# SUBPRIME SECURITIES MARKET BEGAN AS 'GROUP OF 5' OVER CHINESE

**By Mark Pittman**

Dec. 17 (Bloomberg) -- Representatives of five of Wall Street's dominant investment banks gathered around a blonde wood conference table on a February night almost three years ago. Their talks over take-out Chinese food led to the perfect formula for a U.S. housing collapse.

The host was Greg Lippmann, then 36, a fast-talking Deutsche Bank AG trader who aspired to make mortgage securities as big a cash cow for Wall Street as the $12 trillion corporate credit market.

His allies included 34-year-old Rajiv Kamilla, a trader at Goldman Sachs Group Inc. with a background in nuclear physics, and 32-year-old Todd Kushman, who led a contingent from Bear Stearns Cos. Representatives from Citigroup Inc. and JPMorgan Chase & Co. were also invited. Almost 50 traders and lawyers showed up for the first meeting at Deutsche Bank's Wall Street office to help set the trading rules and design the new product.

"To tell you the truth, it's not very glamorous," Lippmann says. "Just a bunch of guys eating Chinese discussing legal arcana."

Those meetings of the "group of five," as the traders called themselves, became a turning point in the history of Wall Street and the global economy.

The new standardized contracts they created would allow firms to protect themselves from the risks of subprime mortgages, enable speculators to bet against the U.S. housing market, and help meet demand from institutional investors for the high yields of loans to homeowners with poor credit.

### Boom Turns Bust

The tools also magnified losses so much that a small number of defaulting subprime borrowers could devastate securities held by banks and pension funds globally, freeze corporate lending, and bring the world's credit markets to a standstill.

For a while, the subprime boom enriched investment bankers, lenders, brokers, investors, realtors and credit-rating companies. It allowed hundreds of thousands of Americans to buy homes they never believed they could afford.

It later became clear that these homeowners couldn't keep up with their payments. Defaults on subprime mortgages have so far produced about $80 billion in losses on securities backed by them. The market for the instruments is so opaque that many firms still aren't sure how much they've lost.

Chief executives at Citigroup, Merrill Lynch & Co. and UBS AG were replaced. To forestall a housing-led recession, the Federal Reserve has cut its benchmark rate three times since August and is injecting as much as $40 billion into the credit system to encourage banks to lend to each other.

*Gregg Lippman, head of Deutsche Bank AG's mortgage traders, and his team were among the Wall Street wizards who engineered the mortgage derivatives.*

### 'You Can't Wait'

This is the story of how Wall Street transmitted the practices of southern California's go-go lending industry and the inflated U.S. real estate market to the global financial system:

-- In Orange County, California, a mortgage lender named Daniel Sadek was among those who took notice of the increase in Wall Street's appetite for subprime loans. He turned the staff at his firm, Quick Loan Funding, into a subprime mortgage factory. "You can't wait," said his ads, aimed at high-risk borrowers. "We won't let you."

-- In Dallas, a hedge-fund manager named Kyle Bass taught himself to use the contracts pioneered by Lippmann's group, then went looking for mortgage-backed securities to bet against. He found them in instruments based on loans Sadek made.

-- In New York, the ratings companies Standard & Poor's, Moody's Investors Service and Fitch Ratings put their stamp of approval on securities backed by loans to people who couldn't afford them. They used historical data to grade the securities and didn't adjust quickly enough for the widespread weakening of criteria used to qualify high-risk borrowers. Among the securities on which they bestowed investment-grade ratings: those backed by Sadek's loans.

*J. Kyle Bass smiles in the office of his company, Hayman Capital Partners, in Dallas, Texas, on Friday, Dec. 14, 2007. Photographer: Mike Fuentes*

### 'Robert Parker of Raw Fish'

Lippmann was a Wall Street renaissance man, with a strong appetite for sushi and an online restaurant guide so comprehensive one blogger labeled him "the Robert Parker of raw fish." He opened the kitchen of the $2.3-million Manhattan loft he lived in then, complete with six burners, two grills and 20- foot island, to an Italian cooking class.

The goal of Lippmann's group on that winter evening in 2005: to design a new financial product that would standardize mortgage-backed securities, including those based on high-yield subprime loans, paving the way for their rapid growth. Of the firms participating that night, Lippmann's Deutsche Bank is based in Frankfurt, UBS in Zurich and the others in New York.

In February 2005, pension funds, banks and hedge funds owned fixed-income securities that were earning returns close to historic lows. AAA-rated securities based on home loans offered yields averaging a full percentage point higher than 10-year Treasuries at the time, according to Merrill.

### Lure of Subprime

The trouble was that most creditworthy borrowers had already refinanced their houses at 2003's record-low mortgage rates. To meet demand for mortgage-backed securities, Wall Street had to find a new source of loans. Those still available mainly involved subprime borrowers, who paid higher rates because they were seen as credit risks.

While the group of five banks had packaged billions of dollars in subprime-based securities, in February 2005 none was among the leaders in the home-equity bond business. Countrywide Securities, RBS Greenwich Capital Markets, Lehman Brothers Holdings Inc., Credit Suisse Group and Morgan Stanley dominated the industry.

The banks wanted more mortgage-backed securities to sell to clients. Creating a standardized "synthetic" instrument, or derivative, would leverage small numbers of subprime mortgages into bigger securities. In this way, the firms could produce enough to meet global demand.

### Building the Rocket

"We called up the guys we felt like we knew and could work with," Lippmann says.

Deutsche Bank sprang for the take-out food, and traders and lawyers sat down to design a new product and create what would soon become one of the hottest capital markets in the world.

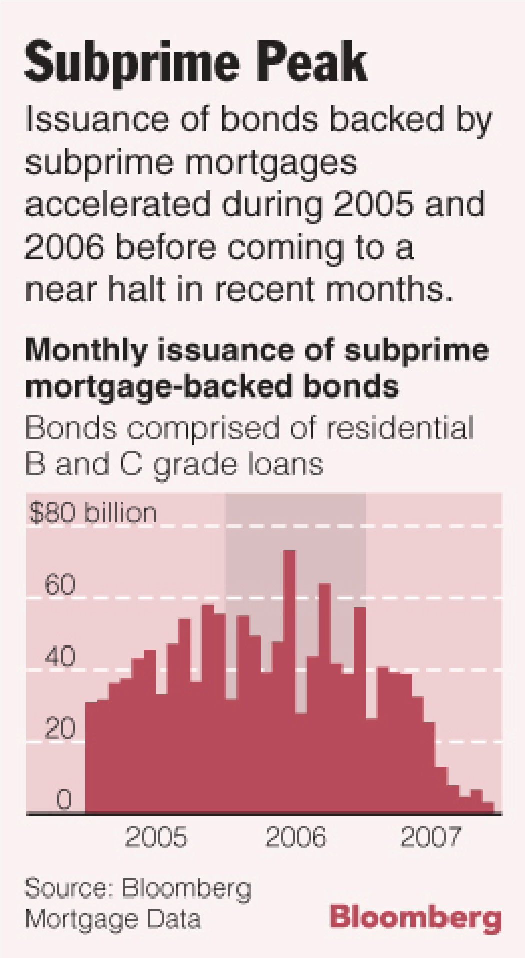
The meetings were monthly, beginning at 5 p.m., after the trading day, and lasted more than three hours each.

"In the beginning, everybody brought their lawyer," says Lippmann.

Eventually, the Chinese food was replaced with deli fare because some participants complained it wasn't kosher.

The group sought to bring "transparency," or openness, and "liquidity," or trading volume sufficient to ensure ease of buying and selling, to the mortgage market.

The most important issues centered on how to account for the eccentricities of mortgage bonds, perhaps the most difficult-to-value securities on Wall Street. Unlike corporate bonds, home loans can be paid back at any time.




