Arcane Market Is Next to Face Big Credit Test

Questions Arise About Insurance Securities

By GRETCHEN MORGENSON

Few Americans have heard of credit default swaps, arcane financial instruments invented by Wall Street about a decade ago. But if the economy keeps slowing, credit default swaps, like subprime mortgages, may become a household term.

Credit default swaps form a large but obscure market that will be put to its first big test as a looming economic downturn strains companies’ finances. Like a homeowner’s policy that insures against a flood or fire, these instruments are intended to cover losses to banks and bondholders when companies fail to pay their debts.

The market for these securities is enormous. Since 2000, it has ballooned from $900 billion to more than $45.5 trillion — roughly twice the size of the entire United States stock market.

No one knows how troubled the credit swaps market is, because, like the now-distressed market for subprime mortgage securities, it is unregulated. But because swaps have proliferated so rapidly, experts say that a hiccup in this market could set off a chain reaction of losses at financial institutions, making it even harder for borrowers to get loans that grease economic activity.

It is entirely possible that this market can withstand a big jump in corporate defaults, if it comes. But an inkling of trouble emerged in a recent report from the Office of the Comptroller of the Currency, a federal banking regulator. It warned that a significant increase in trading in swaps during the third quarter of last year “put a strain on processing systems” used by banks to handle these trades and make sure they match up.

And last week, the American International Group said that it had incorrectly valued some of the swaps it had written and that sharp declines in some of these

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instruments had translated to
$3.6 billion more in losses than
the company had previously esti-
mated. Its stock dropped 12 per-
cent on the news but edged up in
the days after.

A.I.G. says it expects to file its
year-end financial statements on
time by the end of this month with
appropriate valuations.

Placing accurate values on
these contracts is just one of the
uncertainties facing the big
banks, insurance companies and
hedge funds that create and
trade these instruments.

In a credit default swap, two
parties enter a private contract in
which the buyer of protection
agrees to pay the seller premi-
ums over a set period of time; the
seller pays only if a particular
credit event occurs, like default.
These instruments can be sold,
on either end of the contract, by
the insurer or the insured.

But during the credit market
upheaval in August, 14 percent of
trades in these contracts were
unconfirmed, meaning one of the
parties in the resale transaction
was not identified in trade docu-
ments and remained unknown 30
days later. In December, that
number stood at 13 percent. Be-
because these trades are unregulat-
ed, there is no requirement that
all parties to a contract be told
when it is sold.

As investors who have pur-
chased such swaps try to cash
them in, they may have trouble
tracking down who is supposed
to pay their claims.

“This is just a giant insurance
industry that is underregulated
and not very well reserved for
and does not have very good
standards as a result,” said Mi-
ichael A. J. Farrell, chief execu-
tive of Annaly Capital Manage-
ment in New York. “I think unregu-
lated markets that overshadow, in
terms of size, the regulated ones
are a real question mark.”

Because these contracts are
sold and resold among financial
institutions, an original buyer
may not know that a new, po-
tentially weaker entity has taken
over the obligation to pay a claim.

In late 2005, at the urging of the
Federal Reserve Bank of New
York, market participants agreed
to advise their trading partners
in a swap when they assigned
contracts to others. But it is un-
clear how closely participants ad-
here to this practice.

It would be as if homeowners,
facing losses after a hurricane,
could not identify the insurance
companies to pay on their claims.
Or, if they could, they discovered
that their insurer had transferred
the policy to another company that
could not cover the claim.

Credit default swaps were in-
vented by major banks in the
mid-1990s as a way to offset risk
in their lending or bond portfo-
los. At the outset, each con-
tract was different, volume in the
market was small and partici-
pants knew whom they were
dealing with.

Years of a healthy economy
and few corporate defaults led
many banks to write more credit
insurance, finding it a low-risk
way to earn income because fail-
ures were few. Speculators have
also flooded into the credit insur-
ance market recently because
these securities make it easier to
bet on the health of a company
than using corporate bonds.

Both factors have resulted in a
market of credit swaps that now
far exceeds the face value of cor-
porate bonds underlying it. Com-
mercial banks are among the big-
gest participants — at the end of
the third quarter of 2007, the top
25 banks held credit default
swaps, both as insurers and in-
sured, worth $14 trillion, the cur-
rency office said, up $2 trillion
from the previous quarter.

J.P. Morgan Chase, with $7.8 tril-
lion, is the largest player; Cit-
ibank and Bank of America are
behind it with $3 trillion and $1.6
trillion respectively.

But many speculators, par-
ticularly hedge funds, have flocked
to these instruments to bet on a
company failure easily. Before
the insurance was developed, such
a bet would require selling short
a corporation’s bond and going into
the market to borrow it to supply
to the buyer.

The market’s popularity raises
the possibility that undercapital-
ized participants could have trouble
paying their obligations.

“The theme had been that de-
rivatives are an instrument that
helps diversify risk and stabilize
risk-taking,” said Henry Kauf-
man, the economist at Henry
Kaufman & Company in New
York and an authority on the
ways of Wall Street. “My own
view of that is that it has almost
always been highly questionable —
these instru-
mments also encourage sig-
ficant risk-taking and looking at
risk modestly rather than inci-
sively.”

Officials at the International
Swaps and Derivatives Associa-
tion, a trade group, say they are
confident that the market will
stand up, even under stress.

“During the volatility we have
seen in the last eight months,
credit default swaps continue to
trade, unlike other parts of the
credit market that have shut
down,” said Robert G. Pickel,
chief executive of the association.

“Even if we have a series of cred-
it events at the same time, we
have the processes in place to en-
able the market to deliver.”

Such credit problems have
been rare recently. The default
rate among high-yield junk bonds
fell to 0.9 percent in December, a
record low.

But financial history is rife
with examples of market break-
downs that followed the creation
of complex securities. Financial
innovation often gets ahead of
the mechanics necessary to track
trades or regulators’ ability to
monitor the market for safety
and soundness.

The market for default insur-
ance, like the subprime mortgage
securities market, is a product of
good economic times and has
boomed in recent years. In 2000,
$900 billion of credit insurance
contracts changed hands. Since
then, the face value of the con-
tracts outstanding has doubled
every year as new contracts have
been written. In the first six
months of 2007, the figure rose 75
percent; the market now dwarfs
the value of United States Treas-
uries outstanding.

Roughly one-third of the credit
default swaps provided insur-
ance against a default by a spe-
cific corporate debt issuer in
2006, according to the British
Bankers’ Association. Around 30
percent of the contracts were
written against indexes repre-
senting baskets of debt from nu-
merous issuers.

But 16 percent were created to
protect holders of collateralized
debt obligations, complex pools
of bonds that have recently expe-
rienced problems because of
mortgage holdings.

There is no exchange where
these insurance contracts trade,
and their prices are not reported
to the public. Because of this, in-
institutions typically value them
based on computer models rather
than prices set by the market.

Neither are the participants
overseen by regulators verifying
that the parties to the transac-
tions can meet their obligations.

The potential for problems in
sizing up the financial health of did not work, investor confidence could take another dive.

To be sure, the $45 trillion in credit default swaps is not an exact reflection of what would be lost or won if all the underlying securities defaulted. That figure is impossible to pinpoint since the amounts that are recovered in default situations vary.

