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The New York Times

The Reckoning

PATRICK ANDRADE FOR THE NEW YORK TIMES

The articles in this digital newsbook examine the causes of the worst global financial crisis since the Great Depression.

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Business: The Reckoning

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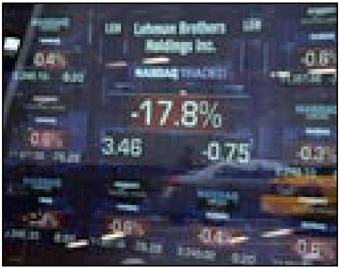

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Business: The Reckoning

The New York Times

GRAPHICS

Business: The Reckoning

The New York Times

Behind Insurer's Crisis, Blind Eye to a Web of Risk

"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 GRETCHEN MORGENSON

FIRST PUBLISHED: SEPTEMBER 28, 2008

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.

One of the Wall Street chief executives 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.

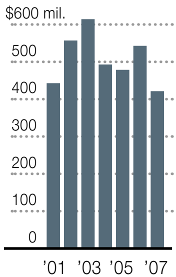
An Insurance Giant, Brought Down

A tiny unit at American International Group . . .

The world's largest insurer was brought to the edge of bankruptcy by its small London unit A.I.G. Financial Products, which sold complex financial contracts, called credit derivatives.

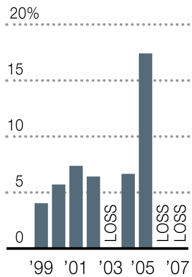
. . . was well compensated . . .

A.I.G.F.P. EMPLOYEE COMPENSATION



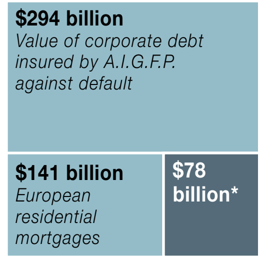
. . . for generating a significant share of revenue . . .

SHARE OF ALL A.I.G. OPERATING INCOME FROM A.I.G.F.P.



Those derivatives had been a big source of revenue for A.I.G., which paid the roughly 400 people in that office an average of more than $1 million a year.

. . . from selling contracts that protected clients from losses on debt.



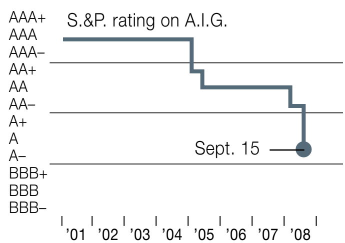
* C.D.O.'s, including some subprime

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 . . .

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.

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



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.

Source: A.I.G. company reports

THE NEW YORK TIMES

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.

An invention originally intended to diminish risk and spread prosperity instead magnified the impact of bad mortgages

In the case of A.I.G., the virus exploded from 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 130 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 supranationals."

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 was a customer of A.I.G.'s credit insurance 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 identified problems in the firm's swaps accounting. Then, three months ago, regulators and federal prosecutors said they were investigating the insurer's accounting.

This was not the first time A.I.G. Financial Products had run afoul of authorities. In 2004, without admitting or denying accusations that it helped clients improperly burnish their financial statements, A.I.G. paid $126 million and entered into a deferred prosecution agreement to settle federal civil and criminal investigations.

The settlement was a black mark on A.I.G.'s reputation and, according to analysts, distressed Mr. Greenberg, who still ran the company at the time. Still, as Mr. Cassano later told investors, the case caused A.I.G. to improve its risk management and establish a committee to maintain quality control.

"That's a committee that I sit on, along with many of the senior managers at A.I.G., and we look at a whole variety of transactions that come in to make sure that they are maintaining the quality that we need to," Mr. Cassano told them. "And so I think the things that have been put in at our level and the things that have been put in at the parent level will ensure that there won't be any of those kinds of mistakes again."

At the end of A.I.G.'s most recent quarter, the London unit's losses reached $25 billion.

As those losses mounted, and A.I.G.'s once formidable stock price plunged, it became harder for the insurer to survive — imperiling other companies that did business with it and leading it to stun the Federal Reserve gathering two weeks ago with a plea for help.

Mr. Greenberg, who has seen the value of his personal A.I.G. holdings decline by more than $5 billion this year, dumped five million shares late last week. A lawyer for Mr. Greenberg did not return a phone call seeking comment.

For his part, Mr. Cassano has departed from a company that is a far cry from what it was a year ago when he spoke confidently at the analyst conference.

"We're sitting on a great balance sheet, a strong investment portfolio and a global trading platform where we can take advantage of the market in any variety of places," he said then. "The question for us is, where in the capital markets can we gain the best opportunity, the best execution for the business acumen that sits in our shop?" □

This article has been revised to reflect the following correction published on September 30, 2008:

Because of an editing error, an article on Sunday [Septwmber 28] about the financial problems of American International Group referred incorrectly to the timing and participants at meetings at the New York Federal Reserve between Saturday, Sept. 13, and Monday, Sept. 15. Although there were indeed meetings that weekend, there was also a separate meeting on Monday to discuss financial aid for A.I.G. Lloyd C. Blankfein, the chief executive of Goldman Sachs, was the only Wall Street chief executive who attended the Monday meeting, not the only chief executive who attended weekend meetings. Also, Henry M. Paulson Jr., the Treasury secretary, did not lead or attend the Monday meeting. (Both Mr. Blankfein and Mr. Paulson did attend the weekend meetings.)

As Credit Crisis Spiraled, Alarm Led to Action

"Panic can cause a prudent person to do rational things that can contribute to the failure of an institution."

— William A. Ackman of the hedge fund Pershing Square Capital Management

By JOE NOCERA

FIRST PUBLISHED: OCTOBER 2, 2008

This article was reported by Andrew Ross Sorkin, Diana B. Henriques, Edmund L. Andrews and Joe Nocera. It was written by Mr. Nocera.

IT WAS EARLY on Wednesday, Sept. 17, when executives at Pershing Square, Bill Ackman's hedge fund, began getting nervous calls and e-mail messages from investors. Mr. Ackman, 42, has been a top Wall Street player for 15 years, making his clients — and himself — billions of dollars.

But now, Mr. Ackman and his colleagues were taken aback by

WIN MCNAMEE/GETTY IMAGES

Treasury Secretary Henry M. Paulson Jr. on his way from the White House to the Treasury Building last Wednesday in Washington.

what they were hearing. His big investors were worried about all of the Pershing assets held by Goldman Sachs, the blue-chip investment bank, whose stock had come under siege.

Never mind that Goldman kept Pershing's assets in a segregated account, and that the money was safe. And never mind that Mr. Ackman believed Goldman was the world's best-run investment bank and would come through the credit crisis unscathed.

Pershing investors still feared their money might be exposed.

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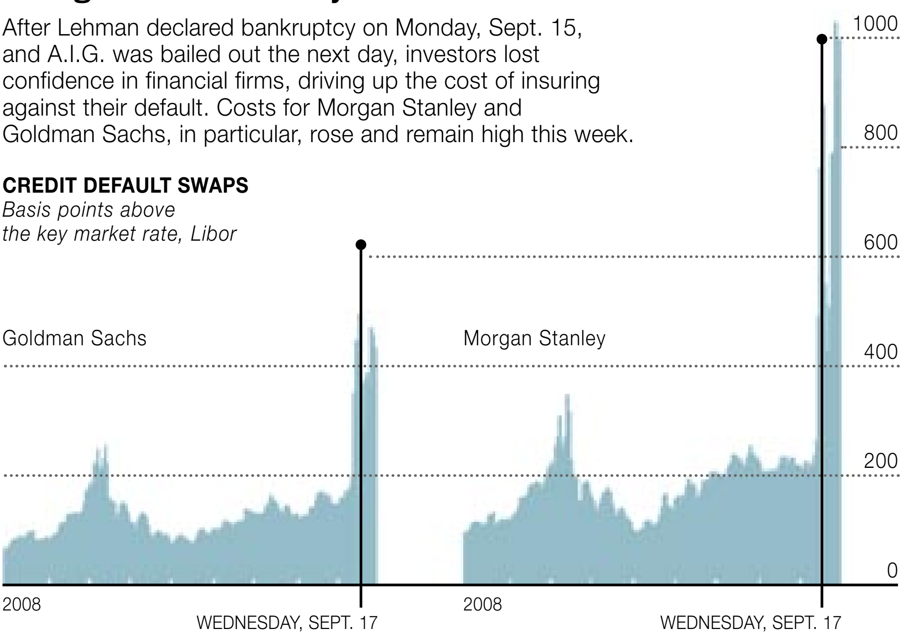
Failing firms set off worry about other firms …

After Lehman declared bankruptcy on Monday, Sept. 15, and A.I.G. was bailed out the next day, investors lost confidence in financial firms, driving up the cost of insuring against their default. Costs for Morgan Stanley and Goldman Sachs, in particular, rose and remain high this week.

CREDIT DEFAULT SWAPS

Basis points above the key market rate, Libor



Sources: Bloomberg; CMA DataVision; iMoneyNet

GRAPHICS BY GUILBERT GATES AND AMY SCHOENFELD/THE NEW YORK TIMES

Mr. Ackman advised Goldman executives to do something to restore confidence — such as getting an infusion of capital from Warren E. Buffett, the billionaire investor. And while Mr. Ackman kept his assets at Goldman, he hurriedly set up accounts at three other institutions — just in case things got much worse.

Pershing had more faith than most. Up and down Wall Street, hedge funds with billions of dollars at Goldman and Morgan Stanley, another storied investment bank, were frantically pull-

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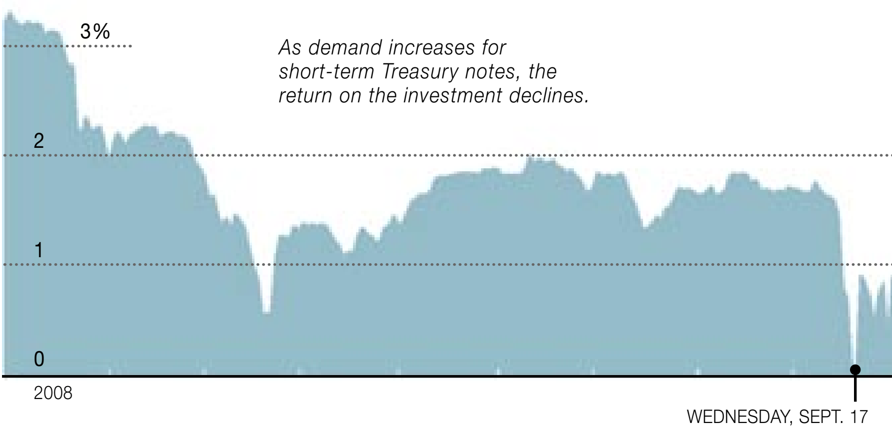
… and investors seek safer bets

Spooked by market turmoil and Lehman's decline, investors moved their money into ultra-safe short-term Treasury notes, bringing the yield down to nearly zero on Sept 17.

As investors moved into Treasury notes, they pulled money out of other parts of the market, tightening credit.

YIELDS ON 3-MONTH TREASURY NOTES



Sources: Bloomberg; CMA DataVision; iMoneyNet

GRAPHICS BY GUILBERT GATES AND AMY SCHOENFELD/THE NEW YORK TIMES

ing money out and looking for safer havens.

Panic was spreading on two of the scariest days ever in financial markets, and the biggest investors — not small investors — were panicking the most. Nobody was sure how much damage it would cause before it ended.

This is what a credit crisis looks like. It's not like a stock market crisis, where the scary plunge of stocks is obvious to all. The credit crisis has played out in places most people can't see. It's banks refusing to lend

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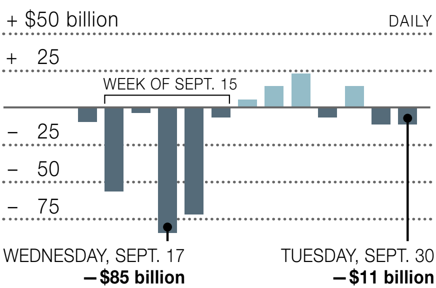
A rush out of money markets ...

One of the oldest and largest money market mutual funds lost money on Sept. 17 because of its exposure to Lehman Brothers.

As it became clear these funds — which had been considered an ultra-safe investment — were at risk, many investors reduced their money market fund holdings.

MONEY MARKET FUND FLOWS

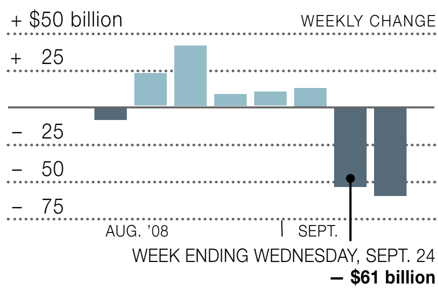


... makes it harder for companies to borrow

Companies regularly borrow money to cover day-to-day operations, like payrolls and purchases. Large firms and banks do this by selling commercial paper to buyers like money market funds.

But turmoil in the money markets on Sept. 17 prevented companies from borrowing, momentarily freezing their ability to do business.

COMMERCIAL PAPER OUTSTANDING



Sources: Bloomberg; CMA DataVision; iMoneyNet

GRAPHICS BY GUILBERT GATES AND AMY SCHOENFELD/THE NEW YORK TIMES

to other banks — even though that is one of the most essential functions of the banking system. It's a loss of confidence in seemingly healthy institutions like Morgan Stanley and Goldman — both of which reported profits even as the pressure was mounting. It is panicked hedge funds pulling out cash. It is frightened investors protecting themselves by buying credit-default swaps — a financial insurance policy against potential bankruptcy — at prices 30 times what they normally would pay.

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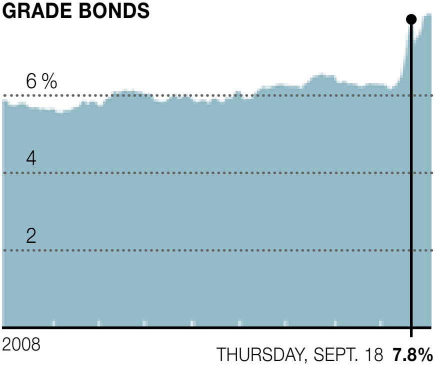
Long-term corporate borrowing costs rise, too

Rates on bonds, which do not come due for years, shot up, meaning even top-rated companies had to pay more interest to raise capital for long-term needs.

YIELDS ON INVESTMENT GRADE BONDS

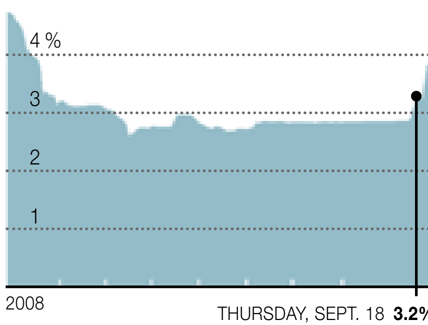


Borrowing costs rise for banks ...

Libor – the interest rate banks charge each other for short-term loans – shot up on Sept. 18, as banks became fearful of lending money.

It is used to set rates on some mortgages, small-business loans, credit cards and student loans.

3-MONTH LONDON INTERBANK OFFERED RATE



Sources: Bloomberg; CMA DataVision; iMoneyNet

GRAPHICS BY GUILBERT GATES AND AMY SCHOENFELD/THE NEW YORK TIMES

It was this 36-hour period two weeks ago — from the morning of Wednesday, Sept. 17, to the afternoon of Thursday, Sept. 18 — that spooked policy makers by opening fissures in the worldwide financial system.

In their rush to do something, and do it fast, the Federal Reserve chairman, Ben S. Bernanke, and Treasury Secretary Henry M. Paulson Jr. concluded the time had come to use the "break the glass" rescue plan they had been developing. But in their urgency,

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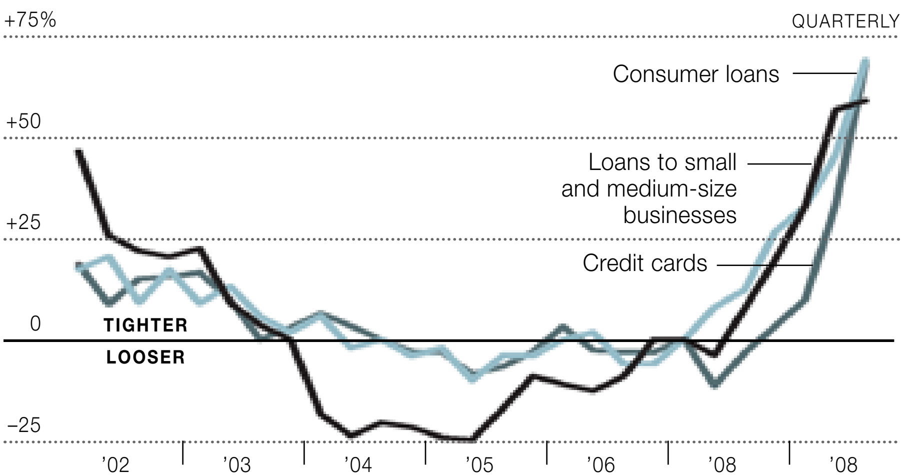
... making lenders less willing to take risks

As banks became less willing to lend money, even to each other, it became more difficult for consumers and businesses to get credit in a market that had already tightened credit standards over the past year.

NET PERCENT OF LENDERS TIGHTENING LOAN STANDARDS



Sources: Bloomberg; CMA DataVision; iMoneyNet

GRAPHICS BY GUILBERT GATES AND AMY SCHOENFELD/THE NEW YORK TIMES

they bypassed a crucial step in Washington and fashioned their $700 billion bailout without political spadework, which led to a resounding rejection this past Monday in the House of Representatives.

That Thursday evening, however, time was of the essence. In a hastily convened meeting in the conference room of the House speaker, Nancy Pelosi, the two men presented, in the starkest terms imaginable, the outline of the $700 billion plan to Congressional leaders. "If

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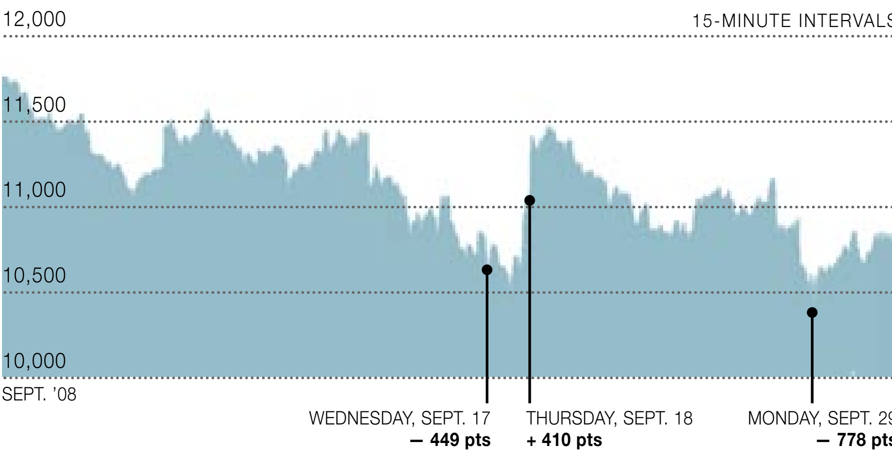
Confidence returns with rescue plan, but plummets when Congress balks

As news of a systemic government bailout leaked late in the afternoon on Thursday, Sept. 18, stocks surged. The administration eventually released a plan responding to fears that tightened credit would continue to harm the economy. After the House failed to pass the $700 billion plan on Monday, Sept. 29, the Dow fell 778 points.

DOW JONES INDUSTRIAL AVERAGE



Sources: Bloomberg; CMA DataVision; iMoneyNet

GRAPHICS BY GUILBERT GATES AND AMY SCHOENFELD/THE NEW YORK TIMES

we don't do this," Mr. Bernanke said, according to several participants, "we may not have an economy on Monday."

Setting the Stage

Wall Street executives and federal officials had known since the previous weekend that it was likely to be a difficult week.

With the government refusing to offer the same financial guarantees that helped save Bear Stearns, Fannie Mae and Freddie Mac, efforts on Saturday to find a buyer for Lehman Brothers had failed.

Sunday was spent preparing to deal with Lehman's bankruptcy, which was announced Monday morning. Merrill Lynch, fearing it would be next, had agreed to be bought by Bank of America. The American International Group was near collapse. (It would be rescued with an $85 billion loan from the Federal Reserve on Tuesday evening.)

With government policy makers appearing to careen from crisis to crisis, the Dow Jones industrial average plunged 504 points on Monday, Sept. 15. Panic was in the air.

At those weekend meetings, Wall Street executives and federal officials talked about the possibility of contagion — that the Lehman bankruptcy might set off so much fear among investors that the market "would pivot to the next weakest firm in the herd," as one federal official put it.

That firm, everyone knew, was likely to be Morgan Stanley, whose stock had been dropping since the previous Monday, Sept. 8. Within three hours on Tuesday, Sept. 16, Morgan Stanley shares fell another 28 percent, and the rising cost of its credit-default swaps suggested investors were predicting bankruptcy.

To allay the panic, the firm decided to report earnings a day early — after the market closed Tuesday afternoon instead of Wednesday morning. The profit was terrific — $1.425 billion, just a 3 percent decline from 2007 — and the thinking was that would give investors the night to absorb the good news.

"I am hoping that this will generally help calm the market," Morgan Stanley's chief financial officer, Colm A. Kelleher, said in an interview late that afternoon. "These markets are behaving irrationally. There's a lot of fear."

The Spreading Contagion

But contagion was already spreading. The problem posed by the Lehman bankruptcy was not the losses suffered by hedge funds and other investors who traded stocks or bonds with the firms. As federal officials had predicted, that turned out to be manageable. (That was one reason the government did not step in to save the firm.)

The real problem was that a handful of hedge funds that used the firm's London office to handle their trades had billions of dollars in balances frozen in the bankruptcy.

Diamondback Capital Management, for instance, a $3 billion hedge fund, told its investors that 14.9 percent of its assets were locked up in the Lehman bankruptcy — money it could not extract. A number of other hedge funds were in the same predicament. (When called for comment, Diamondback officials did not respond.)

As this news spread, every other hedge fund manager had to worry about whether the balances they had at other Wall Street firms might suffer a similar fate. And Morgan Stanley and Goldman Sachs were the two biggest firms left that served this back-office role. That is why Mr. Ackman's investors were calling him. And that is what caused hedge funds to pull money out of Morgan Stanley and Goldman Sachs, hedge their exposure by buying credit-default swaps that would cover losses if either firm couldn't pay money they owed — or do both.

It was fear, not greed, that was driving everyone's actions.

Breaking the Buck

There was another piece of bad news spooking investors — and government officials. On Tuesday, the Reserve Primary Fund, a $64 billion money market fund, and two smaller, related funds, revealed that they had "broken the buck" and would pay investors no more than 97 cents on the dollar.

Money market funds serve a critical role in greasing the wheels of commerce. They use investors' money to make short-term loans, known as commercial paper, to big corporations like General Motors, I.B.M. and Microsoft. Commercial paper is attractive to money market funds because it pays them a higher interest rate than, say, United States Treasury bills, but is still considered relatively safe.

A run on money funds could force fund managers to shy away from commercial paper, fearing the loans were no longer safe. One reason given by the Reserve Primary Fund for breaking the buck was that it had bought Lehman commercial paper with a face value of $785 million that was now worth little because of its bankruptcy. If money market funds became fearful of buying commercial paper, that would make it far more difficult for companies to raise the cash needed to pay employees, for instance. At that point, it would not just be the credit markets that were frozen, but commerce itself.