### 'Pay as You Go'

Traditionally, the best mortgage traders have been those who can read macro-economic trends to guess when homeowners will pre-pay their loans. Until recently, early repayment was perceived as the biggest risk faced by Wall Street's mortgage desks.

One concern with creating a standardized contract for mortgage-backed securities was that it was difficult to agree on a simple method of determining how market-changing events affected the values of the complicated, layered instruments.

To deal with the complexity, the group of five decided to install a "pay-as-you-go" system. When something happened affecting the cash flows underlying the security, the seller would have to make cash payments to the buyer immediately, and vice versa.

### ISDA Steps In

As the group nailed down the details, the International Swaps and Derivatives Association, which sets trading terms for dealers, arranged conference calls including more of Wall Street.

To this point, some of the biggest mortgage underwriters -- Lehman Brothers, Merrill, Bank of America Corp. and Morgan Stanley -- hadn't been included in the negotiations. These firms heard about the talks and demanded to be let in.

On the conference calls, which included the market leaders, things got testy. One point in dispute was whether the contract should be traded on the basis of price or yield.

"Some of those points of detail were getting a little heated on the calls, and it was just thought it would be better to have a meeting face to face to move beyond those points," says Edward Murray, a London-based partner of the international law firm of Allen & Overy who was the chairman of the meeting and the outside counsel for ISDA. "To be frank, the dealers that were not in the group of five were not that happy that there was a group of five."

ISDA sought to resolve the differences by calling a sit- down meeting at its New York headquarters. Over coffee and pastries, Murray faced a crowd of dozens of traders and lawyers. Kamilla and Kushman acted as discussion leaders.

### 'Talk Was Very Firm'

"Rajiv would say something, and I'd be absolutely convinced about what he said," Murray says. "And then Todd would say, 'Well, I don't agree.' And I would be absolutely convinced about what Todd said. And then Rajiv would say 'Well, the reason you're wrong is' and so on, et cetera." Kamilla and Kushman declined to discuss the negotiations.

Michael Edman, one of Morgan Stanley's representatives at the ISDA conference, was less chipper, Murray says.

"Arms folded, frown on his face, I'm not sure that's exactly true, but he wasn't in a happy-go-lucky mood," Murray says. "There wasn't any shouting or anything, but the talk was very firm." Edman, who no longer works for Morgan Stanley, declined to comment.

By June, the differences were sorted out, the new contract was endorsed, and banks that hadn't been party to the group of five negotiations signed on. The banks would go on to create similar derivative contracts to trade securities backed by loans for commercial buildings and collateralized debt obligations, or CDOs, which are securities backed by various kinds of debt.

### Creation of Index

Another necessary step was to create an index to represent the market and help hedge general market exposure. It was called the ABX-HE and would be similar to the indexes traders use for baskets of stocks. This, participants believed, would add to the market's liquidity, or depth, by attracting more trading.

By September 2005, some within Deutsche Bank were beginning to worry about defaults on subprime mortgages and how that might affect the securities based on them. A team of Deutsche Bank analysts that month warned of growing subprime market risks.

The ABX-HE index started trading on Jan. 19, 2006. At 8 a.m. on the first day, John Kane of Sorin Capital started phoning dealers. Kane, then 27, was a trader at Sorin, which runs hedge funds that invest in mortgages and other securities.

His auto mechanic, in describing the debt burden he was carrying to own a home, had planted the idea in Kane's mind that the housing market might be in trouble. Kane thought it through, ran an analysis on available data, and decided to wager against, or "short," subprime. To do that, he turned to the portion of the ABX index dealing with the lowest investment-grade subprime securities.

### Investors Go Short

The trouble was that quotes from brokers selling the ABX were already dropping, an indication that a number of investors wanted to do the same thing.

"All the other dealers were already scared" and dropping their bids, Kane said while on a panel at a November industry conference. "All but Goldman. So I bought from them."

On its first day, the index traded more than $5 billion. The cost of wagering against the securities was rising, a sign that traders saw an increased chance of default. An early warning was visible to anyone who knew where to look.

The new derivatives were a hit among the group of five's customers -- the banks and other institutional investors that bought them to lock in high yields.

In the months to come, Deutsche Bank and at least one other member of the group of five, Goldman Sachs, began using subprime derivative contracts to bet the other way and guard against the possibility that subprime mortgages might default.

### Lippmann Explains

For Lippmann's part, he says, it wasn't that he had "any secret knowledge" of the damaging events that were about to unfold in the U.S housing market. Rather, he says, he thought the risks of a downturn were significant enough to justify the millions of dollars it would cost to "short," or wager against, subprime securities.

He says he told his bosses: "If we're right, we're looking at a sixfold gain. And since a housing market slowdown is not as big a long shot as that, we should take the risk."

Lippman disputes that the derivatives the group of five helped create -- which banks packaged into CDOs -- caused the subprime crisis.

"The problems in subprime are what they are and derivatives did not cause them," Lippmann says. "Derivatives enabled more CDOs to be created and the stakes to be bigger. But the transparency made people realize the problem faster."

Others see things differently. Derivatives, or "synthetics," are "like wearing a seatbelt that allows you to drive faster," says Rod Dubitsky, director of asset-backed research for Credit Suisse. "The total dollar amount of losses, all these losses you're seeing, are from synthetics. No question, it changed the game dramatically."

With reporting by Bob Ivry and Jody Shenn in New York and Kathleen M. Howley in Boston.

Editors: Jeffrey Taylor, Rob Urban

# 'DEAL WITH DEVIL' FUNDED CARRERA CRASH BEFORE BUST

**By Bob Ivry**

Dec. 18 (Bloomberg) -- One week in 2002, Daniel Sadek was $6,000 short of covering the payroll for his new subprime mortgage company, Quick Loan Funding Corp. So he flew to Las Vegas and put a $5,000 chip on the blackjack table.

"I could have borrowed the money, I suppose," Sadek says.

That wouldn't have been his style. With his shoulder-length hair and beard, torn jeans and T-shirts with slogans such as "Where is God?" Sadek looked more like a guitarist for Guns N' Roses than a mortgage banker.

Sadek says he was dealt a jack, then an ace. Blackjack. He would make payroll. Quick Loan Funding, based in Costa Mesa, California, would survive and, for a while, prosper as one of 1,300 mortgage lenders in the state vying to satisfy Wall Street's thirst for subprime debt.

As home prices rose and hunger for high-yield investments grew, Sadek found his niche pushing mortgages to borrowers with poor credit. Such subprime home loans grew to $600 billion, or 21 percent, of all U.S. mortgages last year from $160 billion, or 7 percent, in 2001, according to Inside Mortgage Finance, an industry newsletter. Banks drove that growth because they could bundle subprime loans into securities, parts of which paid interest as much as 3 percentage points higher than 10-year Treasury notes.

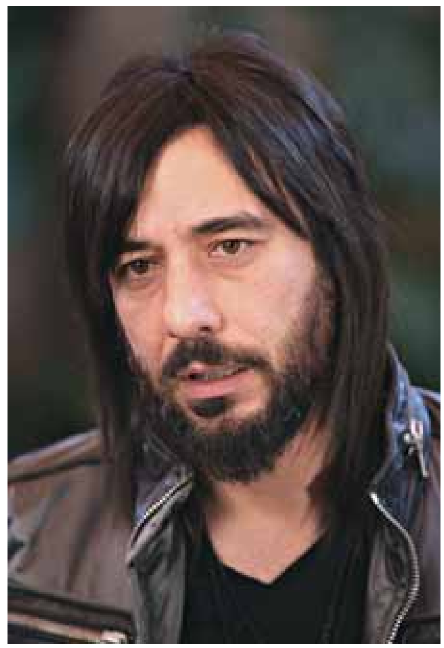
"I never made a loan that Wall Street wouldn't buy," Sadek says. He worked hard to build the business, he says, and the company did nothing illegal.

