

Countrywide Financial: The Subprime Meltdown

INTRODUCTION

Not long ago, Countrywide Financial seemed to have everything going for it. Cofounded by Angelo Mozilo in 1969, by the early 2000s it had become the largest provider of home loans in the United States. At that time one in six U.S. loans originated with Countrywide. In 1993 its loan transactions reached the \$1 trillion mark. Additionally, it was the primary provider of home loans to minorities in the United States and had lowered the barriers of homeownership for lower-income individuals. Countrywide also offered loan closing, capital market, insurance, and banking services to its clients. In the 1970s Countrywide had diversified into the securities market as well.

In 1992 Countrywide created a program called “House America” that enabled more consumers to qualify for home loans, as well as to make smaller down payments. In 2003 the company proposed the “We House America” program with the goal of providing \$1 trillion in home loans to low-income and minority borrowers by 2010.

At the beginning of the twenty-first century, Countrywide’s reputation in the industry was stellar. *Fortune* magazine called it the “23,000% stock” because between 1982 and 2003, Countrywide had delivered investors a 23,000 percent return, exceeding the returns of Washington Mutual, Walmart, and Warren Buffett’s Berkshire Hathaway. In 1999 the company serviced \$216.5 billion in loans. By 2000 the company’s continued increase in revenues was connected in part to home equity and subprime loans. The annual report for that year states, “Fiscal 2000 shows a higher margin for home equity and sub-prime loans (which, due in part to their higher cost structure charge a higher price per dollar loaned).” Subprime loans were a key factor in Countrywide’s immense success and rapid growth. However, the company’s reliance on a lending practice that was originally intended to aid low-income individuals also ended up contributing to its downfall.

UNDERSTANDING SUBPRIME LOANS

To understand Countrywide’s failure, one must first understand the concept of subprime lending. Simply put, subprime lending means lending to borrowers, generally people who would not qualify for traditional loans, at a rate higher than the prime rate (market rate), although just how far above depends on factors like credit score, down payment, debt-to-

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income ratio, and payment delinquencies. Subprime lending is risky because clients are less likely to be able to pay back their loans.

Although subprime loans can be made for a variety of purposes, mortgages have gained the most news coverage. Subprime mortgages fall into three categories. First is the interest-only mortgage, in which borrowers pay only the loan's interest for a set period of time. The second type allows borrowers to pay monthly, but these borrowers often opt to pay an amount smaller than that needed to reduce the amount owed on the loan. Third, borrowers can find themselves with mortgages featuring a fixed interest rate that converts to variable rates after a set period.

Typically, subprime loans are offered to high-risk clients who do not qualify for conventional loans. The average borrower has a credit score of below 620 and is generally in the low-income bracket. However, a 2007 *Wall Street Journal* study revealed that from 2004 to 2006, the rate of middle- and upper-income subprime loan borrowers rose dramatically. During the early to mid-2000s, when real estate prices were booming and consumer confidence levels were high, even clients who could have qualified for regular loans chose to take out subprime loans to finance their real estate speculations. As real estate prices peaked, more well-to-do investors turned to subprime mortgages to finance their expensive homes.

Although they have caused an immense amount of damage in the financial sector, subprime loans comprise a relatively small part of the loan market as a whole. In 2008 more than 6 million U.S. homeowners had subprime loans with a combined value of over \$600 billion. In comparison, all other U.S. loans amounted to over \$10 trillion. However, although these loans make up only a small chunk of the overall loan market, many consider subprime loans to be a key contributor to the 2008–2009 financial crisis.

One of the tools of the subprime loan is the adjustable rate mortgage (ARM), which allows borrowers to pay low introductory payments for three to five years, payments that will then be adjusted annually as the prime interest rate increases or decreases. Another type of ARM involves paying interest for a set number of years with balloon payments, meaning that people make interest payments only for the life of the loan, and then are expected to pay the entire principal at once upon maturity of the loan. These tools worked as long as the housing market remained on an upward trajectory, but when housing prices fell or interest rates increased, people discovered that they were unable to pay.