Just as important, in the eyes of federal officials, was that money market funds had long been viewed by investors as akin to bank accounts — a safe place to store cash and earn interest on that money. Despite lacking federal deposit insurance, these funds held $3.4 trillion in assets.

"Breaking the buck was the Rubicon," said a federal official. "This was the first time in the crisis that you could see stories talking about how it was affecting real people."

Since that Monday, big institutional investors — like pension funds and college endowments — had been pulling money out of money funds. On Tuesday, individual investors joined the stampede.

At the Investment Company Institute, the trade group for the mutual fund industry, executives had organized a conference call that week with top-level fund executives and government officials.

"We were saying to Treasury and the Fed, at a very high level: Pay attention to this issue. This will have an impact," recalled Greg Ahern, the group's chief communication officer.

But government officials monitoring the crisis did not need the warning. They were already watching money fund outflows with alarm.

Surprisingly, stock investors — feeling better because of the government's A.I.G. rescue plan — either did not comprehend or ignored the growing chaos in credit markets; the Dow actually rose 141.51 points on Tuesday.

A Dark Day

The respite was brief. Wednesday, Sept. 17, was one of those dark, ugly market days that offers not even a glimmer of hope.

Fearing the worst, Alex Ehrlich, the global head of prime services at the Swiss bank UBS, arrived at work in New York at 5 a.m. and immediately started putting out fires. Because he ran the firm's prime brokerage unit, clients were calling to see whether their money was safe.

"We were being flooded with client requests to move positions, and the funding markets, which are critically important to prime brokers, were extremely volatile," he said.

Within seconds of the market opening, the Dow was down 160 points. Among the big losers was Morgan Stanley. Despite the strong earnings it had disclosed late Tuesday, its stock continued to plummet. By noon, the Dow was down 330 points. It rallied in the afternoon, but went into free fall in the last 45 minutes, closing down 449 points.

And that was just what investors could see. Behind the scenes, the credit markets had almost completely frozen up. Banks were refusing to lend to other banks, and spreads on credit default swaps on financial stocks — the price of insuring against bankruptcy — veered into uncharted waters.

Moreover, the drain on money

funds continued. By the end of business on Wednesday, institutional investors had withdrawn more than $290 billion from money market funds. In what experts call a "flight to safety," investors were taking money out of stocks and bonds and even money market funds and buying the safest investments in the world: Treasury bills. As a result, yields on short-term Treasury bills dropped close to zero. That was almost unheard of.

In the stock market, Mr. Ehrlich of UBS was horrified by the plunge of Morgan Stanley's shares, given the stellar earnings. "It felt like there was no ground beneath your feet," he said. "I didn't know where it was going to end."

A Chief Executive's Anger

Neither did Morgan Stanley's chief executive, John J. Mack. A week before, his firm's stock was trading in the mid-40s. On Wednesday, it fell from $28.70 a share to $21.75 — down about 50 percent over a week.

"There is no rational basis for the movements in our stock or credit default spreads," Mr. Mack wrote in a companywide memo on Wednesday. Mr. Mack lashed out at the people he felt were responsible for Morgan Stanley's woes: the short-sellers, who profit by betting that a stock will fall.

Like most Wall Street firms, Morgan Stanley over the years had handled transactions for short-sellers, despite complaints by other companies that short-sellers unfairly ganged up on their stock. Nevertheless, Mr. Mack called Senator Charles E. Schumer, Democrat of New York, and Christopher Cox, the chairman of the Securities and Exchange Commission, pressing them to ban short-selling.

He raged about what he viewed as a concerted effort to drive down the firm's stock. "He got emotional," says one person who knows him well.

Meeting with staff members Thursday morning as the stock plunged further — hitting a low of $11.70 midday — Mr. Mack said: "Listen. I know everybody is anxious about the stock price. I'm not selling any shares, and neither is my team. But I understand if you're nervous and want to sell some shares." Some did. (The company said fewer than one-third of employees sold stock that day.)

At the same time, Mr. Mack began talks to merge with Wachovia, and called other banks about possible combinations. He also called Mr. Buffett for advice, while aides in Tokyo contacted Mitsubishi UFJ, Japan's biggest lender, hoping to raise additional capital.

Run on a Fund

Even as stocks tanked, turmoil was worsening in money markets. On Wednesday evening, Paul Schott Stevens, the head of the Investment Company Institute, learned about a problem with another money fund. "This time it was Putnam," recalled Mr. Stevens, referring to the Boston-based mutual fund company Putnam Investments.

Out of the blue, it seemed, there was a run on the $12.3 billion Putnam Prime Money Market Fund. That meant the money fund contagion was spreading. Because of huge withdrawals, Putnam decided it had to shut the fund, and distribute the cash to shareholders. If it did not, the first ones out the door would get a better deal than the laggards.

Executives of the Investment Company Institute and fund officials scrambled to find a solution that would keep Putnam from having to take that step, but they failed. On Thursday, Putnam shuttered the fund. (After the government rescue plan was announced, it sold the fund, intact, to another company, and investors did not lose a penny.)

The Fed Takes Action

Ben Bernanke had spent his career studying financial crises. His first important work as an economist had been a study of the events that led to the Great Depression. Along with several economists, he came up with a phrase, "the financial accelerator," which described how deteriorating market conditions could speed until they became unmanageable.

To an alarming degree, the credit crisis had played out as his academic work predicted. But his research also led Mr. Bernanke to the view that "situations where crises have really spiraled out of control are where the central bank has been on the sideline," according to Mark Gertler, a New York University economist who has collaborated with Mr. Bernanke on some papers.

Mr. Bernanke had no intention of keeping the Fed on the sidelines. As the crisis deepened, it took more aggressive steps. It added liquidity to the system. It opened the discount window — the emergency lending facility that had been reserved for troubled banks — to investment banks. It also agreed to absorb up to $29 billion in Bear Stearns losses and made an $85 billion loan to keep A.I.G. afloat.

Representative Barney Frank, the Massachusetts Democrat who leads the House Financial Services Committee, asked Mr. Bernanke if the Fed had $85 billion to spare. "We have $800 billion," Mr. Bernanke replied, according to Mr. Frank.

Since the Bear Stearns bailout, Treasury and Fed officials had discussed what a broad government intervention might look like. Although there were suggestions for a "bank holiday" — a temporary, nationwide closing of banks, which had not been done since 1933, to stem panicky withdrawals — Mr. Bernanke and Mr. Paulson dismissed the idea, fearing it would do far more harm than good by scaring people needlessly. They had both assembled teams to map out drastic rescue plans — the "break the glass" plans.

Almost from the start, they concluded the best systemic solution was to buy hard-to-sell mortgage-backed securities.

On Wednesday morning, during a conference call with other top officials, including Jean-Claude Trichet, the president of the European Central Bank, Mr. Bernanke sounded them out on a big government bailout. The other officials sounded relieved; their main questions were about whether Congress could act quickly.

That evening, Mr. Bernanke told Mr. Paulson during a conference call: "You have to go to Congress. This is pervasive." Mr. Paulson agreed.

A Sense of Urgency

By Thursday morning, the need for dramatic action had grown even more urgent.

In Asia, stocks had already closed lower. To quell fears before the opening of European markets, the Fed and other central banks announced they would make $180 billion available, in an effort to get banks to start lending to each other again. The Fed had agreed to open its discount window to make loans available to money market funds to prevent further runs.

But it was to little avail.

At 8:30 Thursday morning in the United States, when Mr. Paulson and Mr. Bernanke reviewed the state of affairs, markets remained roiled. The crisis was not easing up.

One Bank's Solution

Lloyd C. Blankfein, Goldman Sachs's chief executive, had arrived at the firm's office on 85 Broad Street just before 7 a.m. Thursday, anticipating another bad day. The investment bank's stock had already been pummeled. From nearly $250 a share last October, it had fallen to $114.50 on Wednesday — after hitting a low of $97.78 that day.

One idea he had been exploring was to transform Goldman into a bank holding company. Mr. Mack, meantime, was also considering such a move for Morgan Stanley, and both were in separate discussions with the Fed. There was safety in that notion — they would become depository institutions regulated by the Fed and others — though it also meant they would not be able to pile on as much debt as they had as investment banks. That would hurt profits. But now profits were less pressing than survival. Mr. Blankfein accelerated the planning.

By 1 p.m., the Dow had fallen another 150 points — meaning that in a day and a half it was down nearly 600 points. Goldman's stock dropped to $85.88, its lowest in nearly six years.

Just then, a prankster piped "The Star-Spangled Banner" over the firm's loudspeaker system on the 50th floor. Fixed-income traders stopped and stood at attention, some with hands on their hearts. Oddly, it was at precisely that moment that the market — and Goldman's shares — started to rise.

The traders began to cheer.

Curbing Short-Selling

What happened? At 1 p.m. New York time, the Financial Services Authority in Britain, which regulates that nation's financial institutions, announced a ban on short-selling of 29 financial stocks that would last at least 30 days.

"When I saw that, I knew we were about to have the mother of all short squeezes," said one hedge fund manager. Realizing that the S.E.C. was likely to follow suit, hedge funds began "covering their shorts" — that is, buying the stocks they had borrowed to short, even if it meant taking a loss.

That caused all kinds of stocks to begin rising. Sure enough, the S.E.C. followed suit the next day, placing a temporary short-selling ban on 799 financial stocks.

A few hours later came the second event. At 3:01 CNBC reported the Treasury and the Fed were planning a giant fund to buy toxic mortgage-backed assets from financial institutions. Though there had been hints of this earlier in the afternoon, and stocks had started rising around 2:30, the wide dissemination set off a huge rally. In a 45-minute burst, the Dow gained another 300 points, closing the day up 410 points.

Meeting on Capitol Hill

Two hours later, Mr. Paulson and Mr. Bernanke trooped up to Capitol Hill for a somber session with Congressional leaders. "That meeting was one of the most astounding experiences

I've had in my 34 years in politics," Senator Schumer recalled.

As the members of Congress and their aides listened, the two laid out their plan. They would begin offering federal insurance to money market funds immediately, in order to stop the run on money funds.

In addition, the S.E.C. would institute a ban on short-selling of financial stocks. Although Treasury officials concede that the move was mostly symbolic — investors can still buy put options that have the same effect as shorting stocks — they did it mainly "to scare the hell out of everybody," as one official put it.

After Mr. Bernanke made his remark about the possibility that there might not be an economy on Monday without this plan, you could hear a pin drop.

"I gulped," Mr. Schumer said.

Congressional leaders were nearly unanimous in saying that it needed to be done for the good of the country. Representative John A. Boehner of Ohio — the Republican House leader who a week later would lead the revolt against the plan — said it was time to put politics aside and move quickly, according to several participants. (An aide to Mr. Boehner denied that he voiced support for the plan, only that he made a plea for cooperation.)

Hearing that Mr. Bernanke and Mr. Paulson wanted legislation passed in a matter of days, the Senate majority leader, Harry Reid, expressed astonishment. "This is the United States Senate," he said. "We can't do it in that time frame." His Republican counterpart, Senator Mitch McConnell, replied, "This time we can."

He was wrong. After a week of wrangling, political infighting and compromise, the House on Monday voted down the legislation. The Dow plunged nearly 778 points, and credit markets had worsened, with interest rates rising and loans becoming harder to obtain.

Two weeks after Mr. Paulson and Mr. Bernanke made their appeal, the House is likely to try again. □

Agency's '04 Rule Let Banks Pile Up New Debt

"We have a good deal of comfort about the capital cushions at these firms at the moment."

— Christopher Cox, chairman of the Securities and Exchange Commission, March 11, 2008.

By STEPHEN LABATON

FIRST PUBLISHED: OCTOBER 3, 2008

AS RUMORS SWIRLED that Bear Stearns faced imminent collapse in early March, Christopher Cox was told by his staff that Bear Stearns had $17 billion in cash and other assets — more than enough to weather the storm.

Drained of most of its cash three days later, Bear Stearns was forced into a hastily arranged marriage with JPMorgan Chase — backed by a $29 billion taxpayer dowry.

Within six months, other lions of Wall Street would also either disappear or transform themselves to survive the financial maelstrom — Merrill Lynch sold itself to Bank of America, Lehman Brothers filed for bankruptcy protection, and Goldman Sachs and Morgan Stanley converted to commercial banks.

How could Mr. Cox have been so wrong?

Many events in Washington, on Wall Street and elsewhere around the country have led to what has been called the most serious financial crisis since the 1930s. But decisions made at a brief meeting on April 28, 2004, explain why the problems could spin out of control. The agency's failure to follow through on those decisions also explains why Washington regulators did not see what was coming.

On that bright spring afternoon, the five members of the Securities and Exchange Commission met in a basement hearing room to consider an urgent plea by the big investment banks.

They wanted an exemption for their brokerage units from an old regulation that limited the amount of debt they could take on. The exemption would unshackle billions of dollars held in reserve as a cushion against losses on their investments. Those funds could then flow up to the parent company, enabling it to invest in the fast-growing but opaque world of mortgage-backed securities; credit derivatives, a form of insurance for

MARK WILSON/GETTY IMAGES

Christopher Cox, left, chairman of the Securities and Exchange Commission, and Roel C. Campos at a House hearing in 2007. Mr. Campos was on the commission in 2004 when a decision was made to change the net capital rule for big investment banks.

bond holders; and other exotic instruments.

The five investment banks led the charge, including Goldman Sachs, which was headed by Henry M. Paulson Jr. Two years later, he left to become Treasury secretary.

A lone dissenter — a software consultant and expert on risk management — weighed in from Indiana with a two-page letter to warn the commission that the move was a grave mistake. He never heard back from Washington.

One commissioner, Harvey J. Goldschmid, questioned the staff about the consequences of the proposed exemption. It would only be available for the largest firms, he was reassuringly told — those with assets greater than $5 billion.

"We've said these are the big guys," Mr. Goldschmid said, provoking nervous laughter, "but that means if anything goes wrong, it's going to be an awfully big mess."

Mr. Goldschmid, an authority on securities law from Columbia, was a behind-the-scenes adviser in 2002 to Senator Paul S. Sarbanes when he rewrote the nation's corporate laws after a wave of accounting scandals. "Do we feel secure if there are these drops in capital we really will have investor protection?" Mr. Goldschmid asked. A senior staff member said the commission would hire the best minds, including people with strong quantitative skills to parse the banks' balance sheets.

Annette L. Nazareth, the head of market regulation, reassured the commission that under the new rules, the companies for the first time could be restricted by the commission from excessively risky activity. She was later appointed a commissioner and served until January 2008.

"I'm very happy to support it," said Commissioner Roel C. Campos, a former federal prosecutor and owner of a small radio broadcasting company from Houston, who then deadpanned: "And I keep my fingers crossed for the future."

The proceeding was sparsely

attended. None of the major media outlets, including The New York Times, covered it.

After 55 minutes of discussion, which can now be heard on the Web sites of the agency and The Times, the chairman, William H. Donaldson, a veteran Wall Street executive, called for a vote. It was unanimous. The decision, changing what was known as the net capital rule, was completed and published in The Federal Register a few months later.

With that, the five big independent investment firms were unleashed.

In loosening the capital rules, which are supposed to provide a buffer in turbulent times, the agency also decided to rely on the firms' own computer models for determining the riskiness of investments, essentially outsourcing the job of monitoring risk to the banks themselves.

Over the following months and years, each of the firms would take advantage of the looser rules. At Bear Stearns, the leverage ratio — a measurement of how much the firm was borrowing compared to its total assets — rose sharply, to 33 to 1. In other words, for every dollar in equity, it had $33 of debt. The ratios at the other firms also rose significantly.

The 2004 decision for the first time gave the S.E.C. a window on the banks' increasingly risky investments in mortgage-related securities.

But the agency never took true advantage of that part of the bargain. The supervisory program under Mr. Cox, who arrived at the agency a year later, was a low priority.

The commission assigned seven people to examine the parent companies — which last year controlled financial empires with combined assets of more than $4 trillion. Since March 2007, the office has not had a director. And as of last month, the office had not completed a single inspection since it was reshuffled by Mr. Cox more than a year and a half ago.

The few problems the examiners preliminarily uncovered about the riskiness of the firms' investments and their increased reliance on debt — clear signs of trouble — were all but ignored.

The commission's division of trading and markets "became aware of numerous potential red flags prior to Bear Stearns's collapse, regarding its concentration of mortgage securities, high leverage, shortcomings of risk management in mortgage-backed securities and lack of compliance with the spirit of certain" capital standards, said an inspector general's report issued last Friday. But the division "did not take actions to limit these risk factors."

Drive to Deregulate

The commission's decision effectively to outsource its oversight to the firms themselves fit squarely in the broader Washington culture of the last eight years under President Bush.

A similar closeness to industry and laissez-faire philosophy has driven a push for deregulation throughout the government, from the Consumer Product Safety Commission and the Environmental Protection Agency to worker safety and transportation agencies.

"It's a fair criticism of the Bush administration that regulators have relied on many voluntary regulatory programs," said Roderick M. Hills, a Republican who was chairman of the S.E.C. under President Gerald R. Ford. "The problem with such voluntary programs is that, as we've seen throughout history, they often don't work."

As was the case with other agencies, the commission's decision was motivated by industry complaints of excessive regulation at a time of growing competition from overseas. The 2004 decision was aimed at easing regulatory burdens that the European Union was about to impose on the foreign operations of United States investment banks.

The Europeans said they would agree not to regulate the foreign subsidiaries of the investment banks on one condition — that the commission regulate the parent companies, along with the brokerage units that the S.E.C. already oversaw.

A 1999 law, however, had left a gap that did not give the commission explicit oversight of the parent companies. To get around that problem, and in exchange for the relaxed capital rules, the banks volunteered to let the commission examine the books of their parent companies and subsidiaries.

The 2004 decision also reflected a faith that Wall Street's financial interests coincided with Washington's regulatory interests.

"We foolishly believed that the firms had a strong culture of self-preservation and responsibility and would have the discipline not to be excessively borrowing," said Professor James D. Cox, an expert on securities law and accounting at Duke School of Law (and no relationship to Christopher Cox).

"Letting the firms police themselves made sense to me because I didn't think the S.E.C. had the staff and wherewithal to impose its own standards and I foolishly thought the market would impose its own self-discipline. We've all learned a terrible lesson," he added.

In letters to the commissioners, senior executives at the five investment banks complained about what they called unnecessary regulation and oversight by both American and European authorities. A lone voice of dissent in the 2004 proceeding came from a software consultant from Valparaiso, Ind., who said the computer models run by the firms — which the regulators would be relying on — could not anticipate moments of severe market turbulence.

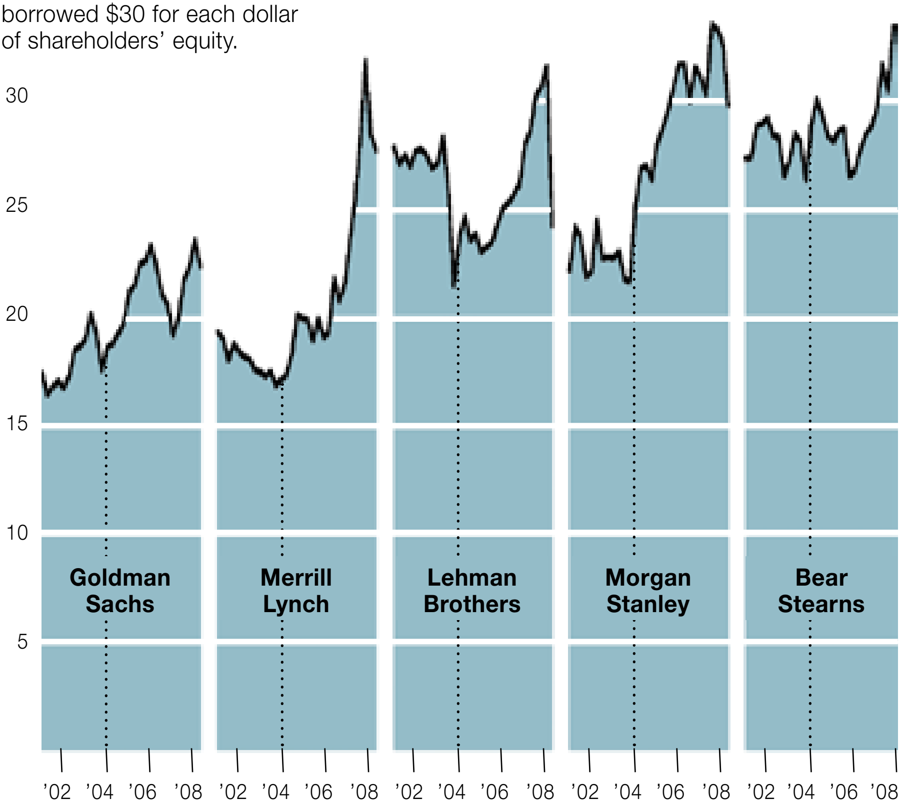
"With the stroke of a pen, capital requirements are removed!" the consultant, Leonard D. Bole, wrote to the commission on Jan. 22, 2004. "Has the trading environment changed sufficiently since 1997, when the current requirements were enacted, that the commission is confident that current requirements in examples such as these can be disregarded?"

Gauging a Decision's Impact

In April 2004, the Securities and Exchange Commission allowed the nation's five largest investment banks much greater ability to borrow more to buy billions of dollars of risky assets. The firms' debt-to-asset ratio rose, in some cases significantly, over the next few years.

GROSS LEVERAGE RATIO BY QUARTER

A ratio of 30:1 means the company had borrowed $30 for each dollar of shareholders' equity.



Source: Bloomberg

THE NEW YORK TIMES

He said that similar computer standards had failed to protect Long-Term Capital Management, the hedge fund that collapsed in 1998, and could not protect companies from the market plunge of October 1987.

Mr. Bole, who earned a master's degree in business administration at the University of Chicago, helps write computer programs that financial institutions use to meet capital requirements.

He said in a recent interview that he was never called by anyone from the commission.

"I'm a little guy in the land of giants," he said. "I thought that the reduction in capital was rather dramatic."

Policing Wall Street

A once-proud agency with a rich history at the intersection of Washington and Wall Street, the Securities and Exchange Commission was created during the Great Depression as part of the broader effort to restore confidence to battered investors. It was led in its formative years by heavyweight New Dealers, including James Landis and William O. Douglas. When President Franklin D. Roosevelt was asked in 1934 why he appointed Joseph P. Kennedy, a spectacularly successful stock speculator, as the agency's first chairman, Roosevelt replied: "Set a thief to catch a thief."

The commission's most public role in policing Wall Street is its enforcement efforts. But critics say that in recent years it has failed to deter market problems. "It seems to me the enforcement effort in recent years has fallen short of what one Supreme Court justice once called the fear of the shotgun behind the door," said Arthur Levitt Jr., who was S.E.C. chairman in the Clinton administration. "With this commission, the shotgun too rarely came out from behind the door."

Christopher Cox had been a close ally of business groups in his 17 years as a House member from one of the most conservative districts in Southern California. Mr. Cox had led the effort to rewrite securities laws to make investor lawsuits harder to file. He also fought against accounting rules that would give less favorable treatment to executive stock options.

Under Mr. Cox, the commission responded to complaints by some businesses by making it more difficult for the enforcement staff to investigate and bring cases against companies. The commission has repeatedly reversed or reduced proposed settlements that companies had tentatively agreed upon. While the number of enforcement cases has risen, the number of cases involving significant players or large amounts of money has declined.

Mr. Cox dismantled a risk management office created by Mr. Donaldson that was assigned to watch for future problems. While other financial regulatory agencies criticized a blueprint by Mr. Paulson, the Treasury secretary, that proposed to reduce their stature — and that of the S.E.C. — Mr. Cox did not challenge the plan, leaving it to three former Democratic and Republican commission chairmen to complain that the blueprint would neuter the agency.

