CASE 9

Countrywide Financial: The Subprime Meltdown

Not too long ago, Countrywide Financial seemed to have everything going for it. Co-founded in part by Angelo Mozilo in 1969, it had become the largest provider of home loans in the United States within a few decades. By the 2000s, one in six U.S. loans originated with Countrywide. In 1993, loan transactions reached the $1 trillion mark. Additionally, it was the number-one provider of home loans to minorities in the United States and had lowered the barriers of homeownership for lower-income individuals. Countrywide offered services such as loan closing, capital market, insurance, and banking. 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, they proposed the "We House America" program with a goal to provide $1 trillion in home loans to low-income and minority borrowers by 2010. The strategies of both programs were similar and included:

- Expanded approval/timely payment rewards
- Multiunit loan programs
- FHA and VA loan programs
- New immigrants initiatives
- Location-efficient mortgages
- Down-payment and closing-cost assistance programs
- Rural housing loans
- Mortgage revenue bond programs
- Rehabilitation loan programs

At the time, Countrywide's reputation in the industry was stellar. *Fortune* magazine called it the "23,000% stock" because between 1982 and 2003, Countrywide delivered

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This case was written by John Fraedrich, O. C. Ferrell, and Jennifer Jackson, with the editorial assistance of Jennifer Sawayda. This case was developed for classroom discussion rather than to illustrate either effective or ineffective handling of an administrative, ethical, or legal discussion by management. All sources used for this case were obtained through publicly available material.

investors a 23,000 percent return, exceeding the returns of Washington Mutual, Wal-Mart, and Warren Buffett's Berkshire Hathaway. In 1999, the company serviced $216.5 billion in loans. In 2000, the increase in revenues was attributed, 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 subprime loans" (which, due in part to their higher cost structure charge a higher price per dollar loaned). Subprime loans were a factor to Countrywide's immense success. However, the company's reliance on what was originally intended to aid low-income individuals 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, although how far above depends on factors like credit score, down payment, debt-to-income ratio, and recent 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, through which borrowers pay only the loan's interest for a set period of time. The second type allows borrowers to pay monthly, but this often means that borrowers 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 for a period, converting to variable rates after a while.

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 low-income. However, a 2007 *Wall Street Journal* study revealed that from 2004–2006 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 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.

In relation to the loan market as a whole, subprime loans comprise a relatively small part. In 2008, over 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. Although they only make up a small chunk of the loan market, many consider subprime loans to be a key contributor to the 2008 financial crisis.

One of the tools of the subprime loan was the adjustable rate mortgage (ARM) that allowed borrowers to pay low introductory payments for three to five years that would then be adjusted annually as the prime interest rate increased or decreased. Another type of ARM was to pay interest for a set number of years with balloon payments, meaning that people would only make interest payments for the life of the loan, and then would be 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 found themselves 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's value. They assured home buyers that even if payments increased, they would be able to afford them because the value of their home would have increased so much. Even consumers with good credit looking to refinance were attracted to the low interest rates without fully recognizing the possible consequences.

THE SUBPRIME CRISIS

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

Although subprime lending has only become a major news topic recently, the subprime concept began in the 1970s in Orange County, California. At this time, rural farmland was being converted into the suburbs, and subprime loans were a way for people to afford to buy homes, even if their credit was poor. The typical subprime recipient would not have met normal lending standards. Yet in the 1970s, 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 originally paid. 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 is when the contractor builds homes, (without buyers) on credit, and takes the sale of some 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 home builders were profiting as well, and costs of materials increased with the high demand. Real estate agents were motivated to push sales through because of commissions they could earn (on average 6 percent of the sales price). Many mortgage officers were also compensated by commissions. Even real estate appraisers began to inflate the value of homes to ensure loans would go through. This was to become one of the chief accusations against Countrywide during the financial crisis.

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 financial industry continued to lend to increasingly risky buyers. Homeowners found that they had 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 homeowners could not pay. 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. Economist Alan Greenspan said the crisis could be "the most wrenching since the end of the Second World War."

Starting late in 2007 and continuing into 2008 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. In 2007, 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, they 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 loans. 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, low- to moderate-income borrowers, and low- to moderate-income tracts had dramatically increased from years past. Countrywide had also increased its commissioned sales force by nearly 60 percent, to 3484 in 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, who would later be implicated in the scandal.

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 negative 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 7 percent delinquent. The industry average was 4.67 percent delinquency. That year foreclosures doubled, and the firm planned to lay 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 work to help borrowers and actively informed their 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. By then questions and accusations had begun to develop against company leaders.