Many financial experts contributed to the problem by telling clients that in the future they would certainly have more income because of the increases in their property value. They assured homebuyers that even if their monthly payments increased, they would be able to afford them because the value of their homes would have increased accordingly. Even con-

sumers with good credit looking to refinance were attracted to the attractive interest rates of these mortgages without fully recognizing the possible consequences.

THE SUBPRIME CRISIS

When first popularized, the financial tool of subprime loans was praised for lowering barriers to home ownership. The U.S. Department of Housing and Urban Development stated that subprime loans were helping many minorities afford homes and were therefore a good tool.

Although subprime lending became a major news topic only in the early part of the twenty-first century, the subprime concept began in the 1970s in Orange County, California. At this time, rural farmland was being converted into suburbs, and subprime loans were a way for people to buy homes even if their credit was poor. The typical subprime recipient would not have met normal lending standards. At that time, the subprime loans made sense as a means to fuel southern California's growth. Homes were appreciating rapidly, so if a family decided to buy a house and live there for three to five years, they could reasonably expect that home to sell for over 50 percent more than what they had paid for it. In addition, Congress passed the Equal Credit Opportunity Act in 1974 to help ensure that all consumers had an equal chance to receive a loan. Potential homeowners, in theory, would no longer be rejected based on sex, race, national origin, or any other factor considered discriminatory.

Contractors also wanted a part of the action. They began to build houses and "flip" them. Flipping occurs when a contractor builds homes without buyers on credit, and then takes the sale of the homes to the lending institution as collateral to obtain more credit to build more homes. Speculators also flipped existing homes by buying them on credit with no intention of keeping them, waiting until the value had increased, and selling them at a profit.

Industries that supplied homebuilders were profiting as well, and costs of materials increased with the high demand. Realtors were motivated to push sales through because of the commissions they would earn (on average 6 percent of the sales price). Commissions were a significant part of many mortgage officers' compensation. Even real estate appraisers began to inflate the value of homes to ensure that loans would go through. One of the chief accusations against Countrywide during the financial crisis was that it had engaged in this practice.

But then something happened that no one had considered. The U.S. economy began to slow. People started working more and earning less money. Jobs started moving abroad, health insurance became more expensive, gas prices increased, and the baby boomers began to sell their homes to fund their retirement. In spite of this, builders kept on building, and the fi-

financial industry continued to lend to increasingly risky buyers. Homeowners found that they had less and less disposable income to make housing payments.

The result was a surplus of housing that homeowners could no longer afford. Banks began to foreclose on houses when the owners could not meet their mortgage payments. As the demand for housing decreased, banks lost significant amounts of money. Many other industries, like the automobile industry and insurance companies, were also negatively affected as struggling citizens tried to cope with the economic downturn. With plummeting stock prices, the United States began experiencing a financial crisis that had a rippling effect across the world.

Late 2007 marked the tipping point for the burgeoning mortgage crisis. Foreclosure rates skyrocketed, and borrowers and investors began to feel the full ramifications of taking the subprime risk. Mortgage defaults played a part in triggering a string of serious bank and financial institution failures as well. Investors began to abandon their mortgage-backed securities, causing huge institutions such as Morgan Stanley, Merrill Lynch, and Citigroup to lose large sums of money. Morgan Stanley, for example, lost over \$265 billion internationally. Bear Stearns required government intervention to stay afloat. Analysts have attributed the banks' failings to poor intra-bank communication and a lack of effective risk management.

Although the chief financial officer (CFO) is supposed to be in charge of risk management, it appears that many institutions viewed the role as merely advisory. It was highly risky for these firms to downplay the importance of the CFO. Not only did many of these banks fail at risk management, but they also were in violation of the Sarbanes–Oxley Act, which requires that a company verify its ability to internally control its financial reporting. A CFO not directly in charge of a company's finances is signing off on something that he or she actually knows little about. The extent of the 2008–2009 financial crisis has made it clear to many that a massive overhaul of the financial industry's regulatory system is needed.