But one of the challenges facing participants in the credit default swap market is that the market value amount of the contracts outstanding far exceeds the $5.7 trillion of the corporate bonds whose defaults the swaps were created to protect against.

To the uninformed trying to understand this complex market, its size might initially seem comforting, as if there were far more insurance covering the bonds than could ever be needed. But because each contract must be settled between buyer and seller if a default occurs, this imbalance can present a problem.

Typically, settling the agreements has required the delivery of defaulted bonds if the insurance buyer wants to be fully covered. If the insurance contracts exceed the bonds that are available for delivery, problems arise.

For example, when Delphi, the auto parts maker, filed for bankruptcy in October 2005, the credit default swaps on the company's debt exceeded the value of underlying bonds tenfold. Buyers of credit insurance scrambled to buy the bonds, driving up their price to around 70 cents on the dollar, a startlingly high value for defaulted debt.

Market participants worked out an auction system where settlements of Delphi contracts could be made even if the bonds could not be physically delivered. This arrangement was done at just over 36 cents on the dollar, so buyers of protection on Delphi who did not have the bonds received $366.25 for every $1,000 in coverage they had bought. Had they been valuing their Delphi insurance coverage at $1,000 per bond, they would have had to write off that position by $633.75 per $1,000 bond.

That is why the valuation of these contracts is of such concern to some participants.

As with other securities that trade privately and by appointment, assigning values to credit

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**Hints of trouble for a relatively unknown financial instrument: credit default swaps.**

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default swaps is highly subjective. So some on Wall Street wonder how much of the paper gains generated in these instruments by firms and hedge funds last year will turn out to be illusory when they try to cash them in.

"The insurance business is very difficult to quantify risk in," said Mr. Farrell of Annaly Capital Management. "You have to really read the contract to make sure you are covered. That is going to be the test of the market this year. As defaults kick in and as these events unfold, you are going to find out who has managed this well."

And who hasn't.
Typically, settling the agreement buyer wants to be fully covered. If the insurance contracts exceed the bonds that are available for delivery, problems arise. For example, when Delphi, the auto parts maker, filed for bankruptcy in October 2005, the credit default swaps on the company’s debt exceeded the value of underlying bonds tenfold. Buyers of credit insurance scrambled to buy the bonds, driving up their price to around 70 cents on the dollar, a startlingly high value for defaulted debt.

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In the Shadow of an Unregulated Market
The value of the credit default insurance market is now much larger than the domestic stock market, mortgage securities market and United States Treasuries market.

Sources: Thomson Proprietary Research, International Swaps and Derivatives Association
Borrowers and Bankers: A Great Divide

The credit crisis has exposed and worsened a dangerous and deepening divide in this country between a vast number of average borrowers and a fairly elite slice of corporations, banks and executives enriched by the mortgage mania.

Borrowers who are in trouble on their mortgages have seen their government move slowly—or not at all—to help them. But banks and the executives who ran them are quickly deemed worthy of taxpayer bailouts.

Cleaning up messes instead of preventing them.

On the ground, this translates into millions of troubled borrowers, left to work through their problems with understaffed, sometimes adversarial loan servicing companies. If they get nowhere, they lose their homes.

Taxpayers, meanwhile, are asked to stand by with money to inject into Fannie Mae and Freddie Mac, the government-sponsored mortgage finance giants, should they need propping up if loan losses balloon.

The message in this disconnect couldn’t be clearer. Borrowers should shoulder the consequences of signing loan documents they didn’t understand, but with punishing terms that quickly made the loans unaffordable. But for executives and directors of the big companies who financed these loans, who grew wealthy while the getting was good, the taxpayer is coming to the rescue.

To be sure, bailouts are becoming increasingly necessary in our highly leveraged, interconnected financial world. One obvious reason that huge companies are not allowed to fail is that so many people are hurt by such debacles.

If a family files for bankruptcy or loses a home, the pain still hurts, but its emotional and financial ripples are confined. And in the heat of a financial crisis,
there is often little time to think through who deserves a bailout and who does not. In especially dire circumstances, leaders have no choice but to rescue companies. Think about Bear Stearns: even though it was relatively small in size for a brokerage firm, its demise had to be averted because of a possible domino effect that might have also taken down its many trading partners. In that multibillion-dollar bailout, it was Bear’s big and wealthy counterparties who benefited.

Fannie Mae and Freddie Mac, however, present an exponentially larger problem. They are unquestionably too big to fail. With $5.2 trillion in mortgages either on their books or guaranteed by them, their bailout was completely predictable. If those companies had been left for road kill, the mortgage market would have ground to a halt and a financial conflagration of historic and devastating proportions would have resulted.

Not all big banks get bailouts, of course. IndyMac Bank, one of the nation’s largest savings and loans, was closed down by regulators last week.

Nevertheless, we are in dangerous territory today where bailouts are concerned, and not only because they feed Americans’ suspicions that only the rich and powerful get help in our country.

Bailouts are also ticklish affairs because of the precarious state of our economy. As Americans are being asked to shore up reckless financial companies, they are also being punished by high oil prices, rocketing food costs and a stomach-churning slide in the buying power of their currency, the once-almighty dollar.

So asking Main Street to bail out Wall Street leads to this inevitable question: Weren’t the financial folks the ones who helped create the mess we’re in?

Yet last week, regulators gave a nice boost to Wall Street and other members of the financial club. Christopher Cox, the chairman of the Securities and Exchange Commission, devised an emergency rule change for traders wishing to sell short the shares of 19 financial companies, including Lehman Brothers, Merrill Lynch, Fannie Mae, Bank of America and Citigroup. The rule states that if you haven’t borrowed the shares you intend to sell short, you can’t make the trade. It extends until July 29.

There are several interesting aspects to this change. First, if the S.E.C. believes that shorting without previously borrowing shares is a problem in the market, why not apply the rule to all stocks? After seeing many of the 19 companies’ stocks shoot higher after the plan was announced, executives at General Electric, the American International Group and MBIA, companies whose shares have also been pummeled in the financial crisis, must surely feel left out of the fun.

Once again, this emergency action smacks of the regulatory responses of recent years: doing nothing to curb the deal-making mania while it is occurring, but when the rout comes along, hurry up and rein it in.

Of course, people prefer rising stock prices to declining ones. Wouldn’t it be wonderful if shares never fell? But such actions call into question the claim that ours is a free-market system. More and more, our version of free markets holds that they are free only when asset values rise. When they fall, the markets must be managed.

Here is a question: Might not the routes, which inevitably follow the manias, be less painful if things were not allowed to get wild and crazy on the upside? Might not the American people be better off with regulators who curb market enthusiasm — whether in the form of errant lending or voracious, ill-considered deal making — when it reaches manic levels, to protect against the free fall, and the bailouts, that ensue?

No, no, no — perish the thought, especially when the taxpayer is there to pick up the bill.

Which returns us to the dispiring divide between those who receive help and those who don’t.

“The banks are too big to fail and the man in the street is too small to bail,” said John C. Bogle, the founder of the Vanguard Group, the mutual funds giant, who is a philosopher of finance.

Mr. Bogle is working on his seventh book, titled “Enough,” which is scheduled to be published in November. He said he was disturbed by the extreme speculation that spread into the entire economy during the housing boom and that now threatens both consumers and investors.

“I predicted last summer that this would be my 10th bear market,” he said. “But this one is different. The others were more marketlike, reflecting problems in the market, not problems in the society and the economy as this one does. As a result, we’re in for a much more troublesome era than after the other big bear markets.”

