How the roof fell in on Countrywide

- by
- Scott Olster

DECEMBER 23, 2010

FORTUNE

Editor's note: This week FORTUNE is publishing excerpts from its favorite business books of 2010. This excerpt fromBethany McLean and Joe Nocera's All the Devils are Heretalks about how Countrywide's Angelo Mozilo was blind to the risky mortgages that would eventually wound his firm and contribute to the global financial crisis.

CEO and co-founder Angelo Mozilo saw a subprime mortgage crisis coming — for everyone except his own company. By Bethany McLean and Joe Nocera

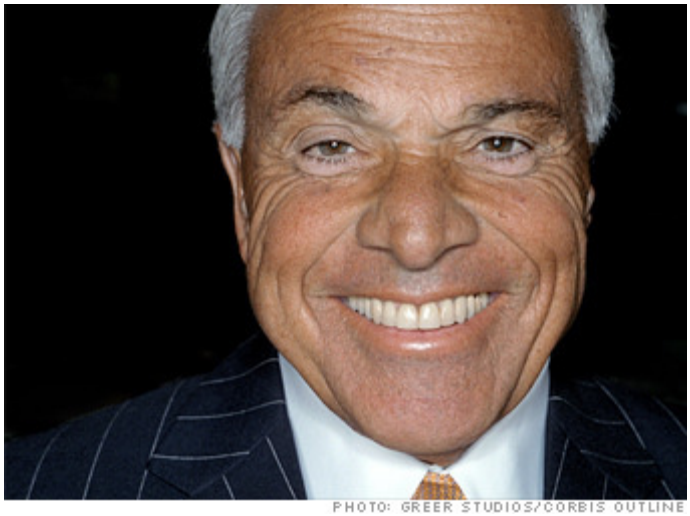


PHOTO: GREER STUDIOS/CORBIS OUTLINE

Mozilo "is a great salesman, and great salesmen are often the ones who get sold," a former Countrywide executive says.

It was one of the more hotly anticipated shows of the fall. On Oct. 18, the trial of Countrywide's former CEO, Angelo Mozilo, along with David Sambol, its president, and Eric Sieracki, the CFO, was set to begin. Mozilo has been publicly excoriated as one of the real villains of the subprime scandal — and the case against him was one of the few the government has brought in the wake of the financial crisis. But almost on the eve of trial, the two sides announced that they'd settled, with Mozilo agreeing to pay a $67.5 million penalty and reparations to investors, and accepting a permanent ban from serving as an officer or director of a public company. (Sambol and Sieracki agreed to far lesser penalties.)

The settlement makes sense for both sides. At the heart of the case was the SEC's contention that the men didn't tell investors the truth about Countrywide's exposure to risky mortgages. But however much we may want to lay the blame for the crisis at Mozilo's feet — at anyone's feet! — the government didn't have a rock-solid case. At the same time, the widespread public outrage, along with some damning e-mails, means that the former executives didn't want to risk a trial.

In any event, even a trial might not have brought out the real story of Angelo Mozilo, the butcher's son from the Bronx, and the company he built — his "baby," as he referred to

Countrywide. Far from founding subprime lending, Mozilo's Countrywide played catch-up to those really at the vanguard. Nor did Mozilo's flaws include any callousness about homeownership. He was a true believer.

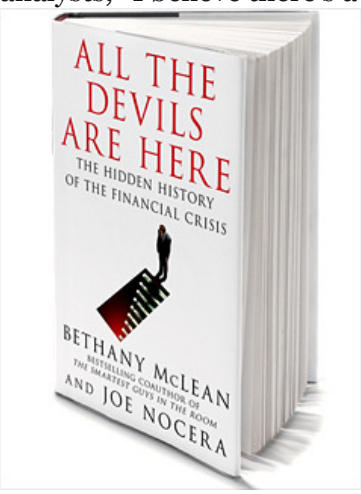
No, Mozilo's fatal flaws were different. One was a desperate hunger to be No. 1, which led Countrywide into a race to the bottom as the mortgage market spiraled out of control. The other was an unwillingness to relinquish control of his baby, which led to an upheaval in Countrywide's executive ranks at the worst possible time. In other words, the real story of what went wrong at Countrywide is a classic business tale of self-delusion, betrayal, and ambition gone awry. –Bethany McLean

What follows is excerpted from All the Devils Are Here: The Hidden History of the Financial Crisis by Bethany McLean and Joe Nocera.

