBS collateral.

S&P purchased loan-level performance data with regard to residential mortgage loans on an ongoing basis for use in developing its criteria with regard to rated RMBS securities, and specifically with regard to S&P's expected performance of the loans backing such securities. As requested, a summary of the times such data was purchased follows:

Year Purchased	Approximate Number of Loans	Summary of Loan Characteristics
2000	166,000	Primarily first lien, fixed rate, prime.
2002	643,000	Expanded to include ARM loans and hybrid loans.
2003	269,000	Conforming residential mortgages in connection with developing criteria for use with pools of conforming loans.

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #1128

Year Purchased	Approximate Number of Loans	Summary of Loan Characteristics
2005	2.9 million	First and second lien loans, including prime, subprime, Alt-A, High LTV and HELOC loans.

These data sets were not direct inputs into the LEVELS model at any time, but rather were the subject of research and analysis toward the development of S&P criteria. As Scott Mason described during his interview by your Staff, the criteria development process involves more than the quantitative analysis of historical data. S&P reviews that data and applies the judgment and experience of its analysts to form opinions about possible future performance, taking into account the specific characteristics of the loans under review. S&P also purchased other data sets for different purposes, including data from millions of loans for development of criteria regarding housing prices.

Accordingly, it is not accurate to say, as the April 23, 2010 memorandum does on pages 7 and 10, that "S&P's models did not contain adequate data" for various types of subprime mortgages. Indeed, S&P's models do not "contain" historical data at all, but instead incorporate and apply S&P's *criteria*, and that criteria was not driven by any particular data set of historical loan information.

The data sets purchased by S&P over this time period were the subject of an ongoing research effort toward the development of an econometric equation for predicting potential mortgage defaults, but the results of those efforts were deemed to be insufficiently reliable to be incorporated into S&P's models. For example, an equation that was developed, in 2004, from the data set of 643,000 loans resulted in *lower* predicted defaults for ARM and hybrid loans than for fixed-rate loans – i.e., the equation predicted that such loans were less risky than fixed-rate loans – a result that was considered counter-intuitive and unreliable.

In its decision not to adopt such an equation as part of its criteria, S&P chose *not* to do precisely what the April 23, 2010 memorandum says it did: it chose *not* to incorporate in its models an equation driven directly and solely by historical data, because S&P did not believe that the equation adequately predicted how certain types of mortgages, such as adjustable rate and hybrid mortgages might perform.

The testimony that the Subcommittee received from S&P's former employee Frank Raiter is inaccurate and unreliable on this subject. Mr. Raiter testified that a version of the LEVELS model was introduced in 2002 or 2003 "based on approximately 650,000" loans. We believe Mr. Raiter is referring to the 2002 data set identified above, but no equation derived using that data set was ever implemented in the LEVELS model for the reasons described above.

Delivery of the 2.9 million data set for analysis did not occur until after Mr. Raiter retired from S&P and he had no involvement in, or access to, that data or any analysis of it. Although an econometric equation of the type considered in 2004 was never deemed appropriate for S&P criteria, S&P continued its concerted efforts to analyze that data, both by employing external consultants and dedicating resources within Standard & Poor's to analyze the data for criteria development.

While it is true, as S&P has said previously, that some loan data – such as borrower FICO scores – has turned out recently to be less predictive of defaults than it had been historically, the analysis of historical data was only one of many factors that S&P took into account in developing opinions about future performance. More fundamentally, the extent and impact of the housing market collapse in 2007 was more severe and precipitous than S&P, like so many others, anticipated.

Sincerely,

S. Penny Windle

Laura E. Stuber, Esq.
Counsel
Permanent Subcommittee on Investigations
199 Russell Senate Office Building
Washington, DC 20510

BY E-MAIL

Footnote Exhibits - Page 0674

STANDARD
&POOR'S

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #1131

Standard & Poor's LEVELS®

Scott Mason
Standard & Poor's

February 2010

The McGraw-Hill Companies

PSI-Standard&Poor's-04-0001

Footnote Exhibits - Page 0675

What Does LEVELS Do?

- **LEVELS analyzes a loan, or pool of loans**
- **Provides an assessment of Foreclosure Frequency, Loss Severity, and Credit Enhancement**

1.

STANDARD &POOR'S

PSI-Standard&Poor's-04-0002

Foreclosure Frequency – Key Drivers

- Loan-to-Value (LTV)
- Occupancy Status
- Property Type
- Loan Purpose
- Loan Balance
- Loan Type
- FICO Score
- Documentation

STANDARD & POOR'S

PSI-Standard&Poor's-04-0003

Loss Severity – Key Drivers

- Loan-to-Value (LTV)
- Assumed Market Value Declines (MVD)
- Housing Volatility Index
- House Price Index
- Foreclosure Timelines

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Credit Enhancement

Foreclosure frequency x loss severity = loss coverage

Foreclosure Frequency	=	The ratio of loans in a pool expected to default
Original Home Value less Market Value Decline	=	Market Price
Loan Balance less Market Price	=	Market Loss
Market Loss + Foreclosure Costs	=	Total Loss ($ amount)
Loss Severity %	=	Total Loss / Loan Balance

STANDARD &POOR'S

PSI-Standard&Poor's-04-0005

Footnote Exhibits - Page 0679

LEVELS – Criteria Updates

- **S&P is committed to continually updating the methodology and assumptions upon which its RMBS ratings are based.**
- **Since 2001, S&P has updated its LEVELS model 18 times.**

5.

STANDARD &POOR'S

PSI-Standard&Poor's-04-0006

LEVELS 5.4.2 – March 27, 2001

- Incorporated updated or new rating criteria for simultaneous second lien mortgages, hybrid adjustable-rate mortgage loans and subprime loans
- Included an updated version of Standard & Poor's Economic Index, adjusting for projected real estate price fluctuations

STANDARD &POOR'S

Footnote Exhibits - Page 0681

LEVELS 5.4.2(a) – J ly 10, 2001

- Updated base case foreclosure frequency based upon a review of a sampling of loans

7.

STANDARD & POOR'S

PSI-Standard&Poor's-04-0008

LEVELS 5.5 – April 3, 2002

- Included criteria revisions and several model performance enhancements, including the new Standard & Poor's House-Price Volatility Index

STANDARD &POOR'S

LEVELS 5.6 – December 1, 2003

- **Updated data requirements to include:**
  - Asset verification
  - Appraisal types
  - Automated Valuation Model use and type
  - Self-employed borrower
  - NextGen FICO
  - Indicate High Cost or Covered Loan
  - Manufactured Housing Property type field added
- **Housing Volatility Index Updated**
- **New Manufactured Housing assumptions built into the model**

STANDARD
&POOR'S

PSI-Standard&Poor's-04-0010

LEVELS 5.6 Continued

- **Revised Loss Severity Model with benchmarks for:**
  - Time to initiate foreclosure
  - Time to foreclose
  - Bankruptcy delays
  - Eviction delays
  - Preservation costs
  - Legal costs
  - Amounts escrowed for taxes and insurance
  - Brokerage cost; and
  - Appraisal and lien search

STANDARD &POOR'S

PSI-Standard&Poor's-04-0011

LEVELS 5.6(a) – September 1, 2004

- **Instituted new foreclosure frequency multiples**
  - Foreclosure frequency multiple calculation was refined

STANDARD &POOR'S

PSI-Standard&Poor's-04-0012

LEVELS 5.6(b) – February 1, 2005

- Updated foreclosure frequency and loss severity assumptions for ARM loans
- Updated foreclosure frequency assumptions for interest-only loans

STANDARD &POOR'S

PSI-Standard&Poor's-04-0013

LEVELS 5.6(c) – August 1, 2005

- Incorporated Option ARM (Negative Amortization) assumptions
- New adjustments to loss coverage for small pools
- Adjusted LTV's of loans to account for curtailments to non-seasoned loans

STANDARD &POOR'S

PSI-Standard&Poor's-04-0014

LEVELS 5.6(d) – March 1, 2006

- Incorporated a discount to the amount of home price appreciation indicated by the Housing Price Index
- For Option ARM loans that have experienced negative amortization, the original balance of the loan will be used to calculate adjusted LTV

STANDARD &POOR'S

PSI-Standard&Poor's-04-0015

LEVELS 5.7 – July 1, 2006

- Adjusted foreclosure frequency on first lien loans with simultaneous second liens, based on loan level analysis
- Increased the base case foreclosure frequency for loans with a high probability of default due to increased risk layering
- Adjusted foreclosure frequency multiples
- Updated Housing Volatility Index assumptions

STANDARD & POOR'S

PSI-Standard&Poor's-04-0016

LEVELS 6.0 – June 1, 2007

- Incorporated into LEVELS the ability to analyze Closed End Second lien loans and loans with Combined Loan to Value ratio (CLTV) up to 100
- CLTV used for foreclosure frequency calculation rather than LTV
- For a first lien loan with a simultaneous second lien, CLTV is used to calculate foreclosure frequency

STANDARD & POOR'S

PSI-Standard&Poor's-04-0017

LEVELS 6.1 – November 12, 2007

- **Reduced reliance on FICO score as a predictor of default**
- **Increased foreclosure frequency assumptions for the following:**
  - two-year hybrid ARMS
  - low FICO and High CLTV purchase money loans
  - stated income and no income documentation loans
- **Updated Housing Volatility Index adjustments**

STANDARD & POOR'S

LEVELS 6.2 – January 9, 2008

- Loans coded with unknown appraisal type assessed a 100% loss severity
- Adjusted the primary mortgage insurer ratings affecting loss severity:
  - **10 = Mortgage Guaranty Insurance Corp. (MGIC) from AA downgrade to AA-**
  - **16 = MGIC Indemnity from AA downgrade to AA-**
  - **19 = Triad Guaranty Insurance Co. from AA downgrade to AA-**

STANDARD & POOR'S

PSI-Standard&Poor's-04-0019

LEVELS 6.3 – March 14, 2008

- Increased functionality with respect to home equity line of credit (HELOC) loans
- Adjustments to delinquency assumptions
- Updated loss severity assumptions based on certain state foreclosure timeline extensions
- Updated data regarding the rating levels of mortgage insurers
- Updated Housing Price Index

STANDARD &POOR'S

LEVELS 6.4.3 – July 14, 2008

- Adjusted the loan-level probability of default assumptions for certain loan types, including short-term hybrid adjustable-rate mortgage loans, interest-only mortgage loans, and mortgage loans that allow for negative amortization
- Updated Housing Price Index
- Revised the Housing Volatility Index
- Adjusted the impact of loan-to-value ratios and combined loan-to-value ratios on credit enhancement
- Revised loan-level adjustments for credit enhancement from the inclusion of primary mortgage insurance

STANDARD &POOR'S

LEVELS 6.5 – December 2, 2008

- Updated loan-level adjustments for primary mortgage insurance
- Updated corporate credit ratings for various primary mortgage insurers
- Updated foreclosure frequency adjustments for all document type codes
- New loss severity adjustments for loans to which an automated valuation model is the primary appraisal type
- Updated Housing Price Index
- New reports summarizing the originator and due diligence fields
- Added four fields relating to third-party due diligence

STANDARD &POOR'S

PSI-Standard&Poor's-04-0022

LEVELS 6.6 – March 31, 2009

- Added VantageScore as an acceptable borrower credit scoring model
- New documentation type code, "P," which indicates that employment was verified verbally, and income was verified by IRS transcripts through the use of IRS Form 4506T
- Updated foreclosure frequency adjustments for "C" and "V" documentation type codes
- Updated Housing Price Index
- Updated counterparty credit ratings for various primary mortgage insurers

STANDARD &POOR'S

PSI-Standard&Poor's-04-0023

LEVELS 7.0 – September 17, 2009

- **Revised credit enhancement adjustment factors to assess the risk in pools of mortgage loans based on loan and borrower characteristics relative to the archetypical pool**
- **Updated data requirements, including:**
  - Added required fields to analyze the flow of funds in a transaction structure
  - Updated to reflect the current corporate credit ratings of mortgage insurance companies
  - Added a requirement that the total debt-to-income ratio be provided for each loan

STANDARD & POOR'S

LEVELS 7.1 – February 11, 2010

- Revised 25 of S&P's state-specific assumptions with respect to timelines for foreclosing on a mortgage loan
- Updated Housing Price Index
- Updated counterparty credit ratings and capital adequacy ratios for affected primary mortgage insurers

STANDARD
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PSI-Standard&Poor's-04-0025

Examination Report for Standard and Poor's Ratings Services, Inc. ("S&P")

1. Introduction

On August 31, 2007, the Staff in the Commission's Office of Compliance Inspections and Examinations ("OCIE"), Division of Trading and Markets ("Trading & Markets") and Office of Economic Analysis ("OEA") (collectively "the Staff") initiated an examination of S&P, and two other credit rating agencies. The focus of the examinations was S&P's activities in rating subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") linked to subprime RMBS.[1] Specifically, key areas of review included:

- the NRSROs' ratings policies, procedures, and practices, including gaining an understanding of ratings models, assumptions, criteria and protocols;
- the adequacy of the disclosure of the ratings process and methodologies used by the NRSROs;
- whether the NRSROs complied with their ratings policies and procedures for initial ratings and ongoing surveillance;
- the efficacy of the NRSROs' conflict of interest policies and procedures; and
- whether ratings were unduly influenced by conflicts of interest related to the NRSROs' role in bringing issues to market and the compensation they received from issuers and underwriters.

The examinations also included a review of whether there were any errors in ratings issued as a result of flaws in ratings models used in response to a press report indicating errors in one firm's model.[2] Initial observations as a result of this aspect of the examinations are included in this report.

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1 Beginning in 2007, delinquency and foreclosure rates for subprime mortgage loans in the United States dramatically increased, creating turmoil in the markets for RMBS backed by such loans and CDOs linked to such loans (collectively "subprime RMBS and CDOs"). As the performance of these securities continued to deteriorate, the three NRSROs most active in rating these instruments downgraded a significant number of their ratings. The NRSROs' performance in rating these structured finance products raised questions about the accuracy of their credit ratings generally as well as the integrity of the ratings process as a whole.

2 See Sam Jones, Gillian Tett, and Paul J. Davies, *Moody's Error Gave Top Ratings to Debt Products*, Financial Times, May 20, 2008, at 1.

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #1145

PSI-SEC (S&P Exam Report)-14-0001

The examination review period generally covered January 2004 through 2007. The firms under examination became subject to the provisions of the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act"), which amended the Securities Exchange Act of 1934 ("Exchange Act"), and the Commission's rules when they registered with the Commission as NRSROs in September 2007. Although S&P was not subject to legal obligations applicable to NRSRO during most of the review period, the Staff nonetheless sought to make relevant factual findings and observations with respect to the activities of S&P in rating subprime RMBS and CDOs during the period, as well as to identify possible areas for improvement in their practices going forward.

Over 50 Commission Staff participated in the examinations of S&P, and two other NRSROs. The examinations included extensive on-site interviews with the rating agencies' staff, including senior and mid-level managers, initial ratings analysts and surveillance analysts, internal compliance personnel and auditors, personnel responsible for building, maintaining and upgrading the ratings models and methods used in the ratings process, and other relevant rating agency staff.

In addition, the Staff reviewed a large quantity of the NRSROs' internal records, including the written policies, procedures and other such documents related to initial ratings, the ongoing surveillance of ratings, and the management of conflicts of interest, and the public disclosures of the procedures and methodologies for determining credit ratings. The Staff also reviewed deal files for subprime RMBS and CDO ratings, internal audit reports and records, and other internal records, including a large quantity of email communications records (the NRSROs produced over two million emails and instant messages that were sorted, analyzed and reviewed using software filtering tools). Finally, the Staff reviewed the NRSROs' public disclosures, filings with the Commission, and other public documents.

2. The Ratings Process

The Rating Agency Act expressly states that the Commission has no authority to regulate the "the substance of the credit ratings or the procedures and methodologies" by which any NRSRO determines credit ratings.[3] As part of these examinations, however, the Staff necessarily sought to develop an understanding of the quantitative analysis used to rate the RMBS and CDOs that have been subject to such dramatic and widespread change.

S&P rates RMBS and CDO transactions by first assessing the underlying collateral and then assessing the deal structure. For RMBS, S&P utilizes its Loan Evaluation and Estimate of Loss System ("LEVELS") model as the basis for the foreclosure frequency and loss severity analyses of a deal's underlying collateral.[4] S&P evaluates cash flows in

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3 15 U.S.C. 78o-7(c)(2).

4 S&P developed the assumptions for the LEVELS model during the 1970's and 1980's, using empirical observations of mortgage default rate data going back at least as far as the Great Depression, which represented the "worst case scenario." As of March 14, 2008, LEVELS, included a total of 77 possible factors, 38 of which are required, related to the loans that are loaded

the Standard & Poor's Interest Rate Evaluator ("SPIRE") model. S&P uses its CDO Evaluator to estimate the gross level of defaults in proposed CDO asset pools.[5] When analyzing cash flow for CDOs, after the CDO Evaluator process, S&P runs a cash flow analysis in a proprietary cash flow model called Genesis.[6] Results from the collateral and cash flow models are subjected to the committee approval process before a final rating is issued.