Mr. Bogle, like most investors, is an optimist at heart. But he believes that we must work to correct the growing imbalances in our country. “We Americans are one lucky bunch,” he said. “But, let’s face the truth. While the Declaration of Independence assures us that ‘all men are created equal,’ we’d best face the fact that we may be created equal but we are born into a society where inequality of family, of education and, yes, even opportunity begins as soon as we are born.”

“But the Constitution demands more,” he adds. “We the people are enjoined to form a more perfect union, to establish justice, ensure domestic tranquility, and to promote the general welfare and to secure the blessings of liberty to ourselves and our posterity. So it’s up to each of us to summon our unique genius, our own power and our own personal magic to restore these values in today’s imbalanced society.”

Not a bad idea, bringing a little 18th-century enlightenment to this moment of 21st-century gloom.
Behind Biggest Insurer’s Crisis, A Blind Eye to a Web of Risk
How a Small, Freewheeling Unit Brought A.I.G. to Its Knees

“It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions.”

— Joseph J. Cassano, a former A.I.G. executive, August 2007

By GRETCEN MORGENSON

Two weeks ago, the nation’s most powerful regulators and bankers huddled in the Lower Manhattan fortress that is the Federal Reserve Bank of New York, desperately trying to stave off disaster.

As the group, led by Treasury Secretary Henry M. Paulson Jr., pondered the collapse of one of America’s oldest investment banks, Lehman Brothers, a more dangerous threat emerged: American International Group, the world’s largest insurer, was teetering. A.I.G. needed billions of dollars to right itself and had suddenly begged for help.

The only Wall Street chief executive participating in the meeting was Lloyd C. Blankfein of Goldman Sachs, Mr. Paulson’s former firm. Mr. Blankfein had particular reason for concern.

Although it was not widely known, Goldman, a Wall Street stalwart that had seemed immune to its rivals’ woes, was A.I.G.’s largest trading partner, according to six people close to the insurer who requested anonymity because of confidentiality agreements. A collapse of the insurer threatened to leave a hole of as much as $20 billion in Goldman’s side, several of these people said.

Days later, federal officials, who had let Lehman die and initially balked at tossing a lifeline to A.I.G., ended up bailing out the insurer for $85 billion.

Their message was simple: Lehman was expendable. But if A.I.G. unspooled, so could some of the mightiest enterprises in the world.

A Goldman spokesman said in an interview that the firm was never imperiled by A.I.G.’s troubles and that Mr. Blankfein participated in the Fed discussions to safeguard the entire financial system, not his firm’s own interests.

Yet an exploration of A.I.G.’s demise and its relationships with firms like Goldman offers important insights into the mystifying, virally connected — and astonishingly fragile — financial world that began to implode in recent weeks.

Although America’s housing collapse is often cited as having caused the crisis, the system was vulnerable because of intricate financial contracts known as credit derivatives, which insure debt holders against default. They are fashioned privately and beyond the ken of regulators — sometimes even beyond the understanding of executives peddling them.

Originally intended to diminish risk and spread prosperity, these inventions instead magnified the impact of bad mortgages like the ones that felled Bear Stearns and Lehman and now threaten the entire economy.

In the case of A.I.G., the virus exploded from Continued on Page 28
a freewheeling little 377-person unit in London, and flourished in a climate of opulent pay, lax oversight and blind faith in financial risk models. It nearly decimated one of the world’s most admired companies, a seemingly sturdy insurer with a trillion-dollar balance sheet, 116,000 employees and operations in 150 countries.

“It is beyond shocking that this small operation could blow up the holding company,” said Robert Arvanitis, chief executive of Risk Finance Advisors in Westport, Conn. “They found a quick way to make a fast buck on derivatives based on A.I.G.’s solid credit rating and strong balance sheet. But it all got out of control.”

The London Office

The insurance giant’s London unit was known as A.I.G. Financial Products, or A.I.G.F.P. It was run with almost complete autonomy, and with an iron hand, by Joseph J. Cassano, according to current and former A.I.G. employees.

A onetime executive with Drexel Burnham Lambert — the investment bank made famous in the 1980s by the junk bond king Michael R. Milken, who later pleaded guilty to six felony charges — Mr. Cassano helped start the London unit in 1987. The unit became profitable enough that analysts considered Mr. Cassano a dark horse candidate to succeed Maurice R. Greenberg, the longtime chief executive who shaped A.I.G. in his own image until he was ousted amid an accounting scandal three years ago.

But last February, Mr. Cassano resigned after the London unit began bleeding money and auditors raised questions about how the unit valued its holdings. By Sept. 15, the unit’s troubles forced a major downgrade in A.I.G.’s debt rating, requiring the company to post roughly $15 billion in additional collateral — which then prompted the federal rescue.

Mr. Cassano, 53, lives in a handsome, three-story town house in the Knightsbridge neighborhood of London, just around the corner from Harrods department store on a quiet square with a private garden.

He did not respond to interview requests left at his home and with his lawyer. An A.I.G. spokesman also declined to comment.

At A.I.G., Mr. Cassano found himself ensconced in a behemoth that had a long and storied history of deftly juggling risks. It insured people and properties against natural disasters and death, offered sophisticated asset management services and did so reliably and with bravado on many continents. Even now, its insurance subsidiaries are financially strong.

When Mr. Cassano first waded into the derivatives market, his biggest business was selling so-called plain vanilla products like interest rate swaps. Such swaps allow participants to bet on the direction of interest rates and, in theory, insulate themselves from unforeseen financial events.

Ten years ago, a “watershed” moment changed the profile of the derivatives that Mr. Cassano traded, according to a transcript of comments he made at an industry event last year. Derivatives specialists from J. P. Morgan, a leading bank that had many dealings with Mr. Cassano’s unit, came calling with a novel idea.

Morgan proposed the following: A.I.G. should try writing insurance on packages of debt known as “collateralized debt obligations.” C.D.O.’s were pools of loans sliced into tranches and sold to investors based on the credit quality of the underlying securities.

The proposal meant that the London unit was essentially agreeing to provide insurance to financial institutions holding C.D.O.’s and other debts in case they defaulted — in much the same way some homeowners are required to buy mortgage insurance to protect lenders in case the borrowers cannot pay back their loans.

Under the terms of the insurance derivatives that the London unit underwrote, customers paid a premium to insure their debt for a period of time, usually four or five years, according to the company. Many European banks, for instance, paid A.I.G. to insure bonds that they held in their portfolios.

Because the underlying debt securities — mostly corporate issues and a smattering of mortgage securities — carried blue-chip ratings, A.I.G. Financial Products was happy to book income in exchange for providing insurance. After all, Mr. Cassano and his colleagues apparently assumed, they would never have to pay any claims.

Since A.I.G. itself was a highly rated company, it did not have to post collateral on the insurance it wrote, analysts said. That made the contracts all the more profitable.

These insurance products were known as “credit default swaps,” or C.D.S.’s in Wall Street argot, and the London unit used them to turn itself into a cash register.

The unit’s revenue rose to $3.26 billion in 2005 from $737 million in 1999. Operating income at the unit also grew, rising to 17.5 percent of A.I.G.’s overall operating income in 2005, compared with 4.2 percent in 1999.

