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Countrywide and the Subprime Mortgage Crisis

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Learning Objectives

After analyzing this case study, students should be able to do the following:

Identify sound business practices that were abandoned by banks in the 1990s and early 2000s regarding their expansion efforts

Trace the corrosive effects of greed and power in deregulated banking, especially among national banks

Countrywide Financial Corporation and Bank of America Corporation were two U.S. companies that grew into industry-leading powerhouses. ¹ However, their aggressive strategies went astray during the financial crisis of 2008. Countrywide's expansion into subprime mortgages left it overexposed when the U.S. real estate market plummeted. On the brink of bankruptcy, Countrywide was acquired by Bank of America in early 2009.

However, Countrywide's problems were deeper than expected. Mark Lacter, writing in *Los Angeles Magazine*, called the acquisition "a disaster, arguably the most expensive, ill-advised deal in the history of banking." Bank of America was saddled for the next several years with massive financial losses, lawsuits, and regulatory issues arising from toxic loans acquired via Countrywide.

Pursuing National Ambitions

Both Countrywide and Bank of America rose to prominence by successfully pursuing ambitious expansion strategies. Countrywide was founded in 1969 by Angelo Mozilo and the late David Loeb with the intention of eventually providing home loans nationwide. The company went public that same year and moved from New York City to Los Angeles to take advantage of the booming California market. After a long period of slow growth in the early 1970s, Countrywide restructured its operations around low-cost products. Through standardized processes, novel distribution systems, computer technology, and such innovations as locking in interest rates from loan origination through closing, Countrywide built a competitive, popular product and was profitable by 1978, according to the *International Directory of Company Histories*.

During the next two decades, Countrywide expanded across the United States, and the company

expanded its services beyond loan generation. It began selling mortgage-backed securities in 1981, started servicing loans from other lenders in 1987, and became a bank holding company with its Treasury Bank acquisition in 2001. After hitting US\$1 billion in sales by 1984, Countrywide originated more than US\$30 billion in loans by 1992, making it the largest mortgage banker in the United States. By January 2006, Countrywide reported quarterly earnings of US\$638.9 million on revenues of US\$2.59 billion.

In the mid-1990s Countrywide had turned its attention to low- and middle-income families and minorities, populations that had drawn little attention from traditional banks and lenders. Countrywide introduced flexible underwriting programs that helped many families that had not previously been able to buy homes. Countrywide "expanded aggressively into subprime and Alt-A lending" as part of that strategy, Arthur Wilmarth wrote in the *Journal of Corporation Law*. According to *Investopedia*, an Alternative-A (Alt-A) mortgage is a riskier loan than prime but less risky than subprime. Those who qualify for an Alt-A mortgage will likely have good credit histories, but factors such as debt-to-income ratio and a lack of documentation about the borrower's income will add risk to the mortgage.

Like Countrywide, Bank of America also traced its success to working outside traditional financial services models. Bank of America was formed in 1998 when Nations Bank of Charlotte, North Carolina, merged with San Francisco, California-based BankAmerica Corporation. BankAmerica was founded as Bank of Italy in 1904 by immigrant Amadeo Peter Giannini, who wanted to help poor citizens who had not previously used a bank. Over the next 41 years, he built one of the world's largest banks by emphasizing consumer lending, acquiring rivals, and introducing branch banking. He battled traditional lending institutions, Wall Street insiders, and regulators. However, once Giannini retired, Bank of America transformed into a more traditional banking company.

Meanwhile, Nations Bank also drew on a maverick reputation. Founded in 1874, the bank became a regional powerhouse in the southeastern United States through more than 70 acquisitions in the 1980s and 1990s.

On April 13, 1998, Bank of America and Nations Bank announced a US\$62 billion merger. The new corporation kept the Bank of America name but was based and controlled in North Carolina. Chief Executive Officer (CEO) Ken Lewis shifted his focus from continual deal making to organic growth as Bank of America consolidated its spot as the largest U.S. bank by assets (US\$572 billion).

Dramatic Fall from Grace

Throughout most of its 40-year history, Countrywide managed to ride out the ups and downs of the business cycle. The company maintained a balanced portfolio among loan origination, servicing, and refinancing, shifting priorities in response to interest rates and market conditions. During the real estate bubble that began around 2001 and peaked in 2006, Countrywide thrived by making loans to consumers across all income levels. It dominated the subprime market, targeting consumers unable to qualify for conventional loans.

By mid-2007, the company "hit a wall with its fast-and-loose lending style," Lacter wrote in *Los Angeles Magazine*. "Supprime defaults were rising rapidly, home prices were plummeting, and Wall

Street bankers—the same ones who had fueled the company's growth—were no longer willing to purchase Countrywide's suspect mortgages."