S&P also used spreadsheets and other models outside LEVELS to rate non-routine loans until they could be incorporated into the RMBS model. For instance, as the market for non-first lien mortgages grew in the late 1990's and early 2000's, S&P developed more simplified spreadsheet-based models to accommodate the rating of pools of such loans until S&P was able to incorporate such modeling into the LEVELS in late 2007.[7]

3. Increase in Number and Complexity of RMBS and CDO deals

From 2002 to 2006, the volume of structured finance deals rated by S&P increased substantially, as did the revenues S&P received from rating those deals. The structured products that S&P rated became increasingly complex, with many employing derivatives such as credit default swaps to replicate the performance of mortgage backed securities. Further, the loans made to retail borrowers being securitized evolved from 30-year fixed rate instruments to newer products such as second lien and adjustable rate mortgages. The increasing number and complexity of deals may have compromised various aspects of S&P's ratings operations for structured finance, as discussed in greater detail below.

a. Revenue, Deal, and Staffing Levels

From 2002 to 2006, the volume of RMBS deals rated by S&P increased by 130%, and the number of CDO deals rated by S&P increased by over 900%.[8] Correspondingly, the revenue S&P derived from RMBS deals increased from $57 million in 2002 to $190.7

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into LEVELS. Loan level information in the tape that is analyzed by LEVELS includes the type of property securing the mortgage, whether the property is occupied, the level of documentation presented by the borrower, the type and term of the loan, and the ratio of the amount of the loan to the value of the residence.

5 CDO Evaluator is made publicly available.

6 The Genesis model is not publicly available. S&P, however, discloses the inputs and criteria used in this cash flow model. For a synthetic CDO there is no need for a cash flow model as payments from the credit default swap exactly equal what is due on liabilities and there is no additional risk aside from credit risk, which is modeled in Evaluator.

7 Representation by Frank Parisi, former Director, Structured Finance, S&P on May 27, 2008 teleconference with Commission Staff.

8 See Letter from Mari B. Maloney, Chief Compliance Officer, Ratings Services, Global Regulatory Affairs, S&P to Matthew Daugherty, Senior Special Counsel, OCIE, SEC (Mar.14, 2008). RMBS deals increased from 713 to 1,639 during that time. CDO deals increased from 34 to 343 during that time.

million in 2006 and CDO revenue increased from $10.1 million in 2002 to $98.7 million in 2006.

For the RMBS group, contemporaneous staffing increases appear roughly in line with volume increases (S&P increased RMBS staff by 168% as volume increased by 130%).[9] For CDOs, however, S&P's staffing increases do not appear to have kept pace with volume increases (S&P increased CDO staff by 119% as volume increased by over 900%).[10]

b. Impact on Ratings Process

The Staff believes that the deal and staffing levels during the review period may have impacted various aspects of the ratings process. For instance, an instant message exchange between the primary analyst on a CDO deal and a member of the deal's rating committee revealed the following:

- Shah: "btw - that deal is ridiculous"
- Mooney: "I know right...model def does not capture half of the..." "risk"
- Shah: "we should not be rating it"
- Mooney: "we rate every deal" "it could be structured by cows and we would rate it"
- Shah: "but there's a lot of risk associated with it - I personally don't feel comfy signing off as a committee member."[11]

In another example, an S&P Associate Director in the Global CDO Group writes to a Director in the Global CDO Group that "Rating Agencies continue to create and [sic] even bigger monster – the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters.;o)"[12]

The Staff also identified internal communications in structured finance groups other than RMBS and CDO that indicated various staffing issues during the review period. For instance, in one email the Managing Director of Global Real Estate Finance states that "[o]ur staffing issues, of course, make it difficult to deliver the value that justifies our

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9 RMBS staff increased from 31 to 83 during the time period.

10 CDO analytical staff increased from 36 to 79 between 2002 and 2006. S&P has indicated that the support from the Synthetic ABS group and quantitative group are particularly important for CDOs. If the Synthetic ABS group's staff is included in the number, the increase is from 36 to 88 (144%). If the quantitative group's staff is also included, the increase is from 36 to 99 (175%).

11 Instant message exchange between Shannon Mooney, Rating Analyst, Quantitative Support, Global CDO Group, S&P, and Rahul Dilip Shah, Associate, Analytical Pool, Global CDO Group, S&P (Apr. 5, 2007, 3:56 PM). Ellipses both in original and added.

12 Email from Chris Meyer, Director, Analytical Pool, Global CDO Group, S&P, to Belinda Ghetti, Director, Global CDO Group, S&P (Dec. 15, 2006, 8:31 PM).

fees"[13] and states in another email that "[t]ensions are high. Just too much work, not enough people, pressure from company, quite a bit of turnover and no coordination of the non-deal "stuff" they want us and our staff to do."[14] Similarly, an email from an Analytical Coordinator in the ABS Group states that [w]e ran our staffing model assuming the analysts are working 60 hours a week and we are short on resources. . . . The analysts on average are working longer than this and we are burning them out. We have had a couple of resignations and expect more. It has come to my attention in the last couple of days that we have a number of staff members that are experiencing health issues."[15]

The Staff believes that the increase in the number and complexity of deals may have further impacted S&P's structured finance ratings operations, as is discussed in more detail below.

The Staff recommends that S&P periodically evaluate if it has sufficient staff and resources to manage its volume of business and meet its obligations under the Rating Agency Act.

S&P's Response:

In its response,[16] S&P stated that it believes its staff increases between 2002 and 2006 were appropriate. S&P noted that it does not have a discrete pool of analysts who rate CDOs of RMBS deals. The staffing levels of CDO analysts noted in its March 14, 2008 letter, therefore, represent analytical staff that worked on any type of CDO, not just CDOs of RMBS. Moreover, it notes that the number of all CDO transactions increased more modestly between 2002 and 2006 than the number of RMBS-related CDOs. In making the case that staffing levels for CDOs were appropriate, S&P notes that including support from members of the Synthetic ABS Group and the additional quantitative support group, which are both important contributors to the CDO rating process decreases the ratio of deals to staff. However, S&P notes that, even without including such supporting staff, it believes that the ratio of deals per analyst that it had in the CDO Group in 2006, was an appropriate level.

13 Email from Gale Scott, Managing Director, Global Real Estate Finance, S&P, to David Klein, Vice President of Finance, Structured Finance Group, S&P (Apr. 27, 2007, 1:13 PM).

14 Email from Gale Scott, Managing Director, Global Real Estate Finance, S&P, to Diane Cory, External Consultant, Structured Finance Group, S&P (May 3, 2006, 10:20 AM).

15 Email from Gail Mcdermott, Analytical Coordinator, ABS Group, S&P, to Abe Losice, Managing Director, RMBS Group, S&P (Dec. 3, 2004, 11:10 AM).

16 See Letter from Vickie A. Tillman, Executive Vice President, Ratings Services, S&P to A. Duer Meehan, OCIE, SEC (June 27, 2008).

S&P stated that it will take prompt steps to conduct a review of structured finance staffing levels and will continue to reevaluate its staffing levels to ensure that they are appropriate and in compliance with the Rating Agency Act.

4. Disclosure of the Ratings Process

The new requirements of the Rating Agency Act specifically address the importance of disclosure. An NRSRO is required to disclose publicly the procedures and methodologies it uses in determining credit ratings.[17] Form NRSRO requires that this disclosure be a general description but sufficiently detailed to provide users of credit ratings with an understanding of the processes employed in determining credit ratings, including, among other things, the quantitative and qualitative models and metrics used to determine credit ratings. S&P explained to the Staff that, prior to being registered as an NRSRO, it disclosed its ratings process during the review period. It appears, however, that certain significant aspects of the rating processes and the methodologies used to rate RMBS and CDOs were not always disclosed, or were not fully disclosed, as summarized below.

For RMBS and CDOs, if a material rating change is approved, S&P's policy is that its terms are communicated both internally and publicly.[18] When new criteria, or changes to existing criteria, are implemented, S&P may apply such changes prior to publication, depending on the circumstances.[19] In its review, the Staff observed a number of occasions where S&P implemented changes to its RMBS ratings criteria outside its SPIRE and LEVELS models without promptly publishing such changes.[20] In published documents, S&P states that when it assigns ratings to structured finance securities, it uses a general framework and established guidelines, as well as various quantitative techniques and models to enhance the rating committee's qualitative opinions. S&P states that these qualitative opinions are an integral part of its rating process.[21] Based on review of produced documents, it does not appear that S&P specifically disclosed which

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17 Section 4(a)(1)(B)(ii) of the Exchange Act.

18 See "Ratings Services, Criteria Process Guidelines," (Mar. 21, 2008) provided under cover of letter from Mari Maloney, Chief Compliance Officer, S&P, to Matthew Daugherty, Senior Special Counsel, OCIE, SEC (June 12, 2008). The guidelines, which contain a publication date of March 21, 2008, are a recently revised and updated version of S&P's criteria process.

19 Id. The guidelines do not provide guidance for such circumstances.

20 See RMBS Criteria Alert #64, dated March 24, 2004, RMBS Internal Analyst Alert #112, dated June 25, 2007, RMBS Criteria Alert, dated October 19, 2006, respectively. Examples include decreasing foreclosure frequency assumptions for pools of first lien 100% LTV loans made to borrowers with minimum FICO scores of 700, increasing AAA loss coverage by 1 basis point for every 1% of a mortgage pool with "non-standard" mortgage insurance, and increasing its foreclosure frequency assumptions for loans that came to S&P on the tape already more than 30 days delinquent.

21 See Principles-Based Rating Methodology for Global Structured Finance Securities," dated May 29, 2007.

out-of-model adjustments a ratings committee may use in determining the ratings for CDOs, or how much weight the rating committee gave to such factors.[22]

The Staff found several communications by S&P employees to outside parties related to the application of unpublished criteria, such as "not all our criteria is published. [F]or example, we have no published criteria on hybrid deals, which doesn't mean that we have no criteria"[23] and "[a]s I pointed out, there is [sic] many pieces of criteria that has [sic] not yet been published. Does that mean it is not criteria? No."[24] Another email states, "[O]ur published criteria as it currently stands is a bit too unwieldy and all over the map in terms of being current or comprehensive. It might be too much of a stretch to say that we're complying with it because our SF [structured finance] rating approach is inherently flexible and subjective, while much of our written criteria is detailed and prescriptive. Doing a complete inventory of our criteria and documenting all of the areas where it is out of date or inaccurate would appear to be a huge job - that would require far more man-hours than writing the principles-based articles."[25]

S&P indicated to the Staff that, as a general practice, it did not adjust an RMBS collateral or cash flow analysis based upon factors that were not incorporated into its LEVELS or SPIRE models.[26] However, the Staff observed instances in its deal files that demonstrated adjustments from its models. For example, one RMBS deal was characterized by two tranches that failed one of the cash flow stress tests, but was nonetheless given the rating under which the tranches failed.[27] In another deal, the margins/coupons in seven of the tranches are different than the structure run in SPIRE.[28] In addition, the Staff observed instances where S&P implemented changes to its ratings criteria which were not incorporated into its LEVELS or SPIRE models.[29]

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22 Qualitative factors which influence the rating committee's decision may result in changes to the structure of the deal or additions and/or modifications to covenants in the deal documents in order to mitigate risks which concern the ratings committee.

23 Email from Anna Widernik, Director, Analytical Pool, Global CDO Group, S&P, to Scott Farrell, Marathon Fund/Issuer (Aug. 31, 2006, 12:04 PM).

24 Email from Jean-Baptiste Carelus, Director, Global CDO Group, S&P, to Brian Rance, Freshfields Bruckhaus Deringer LLP/External Issuer Attorney (Dec. 15, 2006, 12:08 PM).

25 Email from Calvin Wong, Chief Criteria Officer, Structured Finance Surveillance Group, S&P, to Tom Gillis, Managing Director, Research and Criteria, S&P (Mar. 14, 2007, 6:45 PM).

26 Representation by Scott Mason, Director, RMBS Group, S&P, to SEC Staff on December 12, 2007.

27 The SPIRE output indicated "minor int SF ok, per TO." MLMI 2006-RM5. Staff from S&P indicated that the structure was allowed to pass because the interest shortfalls at the two tranches were *de minimis*. Representation by Scott Mason, RMBS Director on June 20, 2008.

28 See HASCO-2006-WMC1.

29 Examples include decreasing the LEVELS foreclosure frequency assumptions for pools of first lien 100% loan-to-value loans made to borrowers with minimum FICO scores of 700, and

The Staff recommends that S&P conduct a review of its current disclosures of its processes and methodologies for rating subprime RMBS and CDOs to assess whether it is fully disclosing its ratings methodologies, and is meeting the requirements of the Rating Agency Act and Form NRSRO. Further, the Staff recommends that S&P review whether its policies governing the timing of disclosure of a significant change to a process or methodology are reasonably designed to comply with these requirements.

S&P's Response:

S&P emphasized the transparency of its rating process by noting, among other things, that it "generally announces" all material changes to its criteria through formal publication. S&P has noted, that although it has developed unpublished criteria in the past, that it has recently formalized policies and procedures related to the publication of criteria. S&P further stated that it consistently publicly discloses the limits of its models. S&P further notes that rating committees are not limited to considering the results of the model outputs in arriving at a rating, because, among other things, S&P's rating models, including SPIRE, do not always consider all of S&P's rating criteria. S&P further noted that it does not, as a matter of routine, memorialize its decisions to adjust model outputs.

S&P stated that it will take prompt steps to conduct the review of the policies and procedures regarding disclosure of the RMBS and CDO rating process, and noted that it had already taken significant steps to enhance its criteria publication process.

5. Written Policies and Procedures for Rating RMBS and CDOs

a. General Policies and Procedures

As of September 2007, NRSROs became subject to a requirement to make and retain certain internal documents relating to its business, including procedures and methodologies used to determine credit ratings.[30] S&P has a public document known as the "U.S. Residential Subprime Mortgage Criteria," which pre-dates this requirement and serves as a guide to its subprime RMBS analytical process. With respect to CDOs, S&P published a "Global Cash Flow and Synthetic CDO Criteria" on March 21, 2002.[31] This document outlines the numerous components of the CDO cash flow and synthetic CDO ratings process including S&P's review of the CDO manager, the analysis of the

increasing LEVELS AAA loss coverage by one basis point for every 1% of a mortgage pool with "non-standard" mortgage insurance. See RMBS Criteria Alert #64, dated March 24, 2004, and RMBS Criteria Alert dated October 19, 2006, respectively.

30 Exchange Act Rule 17g-2. 17 CFR 240.17g-2.

31 See S&P-SEC-002944. This document also is available on the S&P website.

transaction structure, the quantitative models used, and the surveillance process. This document was updated in 2004 and 2006.[32]

However, the Staff observed that S&P had a number of undocumented policies and procedures for rating RMBS and CDOs.[33] The Staff also observed that S&P's ratings policies and procedures that did exist were scattered among numerous documents, rather than in one consolidated location or document.[34] The non-standard nature of S&P's structured finance procedures, publication and disclosure policies over the review period may have impacted its compliance with the ratings process. For instance, in a communication related to upcoming NRSRO registration, the Chief Criteria Officer in the Structured Finance Surveillance Group at S&P states:

> "[O]ur published criteria as it currently stands is a bit too unwieldy and all over the map in terms of being current or comprehensive. It might be too much of a stretch to say that we're complying with it because our SF [structured finance] rating approach is inherently flexible and subjective, while much of our written criteria is detailed and prescriptive. Doing a complete inventory of our criteria and documenting all of the areas where it is out of date or inaccurate would appear to be a huge job - that would require far more man-hours than writing the principles-based articles."[35]

The Staff recommends that S&P conduct a review to assess whether its written policies and procedures used to determine credit ratings for RMBS and CDOs are fully documented in accordance with the requirements of Exchange Act Rule 17g-2.

S&P's Response:

S&P responded that it does not believe that it can or should prescribe fixed analytical steps that the analysts should follow for all structures that S&P might rate, because such rules could oversimplify the rating process and ignore the uniqueness of each deal. S&P notes that it has adopted several measures[36] to ensure consistency of criteria application

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32 See S&P-SEC-002864. S&P also publishes an "Introduction to CDOs and Standard & Poor's Global CDO Ratings." See S&P-SEC-003369. S&P also has published a "Global Synthetic Securities Criteria." See S&P-SEC-002736.

33 For instance ,S&P did not address the use of outside models, including the use of alternatives to the RMBS cash flow model, SPIRE, and the CDO cash flow model, Genesis.

34 See e.g. S&P Role of Rating Committee Chairperson (June 26, 2007), S&P Analytic Documentation Policy (June 26, 2007), and S&P Global Rating Services' Rating Decision-Making Standards Policy (April 3, 2007).

35 Email from Calvin Wong, Chief Criteria Officer, Structured Finance Surveillance Group, S&P, to Tom Gillis, Managing Director, Research and Criteria, S&P (Mar. 14, 2007, 6:45 PM).