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

ISSUES RELATED TO THE BANK OF AMERICA ACQUISITION

In 2008, Bank of America, one of the United States' top financial institutions with $683 billion in 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 while shares were valued at $20/share earlier in the year. Kenneth D. Lewis, Chairman, President, and Chief Executive Officer 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 them 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 could be more reasons why Countrywide allowed Bank of America to acquire it. It may be better able to handle the ethical investigations concerning Countrywide currently underway by the government. Among other issues, Countrywide is coming under increased scrutiny for giving out so-called *liar loans.* Liar loans are mortgages that required no proof of the borrowers' income or assets. These loans allowed consumers to purchase homes with few or no assets. With the additional burden of the financial crisis, many homeowners with liar loans cannot pay their mortgages, nor are they able to refinance their homes because housing prices have plummeted. Some are being forced to foreclose, generating substantial losses for mortgage companies and the economy. One economic site estimated that the true cost of liar loans could total over $100 billion in losses.

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 are now struggling under liar loans are accusing Countrywide of *predatory lending,* saying the company misled them. Although some homeowners may have been truly misled into liar loans, more than 90 percent of liar loan applicants 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. Instead, 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, Executive Managing Director of Business Segment Operations at Countrywide, as well as to pay him a hefty compensation package. Indeed, his credentials show he is qualified. He received a Bachelor's degree in Business Administration and Accounting from California State University, Northridge in 1982. Prior to joining Countrywide in 1985, Sambol served as a Certified Public Accountant with the accounting firm of Ernst & Whinney. After getting hired at Countrywide, his unit led all revenue generating functions of the company. He was instrumental in Countrywide's mortgage division expanding to become the most comprehensive in the industry. In 2007, David Sambol's compensation package was $4,025,000. In March 2008, Bank of America agreed to set up a $20 million retention account, payable in equal installments on the first and second anniversaries of the merger, for Sambol, 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 airplane for business and personal travel.

Much of the public was outraged that Sambol would receive such high compensation after taking part in Countrywide's bad business dealings. At the end of May, Senator Charles E. Schumer, D-N.Y., Chairman 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," Representative Henry A. Waxman, Democrat of California, the committee chairman, said. "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 Sambol was being replaced by Barbara Desoer, Bank of America's chief technology and operations officer. Sambol would continue to receive some, though not all, of his perks.

THE ROLE OF COUNTRYWIDE'S CEO ANGELO MOZILO

Angelo Mozilo is being investigated by the Securities and Exchange Commission due to the sale of company stock options that earned him over $400 million between 2002 and 2008. In a 2007 interview Maria Bartiromo of *BusinessWeek* asked Mozilo about allegations that he profited from 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. In 2007–2008, Mr. Mozilo was named as a defendant in many lawsuits. The plaintiffs include:

- International Brotherhood of Electrical Workers Local 98 Pension Fund
- Norfolk County Retirement System
- Arkansas Teacher Retirement System, Fire & Police Pension Association of Colorado
- Public Employees' Retirement System of Mississippi
- Argent Classic Convertible Arbitrage Fund
- New Jersey Carpenters' Pension Fund
- New York City Employees' Retirement System

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 while in possession of insider information.

Mr. Mozilo's pay also drew heavy scrutiny from members of Congress. Federal securities regulators and congressional investigators found that the use of a flawed peer group and easy bonus targets helped 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 Mr. Mozilo about an e-mail message he 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 complained about his compensation. "It was an emotional time," he said. But in the same hearings, Mr. Mozilo also reminded the audience that Countrywide's stock price had appreciated over 23,000 percent from 1982 to 2007. His performance-based bonuses were approved by shareholders and he exercised the options as he prepared for retirement. "In short, as our company did well, I did well," he said.

BANK OF AMERICA PLANS A RECOVERY

In July 2008, Bank of America bought Countrywide without Sambol and Mozilo. Since 2001, Bank of America has been focused on profit, not growth. However, it might be a while before Bank of America profits from the acquisition of Countrywide. According to the Securities and Exchange Commission, Bank of America has taken on $16.6 billion in Countrywide's debts. Exiting the subprime lending markets is part of Bank of America's long-term plan. The company planned to liquidate its $26.3 billion subprime real estate portfolio in 2008–2009 and said it would manage its existing $9.7 billion portfolio over its remaining term. Bank of America clearly understood that by buying Countrywide it 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." Bank of America plans to replace Countrywide's brand with its own.

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. Countrywide recently agreed to provide $8 billion in loan and foreclosure relief to over 397,000 homeowners. It also agreed to adjust the terms of ARMs according to income. Bank of

America's Barbara Desoer, who replaced David Sambol, said the company is committed to helping homeowners and is cutting interest rates to as low as 2.5 percent.

Countrywide is facing additional investigations for other alleged 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 which, 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 include Democratic Senators Chris Dodd and Kent Conrad, two former cabinet members, and two CEOs from Fannie Mae. These officials denied that they knew they were getting special discounts. Prosecutors are looking into whether these discounts constituted as improper gifts and whether they qualified as illegal on Countrywide's part.

