Case study housing bubble and its burst

Business, Strategic Management

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Case StudyQuestion 1: Explain the cause of the housing bubble and its burst in the mid-2000s. To what extent is this problem the result of ethicalfailure?

Housing Bubble

No single cause can fully explain the crisis but, in my opinion, the two major bases were legislation that promoted homeownership and subprime mortgages. To fully understand theenvironmentthat spawned the housing bubble, we'll have to travel back to the 1930s, when the country was in the midst of theGreat Depression.

During this time frame, homeownership represented only about 40 percent of U. S. households (Thompson, Peteraf, Gamble, Strickland, 2012, p. c-423). Following severe mortgage market disruptions, widespread foreclosures, and sinking homeownership rates, the government created the Federal Housing Administration (FHA), Fannie Mae, the Federal Home Loan Bank (FHLB), and several decades later Freddie Mac to help promote secure and sustainable homeownership for the future generation of Americans (Reforming America's HousingFinanceMarket, A Report to Congress, 2011, P. 5).

A Subprime Mortgage is a type of mortgage that is normally made out to borrowers with lower credit ratings; a conventional mortgage is not offered because the lender views the borrower as having a larger-than-average risk of defaulting on the loan; lending institutions often charge interest on subprime mortgages at a rate that is higher in order to compensate themselves for carrying more risk, as defined by Investopedia. com, 2013. In 1994, subprime mortgages represented approximately 6 percent of total mortgage loans originated but by 2005 the percentage grew to 37. (Thomson et al. , 2012). Private firms like Countrywide, and others, issued more than 84 percent of the subprime mortgages in 2006 (Swift, 2011). Fast-forward to the 2000s and the effects of federal legislation over 60 years increased homeownership to nearly 70 percent (Thomson et al. , 2012) coupled with an explosion of subprime mortgages, and appreciation of home values resulted in the housing bubble.

Housing Bubble Burst

As there are several factors that created the bubble, there are just as many that were responsible for its burst.

The most significant factors were the repeal of a major component of the Glass-Steagall Act and a weakened housing market. First, let's look at the Glass-Steagall Act. One of the components in the Glass-Steagall Act of 1933 separated investment (brokerage) and commercial banking activities (investopedia. com, 2009). The clause stipulated that banks would be allowed to take deposits and make loans, brokers would be allowed to underwrite and sell securities, but no firm would be allowed to do both due to the conflicts of interest and risks to insured deposits (Rickards, 2012). In 1999, President Bill Clinton and Republicans led by Sen.

Phil Gramm repealed part of the Glass-Steagall Act, removing barriers that prohibited any one institution from acting as any combination, at the behest of big banks (Rickards, 2012). Secondly, the U. S. economy began to weaken, with declining demand for housing, which caused home prices to plummet and appreciation in home prices came to an end, and in most cases reversing (Thompson et al. , 2012). Homeowners, investors, and financial institutions did not have enough capital supporting their investments to absorb the resulting losses (Reforming America’s Housing Finance Market, A Report to Congress, 2011, P.). Homeowners were faced with foreclosure when they lost income during the economic slowdown or seen their payment on Adjustable Rate Mortgages (ARMs) rise to a point of unaffordability (Thompson et al. , 2012). In 2008, credit markets froze. Our nation's financial system – which had outgrown and outmaneuvered a regulatory framework largely designed in the 1930s – was driven to the brink of collapse. Millions of Americans lost their jobs, families lost their homes, and small businesses shut down (Reforming America’s Housing Finance Market, A Report to Congress, 2011, P. 5).

Countrywide's Role

Case Study Question 2: Evaluate Countrywide’s role in the subprime mortgage debacle. Was the company’s conduct unethical or illegal? Countrywide’s Role From 2005 to 2007, Countrywide was the leading subprime lender in the country issuing $97. 2 billion in subprime mortgages (Bloomberg Business Week, 2009) but only led in market share by 2 percent.

The bottom 16 subprime mortgage-issuing firms accounted for $363. 5 billion in mortgages (reference chart 1). Countrywide was responsible for 10 percent of a $1 trillion problem. Conduct Unethical or Illegal Countrywide practices were illegal.

Countrywide was charged with predatory lending practices (Thompson et al. , 2012) and later reached a multi-state settlement for $8. 68 billion (Huffman, 2008). “ Countrywide’s lending practices turned theAmerican dreaminto a nightmare for tens of thousands of families by putting them into loans they couldn’t understand and ultimately couldn’t afford,” said Attorney General Edmund G. Brown Jr., a co-leader of the negotiations for the states (Huffman, 2008). The countrywide settlement became the largest predatory lending settlement in history, dwarfing the nationwide $484 million settlement (Huffman, 2008).

Case Study Question 3: Using this case as an example, who benefits and who gets hurt when a company engages in unethical or socially irresponsible behavior? In the long-term, no one benefits from this behavior. In this case study, the companies, shareholders, consumers, and the global economy all suffered from the irresponsible behavior of many in the financial sector. Between June 2007 and November 2008, Americans lost more than a quarter of their net worth (Wikipedia. org, 2013). Total retirement assets dropped by 22 percent, from $10. 3 trillion in 2006 to $8 trillion in mid-2008 (Wikipedia. org, 2013).

As with most unethical or irresponsible corporate behavior, there are no long-term winners.

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