<u>Golden West – "Five Easy Pieces"</u>

The Five Easy Pieces model was developed by Golden West as a way to understand the business model of a traditional thrift mortgage portfolio lender, as well as to reinforce that the business model could only succeed if the company maintained high credit quality, low operating costs and high capital. The Five Easy Pieces model was frequently used as a training tool with managers and employees at the company, and was also used explain the company's portfolio lending business to regulators and rating agencies.

The Five Easy Pieces include the following elements:

(1) the **Spread**, which is the difference between the rate on interest-earning assets (loans) and the rate paid on interest-bearing liabilities (deposits or other borrowings);

(2) earnings on **Free Funds**, which refers to earnings the company can generate on its capital that is invested in earnings assets, i.e., that is not consumed by nonearning assets such as nonperforming loans or facilities;

(3) **Other Income**, which refers to non-interest income from fees, gains on sale of loans or securities, or other items;

(4) **G&A Expense**, which refers to general and administrative operating costs, including salaries, benefits, technology, etc…; and

(5) **Credit Costs**, which refers to losses due to loans that fail to perform.

A way to understand the economics of a mortgage portfolio lender is to look at revenues (Spread, Free Funds, Other Income) and costs (G&A Expense and Credit Costs) generated by the business model as a percentage of average assets.

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For many years, a return on average assets (ROA) of 1.0% was considered a very good return for a bank or savings institution. The following table shows how a traditional bank or savings and loan, such as Golden West, could generate a 1.0% ROA over long-term business and interest rate cycles by focusing on high capital, high-quality assets, and low costs:

Revenues		
Spread	225	basis points
Free Funds	30	
Other Income	15	
Total	**270**	
Costs		
G&A Expense	(100)	
Credit Costs	(5)	
Total	**(105)**	
Pretax Earnings	**165**	
Taxes	(66)	
Earnings (ROA)	**99**	**basis points**

Among the five easy pieces, the most critical components for a mortgage portfolio lender to stay in business, and earn healthy returns, were: (i) maintaining high capital, which would increase the **Free Funds**, (ii) keeping **G&A Expense** low , and (iii) keeping **Credit Costs** low. The effects on ROA of changing any of these can be seen in the following examples.

1. Keeping everything else equal, if the company maintained low capital and/or had high nonearning assets and thus did not have any **Free Funds**, earnings would suffer.

Revenues		
Spread	225	basis points
Free Funds	0	
Other Income	15	
Total	**240**	
Costs		
G&A Expense	(100)	
Credit Costs	(5)	
Total	**(105)**	
Pretax Earnings	**135**	
Taxes	(54)	
Earnings (ROA)	**81**	**basis points**

2. Similarly, everything else being equal to the original case, if **Credit Costs** started to increase to the levels that many banks experienced (e.g. 50 bp), the adverse impact on earnings would also be severe.

Revenues		
Spread	225	basis points
Free Funds	30	
Other Income	15	
Total	**270**	
Costs		
G&A Expense	(100)	
Credit Costs	(50)	
Total	**(150)**	
Pretax Earnings	**120**	
Taxes	(48)	
Earnings (ROA)	**72**	**basis points**

3. Again, everything else being equal to the original case, if **G&A Expense** increased to the levels of many others in the industry (e.g. 175 bp), the adverse impact on earnings would be severe.

Revenues		
Spread	225	basis points
Free Funds	30	
Other Income	15	
Total	**270**	
Costs		
G&A Expense	(175)	
Credit Costs	(5)	
Total	**(180)**	
Pretax Earnings	**90**	
Taxes	(36)	
Earnings (ROA)	**54**	**basis points**

4. And, finally, if the company did not remain vigilant in each of the three critical areas, earnings would virtually disappear.

Revenues		
Spread	225	basis points
Free Funds	0	
Other Income	15	
Total	**240**	
Costs		
G&A Expense	(175)	
Credit Costs	(50)	
Total	**(225)**	
Pretax Earnings	**15**	
Taxes	(6)	
Earnings (ROA)	**9**	**basis points**

As these scenarios show, Five Easy Pieces provides a critical insight into the business model at Golden West throughout its 40 year history, and reinforces why it was so critical to make high-quality loans, keep expenses low, and maintain high capital.

Very few large thrifts were able to meet the required levels to produce a 1.0% ROA with a risk-averse business model because they either disregarded these three critical components or were unable to produce these results even if they tried. As a result, many thrifts had mediocre earnings and they became acquisition targets or were forced or merged out of business by their regulator.

Many other lenders ended up modifying their business models away from a traditional, risk-averse portfolio mortgage business model in some combination of the following ways:

(a) Putting on higher-yielding assets for portfolio and for sale and securitization, such as consumer loans (including auto loans, credit cards, and unsecured loans), commercial real estate loans, business loans, and riskier home mortgages including higher-LTV loans without mortgage insurance, equity loans of credit, construction loans or subprime loans, all of which over time usually resulted in higher **Credit Costs**.

(b) Shifting to business models that focused on generating **Other Income**, particularly mortgage bankers that generated fees and immediate income ("gains on sale") when the loans were sold and pooled into securitizations. The mortgage banking business model that depended on gains on sale required a continual expansion of people, offices and risktaking (pricing and credit) to increase market share. The mortgage banking model depended on there being continued investor interest in acquiring mortgages in the securitization market; if investor interest waned, the mortgage banks often lacked the liquidity and capital to withstanding the downturn.

(c) Tolerating higher **Credit Costs** and/or **G&A Expenses** on the grounds they were more than offset by higher-yielding assets (**Spread**) and fee/gains-based businesses (**Other Income**).