Despite these proceedings, Bank of America's Barbara Desoer remains optimistic about the future. Like so many others, Bank of America suffered horrendous losses as 2008 came to a close, with a drop in net income of 95 percent in the fourth quarter. Yet Desoer has cited some improvements. She said, "But last quarter, the first quarter that Countrywide and Bank of America operated as one company, we made 250,000 first mortgages, worth $51 billion of principal, plus $6 billion of home-equity loans." The company is predicting that home prices will stabilize by late 2009.

CONCLUSION

Countrywide was not the only cause of the financial crisis. Numerous Wall Street companies are being investigated for unethical practices related to this scandal. (This list includes the Bank of America, which has been investigated for potential breaches of fiduciary duty concerning employee retirement funds.) However, Countrywide's unethical behavior was a key contributor to the problems of the economy in 2008–2009. Many consider it to be one of the central villains in this crisis. They allege that Countrywide knowingly engaged in risky loans, offering 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 result is that the United States has lost global credibility as an economic superpower 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 into 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 has failed the majority of its stakeholders. Ethical misconduct and high-risk business practices helped to create the disaster at Countrywide. It remains to be seen whether its acquisition by the Bank of America will be enough to salvage its reputation and to save the business that was once Countrywide Financial.

QUESTIONS

1. Are subprime loans an unethical financial instrument, or are they ethical but misused in a way that created ethical issues?
2. Discuss the ethical issues that caused the downfall of Countrywide Financial.
3. What was the role of founder and CEO Angelo Mozilo in Countrywide's demise?
4. How should Bank of America deal with potential ethical and legal misconduct discovered at Countrywide?

SOURCES: Scott Reckard, "Countrywide Head Ousted by Bank of America," *Los Angeles Times,* May 29, 2008, http://www2.tbo.com/content/2008/may/29/bz-countrywide-head-ousted-by-bank-of-america/?news-money (accessed June 2008); "A Bad Week for Countrywide's David Sambol," May 30, 2008, Fox, united-states-district-court-central-district-of-califo « WordPress.com Tag Feed; "Judge Rules Mozilo and Countrywide Execs Must Face Multi-Million Dollar Federal Lawsuit," May 22, 2008, Fox; Senate Hearings accessed at http://www.nytimes.com/2008/03/07/business/07cnd-pay.html?_r=1&coref=slogin; Patrick McGeehan and Riva D. Atals, "How Bank of America Stumbled," September 28, 2008, http://query.nytimes.com/gst/fullpage.html?res=9405E4DF133DF93BA1575AC0A9659C8B63; Bartiromo Maria, "Countrywide Feels the Heat," *BusinessWeek,* August 29, 2007, http://www.businessweek.com/bwdaily/dnflash/content/aug2007/db20070829_117563.htm?chan=search (accessed March 16, 2008); "Countrywide Financial," Countrywide Financial Corporation, http://about.countrywide.com (accessed March 16, 2008); "Countrywide Moves to Ease Mortgage Misery," *BusinessWeek,* October23, 2007, http://www.businessweek.com/investor/content/oct2007/pi20071023_454573.htm (accessed March 16, 2008); "Equal Credit Opportunity Act," Federal Trade Commission, http://www.ftc.gov/bcp/conline/pubs/credit/ecoa.shtm (accessed March 16, 2008); Roben Farzad, "In Search of a Subprime Villain," *BusinessWeek,* January 24, 2008, http://www.businessweek.com/magazine/content/08_05/b4069077193810.htm?chan=search (accessed March 16, 2008); Carl Gutierrez, "Countrywide's New Bad News," *Forbes,* March 10, 2008, http://www.forbes.com/markets/2008/03/10/countrywide-fbi-mortgage-markets-equity-cx_cg_0310markets26.html (accessed March 16, 2008); Liz Moyer, "A Subprime Solution," *Forbes,* December 6, 2007, http://www.forbes.com/wallstreet/2007/12/05/subprime-paulson-bush-biz-wall-cx_lm_1206subprime.html (accessed March 25, 2008); "Mortgage Industry Statistics," LenderRATEMATCH, freeratesearch.com/en/newsroom/mortgage_statistics/ (accessed April 1, 2008); "Subprime Lending," United States Department of Housing and Urban Development, http://www.hud.gov/offices/fheo/lending/subprime.cfm (accessed March 16, 2008); Rick Wartzman, "The Countrywide Conundrum," *BusinessWeek,* November 9, 2007, http://www.businessweek.com/managing/content/nov2007/ca2007119_693870.htm?chan=search (accessed March 16, 2008); Lisa Myers and Amna Nawaz, October 30, 2008, "Feds Probe Countrywide's 'VIP' Program," NBC News, http://deepbackground.msnbc.msn.com/archive/2008/10/30/1613877.aspx (accessed November 14, 2008); "Bank of America Assumes $16.6B in Countrywide Debt," *Dayton Business Journal,* November 10, 2008, http://www.bizjournals.com/dayton/stories/2008/11/10/daily7.html (accessed November 14, 2008); "Countrywide Agrees to Help Kansas Homeowners," November 13, 2008, http://www.kansascw.com/Global/story.asp?S=9344671 (accessed November 14, 2008); Geoff Colvin, "Signs of Life from the Mortgage Frontline," *Forbes,* November 13, 2008, http://money.cnn.com/2008/11/12/magazines/fortune/colvin_desoer.fortune/?postversion=2008111311 (accessed November 14, 2008); Angela Caputo, "Countrywide Accord Paves Way for More Loan Remodifications," Progress Illinois, November 12, 2008, http://progressillinois.com/2008/11/12/loan-modification-plan; Meg Marco, "Subprime Meltdown: Inside the Countrywide Subprime Lending Frenzy," *The Consumerist,* August 27, 2009, http://consumerist.com/consumer/subprime-meltdown/inside-the-countrywide-subprime-lending-frenzy-293902.php (accessed November 13, 2008); Carl Gutierrez,