In the process, Mr. Cox has surrounded himself with conservative lawyers, economists and accountants who, before the market turmoil of recent months, had embraced a far more limited vision for the commission than many of his predecessors.

'Stakes in the Ground'

Last Friday, the commission formally ended the 2004 program, acknowledging that it had failed to anticipate the problems at Bear Stearns and the four other major investment banks.

"The last six months have made it abundantly clear that voluntary regulation does not work," Mr. Cox said.

The decision to shutter the program came after Mr. Cox was blamed by Senator John McCain, the Republican presidential candidate, for the crisis. Mr. McCain has demanded Mr. Cox's resignation.

Mr. Cox has said that the 2004 program was flawed from its inception. But former officials as well as the inspector general's report have suggested that a major reason for its failure was Mr. Cox's use of it.

"In retrospect, the tragedy is that the 2004 rule making gave us the ability to get information that would have been critical to sensible monitoring, and yet the S.E.C. didn't oversee well enough," Mr. Goldschmid said in an interview. He and Mr. Donaldson left the commission in 2005.

Mr. Cox declined requests for an interview. In response to written questions, including whether he or the commission had made any mistakes over the last three years that contributed to the current crisis, he said, "There will be no shortage of retrospective analyses about what happened and what should have happened." He said that by last March he had concluded that the monitoring program's "metrics were inadequate."

He said that because the commission did not have the authority to curtail the heavy borrowing at Bear Stearns and the other firms, he and the commission were powerless to stop it.

"Implementing a purely voluntary program was very difficult because the commission's regulations shouldn't be suggestions," he said. "The fact these companies could withdraw from voluntary supervision at their discretion diminished the mandate of the program and weakened its effectiveness. Experience has shown that the S.E.C. could not bootstrap itself into authority it didn't have."

But critics say that the commission could have done more, and that the agency's effectiveness comes from the tone set at the top by the chairman, or what Mr. Levitt, the longest-serving S.E.C. chairman in history, calls "stakes in the ground."

"If you go back to the chairmen in recent years, you will see that each spoke about a variety of issues that were important to them," Mr. Levitt said. "This commission placed very few stakes in the ground." □

Pressured to Take More Risk, Fannie Reached Tipping Point

"Almost no one expected what was coming. It's not fair to blame us for not predicting the unthinkable."

— Daniel H. Mudd, former chief executive, Fannie Mae

By CHARLES DUHIGG

FIRST PUBLISHED: OCTOBER 5, 2008

WHEN THE MORTGAGE giant Fannie Mae recruited Daniel H. Mudd, he told a friend he wanted to work for an altruistic business. Already a decorated marine and a successful executive, he wanted to be a role model to his four children — just as his father, the television journalist Roger Mudd, had been to him.

Fannie, a government-sponsored company, had long helped Americans get cheaper home loans by serving as a powerful middleman, buying mortgages from lenders and banks and then holding or reselling them to Wall Street investors. This allowed banks to make even more loans — expanding the pool of homeowners and permitting Fannie to ring up handsome profits along the way.

But by the time Mr. Mudd became Fannie's chief executive in 2004, his company was under siege. Competitors were snatching lucrative parts of its business. Congress was demanding that Mr. Mudd help steer more loans to low-income borrowers. Lenders were threatening to sell directly to Wall Street unless Fannie bought a bigger chunk of their riskiest loans.

So Mr. Mudd made a fateful choice. Disregarding warnings from his managers that lenders were making too many loans that would never be repaid, he steered Fannie into more treacherous corners of the mortgage market, according to executives.

For a time, that decision proved profitable. In the end, it nearly destroyed the company and threatened to drag down the housing market and the economy.

Dozens of interviews, most from people who requested anonymity to avoid legal repercussions, offer an inside account of the critical juncture when Fannie Mae's new chief executive, under pressure from Wall Street firms, Congress and company shareholders, took additional risks that pushed his company, and, in turn, a large part of the nation's financial health, to the brink.

Between 2005 and 2008, Fannie purchased or guaranteed at least $270 billion in loans to risky borrowers — more than three times as much as in all its earlier years combined, according to company filings and industry data.

"We didn't really know what we were buying," said Marc Gott, a former director in Fannie's loan servicing department. "This system was designed for plain vanilla loans, and we were trying to push chocolate sundaes through the gears."

Last month, the White House was forced to orchestrate a $200 billion rescue of Fannie and its corporate cousin, Freddie Mac.

> "The market was changing, and it's our job to buy loans, so we had to change as well."
>
> **DANIEL H. MUDD**

On Sept. 26, the companies disclosed that federal prosecutors and the Securities and Exchange Commission were investigating potential accounting and governance problems.

Mr. Mudd said in an interview that he responded as best he could given the company's challenges, and worked to balance risks prudently.

"Fannie Mae faced the danger that the market would pass us by," he said. "We were afraid that lenders would be selling products we weren't buying and Congress would feel like we weren't fulfilling our mission. The market was changing, and it's our job to buy loans, so we had to change as well."

Dealing With Risk

When Mr. Mudd arrived at Fannie eight years ago, it was beginning a dramatic expansion that, at its peak, had it buying 40 percent of all domestic mortgages.

Just two decades earlier, Fannie had been on the brink of bankruptcy. But chief executives like Franklin D. Raines and the chief financial officer J. Timothy Howard built it into a financial juggernaut by aiming at new markets.

Fannie never actually made loans. It was essentially a mortgage insurance company, buying mortgages, keeping some but reselling most to investors and, for a fee, promising to pay off a loan if the borrower defaulted. The only real danger was that the company might guarantee questionable mortgages and lose out when large numbers of borrowers walked away from their obligations.

So Fannie constructed a vast network of computer programs and mathematical formulas that analyzed its millions of daily transactions and ranked borrowers according to their risk.

Those computer programs seemingly turned Fannie into a divining rod, capable of separating pools of similar-seeming borrowers into safe and risky bets. The riskier the loan, the more Fannie charged to handle it. In theory, those high fees would offset any losses.

With that self-assurance, the company announced in 2000 that it would buy $2 trillion in loans from low-income, minority and risky borrowers by 2010.

All this helped supercharge Fannie's stock price and rewarded top executives with tens of millions of dollars. Mr. Raines received about $90 million between 1998 and 2004, while Mr.

Howard was paid about $30.8 million, according to regulators. Mr. Mudd collected more than $10 million in his first four years at Fannie.

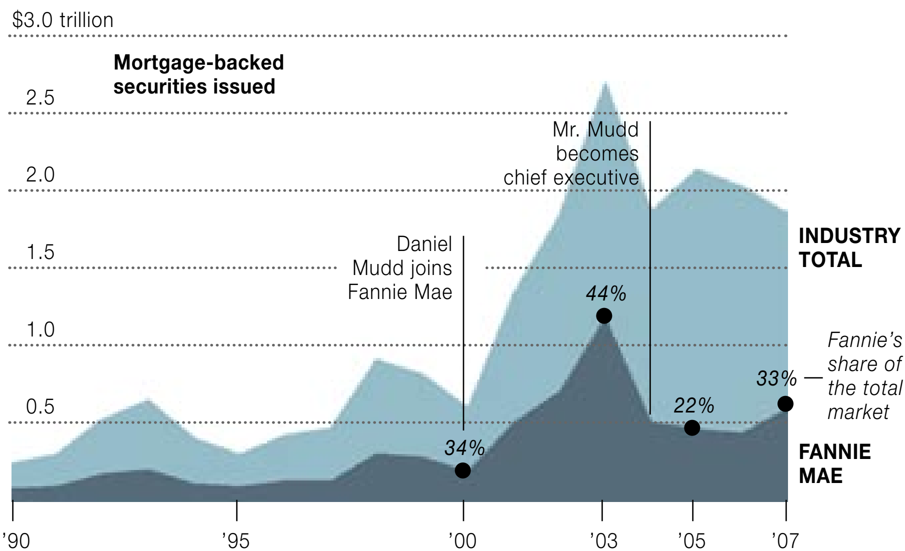
Whenever competitors asked Congress to rein in the company, lawmakers were besieged with letters and phone calls from angry constituents, some orchestrated by Fannie itself. One automated phone call warned voters: "Your congressman is trying to make mortgages more expensive. Ask him why he opposes the American dream of home ownership."

The ripple effect of Fannie's

Leaning on Risks

1 2 NEXT

Daniel H. Mudd joined Fannie Mae in 2000. The company grew quickly through 2003. But in 2004, the year Mr. Mudd became chief executive, it lost half its market share to Wall Street firms and other competitors . . .



Sources: Inside Mortgage Finance; Fannie Mae company reports

THE NEW YORK TIMES

plunge into riskier lending was profound. Fannie's stamp of approval made shunned borrowers and complex loans more acceptable to other lenders, particularly small and less sophisticated banks.

Between 2001 and 2004, the overall subprime mortgage market — loans to the riskiest borrowers — grew from $160 billion to $540 billion, according to Inside Mortgage Finance, a trade publication. Communities were inundated with billboards and fliers from subprime companies offering to help almost anyone buy a home.

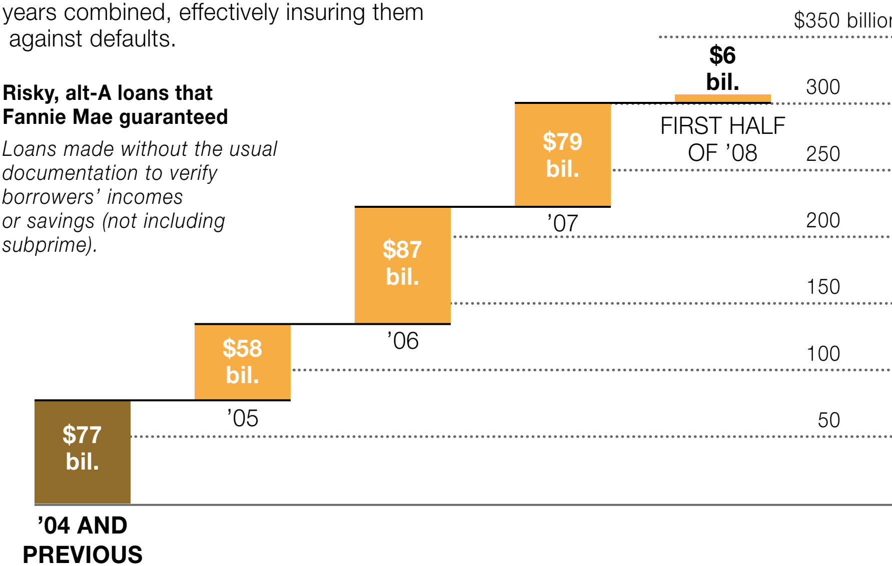
Leaning on Risks

1 2 NEXT

. . . so Fannie greatly increased its business in riskier loans. From 2005 to 2007, it guaranteed payments on almost three times as many loans as it had in all earlier years combined, effectively insuring them against defaults.

Risky, alt-A loans that Fannie Mae guaranteed

Loans made without the usual documentation to verify borrowers' incomes or savings (not including subprime).



Sources: Inside Mortgage Finance; Fannie Mae company reports

THE NEW YORK TIMES

Within a few years of Mr. Mudd's arrival, Fannie was the most powerful mortgage company on earth.

Then it began to crumble.

Regulators, spurred by the revelation of a wide-ranging accounting fraud at Freddie, began scrutinizing Fannie's books. In 2004 they accused Fannie of fraudulently concealing expenses to make its profits look bigger.

Mr. Howard and Mr. Raines resigned. Mr. Mudd was quickly promoted to the top spot.

But the company he inherited was becoming a shadow of its former self.

'You Need Us'

Shortly after he became chief executive, Mr. Mudd traveled to the California offices of Angelo R. Mozilo, the head of Countrywide Financial, then the nation's largest mortgage lender. Fannie had a longstanding and lucrative relationship with Countrywide, which sold more loans to Fannie than anyone else.

But at that meeting, Mr. Mozilo, a butcher's son who had almost single-handedly built Countrywide into a financial powerhouse, threatened to upend their partnership unless Fannie started buying Countrywide's riskier loans.

Mr. Mozilo, who did not return telephone calls seeking comment, told Mr. Mudd that Countrywide had other options. For example, Wall Street had recently jumped into the market for risky mortgages. Firms like Bear Stearns, Lehman Brothers and Goldman Sachs had started bundling home loans and selling them to investors — bypassing Fannie and dealing with Countrywide directly.

"You're becoming irrelevant," Mr. Mozilo told Mr. Mudd, according to two people with knowledge of the meeting who requested anonymity because the talks were confidential. In the previous year, Fannie had already lost 56 percent of its loan-reselling business to Wall Street and other competitors.

"You need us more than we need you," Mr. Mozilo said, "and if you don't take these loans, you'll find you can lose much more."

Then Mr. Mozilo offered everyone a breath mint.

Investors were also pressuring Mr. Mudd to take greater risks.

On one occasion, a hedge fund manager telephoned a senior Fannie executive to complain that the company was not taking enough gambles in chasing profits.

"Are you stupid or blind?" the investor roared, according to someone who heard the call, but requested anonymity. "Your job is to make me money!"

Capitol Hill bore down on Mr. Mudd as well. The same year he took the top position, regulators sharply increased Fannie's affordable-housing goals. Democratic lawmakers demanded that the company buy more loans that had been made to low-income and minority homebuyers.

"When homes are doubling in price in every six years and incomes are increasing by a mere one percent per year, Fannie's mission is of paramount importance," Senator Jack Reed, a Rhode Island Democrat, lectured Mr. Mudd at a Congressional hearing in 2006. "In fact, Fannie and Freddie can do more, a lot more."

But Fannie's computer systems could not fully analyze many of the risky loans that customers, investors and lawmakers wanted Mr. Mudd to buy. Many of them — like balloon-rate mortgages or mortgages that did not require paperwork — were so new that dangerous bets could not be identified, according to company executives.

Even so, Fannie began buying huge numbers of riskier loans.

In one meeting, according to two people present, Mr. Mudd told employees to "get aggressive on risk-taking, or get out of the company."

In the interview, Mr. Mudd said he did not recall that conversation and that he always stressed taking only prudent risks.

Employees, however, say they got a different message.

"Everybody understood that

we were now buying loans that we would have previously rejected, and that the models were telling us that we were charging way too little," said a former senior Fannie executive. "But our mandate was to stay relevant and to serve low-income borrowers. So that's what we did."

Between 2005 and 2007, the company's acquisitions of mortgages with down payments of less than 10 percent almost tripled. As the market for risky loans soared to $1 trillion, Fannie expanded in white-hot real estate areas like California and Florida.

For two years, Mr. Mudd operated without a permanent chief risk officer to guard against unhealthy hazards. When Enrico Dallavecchia was hired for that position in 2006, he told Mr. Mudd that the company should be charging more to handle risky loans.

In the following months to come, Mr. Dallavecchia warned that some markets were becoming overheated and argued that a housing bubble had formed, according to a person with knowledge of the conversations. But many of the warnings were rebuffed.

Mr. Mudd told Mr. Dallavecchia that the market, shareholders and Congress all thought the companies should be taking more risks, not fewer, according to a person who observed the conversation. "Who am I supposed to fight with first?" Mr. Mudd asked.

In the interview, Mr. Mudd said he never made those comments. Mr. Dallavecchia was among those whom Mr. Mudd forced out of the company during a reorganization in August.

Mr. Mudd added that it was almost impossible during most of his tenure to see trouble on the horizon, because Fannie interacts with lenders rather than borrowers, which creates a delay in recognizing market conditions.

He said Fannie sought to balance market demands prudently against internal standards, that executives always sought to avoid unwise risks, and that

Fannie bought far fewer troublesome loans than many other financial institutions. Mr. Mudd said he heeded many warnings from his executives and that Fannie refused to buy many risky loans, regardless of outside pressures .

"You're dealing with massive amounts of information that flow in over months," he said. "You almost never have an 'Oh, my God' moment. Even now, most of the loans we bought are doing fine."

But, of course, that moment of truth did arrive. In the middle of last year it became clear that millions of borrowers would stop paying their mortgages. For Fannie, this raised the terrifying prospect of paying billions of dollars to honor its guarantees.

Sustained by Government

Had Fannie been a private entity, its comeuppance might have happened a year ago. But the White House, Wall Street and Capitol Hill were more concerned about the trillions of dollars in other loans that were poisoning financial institutions and banks.

Lawmakers, particularly Democrats, leaned on Fannie and Freddie to buy and hold those troubled debts, hoping that removing them from the system would help the economy recover. The companies, eager to regain market share and buy what they thought were undervalued loans, rushed to comply.

The White House also pitched in. James B. Lockhart, the chief regulator of Fannie and Freddie, adjusted the companies' lending standards so they could purchase as much as $40 billion in new subprime loans. Some in Congress praised the move.

"I'm not worried about Fannie and Freddie's health, I'm worried that they won't do enough to help out the economy," the chairman of the House Financial Services Committee, Barney Frank, Democrat of Massachusetts, said at the time. "That's why I've supported them all these years — so that they can help at a time like this."

But earlier this year, Treasury Secretary Henry M. Paulson Jr. grew concerned about Fannie's and Freddie's stability. He sent a deputy, Robert K. Steel, a former colleague from his time at Goldman Sachs, to speak with Mr. Mudd and his counterpart at Freddie.

Mr. Steel's orders, according to several people, were to get commitments from the companies to raise more money as a cushion against all the new loans. But when he met with the firms, Mr. Steel made few demands and seemed unfamiliar with Fannie's and Freddie's operations, according to someone who attended the discussions.

Rather than getting firm commitments, Mr. Steel struck handshake deals without deadlines.

That misstep would become obvious over the coming months. Although Fannie raised $7.4 billion, Freddie never raised any additional money.

Mr. Steel, who left the Treasury Department over the summer to head Wachovia bank, disputed that he had failed in his handling of the companies, and said he was proud of his work .

As the housing crisis worsened, Fannie and Freddie announced larger losses, and shares continued falling.

In July, Mr. Paulson asked Congress for authority to take over Fannie and Freddie, though he said he hoped never to use it. "If you've got a bazooka and people know you've got it, you may not have to take it out," he told Congress.

Mr. Mudd called Treasury weekly. He offered to resign, to replace his board, to sell stock, and to raise debt. "We'll sign in blood anything you want," he told a Treasury official, according to someone with knowledge of the conversations.

But, according to that person, Mr. Mudd told Treasury that those options would work only if government officials publicly clarified whether they intended to take over Fannie. Otherwise, potential investors would refuse to buy the stock for fear of being wiped out.

"There were other options on the table short of a takeover," Mr. Mudd said. But as long as Treasury refused to disclose its goals, it was impossible for the company to act, according to people close to Fannie.

Then, last month, Mr. Mudd was instructed to report to Mr. Lockhart's office. Mr. Paulson told Mr. Mudd that he could either agree to a takeover or have one forced upon him.

"This is the right thing to do for the economy," Mr. Paulson said, according to two people with knowledge of the talks. "We can't take any more risks."

Freddie was given the same message. Less than 48 hours later, Mr. Lockhart and Mr. Paulson ended Fannie and Freddie's independence, with up to $200 billion in taxpayer money to replenish the companies' coffers.

The move failed to stanch a spreading panic in the financial world. In fact, some analysts say, the takeover accelerated the hysteria by signaling that no company, no matter how large, was strong enough to withstand the losses stemming from troubled loans.

Within weeks, Lehman Brothers was forced to declare bankruptcy, Merrill Lynch was pushed into the arms of Bank of America, and the government stepped in to bail out the insurance giant the American International Group.

Today, Mr. Paulson is scrambling to carry out a $700 billion plan to bail out the financial sector, while Mr. Lockhart effectively runs Fannie and Freddie.

Mr. Raines and Mr. Howard, who kept most of their millions, are living well. Mr. Raines has improved his golf game. Mr. Howard divides his time between large homes outside Washington and Cancun, Mexico, where his staff is learning how to cook American meals.

But Mr. Mudd, who lost millions of dollars as the company's stock declined and had his severance revoked after the company was seized, often travels to New York for job interviews. He recalled that one of his sons recently asked him why he had been fired.

"Sometimes things don't work out, no matter how hard you try," he replied. □

STEPHEN CROWLEY/THE NEW YORK TIMES

Alan Greenspan, the Federal Reserve chairman, with Treasury Secretary Robert E. Rubin, left, at a House hearing in 1995.

Taking Hard New Look At a Greenspan Legacy

"Not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient."

— Alan Greenspan in 2004

By PETER S. GOODMAN

FIRST PUBLISHED: OCTOBER 9, 2008

GEORGE SOROS, the prominent financier, avoids using the financial contracts known as derivatives "because we don't really understand how they work." Felix G. Rohatyn, the investment banker who saved New York from financial catastrophe in the 1970s, described derivatives as potential "hydrogen bombs."

And Warren E. Buffett presciently observed five years ago that derivatives were "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."

One prominent financial figure, however, has long thought otherwise. And his views held the greatest sway in debates about the regulation and use of derivatives — exotic contracts that promised to protect investors from losses, thereby stimulating riskier practices that led to the financial crisis. For more than a decade, the former Federal Reserve Chairman Alan Greenspan has fiercely objected whenever derivatives have come under scrutiny in Congress or on Wall Street. "What we have found over the years in the marketplace is that derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn't be taking it to those who are willing to and are capable of doing so," Mr. Greenspan told the Senate Banking Committee in 2003. "We think it would be a mistake" to more deeply regulate the contracts, he added.

Today, with the world caught in an economic tempest that Mr. Greenspan recently described as "the type of wrenching financial crisis that comes along only once in a century," his faith in derivatives remains unshaken.

The problem is not that the contracts failed, he says. Rather, the people using them got greedy. A lack of integrity spawned the crisis, he argued in a speech a week ago at Georgetown University, intimating that those peddling derivatives were not as reliable as "the pharmacist who fills the prescription ordered by our physician."

But others hold a starkly different view of how global markets unwound, and the role that Mr. Greenspan played in setting up this unrest.

"Clearly, derivatives are a centerpiece of the crisis, and he was the leading proponent of the deregulation of derivatives," said Frank Partnoy, a law professor at the University of San Diego and an expert on financial regulation.

The derivatives market is $531 trillion, up from $106 trillion in 2002 and a relative pittance just two decades ago. Theoretically intended to limit risk and ward off financial problems, the contracts instead have stoked uncertainty and actually spread risk amid doubts about how companies value them.

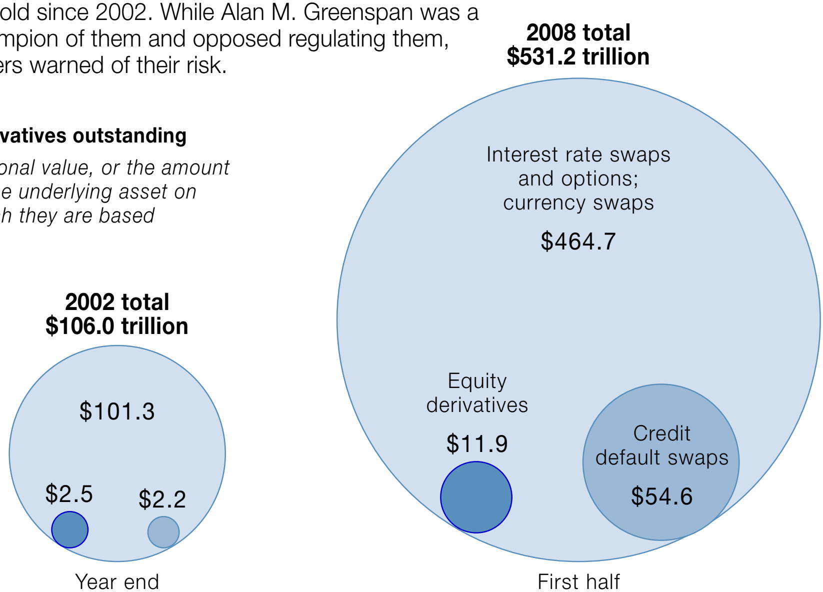
If Mr. Greenspan had acted differently during his tenure as Federal Reserve chairman from

Growth of a Complex Market

The market for financial instruments known as derivatives — contracts intended to hedge against risk whose values are derived from underlying assets — has increased fivefold since 2002. While Alan M. Greenspan was a champion of them and opposed regulating them, others warned of their risk.