Profit margins on the business were enormous. In 2002, operating income was 44 percent of revenue; in 2005, it reached 83 percent.

Mr. Cassano and his colleagues minted tidy fortunes during these high-cotton years. Since 2001, compensation at the small unit ranged from $423 million to $616 million each year, according to corporate filings. That meant that on average each person in the unit made more than $1 million a year.

In fact, compensation expenses took
a large percentage of the unit's revenue. In lean years it was 33 percent; in fatter ones 46 percent. Over all, A.I.G. Financial Products paid its employees $3.56 billion during the last seven years.

The London unit's reach was also vast. While clients and counterparties remain closely guarded secrets in the derivatives trade, Mr. Cassano talked publicly about how proud he was of his customer list.

At the 2007 conference he noted that his company worked with a "global swath" of top-notch entities that included "banks and investment banks, pension funds, endowments, foundations, insurance companies, hedge funds, money managers, high-net-worth individuals, municipalities and sovereigns and supranations."

Of course, as this intricate skein expanded over the years, it meant that the participants were linked to one another by contracts that existed for the most part inside the financial world's version of a black box.

Goldman Sachs was a member of A.I.G.'s derivatives club, according to people familiar with the operation. It bought and sold tranches of A.I.G.'s credit default swaps and also acted as an intermediary for trades between A.I.G. and its other clients.

Few knew of Goldman's exposure to A.I.G. When the insurer's flameout became public, David A. Viniar, Goldman's chief financial officer, assured analysts on Sept. 16 that his firm's exposure was "immaterial," a view that the company reiterated in an interview.

Later that same day, the government announced its two-year, $85 billion loan to A.I.G., offering it a chance to sell its assets in an orderly fashion and theoretically repay taxpayers for their trouble. The plan saved the insurer's trading partners but decimated its shareholders.

Lucas van Praag, a Goldman spokesman, declined to detail how badly hurt his firm might have been had A.I.G. collapsed two weeks ago. He disputed the calculation that Goldman had $20 billion worth of risk tied to A.I.G., saying the figure failed to account for collateral and hedges that Goldman deployed to reduce its risk.

Regarding Mr. Blankfein's presence at the Fed during talks about an A.I.G. bailout, he said: "I think it would be a mistake to read into it that he was there because of our own interests. We were engaged because of the implications to the entire system."

Mr. van Praag declined to comment on what communications, if any, took place between Mr. Blankfein and the Treasury secretary, Mr. Paulson, during the bailout discussions.

A Treasury spokeswoman declined to comment about the A.I.G. rescue and Goldman's role. The government recently allowed Goldman to change its regulatory status to help bolster its finances amid the market turmoil.

An Executive's Optimism

Regardless of Goldman's exposure, by last year, A.I.G. Financial Products' portfolio of credit default swaps stood at roughly $500 billion. It was generating as much as $250 million a year in income on insurance premiums, Mr. Cassano told investors.

Because it was not an insurance company, A.I.G. Financial Products did not have to report to state insurance regulators. But for the last four years, the London-based unit's operations, whose trades were routed through Banque A.I.G., a French institution, were reviewed routinely by an American regulator, the Office of Thrift Supervision.

A handful of the agency's officials were always on the scene at an A.I.G. Financial Products branch office in Connecticut, but it is unclear whether they raised any red flags. Their reports are not made public and a spokeswoman would not provide details.

For his part, Mr. Cassano apparently was not worried that his unit had taken on more than it could handle. In an August 2007 conference call with analysts, he described the credit default swaps as almost a sure thing.

"It is hard to get this message across, but these are very much handpicked," he assured those on the phone.

Just a few months later, however, the credit crisis deepened. A.I.G. Financial Products began to choke on losses — though they were only on paper.

In the quarter that ended Sept. 30, 2007, A.I.G. recognized a $352 million unrealized loss on the credit default swap portfolio.

Because the London unit was set up as a bank and not an insurer, and because of the way its derivatives contracts were written, it had to put up collateral to its trading partners when the value of the underlying securities they had insured declined. Any obligations that the unit could not pay had to be met by its corporate parent.

So began A.I.G.'s downward spiral as it, its clients, its trading partners and other companies were swept into the drowning pool set in motion by the housing downturn.

Mortgage foreclosures set off questions about the quality of debts across the entire credit spectrum. When the value of other debts sagged, calls for collateral on the securities issued by the credit default swaps sideswiped A.I.G. Financial Products and its legendary, sprawling parent.

Yet throughout much of 2007, the unit maintained that its risk assessments were reliable and its portfolios conservative. Last fall, however, the methods that A.I.G. used to value its derivatives portfolio began to come under fire from trading partners.

In February, A.I.G.'s auditors identi-
An Insurance Giant, Brought Down

A tiny unit at American International Group ... was well compensated ... for generating a significant share of revenue ... from selling contracts that protected clients from losses on debt.

... was well compensated ... for generating a significant share of revenue ... from selling contracts that protected clients from losses on debt.

$294 billion Value of corporate debt insured by A.I.G. Financial Products against default

$141 billion European residential mortgages

$78 billion C.D.O.'s including some subprime

A.I.G.F.P. insured $513 billion of debt against default using credit-default swaps. $78 billion worth of insured debt was affected by the decline in the U.S. housing market.

But as certain debt losses mounted, A.I.G. was forced to increase its own financial cushion and write down the value of some of its own holdings ...

... ratings agencies punished the company, ultimately forcing it into a downward spiral.

Initially, A.I.G.'s high credit rating meant no collateral was required to sell the insurance. Because of the way the derivatives contracts were written, A.I.G. was forced to increase the amount of money on hand as the value of the debt declined.

When A.I.G.'s credit ratings were downgraded Sept. 15, the need for more money on hand increased beyond what it could borrow, and it asked the Federal Reserve for help.
Dan A. Bailey Jr. at his Wilmington, N.C., home. His struggle with Countrywide ended up on the Internet, an embarrassing episode for the lender.

The Silence of the Lenders

Borrowers Ask, Is Anyone Listening?

By GRETCHEN MORGENSON

DAN A. BAILEY JR. was desperate when he sat down on May 19 to send an e-mail message to his mortgage lender, the Countrywide Financial Corporation, pleading, yet again, for help.

Behind his payments and fearful of losing his home of 16 years — a 900-square-foot bungalow in Wilmington, N.C. — Mr. Bailey had spent the previous six months unsuccessfully lobbying Countrywide, at the time the nation’s largest home lender and loan servicer.

Mr. Bailey, 41, promised in his e-mail message that he would pay every nickel he owed if Countrywide would modify his mortgage in a way that allowed him to keep his home. He sent the message to a grab bag of Countrywide e-mail addresses, which he had received from www.LoanSafe.org, an online forum for borrowers.

Among the recipients of his e-mail was someone he had never heard of before: Angelo R. Mozilo, Countrywide’s co-founder and chief executive.

Lo and behold, Mr. Mozilo replied — inadvertently, as it turned out.

“This is unbelievable,” Mr. Mozilo said in his message. “Most of these letters now have the same wording. Obviously they are being counseled by some other person or by the Internet. Disgusting.”

Within days, Mr. Mozilo’s e-mail was widely circulated on the Internet and in the news media, offering a rare instance when candid comments from a powerful C.E.O. entered the public realm.

For Mr. Bailey, however, the disdain that Mr. Mozilo expressed was depressingly familiar.