36 These measures include encouraging analysts to engage in ongoing dialogue with their peers and supervisors, hiring experienced analysts, using "project leads" (senior analysts) on each deal, and providing internal guidance on how to apply new ratings approaches.

at the deal level, and does not believe that its approach prevents analysts from consistently applying its criteria.

While S&P does not agree with the Staff's findings on this point, S&P stated that will take prompt steps to review its policies and procedures to ensure that it has appropriately detailed policies and procedures to follow throughout the deal rating process.

b. Policies and Procedures Regarding Technical Errors

As a result of recent attention in the financial press regarding a rating agency's application of flawed rating models to constant proportion debt obligation ("CPDO")[37] deals, the Staff expanded the scope of its exams to review any assignments of erroneous ratings by S&P for any RMBS, CDO and CPDO ratings issued since 2004, as well as S&P's policies for dealing with the discovery of errors in the models and methodologies. In response, S&P indicated that a beta version of its CPDO Evaluator model contained a coding error that was discovered by surveillance in late 2007, which led the model to use a higher discount factor in assessing certain incoming and outgoing cash flows. According to S&P, the error was immediately corrected.[38] Following detection of the error, S&P reviewed the five CPDO transactions in which the beta version was used to make a public rating, and determined that none of the resulting differences in interest rates and discount factors between the erroneous model and corrected model merited a rating action. S&P identified its ratings and criteria committee processes, its transparency, and its surveillance process as "policies and practices" that further the goal of identifying errors.[39]

The staff recommends that S&P review its procedures to identify, correct and rectify errors in its ratings models and methodologies.

S&P's Response:

S&P noted that it already has begun the process of addressing the issue of policies and procedures to detect and disclose errors in the rating process by developing an internal review process for assessing model quality. The process will assess whether S&P's current models remain suitable for their intended use, and will consider all relevant aspects of the models under review.

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37 CPDOs are a type of credit derivative sold to investors looking for long term exposure to credit risk on a highly rated note. Investors buy notes issued by a special purpose vehicle ("SPV").

38 See Letter from Vickie A. Tillman, Executive Vice President, Ratings Services, S&P to A. Duer Meehan, Associate Director, OCIE, SEC (June 12, 2008).

39 Id.

6. Integrity and Accuracy of the Information Provided to S&P

There is no requirement under the federal securities laws that an NRSRO verify the information contained in RMBS loan portfolios presented to it for rating. Additionally, NRSROs are not required to insist that issuers perform "due diligence," and they are not required to obtain reports concerning the level of due diligence performed by issuers.

The Staff notes that pursuant to its policies, procedures, and public pronouncements, S&P did not engage in any due diligence or otherwise seek to verify the accuracy and quality of the loan data underlying the RMBS pools it rated during the review period. In fact, S&P's Code of Ethics clearly states it is under no obligation to perform, and does not perform, due diligence. Moreover, it states that the assignment of a rating is not a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating. S&P solely performed loss and cash flow analyses on the data presented to it; S&P generally did not verify the integrity and accuracy of such information as, in S&P's view, due diligence duties belonged to the other parties in the process. S&P also did not seek representations from sponsors that due diligence was performed.

S&P's Response to Staff's Observations:

S&P noted that Staff correctly observed that it does not undertake any duty of due diligence with respect to data submitted to it in the ratings process, relying instead upon issuers to provide accurate and complete information. S&P has committed, however, to enhance its process of collecting more information about originators' and issuers' processes to assess the accuracy and integrity of their data. Furthermore, S&P has taken, or announced, measures designed to improve the integrity and accuracy of the loan data it receives on underlying RMBS pools:

- S&P announced that it was considering enhancements to its RMBS securitizations that would include the engagement by issuers of independent third parties to randomly sample, for due diligence, the greater of 10% or 200 loans for all subprime transactions.

- In addition, in an agreement with the New York State Attorney General, S&P agreed to develop and publicly disclose due diligence criteria to be performed by underwriters on all mortgages comprising RMBS, and to review those results prior to issuing ratings.[40]

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[40] http://www.oag.state.ny.us/press/2008/june/june5a_08.html

7. Documentation of Significant Steps and Participants in the Rating Process

a. Documentation of Significant Steps in the Ratings Process

As of September 2007, NRSROs are required to retain internal records, including non-public information and workpapers, used to form the basis of credit ratings it issues (Exchange Act Rule 17g-2(b)(2)). Prior to its registration as an NRSRO, S&P recordkeeping policies required that RMBS analysts maintain the essential documents related to a deal in the deal file.[41] The Staff reviewed 52 RMBS deals to determine if S&P followed the policies and procedures in the U.S. Residential Subprime Mortgage Criteria, its file maintenance and recordkeeping policy and other related polices. The Staff found that LEVELS output was missing from 14 deal files,[42] and SPIRE output was missing from nine deal files.[43] In addition, the Staff noted that 11 of the SPIRE outputs contained a different number of tranches, as well as different ratings and coupons than the corresponding information in the CORE form and ratings letter in apparent violation of S&P's record retention policy.[44] S&P also did not consistently document the rationale behind the application of adjustments made to the model output.[45]

With respect to CDOs, S&P required the maintenance of records related to the rating of all synthetic and cash flow CDO transactions, as mandated by S&P's CDO Filing Procedures.[46] Such documents are to be maintained in a file referred to by S&P as the

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41 See S&P Analytic Documentation Policy, dated June 26, 2007. See also Memorandum to RMBS Group from Support Staff, Re: Blue Files, dated November 2004 ("Blue File Memo"). Among the records that must be contained in the blue file are the rating letter and corresponding write up, the prospectus supplement, the prospectus supplement checklist, and the final LEVELS reports and cash flow reports (SPIRE).

42 See IXIS Real Estate Cap 2006-HE5, SASCO 2007-MLN1, ACE 2006-SL1, SABR-2006-WM2, Argent 2006-W5, Long Beach 2006-3, MASTR ABS 2006-FRE2, ACE 2006-FM2, Carrington 2007-RFC1, J.P. Morgan Mortgage Acquisition 2006-RM1, SABR-2006-NC2, SABR 2006-FR2, Soundview 2007-WMC1, Option One Mortgage 2006-2.

43 See MS ABS 2006-NC4, SABR-2006-FR3, SASCO 2007-MLN1, ACE 2006-SL1, GSAMP 2006-S2, Carrington 2007-RFC1, Terwin Mortgage 2006-6, SASCO 2006-ARSI, CWABS 2006-SPS1.

44 See SABR 2006-NC1, Long Beach Mortgage Loan Trust 2006-9, Carrington 2006-NC5, Soundview Home Loan 2007-WMC1, Option One Mortgage 2006-2, Citigroup Mortgage Loan Trust, C-BASS 2007-SL1, SABR 2006-NC1, ARSI 2006-M3, ACE 2006-FM2, Soundview 2007-WMC1.

45 For example, in approximately a third of the deals that the Staff reviewed, the tranche sizes that passed the cash flow stress test in SPIRE were different from the size of the tranches that were ultimately rated, as reflected in the CORE form and signed ratings letter. S&P explained that as long as the ratios between consecutive tranches (*e.g.* between the AAA & AA+ tranches, and between the AA+ and AA tranches, etc.) were consistent between the two forms, the SPIRE stress test would be valid regardless of the absolute size of the tranches. This policy was neither documented as a policy nor in deal files as a rationale for why the sizes were different.

46 See S&P-SEC-003421. The Staff notes that S&P adopted and/or updated its policies and procedures in June 2007 to comply with the Commission's new rules and regulations implementing provisions of the Credit Rating Agency Reform Act of 2006. One of these policies

"Short File."[47] The "Short File" for every rated CDO deal must contain a CORE form which includes a summary of the deal and contact information for deal participants. The CORE form must contain the signatures of the analyst and manager on the first page of the form. This file must also contain the Rating Asset Methodology Presentation ("RAMP"), which is a presentation prepared by the analyst for the rating committee.

The Staff reviewed the documents within 50 CDO "Short Files." Overall, the file contents and disclosures were in accordance with S&P's stated policies and procedures. However, the Staff noted some inconsistencies with respect to the actual review of the CDO manager for particular deals, given that in S&P's view the "collateral manager plays a paramount role in the [CDO] transaction's performance." [48] In addition, many of the RAMPs contained issues that were brought to the rating committees' attention with no documentation as to whether the issues were addressed, or if there was any resolution of the issues to the satisfaction of the analyst or the rating committee.[49] Some of the RAMPs contained summaries of the deal tranches which did not match the CORE form or the final rating letter.[50] In addition, some RAMPs appear to contain issues that went unresolved because of timing constraints or that were deferred to be resolved in future transactions.[51]

Ultimately, the Staff found that S&P failed to retain or document certain significant steps in the rating process, which made it difficult for the Staff to assess compliance with its rating policies and procedures, and to identify the factors that were considered in developing a particular rating. This lack of documentation would similarly make it difficult for S&P's internal compliance staff or internal audit staff to assess compliance with the firm's policies and procedures.

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and procedures was the "Analytic Documentation Policy", which now requires the names of the rating committee attendees and identification of the voting members.

47 Signed Rating Agreement; Signed Rating Letter; Ramps, CORE Form; Working Group List; Offering Circular or Memorandum (if any); and Confirm/Credit Swap Document (for synthetic trades, without OMs).

48 See "An Introduction to CDOs and Standard & Poor's Global CDO Ratings," dated June 8, 2007. S&P publishes reports on CDO managers and the performance of the CDOs it rates (known as CDO Manager Focus, CDO Manager Magnifier, and the European CDO Manager Briefing). The Staff noted that the depth and timing of the review of a manager associated with a deal appeared to vary greatly among deals.

49 See GSC ABS CDO 2006-4u; Independence VII CDO; Point Pleasant Funding 2007-1; Toro ABS CDO II; Magnolia Finance Series 2006-5B; ACA Aquarius 2006-1.

50 See Carina CDO; C-Bass CBO XIX; Cetus ABS CDO 2006-1; Delphinius CDO 2007-1.

51 See Duke Funding X; C-Bass CBO XIX.

b. Documentation of Participants in the Ratings Process

An NRSRO is also required to make and retain records of the identity of any credit analyst that participated in determining the rating and any person that approved the rating before it was issued (Exchange Act Rule 17g-2). This requirement is intended to assist the Commission in monitoring whether the NRSRO is following its procedures and methodologies for determining credit ratings and whether the NRSRO is complying with procedures designed to prevent the misuse of material nonpublic information by identifying the persons with the best information as to how the credit rating was determined.[52]

Prior to its registration as an NRSRO, S&P required the rating analyst and committee chair to sign the CORE Form, which documents, among other things, the rating committee members.[53] In its review of 52 RMBS deal files, the Staff discovered that 13 of the CORE forms retained in the deal files lacked the chair's identity,[54] and six of the CORE forms lacked the signatures of at least one of the non-chair committee members.[55]

For CDO transactions, the Staff observed five files that lacked proper documentation on the Committee/Authorizations section of billing form,[56] two files lacking a complete and accurate record of committee attendees on the front of the billing form when compared to the Required Committee Attendee Information page on the same form,[57] and five files manifested problems regarding the accuracy of the dates of ratings committees and notifications.[58]

52 See Securities Exchange Act Release No. 55857, 72 FR 33564 (June 18, 2007) (S7-04-07).

53 See Blue File Memo, see also Roles and Responsibilities Policy Statement on commercial activities, dated June 26, 2007. Following the adoption of Regulation NRSRO, S&P required the names of all rating committee attendees and identification of the voting members to be recorded as well.

54 See SASCO 2007 MLN1, GSAMP Trust 2006-S2, SAIL 2006-1, SAIL Trust 2006-1, SABR 2006-WM2, MASTR ABS Trust 2006-FRE2, ACE Securities Corp Home Equity 2006-FM2, Carrington Mortgage Loan Trust 2007-FRC1, SASCO 2006-ARS1, CWABS Asset Backed Certificates Trust 2006-SPS1, SG Mortgage Securities Trust 2006-FRE2, IXIS Real Estate Capital Trust 2006-HE3, IXIS Real Estate Capital Trust 2007-HE1, Citigroup Mortgage Loan Trust 2006-HE3.

55 See ACE Securities Corp, Home Equity Loan Trust, 2006-NC2, GSAMP Trust 2006-S2, ACE Securities Corp. Home Equity Loan Trust, 2006-FM2, Carrington Mortgage Loan Trust 2007-RFC1, SG Mortgage Securities Trust 2006-FRE2, IXIS Real Estate Capital Trust 2007-HE1.

56 Norma CDO (no analyst signature); NovaStar ABS CBO (manager signature undated);, Duke Funding X (no chairperson listed on front of CORE form); Bayberry Funding Ltd. (person notified and committee attendees blank on front of CORE form); Jupiter High Grade CDO VII (manager signature undated).

57 GSC ABS CDO 2006-1c, Bayberry Funding Ltd.

58 Bering CDO I (committee date blank), Norma CDO (person notified blank); Jupiter High Grade CDO VII (committee date listed as 7/31/07 and notification date listed as 7/27/07); Ridgeway Court Funding II (committee date 4/13/07, sale date 6/28/07 on CORE Form. The RAMP was dated 4/13/07 but the capital structure on RAMP differs from the final ratings on the CORE form);

The Staff recommends that S&P conduct a review of its current policies and practices for documenting the credit rating process and the identities of RMBS and CDO ratings analysts and committee members to review whether they are reasonably designed to ensure compliance with Exchange Act Rule 17g-2 and to address weaknesses in the policies or in adherence to existing policies that result in gaps in documentation of significant steps and participants in the credit rating process.

S&P's Response:

S&P responded that it had polices and procedures in place to retain key analytical documents before registering as an NRSRO, and has enhanced additional policies and procedures to allow for a more thorough documentation and retention policy after registration, including its new Analytic Documentation Policy, released in June of 2007.

S&P stated that it would take prompt steps to review its documentation policies and procedures. S&P noted that it was working to establish a robust compliance program to monitor adherence to the requirements, including the enhancement of its ratings document repository, and that it has recently sought to enhance employee training in this area.

8. Surveillance Practices

Under the Rating Agency Act, S&P is required to disclose publicly the procedures and methodologies it uses in determining credit ratings. In addition, Section 4(d) of the Rating Agency Act states that a registered NRSRO must maintain adequate financial and managerial resources to produce credit ratings with integrity.

Generally speaking, for any particular RMBS or CDO transaction, the surveillance process consists of monitoring collateral performance through exception reports, periodic reports and event driven reviews, analyst recommendations, and committee determinations and publications.[59] The exception reporting process seeks to identify those transactions for which performance appears to be sufficiently out of line with initial expectations as to merit further analysis. S&P also conducts periodic reviews of RMBS and CDO transactions on a recurring basis regardless of whether the performance of those transactions has triggered an exception review.[60] Additionally, when outside events

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Costa Bella CDO (Notification date on CORE form 9/28/06 but committee meeting was dated 10/24/06. There was a note in the RAMP that the committee was reconvened 11/14/06 because the structure changed, but was not reflected in the CORE form).

59 As a general matter, upgrades are considered when the projected credit support percentage for a tranche is at least a minimum multiple (generally about two times) of the original credit support percentage required for a class which received a higher rating. In contrast, downgrades are considered when the projected credit support percentage for a class is below the original credit support percentage required for its current rating category.

60 See letter from Mari B. Maloney, Chief Regulatory Officer, S&P, to Matt Daugherty, Senior Special Counsel, OCIE, SEC (Mar. 31, 2008).

precipitate the review of a class of deals, the surveillance group conducts an event-driven review. Once a transaction has been identified for further review, the analyst conducts an analysis of the transaction to evaluate the adequacy of available credit support and presents findings to the committee for a possible ratings change.

The Staff requested various types of documentation relating to S&P's RMBS and CDO surveillance process, including copies of monthly periodic reports, exception reports, exception parameters, and guidelines governing communications between surveillance and ratings staff for the period between January 2005 and December 2007.[61] S&P stated it could not provide this type of documentation, explaining that no record of such reports existed because they were created and analyzed electronically, and that no such guidelines governing communications between surveillance and rating staff existed.[62] The Staff also noted internal communications by the surveillance staff which seem to indicate that S&P staff was aware of this data retention issue as far back as June 15, 2007.[63] As such, the Staff could not assess the information being generated by S&P's Surveillance Group during the review period.

Furthermore, in its review of internal S&P documents, the Staff found numerous statements related to surveillance procedures, resources and findings. For example, an S&P internal email from a Managing Director in the Structured Finance Surveillance Group noted:

> "I think the history has been to only re-review a deal under new assumptions/criteria when the deal is flagged for some performance reason. . . . The two major reasons . . . (i) lack of sufficient personnel resources and (ii) not having the same models/information available for surveillance to relook [sic] at an existing deal with the new assumptions (i.e. no cash flow models for a number of assets)."[64]

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61 See Letter from A. Duer Meehan, Associate Director, OCIE, SEC, to Mari B. Maloney, Chief Compliance Officer, Ratings Services, Global Regulatory Affairs, S&P (Apr. 28, 2008).