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CASE 10

Banking Industry Meltdown: The Ethical and Financial Risks of Derivatives

OVERVIEW

The 2008–2009 global recession was caused in part by a failure of the financial industry to take appropriate responsibility for its decision to utilize risky and complex financial instruments. Corporate cultures were built on rewards for taking risks rather than rewards for creating value for stakeholders. Unfortunately, most stakeholders, including the public, regulators, and the mass media, do not always understand the nature of the financial risks taken on by banks and other institutions to generate profits. Problems in the subprime mortgage markets sounded the alarm in the most recent economic downturn. Very simply, the subprime market was created by making loans to people who normally would not qualify based on their credit rating. The debt from these loans was often repackaged and sold to other financial institutions in order to take it off lenders' books and reduce their exposure. When the real estate market became overheated, many people were no longer able to make the payments on their variable rate mortgages. When consumers began to default on payments, prices in the housing market dropped and the values of credit default swaps (CDSs—the repackaged mortgage debt) lost significant value. The opposite was supposed to happen. CDSs were sold as a method of insuring against loss. These derivatives, investors were told, would act as an insurance policy to reduce the risk of loss. Unfortunately, losses in the financial industry were so widespread that even the derivatives contracts that had been written to cover losses from unpaid subprime mortgages could not be covered by the financial institutions that had written these derivatives contracts. The financial industry and managers at all levels have become focused on the rewards for the transaction without concerns about how their actions could potentially damage others.

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In addition to providing a simplified definition of what derivatives are, this case allows for a review of questionable, often unethical or illegal, conduct associated with a number of respected banks in the recent financial crisis. First, we review the financial terminology associated with derivatives, as they were an integral part of the downfall of these financial institutions. Derivatives were, and still are, considered a legal and ethical financial instrument when used properly, but they inherently hold a lot of potential for mishandling. When misused, they provide a ripe opportunity for misconduct. To illustrate the types of misconduct that can result, this case employs a number of examples. First we examine Barings Bank, which ceased to exist because of a rogue trader using derivatives. Next, we look at United Bank of Switzerland (UBS) and its huge losses from bad mortgages and derivatives. Bear Stearns, an investment bank that suffered its demise through derivatives abuse, is the third example. Finally, Lehman Brothers is an investment bank that was involved with high-risk derivatives that also led to its bankruptcy. At the conclusion of this case we examine the risk of derivatives and potential ethical risks associated with the use of these instruments in the financial industry.

DERIVATIVES DEFINED

Derivatives are financial instruments with values that change relative to underlying variables, such as assets, events, or prices. In other words, the value of derivatives is based on the change in value of something else, called the *underlying* trade or exchange. The main types of derivatives are futures, forwards, options, and swaps. A futures contract is an agreement to buy or sell a set quantity of something at a set rate at a predetermined point in the future. The date on which this exchange is scheduled to take place is called the delivery, or settlement, date. *Futures* contracts are often associated with buyers and sellers of commodities who are concerned about supply, demand, and changes in prices. They can only be traded on exchanges. Almost any commodity, such as oil, gold, corn, or soybeans can have a futures contract defined for a specific trade. *Forwards* are similar to futures, except they can be traded between two individuals. A forward contract is a commitment to trade a specified item at a specific price in the future. The forward contract takes whatever form the parties agree to. An *option* is a less binding form of derivative. It conveys the right, but not the obligation, to buy or sell a particular asset in the future. A *call option* gives the investor the right to buy at a set price on delivery day. A *put option* gives the investor the option to sell a good or financial instrument at a set price on the settlement date. It is a financial contract with what is called a *long position*, giving the owner the right, but not the obligation, to sell an amount at a preset price and maturity date. Finally, *swaps* live up to their name. A swap can occur when two parties agree to exchange one stream of cash flows against another one. Swaps can be used to hedge risks such as changes in interest rates, or to speculate on the changing prices of commodities or currencies. Swaps can be difficult to understand, so here is an example. JP Morgan developed CDSs that bundled together as many as three hundred different assets, including subprime loans. Credit default swaps were meant as a form of insurance. In other words, securities were bundled into one financial package and companies such as JP Morgan were essentially paying insurance premiums to the investors who purchased them, who were