After all, Mr. Bailey had received little else from Countrywide after he began trying to renegotiate an adjustable-rate loan that he could no longer afford. Until then, he says, the only guidance the lender provided was a suggestion from an employee of Countrywide’s “home retention team” that he cut back on groceries to pay his mortgage.

“I told her that I probably spend $10 a day on groceries,” Mr. Bailey recalls. “And she said ‘Maybe you can eat less.’”

As record numbers of homeowners try to avoid foreclosure, the responses of big lenders and loan servicers like Countrywide are drawing increased scrutiny. While these companies maintain that they’re doing all they can to help imperiled borrowers, critics contend that homeowners routinely meet roadblocks.

Many borrowers have trouble even reaching a workout specialist; others soon find that the mod-
Send and Reply

In May, Dan A. Bailey Jr. sent an e-mail message to his mortgage lender, Countrywide, asking for help with his loan. The company’s chief executive, intending to forward the message to colleagues with his own comments, accidentally replied to Mr. Bailey. Here are excerpts.

A homeowner sends a message to Countrywide.

“My number one goal is to keep my home that I have lived in for sixteen years, remodeled with my own sweat equity and I would really appreciate the opportunity to do that.”

– Dan A. Bailey Jr.

Within minutes, the chief executive accidentally sends a reply.

“This is unbelievable. Most of these letters now have the same wording. Obviously they are being counseled by some other person or by the Internet. Disgusting.”

– Angelo R. Mozilo, Countrywide chief executive

The homeowner then sends a complaint to a company representative.

“The only hope I had left was that perhaps the countrywide company did want to help the people it is servicing… then I receive that response to my letter. Just great. Now I know, that it is all a nice fat laughing matter to those who are supposed to help.”

– Dan A. Bailey Jr.

Both Bank of America and Countrywide are members of Hope Now. Jim Mahoney, a Bank of America spokesman, said: “The company is committed to keeping as many people in their homes as possible.”

Bank of America is “taking a very hard look at the ongoing foreclosure mitigation efforts that have been under way at Countrywide,” Mr. Mahoney said. “We have outlined a projection to work out $50 billion worth of Countrywide loans and we are really rolling up our sleeves.”

Through the first six months, Countrywide has performed 86,000 loan modifications, Bank of America said; it is completing more than two workouts for every completed foreclosure.

To be sure, not all homeowners can benefit from a restructured loan; renting is a better option for some. And almost everyone agrees that speculators, who bought houses on the gambit that they could flip them to a higher bidder, deserve no special assistance.

That said, foreclosures are vastly outnumbering loan workouts today, a year and a half after the subprime mortgage debacle began creeping into the headlines. In May, for example, even as Hope Now conducted 70,000 loan modifications, an estimated 85,000 families lost their homes to foreclosure. That same month, 276,000 loans either entered or completed foreclosure.

According to an April report by the State Foreclosure Prevention Working Group, a unit of the Conference of State Bank Supervisors, a regulatory alliance, about 70 percent of delinquent borrowers weren’t getting help in renegotiating their mortgages.

“Based on our analysis,” the working group reported, “the collective efforts of servicers and government officials to date have not translated into meaningful improvement in foreclosure prevention outcomes.”

Even when borrowers receive modifications, their loans can still be unaffordable or problematic. According to the working group, 32,800 loans that were recently modified are already delinquent again. One reason may be that very few modifications involve reducing the principal balance on the loan.

In California, an epicenter of the mortgage crisis, only 1.3 percent of loan modifications struck between January and May this year involved a reduction of principal, according to the state’s Department of Corporations. A total of 356 of 21,359 loan modifications in the month that ended May 17 involved a cut in the principal balance, it said.

With the housing bust in full swing, servicers are in something of a vise, to be sure. Their predicament is among the more thorny results of a securitization process that made so much money available for home loans.

When mortgages are pooled into a securitization trust, investors who own them rely on loan servicers to keep track of payments, loan payoffs and other administrative tasks. Servicers have a duty to investors to extract every dime they are owed from borrowers.

Because working out a loan can mean less income or outright losses for investors, servicers have been understandably reluctant to modify mortgages en masse. That could partially explain the
small number of workouts done by lend-
ers in recent months.

Even those borrowers lucky enough to receive loan modifications may still be imperiled by the new terms.

“Unless these are zero-cost, zero-add-
ed-principal loans, we really have to look closely at these workouts,” says Michael Kranzer, president of Fee Disclosure.com, a Web site intended to help consumers reduce fees on home loans. “If they are adding anything to your principal, whether it is late fees or processing fees, you may not be far ahead and you could end up behind.”

But few borrowers, desperate to keep their homes under any circumstances, are likely to question the terms of a loan modification, said Moe Bedard, president of Loan Safe Solutions, a firm that performs forensic loan audits on mort-
gages for borrowers’ lawyers. “Fees are one of my biggest issues with loan mod-
fications,” Mr. Bedard says. “Say you owe a $2,000 fee, and the bank claims that the lender is going to put on the back of the loan with a 6 percent rate. Nobody questions what the $2,000 is and lenders do not sub-
stantiate those fees.”

C

ONSIDER the loan modification Countrywide gave in May to Mr. Bailey, a photographer who is di-

vorced and has no children. Immedi-
ately after he posted Mr. Mozilo’s e-mail on LoanSafe.org, Mr. Bailey said he re-
ceived a call from Countrywide offering the assistance he had sought for so long. (Mr. Mozilo also sent him an apology via e-mail. “I hope and trust that you understand our sincere efforts to help those who are truly in need,” it said.) With the Internet lit up with chatter over Mr. Mozilo’s initial e-mail message, Countrywide pressed Mr. Bailey to sign the loan modification quick, he said. The company also told him that if he spoke with the media about the mod-
ification, it would be rescinded.

“I signed their second paper work,” Mr. Bailey says. “They were in such a rush to do it and I thought it was the only way I could save my house.”

On May 22, three days after Mr. Bailey
sent his e-mail to Mr. Mozilo, he and Countrywide agreed to the loan mod-
fication. Under its terms, Countrywide added to the original principal the missed payments and fees Mr. Bailey owed as a result of his delinquency. The new loan is interest-only for three years and carries a rate of 6 percent. After that, the interest rate rises to 7 percent and principal is added to the payments.

Mr. Bedard has analyzed Mr. Bailey’s original loan, sold to him by Argent Mortgage, as well as the Countrywide loan modification. He found problems with both, he says.

For example, Countrywide didn’t pro-
vide Mr. Bailey with an assessment of total costs of the new loan, Mr. Bedard said. He’s now asking Countrywide to reduce Mr. Bailey’s principal and in-
terest rate. But the company, he says, is declining to go that route.

Scott Silvestri, a Bank of America
spokesman, said he could not comment on specific borrowers’ cases because of privacy constraints. But in general, he said, “Countrywide seeks to provide a meaningful explanation of the terms of each workout it offers, including capital-
ization of arrearages and fees, to the ex-
tent it is possible.”

Mr. Bedard, whose firm charges a flat fee to analyze loans, said he has found problems in at least 80 percent of the 300 mortgages he has examined so far for clients. These include failings in the
notary process, and what he called vi-
olations of both the Truth in Lending Act and the Real Estate Settlement Pro-
cedures Act, or Respa. A common com-
plication, he said, occurs when the in-
terest rates or fees change between the
time a borrower initially receives a cost estimate on the mortgage and when the
borrower finally closes on the loan.