COUNTRYWIDE'S INVOLVEMENT IN THE SUBPRIME CRISIS

During the early 2000s, Countrywide reaped the benefits of subprime lending. In 2001 mortgages contributed to 28 percent of Countrywide's earnings, with subprime loans up to \$280 million (the year before, subprime loans represented \$86.9 million). In 2002 Countrywide's loan portfolio to minorities and low- to moderate-income borrower tracts had dramatically and rapidly increased. Countrywide had also increased its commissioned sales force by nearly 60 percent by 2003, with the goal of increasing overall market share.

Some critics have argued that salespeople were given incentives to undertake riskier transactions in order to continue to grow the company at a rapid rate. One allegation against

Countrywide is that, in order to increase its profit, it would even offer subprime loans to people who qualified for regular loans. Leading the day-to-day operations of the Consumer Markets Division was David Sambol, whom the Securities and Exchange Commission would later charge with securities fraud.

After years of fast growth and upbeat projections, Countrywide's 2007 annual report had a somber tone. The financial crisis had begun and the company was feeling its effects. A significant amount of the report focused on the details of accounting for its mortgage portfolio and default rates. In one year Countrywide depreciated over \$20 billion and absorbed over \$1 billion in losses. By 2008 the company had accrued over \$8 billion in subprime loans with a 7 percent delinquency rate. The industry average was 4.67 percent delinquency. That year foreclosures doubled, and the firm laid off 10 to 20 percent of its employees, or 10,000 to 20,000 people.

The company attempted to ease loan terms on more than 81,000 homeowners with a program called the Countrywide Comprehensive Home Preservation Program. The program allowed consumers to refinance or modify loans with an adjustable rate mortgage for a lower interest rate, or switch to a fixed-rate mortgage. President and chief operating officer David Sambol stated, "Countrywide believes that none of our subprime borrowers that have demonstrated the ability to make payments should lose their home to foreclosure solely as a result of a rate [increase]. This is yet another step in our continuing effort to identify and improve existing programs that assist our customers."

Countrywide also created special divisions to help borrowers and actively informed its customers about their options. The company offered phone counseling teams, personalized resource mailings, and counselors within communities who could meet face to face. Countrywide appeared to be genuine in its attempts to help homeowners, but it was too little too late.

In 2008 Alphonso Jackson, Secretary of Housing and Urban Development (HUD), reported that more than 500,000 Countrywide consumers were in danger of facing foreclosure. The blame for this development was placed primarily on subprime lending and adjustable rate mortgages. Countrywide Financial countered that there were other reasons for delinquencies and foreclosures. It maintained that the main causes of delinquencies and foreclosures were issues like medical problems, divorce, and unemployment—not adjustable rate mortgages. It further claimed that less than 1 percent of its consumers had defaulted on account of adjustable rate mortgages. Still, consumers and government officials began to question whether Countrywide's risky lending played a role in the larger financial crisis.

In 2008 Bank of America, one of the United States' top financial institutions with \$2,264.9 billion in total assets, offered to buy Countrywide Financial for \$4 billion. The price tag was a substantial discount on what the company was actually worth. Bank of America paid approximately \$8/share, when shares had been valued at \$20/share earlier in the year. Kenneth D. Lewis, chair, president, and CEO of Bank of America, said at the time, "We are aware of the issues within the housing and mortgage industries. The transaction reflects those challenges. Mortgages will continue to be an important relationship product, and we now will have an opportunity to better serve our customers and to enhance future profitability."