now on the hook if payments of any of the securities included in the CDS did not come through.

As mentioned before, the value of derivatives is based on different types of underlying values, including assets such as commodities, equities (stocks), bonds, interest rates, exchange rates, or indexes such as a stock market index, consumer price index (CPI), or even an index of weather conditions. For example, a farmer and a grain storage business enter into a futures contract to exchange cash for grain at some future point. Both parties have reduced a future risk. For the farmer it's the uncertainty of the future grain price and for the grain storage business it's the availability of the grain at a predetermined price.

Some believe derivatives lead to market volatility because enormous amounts of money are controlled by relatively small amounts of margin or option premiums. The job of a derivatives trader is something like a bookie taking bets on how people will bet. *Arbitrage* is defined as attempting to profit by exploiting price differences of identical or similar financial instruments, on different markets or in different forms. As a result, derivatives can suffer large losses or returns from small movements in the underlying asset's price. Investors are like gamblers in that they can bet for or against the price (going up or down) and can consequently lose or win large amounts.

BARINGS BANK

Barings Bank, which had been in operation in the United Kingdom for 233 years, ceased to exist on February 26, 1995, when a futures trader named Nick Leeson lost approximately $1.4 billion in company assets. The extinction was, in part, due to a large holding position in the Japanese futures market. Leeson, chief trader for Barings Futures in Singapore, accumulated a large number of opening positions on the Nikkei Index. He then generated losses in the first two months of 1995 when the Nikkei dropped more than 15 percent. To try and recover these losses, Leeson placed what is called a short "straddle" on the Singapore and Tokyo stock markets. He was betting that the stock market would not move significantly in the short term. This strategy is risky but can be profitable in stable markets. Yet when the Kobe earthquake hit and sent the Japanese stock market plummeting, Leeson lost a lot of money. He did not, however, change his approach. In fact, Leeson tried to cover his losses through a series of other risky investments. They, instead, only increased the losses. When he finally quit his job, Leeson sent a fax to his manager stating "sincere apologies for the predicament that I have left you in." Barings was purchased by ING, a Dutch bank, for £1 (approximately $1 U.S. dollar), which then sold it under the name Baring Asset Management (BAM) to MassMutual and Northern Trust in March 2005.

Nick Leeson's life is a rags-to-riches tale. Son of a plasterer, he started his career in 1984 as a clerk with royal bank Coutts and later worked briefly for Morgan Stanley. He then got a position in operations at Barings, and later was transferred to Jakarta. Leeson worked in a back office solving clients' problems of wrongly denominated certificates and difficulties of delivery. Before long, Leeson was appointed manager of a new operation in the futures markets on the Singapore Monetary Exchange (SIMEX). Leeson had the authority to hire traders and staff and to sell six financial products, but

his main business was doing inter-exchange arbitrage or "switching." Switching is betting on small differences between contracts by buying and selling futures simultaneously on two different stock exchanges. For example, if a contract was worth the equivalent of $3 in London and $2.75 in Singapore, Leeson would buy in Singapore and sell in London, making a 25 cent profit.

The key to Leeson's strategy in the 1980s was the knowledge that one stock market was slower in processing trades than the other. To hide any bad bets, Leeson created an error account (named 8888 for its auspiciousness in Chinese numerology) for his losses. Because no one could see the losses hidden by this account, Leeson was widely regarded as a brilliant trader. He had assured Barings that he was not trading with company money and all the positions were perfectly hedged and virtually risk-free. Barings managers had little knowledge in trading and did not suspect Leeson of deception. Based on their trust, Barings put a billion dollars into Leeson's account and made no attempt to check his statements. All it took to bring down this house of cards was one earthquake.

When the Kobe earthquake hit in January 1995 Leeson's luck finally ran out. He fled to Malaysia, Thailand, and Germany; and was finally arrested for fraud in Frankfurt on February 23, 1995. He was extradited back to Singapore and sentenced to six-and-a-half years in Singapore's Changi prison where he was diagnosed with colon cancer and was divorced by his wife. During that time, Leeson wrote *Rogue Trader: How I Brought Down Barings Bank and Shook the Financial World,* which was later made into a movie. He was released from prison in July 1999. Since then he has become CEO of the Galway United Football Club. Although he has tried to atone for his actions, to many he is still considered to be the rogue trader who, through his misuse of derivatives, destroyed the United Kingdom's oldest bank.