Derivatives outstanding

Notional value, or the amount of the underlying asset on which they are based



Source: International Swaps and Derivatives Association

THE NEW YORK TIMES

1987 to 2006, many economists say, the current crisis might have been averted or muted.

Over the years, Mr. Greenspan helped enable an ambitious American experiment in letting market forces run free. Now, the nation is confronting the consequences.

Derivatives were created to soften — or in the argot of Wall Street, "hedge" — investment losses. For example, some of the contracts protect debt holders against losses on mortgage securities. (Their name comes from the fact that their value "derives" from underlying assets like stocks, bonds and commodities.) Many individuals own a common derivative: the insurance contract on their homes.

On a grander scale, such contracts allow financial services firms and corporations to take more complex risks that they might otherwise avoid — for example, issuing more mortgages or corporate debt. And the contracts can be traded, further limiting risk but also increasing the number of parties exposed if problems occur.

Throughout the 1990s, some argued that derivatives had become so vast, intertwined and inscrutable that they required federal oversight to protect the financial system. In meetings with federal officials, celebrated appearances on Capitol Hill and heavily attended speeches, Mr. Greenspan banked on the good will of Wall Street to self-regulate as he fended off restrictions.

Ever since housing began to collapse, Mr. Greenspan's record has been up for revision. Economists from across the ideological spectrum have criticized his decision to let the nation's real estate market continue to boom with cheap credit, courtesy of low interest rates, rather than snuffing out price increases with higher rates. Others have criticized Mr. Greenspan for not disciplining institutions that lent indiscriminately.

But whatever history ends up saying about those decisions, Mr. Greenspan's legacy may ultimately rest on a more deeply embedded and much less scrutinized phenomenon: the spectacular boom and calamitous bust in derivatives trading.

Faith in the System

Some analysts say it is unfair to blame Mr. Greenspan because the crisis is so sprawling. "The notion that Greenspan could have generated a totally different outcome is naïve," said Robert E. Hall, an economist at the conservative Hoover Institution, a research group at Stanford.

Mr. Greenspan declined requests for an interview. His spokeswoman referred questions about his record to his memoir, "The Age of Turbulence," in which he outlines his beliefs.

"It seems superfluous to constrain trading in some of the newer derivatives and other innovative financial contracts of the past decade," Mr. Greenspan writes. "The worst have failed; investors no longer fund them and are not likely to in the future."

In his Georgetown speech, he entertained no talk of regulation, describing the financial turmoil as the failure of Wall Street to behave honorably.

"In a market system based on trust, reputation has a significant economic value," Mr. Greenspan told the audience. "I am therefore distressed at how far we have let concerns for reputation slip in recent years."

As the long-serving chairman of the Fed, the nation's most powerful economic policy maker, Mr. Greenspan preached the transcendent, wealth-creating powers of the market.

A professed libertarian, he counted among his formative influences the novelist Ayn Rand, who portrayed collective power as an evil force set against the enlightened self-interest of individuals. In turn, he showed a resolute faith that those participating in financial markets would act responsibly.

An examination of more than two decades of Mr. Greenspan's record on financial regulation and derivatives in particular reveals the degree to which he tethered the health of the nation's economy to that faith.

As the nascent derivatives market took hold in the early 1990s, and in subsequent years, critics denounced an absence of rules forcing institutions to disclose their positions and set aside funds as a reserve against bad bets.

Time and again, Mr. Greenspan — a revered figure affectionately nicknamed the Oracle — proclaimed that risks could be handled by the markets themselves.

"Proposals to bring even minimalist regulation were basically rebuffed by Greenspan and various people in the Treasury," recalled Alan S. Blinder, a former Federal Reserve board member and an economist at Princeton University. "I think of him as consistently cheerleading on derivatives."

Arthur Levitt Jr., a former chairman of the Securities and Exchange Commission, says Mr. Greenspan opposes regulating derivatives because of a fundamental disdain for government.

Mr. Levitt said that Mr. Greenspan's authority and grasp of global finance consistently persuaded less financially sophisticated lawmakers to follow his lead.

"I always felt that the titans of our legislature didn't want to reveal their own inability to understand some of the concepts that Mr. Greenspan was setting forth," Mr. Levitt said. "I don't recall anyone ever saying, 'What do you mean by that, Alan?' "

Still, over a long stretch of time, some did pose questions. In 1992, Edward J. Markey, a Democrat from Massachusetts who led the House subcommittee on telecommunications and finance, asked what was then the General Accounting Office to study derivatives risks.

Two years later, the office released its report, identifying "significant gaps and weaknesses" in the regulatory oversight of derivatives.

"The sudden failure or abrupt withdrawal from trading of any of these large U.S. dealers could cause liquidity problems in the markets and could also pose risks to others, including federally insured banks and the financial system as a whole," Charles A. Bowsher, head of the accounting office, said when he testified before Mr. Markey's committee in 1994. "In some cases intervention has and could result in a financial bailout paid for or guaranteed by taxpayers."

In his testimony at the time, Mr. Greenspan was reassuring. "Risks in financial markets, including derivatives markets, are being regulated by private parties," he said.

"There is nothing involved in federal regulation per se which makes it superior to market regulation."

Mr. Greenspan warned that derivatives could amplify crises because they tied together the fortunes of many seemingly independent institutions. "The very efficiency that is involved here means that if a crisis were to occur, that that crisis is transmitted at a far faster pace and with some greater virulence," he said.

But he called that possibility "extremely remote," adding that "risk is part of life."

Later that year, Mr. Markey introduced a bill requiring greater derivatives regulation. It never passed.

Resistance to Warnings

In 1997, the Commodity Futures Trading Commission, a federal agency that regulates options and futures trading, began exploring derivatives regulation. The commission, then led by a lawyer named Brooksley E. Born, invited comments about how best to oversee certain derivatives.

Ms. Born was concerned that unfettered, opaque trading could "threaten our regulated markets or, indeed, our economy without any federal agency knowing about it," she said in Congressional testimony. She called for greater disclosure of trades and reserves to cushion against losses.

Ms. Born's views incited fierce opposition from Mr. Greenspan and Robert E. Rubin, the Treasury secretary then. Treasury lawyers concluded that merely discussing new rules threatened the derivatives market. Mr. Greenspan warned that too many rules would damage Wall Street, prompting traders to take their business overseas.

"Greenspan told Brooksley that she essentially didn't know what she was doing and she'd cause a financial crisis," said Michael Greenberger, who was a senior director at the commission. "Brooksley was this woman who was not playing tennis with these guys and not having lunch with these guys. There was a little bit of the feeling that this woman was not of Wall Street."

Ms. Born declined to comment. Mr. Rubin, now a senior executive at the banking giant Citigroup, says that he favored regulating derivatives — particularly increasing potential loss reserves — but that he saw no way of doing so while he was running the Treasury.

"All of the forces in the system were arrayed against it," he said. "The industry certainly didn't want any increase in these requirements. There was no potential for mobilizing public opinion."

Mr. Greenberger asserts that the political climate would have been different had Mr. Rubin called for regulation.

In early 1998, Mr. Rubin's deputy, Lawrence H. Summers, called Ms. Born and chastised her for taking steps he said would lead to a financial crisis, according to Mr. Greenberger. Mr. Summers said he could not recall the conversation but agreed with Mr. Greenspan and Mr. Rubin that Ms. Born's proposal was "highly problematic."

On April 21, 1998, senior federal financial regulators convened in a wood-paneled conference room at the Treasury to discuss Ms. Born's proposal. Mr. Rubin and Mr. Greenspan implored her to reconsider, according to both Mr. Greenberger and Mr. Levitt.

Ms. Born pushed ahead. On June 5, 1998, Mr. Greenspan, Mr. Rubin and Mr. Levitt called on Congress to prevent Ms. Born from acting until more senior regulators developed their own recommendations. Mr. Levitt says he now regrets that decision. Mr. Greenspan and Mr. Rubin were "joined at the hip on this," he said. "They were certainly very fiercely opposed to this and persuaded me that this would cause chaos."

Ms. Born soon gained a potent example. In the fall of 1998, the hedge fund Long Term Capital Management nearly collapsed, dragged down by disastrous bets on, among other things, derivatives. More than a dozen banks pooled $3.6 billion for a private rescue to prevent the fund from slipping into bankruptcy and endangering other firms.

Despite that event, Congress froze the Commodity Futures Trading Commission's regulatory authority for six months. The following year, Ms. Born departed.

In November 1999, senior regulators — including Mr. Greenspan and Mr. Rubin — recommended that Congress permanently strip the C.F.T.C. of regulatory authority over derivatives.

Mr. Greenspan, according to lawmakers, then used his prestige to make sure Congress followed through. "Alan was held in very high regard," said Jim Leach, an Iowa Republican who led the House Banking and Financial Services Committee at the time. "You've got an area of judgment in which members of Congress have nonexistent expertise."

As the stock market roared forward on the heels of a historic bull market, the dominant view was that the good times largely stemmed from Mr. Greenspan's steady hand at the Fed.

"You will go down as the greatest chairman in the history of the Federal Reserve Bank," declared Senator Phil Gramm, the Texas Republican who was chairman of the Senate Banking Committee when Mr. Greenspan appeared there in February 1999.

Mr. Greenspan's credentials and confidence reinforced his reputation — helping him to persuade Congress to repeal Depression-era laws that separated commercial and investment banking in order to reduce overall risk in the financial system.

"He had a way of speaking that made you think he knew exactly what he was talking about at all times," said Senator Tom Harkin, a Democrat from Iowa. "He was able to say things in a way that made people not want to question him on anything, like he knew it all. He was the Oracle, and who were you to question him?"

In 2000, Mr. Harkin asked what might happen if Congress weakened the C.F.T.C.'s authority.

"If you have this exclusion and something unforeseen happens, who does something about it?" he asked Mr. Greenspan in a hearing.

Mr. Greenspan said that Wall Street could be trusted. "There is a very fundamental trade-off of what type of economy you wish to have," he said. "You can have huge amounts of regulation and I will guarantee nothing will go wrong, but nothing will go right either," he said.

Later that year, at a Congressional hearing on the merger boom, he argued that Wall Street had tamed risk.

"Aren't you concerned with such a growing concentration of wealth that if one of these huge institutions fails that it will have a horrendous impact on the national and global economy?" asked Representative Bernard Sanders, an independent from Vermont.

"No, I'm not," Mr. Greenspan replied. "I believe that the general growth in large institutions have occurred in the context of an underlying structure of markets in which many of the larger risks are dramatically — I should say, fully — hedged."

The House overwhelmingly passed the bill that kept derivatives clear of C.F.T.C. oversight. Senator Gramm attached a rider limiting the C.F.T.C.'s authority to an 11,000-page appropriations bill. The Senate passed it. President Clinton signed it into law.

Pressing Forward

Still, savvy investors like Mr. Buffett continued to raise alarms about derivatives, as he did in 2003, in his annual letter to shareholders of his company, Berkshire Hathaway.

"Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers," he wrote. "The troubles of one could quickly infect the others."

But business continued.

And when Mr. Greenspan began to hear of a housing bubble, he dismissed the threat. Wall Street was using derivatives, he said in a 2004 speech, to share risks with other firms.

Shared risk has since evolved from a source of comfort into a virus. As the housing crisis grew and mortgages went bad, derivatives actually magnified the downturn.

The Wall Street debacle that swallowed firms like Bear Stearns and Lehman Brothers, and imperiled the insurance giant American International Group, has been driven by the fact that they and their customers were linked to one another by derivatives.

In recent months, as the financial crisis has gathered momentum, Mr. Greenspan's public appearances have become less frequent.

His memoir was released in the middle of 2007, as the disaster was unfolding, and his book tour suddenly became a referendum on his policies. When the paperback version came out this year, Mr. Greenspan wrote an epilogue that offers a rebuttal of sorts.

"Risk management can never achieve perfection," he wrote. The villains, he wrote, were the bankers whose self-interest he had once bet upon.

"They gambled that they could keep adding to their risky positions and still sell them out before the deluge," he wrote. "Most were wrong."

No federal intervention was marshaled to try to stop them, but Mr. Greenspan has no regrets.

"Governments and central banks," he wrote, "could not have altered the course of the boom." □

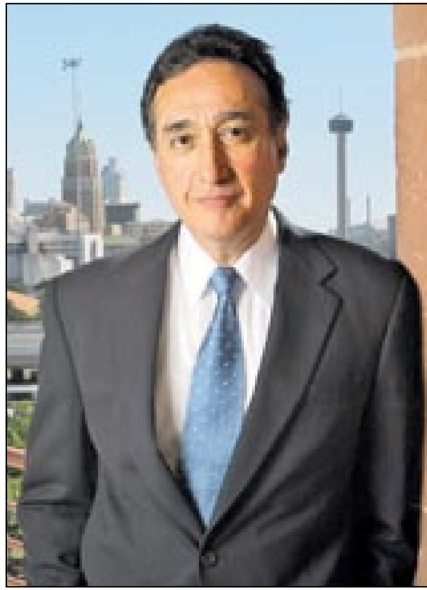
Building Flawed American Dreams

By DAVID STREITFELD
and GRETCHEN MORGENSON
FIRST PUBLISHED: OCTOBER 19, 2008

SAN ANTONIO — A grandson of Mexican immigrants and a former mayor of this town, Henry G. Cisneros has spent years trying to make the dream of homeownership come true for low-income families.

As the Clinton administration's top housing official in the mid-1990s, Mr. Cisneros loosened mortgage restrictions so first-time buyers could qualify for loans they could never get before.

Then, capitalizing on a housing expansion he helped unleash, he joined the boards of a major builder, KB Home, and the largest mortgage lender in the nation, Countrywide Financial — two companies that rode the housing boom, drawing criticism along the way for abusive business practices.



ERICH SCHLEGEL FOR THE NEW YORK TIMES

"There's never been a better time in America to become a homeowner."

— HENRY G. CISNEROS, 2003

Secretary of Housing and Urban Development, 1993-97, and former member of the boards of KB Home and Countrywide Financial

And Mr. Cisneros became a developer himself. The Lago Vista development here in his hometown once stood as a testament to his life's work.

Joining with KB, he built 428 homes for low-income buyers in what was a neglected, industrial neighborhood. He often made the trip from downtown to ask residents if they were happy.

"People bought here because of Cisneros," says Celia Morales, a Lago Vista resident. "There was a feeling of, 'He's got our back.' "

But Mr. Cisneros rarely comes around anymore. Lago Vista, like many communities born in the housing boom, is now under stress. Scores of homes have been foreclosed, including one in five over the last six years on the community's longest street, Sunbend Falls, according to property records.

While Mr. Cisneros says he remains proud of his work, he has misgivings over what his passion has wrought. He insists that the worst problems developed only after "bad actors" hijacked his good intentions but acknowledges that "people came to homeownership who should not have been homeowners."

They were lured by "unscrupulous participants — bankers, brokers, secondary market people," he says. "The country is paying for that, and families are hurt because we as a society did not draw a line."

> Helping low-income families buy homes and watching the failures

The causes of the housing implosion are many: lax regulation, financial innovation gone awry, excessive debt, raw greed. The players are also varied: bankers, borrowers, developers, politicians and bureaucrats.

Mr. Cisneros, 61, had a foot in a number of those worlds. Despite his qualms, he encouraged the unprepared to buy homes — part of a broad national trend with dire economic consequences.

He reflects often on his role in the debacle, he says, which has changed homeownership from something that secured a place in the middle class to something that is ejecting people from it. "I've been waiting for someone to put all the blame at my doorstep," he says lightly, but with a bit of worry, too.

The Paydays During the Boom

After a sex scandal destroyed his promising political career and he left Washington, he eventually reinvented himself as a well-regarded advocate and builder of urban, working-class homes. He has financed the construction of more than 7,000 houses.

For the three years he was a director at KB Home, Mr. Cisneros received at least $70,000 in pay and more than $100,000 worth of stock. He also received $1.14 million in directors' fees and stock grants during the six years he was a director at Countrywide. He made more than $5 million from Countrywide stock options, money he says he plowed into his company.

He says his development work provides an annual income of "several hundred thousand" dollars. All told, his paydays are modest relative to the windfalls some executives netted in the boom. Indeed, Mr. Cisneros says his mistake was not the greed that afflicted many of his counterparts in banking and housing; it was unwavering belief.

It was, he argues, impossible to know in the beginning that the federal push to increase homeownership would end so badly. Once the housing boom got going, he suggests, laws and regulations barely had a chance.

"You think you have a finely tuned instrument that you can use to say: 'Stop! We're at 69 percent homeownership. We should not go further. There are people who should remain renters,' " he says. "But you really are just given a sledgehammer and an ax. They are blunt tools."

From people dizzily drawing home equity loans out of increasingly valuable houses to banks racking up huge fees, few wanted the party to end.

"I'm not sure you can regulate when we're talking about an entire nation of 300 million people and this behavior becomes viral," Mr. Cisneros says.

Homeownership has deep roots in the American soul. But until recently getting a mortgage was a challenge for low-income families. Many of these families were minorities, which naturally made the subject of special interest to Mr. Cisneros, who, in 1993, became the first Hispanic head of the Department of Housing and Urban Development.

He had President Clinton's ear, an easy charisma and a determination to increase a homeownership rate that had been stagnant for nearly three decades.

Thus was born the National

ERICH SCHLEGEL FOR THE NEW YORK TIMES

Henry Cisneros in his office in San Antonio with Sylvia Arce-Garcia, an executive assistant. He is the head of CityView, a developer.

Homeownership Strategy, which promoted ownership as patriotic and an easy win for all. "We were trying to be creative," Mr. Cisneros recalls.

Under Mr. Cisneros, there were small and big changes at HUD, an agency that greased the mortgage wheel for first-time buyers by insuring billions of dollars in loans. Families no longer had to prove they had five years of stable income; three years sufficed.

And in another change championed by the mortgage industry, lenders were allowed to hire their own appraisers rather than rely on a government-selected panel. This saved borrowers money but opened the door for inflated appraisals. (A later HUD inquiry uncovered appraisal fraud that imperiled the federal mortgage insurance fund.)

"Henry did everything he could for home builders while he was at HUD," says Janet Ahmad, president of Homeowners for Better Building, an advocacy group in San Antonio, who has known Mr. Cisneros since he was a city councilor. "That laid the groundwork for where we are now."

Mr. Cisneros, who says he has no recollection that appraisal rules were relaxed when he ran HUD, disputes that notion. "I look back at HUD and feel my hands were clean," he says.

Lenders applauded two more changes HUD made on Mr. Cisneros's watch: they no longer had to interview most government-insured borrowers face to face or maintain physical branch offices. The industry changed, too. Lenders sprang up to serve those whose poor credit history made them ineligible for lower-interest "prime" loans. Countrywide, which Angelo R. Mozilo co-founded in 1969, set up a subprime unit in 1996.

Mr. Cisneros met Mr. Mozilo while he was HUD secretary, when Countrywide signed a government pledge to use "proactive creative efforts" to extend homeownership to minorities and low-income Americans.

He met Bruce E. Karatz, the chief executive of KB Home, when both were helping Los Angeles rebuild after the Northridge earthquake in 1994.

There were real gains during the Clinton years, as homeownership rose to 67.4 percent in 2000 from 64 percent in 1994. Hispanics and African-Americans were the biggest beneficiaries. But as the boom later gathered steam, and as the Bush administration continued the Clinton administration's push to amplify homeownership, some of those gains turned out to be built on sand.

Mr. Cisneros left government in 1997 after revelations that he had lied to federal investigators about payments to a former mistress. In the following years, HUD continued to draw attention in the news media and among consumer advocates for an overly lenient posture toward the housing industry.

In 2000, Mr. Cisneros returned to San Antonio, where he formed American CityVista, a developer, in partnership with KB, and became a KB director. KB's board also included James A. Johnson, a prominent Democrat and the former chief executive of Fannie Mae, the mortgage giant now being run by the government. Mr. Johnson did not return a phone call seeking comment.

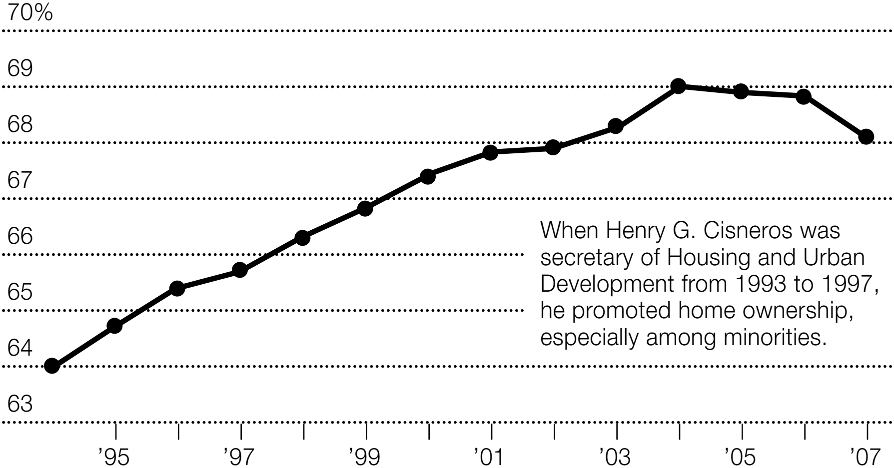
It made for a cozy network. Fannie bought or backed many mortgages received by home buyers in the KB Home/American CityVista partnership. And Fannie's biggest mortgage client was Countrywide, whose board Mr. Cisneros had joined in 2001.

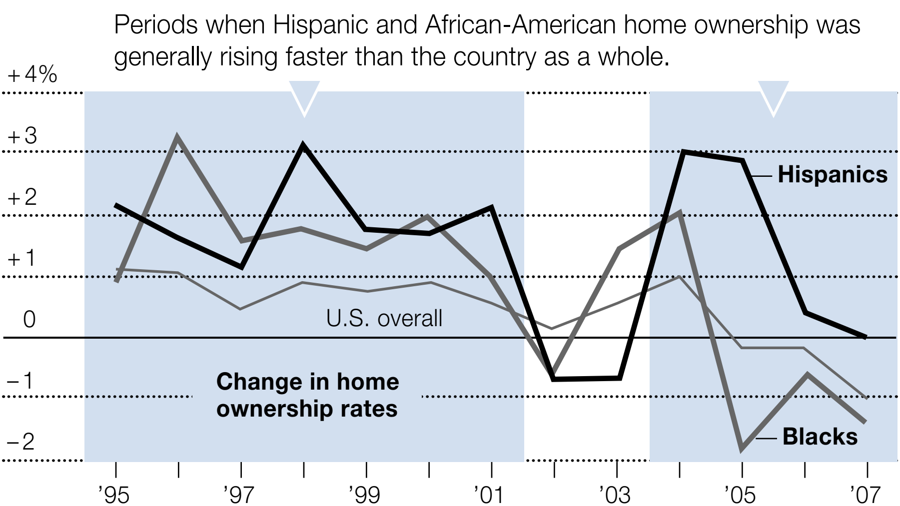
Because American CityVista was privately held, Mr. Cisneros's earnings are not disclosed. He held a 65 percent stake, and KB had the rest. In 2002, KB paid $1.24 million to American CityVista for "services rendered."