At the time Bank of America held \$1.5 trillion in assets, which better equipped the company to deal with the crisis. "Their balance sheet can take a shock much better than Countrywide," said CreditSights senior analyst David Hendler. "When you take the shocks at Countrywide, they have a big, busting consequence that's negative." Bart Narter, senior analyst at Celent, a Boston-based financial research and consulting firm, said, "There's still plenty of risk involved. He's brave to do it. But I think that it's very likely down the road to be profitable, maybe not immediately, but long-term."

However, there may have been other reasons why Countrywide allowed Bank of America to acquire it. It may be that Countrywide thought Bank of America was better able to handle the ethical investigations concerning Countrywide that the government had initiated. Among other issues, Countrywide was coming under increased scrutiny for giving out so-called liar loans. Liar loans are mortgages that require no proof of the borrower's income or assets. These loans allowed consumers to purchase homes while having few or no assets. With the additional burden of the financial crisis, many homeowners with liar loans could not pay their mortgages, nor were they able to refinance their homes because housing prices plummeted. Some were forced into foreclosure, generating substantial losses for mortgage companies and the economy.

Countrywide Financial was one of the top providers of liar loans. These loans allowed the industry to profit, at least for a little while, because people with liar loans were riskier clients, and therefore had to pay higher fees and interest rates to the mortgage company. Many accuse Countrywide of negligence, of giving out highly risky loans to people who could not afford them for the sake of quick profits. Others accuse the company of even more unethical dealings. Some homeowners who struggled under liar loans accused Countrywide of predatory lending, saying the company misled them.

Although some homeowners may have been truly misled into liar loans, an estimated 90 percent of liar loan applicants knowingly overstated their income, with three out of five overstating it by at least 50 percent. This rampant dishonesty, critics charge, could not have occurred without the mortgage company's awareness. It has sparked new investigations into whether Countrywide aided borrowers in falsifying information. Hence, some attest

that Countrywide's buyout by Bank of America may have been more than just an economic choice. It could have been a way to prepare for the onslaught of criticism that would arise against Countrywide.

In March 2008 Bank of America decided to retain David Sambol in the position of Executive Managing Director of Business Segment Operations at Countrywide, as well as to pay him a hefty compensation package. Sambol had received a bachelor's degree in Business Administration and Accounting from California State University–Northridge in 1982. Prior to joining Countrywide in 1985, Sambol had served as a certified public accountant with the accounting firm of Ernst & Whinney. His unit at Countrywide led all revenue-generating functions of the company. He was instrumental in expanding Countrywide's mortgage division to become the most comprehensive in the industry.

In March 2008 Bank of America agreed to set up a \$20 million retention account for Sambol, payable in equal installments on the first and second anniversaries of the merger, plus \$8 million in restricted stock. Sambol's retention package also included the use of a company car or car allowance, country club dues, and financial consulting services through the end of 2009. He was also to continue to have access to a company plane for business and personal travel.

Much of the public was outraged that Sambol had received such generous compensation after his role in Countrywide's questionable business dealings. The outcry over the events at Countrywide and other companies that had participated in the subprime mortgage market was so great that in 2008 the U.S. Congress held a series of hearings to investigate dealings in the subprime market. Senator Charles E. Schumer, D–NY, chair of Congress' Joint Economic Committee, asked Bank of America to reconsider the decision to put Sambol in charge of home lending. "There seem to be two economic realities operating in our country today," said Representative Henry A. Waxman, D–CA, the committee chair. "Most Americans live in a world where economic security is precarious and there are real economic consequences for failure. But our nation's top executives seem to live by a different set of rules. The question before the committee was: when companies fail to perform, should they still give millions of dollars to their senior executives?" After the hearings, Bank of America announced that Barbara Desoer, Bank of America's chief technology and operations officer, would replace Sambol.