The birth of mortgage-backed securities didn't change just Wall Street. It changed the mortgage business on Main Street too. Mortgage origination — that is, the act of making a loan to someone who wants to buy a home — had always been the province of the banks and the S&Ls, which relied on savings and checking accounts to fund the loans. Securitization mooted that business model. Instead, securitization itself became the essential form of funding. Which meant, in turn, that all kinds of new mortgage companies could be formed — companies that competed with banks and S&Ls for mortgage customers, yet operated outside the banking system and were therefore largely unregulated. Not surprisingly, these new companies were run by men who were worlds apart from the local businessmen who ran the nation's S&Ls and banks. They were hard-charging, entrepreneurial, and intensely ambitious — natural salesmen who found in the changing mortgage market a way to make their mark in American business. Some of them may have genuinely cared about putting people in homes. All of them cared about getting rich. None of them remotely resembled George Bailey.

Countrywide Financial, co-founded in 1968 by Angelo Mozilo and David Loeb, was by 1992 the largest originator of single-family mortgages in the country, issuing close to $40 billion in mortgages that year alone. Just as rising rates had crushed the S&Ls a decade before, so did falling interest rates now turbocharge Countrywide's growth. Lower interest rates helped more people afford homes. But Countrywide began advertising a technique that allowed people who already owned their home to take advantage of lower rates. Refinancing, it was called.

By 2006, there was a distinct Dr. Jekyll and Mr. Hyde–like quality to Angelo Mozilo. The good Angelo had been warning for a surprisingly long time that his industry was heading into dangerous territory. "I'm deeply concerned about credit quality in the overall industry," he said in the spring of 2005. "I think that the amount of capacity that's been developed for subprime is much greater than the quality of subprime loans available." A year later he said to a group of analysts, "I believe there's a lot of fraud" in stated-income loans. And he flatly told CNBC's Maria Bartiromo that a housing recession was on the way. "I would expect a general decline of 5% to 10% [in housing prices] throughout the country — some areas 20%. And in areas where you have had heavy speculation, you could have 30%," he said.



The bad Angelo insisted that none of this would be a problem for Country wide. Countrywide wasn't just some fly-by-nightsubprime lender; it was "America's No. 1 home loan lender!" Mozilo and other executives repeatedly stressed the high standards that Countrywide used to make its mortgages. Country wide's "proprietary technology" would help it "avoid any foreclosure," Mozilo told investors, according to the Los Angeles Times.

Inside Countrywide, however, Mozilo was not so sanguine. In the spring of 2006 he wrote an e-mail describing Countrywide's 80/20 subprime loan as "the most dangerous product in existence and there can be nothing

more toxic." Around the same time, Mozilo sent another e-mail saying that he had "personally observed a serious lack of compliance within our origination system as it relates to documentation and generally a deterioration in the quality of loans originated versus the pricing of those loan[s]." He clearly seemed worried.

The discrepancy between private worry and public proclamation would later cause the SEC to charge Mozilo and several of his top aides with fraud for not disclosing Countrywide's growing risks to investors. In Mozilo's case, the government also charged him with insider trading: From November 2006 through August 2007, he got total proceeds of almost $140 million from cashing in stock options. A judge overseeing a class-action lawsuit filed against Countrywide wrote in one ruling that it was "extraordinary" how the "company's essential operations were so at odds with the company's public statements."