62 See Letter from Mari B. Maloney, Chief Compliance Officer, Ratings Services, Global Regulatory Affairs, S&P, to Matthew Daugherty, Senior Special Counsel, OCIE, SEC (May 5, 2008).

63 "If I were the S.E.C. I would ask why can [sic] you go back and run the report for each of the months using the same assumptions? In theory we should be able to do this." Email chain ending in email from Ernestine Warner, Director, RMBS Surveillance Group, S&P, to Andrew Giudici, Director, RMBS Surveillance Group, S&P (June 15, 2007, 9:05 AM).

64 Email from Roy Chun, Managing Director, Structured Finance Surveillance Group, S&P, to Tom Gillis, Managing Director, Research and Criteria, S&P (July 11, 2005, 8:09 PM). A similar email from the Director of the RMBS Surveillance Group noted similar issues: "He asked me to begin discussing taking rating actions earlier on the poor performing deals. I have been thinking about this for much of the night. We do not have the resources to support what we are doing now." "I am seeing evidence that I really need to add to the staff to keep up with what is going on with sub prime and mortgage performance in general, NOW." Email chain ending with email from Ernestine Warner, Director, RMBS Surveillance Group, S&P, to Peter D'Erchia, Global Practice Leader, Structured Finance Surveillance Group, S&P (Feb. 3, 2007, 12:02 PM).

The Staff is concerned about whether the "lack of sufficient personnel resources" drives surveillance policy.

The Staff also noted an email from the Director of the RMBS Surveillance Group which notes that S&P was concerned with reducing the number of exceptions in its reports which may indicate that the surveillance criteria used during part of the review period was inadequate:

> "I agree the percentages [of monthly surveillance alerts for May 2007] are too high. I was thinking that we would record the monthly change in exceptions. I think we changed the exception report process last month. . . . I believe there are less exceptions on this report."[65]

The Staff recommends that S&P conduct a review to determine if adequate resources are devoted to surveillance of outstanding RMBS and CDO ratings. This review should include, for example, whether S&P maintains adequate staffing and has adequate expertise dedicated to performing ongoing surveillance. The Staff also recommends that S&P ensure all its appropriate surveillance records are retained.

S&P's Response:

S&P responded that it understood Staff's findings to be based in part on the unavailability of S&P's historic monthly surveillance reports due to the fact it was not S&P's practice to print or electronically save these reports. It also stated that, following the recent deterioration in the U.S. housing market and performance of subprime loans, S&P had come to rely less on exception reports as a monitoring tools, and instead used vintage reviews of all transactions issued during the time period within a collateral group. The exception reports, therefore, would have flagged deals that were already subject to vintage reviews. Therefore, the adjustments to the exception report tool that were done in conjunction with the broad vintage-based reviews did not have the effect of decreasing the overall number of deals S&P was examining. S&P also noted that the RMBS surveillance group is kept up-to-date about new criteria and assumptions being applied to the initial rating of RMBS deals, but that such changes do not always implicate earlier vintage transactions, and therefore application of the new criteria may be inappropriate.

S&P stated that, although it disagrees with the Staff's findings on this point, it will nonetheless take prompt steps to conduct a review of its surveillance process and consider whether it maintains adequate staffing and expertise for its ongoing surveillance needs. S&P stated that it has already undertaken a number of steps to improve the effectiveness and speed of the surveillance process, including increasing resources, and ensuring separation between new rating and rating surveillance functions.

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65 Email chain ending in email from Ernestine Warner, Director, RMBS Surveillance Group, S&P, to Andrew Giudici, Director, RMBS Surveillance Group, S&P (June 15, 2007, 9:05 AM).

9. Management of Conflicts of Interest

a. "Issuer Pay Model"/Fee Discussions

S&P uses the "issuer pays" model, in which the sponsor or other entity that issues the security is also seeking the rating. Under Exchange Act Rule 17g-5(b)(1), it is a conflict of interest for an NRSRO being paid by issuers or underwriters to determine credit ratings with respect to securities they issue or underwrite. Section 15E(h) of the Exchange Act requires an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed to address and manage conflicts of interest. Such policies and procedures are intended to maintain the integrity of the NRSRO's judgment. Avoiding a conflict of interest prevents an NRSRO from being influenced to issue a more favorable credit rating in order to obtain or retain business of the issuer or underwriter.[66]

To manage this conflict of interest, S&P has established policies to restrict analysts and their immediate managers from participating in fee discussion with issuers.[67] S&P has established a policy that is designed, among other things, to prevent the flow of information about issuers, including sources of fee revenue among its numerous affiliates. S&P requires that ratings analysts must reach their analytic opinions independently from equity analysts and independent from any commercial relationship between S&P and any third party.[68] S&P also prohibits those that negotiate fees for an issuer to vote on a credit rating committee for that issuer and prohibits those that vote on a credit ratings committee for an issuer from being involved in negotiating fees for that issuer. S&P's policy also addresses several areas of potential conflict arising from the sales process, providing that S&P Ratings' employees may not jointly sell or call on ratings customers with other S&P employees or otherwise engage in cross-selling activity. However, S&P explicitly permits an analyst's manager to participate in internal discussions regarding which considerations are appropriate for determining a fee for a particular rated entity.[69]

Despite S&P's policies addressing the issue of fees, the Staff found multiple communications that indicate that analysts are at the very least aware of the firm's fee schedules, and actual (negotiated) fees.[70] There does not appear to be any internal effort

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66 See Securities Exchange Act Release No. 55857, 72 FR 33564 (June 18, 2007) (S7-04-07). And Exchange Act Rule 17g-5.

67 See S&P's Roles and Responsibility Statement.

68 S&P Analytical Firewalls Policy (November 2005).

69 See Guideline No. 5 to S&P's Roles and Responsibility Policy Statement. (June 2007).

70 In one instance a Managing Director and Client Value Manager in the RMBS group, distributed a negotiated fee schedule, a large percentage of the recipients were analysts. Email from Thomas Warrack, Managing Director and Client Value Manager, RMBS Group, S&P, to May Abraham, Associate Director, RMBS Group, S&P (Dec. 29, 2005, 5:29 PM). In another instance, an analyst is copied on an email communication to an issuer containing a letter confirming the fees for a transaction. Email from Mabel Rodriguez, Research Analyst, S&P Segment Operations Client Services, to Robert Perret, Wachovia, copying James Grundy, Associate Analyst, RMBS Group,

to shield analysts from emails and other communications that discuss fees and revenue from individual issuers.[71] In some instances, analysts discuss fees for a rating. For instance, a production manager in the RMBS group writes to several analysts: ". . . if you have not done so please send me any updates to fees on your transactions for this month. It is your responsibility to look at the deal list and see what your deals are currently listed at."[72] The Staff is concerned that analysts could be influenced when determining their ratings by the amount of fees paid by an issuer to S&P.

b. Revenue and Market Share

While the Staff did not identify any instances in which it appears a fee influenced the rating decision for a particular deal, the Staff identified a number of emails suggesting that S&P's development of ratings criteria did not always arise from the objective process described above. In fact, several emails indicate that across various areas in structured finance, the criteria development or amendment process was initiated by a concern about S&P's market share relative to other rating agencies, or a reaction to losing deals to other rating agencies. In most of these instances, it appears that S&P staff responsible for obtaining ratings business would notify other S&P employees, including those responsible for criteria development, about business concerns he or she had related to the criteria:

> "I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision and if so, how much?" "Essentially, Joanne, Rosario and I ended up agreeing with your recommendations but the CDO team didn't agree with you because they believed it would negatively impact business."[73]

For instance, in one email chain related to Commercial Mortgage Backed Securities, after noting a change in a competitor's methodology an S&P employee states: "[w]e are

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S&P (Mar. 27, 2007, 4:02 PM). See also Email from Monica Perelmuter, Director, Subprime NIMs, RMBS Group, S&P, to Julia Clements, Associate Director, RMBS Group, S&P (Dec. 19, 2005, 1:08 PM).

71 An email communication from a Managing Director and Client Value Manager to at least one analyst, requests that the recipient(s) "Please confirm status codes as soon as possible on the below mentioned deals. Additionally, any fees that are blank should be filled in. All issuer/bankers should be called for confirmation." In the same email chain, this request is reinforced by a Managing Director who states "It is imperative that deals are labeled as to Flow or Pending, etc as accurately and timely as possible. These codes along with the fee and closing date, drive our weekly revenue projections . . ." Email chain ending with email from Thomas Warrack, Managing Director and Client Value Manager, RMBS Group, S&P, to Leslie Abergo, Director and Client Value Manager, RMBS Group, S&P (Aug. 24, 2005, 3:53 PM).

72 Email from John Polizzotto, Production Manager, RMBS Group, S&P, to Laura Ahn, Associate Director, RMBS Group, S&P (Jan. 31, 2007, 9:33 AM).

73 Email chain ending with email from Tom Gillis, Managing Director, Research and Criteria, S&P, to Gale Scott, Managing Director, Global Real Estate Finance, S&P (Nov. 9, 2004, 12:11PM).

meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets this week because of the ongoing threat of losing deals."[74] In another email, following a discussion of a competitor's market share related to Net Interest Margin ("NIM") ratings, an S&P employee states "Relying on prepayment penalties and/or cap proceeds is more difficult to estimate and project, but those would be the assumptions that would have to be revisited to recapture market share from Fitch."[75] In another example, following a discussion of losing a bank rating, an S&P employee states "I had a discussion with the team leaders here and we think that the only way to compete is to have a paradigm shift in thinking, especially with the interest rate risk."[76]

The Staff recommends that S&P continue to review its practices, policies and procedures with respect to mitigating and managing the "issuer pays" conflict of interest. In particular, the Staff recommended that S&P consider steps that would insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria.

S&P's Response:

S&P responded that its Analytic Firewalls policy strictly prohibits rating analysts discussing or negotiating fees with an issuer, but that analysts are not prohibited from knowing the amount of rating fees for a particular issuer or discussing such fees internally.[77] S&P also notes that while certain staff with a business interest may question the basis for a particular criterion out of competitive concern, the potential loss of business was not part of the consideration by analytical staff of whether to actually change models or methodologies. Moreover, S&P stated that its fees for certain asset types are determined by a mathematical formula, and that rating analysts have no discretion as to the amount or application of the fee.

S&P stated that it would take prompt steps to consider steps that would further insulate analysts from fee information. S&P noted that it has already undertaken steps to identify and mitigate potential conflicts, including the establishment of the Office of the Ombudsman, who will have oversight power and authority to escalate conflict of interest concerns to the McGraw-Hill's CEO, board of director or audit committee. S&P also noted that it has initiated an analyst rotation program and framework for "look back"

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74 Email from Gale Scott, Managing Director, Global Real Estate Finance, S&P, to Richard Gugliada, Global Practice Leader, Global CDO Group, S&P (Aug. 17, 2004, 6:14 PM).

75 Email from Monica Perelmuter, Director, RMBS Group, S&P, to Chris Deasy, Director, Asset-Backed Commercial Paper Group, S&P (Sept. 25, 2006, 6:50 PM).

76 Email from Yu-Tsung Chang, Executive Managing Director, Head of Ratings Services in Asia/Pacific, S&P, to Joanne Rose, Executive Managing Director, Structured Finance, S&P (May 25, 2004, 12:08PM).

77 The Staff notes that while analysts are not prohibited from discussing fees internally, they are indeed prohibited from discussing internally what factors would be appropriate to consider when determining an appropriate fee to assess for a particular rating.

reviews to ensure the integrity of prior ratings when an analyst leaves S&P to work for a firm with whom the analyst had significant contact before he or she departed.

c. Analyst Compensation

S&P has a policy that generally provides that an analyst may not be compensated or evaluated based upon the amount of revenue that S&P derives from issuers or issues that the analyst rates or with which the analyst regularly interacts.[78] While S&P does not compensate its analysts based on the deals it rates or the ratings provided, like all employees, the amount of an analyst's bonus is tied to the overall success of S&P.

S&P established annual Global Compensation Guidelines between 2005 and 2008. In those guidelines, S&P describes three basic forms of compensation: base salary, short-term cash incentives, and long-term cash incentives. The base salary guidelines describe concepts such as merit increases and promotion, both of which are exclusively tied to an employee's performance. The merit increases come out of a manager's merit increase pool, the source of which is not described in S&P's policies. An employee's base salary also may be adjusted to address an inequity or to maintain a competitive position compared to the external marketplace, cost-of-living, and the organization's financial results.

S&P also awards short-term cash incentives. Managers within a business unit have the responsibility to differentiate the rewards based upon performance. Therefore, a high performer in a profitable division is likely to earn more incentives than a high performer in an unprofitable business. S&P also awards long-term cash incentives, in the form of employee stock options. There is little guidance about appropriate awarding of these options, except that they are generally reserved for senior level employees and S&P provides a certain maximum amount of options that should be awarded in a given year.

d. Securities Transactions by Employees

Exchange Act Rule 17g-5 prescribes that NRSROs must maintain and enforce policies and procedures to manage the conflict of employees owning securities of rated issuers or obligors and prohibits analysts or other persons involved in the approval of credit ratings from owning securities of the entity subject to the analyst's credit rating.[79] S&P has adopted a policy to prohibit its analytical employees and their immediate family members from buying or selling any security of an issuer within the employee's primary area of analytical responsibility or that is rated by the employee's team. S&P imposes an additional restriction on structured finance analysts from buying or selling any security of an issuer related to entities rated by the structured finance group that have been identified as providing market sensitive information.[80] S&P also has adopted a policy that prohibits

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[78] See Section 2.11 of the S&P Ratings Services Code of Conduct (June 2007).

[79] See Exchange Act Rule 17g-5(b)(6) and Rule 17g-5(c)(2).

[80] See Section IV(F)(2) of Appendix 1 to the S&P Code of Ethics (February 2007).

an analytical employee from profiting from the sale of a security within 35 days of its purchase.[81]

S&P's Personal Security Trading System ("PSTS"), checks all S&P Ratings employees' requested transactions against a list of prohibited securities before forwarding the requested transaction on to a compliance examiner and business reviewer for final approval before an employee's transaction is "cleared" by S&P to be executed. S&P also uses its "Accu-rate" system to determine whether an analyst preparing to participate in a rating process is prohibited from doing so by reason of his or her ownership of a particular security. Moreover, S&P maintains relationships with a group of select broker-dealers that automatically report the securities transactions of employees to S&P.[82] If an employee holds an account with a broker-dealer that does not automatically report transactions to S&P, an employee is under the duty to self-report his or her transactions to S&P within ten days of the transaction.[83]

During the course of its examination, the Staff reviewed the emails and trading history of an S&P employee whose trading activity appears to present possible violations restricted security and short term trading restrictions. In this case, an analyst engaged in short-term trading on a number of occasions in his reported brokerage account. When the analyst learned of the new short-term trading policy, he stated his intention in an email to "quietly" move his money from his reported brokerage account, to a brokerage that did not participate in S&P's automatic reporting program, in order to engage in short term trading.[84]

Separately another S&P Analyst purchased shares of common stock of two investment banks who regularly participate in RMBS transactions.[85] The investment banks are not technically "issuers" of the RMBS transactions, nor are they included in the group of securities identified by the RMBS global practice leader as presenting a conflict. However, the Staff is nonetheless concerned that the trades may have violated the intent behind the policy restricting analysts' activity in "issuers" that their group rates because of the close association between the investment banks and a number of S&P-rated special purpose vehicles created for the purpose of issuing structure finance products.

The Staff recommends that S&P conduct a review of its policies and procedures for managing the securities ownership conflict of interest to determine whether such policies

81 See Section IV(G) of Appendix 1 to the S&P Code of Ethics (February 2007). This short-term trading restriction went into effect on March 1, 2007.

82 See Section IV(C)(1) of Appendix 1 to the S&P Code of Ethics (February 2007).

83 See Section IV(C)(2) of Appendix 1 to the S&P Code of Ethics (February 2007).

84 Email from James Grundy, Associate Analyst, RMBS Group, S&P, to Alain Pelanne, Associate Director, Corporate & Government, Consumer Retail Healthcare, S&P (Mar. 5, 2007, 10:38 AM).

85 See Peter G. Graham trade confirmations from E*Trade showing that Graham bought C on July 26, 2007 and bought JPM on Jan. 24, 2008.

and procedures are reasonably designed to ensure that its employees' personal trading is appropriate and does not violate Exchange Act Rule 17g-5.

S&P's Response:

With respect to the issue of an employee's opening an undisclosed brokerage account for the purpose of engaging in short-term trading, S&P noted that the employee, James Grundy, did not disclose to S&P an account in a brokerage that Grundy identified in the relevant email to S&P. Subsequent examination of Staff confirmed that Grundy, in fact, opened an account at the non-participating brokerage. S&P acknowledged that, to the extent that such an account was opened, failure to report such account to S&P would have violated S&P's policies. In response to the issue raised by Staff regarding another employee's trading of a restricted issuer, S&P noted that the two common stocks noted, C and JPM, were not on the restricted list applicable to the employee, and therefore not in violation of S&P's policy.