“It’s the Wild West again with these loan mods,” Mr. Bedard says. “A lot of people are getting mods that are un-
affordable.”

When presented with these find-
ings, Mr. Bedard said, most lenders and ser-
vicers quickly agree to a loan mod-
fication. Many of the deals that his firm has arranged have initial interest rates in the 3 percent range.

Using what is known as a qualified written request under Section 6 of Res-
pa, LoanSafe also asks the servicers whose loans it is examining to detail the amounts owed by a borrower as well as asking it to justify all fees.

“Magically, when we do that, we will get an offer of a modification and those fees often go away,” Mr. Bedard says.

Because servicers must answer such requests within 60 days, Mr. Bedard suggests that all borrowers make them. (A sample letter is on the Web site of the Department of Housing and Urban De-
velopment, at www.hud.gov/offices /
hsg/sfh/res/reslettr.cfm.)

Borrowers and their lawyers say that even as regulators turn up pressure on lenders to modify loans, reaching work-
out representatives remains difficult.

Carrie Mateos, 38, scammed for years to save enough money for a down pay-
ment and a cash cushion to buy a home in Miami. In June 2007, she and her hus-
band, Daniel, got two loans totaling $409,000 from Countrywide that helped them realize that dream. Both had ster-
ling credit scores at the time.

At the closing, Ms. Mateos says she discovered that the loan terms had changed from the initial estimate; the interest rate was higher on the first loan, for example. Because they were in the midst of the closing, the couple felt that they had to sign the documents. Weeks later, Ms. Mateos was laid off from her job as an office manager. By last January, she still hadn’t found work and the couple’s $80,000 rainy-day fund had dwindled to $5,000. To raise money, Ms. Mateos had three yard sales, even selling the family’s dining-room and liv-

ing-room furniture.

But Ms. Mateos said she was worried that they would soon fall behind on their mortgage. In March, she called Coun-
trywide to ask if she could skip one pay-
ment and make it up in the following months. She had found a new job but said she knew that it would take some time to rebuild the family’s finances.

Getting through to someone at the company was almost impossible, she said; calling the toll-free number it pro-
vided meant “being bounced around the
Countrywide black hole.”

“They would transfer me to their Hope department, then they would send you to customer service, then to loan re-
tention,” she added. “I would send stuff to them certified mail and get back the forms saying they had received it. But they would tell me they didn’t get it.”

W

HEN she finally got through to a person at the company, she was told that, under company rules, Countrywide couldn’t do any-
ting until the Mateoses were at least three months behind. “Then I find out you don’t have to be three months be-
hind; you just have to have a hardship,” she says. “I was showing I had a hard-
ship; I just wanted them to help me get back on track.”

Although the Mateoses were never behind on more than one payment, the fees started climbing. In May, she said, Countrywide offered to reduce the couple’s first mortgage payment to $2,242 from $2,405 for two months but that they would then owe $5,299 at the end of the third month. That meant the deal would cost the couple an extra $2,568, because of what Countrywide called “fees and adjustments.”

The couple declined.

Now Ms. Mateos is questioning Coun-
trywide about why the interest rates on
her original loan changed before the closing. “It’s frustrating,” she says. “They’re trying to get away with giving as little help as possible.”

□
Carrie Mateos, 38, scrimped for years and saved up a cash cushion to buy a home in Miami. In June 2007, she and her husband, Daniel, got two loans totaling $409,000 from Countrywide that helped them realize that dream. Both had sterling credit scores at the time.

Ms. Mateos had three yard sales, even selling the family’s dining-room and living-room furniture.

Standardized processes for mortgage modifications hadn’t been set up for such work; servicing units were originally intended to collect monthly checks from borrowers to pay off their loans. Servicers have been understandably reluctant to modify mortgages en masse. That could partially explain the small number of workouts done by lenders in recent months.

Even before the housing crisis of 2007, loan modifications were a common sight for many homeowners, and servicers were struggling to respond adequately. Now, as a result of the mortgage crisis, servicers are impeded by loan servicers’ inaction or incompetence. Some homeowners, eager to sell their homes before the value falls further, say they are impeded by loan servicers’ inaction or incompetence.

Moe Bedard is president of Loan Safe Solutions. He said his firm found problems in at least 80 percent of 300 mortgages it examined for clients.

When mortgages are pooled into a trust, they rely on loan servicers to keep track of payments, loan payoffs and other administrative tasks. Servicers have been reluctant to modify mortgages en masse, less income or outright losses for investors, and servicers have been understandably reluctant to modify mortgages en masse. That could partially explain the small number of workouts done by lenders in recent months.

Within minutes, this week’s podcast discussed a mortgage crisis, only 1.3 percent of loan modifications struck between January and May this year involved a reduction of principal balance. A total of 356 of 21,359 loan modifications in the month that ended May 17 involved a cut in the principal balance, it said.

The real outrage is that none of this had to happen,” said William A. Fleck, a spokesman, said it could not comment on specific borrowers’ cases because of confidentiality rules, Countrywide couldn’t do anything until the Mateoses were at least three months past due on their mortgage and had no more than $4,000 in reserves. Initially, Countrywide offered to help with the Mateoses’ first mortgage, butʻs pay is based on profit growth. The only hope I had left was that perhaps the Countrywide company did want to help the people it is servicing. That was to be expected of left field. Fears that Fannie and Freddie were getting too big have been a recurring theme in recent years. And Congress has had ample opportunity to create a new regulator that would be vigilant in overseeing mortgage market.

Although the Mateoses were never divorced and have no children, immediately after he posted Mr. Mozilo’s e-mail on LoanSafe.org, Mr. Bailey said he received a call from Countrywide offering to do nothing until the Mateoses were at least three months past due on their mortgage and had no more than $4,000 in reserves. Initially, Countrywide offered to help with the Mateoses’ first mortgage, butʻs pay is based on profit growth. The only hope I had left was that perhaps the Countrywide company did want to help the people it is servicing. That was to be expected of left field. Fears that Fannie and Freddie were getting too big have been a recurring theme in recent years. And Congress has had ample opportunity to create a new regulator that would be vigilant in overseeing mortgage market.

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How the Thundering Herd Faltered and Fell

Merrill Lynch Couldn’t Escape the Housing Crash

“We’ve got the right people in place as well as good risk management and controls.”
— E. Stanley O’Neal, 2005

By GRETCHEN MORGENSON

THERE were high-fives all around Merrill Lynch headquarters in Lower Manhattan as 2006 drew to a close. The firm’s performance was breathtaking; revenue and earnings had soared, and its shares were up 40 percent for the year.

And Merrill’s decision to invest heavily in the mortgage industry was paying off handsomely. So handsomely, in fact, that on Dec. 30 that year, it essentially doubled down by paying $1.3 billion for First Franklin, a lender specializing in risky mortgages.

The deal would provide Merrill with even more loans for one of its lucrative assembly lines, an operation that bundled and repackaged mortgages so they could be resold to other investors.

It was a moment to savor for E. Stanley O’Neal, Merrill’s autocratic leader, and a group of trusted lieutenants who had helped orchestrate the firm’s profitable but belated mortgage push. Two indispensable members of Mr. O’Neal’s clique were Osman Semerci, who, among other things, ran Merrill’s bond unit, and Ahmass L. Fakahany, the firm’s vice chairman and chief administrative officer.