### U.S. Pays the Bill

In 2005 and 2006, New York bankers expanded the market for mortgage-backed securities by creating new subprime derivatives contracts. The contracts, based on the value of the underlying home loans, allowed Wall Street firms to sell more subprime securities and offered a new way to hedge against defaults or bet that the U.S. housing market would decline. Investors from Germany to Japan poured about $1.2 trillion into mortgage-backed securities in those two years, according to Global Insight Inc., an investment research firm in Waltham, Massachusetts.

Now the U.S. economy is paying the bill for that easy credit. Nearly one in six subprime borrowers has missed a monthly payment, sending home prices to their first annual decline since the Great Depression. The Federal Reserve cut its main interest rate three times to fend off recession, and Wall Street firms that posted record profits the last three years have written down more than a combined $80 billion on subprime-related losses.

Sadek, now 39, got into the lending business in 2002, just as home prices were in the early stages of a record five-year surge. Staked by banks including Citigroup Inc., Sadek and others in his industry tripled the subprime market in five years.



*Daniel Sadek, owner of Quick Loan Funding, speaks during an interview in Newport Beach, California, U.S., on Tuesday, Dec. 18, 2007. Photographer: Tim Rue*

### Lamborghini, McLaren, Soap Star

"I was working every day, all day, from dusk to dusk," says Sadek, who pumped gas and sold cars before creating Quick Loan Funding. "I slept in my office sometimes. I worked about 80 or 90 hours a week."

Sadek collected a fleet of cars that included a Lamborghini, a McLaren, a Ferrari Enzo, a Saleen S7 and a Porsche, frequented casinos and was engaged to soap opera actress Nadia Bjorlin.

"Daniel was charismatic, crazy, unconventional and passionate about his company and his borrowers," says Lisa Iannini, a former employee.

Sadek would try to help Bjorlin break out of TV's "Days Of Our Lives," co-writing and spending $35 million to produce "Redline," a feature film about illicit car racing, starring Bjorlin as a daring leadfoot.

The movie's climactic line, delivered by actor Angus Macfadyen: "Do you believe in destiny?"

Sadek did.

*Financier Daniel Sadek carries actress Nadia Bjorlin on the red carpet at the premier of the movie "Redline," in Los Angeles, California.*
*Photographer: Alexandria Wyman*

### Wiping the Slate Clean

When homeowner Christopher Aultman, a mechanic for Union Pacific Railroad, called Quick Loan Funding in July 2005, a man identifying himself as Tim answered.

"He was friendly and he sounded like he knew what he was talking about," Aultman says.

Aultman wanted to refinance the 30-year fixed-rate mortgage on his four-bedroom home in Victorville, California, 80 miles northeast of Los Angeles. He needed to tap $20,000 in equity to pay off mounting debts, and he wanted to build a backyard play area for his three children.

His average credit score was 465 out of a possible 850, according to Aultman's loan documents. That is well below the U.S. median of 720, according to Fair Isaac Corp., whose software measures consumer creditworthiness.

Quick Loan Funding was the only lender that would talk to him, Aultman says.

"We'd been struggling and running away from bills, and I was tired of living that way," says Aultman, now 35. "I wanted to be responsible and take care of my debts and wipe the slate clean."

### Passed Officer to Officer

A year earlier, Aultman had paid $204,000 for the house. Quick Loan Funding's appraiser said it was worth $360,000. When Aultman called back later with questions, he says he was told Tim no longer worked there.

"I was passed from loan officer to loan officer," Aultman says. "It just didn't feel right. But I was praying it was going to come through. I was desperate."

Loan officers were hired and fired all the time at Quick Loan Funding's 26,000-square-foot call center in Irvine, says Bryan Buksoontorn, who joined the company in 2004. By then, Irvine had become a hotbed of subprime lending companies.

"We were motivated by fear," says Buksoontorn, 28, who is now an independent mortgage broker. "It was a boiler room. You had to make your numbers."

Buksoontorn's job: get the caller's credit card and charge $475 for an appraisal, he says.

"You told the callers what they wanted to hear and you got the credit card," says Steven Espinoza, 39, an employee from 2003 to 2005.

### 'Close 'Em, Close 'Em'

Sadek and his managers would berate the sales staff, many of whom had no experience or training, Buksoontorn says.

"They would get in your face," he says. '"Why aren't you ordering appraisals? Why aren't you selling?"'

Sadek brought a car salesman's mentality to mortgages, Espinoza says.

"It's the same type of hard sell," Espinoza says. "Close 'em, close 'em, close 'em."

Iannini, who was vice president for compliance and risk management, says she tried to make sure the hard sell didn't result in bad loans.

"I went to work every day as an uninvited hall monitor at a fraternity party," Iannini says.

Sadek says 95 percent of Quick Loan Funding's mortgages were made to subprime borrowers.

"If we had a prime borrower on the line, we hung up on them," Buksoontorn says. "We were geared toward subprime because they were easier to close. We were giving them money no other bank would dare to give them."

**Citigroup's Backing**

Sadek says that with the support of Citigroup, which funded the loans, he pioneered lending to homebuyers with credit scores of less than 450.

Citigroup spokesman Stephen Cohen said the bank doesn't comment on its relationships with clients.

"We made most of our money from selling loans to banks," Sadek says.

Quick Loan Funding, like many subprime companies, specialized in 2/28 loans -- 30-year mortgages that start with lower "teaser" interest rates and ratchet higher after two years.

A key selling point was the 50 percent rise in home prices nationally from 2001 to 2006, according to the National Association of Realtors. Mortgage salespeople told homeowners that as long as values continued to increase, they could refinance or sell before their interest rates jumped.

**'They Believed'**

It wasn't a lie. Year over year, prices hadn't fallen since the 1930s, according to the Realtors group. The belief that values would form a stairway even seduced Quick Loan Funding employees who took out 2/28 loans themselves, says Marcus Bednar, 32, a former sales manager.

"They believed everything the borrowers believed, that the market was going to go up," Bednar says. "It wasn't just something we were pushing because we tried to rip people off."

Bednar adds, "We were never encouraged to do anything shady."

Borrowers with subprime adjustable-rate mortgages are seven times more likely to default than those with prime fixed-rate mortgages, according to the Mortgage Bankers Association.

Quick Loan Funding, like most subprime lenders, wrote so- called stated-income or "no doc" loans that don't require the borrower to document income with pay stubs or tax forms. They are also known as "liar loans."

The Federal Reserve staff today recommended a ban on such loans.


*Homeowner Christopher Aultman poses in front of his house in Victorville, California, U.S., on Monday, Dec. 3, 2007. Photographer: Hector Mata*

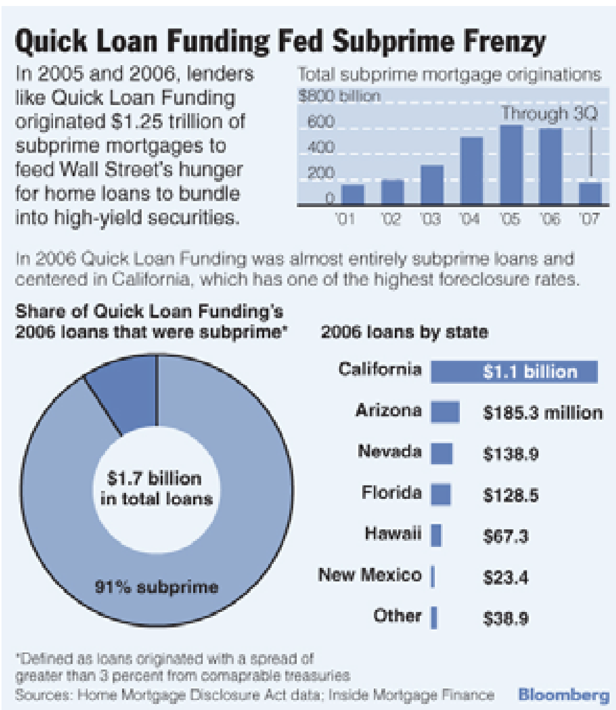
**Reviewed, Rejected**

In 2004, Bohan Group, a due diligence underwriting company, was hired by a bank to double-check the suitability of mortgages written by Quick Loan Funding that the bank was looking at buying and turning into securities. Bohan sent Nicole Singleton, 39, to the Irvine office. She reviewed 40 loans and rejected every one, she says.