'A Little Too Ambitious'

One of American CityVista's first projects, unveiled in late 2000, was Lago Vista — Spanish for "Lake View." The location was unusual: San Antonio's proud and insular South Side, a Hispanic area home to secondhand car dealers, light industry and pawnshops.

United States Home Ownership Rates





Source: Census Bureau

THE NEW YORK TIMES

Mr. Cisneros and KB pledged to transform an overgrown patch of land into a showcase. Homes were initially priced from $70,000 to about $95,000, and Mr. Cisneros promised that Lago Vista would be ringed with jogging paths and maple trees.

The paths were never built, and few trees provide shade from the Texas sun. The adjoining "lake" — at one point a runoff pit for an asphalt plant — is fenced off, a hazard to neighborhood children. The houses are gaily painted in pink, blue, yellow or tan, and most owners keep their yards green and tidy.

KB considers Lago Vista a "model community," a spokeswoman said.

To get things rolling in Lago Vista, traditional bars to homeownership were lowered to the ground. Fannie Mae, CityVista and KB promoted a program allowing police officers, firefighters, teachers and others to get loans with nothing down and no closing costs.

KB marketed its developments in videos. In one from 2003, Mr. Karatz declared: "One of the greatest misconceptions today is people who sit back and think, 'I can't afford to buy.' " Mr. Cisneros appeared — identified as a former HUD director — saying the time was ripe to buy a home. Many agreed.

Victor Ramirez and Lorraine Pulido-Ramirez bought a house in Lago Vista in 2002. "This was our first home. I had nothing to compare it to," Mr. Ramirez says. "I was a student making $17,000 a year, my wife was between jobs. In retrospect, how in hell did we qualify?"

The majority of buyers in Lago Vista "were duped into believing it was easier than it was," Mr. Ramirez says. "The attitude was, 'Sign here, sign here, don't read the fine print.' " He added that some fault lay with buyers: "We were definitely willing victims." (The Ramirez family veered close to foreclosure, but the couple now have good jobs and can make their payments.)

KB and Mr. Cisneros eventually built more than a dozen developments, primarily in Texas. But the shine slowly came off Lago Vista.

"It started off fabulously," Mr. Karatz recalled. Then sales slowed considerably. "It was probably, looking back, a little too ambitious to think that there would be sufficient local demand."

And then the foreclosures started. "A lot of people got approved for big amounts," says Patricia Flores, another Lago Vista homeowner. "They bit off more than they could chew." Families split up under the strain of mortgage payments. One residence had so much marital turmoil that neighbors nicknamed it "The House of Broken Love."

Some homes were taken over and sold at a loss by HUD, which had insured them. KB was also a mortgage lender, a business many home builders pursued because it was so profitable. At times, it was also problematic.

Officials at HUD uncovered problems with KB's lending. In 2005, about two years after Mr. Cisneros left the KB board, the agency filed an administrative action against KB for approving loans based on overstated or improperly documented borrower income, and for charging excessive fees. Because HUD does not specify where improprieties take place, it is not clear if this occurred at Lago Vista.

KB Home paid $3.2 million to settle the HUD action without admitting liability or fault, one of the largest settlements collected by the agency's mortgagee review board. Shortly afterward, KB sold its lending unit to Countrywide. Then they set up a joint venture: KB installed Countrywide sales representatives in its developments.

By 2007, almost three-quarters of the loans to KB buyers were made by the joint venture. In Lago Vista, residents secured loans from a spectrum of federal agencies and lenders.

During years of heady growth, and then during a deep financial slide, Countrywide became a lightning rod for criticism about excesses and abuses leading to the housing bust — which Countrywide routinely brushed off.

Mr. Cisneros says he was never aware of improprieties at

KB or Countrywide, and worked with them because he was impressed by Mr. Karatz and Mr. Mozilo. Mr. Mozilo could not be reached for comment.

Still, Countrywide expanded subprime lending aggressively while Mr. Cisneros served on its board. In September 2004, according to documents provided by a former employee, lending audits in six of Countrywide's largest regions showed about one in eight loans was "severely unsatisfactory" because of shoddy underwriting.

HUD required such audits and lenders were expected to address problems. Mr. Cisneros was a member of the Countrywide committee that oversaw compliance with legal and regulatory requirements. But he says he did not recall seeing or receiving the reports.

Nor, he says, was there ever a board vote about the wisdom of subprime lending.

"The irresistible temptation to engage in subprime was Countrywide's fatal error," he says. "I fault myself for not having seen it and, since it was not something I could change, having left."

Mr. Cisneros left Countrywide's board last year. At the time, he expressed "enormous confidence in the leadership." In 2003, Mr. Cisneros ended his partnership with KB because, he says, he felt constrained working with just one builder. He formed a new company with the same mission, CityView, that has raised $725 million.

Mr. Karatz has a different recollection of why the partnership ended.

"It didn't become an important part of KB's business," he says. "It was profitable but I don't think as profitable in those initial years as Henry's group wanted it to be."

Troubles in Lago Vista

Today in Lago Vista, many are just trying to get by. Residents say crime has risen, and with association dues unpaid, they cannot hire security. Salvador Gutierrez, a truck driver, woke up recently to see four men stealing the tires off his pickup. Seventeen houses are for sale, but there are few buyers.

Hugo Martinez, who got a pair of Countrywide loans to buy a two-bedroom house with no down payment, recently lost his job with a car dealership. He has a lower-paying job as a mechanic and can't refinance or sell his house.

"They make it easy when you buy," Mr. Martinez says. "But after a while, the interest rate goes up. KB Home says they cannot help us at all."

Five years ago, Carlo Lee and Patricia Reyes bought their first home, a three-bedroom house in Lago Vista.

After Mrs. Reyes became ill last year and lost her job, they fell behind on their payments. Last month, Mr. Reyes was laid off from one of his jobs, assembling cabinets. He still works part time at a hospital, but unless the couple come up with missed payments and fees, they will lose their home.

"Everyone isn't happy here in Lago Vista," Mr. Reyes says. "Everyone has a lot of problems."

Countrywide was bought recently at a fire-sale price by Bank of America. Mr. Cisneros describes Mr. Mozilo as "sick with stress — the final chapter of his life is the infamy that's been brought on him, or that he brought on himself."

Mr. Karatz was forced out of KB two years ago amid a compensation scandal. Last month, without admitting or denying the allegations, he settled government charges that he illegally backdated stock options worth $6 million.

For his part, Mr. Cisneros says he is proud of Lago Vista. "It is inaccurate to say that we put people into homes that they couldn't afford," he says. "No one was forcing people into homes."

He also remains bullish on home building, despite the current carnage.

"We're not selling cigarettes," he says. "We're not drawing people into casino gambling. We're building the homes they're going to raise their families in. □

David Streitfeld reported from San Antonio, and Gretchen Morgenson from New York.

Struggling to Keep Up As the Crisis Raced On

"I feel like Butch Cassidy and the Sundance Kid. Who are these guys that just keep coming?"

— Treasury Secretary Henry Paulson Jr.

By JOE NOCERA and EDMUND L. ANDREWS

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TODD HEISLER/THE NEW YORK TIMES

Henry M. Paulson Jr. says he could not have made the Fed rescue Lehman Brothers.

IT WAS THE WEEKEND of Sept. 13, and the moment Treasury Secretary Henry M. Paulson Jr. had feared for months was finally upon him: Lehman Brothers was hurtling toward bankruptcy — fast.

Knowing that Lehman had billions of dollars in bad investments on its books, Mr. Paulson had long urged Lehman's chief executive, Richard S. Fuld Jr., to find a solution for his firm's problems. "He was asked to aggressively look for a buyer," Mr. Paulson recalled in an interview.

But Lehman could not — despite what Mr. Paulson described as personal pleas to other firms to buy some of Lehman's toxic assets and efforts to persuade another bank to acquire Lehman. With all options closed, he said, the government's hands were tied. Although the Federal Reserve had helped bail out Bear Stearns — and was within days of bailing out the giant insurer

American International Group — it could not help Lehman, even as its default threatened to wreak havoc on financial markets.

"We didn't have the powers," Mr. Paulson insisted, explaining a decision that many have since criticized — to allow Lehman to go bankrupt. By law, he continued, the Federal Reserve could bail out Lehman with a loan only if the bank had enough good assets to serve as collateral, which it did not.

"If someone thinks Hank Paulson could have made the Fed save Lehman Brothers, the answer is, 'No way,' " he said.

But that is not the way that many who have scrutinized his actions see it. Bankers involved say they do not recall Mr. Paulson talking about Lehman's impaired collateral. And they said that buyers walked away for one reason: because they could not get the same kind of government backing that facilitated the Bear Stearns deal. In retrospect, they added, it was emblematic of the miscalculations by the government in reacting to the crisis.

The day after Lehman collapsed, the Fed saved A.I.G. with an emergency $85 billion loan, but the credit markets around the world began freezing up anyway. It was at this point that Mr. Paulson — feeling outgunned by pursuers, like Butch and Sundance — decided he had to find a systemic solution and stop lurching from crisis to crisis, fixing one company's problems only to find several more right behind.

"Ben said, 'Will you go to Congress with me?' " said Mr. Paulson, referring to the Federal Reserve chairman, Ben S. Bernanke. "I said: 'Fine, I'm your partner. I'll go to Congress.' "

Seeing a Problem Earlier

In nearly a century, no Treasury secretary has faced a more difficult financial crisis than that Mr. Paulson is contending with. For months, he and his team have been working around the clock, often seven days a week, trying — in vain — to keep it from deepening. In an hourlong interview with The New York Times, Mr. Paulson defended Treasury's actions, saying that he and his aides had done everything they could, given the deep-rooted problems of financial excess that had built up over the past decade.

"I could have seen the subprime problem coming earlier," he acknowledged in the interview, quickly adding in his own defense, "but I'm not saying I would have done anything differently."

History will be the final judge. But in contrast with Mr. Paulson's perspective, other government officials and financial executives suggest that Treasury's epic rescue efforts have evolved as chaotically as the crisis itself. Especially in the past month, as the financial system teetered on the abyss, questions have been raised about the government's — and Mr. Paulson's — decisions. Executives on Wall Street and officials in European financial capitals have criticized Mr.

TODD HEISLER/THE NEW YORK TIMES

Henry Paulson said the risk of the credit crisis became clear only this year. Before, he said, "we thought there was a reasonable chance of getting through this."

Paulson and Mr. Bernanke for allowing Lehman to fail, an event that sent shock waves through the banking system, turning a financial tremor into a tsunami.

"For the equilibrium of the world financial system, this was a genuine error," Christine Lagarde, France's finance minister, said recently. Frederic Oudea, chief executive of Société Générale, one of France's biggest banks, called the failure of Lehman "a trigger" for events leading to the global crash. Willem Sels, a credit strategist with Dresdner Kleinwort, said that "it is the clear that when Lehman defaulted, that is the date your money markets freaked out. It is difficult to not find a causal relationship."

In addition, Mr. Paulson and Mr. Bernanke have been criticized for squandering precious time and political capital with their original $700 billion bailout plan, which they presented to Congressional leaders days after the Lehman bankruptcy. The two men sold the plan as a vehicle for purchasing toxic mortgage-backed securities from banks and others.

But even after the House finally passed the bill on Oct. 3, markets remained in turmoil. It was not until Britain and other European countries moved to put capital directly into their banks, and the United States followed their lead, that some calm returned.

In the interview, Mr. Paulson said that even before the House acted, he had directed his staff to start drawing up a plan for using some of the $700 billion to recapitalize the banking system — something that Congress was never told and that he had publicly opposed.

Why? Because in the week before the plan passed Congress, conditions deteriorated significantly, Mr. Paulson said.

But many complain the worst of the turmoil might have been avoided if it hadn't been for Mr. Paulson sticking with an original bailout plan that they viewed as poorly conceived and unworkable. "They were asking the most basic questions," said one Wall Street executive who spoke to Treasury officials after the bailout bill was passed. "It was clear they hadn't thought it through." Senator Charles E. Schumer, Democrat of New York, who had called for an infusion of capital into banks in mid-September, said, "They are so much more on top of this recapitalization plan than they were about the auction plan."

Even as he defended his actions, Mr. Paulson said he was worried that some of the government's moves could wind up haunting future Treasury secretaries. He pointed in particular to the decision to guarantee all bank deposits and interbank loans, something the United States did to keep pace with similar decisions in Europe. "We had to," Mr. Paulson said. "Our banks would not have been able to compete."

But the federal guarantees could create "moral hazard" and simply encourage banks to take on dangerous risk, he acknowledged. "This is the last thing I wanted to do," he said.

Summer of Eroding Conditions

The subprime mortgage debacle began emerging in the summer of 2007, about a year after Mr. Paulson left his job as head of Goldman Sachs and joined the Bush administration. But the true depth and extent of the losses did not become clear until earlier this year, Mr. Paulson said.

"We thought there was a reasonable chance of getting through this," he recalled.

Then came the near failure in March of Bear Stearns, which was rescued in a takeover by JPMorgan Chase only after the Fed agreed to cover $29 billion in losses. That briefly lulled the markets into thinking the worst might be over. But during the summer, conditions deteriorated, and in early September the government was forced to take over Fannie Mae and Freddie Mac, the mortgage finance giants.

With increasing speed, other problems emerged, most notably Lehman and A.I.G., which was also burdened with bad mortgage-related investments. Both became the focus of intense meetings the weekend of Sept. 13-14.

Mr. Paulson, by then, had become frustrated with what he perceived as Mr. Fuld's foot-dragging. "Lehman announced bad earnings around the middle of June, and we told Fuld that if he didn't have a solution by the time he announced his third-quarter earnings, there would be a serious problem," Mr. Paulson said. "We pressed him to get a buyer."

Here the views of Mr. Paulson and his critics start to diverge, over what transpired in marathon meetings with Wall Street executives at the Federal Reserve Bank of New York that weekend.

Lehman officials said they believed the firm had not one but two potential buyers: Bank of America and Barclays, the big British bank. But both had conditions. Bank of America wanted the Fed to make a $65 billion loan to cover any exposure to Lehman's bad assets, according to one person privy to the discussions who did not want to be identified because of their sensitive nature. Although this was more than double what the Fed had made available to facilitate the takeover of Bear Stearns by JPMorgan, Bank of America justified the request on the grounds that Lehman was larger.

Barclays also wanted a guarantee to protect against losses should Lehman's business worsen before Barclays could compete its takeover.

The government initially was not clear in telling Bank of America and Barclays that no help would be forthcoming, participants said. The New York Fed president, Timothy F. Geithner, in particular, was uncomfortable about drawing a line in the sand against government support for a Lehman takeover. Participants said they were left with the impression from Mr. Paulson and Mr. Geithner that the government might well provide help for a serious buyer, with Mr. Paulson also trying to get Wall Street firms to create a $10 billion fund to absorb some of Lehman's bad assets.

It remains unclear whether a more consistent message would have changed the outcome. But by Saturday, Bank of America, frustrated by the government's unwillingness to commit to a deal, turned its attention to Merrill Lynch, which agreed to a takeover. Barclays, equally frustrated, walked away on Sunday, said the person with knowledge of the discussions.

Mr. Paulson said in the interview that Treasury was not at fault. The $10 billion industry fund had not worked because executives in the room realized that bailing out Lehman would not end the crisis. There were too many other firms that needed help. "I didn't want to see Lehman go," Mr. Paulson said. "I understood the consequences better than anybody."

At a White House briefing on Sept. 15, Mr. Paulson shed no tears over Lehman's failure. "I never once considered it appropriate to put taxpayer money on the line in resolving Lehman Brothers," he told reporters.

In the interview, however, Mr. Paulson said the main issue was whether it was legal. Under the law, the Fed has the authority to lend to any nonbank, but only if the loan is "secured to the satisfaction of the Federal Reserve bank." When pressed about why it was legal for the Fed to lend billions of dollars to Bear Stearns and A.I.G. but not Lehman Brothers, Mr. Paulson emphasized that Lehman's bad assets created "a huge hole" on its balance sheet. By contrast, he said, Bear Stearns and A.I.G. had more trustworthy collateral.

People close to Lehman, however, say it was never told this by the government. "The Fed and the S.E.C. had their people on site at Lehman during 2008," said a person in the Lehman camp. "The government saw everything in real time involving Lehman's liquidity, funding, capital, risk management and marks — and never expressed any concerns about collateral or a hole in the balance sheet."

The aftermath of the Lehman bankruptcy was disastrous. "Lehman was one of the single largest issuers of commercial paper in the world," said Joshua Rosner, a managing director at Graham Fisher & Company, referring to short-term debt issued by companies to finance day-to-day operations; this market locked up in the wake of Lehman's failure. "How could you let it go bankrupt and not expect the commercial paper market to be completely crushed?" Why Bear Stearns but not Lehman, wonders Representative Barney Frank. Mr. Frank, Democrat of Massachusetts and chairman of the House Financial Services Committee, has generally been a supporter of Mr. Paulson during the crisis. "If it was the right thing to do, why did they do it only once?" he asked.

In response, Mr. Paulson said that only now that the bailout bill has been passed does the government have the authority to intervene in a nonbank failure in cases of firms that lack adequate collateral, like Lehman.

A Difficult Sell

Lehman's failure was followed by another strategic misstep by Treasury, critics say. They assert that Mr. Paulson initially pushed the wrong systemic fix: a bailout plan that revolved around buying up toxic securities, rather than putting capital into the banking system, a far more direct way of providing assistance.

Mr. Paulson rejects this view. In the interview, he cited several reasons he and Mr. Bernanke concentrated initially on purchasing distressed assets. First, he said, this plan had been in the works for months and was much further developed. "If we had felt going in that the right way to deal with the problem was to put equity in, we would have taken some time and developed a program," he said.

He also worried that Congress would not be receptive to the idea of Treasury taking an ownership stake in banks: "This is a very complicated and difficult sell. We want to put equity in, but we don't want to nationalize the banks. And I don't know how to sell that."

But he doesn't dispute that he changed direction. Mr. Paulson said that by Oct. 2, as he was departing for a weekend getaway to an island with his family — his first weekend off in nearly two months — he told his staff, "We are going to put capital into banks first."

Although the bailout bill still had not passed, the financial markets had deteriorated. He did not, however, inform Congress of his change of heart, and the House debate revolved almost entirely around the asset-purchase plan.

Just 11 days later, Treasury had come up with a plan to inject capital into the banks — which Mr. Paulson sold to the nation's nine largest financial institutions on Oct. 13. "I can imagine being dinged for some things," he said, "but not for moving that quickly."

He also defended Treasury's recapitalization plan against critics who say that he did not extract a high enough price from the banks getting taxpayers' money. "I could not see the United States doing things like putting in capital on a punitive basis that hurts investors. And we don't want to run banks."

The Global Extent

Asked what he might have done better, Mr. Paulson replied, "I could have made a better case to the public."

He added, "I never felt worse than when the House voted no" on the bailout plan Sept. 26, its initial rejection before ultimately passing the plan.

As for Lehman, Mr. Paulson insisted that it was "a symptom and not a cause" of the financial meltdown that took place in recent weeks. The real problem, he contended, is that banks all over the world made wrong-headed loans that have now come back to haunt them. After meeting recently with European central bankers, he said, "the thing that took your breath away was the extent of the problem. Look at country after country that said they didn't have a problem, and it turned out they had a huge problem."

Mr. Paulson added, "No one will, 10 years from now, write the story that this crisis was about Lehman Brothers going down." □

Nelson D. Schwartz and Stephen Labaton contributed reporting.

From Midwest to M.T.A., Pain From Global Gamble

"People come up to me in the grocery store and say, 'How did we get suckered into this?'"

— Marc Hujik, of the Kenosha, Wis., school board

By CHARLES DUHIGG and CARTER DOUGHERTY

FIRST PUBLISHED: NOVEMBER 2, 2008

ON A SNOWY DAY two years ago, the school board in Whitefish Bay, Wis., gathered to discuss a looming problem: how to plug a gaping hole in the teachers' retirement plan.

It turned to David W. Noack, a trusted local investment banker, who proposed that the district borrow from overseas and use the money for a complex investment that offered big profits.

"Every three months you're going to get a payment," he promised, according to a tape of the meeting. But would it be risky? "There would need to be 15 Enrons" for the district to lose money, he said.

ASHLEY GILBERTSON FOR THE NEW YORK TIMES

"This is something I'll regret until the day I die," said Shawn Yde of the Whitefish Bay schools.

The board and four other nearby districts ultimately invested

$200 million in the deal, most of it borrowed from an Irish bank. Without realizing it, the schools were imitating hedge funds.

Half a continent away, New York subway officials were also being wooed by bankers. Officials were told that just as home buyers had embraced adjustable-rate loans, New York could save money by borrowing at lower interest rates that changed every day.

For some of the deals, the officials were encouraged to rely on the same Irish bank as the Wisconsin schools.

During the go-go investing years, school districts, transit agencies and other government entities were quick to jump into the global economy, hoping for fast gains to cover growing pension costs and budgets without raising taxes. Deals were arranged by armies of persuasive financiers who received big paydays.

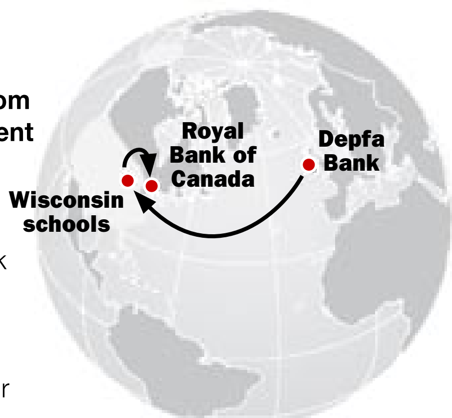
But now, hundreds of cities and government agencies are

All Connected: How a Crisis Spread Far and Wide

1 2 3 4 NEXT

Wisconsin schools borrowed from an Irish bank to buy an investment managed by a Canadian bank.

In 2006, five Wisconsin school districts borrowed from Depfa Bank and invested in what they believed were high-grade bonds managed by the Royal Bank of Canada. The districts were hoping to bolster their retirement funds.



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facing economic turmoil. Far from being isolated examples, the Wisconsin schools and New York's transportation system are among the many players in a financial fiasco that has ricocheted globally.

The Wisconsin schools are on the brink of losing their money, confronting educators with possible budget cuts. Interest rates for New York's subways are skyrocketing and contributing to budget woes that have transportation officials considering higher fares and delaying long-planned track repairs.

And the bank at the center of the saga, named Depfa, is now in trouble, threatening the stability of its parent company in Munich and forcing German officials to intervene with a multibillion-dollar bailout to stop a chain reaction that could freeze Germany's economic system.

"I am really worried," said Becky Velvikis, a first-grade teacher at Grewenow Elementary in Kenosha, Wis., one of the

All Connected: How a Crisis Spread Far and Wide

1 | 2 | 3 | 4 | NEXT

But the investment was more complicated and risky than the schools realized.

The schools' money was actually used as insurance on $20 billion in corporate bonds – a promise to pay bondholders if corporations failed to pay their debts. The investment was registered in the Cayman Islands and managed by the Canadian bank, ACA and UBS.

THE NEW YORK TIMES

districts that invested in Mr. Noack's deal. "If millions of dollars are gone, what happens to my retirement? Or the construction paper and pencils and supplies we need to teach?"