S&P stated that it would take prompt steps to address any issues uncovered with respect the S&P's trading policy to the extent possible.

10. Internal Audit Program

The McGraw-Hill Companies, Inc. currently performs corporate-wide internal audits, including audits of the credit rating process.[86] S&P did not produce any examples of such audits, despite the Staff's request to see all audits of RMBS or CDO ratings services conducted between January 1, 2003 and November 30, 2007.[87]

Between 2003 and 2005, a member of its Global Regulatory Affairs Department performed file review of the structured finance group's ratings. S&P provided the Staff with copies of the review of the structured finance group's ratings and surveillance files conducted during that time period. The audit records demonstrate that the reviews were limited to evaluating the completeness of the ratings and surveillance files. S&P produced no audits performed in 2006 and 2007.

S&P's review of ratings and surveillance files was limited to a single page of factors, which did not vary between ratings and surveillance.[88] The factors were accompanied by a space to check "yes" or "no," with hand-written notes on the face of the checklist providing the only documentation of rationale behind a finding. S&P audit records

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86 S&P is a division of the McGraw-Hill Companies, Inc.

87 S&P represented to the Staff that it is in the process of developing and augmenting the S&P Compliance Department, as well as its internal audit program.

88 The factors reviewed included documents related to the key processes within the ratings and surveillance process, including analytical documents (*i.e.* LEVELS, CORE and SPIRE, etc.), the ratings/surveillance committee and appeal process, issuer notification of action, and rating dissemination.

revealed only four examples of the file reviewer's notifying management of the findings of the reviews and provided no examples of management's response to the reviews.[89]

The Staff recommends that S&P review whether its internal audit functions, particularly in the RMBS and CDO ratings areas, are adequate, and whether they provide for proper management's follow-up.

S&P's Response:

S&P noted that it had no formal internal audit program prior to its registration as an NRSRO, but that S&P did conduct periodic file reviews where it employed the checklist approach described by Staff. S&P noted that it has recently taken steps to provide greater and more in-depth oversight and monitoring, leading to a program that produces both formal audit findings and recommendations.

S&P also stated that it would take further steps to review the adequacy of its internal audit program. S&P stated that it is working to expand and formalize its compliance and monitoring program and working on procedures for monitoring adherence to its requirements. Among these procedures are: an email monitoring program, creation and implementation of a compliance monitoring database, in-person, onsite, internal reviews of policy compliance, and coordination with the internal audit department of McGraw-Hill. S&P also noted that it recently hired experienced staff to address these issues. S&P has also committed to re-evaluate and formalize S&P's oversight function, in a number of ways including, the engagement of an external firm to review S&P's compliance processes, the establishment of a board to handle all new Ratings' policies and procedures, and separating the quality and criteria governance responsibilities into two separate functions.

11. Conclusion

The Staff intends to send a deficiency letter to S&P outlining its findings and recommendations. The Staff will request that S&P provide a written response within 30 days outlining any remedial action planned or already taken to address the findings and recommendations in the letter. S&P will be asked to include in its response a timetable for implementing the proposed remedial action. The letter will also request that S&P send OCIE a written confirmation in 12 months detailing the status of implementation of each remedial action.

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89 Memorandum from Tonya Tullch, Compliance Officer, S&P to Tom Gillis, Managing Director, Research and Criteria, S&P (October 28, 2004), Memorandum from Tonya Tullch, Compliance Officer, S&P to Tom Gillis, Managing Director, Research and Criteria, S&P (January 22, 2003), Memorandum from Tonya Tullch, Compliance Officer, S&P to Tom Gillis, Managing Director, Research and Criteria, S&P (March 13, 2003), Memorandum from Tonya Tullch, Compliance Officer, S&P to Tom Gillis, Managing Director, Research and Criteria, S&P (May 9, 2003).

VerDate Nov 24 2008 10:11 May 19, 2011 Jkt 57323 PO 00000 Frm 001524 Fmt 06602 Sfmt 06602 P:\DOCS\57323.TXT SAFFAIRS PsN: PAT

57323.520

Footnote Exhibits - Page 0723

From:	Mazataud, Paul
Sent:	Tuesday, June 20, 2006 9:18 PM (GMT)
To:	Kimon, Noel <Noel.Kimon@moodys.com>
Cc:	Le Henaff, Anne <Anne.LeHenaff@moodys.com>; Levington, Gareth <Gareth.Levington@moodys.com>
Subject:	My discussion with Pascale Viala (CIFG)

I had lunch with Pascale today.

Most of our discussion was about Cash CLOs. She said she has recently heard a lot of negative feedback on Moody's from several managers and bankers. She mentioned four points

1. **Shadow ratings**. Managers are not happy with Moody's shadow ratings. She said that this was their most important point. Unfortunately it is really hard to interpret this comment as she had never heard of the switch from MKMV to the new dedicated team. Consequently, I do not know if the criticisms were against the MKMV process or against the new process. Some of their comments seemed related to MKMV ("managers like to talk to persons who understand corporate credits").

2. **Resources**: Moody's does not have enough resources to rate CLOs. Moody's is too slow. Moody's does not understand that the time it takes to launch a CLOs is getting shorter and shorter. Moody's cannot cope with this more recent pace. (Note that this comment is consistent with what Uddjaval Desai from JP Morgan told us).

3. **Documentation review:** Moody's "requires" many more "structural features" than its competitors (Note that this comment is consistent with what John Convery from DB told us). I told her that all these "requirements" are described in public reports and are well accepted in the US market. She agrees with it but she says that it does not mean that European managers accept them.

4. **Managers are tired of large "grids"**. They would rather prefer a model based test like what S&P and Fitch do. Pascale disagrees with these managers. As a wrapper, she hates that the credit quality of what she wraps is linked to a black box. Also, she hates the fact that the black box can change from time to time.

Because of these four points, she says that several managers are considering doing deals without Moody's. Mizuho (Harvest IV) is one of them. She encourages us to make sure that we pay a visit to large European CLO managers (note that we recently paid a visit to Mizuho).

A few other things she said:

a. The market does not like Moody's for CDO of ABS either because of our lower ratings on CMBS assets

b. She thinks that the European CRE CDO market will be big and worth investing in. However, she does not expect any deal to be launched before 2007.

c. She does not believe in the development of the project finance CDO market because of the low supply.

d. She considers that the synthetic market is quasi dead.

e. She recently recruited a senior person from S&P London (this lady will start at CIFG in early July).

f. She recommends that we hire senior persons of S&P and Fitch to address our resource problem. She sent me an email with three names she specifically recommends (two from S&P and one from Fitch).

I'll give you a call to propose an action plan.

Thanks,

Paul

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #1151

MIS-OCIE-RMBS-0035460

From: Vonderhorst, Brian
Sent: Friday, January 19, 2007 9:38 AM
To: Warrack, Thomas; Barnes, Susan
Subject: FW: Panel questions

here are the proposed questions for the rating agency panel...2 moderators remember...

-----Original Message-----
From: Yalamanchili, Kishore [mailto:Kishore.Yalamanchili@blackrock.com]
Sent: Tuesday, January 16, 2007 6:24 PM
To: Glenn.Costello@fitchratings.com; Ross, Justin; mnelson@dbrs.com; scott_mason@sandp.com; Kornfeld, Warren; Vonderhorst, Brian
Cc: jross@americansecuritization.com
Subject: Panel questions

Here are the questions for our panel. I am sending them again as some of you might have not received all of them. We will have a followup call on Thursday morning.

Thanks

Josh's questions

1) What new model enhancements are being worked on?
2) What is work is being done to improve the transparency of the rating process for HELOCs and Fixed Rate 2nds
3) What adjustments outside of the models are being made to Loss Coverage Levels, (ie Adjustments for Reserves, Mtg History, Time Since Foreclosure and BK)
4) What is the Outlook/Consequence to deals where the Originator/Seller has gone Bankrupt. What Originator adjustments are being made to levels.
5) What is the approach to rating transactions with LPMI as a form of credit enhancement. What claims denial assumptions are made?

Kishore's questions

We have seen rapid weakness in collateral performance in 2006 in the home equity sector. In the past we witnessed similar detoriation in some auto pools soon after issuance. There were also cases of originator/servicer problems that finally culminated in them filing for bankruptcy. What are the steps you are taking to detect adverse changes in collateral , issuer or servicer either before deals are issued or on an ongoing basis after issuance?

As an investor, I believe that deal triggers are highly favorable to issuers/residual holders. We have seen cases where collateral pool may be performing poorly, yet the subordinate classes and residual holders received cash flows due to ineffective triggers. Some of you have put forward interesting proposals to address this. Going forward, how are you addressing this critical issue?

Frequently when talking to rating analysts regarding new issues, the analyst mentions the agency model's output without any explanation for some of the things we noticed in the deal. These items might actually merit a discussion as to how the agency accounted for them in the ratings process. What steps are you taking to better communicate and comfort investors about your rating process? In other wards, how do we break the "black box" that determines enhancement levels?

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #1152

PSI-S&P-RFN-000044

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Declining home prices, EPDs, originator/issuers filing for bankruptcy or up for sale are some of the important trends in ABS sectors. How are you addressing these in your rating process in 2007? Are there other trends that investors should be aware of? Are there any significant changes in credit enhancement levels due to these trends?

We occasionally see deals put on credit watch and taken off watch list. Is there a method to these seemingly arbitrary actions? What are your policies regarding ratings changes, in particular, how often do you revise them? what are the triggers for revisions?

PSI-S&P-RFN-000045

DATE: 07/16/2007
TIME: 18:02:02
AUTHOR: Snailer, Joseph
RECEIPIENT: Liu, Qingyu (Maggie); Wang, Jinyang; Arora, Rakesh
CC: Agarwal, Navneet
SUBJECT: RE: Notching Status

Thanks for asking - wouldn't want you all to do a bunch of work and have to re-do it.

-----Original Message-----
From: Liu, Qingyu (Maggie)
Sent: Monday, July 16, 2007 6:02 PM
To: Snailer, Joseph; Wang, Jinyang; Arora, Rakesh
Cc: Agarwal, Navneet
Subject: RE: Notching Status

I see. Thanks for the clarification.

-----Original Message-----
From: Snailer, Joseph
Sent: Monday, July 16, 2007 6:00 PM
To: Liu, Qingyu (Maggie); Wang, Jinyang; Arora, Rakesh
Cc: Agarwal, Navneet
Subject: RE: Notching Status

The ratings you are generating should reflect what we would have rated the deals when they were issued knowing what we knew then and using the methology in effect then (ie, using the OC model we built then). Let me know if you have any questions.

-----Original Message-----
From: Liu, Qingyu (Maggie)
Sent: Monday, July 16, 2007 5:18 PM
To: Wang, Jinyang; Snailer, Joseph; Arora, Rakesh
Cc: Agarwal, Navneet
Subject: RE: Notching Status

All,

I have a question when I am running the OC model especially models from the first half of 2006. Some deals in the first half of 2006 we already downgraded within last week or last month. If we were to rate the bonds using the OC model we built then, the bond probably would be a Ba level. However, given today's market condition, the bond we rated Ba then we already downgraded to B or Caa last week. Shall we still provide rating for those bond we did not rate then using the old methodology and the old loss coverage number?

Thanks,
Maggie

-----Original Message-----
From: Wang, Jinyang
Sent: Monday, July 16, 2007 10:18 AM
To: Snailer, Joseph; Arora, Rakesh
Cc: Liu, Qingyu (Maggie)
Subject: RE: Notching Status

Joe:

Maggie and her team have completed 21 deals from second half of 2006.

PSI-MOODYS-RFN-000029

Footnote Exhibits - Page 0727

~~There are 47 deals from the first half of 2006 which they will complete by next~~ Wednesday. 5 deals from Jan 2006 was completed during the previous study.

-Zoë

-----Original Message-----
From: Snailer, Joseph
Sent: Monday, July 16, 2007 9:30 AM
To: Wang, Jinyang; Arora, Rakesh
Subject: Notching Status

Could you let me know where we stand on the OC model runs? The weekly task force meeting is tomorrow and I would like to update them.

Thanks.

PSI-MOODYS-RFN-000030

From:	Kimon, Noel
Sent:	Friday, June 1, 2007 1:50 PM (GMT)
To:	Mirenda, Anthony (Tony) <Anthony.Mirenda@moodys.com>; Piels, Daniel <Daniel.Piels@moodys.com>; Duca, James <James.Duca@moodys.com>
Cc:	Mazataud, Paul <Paul.Mazataud@moodys.com>; Adler, Michael <Michael.Adler@moodys.com>
Subject:	RE: Financial Times inquiry on transparency of assumptions

Tighter spreads on recent deals also belie Paul's assertion. See below.

CMBS Market Tone Improves; Bond Spreads Tighten
Thursday, May 31, 2007
Commercial Real Estate Direct Staff Report
The CMBS market, after suffering nearly three straight months of spread widening, is starting to perk up substantially.
Last Thursday, a $3.2 billion transaction, Banc of America Commercial Mortgage Trust, 2007-2, saw its 30 percent subordination AAA bonds price at 30 basis points over swaps. That was a 1 bp tightening from the deal immediately preceding it, Morgan Stanley Capital I Trust Inc., 2007-IQ14.

The market's tone has continued to improve since then. Spreads on the secondary market tightened even more, with long AAA spreads at 25.5-33 bp, down from 27.5-35 bp a week earlier. And lower in credit, the tightening has been even more pronounced, with BBB bonds quoted at spreads of 175-195 bp over swaps, compared with 185-195 bp a week earlier.

Meanwhile, two new conduits were on the cusp of being priced, the $2.9 billion ML-CFC Commercial Mortgage Trust, 2007-7, and the $3.3 billion JPMorgan Chase Commercial Mortgage Trust, 2007-CIBC19. And both were seeing tight levels. Their super-senior AAA bonds were being shopped at 29-30 bp over swaps, while their BBB bonds were offered at 160-165 bp over swaps. That compares with a spread of 195 bp over swaps for the BBB bonds from Wachovia Commercial Mortgage Trust, 2007-C31, which priced on May 11.

The tightening was attributed to three key factors: investors might have decided they had overreacted in pushing spreads as wide as they did over the past few weeks; lenders have finally started to tighten their lending standards, and Moody's Investors Service last week reassured the market that it would not downgrade deals that were recently priced unless they had credit issues.

-----Original Message-----
From: Mirenda, Anthony (Tony)
Sent: Friday, June 01, 2007 9:44 AM
To: Piels, Daniel; Duca, James; Kimon, Noel
Cc: Mazataud, Paul; Adler, Michael
Subject: RE: Financial Times inquiry on transparency of assumptions

Noel, Jim,

While I have not been closely involved in this story, it seems clear from Dan's note that Paul Davies does not fully understand or is not convinced of our position. I understand that we have a solid story to tell here, if so it could be a good opportunity and time well spent to walk him through our messages and reinforce our arguments.

tony

-----Original Message-----
From: Piels, Daniel
Sent: Friday, June 01, 2007 7:33 AM
To: Duca, James; Kimon, Noel
Cc: Mazataud, Paul; Adler, Michael; Mirenda, Anthony (Tony)

Permanent Subcommittee on Investigations
Wall Street & The Financial Crisis
Report Footnote #1159

MIS-OCIE-RMBS-0364942

Subject: FW: Financial Times inquiry on transparency of assumptions
Importance: High

Good Morning Jim and Noel,

Jim, by way of introduction, my name's Dan Piels and I handle SFG media relations in Europe. Paul Mazataud spent 20 minutes this morning speaking with Paul Davies, Financial Times Structured Finance reporter, providing guidance closely in line with what Noel and Brian outlined below.

Paul Davies has a copy of the CMBS Conduit Subordination Adjustment report and would like to discuss it further with you, Jim. While Davies acknowledged our arguments, he expressed scepticism that given the magnitude of the changes, they would not lead to more important adjustments of expected loss that would in turn lead to potential downgrades. Please advise as to your interest and availability to speak with him - his deadline is today and he's hoping to write an article this afternoon (London time). He's free after 9:30 AM New York time. Davies' tone this morning was friendly but critical. I look forward to hearing from you and would be happy to arrange a conference call.

Regards,

Dan

Daniel Piels
Rating Communications
Moody's Investors Service
daniel.piels@moodys.com
O: +44 20 7772 8727
M: +44 7920 801 833

-----Original Message-----
From: Clarkson, Brian
Sent: 25 May 2007 16:21
To: Kimon, Noel; Scholz, Detlef; Drevon, Frederic; Weill, Nicolas; Duca, James
Cc: Piels, Daniel; Mazataud, Paul
Subject: Re: Financial Times inquiry on transparency of assumptions

The only thing I would add is the frequency of monitoring and that when any deal nears the lower end of our expected loss assumption we would

Alert the market by putting the transactions on review for possible downgrade.