Sadek says he fostered a competitive selling atmosphere, and underperforming workers "either quit because they're not making money or they're fired because they don't work." He says Quick Loan Funding "thrived on customer service, so the idea of hanging up on callers is not right."

"If the loans were so bad, why did Wall Street keep buying them?" Sadek says.

In July 2005, Espinoza, Buksoontorn, Bednar and other employees sued Quick Loan Funding in federal court alleging various workplace abuses, including failing to pay overtime and not providing adequate lunch breaks. Sadek later settled with the employees, agreeing to pay them more than $3 million, says Jon Mower, an Irvine attorney who represented the loan officers. "I don't think Quick Loan Funding was much different than many of the other subprime companies," Mower says.




**'I Can't Do This'**

Sadek denies the charges, adding that it's the type of lawsuit a jury would never decide in the employer's favor.

"They see me as a rich guy and who do you think they are going to believe?" he says.

To get $20,000 in cash from the Quick Loan Funding refinance, Aultman was told, his monthly payments would rocket to $2,264 from $1,464.

"I said I can't do this," Aultman says. "They said take the mortgage, make the payments and once everything is paid off, within 30 days your credit will shoot up 150 points and we'll get you a better rate and everybody wins."

They convinced him, he says. The company sent a notary to his house with the documents to sign. It was 9:30 p.m. Aultman was worn out from work and the rest of the family was in bed.

Aultman says he didn't see the pre-payment penalty in his contract. If he refinanced within two years, he'd have to pay six months interest.

**Crying in Son's Room**

He also says he didn't notice his income on the contract: $5,950 a month. At the time Aultman says he made $3,420.

Sadek says he watched employees closely and anyone caught falsifying information would be "fired on the spot."

For a $247,500 mortgage, Aultman paid Quick Loan Funding $10,813, including origination fee, application fee, processing fee, underwriting fee and quality control fee, according to his loan documents.

The average closing costs for a mortgage of that amount in California is about $5,000, according to Pete Ogilvie, president of the California Association of Mortgage Brokers.

Sadek defends charging those fees by saying he took more of a risk by lending to people with such lousy credit. If legislators want to limit fees, they ought to pass laws against them, he says.

Aultman received $21,674.70 in cash, according to the documents.

The monthly payments proved too steep and he fell behind.

"I feel burned," Aultman says. "There's a lot of nights I've gone into my son's room and watched him sleep and I've cried."

**Reining in Loan Officers**

Quick Loan Funding's survival, like that of other non-bank mortgage lenders, depended on a stream of new borrowers like Aultman. To fund the mortgages, the company had $400 million in short-term credit from Citigroup. To pay that off, Quick Loan Funding sold the mortgages to securitizers as soon as it could.

By August 2005, Sadek was spending most of his time working on his movie, "Redline." He hired Iannini to upgrade the company's risk management.

“My biggest problem day to day was reining in uneducated loan officers,” Iannini says. “You have to almost use police force tactics and threaten brutality on a sales floor of a lending institution and have that whip ready to crack, because you never know what employee will be pressured by what influences on any given day.”

Iannini had worked at two other mortgage lenders before joining Quick Loan Funding. She says Sadek’s firm was the most committed of the three to maintaining lending standards.

## Ferrari Crash

Asked about borrowers who have trouble making their payments, Sadek quickly leafs through a mortgage application. He stops, folds over the pages and points to the line that says, “Cash to borrower.”

“Who’s getting ripped off?” he says.

Sadek was featured on TV newscasts in March. During a publicity event for “Redline” at an Irwindale racetrack, comedian Eddie Griffin, a star of the movie, drove Sadek’s $1.2 million Ferrari Enzo into a concrete barrier, wrecking it.

Sadek, who appears in “Redline” as a poker player, also intentionally trashed two of his own Porsches in the making of the movie. In one scene, a Carrera is catapulted high in the air before it crashes.

Aultman, meanwhile, says his credit score hasn’t climbed and he has received two notices of foreclosure since refinancing with Quick Loan Funding in November 2005.

## ‘Everything’s Not OK’

“You go to soccer games, and everything’s great with the other parents,” Aultman says. “Nobody knows it, the wife doesn’t know it, the kids don’t know it, but their old man is in trouble. I put up a fa‡ade that everything’s OK. Everything’s not OK.”

Aultman is trying to sell his house, but three others within sight of his driveway also have for-sale signs.

“I’m embarrassed,” Aultman says. “I made a deal with the devil. I didn’t know what I was signing.”

Sadek may be in trouble, too. The California Department of Corporations wants to revoke his lending license. The state says he tried to use the bank account of his escrow company, Platinum Coast, to apply for markers, or gambling loans, at three Las Vegas casinos in April and May.

“It was a bank error,” Sadek says. “No money ever left the account.”

Sadek holds up a copy of the marker application. It has his name at the top and his signature at the bottom. In the middle of the page is a bank-account number. He says he thought it was his personal account. It wasn’t. It turned out to be Platinum Coast’s, Sadek says.

He says he didn’t know what he was signing.

With reporting by Kathleen M. Howley in Boston, Craig Torres and Alison Vekshin in Washington and Mark Pittman in New York.

Editors: Jeffrey Taylor, Rob Urban

# BASS SHORTED SUBPRIME TO 'GOD, I HOPE YOU'RE WRONG' WALL STREET

**By Mark Pittman**

Dec. 19 (Bloomberg) -- J. Kyle Bass, a hedge fund manager from Dallas, strode into a New York conference room in August 2006 to pitch his theory about a looming housing market meltdown to senior executives of a Wall Street investment bank.

Home prices had been on a five-year tear, rising more than 10 percent annually. Bass conceived a hedge fund that bet on a crash for residential real estate by trading securities based on subprime mortgages to the least credit-worthy borrowers. The investment bank, which Bass declines to identify, owned billions of dollars in mortgage-backed securities.

"Interesting presentation," Bass says the firm's chief risk officer said into his ear, his arm draped across Bass's shoulders. "God, I hope you're wrong."

Within six months, Bass was right. Delinquencies of home loans made to people with poor credit reached record levels, and prices for the securities backed by these subprime mortgages plunged. The world's biggest financial institutions would write off more than $80 billion in subprime losses, while Bass, his allies and a handful of Wall Street proprietary trading desks racked up billions in profits.

Bass and investors like him saw opportunity in a range of new investment tools that banks created to sell subprime securities worldwide. These included mortgage bond derivatives, contracts whose values were tied to packages of home loans. The vehicles allowed hedge funds like Bass's to bet against particular pools of mortgages.

### Money to Be Made

From the bankers who expanded the subprime market, to the sales companies that mass-marketed high-risk mortgages, to the ratings companies that blessed investment-grade designations with securities based on such loans, there was money to be made, and everyone charged after it.

The new subprime derivatives, which amplified the risks of the underlying mortgages, were sold to banks and institutional investors. When borrowers started to default on high-yield, high-risk subprime mortgages by the thousands, the values of these leveraged securities plunged.

An index designed to be a proxy for the lowest investment- grade subprime mortgage bonds sold in the second half of 2005, the ABX-HE-BBB- 06-01, traded as high as 102.19 cents on the dollar when it started in January 2006 and today trades at about 30 cents on the dollar.