The trail through Wisconsin, New York and Europe illustrates how this financial crisis has moved around the world so fast, why it is so hard to tame, and why cities, schools and many other institutions will probably struggle for years.

"The local papers and radio shows call us idiots, and now when I go home, my kids ask me, 'Dad, did you do something wrong?' " said Shawn Yde, the director of business services in the Whitefish Bay district. "This is something I'll regret until the day I die."

Selling Risk

Whitefish Bay's school district did not intend to become a hedge fund. It and four nearby districts were just trying to finance retirement obligations

All Connected: How a Crisis Spread Far and Wide

1 2 3 4 NEXT

Losses by the schools contributed to a financial crisis at the Irish bank and its German owner.

The investment started going bad earlier this year, and the schools indicated they would likely not repay Depfa. That and other woes caused a crisis at the bank. Its parent, Hypo Real Estate, received a $75 billion bailout from Germany this fall.

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that were growing as health care costs rose.

Mr. Noack, the local representative of Stifel, Nicolaus & Company, a St. Louis investment bank, had been advising Wisconsin school boards for two decades, helping them borrow for new gymnasiums and classrooms. His father had taught at an area high school for 47 years. All six of his children attended Milwaukee schools.

Mr. Noack told the Whitefish Bay board that investing in the global economy carried few risks, according to the tape.

"What's the best investment? It's called a collateralized debt obligation," or a C.D.O., Mr. Noack said. He described it as a collection of bonds from 105 of the most reputable companies that would pay the school board a small return every quarter.

"We're being very conservative," Mr. Noack told the board, composed of lawyers, salesmen and a homemaker who lived in the affluent Milwaukee suburb.

All Connected: How a Crisis Spread Far and Wide

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Troubles spread to local government investors with bonds guaranteed by the Irish bank.

Depfa had also guaranteed dozens of bonds issued by entities like the Metropolitan Transportation Authority in New York. As Depfa's troubles mounted, those guarantees became more expensive. The agencies must pay penalties to Depfa.

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Soon, Whitefish Bay and the four other districts borrowed $165 million from Depfa and contributed $35 million of their own money to purchase three C.D.O.'s sold by the Royal Bank of Canada, which had a relationship with Mr. Noack's company.

But Mr. Noack's explanation of a C.D.O. was very wrong. Mr. Noack, who through his lawyer declined to comment, had attended only a two-hour training session on C.D.O.'s, he told a friend.

The schools' $200 million was actually used as collateral for a complicated form of insurance guaranteeing about $20 billion of corporate bonds. That investment — known as a synthetic C.D.O. — committed the boards to paying off other bondholders if corporations failed to honor their debts.

If just 6 percent of the bonds insured went bad, the Wisconsin educators could lose all their money. If none of the bonds defaulted, the schools would receive about $1.8 million a year after paying off their own debt. By comparison, the C.D.O.'s offered only a modestly better return than a $35 million investment in ultra-safe Treasury bonds, which would have paid about $1.5 million a year, with virtually no risk.

The boards, as part of their deal, received thick packets of documents.

"I've never read the prospectus," said Marc Hujik, a local financial adviser and a member of the Kenosha school board who spent 13 years on Wall Street. "We had all our questions answered satisfactorily by Dave Noack, so I wasn't worried."

Wisconsin schools were not the only ones to jump into such complicated financial products. More than $1.2 trillion of C.D.O.'s have been sold to buyers of all kinds since 2005 — including many cities and government agencies — an increase of 270 percent from the four previous years combined, according to Thomson Reuters.

"Selling these products to municipalities was pretty widespread," said Janet Tavakoli, a finance industry consultant in Chicago. "They tend to be less sophisticated. So bankers sell them products stuffed with junk."

From the Wisconsin deal, the Royal Bank of Canada received promises of payments totaling about $11.2 million, according to documents. Stifel Nicolaus made about $1.2 million. Mr. Noack's total salary was about $300,000 a year, according to someone with knowledge of his finances. And Depfa received interest on its loans.

In separate statements, the Royal Bank of Canada and Stifel Nicolaus said board members signed documents indicating they understood the investments' risks. Both companies said they were not financial advisers to the boards but merely sold them products or services. Stifel Nicolaus said its relationship with the boards ended in 2007. Mr. Noack now works for a rival firm.

"Everyone knew New York guys were making tons of money on these kinds of deals," said Mr. Hujik, of the school board. "It wasn't implausible that we could make money, too."

A Bank Goes Global

By the time Depfa financed the Wisconsin schools' investment, it had already become an emblem of the new global economy. It was founded 86 years ago as a sleepy German lender, and for most of its history had focused on its home market.

But in 2002 a new chief executive, Gerhard Bruckermann, moved Depfa to the freewheeling financial center of Dublin to take advantage of low corporate taxes. He soon pushed the company into São Paulo, Mumbai, Warsaw, Hong Kong, Dallas, New York, Tokyo and elsewhere. Depfa became one of Europe's most profitable banks and was famous for lavish events and large paychecks. In 2006, top executives took home the equivalent of $33 million at today's exchange rates.

Mr. Bruckermann was a gregarious leader who joked that he hoped to make all employees into millionaires. He divided his time between a London home and a vast farm in Spain, where he grew exotic medicinal plants. And his success fueled an arrogance, former colleagues say.

Mr. Bruckermann once told a trade publication that Depfa, unlike German banks, understood how to benefit from the global economy. "With our efforts, we are like the one-eyed man who becomes king in the land of the blind," he was quoted as saying.

Mr. Bruckermann, who left the bank earlier this year, did not respond to requests for an interview.

But as Depfa grew, other European banks began competing with the firm. So executives stretched into riskier deals — the sort that would eventually send shockwaves across Europe and the United States.

Some of Mr. Bruckermann's employees grew concerned about deals like one struck in 2005 with the Metropolitan Transportation Authority of New York, the agency overseeing the city and suburban subways, buses and trains.

For years, municipal agencies like the M.T.A. had raised money by issuing plain-vanilla bonds with fixed interest rates. But then bankers began telling officials that there was a way to get cheaper financing.

Bankers said that cities, like home buyers, could save money with adjustable-rate loans, where the payments started low and changed over time. What they did not emphasize was that such payments could eventually skyrocket. Such borrowing — known as variable-rate bonds — also carried big fees for Wall Street.

The pitches were very successful. Municipalities issued twice as many variable-rate bonds last year as they did a decade earlier.

But variable-rate bonds had a hitch: many investors would purchase them only if a bank like Depfa was hired as a buyer of last resort, ready to acquire bonds from investors who could find no other buyers. Depfa collected fees for serving that role, but expected it would rarely have to honor such pledges.

Mr. Bruckermann's salespeople traveled the world encouraging officials to sign up for variable-rate loans. And bureaucrats and politicians, including some in New York, jumped in.

By 2006 Depfa was the largest buyer of last resort in the world, standing behind $2.9 billion of bonds issued that year alone. It backed a $200 million bond issued by the M.T.A.

But as Depfa grew, it became more reliant on enormous short-term loans to finance its operations. Those loans cost less, and thus helped the bank achieve higher profits, but only when times were good. Indeed, some employees were worried about that debt.

But Mr. Bruckermann plowed ahead, and it paid off. In 2007, even as the global economy was softening, Mr. Bruckermann persuaded one of Germany's biggest lenders, Hypo Real Estate, to purchase Depfa for $7.8 billion. Mr. Bruckermann's cut was more than $150 million. He left the company to grow oranges on his Spanish estate.

The Risks Turn Bad

Last March the delicate web tying Wisconsin, Dublin and Manhattan became an anchor dragging everyone down.

Mr. Yde, the director of business services for the Whitefish Bay district, began receiving troubling messages indicating the district's investments were declining. Worried, he started coming into his office at dawn, before the hallways of Whitefish Bay High School filled with students.

As the sun rose, Mr. Yde searched for explanations by the light of his computer screen. He Googled "C.D.O.'s." He called bankers in London and New York. Each person referred him to someone else.

Then notices arrived saying that the bonds insured by Whitefish Bay's C.D.O.'s were defaulting. It became increasingly likely that the district's money would be seized to pay off other bondholders. Most, if not all, of the $200 million would probably be lost.

As other districts received similar notices, panic grew. For some boards, interest payments on borrowed money were now larger than revenue from the investments. Officials began quietly warning that they might have to dip into school funds.

"This is going to have a tremendous financial impact," said Robert F. Kitchen, a member of the West Allis-West Milwaukee school board. Officials say some districts may have to cut courses like art and drama, curtail gym and classroom maintenance, or forgo replacing teachers who retire.

Problems were emerging elsewhere, as well.

Depfa's executives were realizing that their loans to the Wisconsin schools were unlikely to be repaid. Additionally, bonds all over the world were declining in value, exposing the company to the possibility they would have to make good on their pledges as a buyer of last resort. And Depfa was still borrowing billions each month to cover its short-term loans. By autumn, the short-term debt of the bank and its parent company, Hypo, totaled $81 billion.

Then, in mid-September, the American investment bank Lehman Brothers went bankrupt. Short-term lending markets froze up. Ratings agencies, including Standard & Poor's, downgraded Depfa, citing the company's difficulties borrowing at affordable rates.

That set off a crisis in Germany, where officials worried that Depfa's sudden need for cash would drag down its parent company and set off a chain reaction at other banks. The German government and private banks extended $64 billion in credit to Hypo to stop it from imploding.

"We will not allow the distress of one financial institution to endanger the entire system," Angela Merkel, the German chancellor, said at the time.

That crisis spread almost immediately to the M.T.A.

The transportation authority, guided by Gary Dellaverson, a rumpled, cigarillo-smoking chief financial officer, had $3.75 billion of variable-rate debt outstanding.

About $200 million of that debt was backed by Depfa. When the bank was downgraded, investors dumped those transportation bonds, because of worries they would get stuck with them if Depfa's problems worsened. Depfa was forced to buy $150 million of them, and bonds worth billions of dollars issued by other municipalities.

Then came the twist: Depfa's contracts said that if it bought back bonds, the municipalities had to pay a higher-than-average interest rate. The New York transportation authority's repayment obligation could eventually balloon by about $12 million a year on the Depfa loans alone.

On its own, that cost could be absorbed by the agency. But, as the economy declined, the M.T.A. had lost hundreds of millions because tax receipts — which finance part of its budget — were falling. And its ability to renew its variable-rate bonds at low interest rates was hurt by the trouble at Depfa and other banks. The transportation authority now faces a $900 million shortfall, according to officials. It is "fairly breathtaking," Mr. Dellaverson told the M.T.A.'s finance committee. "This is not a tolerable long-term position for us to be in."

In a recent interview, Mr. Dellaverson defended New York's use of variable bonds.

"Variable-rate debt has helped M.T.A. save millions of dollars, and we've been conservative in issuing it," he said. "But there are risks, which we work hard to mitigate. Usually it works. But what's happening today is a total lack of marketplace rationality."

In a statement, the transportation authority said that it was exploring options to reduce the cost of the Depfa-backed bonds, that its variable-rate bonds had delivered savings even during the current turmoil and that the agency had remained within its budget on debt payments this year.

However, the transportation authority has already announced it will raise subway and train fares next year because of various fiscal problems, and may be forced to shrink the work force and reduce some bus routes. Some analysts say fares will probably rise again in 2010.

The Depfa fallout doesn't end there. Rating agencies have downgraded the bonds of more than 75 municipal agencies backed by Depfa, including in California, Connecticut, Illinois and South Dakota. Officials in Florida, Massachusetts and Montana have cut budgets because of C.D.O.'s or similar risky bets.

And Hypo, the German company that bought Depfa, last week asked the German government for financial help for the third time. Depfa has frozen much of its business, according to Wall Street bankers, and though it continues to honor its commitments, some wonder for how long.

The Wisconsin school districts have filed suit against the Royal Bank of Canada and Stifel Nicolaus alleging misrepresentations. Board members hope they will prevail and schools and retirement plans will emerge unscathed. The companies dispute the lawsuit's claims. Mr. Noack is not named as a defendant and is cooperating with the school boards.

In Mrs. Velvikis's classroom at Grewenow Elementary in Kenosha, students have recently completed a lesson in which each first grader contributed a vegetable to a common vat of "stone soup." The project — based on a children's book — teaches the benefits of working together. The schools have learned that when everyone works together, they can also all starve.

"Our funding is already so limited," Mrs. Velvikis said. "We rely on parent donations for some supplies. You hear about all these millions of dollars that have been lost, and you think, that's got to come out of somewhere." □

CHRISTOPHE VORLET

How the Thundering Herd Faltered and Fell

"We've got the right people in place as well as good risk management and controls."

— E. Stanley O'Neal, 2005

By **GRETCHEN MORGENSON**

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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

Merrill ventured into derivatives made from other derivatives.

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 prompted the credit crisis, regulators and investors who continue to pick through the wreckage are finding that exotic products known as derivatives — like those 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 $71 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, Leh-

AXEL KOESTER FOR THE NEW YORK TIMES

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

man 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 ignominious 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 Ownit 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 mortgages, 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 slapped together faster, and they generated fatter fees than regular C.D.O.'s, making them especially attractive to Wall Street.

SUSAN FARLEY FOR THE NEW YORK TIMES

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

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, "and 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 commodities at JPMorgan 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 return 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 mortgages that it 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 Capital One Financial Corporation, 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," talking 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. Semerci, a details-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. Semerci 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 synthetics.

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 the products.

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 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 manic lending boom ever 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, finally beating 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. Semerci 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 $260 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. □

A Leading Deregulator Looks Back, Unswayed

"The work of this Congress will be seen as a watershed, where we turned away from the outmoded, Depression-era approach to financial regulation and adopted a framework that will position our financial services industries to be world leaders into the new century."

— Phil Gramm, Dec. 15, 2000

LISA KRANTZ FOR THE NEW YORK TIMES

Phil Gramm, banker and former senator.

By ERIC LIPTON and STEPHEN LABATON

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WASHINGTON — Back in 1950 in Columbus, Ga., a young nurse working double shifts to support her three children and disabled husband managed to buy a modest bungalow on a street called Dogwood Avenue.

Phil Gramm, the former United States senator, often told that story of how his mother acquired his childhood home. Considered something of a risk, she took out a mortgage with relatively high interest rates that he likened to today's subprime loans.

A fierce opponent of government intervention in the marketplace, Mr. Gramm, a Republican from Texas, recalled the episode during a 2001 Senate debate over a measure to curb predatory lending. What some view as exploitive, he argued, others see as a gift.

"Some people look at subprime lending and see evil. I look at subprime lending and I see the American dream in action," he said. "My mother lived it as a result of a finance company making a mortgage loan that a bank would not make."

On Capitol Hill, Mr. Gramm became the most effective proponent of deregulation in a generation, by dint of his expertise (a Ph.D in economics), free-market ideology, perch on the Senate banking committee and force of personality (a writer in Texas once called him "a snapping turtle"). And in one remarkable stretch from 1999 to 2001, he pushed laws and promoted policies that he says unshackled businesses from needless restraints but his critics charge significantly contributed to the financial crisis that has rattled the nation.

He led the effort to block measures curtailing deceptive or predatory lending, which was just beginning to result in a jump in home foreclosures that would undermine the financial markets. He advanced legislation that fractured oversight of Wall Street while knocking down Depression-era barriers that restricted the rise and reach of financial conglomerates.

And he pushed through a provision that ensured virtually no regulation of the complex financial instruments known as derivatives, including credit swaps, contracts that would encourage risky investment practices at Wall Street's most venerable institutions and spread the risks, like a virus, around the world.

Many of his deregulation efforts were backed by the Clinton administration. Other members of Congress — who collectively received hundreds of millions of dollars in campaign contributions from financial industry donors over the last decade — also played roles.

Many lawmakers, for example, insisted that Fannie Mae and Freddie Mac, the nation's largest mortgage finance companies, take on riskier mortgages in an effort to aid poor families. Several Republicans resisted efforts to address lending abuses. And Congressional committees failed to address early symptoms of the coming illness.

But, until he left Capitol Hill in 2002 to work as an investment banker and lobbyist for UBS, a Swiss bank that has been hard hit by the market downturn, it was Mr. Gramm who most effectively took up the fight against more government intervention in the markets.

"Phil Gramm was the great spokesman and leader of the view that market forces should drive the economy without regulation," said James D. Cox, a corporate law scholar at Duke University. "The movement he helped to lead contributed mightily to our problems."

In two recent interviews, Mr. Gramm described the current turmoil as "an incredible trauma," but said he was proud of his record.

He blamed others for the crisis: Democrats who dropped barriers to borrowing in order to promote homeownership; what he once termed "predatory borrowers" who took out mortgages they could not afford; banks that took on too much risk; and large financial institutions that did not set aside enough capital to cover their bad bets.

But looser regulation played virtually no role, he argued, saying that is simply an emerging myth.

"There is this idea afloat that if you had more regulation you would have fewer mistakes," he said. "I don't see any evidence in our history or anybody else's to substantiate it." He added, "The markets have worked better than you might have thought."

Rejecting Common Wisdom

Mr. Gramm sees himself as a myth buster, and has long argued that economic events are misunderstood.

Before entering politics in the 1970s, he taught at Texas A & M University. He studied the Great Depression, producing research rejecting the conventional wisdom that suicides surged after the market crashed. He examined financial panics of the 19th century, concluding that policy makers and economists had repeatedly misread events to justify burdensome regulation.

"There is always a revisionist history that tries to claim that the system has failed and what we need to do is have government run things," he said.

From the start of his career in Washington, Mr. Gramm aggressively promoted his conservative ideology and free-market beliefs. (He was so insistent about having his way that one House speaker joked that if Mr. Gramm had been around when Moses brought the Ten Commandments down from Mount Sinai, the Texan would have substituted his own.)

He could be impolitic. Over the years, he has urged that food stamps be cut because "all our poor people are fat," said it was hard for him "to feel sorry" for Social Security recipients and, as the economy soured last summer, called America "a nation of whiners."

His economic views — and seat on the Senate banking committee — quickly won him support from the nation's major financial institutions. From 1989 to 2002, federal records show, he was the top recipient of campaign contributions from commercial banks and in the top five for donations from Wall Street. He and his staff often appeared at industry-sponsored speaking events around the country.

From 1999 to 2001, Congress first considered steps to curb predatory loans — those that typically had high fees, significant prepayment penalties and ballooning monthly payments and were often issued to low-income borrowers. Foreclosures on such loans were on the rise, setting off a wave of personal bankruptcies.

But Mr. Gramm did everything he could to block the measures. In 2000, he refused to have his banking committee consider the proposals, an intervention hailed by the National Association of Mortgage Brokers as a "huge, huge step for us."

A year later, he objected again when Democrats tried to stop lenders from being able to pursue claims in bankruptcy court against borrowers who had defaulted on predatory loans.

While acknowledging some abuses, Mr. Gramm argued that the measure would drive thousands of reputable lenders out of the housing market. And he told fellow senators the story of his mother and her mortgage.

"What incredible exploitation," he said sarcastically. "As a result of that loan, at a 50 percent premium, so far as I am aware, she was the first person in her family, from Adam and Eve, ever to own her own home."

Once again, he succeeded in putting off consideration of lending restrictions. His opposition infuriated consumer advocates. "He wouldn't listen to reason," said Margot Saunders of the National Consumer Law Center. "He would not allow himself to

LISA KRANTZ FOR THE NEW YORK TIMES

TO BANKERS, A 'CONQUERING HERO'

During his time in the Senate, Phil Gramm led the fight against more government intervention in the financial markets.

be persuaded that the free market would not be working."

Speaking at a bankers' conference that month, Mr. Gramm said the problem of predatory loans was not of the banks' making. Instead, he faulted "predatory borrowers." The American Banker, a trade publication, later reported that he was greeted "like a conquering hero."

At the Altar of Wall Street

Mr. Gramm would sometimes speak with reverence about the nation's financial markets, the trading and deal making that churn out wealth.

"When I am on Wall Street and I realize that that's the very nerve center of American capitalism and I realize what capitalism has done for the working people of America, to me that's a holy place," he said at an April 2000 Senate hearing after a visit to New York.

That viewpoint — and concerns that Wall Street's dominance was threatened by global competition and outdated regulations — shaped his agenda.

In late 1999, Mr. Gramm played a central role in what would be the most significant financial services legislation since the Depression. The Gramm-Leach-Bliley Act, as the measure was called, removed barriers between commercial and investment banks that had been instituted to reduce the risk of economic catastrophes. Long sought by the industry, the law would let commercial banks, securities firms and insurers become financial supermarkets offering an array of services.

The measure, which Mr. Gramm helped write and move through the Senate, also split up oversight of conglomerates among government agencies. The Securities and Exchange Commission, for example, would oversee the brokerage arm of a company. Bank regulators would supervise its banking operation. State insurance commissioners would examine the insurance business. But no single agency would have authority over the entire company.

"There was no attention given

to how these regulators would interact with one another," said Professor Cox of Duke. "Nobody was looking at the holes of the regulatory structure."

The arrangement was a compromise required to get the law adopted. When the law was signed in November 1999, he proudly declared it "a deregulatory bill," and added, "We have learned government is not the answer."

In the final days of the Clinton administration a year later, Mr. Gramm celebrated another triumph. Determined to close the door on any future regulation of the emerging market of derivatives and swaps, he helped pushed through legislation that accomplished that goal.

Created to help companies and investors limit risk, swaps are contracts that typically work like a form of insurance. A bank concerned about rises in interest rates, for instance, can buy a derivatives instrument that would protect it from rate swings. Credit-default swaps, one type of derivative, could protect the holder of a mortgage security against a possible default.

Earlier laws had left the regulation issue sufficiently ambiguous, worrying Wall Street, the Clinton administration and lawmakers of both parties, who argued that too many restrictions would hurt financial activity and spur traders to take their business overseas. And while the Commodity Futures Trading Commission — under the leadership of Mr. Gramm's wife, Wendy — had approved rules in 1989 and 1993 exempting some swaps and derivatives from regulation, there was still concern that step was not enough.

After Mrs. Gramm left the commission in 1993, several lawmakers proposed regulating derivatives. By spreading risks, they and other critics believed, such contracts made the system prone to cascading failures. Their proposals, though, went nowhere.

But late in the Clinton administration, Brooksley E. Born, who took over the agency Mrs. Gramm once led, raised the issue anew. Her suggestion for government regulations alarmed the markets and drew fierce opposition.

In November 1999, senior Clinton administration officials, including Treasury Secretary Lawrence H. Summers, joined by the Federal Reserve chairman, Alan Greenspan, and Arthur Levitt Jr., the head of the Securities and Exchange Commission, issued a report that instead recommended legislation exempting many kinds of derivatives from federal oversight.

Mr. Gramm helped lead the charge in Congress. Demanding even more freedom from regulators than the financial industry had sought, he persuaded colleagues and negotiated with senior administration officials, pushing so hard that he nearly scuttled the deal. “When I get in the red zone, I like to score,” Mr. Gramm told reporters at the time.

Finally, he had extracted enough. In December 2000, the Commodity Futures Modernization Act was passed as part of a larger bill by unanimous consent after Mr. Gramm dominated the Senate debate.

“This legislation is important to every American investor,” he said at the time. “It will keep our markets modern, efficient and innovative, and it guarantees that the United States will maintain its global dominance of financial markets.”

But some critics worried that the lack of oversight would allow abuses that could threaten the economy.

Frank Partnoy, a law professor at the University of San Diego and an expert on derivatives, said, “No one, including regulators, could get an accurate picture of this market. The consequences of that is that it left us in the dark for the last eight years.” And, he added, “Bad things happen when it’s dark.”

In 2002, Mr. Gramm left Congress, joining UBS as a senior investment banker and head of the company’s lobbying operation.

But he would not be abandoning Washington.