UBS

United Bank of Switzerland (UBS) is a diversified global financial services company, headquartered in Switzerland. It is the world's largest manager of private wealth assets and the second-largest bank in Europe with overall invested assets of approximately $3.167 trillion U.S. dollars. In 2000, UBS acquired PaineWebber Group Inc. to become the world's largest wealth management firm for private clients. On June 9, 2003, all UBS business groups rebranded under the UBS name as the company began operating as one large firm. As a result of the rebranding, UBS took a $1 billion write-down for the loss of goodwill associated with the retirement of the PaineWebber brand. UBS is no longer an acronym but is the company's brand name. Its logo of three keys stands for confidence, security, and discretion. UBS had offices in the world's financial centers in fifty countries, and employs approximately eighty-two thousand people.

Recently, UBS has come under scrutiny for questionable practices. In 2008, Internal Revenue Service investigators asked for some 20,000 American client names suspected of hiding as much as $20 billion in assets to avoid at least $300 million in federal taxes on funds in offshore accounts. The issue is complicated because using offshore accounts is not illegal in the United States, but hiding income in undeclared accounts is. However, Switzerland does not consider tax evasion a crime and using

undeclared accounts is legal. In May 2008, former UBS bankers Mario Staggl and Bradley Birkenfeld were indicted in Florida for helping an American property developer evade taxes by creating bogus trusts and corporations to hide the ownership and control of offshore assets. They are also accused of advising clients to destroy bank records and of helping them to file false tax returns. UBS asked bankers to sign papers saying that they, not the bank, would be responsible if they broke non-Swiss tax laws. Indian authorities are probing suspected violations of foreign exchange controls involving accounts held at UBS by two companies controlled by India's richest man. The accusations involve transactions that were allegedly arranged by unspecified parties by taking overdrafts on accounts held with UBS London.

However, tax evasion is not the only problem UBS faces. It too has suffered from the subprime crisis due to its heavy dependence on derivatives and mortgage-related securities. In fact, UBS suffered more losses than any other lender in Europe. By November 2008, the bank had been forced to write-down over $46 billion in losses on bad mortgages and derivatives (write-downs represent a reduction in an asset's book value). The bank blamed weak risk controls and risky investment dealings for its loss.

In 2008, UBS appealed to the Swiss government, which doled out an aid package of approximately $59.2 billion to the ailing bank. In exchange, UBS agreed to forgo nearly $27.7 million in pay to the company's top three executives. From now on, the bank promises, bonuses will depend more on the bank's performance, a decision that comes as a relief to those who have criticized what they see as the bank's excessive pay for CEOs. Additionally, some CEOs who resigned promised to return some of the compensation they received. Time will tell whether these combined decisions will be able to resolve the bank's burgeoning problems.

BEAR STEARNS

Unlike many companies that existed before the Great Depression of 1929, Bear Stearns thrived through much of the twentieth century. Unfortunately, nearly eighty years later, Bear Stearns would encounter another severe economic crisis that it would not survive. JP Morgan acquired the company in March 2008 after it lost billions in the subprime crisis.

Bear Stearns was a global investment bank and a securities and brokerage firm. Located in New York, NY, it began as an equity trading-house in 1923 founded by Joseph Bear, Robert Stearns, and Harold Mayer. With an initial $500,000 in capital, the company thrived in the 1920s and 1930s, even after the stock market crash. In fact, the company did so well that while other banks were failing by the dozens, Bear Stearns was able to pay out bonuses. By 1933, the company employed seventy-five people and opened its first regional office in Chicago.

About twenty years later, the company began operating international offices. Bear Stearns continued to grow and prosper, and in 1985 it formed a holding company known as Bear Stearns Companies, Inc. In 2002, while other firms were struggling, Bear Stearns was the only securities firm to report a first-quarter profit increase. It also began focusing more on the housing industry, which would spell out its doom a mere five years later.

In 2005, Bear Stearns was listed as *Fortune* magazine's "America's Most Admired Securities Firm" for the second time in three years. At the end of November 2006, the company's total capital was $66.7 billion and its assets totaled $350.4 billion. The subprime crisis first hit Bear Stearns early in 2007. Previously, the bank had seen a fifty-two-week high of $133.20 per share. By September 2007, two of Bear Stearns' hedge funds had collapsed and the company's third-quarter profit had decreased by 61 percent. By November it had written off $1.2 billion in mortgage securities. In March 2008, the Federal Reserve attempted to bail out the company, but it could not save Bear Stearns. JP Morgan agreed to buy Bear Stearns for a mere $2 per share, which was a decrease of $131 per share in about a year. After lawsuits and intense negotiations, JP Morgan raised the buying price to $10 per share.