*J. Kyle Bass smiles in the office of his company, Hayman Capital Partners, in Dallas, Texas, on Friday, Dec. 14, 2007. Photographer: Mike Fuentes*

### Private Island, Racing Porsche

Bass, a former salesman for Bear Stearns Cos. and Legg Mason Inc., had struck out on his own in early 2006. He started Hayman Capital Partners, specializing in corporate turnarounds, restructurings and mortgages. Bass isn't related to the Texas billionaire Robert Bass.

Bass named Hayman for the private island off Australia where he spent his honeymoon. He drove a $200,000 500-horsepower Porsche Ruf RTurbo with a built-in racecar-style crash cage.

A former competitive diver who had put himself through Texas Christian University in Fort Worth partly on an athletic scholarship, Bass was about to take his most ambitious plunge yet: betting home values would decline for the first time since the Great Depression.

"We were saying that there were going to be $1 trillion in loans in trouble," Bass says. "That had really never happened before. You had to have an imagination to believe us."

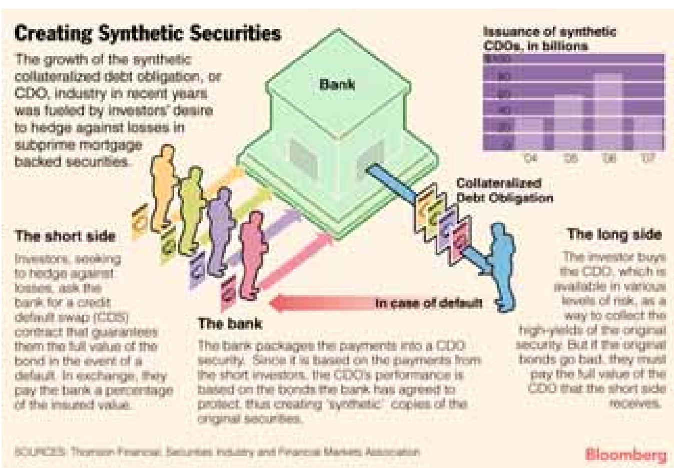
### New Tools, Deep Research

Another early convert was Alan Fournier of Pennant Capital in Chatham, New Jersey. In his earlier sales jobs, Bass had sold securities to Fournier. Now the two joined forces to research bad loans.

On the other side of their trades would be investors chasing the high yields from securities based on subprime loans. This group included Wall Street firms, German and Japanese banks and U.S. and foreign pension funds. They were reassured by the securities' investment-grade ratings, even as foreclosures started in some parts of the U.S.

The traditional way for a speculator to wager against, or short, the housing market was to sell the stocks of major home- building companies with borrowed money and repurchase them for a lower price if the shares fell.

Bass had tried that strategy in the past and found there were limits on its effectiveness, he says. There was always a danger that a leveraged buyout firm would bid for the home- building company and cause the stock to rise, which would cost anyone shorting the stock money.




### Understanding the Trades

The new, standardized mortgage bond derivative contracts created a strategy with less risk and greater profit potential.

To learn about the contracts, Bass visited Wall Street trading desks and mortgage servicers. He met with housing lenders and hedge fund analysts. He read Yale Professor Frank Fabozzi's book on mortgage-backed securities, "Collateralized Debt Obligations: Structures and Analysis." Twice.

"What I didn't understand was the synthetic marketplace," Bass says. "When someone explained to me that it was a synthetic CDO that takes the other side of my trade, it took me a month to understand what the hell was going on."

Bass and Fournier hired private detectives, searched news reports, asked Wall Street underwriters which mortgage companies' loans were at risk of default and called those lenders directly. In this blizzard of research, Bass turned up the California mortgage lender Quick Loan Funding and its proprietor, Daniel Sadek.

### Guy 'to Bet Against'

The hedge fund traders learned from a news account that Sadek was dating a soap opera actress, Nadia Bjorlin, and using profits from his mortgage company to fund a movie about car racing, in which she starred.

"When they started catapulting Porsche Carrera GTs and he says, 'What the hell, what are a couple of cars being thrown around?' I'm thinking, 'That's the guy you want to bet against,"' Bass says.

Bass called Quick Loan Funding directly. He says he got on the phone with a senior loan officer, identified himself and said he was interested in the mortgage business. As Bass tells it, the conversation sealed his determination to short Quick Loan's mortgages.

For his part, Sadek says he was never told that hedge funds had asked how his firm did business. He disputes Bass's characterization of Quick Loan's mortgages.

"If my loans were so bad, why did Wall Street keep buying them to securitize?" Sadek says.

### Recruiting Investors

Armed with their understanding of the loans they wanted to short and a plan for doing so, Bass and Fournier hit the road, making separate pitches to potential investors that the market was about to collapse.

"My biggest fear was that it was going to happen before I could get the money," Bass says.

One of Bass's first investors was Aaron Kozmetsky, a Dallas investor with whom he already had a business relationship. Kozmetsky's grandfather, George Kozmetsky, was one of the founders of Teledyne Technologies Inc. While Aaron Kozmetsky had invested in almost every venture Bass had ever offered, this time Bass put a note of urgency into his pitch.

"It was the first time he's said, 'Drop what you're doing. You need to meet with me on this. Make time for me,"' Kozmetsky says. Kozmetsky invested more than $1 million.

Daniel Loeb, the chief executive of Third Point LLC, a New York-based company that oversees about $5.7 billion, had put money in another of Bass's pools. He describes Bass as "probably the most astute salesperson who covered us." Loeb passed on Bass's subprime fund.

"I obviously missed the boat on that one," Loeb says now.

Loeb still did all right. He invested in Bass's main hedge fund that specializes in turnarounds, restructurings and bankruptcies. Loeb says that fund is up 160 percent this year.

## Laying the Bets

Bass and Fournier focused on single-name mortgage bond derivatives to be more certain that their bets were right. Both bought only securities rated BBB and BBB-, rather than AAA rated securities, expecting them to pay off more quickly.

Bass says he raised about $110 million and used the leveraging effect of derivatives to sell short about $1.2 billion of subprime securities. Two-thirds of it was based on BBB rated mortgage instruments, some involving Sadek's loans. One was Nomura Home Equity Loan Inc. 2006-HE2 M8, an instrument based 37 percent on loans issued by Quick Loan Funding.

The remaining third of Bass's investment involved securities rated one grade lower, BBB-, some also incorporating Quick Loan Funding mortgages. As Bass and Fournier executed their trades in August and September 2006, foreclosures were beginning to spread across the U.S.

## 'Fat Pitch'

"This is the fat pitch," Bass says. "This is the once-in-a-lifetime, low-risk, incredibly high-reward scenario where we're going to be right."

In January, Bass decided he needed "to meet the enemy" by going to the American Securitization Forum convention in Las Vegas and listening to presentations from managers of the synthetic collateralized debt obligations that took the other side of his trades.

"I came away relieved," Bass says. "They said, 'We know what we're doing. We've been doing it for 10 years. Our models are robust."'

In May, two independent researchers, Joshua Rosner of Graham Fisher & Co. and Joseph Mason, of Drexel University, concluded in an 84-page study that the U.S. ratings companies Standard & Poor's, Moody's and Fitch had been wrong to bless billions of dollars of mortgage securities with AAA and BBB ratings.

After a May 3 presentation at the Hudson Institute in Washington, Rosner stood on K Street and lit up an American Spirit cigarette.

"The ratings are just wrong," Rosner says. "Completely wrong."

For Bass and Fournier, it was validation of their trading strategy. As investors worldwide began to panic, Bass and Fournier watched the values of their short positions soar.

With reporting by Bob Ivry in New York and Kathleen M. Howley in Boston.

Editors: Jeffrey Taylor, Rob Urban

# RATING SUBPRIME INVESTMENT GRADE MADE 'JOKE' OF CREDIT EXPERTS

**By Kathleen M. Howley**

Dec. 20 (Bloomberg) -- As storm clouds gathered over New York on July 10, Standard & Poor's started a 10 a.m. conference call to discuss why the credit rating company was about to take its most dramatic action in more than two years.