A native of Turkey who began his career trading stocks in Istanbul, Mr. Semerci, 41, oversaw Merrill’s mortgage operation. He often played the role of tough guy, former executives say, silencing critics who warned about the risks the firm was taking.

At the same time, Mr. Fakahany, 50, an Egyptian-born former Exxon executive who oversaw risk management at Merrill, kept the machinery humming along by loosening internal controls, according to the former executives.

Mr. Semerci’s and Mr. Fakahany’s actions ultimately left their firm vulnerable to the increasingly risky business of manufacturing and selling mortgage securities, say former executives, who requested anonymity to avoid alienating colleagues at Merrill.

To make matters worse, Merrill sped up its hunt for mortgage riches by embracing and trafficking in complex and lightly regulated contracts tied to mortgages and other debt. And Merrill’s often inscrutable financial dance was emblematic of the outsize hazards that Wall Street courted.

While questionable mortgages made to risky borrowers

Continued on Page 9
prompted the credit crisis, regulators and investors who continue to pick through the wreckage are finding that exotic products known as derivatives — like the one that Merrill used — transformed a financial brush fire into a conflagration.

As subprime lenders began toppling after record waves of homeowners defaulted on their mortgages, Merrill was left with $7 billion of eroding mortgage exotica on its books and billions in losses.

On Sept. 15 this year — less than two years after posting a record-breaking performance for 2006 and following a weekend that saw the collapse of a storied investment bank, Lehman Brothers, and a huge federal bailout of the insurance giant American International Group — Merrill was forced into a merger with Bank of America.

It was an ignominous end to America’s most famous brokerage house, whose ubiquitous corporate logo was a hard-charging bull.

“The mortgage business at Merrill Lynch was an afterthought — they didn’t really have a strategy,” said William Dallas, the founder of Owmit Mortgage Solutions, a lending business in which Merrill bought a stake a few years ago. “They had found this huge profit potential, and everybody wanted a piece of it. But they were pigs about it.”

Mr. Semerci and Mr. Fakahany did not return phone calls seeking comment. Bill Halldin, a Merrill Lynch spokesman, said, “We see no useful purpose in responding to unnamed, former Merrill Lynch employees about a risk management process that has not existed for a year.”

Typical of those who dealt in Wall Street’s dizzying and opaque financial arrangements, Merrill ended up getting burned, former executives say, by inadequately assessing the risks it took with newfangled financial products — an error compounded when it held on to the products far too long.

The fire that Merrill was playing with was an arcane instrument known as a synthetic collateralized debt obligation. The product was an amalgam of collateralized debt obligations (the pools of loans that it bundled for investors) and credit-default swaps (which essentially are insurance that bondholders buy to protect themselves against possible defaults).

Synthetic C.D.O.’s, in other words, are exemplars of a type of modern financial engineering known as derivatives. Essentially, derivatives are financial instruments that can be used to limit risk; their value is “derived” from underlying assets like mortgagess, stocks, bonds or commodities. Stock futures, for example, are a common and relatively simple derivative.

Among the more complex derivatives, however, are the mortgage-related variety. They involve a cornucopia of exotic, jumbo-size contracts ultimately linked to real-world loans and debts. So as the housing market went sour, and borrowers defaulted on their mortgages, these contracts collapsed, too, amplifying the meltdown.

The synthetic C.D.O. grew out of a structure that an elite team of J. P. Morgan bankers invented in 1997. Their goal was to reduce the risk that Morgan would lose money when it made loans to top-tier corporate borrowers like I.B.M., General Electric and Procter & Gamble.

Regular C.D.O.’s contain hundreds or thousands of actual loans or bonds. Synthetics, on the other hand, replace those physical bonds with a computer-generated group of credit-default swaps. Synthetics could be slappied together faster, and they generated fatter fees than regular C.D.O.’s, making them especially attractive to Wall Street.

Michael A. J. Farrell is chief executive of Annaly Capital Management, a real estate investment trust that manages mortgage assets. A unit of his company has liquidated billions of dollars in collateralized debt obligations for clients, and he believes that derivatives have magnified the pain of the financial collapse.

“We have auctioned billions in credit-default swap positions in our C.D.O. liquidation business,” Mr. Farrell said. “What we have learned is that the carnage we are witnessing now would have been much more contained, to use that overworked word, without credit-default swaps.”

The bankers who invented the synthetics for J. P. Morgan say they kept only the highest-quality and most bulletproof portions of their product in-house, known as the super senior slice. They quickly sold anything riskier to firms that were willing to take on the dangers of ownership in exchange for fatter fees.

“In 1997 and 1998, when we invented super senior risk, we spent a lot of time examining how much is too much to have on our books,” said Blythe Masters, who was on the small team that invented the synthetic C.D.O. and is now head of asset management at J.P. Morgan Chase. “We would warehouse risk for a period of time, but we were always focused on developing a market for whatever we did. The idea was we were financial intermediaries. We weren’t in the investment business.”

For years, the product that Ms. Masters and her colleagues invented remained just a mechanism for offloading risk in high-grade corporate lending. But as often occurs with Wall Street alchemy, a good idea started to be misused — and a product initially devised to insulate against risk soon morphed into a device that actually concentrated dangers.

This shift began in 2002, when low interest rates pushed investors to seek higher returns.

“Investors said, ‘I don’t want to be in equities anymore and I’m not getting any returns in my bond positions’,” said William T. Winters, co-chief executive of JPMorgan’s investment bank and a colleague of Ms. Masters on the team that invented the first synthetic. “Two things happened. They took more and more leverage, and they reached for riskier asset classes. Give me yield, give me leverage, give me return.”

A few years ago, of course, some of the biggest returns were being harvested in the riskier reaches of the mortgage market. As C.D.O.’s and other forms of bundled mortgages were pooled nationwide, banks, investors and rating agencies all claimed that the risk of owning such packages was softened because of the broad diversity of loans in each pool.

In other words, a few lemons couldn’t drag down the value of the whole package.

But the risk was beneath the surface. By 2005, with the home lending mania in full swing, the amount of C.D.O.’s holding opaque and risky mortgage assets far exceeded C.D.O.’s composed of blue-chip corporate loans. And inside even more abstract synthetic C.D.O.’s, the risk was harder to parse and much easier to overlook.

Janet Tavakoli, president of Tavakoli Structured Finance, a consulting firm in Chicago, describes synthetic C.D.O.’s as a fanciful structure “sort of like a unicorn born out of the imagination.”

More important, she said, is that the products allowed dicier assets to be passed off as higher-quality goods, giving banks and investors who traded them a false sense of security.

“A lot of deals were doomed from the start,” Ms. Tavakoli said.

By 2005, Merrill was in a full-on race to become the biggest mortgage player on Wall Street. A latecomer to the arena, it especially envied Lehman Brothers for the lush mortgage profits that it was already hauling in, former Merrill executives say.

Lehman had also built a mortgage assembly line that Merrill wanted to emulate. Lehman made money every step of the way: by originating mortgage loans, administering the paperwork surrounding them, and packaging them into C.D.O.’s that could be sold to investors.