Countrywide was by no means the only lender rocked when the economy slowed, housing prices fell, and foreclosures and delinquencies skyrocketed. The resulting subprime mortgage crisis was a major factor in the global economic meltdown the following year. "As Countrywide made loans, then bundled and sold them to Wall Street," Zachery Goldfarb wrote in the *Washington Post* in June 2009, "the firm helped saddle the books of banks and other firms with ill-fated mortgage investments, sowing the seeds of today's crisis."

During the first two quarters of 2007, Countrywide reported falling revenues and rising mortgage defaults. These factors increased its vulnerability to the credit tightening that occurred that summer. While the lender had packaged its less risky loans as securities for resale to federal agencies, it relied on secondary markets to sell off subprime and other nonconforming loans. On August 3, the secondary market froze for all but the highest-rated mortgages. A few days later, rival American Home Mortgage Investment Corporation collapsed, sparking speculation that Countrywide might follow. When Countrywide reported liquidity concerns to the Securities and Exchange Commission (SEC), credit agencies downgraded the company's stock and the price plummeted by more than 75 percent.

For decades, Paul Muolo wrote in *Mortgage Strategy*, Countrywide "had been the poster child for everything right in U.S. residential lending." Now it was suffering "from what looked like a temporary correction in the housing market [and] it needed money because of concerns about its liquidity."

With financial turmoil accelerating, the Federal Reserve Bank loosened regulations so Citibank N.A. and Bank of America could loan additional capital. On August 23, 2007, cash-hungry Countrywide raised US\$2 billion by selling a 16 percent stake to Bank of America, one of its earliest investors.

In October 2007, Larry Light termed the investment "shrewd" in a *Forbes* article. "The mortgage lender, desperate for capital, agreed to terms very favorable for BofA. For its [US]\$2 billion, the bank got preferred shares convertible into common [stock] worth [US]\$2.4 billion at the time of the transaction and paying twice as much in dividends as the common."

While the capital infusion stabilized Countrywide, the company still faced difficult times. It cut staff by 20 percent, paring 12,000 jobs in September. Company leaders retreated from the subprime market. On October 26, Countrywide reported it lost US\$1.2 billion, its first losing quarter in 25 years. Renewed bankruptcy rumors swirled.

On January 11, 2008, Bank of America announced an agreement to acquire Countrywide for US\$4.1 billion in stock. Ironically, Bank of America had exited the subprime market six years earlier because CEO Lewis said the business was "volatile and risky," Lacter reported. Lewis had told *Forbes* in October 2007 that Bank of America invested in Countrywide not in anticipation of a takeover but rather to partner with the mortgage expert to improve its loan origination business. However, by December, Countrywide had become an appealing target. Lewis reversed his strategy and approached Countrywide CEO Angelo Mozilo about a possible acquisition, striking a deal the

next month.

Uncovering "A Rat's Nest"

In the months immediately following the deal announcement, the union of Countrywide and Bank of America was generally well received. "Looking back, I remember the deal actually making some sense," Lacter wrote in *Los Angeles Magazine*. Bank of America "had visions of being the Walmart of banking," he continued. The deal increased Bank of America's base of 4 million mortgages to 14 million, and it added potential new customers for other banking products. Lacter noted the banking industry agreed with Lewis that once Countrywide worked through its mortgage delinquency issues over the next few years, the deal would pay off.

Writing for *Mortgage Banker* in October 2009, Robert Stowe England stated the deal gave Bank of America "the extensive production platform and technology edge of a former industry leader. Add to that BofA's internal discipline and a focus on profitable origination, and you have the makings of a mortgage powerhouse." Banking analyst Richard Bove told England, "At all levels, I think that acquisition makes an enormous amount of sense."

For many months, the deal did work. However, a refinancing boom during late 2008 and early 2009 overwhelmed the bank and Countrywide, delaying integration of the companies, England reported. Bank of America Mortgage and Countrywide originated a combined US\$315.3 billion in 2008, followed by another US\$203.5 billion during the first six months of 2009. When negative media made the Countrywide brand less appealing, the unit was rechristened Bank of America Home Loans.

But as fallout from the 2008 financial crisis continued, a new name could not salvage Countrywide's reputation. The brand that once helped Americans buy homes was seen to reflect the reckless and sometimes dishonest practices of a financial services industry gone amok. Media reports, regulatory investigations, and lawsuits portrayed a company that gambled on risky loans, cut corners, and falsified documents to build market share and profits.