S&P analysts said they might cut ratings on $12 billion of the world's worst-performing subprime mortgage bonds, some of them less than a year after they had been given investment-grade designations. Not since 2005, when it downgraded Ford Motor Co. and General Motors Corp., had S&P generated so much attention.

S&P Chief Economist David Wyss, 63, and Managing Director Thomas Warrack, 45, made a 20-minute presentation and then opened the line for questions from investors and analysts.

"I'd like to understand why now, when you could have made this move many, many months ago," said Steven Eisman, 45, who manages the $1.5 billion FrontPoint Financial Services hedge fund for Morgan Stanley in Greenwich, Connecticut. "The paper just deteriorates every single month."

Warrack and Managing Director Susan Barnes, 42, explained S&P's view of the time needed to accurately judge the performance of securities. Eisman cut them off. "You need to have a better answer," he said.

As the five-year real estate boom approached its peak in 2005, Wall Street marketed a new type of security backed by high-interest subprime mortgages issued to the least credit-worthy homebuyers. Blessed by the biggest credit rating companies as safe investments, these instruments offered higher returns than government bonds with the same ratings.

### 'God-Like Status'

Investment banks including Bear Stearns Cos., Deutsche Bank AG and Lehman Brothers Holdings Inc. sold $1.2 trillion of these securities in 2005 and 2006, said Brian Bethune, director of financial economics for Global Insight Inc. in Waltham, Massachusetts.

None of this could have happened without the participation of Wall Street's three biggest arbiters of credit -- Moody's Investors Service, S&P and Fitch Ratings. About 80 percent of the securities carried AAA ratings, the same designation given to U.S. Treasury bonds.

This implied the investments couldn't fail, says Sylvain Raynes, 50, a former Moody's analyst who now is a principal at R&R Consulting, a structured securities valuation firm in New York.

"The rating agencies had an almost God-like status in the eyes of some investors," Raynes says. "Now, that trust is gone. It's been replaced with a feeling of betrayal."

*U.S. Securities and Exchange Commission Chairman Christopher Cox speaks at a news conference on financial reporting in New York. Photographer: Robert Caplin*

### Guidance to Issuers

The companies' ratings underpinned Wall Street's expansion of the global market for securities based on high-risk subprime loans. Driven by the innovations of a group of Wall Street bankers, the subprime securities markets expanded quickly in 2005 and 2006, reaching into every corner of the world's investment community and winding up in the portfolios of banks and public investment pools from Europe to Asia.

Many institutional investors' own rules, in addition to state or national laws, bar them from buying securities that don't carry investment-grade ratings.

Issuers got guidance from rating companies on how to shape their subprime securities to win the ratings, says Joshua Rosner, managing director of the New York-based research firm Graham Fisher & Co. Investment banks used software distributed by the ratings companies to show them how to meet the requirements, then paid the companies to have the securities rated, he says.

*Federal Reserve board of Governor Susan Schmidt Bies speaks during a conference on Enterprise Risk Management at the Federal Reserve Bank of Richmond Charlotte Branch in Charlotte, North Carolina. Photographer: Anne McQuary*

**Reaching 'Desired Rating'**

"The idea that the rating agencies are impartial in the world of structured finance is a joke," Rosner says. "The issuers use the publicly available model to structure a pool and then sit down with the rating agencies to fine-tune it until they reach the desired rating."

Distributing the criteria and discussing them with issuers is a matter of transparency, says Claire Robinson, Moody's senior managing director of asset finance and public finance.

"We do not structure transactions," Robinson says. "We do not provide consulting services in terms of assembling transactions or choosing assets or pools or anything of that nature. We comment on credit quality."

Moody's raised "credit enhancement" requirements for bonds in 2006 as analysts noted the deterioration of lending standards, she says. The practice requires additional collateral or insurance to protect investors who purchase the higher-rated levels, or tranches, of a security.

**Rating Sadek's Loans**

One $720 million loan pool created by Tokyo-based Nomura Holdings Inc. was rated Baa3, an investment-grade rating, by Moody's when issued in 2006. Now, it's rated Caa1, seven levels deep into junk-bond territory, and priced at 32 percent of the original value after 29 percent of the mortgages defaulted.

Almost 40 percent of the loans in the pool were originated by Costa Mesa, California-based Quick Loan Funding, run by Daniel Sadek, a broker who started the subprime company in 2002 with the motto: "You can't wait. We won't let you."

It wasn't the first misstep by Moody's, founded in 1900 by former Wall Street errand runner John Moody. Nor was it a first for Standard & Poor's, started in 1860 by Henry Poor, a Maine farm boy turned journalist known for citing "the investor's right to know."

The raters faced vitriol and lawsuits in 2001 when they were slow to downgrade Enron Corp. and WorldCom Inc. as accounting discrepancies emerged. In Enron's case a downgrade would have put the Houston-based energy company into default because of so-called rating triggers on its bonds. The rating companies were also criticized in 1994 for keeping bonds sold by Orange County, California, at investment grade even as the county filed the nation's largest municipal bankruptcy.

**'Cultural Shift'**

Colorado's Jefferson County School District sued Moody's in 1995 claiming the company issued a negative rating after the district refused to hire Moody's to evaluate its bonds. While the suit was dismissed in 1996, the dispute set off a three-year antitrust investigation by the Department of Justice that ended in 1999 with no action.

The probe led to the ouster of Thomas McGuire, Moody's chief of corporate ratings, and started a "cultural shift," as Moody's prepared to go public, says

Ann Rutledge, an analyst who left in 1999 after four years. In early 2000 the board of Dun & Bradstreet Corp., Moody's parent, voted to split into separate publicly traded companies. Employees were required to take a six-week class on "issuer relationships" with listening exercises, Rutledge says.

### Customer Service

"There used to be a strong sense that we weren't a touchy, feely company," says Rutledge, who is now a principal at R&R Consulting, along with her husband, Raynes, a fellow Moody's alum. "Our attitude used to be: We're not here to be your friend. We're here to look at credit quality. But that began to change."

Initiatives such as the listening exercises were part of the company's emphasis on customer service, says Warren Kornfeld, managing director of Moody's.

"We care very deeply what people think," Kornfeld says. "We want to have a dialogue with investors, and we want to have a dialogue with issuers. Our value to the market is our accessibility."

The lure of profits as the housing market began a run of five record-breaking years in 2000 fueled the change, says Graham Fisher's Rosner.

"They went from looking at companies that already existed to having a role in structuring securities," Rosner says.

### Regulator Sounds Warning

S&P, a unit of New York-based McGraw-Hill Cos., issued ratings for about 98 percent of all new subprime mortgage bonds created last year, according to the industry newsletter Inside B&C Lending. Moody's, whose parent is New York-based Moody's Corp., provided ratings on 97 percent, while Fitch assessed 51 percent.

Fitch, owned by Paris-based Fimalac SA, declined to comment, according to spokesman James Jockle.

One regulatory voice was issuing warnings. In a June 2006 speech at a Mortgage Bankers Association conference in Half Moon Bay, California, Susan Bies, the Federal Reserve governor in charge of regulation, urged the bankers to tighten credit standards for adjustable subprime mortgages. Bies said borrowers might default because of "payment shock" when interest rates rose.

"The recent easing of traditional underwriting controls and the sale of non-traditional products to subprime borrowers may contribute to losses on these products," Bies said.

*Daniel Sadek, owner of Quick Loan Funding, speaks during an interview in Newport Beach, California, U.S., on Tuesday, Dec. 18, 2007. Photographer: Tim Rue*

### Lowering Standards

The bankers didn't listen. The Fed's survey of senior loan officers issued the following month showed that 10 percent of U.S. lenders had lowered standards to qualify customers for mortgages.