-----Original Message-----
From: Kimon, Noel
To: Scholz, Detlef; Drevon, Frederic; Clarkson, Brian; Weill, Nicolas; Duca, James
CC: Piels, Daniel; Mazataud, Paul
Sent: Fri May 25 11:12:26 2007
Subject: RE: Financial Times inquiry on transparency of assumptions

I guess that the stock answer would be that we do assess the impact of model adjustments and credit enhancement adjustments on the inventory of outstanding deals. Every rating we assign has a range of expected losses. Typically new issuances are close to the middle of that range. We do not downgrade until expected losses fall outside that range.

In assigning new ratings we are always reevaluating the assumptions that we make when assigning ratings. When there is a market shift, we want to evaluate that shift and incorporate that evaluation into our ratings as soon as possible. Gradual shifts typically would not result in adjustments to recently assigned ratings.

-----Original Message-----
From: Scholz, Detlef
Sent: Friday, May 25, 2007 10:53 AM
To: Kirnon, Noel; Drevon, Frederic; Clarkson, Brian; Weill, Nicolas; Duca, James
Cc: Piels, Daniel; Mazataud, Paul
Subject: FW: Financial Times inquiry on transparency of assumptions

Heads-up/note on further question that the FT (Paul Davis) are pursuing: Why don't we reassess all outstanding bonds when we announce to change our model assumptions for future transaction? He is focussing on US CMBS's recent changes, but this question applies across the board. May I suggest to work on a joint response as this question will come up on Thursday?

-----Original Message-----
From: Piels, Daniel
Sent: 25 May 2007 16:28
To: Kolter, Daniel; Palimeri, Ifigenia; Philipp, Tad
Cc: Scholz, Detlef; Adler, Michael
Subject: Financial Times inquiry on transparency of assumptions

Please see below an email from Paul Davies, the FT structured finance reporter. Are we in a position to provide clarity on the transparency of assumptions? Is he referring to the report we put out in the US about phasing in an increase to CMBS conduit subordination? Please advise.

-----Original Message-----
From: Paul.J.Davies@FT.com [mailto:Paul.J.Davies@FT.com]
Sent: 25 May 2007 15:15
To: Piels, Daniel
Subject: Re: Breakfast meeting next week w/Brian Clarkson of Moody's

Of course, please invite him. I've never actually met him myself so would be good. I also want to talk either then or at another time, but soon, about transparency of not just methodology but also assumptions. The hook is the recent changes to CMBS in the US which mean that future ratings are not directly comparable to older ratings, while other ratings do not get re-assessed under new assumptions... This is a broad characteristic of the evolution of structured finance ratings I think and there are many other examples, so the questions are really about how and why in such situations the new standards are not applied retrospectively...

I am thinking of writing a piece about this and will be talking to other agencies also. Oh and by the way, I'll be stuck doing DIY all weekend!

Best regards

Paul J Davies
Capital Markets Reporter

Financial Times

0207 873 4838
Paul.J.Davies@ft.com

Confidential Treatment Requested
by Moody's Investors Service

MIS-OCIE-RMBS-0364944

"Piels, Daniel" <

<Daniel.Piels@moo To: <Paul.J.Davies@FT.com><

dys.com> cc:

Subject: Breakfast meeting next week w/Brian Clarkson of Moody's

25/05/2007 12:41

Hi Paul,

Got any plans for the long weekend? Sadly, I'm not going anywhere.

Just to let you know, Paul Mazataud and Neal Shah, co-head of EMEA RMBS team will also be joining us on Thursday at 1 Lombard Street, as you indicated you wanted to talk about UK subprime.

I was also wondering if you would object to me inviting to the breakfast John Plender, the FT Insight columnist. He wrote a column this week about a stretched credit cycle that caught our attention. Is this amenable? If not, we're happy to arrange something separate with John. Please advise.

Regards,

Dan

Daniel Piels
Rating Communications
Moody's Investors Service
daniel.piels@moodys.com
O: +44 20 7772 8727
M: +44 7920 801 833

From: Momin, Inayat
Sent: Tuesday, July 12, 2005 2:03 PM
To: Jordan, Pat
Cc: Vega, Juan; Gillis, Tom; Gilkes, Kai; Cantor, David; Tesher, David; Carrier, Henry; Anderberg, Stephen
Subject: RE: Delay in Evaluator 3.0 incorporation in EOD/CDOi platform

Pat,

Thanks of the updates.
It would take 2 to 3 weeks for one fulltime resource to replace E2.4.3 with E3.0

Inayat

-----Original Message-----
From: Jordan, Pat
Sent: Tuesday, July 12, 2005 12:16 PM
To: Momin, Inayat
Cc: Vega, Juan; Gillis, Tom; Gilkes, Kai; Cantor, David; Tesher, David; Carrier, Henry; Anderberg, Stephen
Subject: RE: Delay in Evaluator 3.0 incorporation in EOD/CDOi platform

Inayat,

Thank you for the comparison reports. At this point we are not ready to proceed with E3, nor do we know when we will be. So please continue under the

the assumption that E2.4.3 will be the version available on the CDOi platform. Our goal is to determine what changes we want to make to the Beta E3, test the impact and decide if/when to proceed with a roll-out, but I'll be surprised if that all happens any sooner than September, and could take longer.

How long and how many resources will it take to replace E2.4.3 once we have decided on E3?

Pat

-----Original Message-----
From: Carrier, Henry
Sent: Tuesday, July 12, 2005 10:11 AM
To: Momin, Inayat
Cc: Vega, Juan; Gillis, Tom; Gilkes, Kai; Jordan, Pat; Cantor, David
Subject: RE: Delay in Evaluator 3.0 incorporation in EOD/CDOi platform

Inayat,

The decision to go to Evaluator 3.0 in EOD/CDOi platform is an analytical matter. Pat Jordan will make the final decision. Until further notice, assume that we are going with the older version.

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Henry

-----Original Message-----
From: Momin, Inayat
Sent: Tuesday, July 12, 2005 10:05 AM
To: Carrier, Henry; Cantor, David
Cc: Vega, Juan
Subject: RE: Delay in Evaluator 3.0 incorporation in EOD/CDOi platform

Henry/ David:

Per your suggestion, a comparison report has been provided two weeks ago.
We would like to have a feedback on this, so that we can plan our work about switching to the v3.0 engine.
Please let us know if any decision has been made regarding switching to v3.0

Thanks,
Inayat

-----Original Message-----
From: Momin, Inayat
Sent: Tuesday, June 28, 2005 12:54 PM
To: Carrier, Henry; Cantor, David; Chen, John; Tomlinson, Sandra; Murray, Tom; Scanlin, Kate; Anderberg, Stephen; D'Erchia, Peter; Galli, Stephen; Gillis, Tom; Watson, Bob; Vega, Juan; Sargsyan, Eduard; Drexler, Michael; Jordan, Pat; Mydeen, Shaik

Subject: RE: Delay in Evaluator 3.0 incorporation in EOD/CDOi platform

All:

Here are the comparison reports. Please let us know when EOD should be switched to CDO Evaluator v3.0

Last 3 months historical numbers for the approved deals:
ROC numbers => \\nycsvr04\Group_Sfdb\EOD-ROC\ROC-Report\27-JUN-2005\ROC-HIST-Comp-2-5-2-Vs-3-0.xls
SDR numbers => \\nycsvr04\Group_Sfdb\EOD-ROC\ROC-Report\27-JUN-2005\SDR-HIST-Comp-2-5-2-Vs-3-0.xls

Current numbers for the approved deals using ratings as of June-24-2005:
ROC numbers => \\nycsvr04\Group_Sfdb\EOD-ROC\ROC-Report\27-JUN-2005\ROC-DAILY-Comp-2-5-2-Vs-3-0.xls
SDR numbers => \\nycsvr04\Group_Sfdb\EOD-

PSI-S&P-RFN-000018

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~~ROC\ROC-Report\27-JUN-2005\SDR-DAILY-Comp-2-5-2-~~
Vs-3-0.xls

Thanks,
Inayat

-----Original Message-----
From: Carrier, Henry
Sent: Tuesday, June 21, 2005 5:55 PM
To: Jordan, Pat
Cc: Cantor, David; Chen, John; Tomlinson, Sandra; Murray, Tom; Scanlin, Kate; Anderberg, Stephen; D'Erchia, Peter; Galli, Stephen; Gillis, Tom; Watson, Bob; Momin, Inayat; Vega, Juan; Sargsyan, Eduard; Drexler, Michael

Subject: Delay in Evaluator 3.0 incorporation in EOD/CDOi platform

Pat,

Please forward this e-mail as appropriate.

As we discussed, I have asked Inayat Momin to delay the incorporation of Evaluator 3.0 (E-3) in the EOD/CDOi platform until you give us the ok. We will continue to use version 2.4. My understanding is that we need to address the impact of new default and correlation tables on existing ratings before we release E-3.

Inayat has offered to run previously approved deals for CDOi (about 150 US Cash deals, w/ bonds or loan portfolios) under both e2.4 and e3.0. This should help you assess the impact of the changes. He will run the two analyses for the latest 3 months. The noise form any data issue should be negligible.

Note that when we do decide to incorporate E3 in the platform, we will need time to reprocess all the deals and their reports. This may delay the launch. Further all deals and all their reports will show the results from E3.

Henry

Henry J. Carrier
Managing Director, Strategic Operations

PSI-S&P-RFN-000019

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Structured Ratings
Standard & Poor's Credit Market Services
55 Water Street
41st Floor
New York, NY 10041
Direct: 212-438-6635
Fax:: 212-438-0086
Main: 212-438-2000
henry_carrier@standardandpoors.com

PSI-S&P-RFN-000020

From: Tesher, David
Sent: Monday, May 22, 2006 10:26 AM
To: Kambeseles, Peter
Subject: FW: Draft #2: E3 Surveillance Policy for Cash CDOs

What do you think before I send this out ...

-----Original Message-----
From: Anderberg, Stephen
Sent: Friday, May 19, 2006 5:24 PM
To: Jordan, Pat; Tesher, David; Inglis, Perry; Collingridge, Simon
Subject: Draft #2: E3 Surveillance Policy for Cash CDOs

Pat and David,

I've made changes to reflect our discussion this afternoon - let me know if I've failed to capture anything properly. I'll be in the all-day VCDS training session on Monday, Tuesday and Wednesday but will can stop by in the evening if you have any concerns.

Perry and Simon,

FYI, I'm forwarding this at Pat's request. Also, I apologize for stating the obvious but this needs to kept from Paul's eyes

Thanks!

Steve

PRIVILEGED AND CONFIDENTIAL - S&P DISCUSSION PURPOSES ONLY

Prior to Transition Date (in preparation for final implementation of E3 for cash CDOs):

- A large majority of the pre- E3 cash flow CDOs will be run through E3 in batch processes to see how the ratings look within the new model
- In the US, the Primary side will handle batch runs for 2005 & 2006 deals; CDO Surveillance will produce batch runs for deals originated 2000 through 2004
- Ratings falling ***more than*** 3 notches +/- from the current tranche rating in the batch process will be reviewed in detail for any modeling, data, performance or other issues
- If any transactions are found to be passing/failing E3 by more than 3 notches due to performance reasons they will be handled through the regular surveillance

PSI-S&P-RFN-000021

~~process to see if the ratings are stable under current criteria (i.e., if they pass~~ E2.4.3 using current cash flow assumptions the ratings will remain unchanged)

- If any transactions are found to be passing/failing E3 by more than 3 notches due to a model gap between E2.4.3 and E3, they will be reviewed by a special E3 committee, including representatives from the surveillance, primary CDO ratings and criteria groups.
- The special committee will review the "model gap" deals by looking at the results of cash flow analysis generated under both E2.4.3 and E3 as well as looking at other factors - structure, collateral, management, etc. - to determine whether or not an action will be required in connection with the E3 rollout
- Transactions failing E3 purely due to the change in modeling assumptions - i.e., not due to any structural, management or collateral weaknesses - will not have ratings adjusted by the special committee

For the synthetic CDOs, the pre-E3 transactions were run through E3 Low immediately before the release of the model to see if they fell within the "tolerance band" established for the pre-E3 deals under the new model. The 3 notch gap discussed above is the equivalent "tolerance band" for the cash flow deals.

Surveillance Policy for Cash flow CDOs Post Final E3 release (i.e., following the transition date and transition date steps taken above):

- Transactions rated under E2.4.3 will be monitored and placed on CreditWatch based solely on E2.4.3, and GROC will be generated for these deals under E2.4.3 for both surveillance and publishing purposes
- Cash flow runs for E2.4.3 deals will be generated, reviewed and taken to committee if (and only if) a transaction fails GROC under E2.4.3; the committees for these transactions will review cash flow runs generated under both models (E2.4.3 and E3.x). This is the only point in the surveillance process for which E3.x cash flow analysis will be generated for transactions rated with E2.4.3. The results from E2.4.3 will be used to arrive at the committee's rating decision, while the E3.x results will be reviewed on an ongoing basis to monitor the gap in results produced by the two models
- Although it is contemplated that transactions rated using E2.4.3 will continue to be monitored using E2.4.3 following the transition date, Standard & Poor's reserves the right to surveill its rated transactions using the appropriate model for its credit opinion, the performance of the transactions, or for any other reason
- Transactions rated under E3 will be monitored and surveilled using E3, and GROC will be generated for these deals under E3 for both surveillance and publishing purposes
- Transactions rated prior to the final transition date using E3 SDRs and E2.4.3 BEDRs will be monitored and surveilled using E3 SDRs and E2.4.3 BEDRs, and GROC will be generated for these deals using E3 SDRs and E2.4.3 BEDRs for both surveillance and publishing purposes

Thanks,

Steve

Stephen Anderberg
Director, Structured Finance Ratings
stephen_anderberg@standardandpoors.com

PSI-S&P-RFN-000022

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Standard & Poor's
55 Water Street, 41st Floor
New York, NY 10041-0003
(212) 438-8991
(212) 438-2664 fax

PSI-S&P-RFN-000023

From: Parisi, Frank
Sent: Monday, March 12, 2007 10:13 AM
To: Griep, Cliff; Gillis, Tom; Barnes, Susan; Warner, Ernestine
Subject: RE: Comments on sub prime article

Cliff,

Thanks for your comments and thoughts. Clearly some are editorial and some relate to our criteria and policies; the former can be quickly addressed. To one of your specific points, Tom and I have been looking at the performance of the 2005 vintage as well, and it looks like that too may need to be addressed as you've suggested.

Thanks, Frank

> -----Original Message-----
> From: Griep, Cliff
> Sent: Monday, March 12, 2007 9:53 AM
> To: Gillis, Tom; Parisi, Frank; Barnes, Susan; Warner, Ernestine
> Subject: Comments on sub prime article
>
> We should lead with our projections for performance and the
> consequent ratings impact.
>
> I believe david wyss mentioned an actual decline in nominal
> home prices nationally has already occured. The article
> should incorporate.
>
> The statement of 2006 vintage being only 50 percent more
> risky than 2000 vintage mat understate the risk. We must
> cover the changes in product type, the interest rate risk in
> more detail, and the dramatuc increase in limited income
> documentation. Do we have any measure on historic performance
> of no doc lending in sub prime? Should we say more about the
> performance impact of confirmed seconds, or ltv?
>
> It would be helpful to compare market context. We currently
> have meaningful bankruptcies of sub prime lenders, large
> losses reported by some banks, the regulators forcing tighter
> underwriting standards, etc. This is all different than 2000.
>
> Hasn't loan purpose been more risky as well. Do we track
> speculative activity, for investment and second home on a
> macro level, and what is it telling us about comparisons?
>
> Can we size the payment shock exposure relative to payment or
> capacity?
>
> Our loss estimates are within the context of our criteria.
> Are we completely satisfied that our criteria captures all
> the relevant risk? Should we defend our criteria more explicity?
>
> Why did the criteria change made in mid 2006 not impact any
> outstanding transactions at the time we changed it,
> especially given the magnitude of the change we are

PSI-S&P-RFN-000015

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-> highlighting in the article? Should we apply the new criteria
> now, given what we now know? If we did, what would be the impact?
>
> Why are we focused only on the 2006 vintage? Are we
> suggesting 2005 will not have issues?
>
> What are the a, aa, and aaa, levels of credit support for the
> first half 06 vintage? Should we mention these?
>
> I don't think the readers will understand what we mean when
> we say a single b scenario, or a bb scenario. We should explain this.
>
> We seem to disparage market views by using the terms
> "rhetoric" and "hype". We should simply state our views
> authoritatively without characterizing others.
>
> Several of the comparisons on the first page require
> clarification. I.e. Serious delinwquency in 06 vintage is
> compared to delinquency in 2000 vintage.
>
> We cite imprudent underwriting standards as a reason for the
> concern about 2006 vintage. What is our view of underwriting
> standards and how does this view impact our view and analysis?
>
> Given the overall projections, should we be taking more
> aggressive rating actions on bbb and speculative grade traunches?
>
> Were the criteria adjusted between 2000 and 2006 and are
> these criteria changes relevant? Should they be covered?
>
> Should we review our no doc lending criteria or are we
> satisfied it adequately captures the risk?
>
> Should we comment in greater detail on the changes in product
> mix between 2000 and 2005 and 6?
>
> Should we comment on the overall impact on servicing expected
> from the current developments, given new century, etc.
>
> Sent from my GoodLink synchronized handheld (www.good.com)
>

PSI-S&P-RFN-000016

DATE: 05/15/2007
TIME: 17:16:08
AUTHOR: Dronov, Alexey (CALYON)
RECEIPIENT: May, William
CC:
SUBJECT: RE: Stratford CLO

Bill - the timing for Stratford has been pushed back one month, so we will be pricing the deal in june. Should we still use the old methodology?