Eager to build its own money machine, Merrill went on a buying spree. From January 2005 to January 2007, it made 12 major purchases of residential or commercial mortgage-related companies or assets. It bought commercial
properties in South Korea, Germany and Britain, a loan servicing operation in Italy and a mortgage lender in Britain. The biggest acquisition was First Franklin, a domestic subprime lender.

The firm's goal, according to people who met with Merrill executives about possible deals, was to generate in-house mortgage business that could package into C.D.O.'s. This allowed Merrill to avoid relying entirely on other companies for mortgages.

That approach seemed to be common sense, but it was never clear how well Merrill's management understood the risks in the mortgage business.

Mr. O'Neal declined to comment for this article. But John Kanas, the founder and former chief executive of North Fork Bancorp, recalls the many hours he spent talking with Mr. O'Neal, Mr. Fakahany and other Merrill executives about a possible merger in 2005.

"We spent a great deal of time with Stan and the entire management team at Merrill trying to learn their business and trying to explain our business to them," Mr. Kanas said. "Unfortunately, in the end we were put off by the fact that we couldn't get comfortable with their risk profile and we couldn't get past the fact that we thought there was a distinct possibility that they didn't understand fully their own risk profile."

Mr. Kanas, who later sold his bank to the rival Financial Corporation of America, had many meetings with Mr. Fakahany, who was responsible for the firm's credit and market risk management as well as its corporate governance and internal controls. Former executives say Mr. Fakahany had weakened Merrill's risk management unit by removing longstanding employees who "walked the floor," dealing with traders and other workers to figure out what kinds of risks the firm was taking on.

Former Merrill executives say that the people chosen to replace those employees were loyal to Mr. O'Neal and his top lieutenants. That made them more concerned about achieving their superiors' profit goals, they say, than about monitoring the firm's risks.

A pivotal figure in the mortgage push was Mr. Semerici, a detail-oriented manager, whom some former employees described as intimidating. He joined Merrill in 1992 as a financial consultant in Geneva.

After that, he became a fixed-income sales representative for the firm's London unit. He later rose quickly through Merrill's ranks, ultimately overseeing a broad division: fixed income, currencies and commodities.

Always carrying a notebook with his operations' daily profit-and-loss statements, Mr. Semerici would chastise traders and other moneymakers who told risk management officials exactly what they were doing, a former senior Merrill executive said.

"There was no dissent," said the former executive, who requested anonymity to maintain relationships on Wall Street. "So information never really traveled."

Beyond assembling its own mortgage machine and failing to police risks so it could book fatter profits, Merrill also dove into the C.D.O. market — primarily synthesizing mortgage-backed securities.

Unlike the C.D.O. pioneers at J.P. Morgan who saw themselves as financial designers and intermediaries wary of the dangers of holding on to their products too long, Merrill seemed unafraid to stockpile C.D.O.'s to reap more fees.

Although Merrill had a scant presence in the C.D.O. market in 2002, four years later it was the world's biggest underwriter of collateralized debt obligations for clients.

The risk in Merrill's business model became viral after A.I.G. stopped insuring the highest-quality portions of the firm's C.D.O.'s against default.

For years, Merrill had paid A.I.G. to insure its C.D.O. stakes to limit potential damage from defaults. But at the end of 2005, A.I.G. suddenly said it had enough, citing concerns about overly aggressive home lending. Merrill couldn't find an adequate replacement to insure itself. Rather than slow down, however, Merrill's C.D.O. factory continued to hum and the firm's unhedged mortgage bets grew, its filings show.

The number of mortgage-related C.D.O.'s being produced across Wall Street was staggering, and all of that activity represented a gamble that mortgages underwritten during the most jilted leg of 2006 would pay off.

In 2005, firms issued $178 billion in mortgage and other asset-backed C.D.O.'s, compared with just $4 billion worth of C.D.O.'s that used safer, high-grade corporate bonds as collateral. In 2006, issuance of mortgage and asset-backed C.D.O.'s totaled $316 billion, versus $40 billion backed by corporate bonds.

Firms underwriting the C.D.O.'s generated fees of 0.4 percent to 2.5 percent of the amount sold. So the fees generated on the $316 billion worth of mortgage- and asset-backed C.D.O.'s issued in 2006 alone, for example, would have been about $1.3 billion to $8 billion.

Merrill, the biggest player in the C.D.O. game, appeared to be a cash register. After its banner year in 2006, it produced another earnings record in the first quarter of 2007. It had easily beaten three rivals, Lehman, Goldman Sachs and Bear Stearns, in profit growth.

But as 2007 progressed, the mortgage business began to fall apart — and the impact was brutal. As mortgages started to fail, the debt ratings on C.D.O.'s were cut; anyone left holding the products was locked in a downward spiral because no one wanted to buy something that was collapsing. Among the biggest victims was Merrill.

In October 2007, the firm shocked investors when it announced a $7.9 billion write-down related to its exposure to mortgage C.D.O.'s, resulting in a $2.3 billion loss, the largest in the firm's history. Mr. Semerici was forced out, later landing at a London-based hedge fund, the Duet Group.

Merrill's board also ousted Mr. O'Neal. On top of the $70 million in compensation he was awarded during his four-year tenure as chief executive, Mr. O'Neal departed with an exit package worth $161 million.

JOHN A. THAIN, a former Goldman Sachs executive who was also head of the New York Stock Exchange, was hired as Merrill's chief executive to try to clean up Mr. O'Neal's mess. But multibillion-dollar losses kept piling up, and Merrill was hard pressed to raise enough to replenish its coffers.

"None of the trading businesses should be taking risks, either single positions or single trades, that wipe out the entire year's earnings of their own business," Mr. Thain said in January. "And they certainly shouldn't take a risk to wipe out the earnings of the entire firm."

A month later, Mr. Fakahany left Merrill. Upon his departure, in a statement that Merrill issued, he said: "I leave knowing that the firm's financial condition is significantly enhanced and the new team is in place and moving forward."

Mr. Fakahany continued to receive a Merrill salary until the end of this summer; he does not appear to have received an exit package.

Mr. Thain, meanwhile, sold off assets for whatever price he could get to try to salvage the firm. In August, he arranged a sale of $31 billion of Merrill's C.D.O.'s to an investment firm for 22 cents on the dollar. For the first nine months of this year, Merrill recorded net losses of $14.7 billion on its C.D.O.'s. Through October, some $280 billion of asset-backed C.D.O.'s have started to default.

As the depth of Merrill's problems emerged, its shares plummeted. With Lehman on the verge of collapse, Wall Street began to wonder if Merrill would be next.

Some banks were so concerned that they considered stopping trading with Merrill if Lehman went under, according to participants in the Federal Reserve's weekend meetings on Sept. 13 and 14.

The following Monday, Merrill — torn apart by its C.D.O. venture — was taken over by Bank of America.
Ahmass Fakahany, left, and Osman Semerci, center, worked under E. Stanley O’Neal to expand Merrill’s investments related to mortgages. Such investments led to a $7.9 billion write-down a year ago, and Mr. O’Neal was forced out.
In 1997, J. P. Morgan bankers like Blythe Masters, left, and William Winters served on a small team that pioneered synthetic C.D.O.'s.

Michael A. J. Farrell, head of a real estate investment trust that manages mortgage assets, says derivatives have made the financial collapse worse.

Merrill bought into William Dallas's company to further capitalize on the mortgage market. "They had found this huge profit potential," he said.