THE ROLE OF COUNTRYWIDE'S CEO ANGELO MOZILO

Angelo Mozilo was investigated by the SEC for potential fraud, although he maintained his innocence. The SEC was particularly concerned about the sale of company stock options that netted Mozilo over \$400 million between 2002 and 2008. In a 2007 *Businessweek* interview, Mozilo was asked about allegations that he had made over \$100 million on stock

sales in the previous year. Mozilo asserted, "I have not sold any stock, to my recollection, in 10 years. Everything I've sold was options. The selling is because [when the options] expire, I no longer have the benefit of what I have built and what this team has built for the last 40 years. Up until this debacle, I created \$25 billion in value for shareholders. There have been very few—only about 11 stocks—that have performed better over the last 25 years than Countrywide. I could have sold all of those shares at 40 bucks a share and didn't because I want to be aligned with the shareholders."

The public did not seem to believe Mozilo's defense, especially after he received a \$100 million severance package when Countrywide was sold to Bank of America. Mozilo was named as a defendant in many subsequent lawsuits. The plaintiffs included:

- Arkansas Teacher Retirement System
- Fire & Police Pension Association of Colorado
- Public Employees' Retirement System of Mississippi
- New York City Employees' Retirement System
- New York Life Insurance Co., TIAA-CREF Life Insurance Co., Dexia Holdings, Inc.
- The State of California, which settled for \$6.5 million with Countrywide
- Allstate, which filed a lawsuit against Countrywide and Mozilo for over \$700 million in mortgage-backed securities. The lawsuit was later dismissed after a judge ruled that Bank of America should not be liable for the mortgage-backed securities Allstate purchased from Countrywide.

One lawsuit alleged misconduct and disregard of fiduciary duties, including a lack of good faith and lack of oversight of Countrywide's lending practices. The lawsuit also accused Countrywide of improper financial reporting and lack of internal controls, alleging that Mozilo was paid \$10 million more than was disclosed. Additionally, the company claimed that Countrywide's officers and directors unlawfully sold over \$848 million of stock between 2004 and 2008 at inflated prices using insider information. In 2010 Countrywide agreed to pay \$600 million to settle class-action lawsuits filed against the company.

Mozilo's pay also drew heavy scrutiny from members of Congress. Federal securities regulators and congressional investigators found that easy bonus targets and other underhanded methods helped him inflate his pay. In the hearings about executive pay, Congressman Elijah E. Cummings of Maryland said, "We've got golden parachutes drifting off to the golf course and have people I see every day who are losing their homes and wondering where their kids will do their homework." He then asked Mozilo about an e-mail message he had sent demanding that the taxes due on his wife's travel on the corporate jet be covered by the company. "It sounds out of whack today because it is out of whack, but in 2006 the company was going great," said Mozilo. "In today's world I would never write that memo." He also apologized for another e-mail message in which he had complained about his compensation. "It was an emotional time," he said. In the same hearings, however, Mozilo also reminded the audience that Countrywide's stock price had appreciated over 23,000 percent from 1982 to 2007. Shareholders did approve Mozilo's performance-based bonuses, and he exercised the options as he prepared for retirement. "In short, as our company did well, I did well," he said.

In June 2009 the SEC charged Mozilo, David Sambol, and former financial chief Sieracki with securities fraud, accusing the men of misleading the market and not providing adequate disclosure about Countrywide's risks. The SEC pointed to seemingly incriminating emails that Mozilo had sent, including one in which he described their loans as a "toxic product." In another email, Mozilo expressed concern over adjustable rate mortgages, stating 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." Mozilo, who was also charged with insider trading, agreed to pay \$67.5 million to settle with the SEC and has been permanently barred from serving on a board or as an officer of any company. Sambol settled for \$5.52 million and has been barred from serving in a public company for three years, while Sieracki settled for \$130,000. Mozilo's penalty was the largest filed against a senior executive to date.