What caused a long-standing institution like Bear Stearns to fall? Its investment in subprime loans was a significant factor, but derivatives could also be a major reason. Since its failure, information has come out that Bear Stearns widely misrepresented client information on loan applications in order to make them appear more desirable mortgage recipients. Once these risky subprime loans were given out, the company packaged and sold the debt as securities to other institutions. The securities were backed by cash flow from the loans, which only works when loan payments come in when they are supposed to. In this way, Bear Stearns managed to keep the risky subprime lending debt off of its books and moved the onus to investors. Bear Stearns had derivatives amounting to $13.4 trillion at the end of November 2007.

Since its failure, the Bear Stearns scheme has since been exposed as a risky "house of cards." Executives have been charged with misleading investors by concealing that hedge funds were failing as the mortgage market crumbled. Investors lost $1.6 billion in assets. Executives Ralph R. Cioffi and Matthew M. Tannin were arrested and face criminal charges. Yet this does little to console investors or Bear Stearns employees as they have watched the company's fall and acquisition by JP Morgan.

LEHMAN BROTHERS

Even though the firm had been around for over 150 years, Lehman Brothers found that it too could not survive the subprime mortgage crisis. On September 14, 2008, Lehman Brothers, the fourth-largest investment bank in the United States, filed for Chapter 11 bankruptcy.

Lehman Brothers was founded by Henry, Emanuel, and Mayer Lehman, German immigrants who migrated to America in the mid-nineteenth century. It opened its first store in Montgomery, Alabama, in 1850. As cotton was the cash crop of the South, the brothers often accepted payment in cotton and began acting as brokers for those who were buying and selling the crop. The brothers' business expanded quickly, and they opened an office in New York in 1858. Soon they had transformed from brokerage to merchant banking and Lehman Brothers became a member of the New York Stock Exchange in 1887.

The company continued to thrive even through the stock market crash of 1929. It began advising and financing several businesses, including Halliburton, Digital Equipment, and Campbell Soup. The firm opened its first international office in Paris

in 1960. After going public in 1994, Lehman Brothers joined the S&P 100 Index in 1998 and watched its stock rise to $100 per share by the early 2000s. In 2007, the same year as the beginning of the subprime crisis, Lehman Brothers was ranked number one on the *Fortune* "Most Admired Firms" list. CEO Richard Fuld was placed on the list of the world's thirty best CEOs. For its third-quarter, Lehman Brothers possessed assets worth $275 billion.

Then the subprime mortgage crisis hit. By August 2008 the company's shares had lost 73 percent of their value. Even as the company asked for government aid, its executives continued to pocket millions of dollars in bonuses, an action that caused public outrage. In September, the company filed for bankruptcy with $613 billion in debt. Company shares rapidly fell 90 percent to 21 cents per share. The bank received some relief after Barclay PLC agreed to purchase much of Lehman Brothers for $1.75 billion. The purchase of Lehman Brothers was welcome news for some workers, as many of them thought they were going to lose their jobs. Yet this does little to help many shareholders, who had already seen their stocks reduced to nothing. Even CEO Fuld had lost $600 million since December 2007.

What caused such a well-established company like Lehman Brothers to go belly-up? Its dependence on subprime mortgages was the central factor. Additionally, some are accusing the firm of unethical behavior in its dealings with First Alliance Mortgage, a company accused of "predatory lending." Lehman Brothers helped bundle millions of dollars in mortgages into derivatives instruments for First Alliance and helped make them seem like appealing investment vehicles for Wall Street. Of course, when the loans defaulted, it contributed to the massive financial crisis of today.

Lehman Brothers had also acquired several credit default swaps (CDSs). The company had acquired large amounts of subprime mortgage debt and other lower rated assets when securitizing the underlying mortgages. Even though Lehman had closed its subprime mortgage division in 2007, it maintained much of its subprime mortgage liability through 2008, resulting in large losses from the collapse of the subprime market. Creditors of Lehman Brothers, AIG among them, had taken out credit default swaps to hedge against the case of a Lehman bankruptcy. The estimated amount of settling these swaps stands at $100 to $400 billion. Additionally, many major money market funds had significant exposure to Lehman Brothers, the bankruptcy of which caused the investors in these money market accounts to lose millions. Undoubtedly, the fall of Lehman Brothers will have severe effects on businesses across the world for a long time, a negative legacy of this once great company.