There is little question that the money, and the accolades, had come to matter too much to Mozilo. And yet it's unclear whether Mozilo was, in fact, trying to deceive Countrywide's investors, or whether he was so desperate to win the market share battle that he simply couldn't see the ultimate cost of the bad loans Country wide was making. He remained, quite simply, the truest of true believers, both in his company and in the transcendent virtue of subprime loans Countrywide made. He used to say that if 10% of subprime borrowers defaulted, that meant 90% were paying their mortgages on time, every last one of them a borrower who wouldn't have otherwise had a shot at the American dream. "Angelo — he totally believed," says a former executive. "He'd say, 'When I look a home owner in the eye, I can tell if they'll pay.' We'd say, 'Angelo, we don't even do a personal interview anymore — would you stop saying you can see it in their eyes?'"

As for Countrywide, Mozilo was convinced that it had become so big and so strong that it was impregnable. By 2006 it ranked 122 on the Fortune 500, with $18.5 billion in 2005 revenue, $2.4 billion in profits, and a mortgage-origination engine that had generated a staggering $490 billion in loans. Surely, a company with that kind of financial might could weather even a severe housing downturn. It might even help Countrywide in the long run, by putting some of its subprime-only competitors out of business. During an investor presentation in 2006, Mozilo read the names of some of the companies that had exited the business: Great Western, Home Savings, GlenFed, American Residential, and others. "These are the very ones that equity analysts told me that I should be fearing ... all gone," he said. "And 10 years from now when we read this list, you'll see that most of the players today will be gone. Except for Country wide."

Yes, Mozilo saw that Countrywide was making some risky loans, but what he didn't see — what he couldn't see — was that these loans could make his company every bit as vulnerable as the competitors he disparaged. "If you're a true believer, you can ignore things you shouldn't ignore!" says one former Countrywide executive. "That was Angelo Mozilo's problem." Another puts it a little differently: "He's a great salesman, and great salesmen are often the guys who get sold."

Like other mortgage originators, Countrywide kept the riskiest piece of a securitization, the residuals, on its own balance sheet. By the end of 2006, Countrywide had $2.8 billion worth of residuals on its balance sheet, representing about 15% of its equity. The company's internal enterprise risk-assessment map — a key risk report — was flashing orange.

Then, starting in 2005, Countrywide began to keep both pay-option ARMs and a chunk of home-equity loans — both the loans themselves and the residuals from home-equity securitizations –on its balance sheet as well.

In theory this made sense. Country wide wasn't just a mortgage shop, dependent on the vicissitudes of the mortgage market — it was a financial institution that could thrive in all markets. The rationale was that while there would be some delinquencies, the income stream from these loans would provide stability during tougher times. But, of course, that depended on the quality of the loans.

By the end of 2006, Countrywide had $32.7 billion worth of pay-option ARMs on its balance sheet, up from just $4.7 billion at the end of 2004. As Mozilo later wrote in an e-mail, "We have no way, with any reasonable certainty, to assess the real risk of holding these loans on our balance sheet ... The bottom line is that we are flying blind on how these loans will perform in a stressed environment." The risk of Countrywide's dependence on the market could be mitigated if it were tightly managed. But the more loans and residuals that were put on Countrywide's balance sheet, the harder that became.

If the market ever got spooked about Countrywide's health — if, say, investors began to question the value of the residuals or the loans on Country wide's balance sheet — and shut off the supply of cash, Countrywide could be in jeopardy. Says an analyst: "I told Angelo that his Achilles' heel was funding. In his typical way, Angelo said, 'You're all wrong.'"

On July 24, 2007, two weeks after the rating agencies made their first big downgrade move and one week before the bankruptcy of the Bear Stearns hedge funds, Countrywide announced its results for the first half of the year.

In a last, desperate grab for market share, Countrywide had waited until March 2007 to stop offering "piggy back" loans that allowed borrowers to purchase a home with no money down. As other, weaker correspondent lenders — those that made loans themselves but then sold their loans to bigger lenders — began to go under, Countrywide ramped up its business of buying loans. Since Countrywide was no longer entering into agreements to sell its loans before they were made or purchased, the company was bearing all the risk that the market would crack on its own books.