BANK OF AMERICA PLANS: A RECOVERY

In July 2008 Bank of America bought Countrywide without Sambol or Mozilo. Since 2001 Bank of America has been focused on profit, not growth, and it might be a while before the company profits from the acquisition. Bank of America took on \$16.6 billion in Countrywide's debts. Exiting the subprime lending market is part of Bank of America's long-term plan. The company liquidated \$26.3 billion of its subprime real estate portfolio in 2008–2009 and has managed its existing \$9.7 billion portfolio over its remaining term.

Bank of America clearly understood that in buying Countrywide, it had inherited a volatile earning stream that had become unattractive from a risk-reward standpoint. Kenneth

Lewis, CEO of Bank of America, said at the time, “We are committed to achieving consistent, above-average shareholder returns and these actions are aimed at achieving that mission.”

In addition to managing Countrywide’s debt, Bank of America must also handle the stream of lawsuits being filed against the company. Many of these lawsuits claim that the company duped homeowners with predatory loan practices. Bank of America’s Barbara Doerer, who replaced David Sambol, said the company is committed to helping homeowners and cut interest rates to as low as 2.5 percent. Bank of America also created a unit called Legacy Asset Servicing to manage over a million troubled mortgages, many of which were subprime loans.

Countrywide is facing additional investigations for other alleged cases of misconduct. In March 2008 the FBI started an investigation to find out whether Countrywide misrepresented its financial information. Additionally, the FBI is investigating Countrywide’s VIP program that, according to an insider, provided special mortgage deals to certain high-up officials, known as “Friends of Angelo’s.” These deals included discount rates and fees not offered to ordinary Countrywide customers. Those implicated in these dealings included Democratic senators Chris Dodd and Kent Conrad, two former cabinet members, and two CEOs from Fannie Mae. These officials have denied that they knew they were getting special discounts. Prosecutors looked into whether these discounts constituted improper gifts. A Senate panel later determined that Chris Dodd and Kent Conrad had not violated ethics rules. However, the scandal did tarnish the men’s reputations. Four men from the House of Representatives were also found to have received loans through Angelo’s VIP program.

In 2013 Bank of America’s Countrywide unit was found liable for defrauding Fannie Mae and Freddie Mac. Former executive Rebecca Marione was also found liable. The federal government is seeking \$864 million from Bank of America for losses that the government sustained during the crisis from the defective loans that Countrywide sold. Countrywide has denied allegations that fraud was involved. Bank of America did agree to a \$500 million settlement with investors, who claimed that Countrywide had misled them into purchasing risky mortgages.

CONCLUSION

Countrywide was not the only cause of the financial crisis. Numerous other Wall Street companies were investigated for unethical practices related to this scandal. (The list includes Bank of America, which has been investigated for potential breaches of fiduciary du-

ty concerning employee retirement funds.) However, Countrywide's unethical behavior was a key contributor to the problems in the economy during 2008–2009. Many consider it to be one of the central villains in this crisis. They allege that Countrywide knowingly engaged in risky loans and offered subprime loans even to those who qualified for regular loans in order to profit from the higher rates. In the process, it may have helped to falsify lender information, allowing those with no assets to obtain loans. The consequence was a surplus of housing, plummeting housing prices, and a slew of foreclosures, all of which placed the economy in a precarious state. The United States has lost global credibility as an economic leader of the free world.

The Countrywide scandal has brought up other issues, including that of executive compensation. Should executives receive hefty compensation packages and severance pay when their companies flounder? Should they be called to account for not exercising due care? Many people think so, as evidenced by the enormous public outrage facing those like David Sambol and Angelo Mozilo. It is clear that Countrywide failed the majority of its stakeholders. Ethical misconduct and high-risk business practices helped to create the disaster at Countrywide, and it remains to be seen whether Bank of America will be able to salvage the reputation and to save the business that was once Countrywide Financial.

QUESTIONS

1. Are subprime loans an unethical financial instrument, or are they ethical tools that were misused?
2. Discuss the ethical issues that caused the downfall of Countrywide Financial.
3. How should Bank of America deal with potential ethical and legal misconduct discovered at Countrywide?

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