ETHICAL ISSUES WITH DERIVATIVES

Derivatives (especially swaps) expose investors to counterparty risk. For example, if a business wants a fixed interest loan but banks only offer variable rates, the business swaps payments with another business that wants a variable rate, creating a fixed rate for the first business. However, if the second business goes bankrupt, the first business loses its fixed rate and has to pay the variable rate. If interest rates increase to the point where the first business cannot pay back the loan, it causes a chain reaction of failures. Derivatives may also pose high amounts of risk for the small or inexperienced investors.

Because derivatives offer the possibility of large rewards, they offer an attraction to individual investors. But the basic premise of derivatives is to transfer risk among parties based on their willingness to assume additional risk, or hedge against it. Many smaller investors do not comprehend this until they lose. As a result, a chain reaction leading to a domestic or global economic crisis can occur. Warren Buffett, a well-known investor, has stated that he regards derivatives as "financial weapons of mass destruction." Derivatives have been used to leverage the debt in an economy, sometimes to a massive degree. When something unexpected happens, an economy will find it very difficult to pay its debts, thus causing a recession or even depression. Marriner S. Eccles, U.S. Federal Reserve Chairman from 1934 to 1948, stated that an excessively high level of debt was one of the primary causes of the Great Depression.

Some experts believe derivatives have significant benefits as well. Although it is always the case with derivatives that someone loses while someone else gains, under normal circumstances, derivatives should not adversely affect the economic system because it is not a zero-sum game—derivatives theoretically allow for absolute economic growth; meaning while one party gains in relation to the other, both gain relative to their previous positions. Former Federal Reserve Board Chairman Alan Greenspan commented in 2003 that he believed that derivatives softened the impact of the economic downturn at the beginning of the twenty-first century and UBS, for example, believed derivatives were part of its future.

However, derivatives have a checkered history. In the 1900s, derivatives trading and bucket shops were rampant. Bucket shops are small operators in options and securities that lure clients into transactions and then flee with the money, setting up shop elsewhere. In 1922, the federal government attempted to stop this practice with the Grain Futures Act, and in 1936 options on grain futures were temporarily banned in the United States as well as in other countries. In 1972, the Chicago Mercantile Exchange (the Merc) created the International Monetary Market, allowing trading in currency futures representing the first futures contracts associated with nonphysical commodities. In 1975, the Merc responded with the Treasury bill futures contract that was based purely on interest rate futures. In 1977 and 1982, T-bond (Treasury) futures contracts, Eurodollar contracts, and stock index futures were created. The 1980s marked the beginning of swaps and other over-the-counter derivatives. Soon large, and even some not so large, corporations were using derivatives to hedge a wide variety of investment risks. Derivatives soon became too complex for the average person to understand, and Wall Street turned to mathematicians and physicists to create models and computer programs that could analyze these exotic instruments.

Finally, the ethical issues in using derivatives rest with managers and traders who use this highly complex and risky financial instrument. Derivatives are used in sales transactions where there is an opportunity of great financial rewards that does not take into account the level of risk for investors or other stakeholders. If the risk associated with a derivative is not communicated to the investor, this could result in deception or even fraud. It has become apparent that the use of derivatives such as credit default swaps became so profitable that traders and managers lost sight of anything but their incentives for selling these instruments. In other words, financial institutions were selling what could be called defective products because a true risk of these financial instruments was not understood or disclosed to the customer. In some cases these

defective products were given to traders to sell without any due diligence from the company as to the level of risk.

CONCLUSION

While derivatives, including *credit default swaps,* were not the only cause of the failure of the banks discussed in this case, the use of these instruments by decision makers resulted in taking enormous risks. In hindsight these actions seem to be unwise and unfair to stakeholders. An ethical issue relates to the level of transparency that exists in using complex financial instruments to create profits for customers. If purchasers do not understand the potential risks and the possibility of loss of their money, then a chance for deception exists. In the banks examined in this case, there is no doubt that a number of key decision makers not only pushed the limits of legitimate risk-taking, but also engaged in manipulation, and in some cases fraud, to deceive stakeholders.

At this point, it is doubtful whether banks have learned enough about the 2008–2009 financial crisis to avoid future failures. Investors and shareholders need to start looking beyond short-term results and need to start understanding the value of long-term thinking. The CEO and Board of Directors need to develop a transparent business model that balances risk with market opportunity. The ethical risks of lower-level managers using deception and manipulation to create profits, often through loopholes and unregulated areas of decision making, are high. Through ethical leadership and compliance programs these risks can be minimized.

QUESTIONS

1. What are the ethical risks associated with derivatives?
2. What is the difference between making a bad business decision associated with derivatives and engaging in unethical conduct using derivatives?
3. What kinds of investment decisions drove Barings Bank, UBS, Bear Stearns, and Lehman Brothers to financial disasters?
4. How can an ethical corporate culture with adequate internal controls, including ethics and compliance policies, prevent future disasters in financial companies?

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