"Unfortunately for Bank of America, it has been an ugly history, riddled with faulty sub-prime loans, allegations about illegal foreclosures, poor underwriting—the list goes on and on," Muolo wrote in *Mortgage Banker*. The world soon realized that "rising home values can cover a variety of sins," Lacter commented. "Once BofA took over, it discovered a rat's nest of bad loans, many of them resulting from Countrywide having given mortgages to people whose financial conditions weren't adequately reviewed." The bank found "Countrywide's financial hole was much deeper than anyone imagined."

Countrywide's practices brought more lawsuits and probes from state and federal agencies, consumer advocates, and investors. Those actions maintained the company misled shareholders and borrowers. Some issues had surfaced before the company was sold, such as a consent order that cost Countrywide US\$150 million and US\$8 billion in mortgage modifications.

The pace and scope of lawsuits increased dramatically after 2008. For example, Allstate Corporation filed a federal lawsuit charging Countrywide with fraud, claiming it misrepresented the

"value and risk" of some US\$700 million in toxic debt underlying mortgage-backed securities that Allstate had purchased. Similarly, AIG, Inc., filed suit in October 2011, seeking US\$10 billion.

By late 2011, Bank of America had "racked up well over US\$15 billion in mortgage-related writedowns and losses—a figure that will continue to grow as it pays civil damages claims and legal settlements," Muolo reported in *Mortgage Strategy*.

Countrywide's fall also demonized former chairman Mozilo. During the boom years, Mozilo was a high-profile CEO with an extravagant lifestyle, netting US\$470 million between 2001 and 2006 alone, according to Lacter. But as Countrywide unraveled, his public image darkened. Articles about the "Friends of Angelo" program, which provided cut-rate loans to friendly Washington politicians, added to an image of industry insiders working against the public good.

On June 4, 2009, the SEC charged Mozilo and two other ex-Countrywide executives with securities fraud for "deliberately misleading investors about the significant credit risks being taken in efforts to build and maintain the company's market share." The commission also charged Mozilo with insider trading that netted him almost US\$140 million in profits. The *Washington Post* reported that "mortgage pioneer" Mozilo was "the most prominent executive accused of illegality in connection with the financial crisis." Mozilo eventually settled with the SEC for US\$67.5 million. According to Lacter, more than two-thirds of the settlement was paid by others.

In October 2011, Kate Berry reported in *American Banker* that Wells Fargo & Company had moved past Bank of America as the largest mortgage banker in the United States. Bank of America had an estimated 16 percent of the market in the third quarter of 2011, whereas Wells Fargo's share had risen to 27 percent.

Bank of America continued to trim Countrywide's former operations, closing offices and eliminating staff. Richard Clough reported in the *Los Angeles Business Journal* that Bank of America was shutting its correspondent mortgage lending unit by the end of 2011 after an attempted sale of the unit that summer to Fortress Investment Group fell apart. The unit had "accounted for nearly US\$22 billion—or more than half—of Bank of America's second quarter mortgage lending," Clough wrote.

Speculation continued over whether Bank of America would continue digging out of the Countrywide mess or divest those assets that were dragging down the other, profitable units of the company. Berry in *American Banker* noted that the bank had reserved another US\$18 billion for expected additional mortgage losses in mid-2011. When Fitch Ratings downgraded the bank in December 2011, the factors cited in the decision included "BAC's loan exposure to the U.S. residential real estate market" and "ongoing litigation risks" over Countrywide. While Bank of America maintained from the beginning that the deal meant short-term pain for long-term gain, the pain was more intense and extended than most anticipated.

One option was to simply let Countrywide slide into bankruptcy, since Bank of America had maintained Countrywide as a separate legal entity. However, analysts quoted by Jeff Horwitz in *American Banker* said that while Bank of America could legally drop Countrywide, "the fallout from an attempted Countrywide bankruptcy might be insurmountable." The move would probably be

considered a cross-default, cutting off Bank of America from the debt swap markets and perhaps triggering federal action.

The *New York Times* reported in December 2010 that Bank of America had written off more than US\$5 billion due to Countrywide. However, CEO Brian Moynihan told the paper, "Our company bought it and ... we'll clean it up." A year later, Reuters quoted Moynihan as saying the bank was still considering all its options for Countrywide.

Questions

Explain how insider trading by banking heads can be seen as implicating banks in wrongdoing.

Name and explain the reckless practices of the financial services industry that brought about the financial collapse.

Footnotes:

1 This essay originally appeared in *Corporate Disasters: What Went Wrong and Why*. Detroit: Gale, 2012. Learning Objectives and Questions for Discussion have been added by the staff of Business Insights: Global.

Further Readings

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