Alexey Dronov - VP
Structured Credit, Derivatives & CDOs
Calyon Corporate & Investment Bank
1301 Avenue of the Americas
New York, NY 10019
212-261-7497 (Office)
617-448-2074 (Mobile)
alexey.dronov@us.calyon.com

From: May, William [mailto:William.May@moodys.com]
Sent: Wednesday, April 11, 2007 6:45 PM
To: Dronov, Alexey (CALYON)
Subject: RE: Stratford CLO

Alex,
Go ahead and use the old methodology.
Regards,
Bill

-----Original Message-----
From: Dronov, Alexey (CALYON) [mailto:Alexey.Dronov@us.calyon.com]
Sent: Wednesday, April 11, 2007 4:14 PM
To: May, William
Subject: RE: Stratford CLO

Bill,

We intend to price the Stratford deal in May but closing will be in June. Should we use the old methodology or the new one? I talked to Danielle Nazarian and Rudy Bunja about some of the LCDS features of the deal and they thought it would make sense to use the old methodology, but suggested that I double check with you. Thanks.

Alexey Dronov - VP
Structured Credit, Derivatives & CDOs
Calyon Corporate & Investment Bank
1301 Avenue of the Americas
New York, NY 10019
212-261-7497 (Phone)

PSI-MOODYS-RFN-000040

Footnote Exhibits - Page 0743

617-448-2074 (Mobile)
alexey.dronov@us.calyon.com

From: May, William [mailto:William.May@moodys.com]
Sent: Thursday, April 05, 2007 3:15 PM
To: Dronov, Alexey (CALYON)
Cc: Dupont-Madinier, Cyprien (CALYON)
Subject: RE: Stratford CLO

Alexey,
Your analysts are:
Quant: Elina.kolmanovskaya@moodys....com <mailto:Elina.kolmanovskaya@moodys.com>. # is 553-7852.
Legal: mark.froeba@moodys.com <mailto:mark.froeba@moodys.com>. # is 553-4149.
Regards,
Bill

-----Original Message-----
From: Dronov, Alexey (CALYON) [mailto:Alexey.Dronov@us.calyon.com]
Sent: Monday, April 02, 2007 7:15 PM
To: May, William
Cc: Dupont-Madinier, Cyprien (CALYON)
Subject: Stratford CLO

Bill,

We are working on a 700M-1B CLO for Highland Asset Management. The deal is a standard CLO except that potentially the entire collateral pool can consist of LCDS. The AAA tranche will be a revolver like the A-2 tranche in the duane street deals I structured at Morgan Stanley. The manager will have the ability to block portions of the revolver to invest in LCDS on an unfunded basis, also like in the duane street deals. The timing for the deal is as follows:

pricing - beg of may
closing - end of may

Please let us know who will be working on the deal on your end.

Alexey Dronov - VP
Structured Credit, Derivatives & CDOs
Calyon Corporate & Investment Bank
1301 Avenue of the Americas
New York, NY 10019
212-261-7497 (Phone)
617-448-2074 (Mobile)
alexey.dronov@us.calyon.com

PSI-MOODYS-RFN-000041

*********************************Calyon*********************************
*
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PSI-MOODYS-RFN-000042

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PSI-MOODYS-RFN-000043

From: Mcdermott, Gail
Sent: Thursday, December 09, 2004 6:07 AM
To: Jordan, Pat
Subject: FW: Staffing and Allocation

Per my voice mail this is the e-mail I was referring too.

Gail

-----Original Message-----
From: Mcdermott, Gail
Sent: Friday, December 03, 2004 11:10 AM
To: Losice, Abe; Jordan, Pat
Subject: RE: Staffing and Allocation

Thanks Abe, would ABCP needs be met by the changes stated in the chart below?

Pat and Abe,
The below allocation chart results either in a status quo of resources or a net reduction of staff to RMBS (see reasoning below). I am trying to put my hat on not only for ABS/RMBS but for the department and be helpful but feel that it is necessary to re-iterate that there is a shortage in resources in RMBS. If I did not convey this to each of you I would be doing a disservice to each of you and the department. As an update, December is going to be our busiest month ever in RMBS. I am also concerned that there is a perception that we have been getting all the work done up until now and therefore can continue to do so.

We ran our Staffing model assuming the analysts are working 60 hours a week and we are short resources. We could talk about the assumptions and make modifications but the results would be similar. The analysts on average are working longer than this and we are burning them out. We have had a couple of resignations and expect more. It has come to my attention in the last couple of days that we have a number of staff members that are experiencing health issues.

This shortage in staffing assumes that the only projects we work on next year are SPIRE and LEVELS maintenance. In reality there are other operational items that come up (NIKU, Documentum, Criteria Encyclopedia and CORE redesign) in addition to the exhaustive criteria list which has over 45 issues that need or should be addressed to keep us positioned at the forefront of the marketplace

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most notably Predatory Lending issues, cashflow criteria, Commercial criteria, etc. that do take up time.

I have also thought about our discussion with Joanne in terms of focusing on are top tier clients which is approximately 80% of our revenue. This would result in a reduction (+ or -) of $25 mil. dollars. If this is possible we would have to lay the ground work in terms of managing expectations since we are asked on a weekly basis (sometimes daily) from finance what are revenue estimate is.

My reasoning for stating that the chart results in a net reduction are as follows:

1. As Abe mentioned, some of the changes are on paper only. For example increasing Kanika, Monica and Justin's allocation would not result in productivity gains since they are working more hours in RMBS than their current allocation reflects;

2. We received authorization yesterday to hire replacements for Linda (AD) and Guy (Assoc.). We may downgrade the AD req. to an Associate req. depending on the pool of candidates. It will take a couple of years to get these replacements to be as productive as Linda and Guy.

3. Brian Grow will be leaving next year for Australia which will be a loss of 1FTE. Brian is one of our top ADs.
4. Mark Levin currently allocated 50% to RMBS posted for the commercial openings.
5. Increases of Smith, Devone, Goldenberg, from 50% to 100% and adding Rocha (if possible) will not fill the above voids.

I would like to make the following recommendations:

1 Consider asking if there are any existing reqs. in the department that have not been filled that could be allocated to ABS/RMBS.

2. Gail and Abe discussing further with Brian O'Keefe if there are any Directors currently available in CDOs to be allocated elsewhere (50%).

3. Discussing further whether there are any members of staff not being fully utilized.
4. Requesting adds to staff if #1 and #2 are not feasible.
5. Abe and I make a recommendation to Pat J. on the bullet points related to CDOs, surveillance and where to start the replacements/(new hires?) based on answers to #1-4.

PSI-S&P-RFN-000035

Thank you for you attention to this matter.

Gail

-----Original Message-----
From: Losice, Abe
Sent: Friday, December 03, 2004 12:01 AM
To: Mcdermott, Gail; Jordan, Pat
Subject: Staffing and Allocation

Gail and Pat,

We have not yet reviewed the results of last week's meeting regarding staffing and allocation. Here are a list of issues that actions have been taken or questions are left open:

- Pat, you have reported to Peter that we will not currently allocate to CMBS Surveillance.
- I delivered to Kim the resumes of the applicants for the CMBS positions (Digney, Levin, Zuliani, and Homa).
- I reported to Diane Audino that we are not circulating the Associate posting for LASF and we will not allocate for it from ABS/ RMBS.
- We had discussed adding to the analytical pool currently. Resignations of Wu and Maurice in addition to transfer of Wrede could give rise to replacement reqs. How many are we authorized for? Are we adding above these 2 or 3 in recognition of having hired a small Associate class of '04? Would we hire directly for RMBS or would we hire for LOC, Synthetics, and Surveillance? How much has been shared with Debbie O'Connor's group?
- Stephanie Payne has declined. Only 2 of the '04 summer associates have agreed to join (Matt and Steve). In addition to only one hire from summer '03 (Nicole Billick) points to a lot of work for recruitment with low results. It will be a good test for us to go into the market at this time, away from on-campus recruitment at our targeted schools, and see if we can find comparable or at least acceptable candidates.
- There were discussions about Ravi Myneni and others, such as Chui Ng, in CDO. They could be immediately useful helping on ABCP.
- We talked about maintaining pool allocation to CDO of at least 2 FTE. Are we trying for that level for surveillance?

PSI-S&P-RFN-000036

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- I have started some notes for allocation of analysts. Some are just cosmetic changes to reflect reality. Some are ideas that have to be explored for feasibility. It is for review and discussion. It doesn't really reflect it, but it is meant to lead to flexibility in support of RMBS and ABCP.

<< File: Alloc_notes.doc >>
Thanks,

Abe

Abe Losice
Managing Director
Structured Finance
Standard & Poor's
55 Water Street, 40th Floor
New York, NY 10041

Phone: (212) 438-7326
Fax: (212) 438-2649
abe_losice@sandp.com

PSI-S&P-RFN-000037

From: Diane Cory [ddcory@earthlink.net]
Sent: Wednesday, May 03, 2006 9:27 AM
To: Scott, Gale
Subject: RE: Change in scheduling/Coaching sessions/Other stuff

Importance: High

Gale,

Let's order "Coaching for Performance" by John Whitmore and "The Inner Game of Work" by Timothy Gallwey. Thanks!

Diane

>Diane,
>
>Which books should I order? I will do it now.
>
>Gale C. Scott
>Managing Director
>Global Real Estate Finance
>Standard & Poor's Rating Services
>55 Water Street, 41st Floor
>New York, New York 10041
>
>ph: (212) 438-2601
>fax: (212) 438-2659
>gale_scott@standardandpoors.com
>
>
>-----Original Message-----
>From: Scott, Gale
>Sent: Tuesday, May 02, 2006 8:12 PM
>To: 'Diane Cory'
>Subject: RE: Change in scheduling/Coaching sessions/Other stuff
>Importance: High
>
>
>Hi Diane,
>
>Thank you so much for contacting me about this. Swamped is a
>serious understatement. We spend most of our time keeping each
>other and our staff calm. Tensions are high. Just too much work,
>not enough people, pressure from company, quite a bit of turnover
>and no coordination of the non-deal "stuff" they want us and our
>staff to do......enough said.
>
>Of course you should go ahead and accommodate surveillance. Using
>part of the VCDS session to introduce some basics is a brilliant
>idea (Diane, what's wrong with us...why didn't we think of this).
>Then we can have more in depth training later in the summer as you
>suggest.

>
>I am available this Thursday from 12 noon to 3:00pm and then any
>time after 4:30pm for a call. Does anywhere in this timeframe work
>for both of you?
>
>Gale C. Scott
>Managing Director
>Global Real Estate Finance
>Standard & Poor's Rating Services
>55 Water Street, 41st Floor
>New York, New York 10041
>
>ph: (212) 438-2601
>fax: (212) 438-2659
>gale_scott@standardandpoors.com
>
>
>-----Original Message-----
>From: Diane Cory [mailto:ddcory@earthlink.net]
>Sent: Tuesday, May 02, 2006 5:18 PM
>To: Scott, Gale
>Subject: Change in scheduling/Coaching sessions/Other stuff
>Importance: High
>
>
>Dear Gale,
>
>Since I haven't heard from you regarding the coaching I am thinking
>you are totally swamped...and some things have changed since I sent
>you the proposal for the coaching sessions for the MD coaches.
>
>Daniel and I have been asked to facilitate a session for Global
>Surveillance on Thursday and Friday, June 1-2. We would like to
>accommodate them, if possible.
>
>Daniel is wondering if we might design part of the upcoming VCDS
>session in May to focus on coaching and take the group through some
>of the basics...would that help accomplish several things at once?
>(If you want to do this, we need to have you order the coaching books
>right away.) Then you and I can look at our schedules again and come
>up with a planning time and a two-day and a one-day session perhaps
>beginning at the end of August.
>
>Where's your thinking? Daniel and I are home most of this week and
>are happy to schedule a phone call with you.
>
>Hope you and your family are well. I have lots to share...
>
>Warm regards,
>Diane
>--
>Diane Cory
>
>Phone: (603) 642-6729
>Fax: (603) 642-6479
>

PSI-S&P-RFN-000013

>U.S.A.
>
>--
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--
Diane Cory

Phone: (603) 642-6729
Fax: (603) 642-6479

U.S.A.

PSI-S&P-RFN-000014

From: Jordan, Pat
Sent: Tuesday, October 31, 2006 12:28 PM
To: Rose, Joanne; Veneable, Dawanna; Boyd, Sheila
Cc: Klein, David
Subject: A CDO Director resignation

Importance: High

Unfortunately, one of our excellent and market experienced Directors, Todd Jaeger, resigned Friday afternoon to join RBC Greenwich Capital.

"Stupid money", was being thrown at him by many many (I am not exaggerating) market participants, and he took RBC's offer b/c he knows the guyswho run the CDO group and is comfortable working for them. We have been aware of Todd's frustration with having to do high deal volume (10 in his pipeline regularly) on top of the things, such as developing our hybrid criteria, but b/c of our staffing shortage have been able to make only slow progress in reassigning more junior work.

While I realize that our revenues and client service numbers don't indicate any ill affects from our severe understaffing situation, I am more concerned than ever that we are on a downward spiral of morale, analytical leadership/ quality and client service. Anything that can be done to receive immediate approval for the recently requested adds to staff as well as Todd's replacement is needed asap. At the risk of stating the obvious, Todd, and Winnie Fong last month, are not sticking around for S&P bonuses. Reliable rumor has it that Todd was offered $500k for now to March (end of their comp year). And then given an indication to expect at least $800k for the next full comp year. I'm very much aware that we can't come close to matching this, but we must both continue to make market adjustments, and try to build a bench through hiring.

The market for anyone with CDO experience is so hot, that even our most junior staff are quickly (within 12-18 months) valuable to the market. We expect more resignations.

PSI-S&P-RFN-000001

DATE: 07/09/2007
TIME: 12:04:56
AUTHOR: Jim Badenhausen
RECEIPIENT: Yoshizawa, Yuri
CC: Kimon, Noel; Clarkson, Brian; McDaniel, Raymond; Westlake, Lisa; Harris, Gus; Subprime Working Group - Craig Brown; Subprime Working Group - Michael Gross
SUBJECT: FW: CDO Surviellance Note 7_071.doc

Dear Yuri -

Thanks for sharing this draft of the CDO surveillance piece you're planning to publish later this week. We took a look at it over the weekend, and think there is alot of good information here. We did had a few reactions to the document - from an outsider's perspective - that we wanted to share with you as you continue to refine this in the days ahead.

- We thought it might be useful, at the outset, to provide an easily digestable overview of what you look at as part of your CDO surveillance - including the performance of underlying assets, the CDO structural features and the asset manager's decisions. This would be especially useful for the press and other less sophisticated audiences, although perhaps it could even be a helpful reminder for more sophisticated investors. Fitch has a slide like this, which you may have already seen, in the sub-prime/CDO presentation posted on their website (see the attached deck), and we've pasted the relevant slide below for easy reference.

- Presumably one of the most important parts of this document, given the current market environment, is the discussion of the factors that could lead to an upgrade/downgrade. And, as outsiders who aren't as familiar with CDOs and the surveillance process itself, we had a little trouble understanding the chart you've included here. We thought this section might benefit from a little more "user-friendly" context and explanation, to the extent possible, as it could help the press and other key constituencies understand the key drivers you look at in monitoring these securities.

- We also were wondering if it might be worthwhile to talk specifically about the surveillance of CDOs backed by RMBS's, given the scrutiny that they are under right now. For instance, in the attached deck posted on their website (and in the slide pasted below), S&P talks about their "integrated process for CDO and RMBS surveillance" and mentions that "prior to the release of RMBS rating actions we are fully aware of the exposures within our rated CDO transactions, and have made at least a preliminary assessment of any potential CDO rating impact." That could be a good message to put out into the marketplace, if Moody's CDO surveillance process works in a similar way.

- In the section about your CDO surveillance infrastructure, we were struck by the data point about the 26 professionals who are dedicated to monitoring CDO ratings. While this is, no doubt, a strong team, we wanted to at least raise the question about whether the company's critics could twist that number - e.g., by comparing it to the 13,000+ CDOs you're monitoring - and once again question if you have adequate resources to do your job effectively. Given that potential risk, we thought you might consider removing any specific reference to the number of people on the CDO surveillance team.

- There is quite a bit of talk here about Moody's "automated" surveillance systems, and they are obviously an important part of the surveillance process. But this also could be misconstrued by critics to make it sound like your surveillance system is on "autopilot." We were wondering if there is more you could say about the rigorous analysis that your analysts - and the ratings committees - do in this process.