In September 2006, Congress passed the Credit Rating Agency Reform Act, after hearings and investigations that began in the wake of the Enron meltdown. The measure gave authority to the Securities and Exchange Commission to designate, regulate and investigate rating companies.

The law also prohibits notching, the threat of unsolicited bad ratings unless an agency is hired to assess a security. It also requires the rating companies to disclose any potential conflicts of interest.

On Sept. 26, SEC Chairman Christopher Cox told the Senate Committee on Banking, Housing and Urban Affairs that his agency was investigating whether the rating companies were "unduly influenced" by asset-backed issuers and underwriters who paid for ratings.

### 'Tainted' by 'Conflict'

The same day Cox testified in Washington, Teamsters Local 282 Pension Trust Fund sued Moody's in U.S. District Court in New York alleging that the company's ratings misled investors and caused losses on bonds backed by subprime mortgages. The suit defied conventional belief that rating opinions are protected by the free-speech provisions of the First Amendment to the U.S. Constitution.

"This goes beyond the realm of protected opinion," says Ira Press, the Kirby McInerney LLP attorney in New York representing the pension fund. "There's evidence that in some cases the ratings were something other than pure opinion. They were tainted by an economic conflict of interest."

Anthony Mirenda, a spokesman for Moody's, says the Teamsters' suit "is entirely without merit, and we expect it to be dismissed

### Less Transparency

In October, Connecticut Attorney General Richard Blumenthal issued subpoenas to Moody's, S&P and Fitch Ratings as part of a fair-trade investigation into practices including alleged notching. All the companies have said they are cooperating with the investigation. "The essential conflict is they are being paid by the people that they rate, they are working with the people they rate," says Arthur Levitt, former Securities & Exchange Commission chairman, a Bloomberg LP board member and a senior adviser to the Carlyle Group, a Washington-based hedge fund.

One remedy suggested by New York Democratic Senator Charles Schumer and others would be to have investors, not bond issuers, pay for credit assessments.

Paul Coughlin, S&P's executive managing director, says that would reduce transparency by giving some investors information others don't have. In the current arrangement, rating actions are announced via press releases and reports posted on the company's Web site.

"With the issuer-pay model the information is widely known and freely available," Coughlin says in an interview. "The other option is to do it by a subscription-pay model, which reduces transparency in the marketplace."

S&P's president, Kathleen Corbet, resigned in August after lawmakers and investors criticized the company for failing to judge the risks of subprime securities.

### Jose Sepulveda's Pension

In coming months, subprime losses will reach into almost every home in the U.S. as pension funds reveal setbacks, the former Moody's analyst Raynes says. Some funds won't show the extent of their subprime losses until they issue reports for the current fiscal year, some as late as September 2008.

"The smallest investor, not Wall Street, is the one who will pay the ultimate price because he trusted the fund managers who blindly followed the rating agencies," Raynes says.

Jose Sepulveda, 57, worked 34 years as a reading teacher and elementary school principal in southern Texas towns along the banks of the Rio Grande, the border between the U.S. and Mexico. Now retired in Weslaco, Texas, he says he thought he was as far as he could be from the mortgage crisis roiling markets in New York, London and Tokyo.

He wasn't far enough. The Austin-based Teacher Retirement System of Texas, the manager of Sepulveda's retirement money, holds $6 billion of securities backed by assets that include subprime mortgages, most of it rated AAA, according to a report on the fund's Web site.

"How could anyone think that investments backed by subprime loans were safe?" Sepulveda says.

With reporting by Bob Ivry and Mark Pittman in New York.

Editors: Jeffrey Taylor, Rob Urban.

# SAVANNAH CRIES ABOUT A BICYCLE LEFT BEHIND IN RESET OF SUBPRIME(CORRECT)

(CORRECTS TO ADD CONTEXT TO COMMENTS BY DAVID EINHORN IN 13TH-14TH PARAGRAPHS OF STORY PUBLISHED DEC. 21.)

**By Bob Ivry**

Dec. 21 (Bloomberg) -- When California homeowner Christopher Aultman stopped writing mortgage checks, Charles Prince of Citigroup Inc. paid.

Some of the $16.6 billion that Prince's New York-based bank estimates it lost on wrong-way subprime bets flowed to investors who for the first time were able to wager that U.S. mortgages would collapse. The subprime derivatives market created in 2005 by a group of Wall Street bankers made that payday possible.

The derivatives were based on subprime mortgages, given to borrowers with bad or incomplete credit. Securities firms packaged and sold that debt in structured financial products where the risk was hidden by investment-grade ratings and the values proved impossible to calculate.

"These structured products were crazy profitable for Wall Street until they blew up," says Randall Dodd, senior financial sector expert for the International Monetary Fund in Washington. "Ultimately it's about excessive risk-taking and greed."

The risks were amplified by the derivatives, contracts whose values are derived from packages of home loans and are used to hedge risk or for speculation. The vehicles allowed investors to bet against particular pools of mortgages.

The magnified losses caused by derivatives made it possible for a small number of defaulting subprime borrowers to freeze world credit markets.

## Credit Squeeze

That's what happened in July after payments in the first quarter stopped on 13.8 percent of subprime mortgages representing 4.8 percent of total U.S. borrowers.

The defaults caused demand for subprime securities to dry up. Uncertainty over the value of the financial products spread to investment funds globally. Corporate lending stopped because no one knew what collateral was worth. By Aug. 10, the Federal Reserve and the European Central Bank were forced to inject a combined $275 billion into the banking system to keep money flowing.

The hedging offered by derivatives made investors feel invulnerable, says Paul Kasriel, chief economist at Northern Trust Co. in Chicago.

"Derivatives don't reduce risk, they shift risk," Kasriel says. "The development of the derivatives market enabled investors to shift risk at a lower cost, and that encouraged them to take on more risk."

*Charles 'Chuck' Prince, chairman and chief executive officer of Citigroup, Inc., leaves following a speech by New York Federal Reserve Bank President Timothy Geithner at the Council on Foreign Relations in New York. Photographer: Daniel Acker*

## Wagering Against Mortgages

From 2001 to 2006, as U.S. home prices rose 50 percent nationally, owning the debt and guessing that borrowers would keep current paid off. Since July 2006, however, when housing supply began to outstrip demand and the number of late payments started to rise, the short position, or wagering against the performance of mortgages, has prevailed.

Many of those responsible for the economic upheaval caused by subprime derivatives have also been its victims.

Inadequate lending standards permeated residential and commercial real estate and corporate credit, said David Einhorn, co-founder of Greenlight Capital LLC in New York and a former director of New Century Financial Corp., the second-biggest subprime lender in 2006. In comments at an investors conference in October, he criticized loan standards in areas besides subprime, including the lending in two Manhattan commercial real estate deals.

"These are loans based on the borrowers' ability to refinance rather than the borrowers' ability to repay," Einhorn said.

If the borrowers defaulted when adjustable-rate mortgages reset, the mortgage salesmen still got their commissions. Now many of them are jobless and broke.

**Sadek Closes Shop**

Daniel Sadek, who says his Costa Mesa, California, subprime lender Quick Loan Funding catered to borrowers with credit scores as low as 420 out of 850, had to close shop in August when Citigroup cut the company's $400 million credit line.

"I'm surprised they went under," says borrower Kathy Cleeves of Tenino, Washington. "They made a fortune off us."

Borrowers bought houses and took out equity loans they couldn't afford. That didn't matter. As home prices kept rising they could always refinance. Now many of them face foreclosure.

Aultman, a Union Pacific Railroad mechanic with an average credit score of 465, took $21,000 in cash out of a 2005 refinance with Quick Loan Funding. The payments on his house in Victorville, California, adjusted to $2,650 this month, almost double what he was paying for the fixed-rate mortgage he had before the refinance. He was planning to refinance again before he discovered that he couldn't qualify.