The rot Mozilo had long insisted wouldn't infect Countrywide had started to spread. Although the company announced a profitable quarter, investors were shocked to hear that its earnings had declined for the third quarter in a row on a year-over-year basis — and that delinquency rates on Countrywide's subprime mortgages had more than doubled, to 23.7%, from less than 10% at the end of March. Delinquencies in prime mortgages — prime mortgages — also spiked. And the company revealed that it was taking several other hits, including $417 million worth of impairments, mostly due to declines in the value of home-equity residuals, and another $293 million in losses in loans held on its balance sheet.

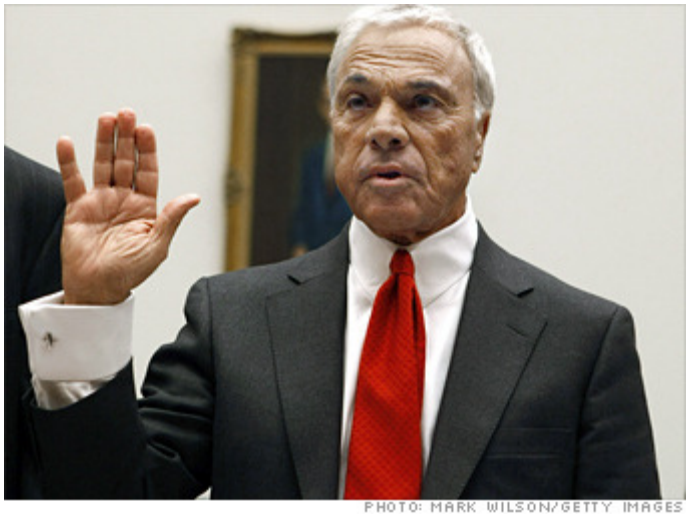


PHOTO: MARK WILSON/GETTY IMAGES

Mozilo at a congressional hearing on the mortgage crisis in 2008

"We are experiencing home price depreciation almost like never before, with the exception of the Great Depression," said Mozilo on the company's conference call that day. Morgan Stanley analyst Ken Posner was startled by the news. "That is just not a charge-off ratio one would expect for a — at least for an old-fashioned prime portfolio," he said on the conference call. "Countrywide is a mortgage supermarket," responded chief risk officer John McMurray. "So it is my belief that the portfolio that we have for the most part is going to be a good reference for what exists on a broader basis."

At another point during the conference call, McMurray noted, "So the way I think about prime is that it covers a very vast spectrum ..." The implication was clear. Countrywide was acknowledging that prime and subprime weren't as clearly delineated as most had believed. While investors who dug through the prospectuses for Countrywide's mortgage-backed securities might have known that, it came as a shock to many. McMurray also had two messages

that were contrary to everything Mozilo had preached over the years. “Leverage at origination matters,” he said. “More leverage means more serious delinquencies.” That is, the more debt the customer borrowed, the more likely he was going to default. And he said, “Documentation matters. The less documentation, the higher the serious delinquency, all else equal.”

That day Countrywide’s stock fell more than 10%, to close at $30.50.

Most companies file their official quarterly documents with the SEC several weeks after announcing their results to Wall Street. Thus it was that on Aug. 9, several weeks after its disastrous conference call, Countrywide filed its quarterly report with the SEC. In it Countrywide cited “unprecedented market conditions,” and wrote that while “we believe we have adequate funding liquidity … the situation is rapidly evolving and the impact on the Company is unknown.” The next day Countrywide held a special board meeting, the board members participating by phone.

Countrywide had always assumed that in desperate times it would be able to pledge its prime mortgages as collateral for a loan. But they couldn’t. Wall Street firms “in almost every case had a very large exposure to mortgages,” as Countrywide treasurer Jennifer Sandefur later put it, and they didn’t want more. Plus, everyone was suddenly asking Wall Street for money. “It was an Armageddon … scenario,” Sandefur said. “It was — you know, a worst-case scenario of kind of epic proportions.”

As soon as he read Countrywide’s filing, Kenneth Bruce, a Merrill Lynch analyst who followed the company, knew that it was at risk. “LIQUIDITY IS THE ACHILLES’ HEEL,” read the headline of his report to his clients. “We cannot understate the importance of liquidity for a specialty finance company like CFC,” wrote Bruce. “If enough financial pressure is placed on CFC” — Countrywide’s ticker — “or if the market loses confidence in its ability to function properly, then the model can break.” His shocking conclusion: “[I]t is possible for CFC to go bankrupt.”

Within days, Countrywide drew down its entire $11.5 billion credit facility — an obvious sign of desperation. It also tried to get the Fed to use its emergency lending authority, but the Fed refused.

On Aug. 23, 2007, shortly before the market opened, Countrywide announced that Bank of America BAC 0.51% would invest $2 billion, giving the market the confidence that Countrywide had access to the deep pockets it needed to keep running. (The bank had loaned Mozilo $75,000 in 1969, allowing him to start up Countrywide.) In an interview with CNBC’s Maria Bartiromo, Mozilo blasted Bruce’s report: “[T]o yell fire in a very crowded theater where you had, you know, panic was already setting in … was totally irresponsible and baseless.” He added, “At the end of the day, we’re the only game left in town.”

After watching Mozilo, Kerry Kil linger, the CEO of Washington Mutual, sent an e-mail to Steve Rotella, WaMu’s chief operating officer. “By the way,” he wrote, “that great orange-skinned prophet from Calabasas was in fine form today on CNBC. He went after the analyst at Merrill, predicted housing would lead us into a recession, said the chance of CFC bankruptcy was no greater than when the stock was at 40, and said, ‘What doesn’t kill us makes us stronger.’ He continues to give the class-action lawyers good fodder for their stock-drop lawsuits.”

In his inimitable way, Mozilo tried to fend off the inevitable. In the fall of 2007, Countrywide hired a public relations firm to help launch a “game plan to regain control of the agenda,” according to a memo obtained by the Wall Street Journal. Although the memo was meant to serve as talking points for another top Countrywide executive — Drew Gissinger — the pugnacious tone had all the earmarks of Angelo Mozilo.

“Our position in the industry makes us a huge and very visible target,” the memo read. “[W]e’re being attacked from all sides today in large part because we’re No. 1. Not just No. 1 overall, but for the first time in mortgage banking history, we’re No. 1 in each of the 4 major

divisions — Wholesale, Retail, Correspondence, and Consumer Direct. This is what makes us such a huge threat to our competitors.

"[I]t's gotten to the point where our integrity is being attacked," the memo continued. "NOW IT'S PERSONAL! ... WE'RE NOT GOING TO TAKE IT." It ended by asking Countrywide's employees to sign a pledge that they would "protect our house" — that is, defend the company from the growing storm of accusations about its lending practices. The stock continued to fall.

In January 2008, Countrywide hired Sandler O'Neill, a boutique investment bank, to explore its options. According to one person who was there, Countrywide CFO Eric Sieracki presented a "base-case scenario," a "stress scenario," and a "severe scenario." Jimmy Dunne, Sandler's blunt CEO, dismissed the base-case scenario out of hand. What was coming was likely to be even worse than Countrywide's severe scenario, he said. Countrywide needed to sell. And the best — maybe the only — buyer was Bank of America. "Ken Lewis, when he covets a target, cannot say no," Dunne said. (Lewis, the CEO of Bank of America, would become infamous for buying Merrill Lynch during the height of the crisis in a deal that was surrounded by controversy and criticism. Ultimately, that acquisition would cost him his job.) Says one person who was there: "Mozilo and all these guys, they thought they were making widgets. They got too far away from understanding the real risk in the balance sheet. Even at the end, they were saying that things were okay. They believed it. They were crazy."

In January 2008, Bank of America acquired Countrywide for $4 billion; less than a year earlier its market capitalization had been more than six times that amount, at nearly $25 billion. During the second half of 2007, Countrywide took $5.2 billion in write-downs and increases to loan loss reserves, according to a shareholder lawsuit later filed against the company. The write-downs essentially wiped out Countrywide's earnings for 2005 and 2006.

Just before the acquisition, Mozilo told investors, "I believe very strongly that no entity in this nation has done more to help American homeowners achieve and maintain the dream of homeownership than Countrywide."