- There are also several parts of this paper that make the CDO surveillance/monitoring process sound potentially slower than it no doubt is (e.g., "the ultimate decision to upgrade/downgrade is subject to additional analysis over a period of a few weeks to a few months"). Again, we are concerned that statements like this could be taken out of context by your critics and twisted to sound like evidence of a slow, ineffective monitoring process. Perhaps some of these turns of phrase could be reworked with those external audiences in mind.

Hope these thoughts are helpful. Let us know if you have any questions or would like to discuss this further.

Thanks.

- Jim, Michael and Craig

EXCERPT FROM FITCH PRESENTATION on SUB-PRIME/CDO'S (SLIDE 54)

CDO Surveillance Framework

Three Pillars of CDO Performance

§ Performance of Underlying Assets

PSI-MOODYS-RFN-000023

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o Primary CDO performance driver is the performance of the underlying assets

o Successful CDO surveillance must be able to measure and monitor performance changes

§ CDO Structural Features

o CDO structural features vary deal-by-deal

o Features may impact rating actions on specific CDO tranches

o Features may impact severity of rating actions on CDO tranches

§ Asset Manager's Decisions

o Asset Manager incentive or focus may change throughout the life of a CDO

o Successful CDO Surveillance must work with Asset Managers to:

§ Understand manager's view on asset selection

§ Understand manager's view of asset performance and trading strategy

§ Assess manager's ability to adjust to current market conditions

EXCERPT FROM S&P PRESENTATION on SUB-PRIME/CDO'S (SLIDE 26)

S&P Has an Integrated Process for CDO and RMBS Surveillance

. Standard & Poor's has an integrated surveillance process to ensure the ratings on our rated RMBS bonds and CDO transactions reflect our most current credit view

. CDO Surveillance is informed of RMBS Surveillance's current credit opinion and outlook for rated transactions

. RMBS Surveillance is aware of RMBS exposure within Standard & Poor's rated CDO transactions

PSI-MOODYS-RFN-000024

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Prior to the release of RMBS rating actions we are fully aware of the exposures within our rated CDO transactions, and have made at least a preliminary assessment of any potential CDO rating impact

From: Yoshizawa, Yuri [mailto:Yuri.Yoshizawa@moodys.com]
Sent: Friday, July 06, 2007 5:47 PM
To: Kirnon, Noel
Cc: Clarkson, Brian; McDaniel, Raymond; Westlake, Lisa; Harris, Gus; Badenhausen, Jim
Subject: FW: CDO Surviellance Note 7_071.doc

FYI - This is a draft of the CDO surveillance piece that we'll be publishing next week and discussing as one part of the CDO portion of the teleconference. Along with finalizing this piece, we'll be working on the teleconference slides over the weekend and during the first couple of days of next week.

-----Original Message-----
From: Yoshizawa, Yuri
Sent: Friday, July 06, 2007 5:08 PM
To: 'Jeremy Gluck'; Polansky, Jonathan
Cc: Harris, Gus; Park, John
Subject: RE: CDO Surviellance Note 7_071.doc

My comments to the updated document.

Thanks.

-----Original Message-----
From: Jeremy Gluck [mailto:jandjgluck@sbcglobal.net]
Sent: Thursday, July 05, 2007 2:03 PM
To: Polansky, Jonathan
Cc: Harris, Gus; Yoshizawa, Yuri; Park, John
Subject: Re: CDO Surviellance Note 7_071.doc

Sorry, looks like I sent the wrong version--there really is a conclusion in the attachment.

----- Original Message ----
From: "Polansky, Jonathan" <Jonathan.Polansky@moodys.com>
To: Jeremy Gluck <jandjgluck@sbcglobal.net>
Sent: Thursday, July 5, 2007 10:31:57 AM
Subject: RE: CDO Surviellance Note 7_071.doc

PSI-MOODYS-RFN-000025

Footnote Exhibits - Page 0758

Jerry,

Were you going to write the conclusion or were you thinking that we'd take care of it? I'm new at this so i'm not sure what you've done in the past. (also wanted to make sure that you sent back you're final version because this one still had the notes of a conclusion from gus and not a conclusion). Thanks.

Jon

-----Original Message-----
From: Jeremy Gluck [mailto:jandjgluck@sbcglobal.net]
Sent: Thursday, July 05, 2007 1:17 PM
To: Polansky, Jonathan
Cc: Harris, Gus; Park, John; Yoshizawa, Yuri
Subject: Re: CDO Surviellance Note 7_071.doc

Thanks for everyone's quick comments. I've attached an updated draft. Let me know if you'd like me to make further changes.

Regards,
Jerry

----- Original Message ----
From: "Polansky, Jonathan" <Jonathan.Polansky@moodys.com>
To: Jeremy Gluck <jandjgluck@sbcglobal.net>
Cc: "Harris, Gus" <Gus.Harris@moodys.com>; "Park, John" <John.Park@moodys.com>; "Yoshizawa, Yuri" <Yuri.Yoshizawa@moodys.com>
Sent: Wednesday, July 4, 2007 10:54:34 AM
Subject: RE: CDO Surviellance Note 7_071.doc

Jerry,

My comments are attached (should incorporate John's and Gus' comments -John pls verify - I added the #s from Carie and Chris. Also, the original deal score explainatory paper is attached for reference - you'll see Gus' suggestion. Thanks.

Jon <<CDO Surviellance Note 7_07jp.doc>> <<Mdsr.pdf>>

-----Original Message-----
From: Harris, Gus
Sent: Wednesday, July 04, 2007 12:36 PM
To: 'Jeremy Gluck'
Cc: Park, John; Polansky, Jonathan; Yoshizawa, Yuri
Subject: CDO Surviellance Note 7_071.doc

PSI-MOODYS-RFN-000026

<< File: CDO Surviellance Note 7_071.doc >>

My comments are attached. Thanks Jerry

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PSI-MOODYS-RFN-000027

2007 Performance Management Process (PMP)

Review Period: 2007

General Information

Employee Information

D'ERCHIA	**PETER**	**J**
Last Name	First Name	Middle
MD-BUSINESS DEVELOPMENT	**CORPORATE & GOV'T RATINGS**	**NEW YORK, NY**
Title	Department	Location

Manager Information

MONTRONE, WILLIAM L	**MD-RATINGS C&G US PUBLIC FIN**
Manager Name	Title

Overview

Section I -Goals

Goal

Goal	CDO Initiative

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Footnote Exhibits - Page 0761

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Permanent Subcommittee on Investigations

Summary Section

Overall Comments

Employee Comments

This may be the first time in my 26 year career with S&P that I have commented on a supervisor's performance evaluation. I do not agree with Joanne's overall evaluation of my 2007 performance. In my mid-year review for 2007, Joanne states: "Peter is on track for a good performance year." My 2007 performance goals were being met through the first half of the year, as Joanne acknowledged, and after the mid-year, I continued to meet them. Joanne's negative comments in this year-end review, such as I was "notably absent from many discussions" and that Joanne did not "feel [my] leadership", are the result of a disagreement she and I had over the subprime debt deterioration. In early July 2007, I strongly disagreed with Joanne about subprime debt deterioration. My professional assessment on that matter appears to have clouded her objectivity about my year-end performance.

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Permanent Subcommittee on Investigations

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Permanent Subcommittee on Investigations

Even more offensive -- and flatly wrong -- is the
statement that I am not working for a good outcome
for
S&P. That is all I am working towards and have
been for
26 years. It is hard to respond to such comments,
which

I think reflect Joanne's personal feelings arising from our
disagreement over subprime debt deterioration, not professional assessment.
I do not accept the comment that I was not actively engaged with direct reports or the broader department.
My direct report evaluations have been stellar; turnover
in my group is less that 1% over the last three years;
and I have exceeded my revenue budget the last seven
years. Such comments, and others like it, suggest to me
that this year-end appraisal, in contrast to the mid-year
appraisal, has more to do with our differences over subprime deterioration than an objective assessment of
my overall 2007 performance.

Mid-Year Review Date/Comments

Peter is on track for a good performance year. He should continue to
try to work with the other members of the SFLT to continue to improve
our surveillence functions.

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Second Level Manager Comments

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Permanent Subcommittee on Investigations

Signatures

Employee:	PETER D'ERCHIA	Date	02/08/2008
Manager:	VICKIE TILLMAN	Date	02/08/2008
Second Level Manager:	VICKIE TILLMAN	Date	01/25/2008

DATE: 10/12/2007
TIME: 21:44:41 GMT
AUTHOR: Hu, Jian
RECEIPIENT: Carrafiello, Crystal; Steckert, Marianne; Yoshizawa, Yuri; Kolchinsky, Eric; Trefflich, Kara; Adler, Michael; Trier, Nathan; Fu, Yvonne; Cantor, Richard; Kanef, Michael; Teicher, David; Thomas, Julia; Adler, Michelle; Weill, Nicolas; Polansky, Jonathan; Robinson, Claire; Kornfeld, Warren; Leshko, Courtney; Jonas, Gregory; Liberman, Jessica; Harris, Gus; Park, John; Kimon, Noel; Hemmerling, Brett; Osborne, Timothy; Mirenda, Anthony (Tony); Laserson, Fran; Huber, Linda
CC:
SUBJECT: RE: Fitch's teleconference presentation and questions from their Q&A

After S&P, Fitch is now also blaming fraud for the impact on RMBS rating, at least partially.

Fitch CEO says fraudulent lending practices may have contributed to problems with ratings

<javascript:void(0);>

594 words

12 October 2007

9:09:58 PM GMT

Associated Press Newswires </tools/sourceDetails.aspx?srcs=APRS>

English

Credit rating agencies, which guide investors about the risks of bonds, have come under scrutiny for giving their blessing to mortgage-backed securities that have since plummeted in value. Now, Congress, several states and the Securities and Exchange Commission are probing the agencies.

Stephen Joynt, chief executive of No. 3 player Fitch Ratings, said in a recent interview that the blame may lie with fraudulent lending practices, not his industry.

AP: Companies and other bond issuers pay you to rate their securities. One senator compared this to paying a movie critic for a review.

Joynt: For a long time it's been acknowledged that there's a potential for a conflict of interest in the business model that has issuers pay rating agencies.

Would you support changes to the system of being paid by the issuers?

I think it would be very difficult to change or transition away from that today. The reason (for) the original model to have the issuers pay was ... they wanted rating agencies to be capable of paying higher salaries for a more competent staff. I think that's still probably an important need.

Has the SEC been in contact with you?

We had a pretty extensive meeting with them several weeks ago. I think maybe 10 or 15 representatives came up and sat for maybe a four-hour meeting. We gave them a good update on our process of rating mortgage-backed securities, which is what they were interested in.

Your industry's taken heat for awarding high ratings to bond offerings backed by mortgages sold to people with poor credit. How did you determine your ratings?

We would have based it primarily on the best indicators like FICO scores. It turns out that (homeowners' credit scores) may not be the best indicators of the performance on this batch of **subprime** securities. It also may be true that some of the underlying information on some of the loans may have contributed to that performance, possibly by being fraudulent. Some have suggested that the incidence of fraud in the processing of more recent **subprime** mortgages, especially in the last year and a half, may have been far more extensive than we had seen in the past.

Did you make the right calls with the information you had?

We've recently gone back and reviewed all of the mortgage-backed securities for **subprime** that we rated in 2006 that people are questioning most, and we've reaffirmed all of our triple-A ratings just in the last several weeks. We've made some changes in double-A and single-A. There's certainly been deterioration in that.

It's not the first time rating agencies have grabbed headlines. In the days of the Enron scandal, the industry was also accused of missing the boat.

I wouldn't say that finding these particular two headlines and linking them is the way I would present our reputation or image in the market.

Is your industry being made a scapegoat?

Is there something we could have done different or better? We should focus on our primary job. That's our lead job, as contrasted with spending a lot of time and energy to put in place responses to the people who are offering critiques.

Did you do a better job than your competitors?

I can think of specific instances where we declined to rate certain things that the others did. Maybe they can think of the same instances for us.

7

Regards,

Jian Hu
Structured Finance - CDOs/Derivatives
Moody's Investors Service
Tel: 212.553.7855

-----Original Message-----
From: Hu, Jian
Sent: Wednesday, October 10, 2007 12:58 PM
To: Carrafiello, Crystal; Steckert, Marianne; Yoshizawa, Yuri; Kolchinsky, Eric; Trefflich, Kara; Adler, Michael; Trier, Nathan; Fu, Yvonne; Cantor, Richard; Kanef, Michael; Teicher, David; Thomas, Julia; Adler, Michelle; Weill, Nicolas; Polansky, Jonathan; Robinson, Claire; Kornfeld, Warren; Leshko, Courtney; Jonas, Gregory; Liberman, Jessica; Harris, Gus; Park, John; Kimon, Noel; Hemmerling, Brett; Osborne, Timothy; Mirenda, Anthony (Tony); Laserson, Fran; Huber, Linda
Subject: RE: Fitch's teleconference presentation and questions from their Q&A

Also, CreditFlux sent out an alert on a S&P conference yesterday:

S&P says it underestimated extent of fraud in subprime industry

PSI-MOODYS-RFN-000036

News Digest, 9 October 2007

At a conference today, S&P said it underestimated the extent of fraud in the subprime industry. The agency's chief economist David Wyss said the US subprime housing crisis will not reach its peak until 2009. He said the extent of fraud in the subprime industry increased sharply in 2006. He added that US economic growth will lag at 2% in 2007 and 2008, down from 2.9% in 2006. Due to the subprime crisis, he said the US would contribute only 9% of world growth in 2007

Regards,

Jian Hu
Structured Finance - CDOs/Derivatives
Moody's Investors Service
Tel: 212.553.7855

-----Original Message-----
From: Carrafiello, Crystal
Sent: Wednesday, October 10, 2007 12:45 PM
To: Steckert, Marianne; Yoshizawa, Yuri; Kolchinsky, Eric; Trefflich, Kara; Adler, Michael; Trier, Nathan; Fu, Yvonne; Cantor, Richard; Kanef, Michael; Teicher, David; Thomas, Julia; Adler, Michelle; Weill, Nicolas; Polansky, Jonathan; Robinson, Claire; Kornfeld, Warren; Leshko, Courtney; Jonas, Gregory; Liberman, Jessica; Harris, Gus; Park, John; Kimon, Noel; Hemmerling, Brett; Osborne, Timothy; Hu, Jian; Mirenda, Anthony (Tony); Laserson, Fran; Huber, Linda
Subject: Fitch's teleconference presentation and questions from their Q&A

A little intelligence from Fitch's recent teleconference that may assist in your preparation.

Slides from their presentation attached.

<< File: Fitch Slides.pdf >>
Some key points:

- A whole section is devoted to closed-end seconds, which they were just getting around to.
- They noted that they have chosen to take aggressive action to give the best estimate as to where they think the ratings are going, rather than engage in more mild, but serial downgrades, which does not serve the market
- They confirmed 100% of first-lien backed AAAs
- If I am interpreting the transition matrix on slide 17 correctly, about 11% of triple-B's downgraded went to single B and less than 2% to triple-C.
- They do not appear to have left any rating classes under review
- They indicated they will do another full review of the 2006 vintage in 6 months.
- They noted that they are likewise currently reviewing 1st half '07 deals.
- They focused solely on the RMBS and did not provide projections of likely CDO rating impact.

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- There was some discussion of how they look at home price appreciation and other statistics on a state-by-state basis and that next month they will be upgrading their model to take in differences by the top 50 US metropolitan markets.

Questions asked during the Q&A

- What is the rationale for reviewing the '07 transactions so soon after rating them?
- How can you square your assumptions on underlying home price appreciation with that reflected in the performance of the ABX?
- The 2005 vintage is just facing resets and we are already seeing significant deterioration in terms of delinquencies. What are your expectations on initial 90-day delinquencies and what type of roll-rates are you using from there?
- The availability of credit has changed substantially, impacting the ability to refinance. How have you adjusted your models to reflect this?
- The market's perception is that ratings continue to lag. Can you provide us confidence that, as you have stated, this is not just one in a "stair-step" approach to rating revisions?
- How do you see the performance of first liens without a second lien to first liens with a second lien?
- Where do you think we stand in terms of the ARM resets for RMBS?
- Do you believe that there is a high percentage of fraudulent loans, particularly among the second liens, and that after they are removed, the rest of the pool will perform better?
- Apparently another rating agency has said that they may have to take additional actions as the result of lower-than-expected levels of loan modifications. Does Fitch share that concern?
- Has your model factored in the impact of a recession and or are we likely to be on a similar call 6 months from now hearing "who knew we were going to have a recession?" How resilient would the triple-B's and below-investment-grade ratings be relative to the triple-A's?
- Is Fitch taking more actions because it is rating worse deals?
- How do the rating actions flow through to the mezzanine CDOs and is the way that you are looking at these loss projections different from the views of the CDO team?
- What is your thinking on the impact of foreclosure processing? Is the deluge problematic in terms of timelines and loss severities?
- How are you stress-testing the capacity of the servicers in your rating methodology for them?

PSI-MOODYS-RFN-000038