Bankers bought loans to turn into securities that gave them the highest yield. If the borrowers defaulted, the bankers still got their fees. Now the losses are piling up.

**Billions Lost**

The biggest securities firms worldwide are collectively expected to write down about $89 billion in subprime-related losses in the second half of 2007.

Citigroup, the biggest U.S. bank, said it will write down as much as $11 billion in assets on top of $5.6 billion already announced. Citigroup was one of a "group of five" Wall Street firms that created the subprime derivatives market.

Morgan Stanley, the second-biggest U.S. securities firm, wrote down $9.4 billion in mortgage-related investments this week.

"Our assumptions included what at the time was deemed to be a worst-case scenario," Chief Financial Officer Colm Kelleher

*Homeowner Christopher Aultman poses in front of his house in Victorville, California, U.S., on Monday, Dec. 3, 2007. Photographer: Hector Mata*

said on Dec. 19. "History has proven that that worst- case scenario was not the worst case."

Bear Stearns Cos. announced a $1.9 billion writedown on mortgage losses yesterday, sending the New York-based firm to its first quarterly loss since it went public in 1985.

**'The Risk Remained'**

Merrill Lynch & Co., the world's largest brokerage, and UBS AG, Europe's biggest bank by assets, dismissed their chief executives after they reported a combined $11.4 billion in subprime-related losses in the third quarter. Merrill may post an additional $8.6 billion in losses for the fourth quarter, David Trone, an analyst at Fox-Pitt Kelton Cochrane Caronia Waller, said yesterday.

"Derivatives led a lot of people to believe that risk was being dispersed in a way that made things safer, but the risk remained after people thought they'd moved it off their balance sheets," says Bose George, a mortgage industry analyst at Keefe, Bruyette & Woods Inc. in New York.

Investors didn't know what they were buying, says Sylvain Raynes, a principal in New York-based R&R Consulting Inc. and co-author of the book, "The Analysis of Structured Securities." It didn't matter if a certain number of borrowers defaulted because the returns on some parts of the financial instruments were as much as 3 percentage points higher than 10- year Treasury yields.

### Losses Worldwide

Now the losses are spreading. Florida schools and cities pulled almost half their deposits from a $27 billion state investment pool linked to subprime mortgages.

A hospital management company in suburban Melbourne, Australia, lost a quarter of its portfolio in July on subprime- linked investments.

Japan's 36 banks booked combined losses of 244 billion yen ($2.17 billion) in the fiscal first half on subprime-related assets, according to the Financial Services Agency.

Sumitomo Trust & Banking Co., Japan's fifth-largest bank by market value, says fiscal first-half profit fell 41 percent on higher provisions for bad loans.

Eight towns in northern Norway, including Hattfjelldal, a village where reindeer outnumber the 1,500 residents, lost a combined 350 million kroner ($64 million) on securities containing subprime mortgages.

"We are a stoic people, used to fighting against the forces of nature, so we'll manage," says Hattfjelldal Mayor Asgeir Almaas. "We won't let this break us."

### 'Not Bedtime Reading'

Information about investments in derivatives, such as so- called synthetic collateralized debt obligations, was voluminous and available. A lot of it was also unread.

"These documents are not bedtime reading," Gerald Corrigan, managing director in charge of risk management at Goldman Sachs, told a U.K. parliament committee. "You have to work at it."

The three biggest ratings companies -- Moody's Investors Service, Standard & Poor's and Fitch Ratings -- were forced to lower ratings on a record number of CDOs last month, according to a Morgan Stanley report, as subprime-backed securities deteriorated.

S&P says it downgraded 16 percent of subprime vehicles issued in 2005 and 29 percent of the 2006 vintage. By comparison, the company says it upgraded 0.07 percent of its 2005 securities and 0.08 percent of 2006.

### Sniffing Out the Worst

Those who bet against the mortgage industry fared better.

J. Kyle Bass of Hayman Capital Partners in Dallas hired private investigators to help him sniff out the worst lenders. He says he turned a $110 million stake into about $600 million.

Deutsche Bank AG's writedowns on subprime losses were 2.16 billion euros ($3.09 billion) -- less than they would have been if not for the offsetting short trades of Greg Lippmann, the bank's global head of asset-backed securities trading.

Goldman Sachs avoided the losses other banks suffered by betting that U.S. homeowners would walk away from their debts.

John Paulson of New York-based Paulson & Co. made similar bets. One of his hedge funds returned 436 percent in the first nine months of 2007, based on data compiled by Bloomberg.

"The people who dug deep and analyzed the underlying collateral of the securities made a lot of money betting against them," says Girish Reddy, former co-head of equity derivatives at Goldman Sachs and managing partner of Prisma Capital Partners LP in Jersey City, New Jersey.


*J. Kyle Bass smiles in the office of his company, Hayman Capital Partners, in Dallas, Texas, on Friday, Dec. 14, 2007. Photographer: Mike Fuentes*

### Savannah Loses a Bicycle

Nobody paid more dearly than Savannah Nesbit. The six-year- old and her family lost their house in Boston's Dorchester neighborhood last month after failing to pay a subprime mortgage that adjusts higher every six months. Savannah got her first bicycle for her birthday in August, pink with streamers dangling from the handlebars. She decorated the present from her grandmother with stickers of Dora the Explorer, her favorite animated character. When sheriff's deputies emptied the house and changed the locks, they left Savannah's bike behind. "She cries about that bike every night, and she wants me to buy her another one, but I can't afford it right now because I have my own financial problems," says Savannah's grandmother, Anne Marie Wynter, whose home is also in foreclosure.

Daniel Sadek, owner of Quick Loan Funding, speaks during an interview in Newport Beach, California, U.S., on Tuesday, Dec. 18, 2007. Photographer: Tim Rue

**Sadek 'Under Water'**

Sadek's Quick Loan Funding had 700 employees at its 2005 peak. Now Sadek is making payments on three residential properties he mortgaged in a failed attempt to keep his firm afloat. He also owns a restaurant in Newport Beach, California. "I'm under water," he says, puffing on a Marlboro Light. "I'm trying to sell everything, and nothing is being sold."

His attempts to bankroll a film career for his former fiancee, soap opera actress Nadia Bjorlin, came to naught. Last month, Bjorlin returned to her role as Chloe Lane on "Days of Our Lives."

Aultman, the railroad mechanic, teeters on the brink of foreclosure. He has been trying to modify his loan terms with Countrywide Financial Corp., which now owns his mortgage.

"It's scary, very scary," Aultman says. "Sometimes I'll walk through the house and touch the walls and say to myself, 'This is mine."'

Moody's, S&P and Fitch continue to be arbiters of the quality of securities, though their reputations have suffered.

**State, SEC Probes**

The Connecticut attorney general is investigating the three companies, including whether they rank debt against issuers' wishes and then demand payment, whether they threaten to downgrade debt unless they win a contract to rate all of an issuer's securities, and the practice of offering ratings discounts in return for exclusive contracts.

The Securities and Exchange Commission and two other states, New York and Ohio, have launched separate investigations of the ratings companies. Moody's also faces a shareholder lawsuit.

Deutsche Bank recently began meetings to create a new index on another security, Alt-A mortgage bonds. It will allow hedging against defaults by Alt-A borrowers, who have prime credit and get mortgages without verifying their incomes.

Investors will also be able to wager that Alt-A homeowners will quit making payments, potentially turning losses into more and bigger paydays.

With reporting by Kathleen M. Howley in Boston; Anthony Effinger in Portland, Oregon; Garfield Reynolds in Sydney; Robin Wigglesworth in Oslo; Takahiko Hyuga, Finnbar Flynn and Kathleen Chu in Tokyo; Sebastian Boyd in London; David Evans in Los Angeles; Mark Pittman, Jody Shenn, Bradley Keoun, Christine Harper, Shannon D. Harrington and Yalman Onaran in New York.

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