Lobbying From the Outside

Soon, he was helping persuade lawmakers to block Congressional Democrats’ efforts to combat predatory lending. He arranged meetings with executives and top Washington officials. He turned over his $1 million political action committee to a former aide to make donations to like-minded lawmakers.

Mr. Gramm, now 66, who declined to discuss his compensation at UBS, picked an opportune moment to move to Wall Street. Major financial institutions, including UBS, were growing, partly as a result of the Gramm-Leach-Bliley Act.

Increasingly, institutions were trading the derivatives instruments that Mr. Gramm had helped escape the scrutiny of regulators. UBS was collecting hundreds of millions of dollars from credit-default swaps. (Mr. Gramm said he was not involved in that activity at the bank.) In 2001, a year after passage of the commodities law, the derivatives market insured about $900 billion worth of credit; by last year, the number hadswelled to $62 trillion.

But as housing prices began to fall last year, foreclosure rates began to rise, particularly in regions where there had been heavy use of subprime loans. That set off a calamitous chain of events. The weak housing markets would create strains that eventually would have financial institutions around the world on the edge of collapse.

UBS was among them. The bank has declared nearly $50 billion in credit losses and write-downs since the start of last year, prompting a bailout of up to $60 billion by the Swiss government.

As Mr. Gramm's record in Congress has come under attack amid all the turmoil, some former colleagues have come to his defense.

"He is a true dyed-in-the-wool free-market guy. He is very much a purist, an idealist, as he has a set of principles and he has never abandoned them," said Peter G. Fitzgerald, a Republican and former senator from Illinois. "This notion of blaming the economic collapse on Phil Gramm is absurd to me."

But Michael D. Donovan, a former S.E.C. lawyer, faulted Mr. Gramm for his insistence on deregulating the derivatives market.

"He was the architect, advocate and the most knowledgeable person in Congress on these topics," Mr. Donovan said. "To me, Phil Gramm is the single most important reason for the current financial crisis."

Mr. Gramm, ever the economics professor, disputes his critics' analysis of the causes of the upheaval. He asserts that swaps, by enabling companies to insure themselves against defaults, have diminished, not increased, the effects of the declining housing markets.

"This is part of this myth of deregulation," he said in the interview. "By and large, credit-default swaps have distributed the risks. They didn't create it. The only reason people have focused on them is that some politicians don't know a credit-default swap from a turnip."

But many experts disagree, including some of Mr. Gramm's former allies in Congress. They say the lack of oversight left the system vulnerable.

"The virtually unregulated over-the-counter market in credit-default swaps has played a significant role in the credit crisis, including the now $167 billion taxpayer rescue of A.I.G.," Christopher Cox, the chairman of the S.E.C. and a former congressman, said Friday.

Mr. Gramm says that, given what has happened, there are modest regulatory changes he would favor, including requiring issuers of credit-default swaps to demonstrate that they have enough capital to back up their pledges. But his belief that government should intervene only minimally in markets is unshaken.

"They are saying there was 15 years of massive deregulation and that's what caused the problem," Mr. Gramm said of his critics. "I just don't see any evidence of it." □

Griff Palmer contributed reporting from New York.

Citigroup Saw No Red Flags Even as It Made Bolder Bets

"Our job is to set a tone at the top to incent people to do the right thing and to set up safety nets to catch people who make mistakes or do the wrong thing and correct those as quickly as possible. And it is working. It is working."

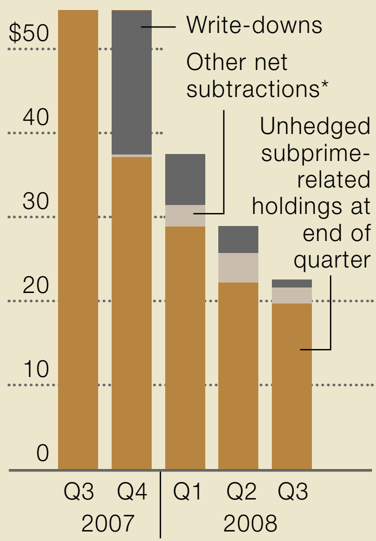
— Charles O. Prince III, Citigroup's chief executive, in 2006

By ERIC DASH and JULIE CRESWELL

FIRST PUBLISHED: NOVEMBER 23, 2008

Citigroup has written down the value of its subprime-mortgage-related holdings over the last year.

CITIGROUP'S SUBPRIME-RELATED HOLDINGS *in billions*



*Including sales and transfers

Source: Citigroup

THE NEW YORK TIMES

In September 2007, with Wall Street confronting a crisis caused by too many souring mortgages, Citigroup executives gathered in a wood-paneled library to assess their own well-being.

There, Citigroup's chief executive, Charles O. Prince III, learned for the first time that the bank owned about $43 billion in mortgage-related assets. He asked Thomas G. Maheras, who oversaw trading at the bank, whether everything was O.K.

Mr. Maheras told his boss that no big losses were looming, according to people briefed on the meeting who would speak only on the condition that they not be named.

For months, Mr. Maheras's reassurances to others at Citigroup had quieted internal concerns about the bank's vulnerabilities. But this time, a risk-management team was dispatched to more rigorously examine Citigroup's huge mortgage-related holdings. They were too late, however:

MICHAEL APPLETON FOR THE NEW YORK TIMES

A FINANCIAL SUPERMARKET

Exposure to obscure mortgage-related assets from Citigroup's trading operations has taken a severe toll on the company, which provides financial services ranging from retail banking to advising companies on mergers.

within several weeks, Citigroup would announce billions of dollars in losses.

Normally, a big bank would never allow the word of just one executive to carry so much weight. Instead, it would have its risk managers aggressively look over any shoulder and guard against trading or lending excesses.

But many Citigroup insiders say the bank's risk managers never investigated deeply enough. Because of longstanding ties that clouded their judgment, the very people charged with overseeing deal makers eager to increase short-term earnings — and executives' multimillion-dollar bonuses — failed to rein them in, these insiders say.

Today, Citigroup, once the nation's largest and mightiest financial institution, has been brought to its knees by more than $65 billion in losses, writedowns for troubled assets and charges to account for future losses. More than half of that amount stems from mortgage-related securities created by Mr. Maheras's team — the same products Mr. Prince was briefed on during that 2007 meeting.

Citigroup's stock has plummeted to its lowest price in more than a decade, closing Friday at $3.77. At that price the company is worth just $20.5 billion, down from $244 billion two years ago. Waves of layoffs have accompanied that slide, with about 75,000 jobs already gone or set to disappear from a work force that numbered about 375,000 a year ago.

Burdened by the losses and a crisis of confidence, Citigroup's future is so uncertain that regulators in New York and Washington held a series of emergency meetings late last week to discuss ways to help the bank right itself.

And as the credit crisis appears to be entering another treacherous phase despite a $700 billion federal bailout, Citigroup's woes are emblematic of the haphazard management and rush to riches that enveloped all of Wall Street. All across the banking business, easy profits and a booming housing market led many prominent financiers to overlook the dangers they courted.

While much of the damage inflicted on Citigroup and the broader economy was caused by errant, high-octane trading and lax oversight, critics say, blame also reaches into the highest levels at the bank. Earlier this year, the Federal Reserve took the bank to task for poor oversight and risk controls in a report it sent to Citigroup.

The bank's downfall was years in the making and involved many in its hierarchy, particularly Mr. Prince and Robert E. Rubin, an influential director and senior adviser.

Citigroup insiders and analysts say that Mr. Prince and Mr. Rubin played pivotal roles in the bank's current woes, by drafting and blessing a strategy that involved taking greater trading risks to expand its business and reap higher profits. Mr. Prince and Mr. Rubin both declined to comment for this article.

When he was Treasury secretary during the Clinton administration, Mr. Rubin helped loosen Depression-era banking regulations that made the creation of Citigroup possible by allowing banks to expand far beyond their traditional role as lenders and permitting them to profit from a variety of financial activities. During the same period he helped beat back tighter oversight of exotic financial products, a development he had previously said he was helpless to prevent.

And since joining Citigroup in 1999 as a trusted adviser to the bank's senior executives, Mr. Rubin, who is an economic adviser on the transition team of President-elect Barack Obama, has sat atop a bank that has been roiled by one financial miscue after another.

Citigroup was ensnared in murky financial dealings with the defunct energy company Enron, which drew the attention of federal investigators; it was criticized by law enforcement officials for the role one of its prominent research analysts played during the telecom bubble several years ago; and it found itself in the middle of regulatory violations in Britain and Japan.

For a time, Citigroup's megabank model paid off handsomely, as it rang up billions in earnings each quarter from credit cards, mortgages, merger advice and trading.

But when Citigroup's trading machine began churning out billions of dollars in mortgage-related securities, it courted disaster. As it built up that business, it used accounting maneuvers to move billions of dollars of the troubled assets off its books, freeing capital so the bank could grow even larger. Because of pending accounting changes, Citigroup and other banks have been bringing those assets back in-house, raising concerns about a new round of potential losses.

To some, the misery at Citigroup is no surprise. Lynn Turner, a former chief accountant with the Securities and Exchange Commission, said the bank's balkanized culture and pell-mell management made problems inevitable.

"If you're an entity of this size," he said, "if you don't have controls, if you don't have the right culture and you don't have people accountable for the risks that they are taking, you're Citigroup."

Questions on Oversight

Though they carry less prestige and are paid less than Wall Street traders and bankers, risk managers can wield significant clout. Their job is to monitor trading floors and inquire about how a bank's money is being invested, so they can head off potential problems before blowups occur. Though risk managers and traders work side by side, they can have an uncomfortable coexistence because the monitors can put a brake on trading.

That is the way it works in theory. But at Citigroup, many say, it was a bit different.

David C. Bushnell was the senior risk officer who, with help from his staff, was supposed to keep an eye on the bank's bond trading business and its multi-billion-dollar portfolio of mortgage-backed securities. Those activities were part of what the bank called its fixed-income business, which Mr. Maheras supervised.

One of Mr. Maheras's trusted deputies, Randolph H. Barker, helped oversee the huge build-up in mortgage-related securities at Citigroup. But Mr. Bushnell, Mr. Maheras and Mr. Barker were all old friends, having climbed the bank's corporate ladder together.

It was common in the bank to see Mr. Bushnell waiting patiently — sometimes as long as 45 minutes — outside Mr. Barker's office so he could drive him home to Short Hills, N.J., where both of their families lived. The two men took occasional fly-fishing trips together; one expedition left them stuck on a lake after their boat ran out of gas.

Because Mr. Bushnell had to monitor traders working for Mr. Barker's bond desk, their friendship raised eyebrows inside the company among those concerned about its controls.

After all, traders' livelihoods depended on finding new ways to make money, sometimes using methods that might not be

MARK WILSON/GETTY IMAGES

OVERSEEING RISK

David Bushnell was a risk officer for bond trading.

in the bank's long-term interests. But insufficient boundaries were established in the bank's fixed-income unit to limit potential conflicts of interest involving Mr. Bushnell and Mr. Barker, people inside the bank say.

Indeed, some at Citigroup say that if traders or bankers wanted to complete a potentially profitable deal, they could sometimes rely on Mr. Barker to convince Mr. Bushnell that it was a risk worth taking.

Risk management "has to be independent, and it wasn't independent at Citigroup, at least when it came to fixed income," said one former executive in Mr. Barker's group who, like many other people interviewed for this article, insisted on anonymity because of pending litigation against the bank or to retain close ties to their colleagues. "We used to say that if we wanted to get a deal done, we needed to convince Randy first because he could get it through."

Others say that Mr. Bushnell's friendship with Mr. Maheras may have presented a similar blind spot.

"Because he has such trust and faith in these guys he has worked with for years, he didn't ask the right questions," a former senior Citigroup executive said, referring to Mr. Bushnell.

Mr. Bushnell and Mr. Barker did not return repeated phone calls seeking comment. Mr. Maheras declined to comment.

For some time after Sanford I. Weill, an architect of the merger that created Citigroup a decade ago, took control of Citigroup, he toned down the bank's bond trading. But in late 2002, Mr. Prince, who had been Mr. Weill's longtime legal counsel, was put in charge of Citigroup's corporate and investment bank.

According to a former Citigroup executive, Mr. Prince started putting pressure on Mr. Maheras and others to increase earnings in the bank's trading operations, particularly in the creation of collateralized debt obligations, or C.D.O.'s — securities that packaged mortgages and other forms of debt into bundles for resale to investors.

Because C.D.O.'s included so many forms of bundled debt, gauging their risk was particularly tricky; some parts of the bundle could be sound, while others were vulnerable to default.

"Chuck Prince going down to the corporate investment bank in late 2002 was the start of that process," a former Citigroup executive said of the bank's big C.D.O. push. "Chuck was totally new to the job. He didn't know a C.D.O. from a grocery list, so he looked for someone for advice and support. That person was Rubin. And Rubin had always been an advocate of being more aggressive in the capital markets arena. He would say, 'You have to take more risk if you want to earn more.' "

It appeared to be a good time for building up Citigroup's C.D.O. business. As the housing market around the country took flight, the C.D.O. market also grew apace as more and more mortgages were pooled together into newfangled securities.

From 2003 to 2005, Citigroup more than tripled its issuing of C.D.O.'s, to more than $20 billion from $6.28 billion, and Mr. Maheras, Mr. Barker and others on the C.D.O. team helped transform Citigroup into one of the industry's biggest players. Firms issuing the C.D.O.'s generated fees of 0.4 percent to 2.5 percent of the amount sold — meaning Citigroup made up to $500 million in fees from the business in 2005 alone.

Even as Citigroup's C.D.O. stake was expanding, its top executives wanted more profits from that business. Yet they were not running a bank that was up to all the challenges it faced, including properly overseeing billions of dollars' worth of exotic products, according to Citigroup insiders and regulators who later criticized the bank.

When Mr. Prince was put in charge in 2003, he presided over a mess of warring business units and operational holes, particularly in critical areas like risk-management and controls.

"He inherited a gobbledygook of companies that were never integrated, and it was never a priority of the company to invest," said Meredith A. Whitney, a banking analyst who was one of the company's early critics. "The businesses didn't communicate with each other. There were dozens of technology systems and dozens of financial ledgers."

Problems with trading and banking oversight at Citigroup became so dire that the Federal Reserve took the unusual step of telling the bank it could make no more acquisitions until it put its house in order.

In 2005, stung by regulatory rebukes and unable to follow Mr. Weill's penchant for expanding Citigroup's holdings through rapid-fire takeovers, Mr. Prince and his board of directors decided to push even more aggressively into trading and other business that would allow Citigroup to continue expanding the bank internally.

One person who helped push Citigroup along this new path was Mr. Rubin.

Pushing Growth

Robert Rubin has moved seamlessly between Wall Street and Washington. After making his millions as a trader and an executive at Goldman Sachs, he joined the Clinton administration.

Mr. Weill, as Citigroup's chief, wooed Mr. Rubin to join the bank after Mr. Rubin left Washington. Mr. Weill had been involved in the financial services industry's lobbying to persuade Washington to loosen its regulatory hold on Wall Street.

As chairman of Citigroup's executive committee, Mr. Rubin was the bank's resident sage, advising top executives and serving on the board while, he insisted repeatedly, steering clear of daily management issues.

"By the time I finished at Treasury, I decided I never wanted operating responsibility again," he said in an interview in April. Asked then whether he had made any mistakes during his tenure at Citigroup, he offered a tentative response.

"I've thought a lot about that," he said. "I honestly don't know. In hindsight, there are a lot of things we'd do differently. But in the context of the facts as I knew them and my role, I'm inclined to think probably not."

Besides, he said, it was impossible to get a complete handle on Citigroup's vulnerabilities unless you dealt with the trades daily.

"There is no way you would know what was going on with a risk book unless you're directly involved with the trading arena," he said. "We had highly experienced, highly qualified people running the operation."

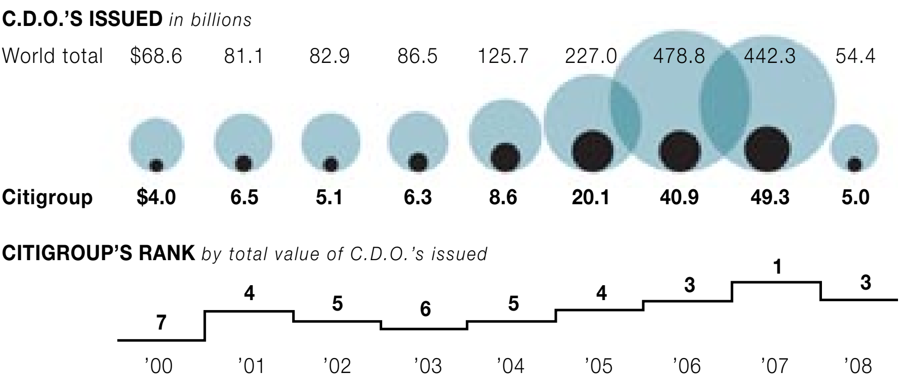
But while Mr. Rubin certainly did not have direct responsibility for a Citigroup unit, he was an architect of the bank's strategy.

In 2005, as Citigroup began its effort to expand from within, Mr. Rubin peppered his colleagues with questions as they formulated the plan. According to current and former colleagues, he believed that Citigroup was falling behind rivals like Morgan Stanley and Goldman, and he pushed to bulk up the bank's high-growth fixed-income trading, including the C.D.O. business.

Former colleagues said Mr. Rubin also encouraged Mr. Prince to broaden the bank's appetite for risk, provided that it also upgraded oversight — though the Federal Reserve later would conclude that the bank's

Citigroup's Exotic Investments

Because Citigroup bundled mortgages and many other types of debt into collateralized debt obligations, or C.D.O.'s, it made risk hard to gauge.



Source: Thomson Reuters

THE NEW YORK TIMES

oversight remained inadequate.

Once the strategy was outlined, Mr. Rubin helped Mr. Prince gain the board's confidence that it would work.

After that, the bank moved even more aggressively into C.D.O.'s. It added to its trading operations and snagged crucial people from competitors. Bonuses doubled and tripled for C.D.O. traders. Mr. Barker drew pay totaling \$15 million to \$20 million a year, according to former colleagues, and Mr. Maheras became one of Citigroup's most highly compensated employees, earning as much as \$30 million at the peak — far more than top executives like Mr. Bushnell in the risk-management department.

In December 2005, with Citigroup diving into the C.D.O. business, Mr. Prince assured analysts that all was well at his bank.

"Anything based on human endeavor and certainly any business that involves risk-taking, you're going to have problems from time to time," he said. "We will run our business in a way where our credibility and our reputation as an institution with the public and with our regulators will be an asset of the company and not a liability."

Yet as the bank's C.D.O. machine accelerated, its risk controls fell further behind, according to former Citigroup traders, and risk managers lacked clear lines of reporting. At one point, for instance, risk managers in the fixed-income division reported to both Mr. Maheras and Mr. Bushnell — setting up a potential conflict because that gave Mr. Maheras influence over employees who were supposed to keep an eye on his traders.

C.D.O.'s were complex, and even experienced managers like Mr. Maheras and Mr. Barker underestimated the risks they posed, according to people with direct knowledge of Citigroup's business. Because of that, they put blind faith in the passing grades that major credit-rating agencies bestowed on the debt.

While the sheer size of Citigroup's C.D.O. position caused concern among some around the trading desk, most say they kept their concerns to themselves.

"I just think senior managers got addicted to the revenues and arrogant about the risks they were running," said one person who worked in the C.D.O. group. "As long as you could grow revenues, you could keep your bonus growing."

To make matters worse, Citigroup's risk models never accounted for the possibility of a national housing downturn, this person said, and the prospect that millions of homeowners could default on their mortgages. Such a downturn did come, of course, with disastrous consequences for Citigroup and its rivals on Wall Street.

Even as the first shock waves of the subprime mortgage crisis hit Bear Stearns in June 2007, Citigroup's top executives expressed few concerns about their bank's exposure to mortgage-linked securities.

In fact, when examiners from the Securities and Exchange Commission began scrutinizing Citigroup's subprime mortgage holdings after Bear Stearns's problems surfaced, the bank told them that the probability of those mortgages defaulting was so tiny that they excluded them from their risk analysis, according to a person briefed on the discussion who would speak only without being named.

Later that summer, when the credit markets began seizing up and values of various C.D.O.'s began to plummet, Mr. Maheras, Mr. Barker and Mr. Bushnell participated in a meeting to review Citigroup's exposure.

The slice of mortgage-related securities held by Citigroup was "viewed by the rating agencies to have an extremely low probability of default (less than .01%)," according to Citigroup slides used at the meeting and reviewed by The New York Times.

Around the same time, Mr. Maheras continued to assure his colleagues that the bank "would never lose a penny," according to an executive who spoke to him.

In mid-September 2007, Mr. Prince convened the meeting in the small library outside his office to gauge Citigroup's exposure.

Mr. Maheras assured the group, which included Mr. Rubin and Mr. Bushnell, that Citigroup's C.D.O. position was safe. Mr. Prince had never questioned the ballooning portfolio before this because no one, including Mr. Maheras and Mr. Bushnell, had warned him.

But as the subprime market plunged further, Citigroup's position became more dire — even though the firm held onto the belief that its C.D.O.'s were safe.

On Oct. 1, it warned investors that it would write off $1.3 billion in subprime mortgage-related assets. But of the $43 billion in C.D.O.'s it had on its books, it wrote off only about $95 million, according to a person briefed on the situation.

Soon, however, C.D.O. prices began to collapse. Credit-rating agencies downgraded C.D.O.'s, threatening Citigroup's stockpile. A week later, Merrill Lynch aggressively marked down similar securities, forcing other banks to face reality.

By early November, Citigroup's anticipated write-downs ballooned to $8 billion to $11 billion. Mr. Barker and Mr. Maheras lost their jobs, as Mr. Bushnell did later on. And on Nov. 4, Mr. Prince told the board that he, too, would resign.

Although Mr. Prince received no severance, he walked away with Citigroup stock valued then at $68 million — along with a cash bonus of about $12.5 million for 2007.

Putting Out Fires

Mr. Prince was replaced last December by Vikram S. Pandit, a former money manager and investment banker whom Mr. Rubin had earlier recruited in a senior role. Since becoming chief executive, Mr. Pandit has been scrambling to put out fires and repair Citigroup's deficient risk-management systems.

Earlier this year, Federal Reserve examiners quietly presented the bank with a scathing review of its risk-management practices, according to people briefed on the situation.

Citigroup executives responded with a 25-page single-spaced memo outlining a sweeping overhaul of the bank's risk management.

In May, Brian Leach, Citigroup's new chief risk officer, told analysts that his bank had greatly improved oversight and installed several new risk managers. He said he wanted to ensure "that Citi takes the lessons learned from recent events and makes critical enhancements to its risk management frameworks. A change in culture is required at Citi."

Meanwhile, regulators have criticized the banking industry as a whole for relying on outsiders — in particular the ratings agencies — to help them gauge the risk of their investments.

"There is really no excuse for institutions that specialize in credit risk assessment, like large commercial banks, to rely solely on credit ratings in assessing credit risk," John C. Dugan, the head of the Office of the Comptroller of the Currency, the chief federal bank regulator, said in a speech earlier this year.

But he noted that what caused the largest problem for some banks was that they retained dangerously big positions in certain securities — like C.D.O.'s — rather than selling them off to other investors.

"What most differentiated the companies sustaining the biggest losses from the rest was their willingness to hold exceptionally large positions on their balance sheets which, in turn, led to exceptionally large losses," he said.

Mr. Dugan did not mention any specific bank by name, but Citigroup is the largest player in the C.D.O. business of any bank the comptroller regulates.

For his part, Mr. Pandit faces the twin challenge of rebuilding investor confidence while trying to fix the company's myriad problems.

Citigroup has suffered four consecutive quarters of multibillion-dollar losses as it has written down billions of dollars of the mortgage-related assets it held on its books.

But investors worry there is

still more to come, and some board members have raised doubts about Mr. Pandit's leadership, according to people briefed on the situation.

Citigroup still holds $20 billion of mortgage-linked securities on its books, the bulk of which have been marked down to between 21 cents and 41 cents on the dollar. It has billions of dollars of giant buyout and corporate loans. And it also faces a potential flood of losses on auto, mortgage and credit card loans as the global economy plunges into a recession.

Also, hundreds of billions of dollars in dubious assets that Citigroup held off its balance sheet is now starting to be moved back onto its books, setting off yet another potential problem.

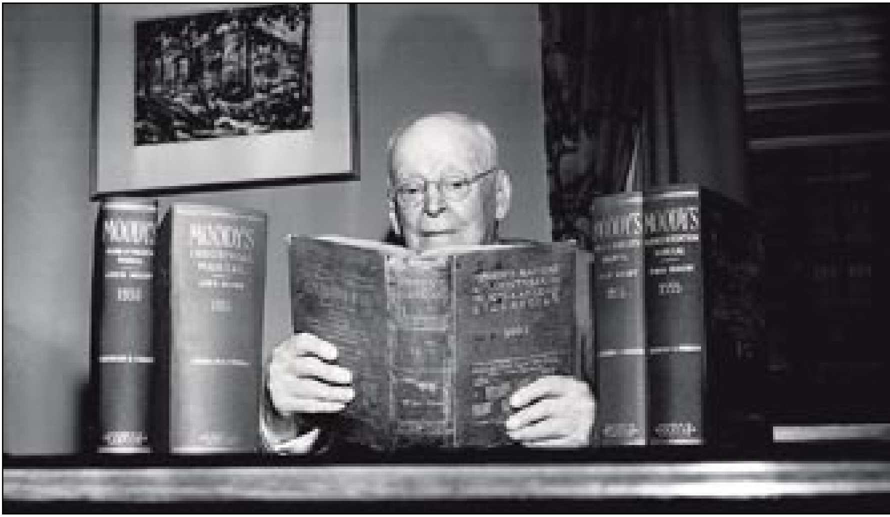
The bank has already put more than $55 billion in assets back on its balance sheet. It now says an added $122 billion of assets related to credit cards and possibly billions of dollars of other assets will probably come back on the books.

Even though Citigroup executives insist that the bank can ride out its current difficulties, and that the repatriated assets pose no threat, investors have their doubts. Because analysts do not have a complete grip on the quality of those assets, they are warning that Citigroup may have to set aside billions of dollars to guard against losses.

In fact, some analysts say they believe that the $25 billion that the federal government invested in Citigroup this fall might not be enough to stabilize it.

Others say the fact that such huge amounts have yet to steady the bank is a reflection of the severe damage caused by Citigroup's appetites.

"They pushed to get earnings, but in doing so, they took on more risk than they probably should have if they are going to be, in the end, a bank subject to regulatory controls," said Roy Smith, a professor at the Stern School of Business at New York University. "Safe and soundness has to be no less important than growth and profits but that was subordinated by these guys." □



THE NEW YORK TIMES

John Moody in 1956. He made his name by publishing opinions on risks facing investors.

Debt Watchdogs: Tamed or Caught Napping?

"These errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue, or a little bit of both."

— A Moody's managing director responding anonymously to an internal management survey, September 2007.

By GRETCHEN MORGENSON

FIRST PUBLISHED: DECEMBER 7, 2008

THE HOUSING MANIA was in full swing in 2005 when analysts at Moody's Investors Service, the nation's oldest and most prestigious credit-rating agency, were pressured to go back to the drawing board.

Moody's, which judges the quality of debt that corporations and banks issue to raise money, had just graded a pool of securities underwritten by Countrywide Financial, the nation's largest mortgage lender. But Countrywide complained that the assessment was too tough.

The next day, Moody's changed its rating, even though no new and significant information had come to light, according to two people briefed on the change who requested anonymity to preserve their professional relationships.

Moody's had assigned high grades to many securities containing Countrywide mortgages. Those securities and mortgages, issued during the lending spree of recent years, later soured — leaving investors with large losses and homeowners and communities struggling with foreclosures.

That was not the only time Moody's softened its stance on Countrywide securities. It elevated ratings several times after Countrywide complained, the people briefed on the matter say.

Since the subprime mortgage troubles exploded into a full-blown financial crisis last year, the three top credit-rating agencies — Moody's, Standard & Poor's and Fitch Ratings — have faced a firestorm of criticism about whether their rosy ratings of mortgage securities generated billions of dollars in losses to investors who relied on them.

The agencies are supposed to help investors evaluate the risk of what they are buying. But some former employees and many investors say the agencies, which were paid far more to rate complicated mortgage-related securities than to assess more traditional debt, either underestimated the risk of mortgage debt or simply overlooked its danger so they could rake in large profits during the housing boom.

A Moody's spokesman, Anthony Mirenda, said the company would not change ratings without substantive reasons. "As a matter of policy, Moody's is obligated to reconvene a rating committee if there is new information put forth by an issuer that could have a material impact on a security's creditworthiness," he said, "and our policies prohibit changes to ratings for anything other than credit considerations."

He added that "Moody's knows of no instances in which a reconvened rating committee resulted in improper changes to ratings on Countrywide securities."

Bank of America, which took over Countrywide earlier this year, said it could not verify details of prior management's interactions with Moody's.

Members of Congress have grilled the agencies, asking their executives to answer accusations of incompetence and to say whether they assigned glowing ratings to keep clients happy and expand their business.

State and federal officials are also making inquiries. Moody's recently disclosed in its regulatory filings that it had received subpoenas from state attorneys general and other authorities pertaining to its role in the credit crisis.

Moody's said it was cooperating with the investigations.

"Moody's credit ratings play an important but limited role in the financial markets — to offer reasoned, independent, forward-looking opinions about relative credit risk, based on rigorous analysis and published methodologies," Mr. Mirenda said. The company denies that it went easy on ratings to generate income.

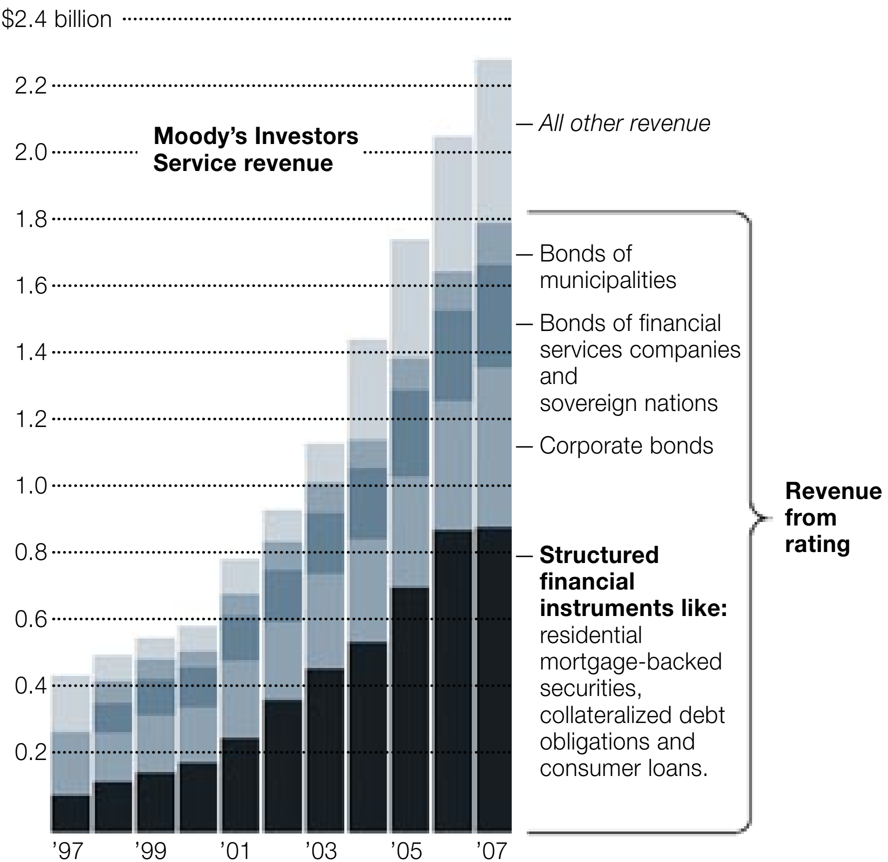
That the credit-rating agencies missed immense problems in the mortgage-related securities they blessed is undeniable. Moody's declined to say how many classes of the securities it has downgraded. But the number is in the thousands and the original value in the hundreds of billions of dollars.

When Moody's began lowering the ratings of a wave of debt in July 2007, many investors were incredulous.

"If you can't figure out the loss ahead of the fact, what's the use of using your ratings?" asked an executive with Fortis Investments, a money management firm, in a July 2007 e-mail message to Moody's. "You have legitimized these things, leading people into dangerous risk."

Benefiting From the Housing Boom

Rating bonds and other financial instruments makes up the lion's share of Moody's revenue, which has increased fivefold over the last 10 years. But revenue from rating complex — and often toxic — debt securities grew the fastest and became its largest revenue source.



Source: company reports

THE NEW YORK TIMES

Whether such risks were truly undetectable, or were ignored by Moody's and the other agencies, is at the core of what regulators, legislators, investigators and investors are trying to determine.

Moody's current woes, former executives say, were set in motion a decade or so ago when top management started pushing the company to be more profit-oriented and friendly to issuers of debt. Along the way, the firm, whose objectivity once derived from the fact that its revenue came from investors who bought Moody's research and analysis, ended up working closely with the companies it rated, and being paid by them.

And in 2000, when Moody's issued stock to the public for the first time, executives hungry to churn out quarterly profit growth had another incentive to redirect the firm's focus from low-margin ratings of relatively simple bonds to highly lucrative assessments of much more complex debt securities.

As it rode the mortgage wave, Moody's came to enjoy profit margins that were higher than those of the mightiest of Fortune 500 companies, including Exxon and Microsoft.

"Moody's was like a good watchdog that had regarded the financial markets as its turf and barked and growled when anybody it didn't know came near it," said Thomas J. McGuire, a former director of corporate development at the company who left in 1996. "But in the '90s, that watchdog got muzzled and gelded. It was told to turn into a lapdog."

A Lucrative Niche

A key reason for the soaring housing market was a process known as securitization. The machinery, devised by Wall Street, packaged individual mortgages into ever larger and more complex bundles. This allowed banks to sell their loans to investors, thereby reducing the banks' risk and allowing them to lend more to aspiring homeowners.

Wall Street made handsome profits bundling and selling the loans, and investors stepped up to buy the packaged debt, often because rating agencies like Moody's had graded it as safe enough for the investors' portfolios.

The agencies divided the securities into slices known as tranches and analyzed each based on its risk. The securities deemed safest received the rating Moody's called Aaa.

Consider a residential mortgage pool put together in summer 2006 by Goldman Sachs. Called GSAMP 2006-S5, it held $338 million of second mortgages to subprime, or riskier, borrowers.

The safest slice of the security held $165 million in loans. When it was issued on Aug. 17, 2006, Moody's and S.& P. rated it triple-A. Just eight months later, Moody's alerted investors that it might downgrade the top-rated tranche. Sure enough, it dropped the rating to Baa, the lowest investment-grade level, on Aug. 16, 2007.

Then, on Dec. 4, 2007, Moody's downgraded the tranche to a "junk" rating. On April 15 of this year, Moody's downgraded the tranche yet again; today, it no longer trades. The combination of downgrades and defaults hammered the securities.

Reversals like this have enraged investors. Internal e-mail messages disclosed by Congress in October, for example, recounted a July 2007 conversation Moody's had with an irate customer at Pimco, a major money management firm.

"He feels that Moody's has a powerful control over Wall Street but is frustrated that Moody's doesn't stand up to Wall Street," the e-mail stated. "They are disappointed that in this case Moody's has 'toed the line. Someone up there just wasn't on top of it,' he said." For decades after its founding in 1909, Moody's was an independent and respected arbiter of credit quality. Today, the company's 1,200 analysts rate debts of 100 nations, 12,000 corporate issuers, 29,000 public issuers like cities and 96,000 complex securities known as "structured finance." It is a franchise that generated revenue of $1.35 billion and earnings of $370 million in the first three quarters of this year alone.

Edmund Vogelius, a Moody's vice president, explained the company's business model in a 1957 article in The Christian Science Monitor.

"We obviously cannot ask payment for rating a bond," he wrote. "To do so would attach a price to the process, and we could not escape the charge, which would undoubtedly come, that our ratings are for sale."

In the early 1970s, Moody's and other rating agencies began charging issuers for opinions. The numbers of securities — and their complexity — had increased and the agencies could no longer finance their operations on revenue from investors who bought Moody's publications.

In 1975, the Securities and Exchange Commission secured the rating agencies' positions by allowing banks to base their capital requirements on the ratings of securities they held. The upside of this was that it theoretically created an elegant self-policing mechanism: any firm that ran afoul of the agencies also would run afoul of investors. The heavier hand of direct government regulation could be scaled back.

But for Mr. McGuire, the former director of corporate development at Moody's, there were also dangers in relying on ratings as a form of regulation because the agencies would be able to sell ratings even if they failed investors.

"Rating agencies are staffed by ordinary people with families to support and bills to meet and mortgages to pay," he said in a speech to the S.E.C. in 1995. "Government regulators are inadvertently subjecting those people to improper pressure, and share accountability for any scandals which may result."

Fortunes Tied to Issuers

As the agencies exerted growing sway, they became the arbiters that issuers loved to hate. Yet instead of viewing that ire as a reflection of their independence, Moody's executives decided that it signaled a need to become more friendly to issuers of debt, according to Jerome S. Fons, a former managing director for credit quality at Moody's.

"In my view, the focus of Moody's shifted from protecting investors to being a marketing-driven organization," he said in testimony before Congress last month. "Management's focus increasingly turned to maximizing revenues. Stock options and other incentives raised the possibility of large payoffs."

An early proponent of the profit push was John Rutherfurd Jr., who joined Moody's in 1985. In 1998, he became chief executive; a news release that year praised him for helping the company's bottom line.

According to people who worked with him at Moody's, Mr. Rutherfurd was very focused on profit. They recall a conversation about 10 years ago in which he said he wanted every Moody's analyst to produce at least $1 million in revenue each year. This encouraged Moody's to generate as many ratings per analyst as possible.

In an interview, Mr. Rutherfurd said that he might have discussed such a goal but that he did not recall it specifically.

"Moody's has to be all the time both a standards business and a service business," he said. "I wasn't in Moody's in the old days, so to speak, but I think I always understood both elements of what we had to do."

By the time Moody's became a public company in 2000, structured finance had become its top source of revenue. Employees in this unit rated bundles of assets like credit card receivables, car loans and residential mortgages. Later they rated collateralized debt obligations, or C.D.O.'s, yet another combination of various bundles of debt.

Moody's could receive between $200,000 and $250,000 to rate a $350 million mortgage pool, for example, while rating a municipal bond of a similar size might have generated just $50,000 in fees, according to people familiar with Moody's fee structure.

A standard of profitability at many companies is its operating margin, which measures how much of its revenue is left over after it pays most expenses. While operating margins at Moody's were always enviable — in 2000 they stood at 48 percent — they climbed even higher as revenue from structured finance rose. From 2000 to 2007, company documents show, operating margins averaged 53 percent.

Even thriving companies like Exxon and Microsoft had margins of 17 and 36 percent respectively in 2007. But Moody's and its counterparts were not founded to be profit machines.

"The mistaken notion that Moody's was a company like any other, that was very fundamental," said Sylvain Raynes, a former Moody's analyst who is co-founder of R&R Consulting, a firm that helps investors gauge debt risks. "It is not just a profit-maximization entity like Exxon or Microsoft. Moody's has a duty to the American public. People trusted it."

HIROKO MASUIKE FOR THE NEW YORK TIMES

Sylvain Raynes left Moody's to start a consultancy.

Moody's soaring fortunes were tied to the housing boom. When the Federal Reserve Board cut interest rates to 1 percent in 2003, Moody's structured-finance revenue stood at $474 million, more than twice the amount generated just three years earlier.

As low interest rates fed the housing surge, Moody's structured-finance business continued to rack up impressive gains. In 2005, structured finance generated $715 million, or 41 percent, of Moody's total revenue.

In both 2005 and 2006, almost all of the unit's growth came from mortgage-related securities, the company said, rather than other forms of debt like credit card receivables or auto loans. By the first quarter of 2007, structured finance accounted for 53 percent of Moody's revenue.

The man overseeing Moody's structured-finance unit in the midst of the mania was Brian M. Clarkson, 52. He had joined Moody's as an analyst in 1991 and rose through the organization until he became president in 2007. He resigned last May; he declined to comment for this article.

As mortgage securities grew more complex, investors leaned more heavily on the agencies' ratings. There was little transparency around the composition and characteristics of the loans held in the pools, and the securitization process grew so complicated that it required sophisticated systems to assess the risks embedded in each bundle.

Even though the standards at many lenders declined precipitously during the boom, rating agencies did not take that into account. The agencies maintained that it was not their responsibility to assess the quality of each and every mortgage loan tossed into a pool.

Anger From Investors

By early 2007, it was becoming more and more obvious that the subprime mortgage boom was ending. Yet Moody's did not start downgrading mortgage-related securities until that summer. In July and August, the firm cut the ratings on almost 1,000 securities valued at almost $25 billion.

Raymond W. Mc-Daniel, the chief of Moody's, which rated a residential mortgage pool put together by Goldman Sachs, right.

Unassociated Document

Prospectus Supplement to Prospectus Dated August 3, 2006

$[illegible]

(Approximate)[1]

Mortgage Pass-Through Certificates, Series 2006-S5

GSAMP Trust 2006-S5

Issuing Entity

GS Mortgage Securities Corp.

Depositor

Goldman Sachs Mortgage Company

Class	Approximate Initial Class Principal Balance[1]	Pass-Through Rate	Type	Ratings (S&P/Moody's)
A-1	$164,416,000	Variable[2]	Senior	AAA/Aaa
A-2	$ 67,155,000	5.658%[3]	Senior	AAA/Aaa
M-1	$ 27,789,000	Variable[4]	Subordinate	AA/Aa2
M-2	$ 8,601,000	Variable[5]	Subordinate	AA-/Aa3

"These loans are defaulting at a rate materially higher than original expectations," Moody's said. Investors sharply criticized Moody's over the tardiness of the response, internal documents made public in Congressional hearings show.

Two e-mail messages in July 2007 recount conversations Moody's had with executives at Vanguard, BlackRock and Fortis, three huge money management firms. While Fortis offered some of the harshest assessments, none of the firms were pleased.

The Vanguard executive, the messages show, was frustrated that Moody's was willing to "allow issuers to get away with murder." As a result, the Moody's messages say, Vanguard "finds itself 'less and less relying on the opinions of rating agencies.'" BlackRock, meanwhile, said that Moody's "relied too much on manufactured data that is weak" when rating residential mortgage securities.

Two months later, Moody's executives held a meeting for their managing directors to talk about the crisis. The tone of the meeting, according to a transcript released by Congress, was defiant.

Moody's had become a "punching bag," said one of its executives, an easy target for investors eager to deflect responsibility for escalating mortgage losses.

"One of the questions everybody asks is, 'Why does everybody hate us so much?' " Mr. Clarkson said during the meeting. "The theory that I've come up with lately is the fact that it's perfect. It's perfect to be able to blame us for everything."

During the meeting, Moody's executives predicted that the current crisis of confidence would pass, just as investor outrage over the company's failure to detect trouble at Enron and Worldcom had several years earlier.

Other employees at the meeting were not so sure. When asked by top management if the meeting addressed the topics of greatest concern, one managing director whose anonymous comments were part of the documents given to Congress said there had been "really no discussion of why the structured group refused to change their ratings in the face of overwhelming evidence they were wrong."

And two months later, Christopher Mahoney, former vice chairman of Moody's and the person who led its credit policy committee, e-mailed Raymond W. McDaniel, the firm's chief executive. The e-mail contained a copy of a message board post that said although mistakes had been made in subprime mortgage loss estimates, "more importantly I think sector wide risk management rules should have done more to alert investors of problems." □

This article has been revised to reflect the following correction published on December 14, 2008

An article last Sunday [December 7] about credit ratings assigned by Moody's Investors Service misattributed the content of an e-mail message that said the firm did not do enough to alert investors to mortgage risks. Christopher Mahoney, a former vice chairman of Moody's, copied the statement from an online message board and sent it to the firm's chief executive by e-mail; the comment was not by Mr. Mahoney.

A Champion of Wall Street Reaps Benefits

"We are not going to rest until we change the rules, change the laws and make sure New York remains No. 1 for decades on into the future."

— Senator Charles E. Schumer, referring to financial regulations, Jan. 22, 2007

By ERIC LIPTON and RAYMOND HERNANDEZ

FIRST PUBLISHED: DECEMBER 14, 2008

WASHINGTON — As the financial crisis jolted the nation in September, Senator Charles E. Schumer was consumed. He traded telephone calls with bankers, then became one of the first officials to promote a Wall Street bailout. He spent hours in closed-door briefings and a weekend helping Congressional leaders nail down details of the $700 billion rescue package.

The next day, Mr. Schumer appeared at a breakfast fund-raiser in Midtown Manhattan for Senate Democrats. Addressing Henry R. Kravis, the buyout billionaire, and about 20 other finance industry executives, he warned that a bailout would be a hard sell on Capitol Hill. Then he offered some reassurance: The businessmen could count on the Democrats to help steer the nation through the financial turmoil.

"We are not going to be a bunch of crazy, anti-business liberals," one executive said, summarizing Mr. Schumer's remarks. "We are going to be effective, moderate advocates for sound economic policies, good responsible stewards you can trust."

The message clearly resonated. The next week, executives at firms represented at the breakfast sent in more than $135,000 in campaign donations.

Senator Schumer plays an unrivaled role in Washington as beneficiary, advocate and overseer of an industry that is his hometown's most important business.

An exceptional fund raiser — a "jackhammer," someone who knows him says, for whom " 'no' is the first step to 'yes,' " — Mr. Schumer led the Democratic Senatorial Campaign Committee for the last four years, raising a record $240 million while increasing donations from Wall Street by 50 percent. That money helped the Democrats gain power in Congress, elevated Mr. Schumer's standing in his party and increased the industry's clout in the capital.

But in building support, he has embraced the industry's free-market, deregulatory agenda more than almost any other Democrat in Congress, even backing some measures now blamed for contributing to the financial crisis.

Other lawmakers took the lead on efforts like deregulating the complicated financial instruments called derivatives, which are widely seen as catalysts to the crisis.

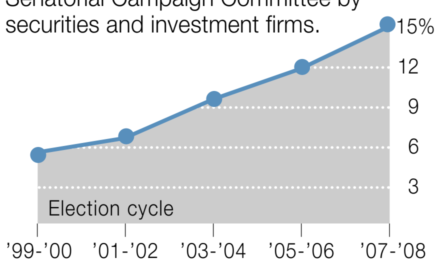
Few have raised more from Wall Street than Charles E. Schumer has ...

Top recipients from securities and investment firms

HOUSE 1989-90 to 1997-98		
1. Charles E. Schumer	**D**	**$2,501,814**
2. Dick Zimmer	R	755,939
3. Tom Campbell	R	736,175
4. Nita M. Lowey	D	551,056
5. