Countrywide Case

1. Without making specific reference to the practices of CFC, describe what you believe to be an ethical lending policy. Be specific about the practices you would require and those you would prohibit as well as the ethical theories underlying your decision.

Ethics is what a society views as right or wrong. I am a believer of ethical relativism. According to the text, ethical relativism states that whether something is ethical or unethical depends on local customs, social mores, and varies from one nation to another. From the perspective of a US taxpayer who provides the safety net for FHA lenders, I would require the following practices for lending:

1. I would require that underwriters have strict laws/regulations for what is acceptable documentation to verify borrower income and finances. It is unethical to allow people to borrow money when it is likely they will default, especially when the government is backing the loan. If an underwriter does not have the necessary financial documentation to review to assess a client’s risk of defaulting, bad lending decisions are more likely. Underwriters/originators should face steep fines and penalties for not complying with the regulations. It is unethical to set borrowers up for failure. Since the Great Depression, the government has passed laws to allow more and more people to obtain mortgages as a social service; however, we recently witnessed the negative effects of that. If borrowers do not demonstrate sufficient income, finances, and documentation to borrow, then the borrower should rent rather than buy. The “dream” of owning a home should be for those who can afford to buy one and pay the mortgage payments.

2. When calculating the risk of default and whether to lend money to a borrower, lenders must have an objective system based on financial ratios and credit history. Discriminatory factors such as the neighborhood the house is in, race, gender, and age should be excluded from the decision process to approve or deny the loan. Lenders must document why a borrower is approved or denied in each case. Auditors should examine the reasons to determine if the approvals and denials are based on the objective criteria established by the lender. It is unethical to discriminate based on factors such as race, gender, age, and neighborhood.
3. Mortgage originators would be required to hold a significant random sample of the mortgages they originate. I would prohibit mortgage originators from selling all or most of their loan portfolios as MBSs. For example, mortgage originators would be required to retain at least half of all loans given to subprime borrowers.

4. Loan applications and closing documents should have clear disclosures with common language people can understand. Borrowers should not feel compelled to hire an attorney to read through mortgage documents.

5. Banks would still be able to lend to borrowers with a higher risk of default; however, the government safety net would not be as significant. The default risk and government backed reimbursement percentage in the case of a default for FHA loans would have an inverse relationship; the higher the risk of a borrower defaulting, the less the bank will be reimbursed by the federal government if the borrower defaults. Banks should be “rewarded” with a higher reimbursement percentage in the case of a default for giving loans to borrowers who are well qualified.

6. Lenders should be allowed to sell MBSs; however, the securities should be stringently audited to determine if the risk of the security matches what the lender states the risk is. If a lender puts together a MBS that contains a bundle of subprime loans mixed with a bundle of low risk loans, how is that communicated to the investor? MBS prospectuses should be detailed and list out the risks of the individual mortgages. It is unethical to misinform or not properly inform investors of material information that affects risk.

2. Were the business practices of CFC ethical? Describe the policies you find to be particularly ethical, if any, and the practices you find to be particularly unethical, if any. Justify your classification of a practice as ethical or unethical by reference to the theories enumerated in your answer to #1.

The practices of CFC were certainly unethical. CFC was concerned with growing the business and adding more loans (regardless of the quality of loans) to its portfolio and selling MBSs. Its executives were greedy.

According to the article, in 1994, subprime mortgages accounted for 6% of mortgage originations. By the end of 2005, subprime mortgages accounted for over 37% of total mortgage
originations. Lenders had money to lend so they were aggressively trying to find borrowers. Underwriters relaxed documentation requirements for loans. It stated in the article that borrowers just had to state their income and provide no proof; that is unbelievable. Mortgage originators gave mortgages to people who were not qualified. That risk was then passed to investors and the government via MBSs.

CFC was charged with using predatory lending practices. CFC used tactics such as deception, fraud, and manipulation to convince borrowers to agree to mortgage terms that were illegal or unethical.

One thing CFC did right was it did not discriminate against borrowers based on race, religion, age, ethnicity, etc. The article did not accuse CFC of discrimination. It gave mortgages to anyone and everyone.

What I read did not mention whether CFC had to retain a portion of the loans it originated or if it was able to get rid of all of them as MBSs. The implication from the reading is that CFC originated high risk loans, bundled them with less risk loans, and sold them to investors as low risk MBSs. CFC did not retain a significant percentage of the loans originated.

3. Identify an alternative set of business practices that CFC might have adopted to improve its ethical position. Be specific about the ethical improvement that would result, as well as any ethical tradeoffs that need to be considered.

CFC should have done a better job explaining risk to investors of its MBSs. If investors were aware of the borrowers that CFC was giving loans to, they may have invested in a different “low risk” investment. Or, investors may have bought the higher risk MBSs if paid a premium.

Mortgage originators should not have given loans to people who were not qualified. Many consumers had their lives ruined when their homes were taken from them. Also, by giving so many loans out, it created a bubble by inflating home prices. When the bubble popped, housing prices dropped and many homeowners were left with negative equity. Some could argue that not giving mortgages to lower income borrowers would be unethical because they deserve the dream of home ownership. I argue to give them mortgages they can afford or they can choose to rent.
CFC should not have had a VIP program. According to the concept appearance of impropriety, it appeared wrong so it was wrong/unethical. Also, the executive compensation plan was extremely high for being a GSE.

CFC should not have been allowed to create MBSs and sell them. A third party securities broker should have been hired to create the MBSs and sell them. CFC was permitted to originate loans and group them how it pleased and sell them. If a securities broker were used, it may have assessed the level of risk differently than CFC did.

The greed and unethical behavior started at the top of the company. The human resources office should have had mandatory ethics training for all employees. This would have bred a culture of ethical behavior. Employees would have attempted to do the right thing.

It was not just CFC that behaved unethically; it was a huge industry that was behaving unethically. It would not have been financially beneficial for CFC to behave ethically in an unethical industry. I think being ethical would have hurt CFC’s business because the other unethical predatory lenders would have given loans to people whom CFC denied. If CFC wanted to fix the problem, it should have lobbied for federal regulation and laws to fix the industry rather than be the one ethical lender amongst an industry of unethical businesses.

Submitted by David Weaver (Accounting major)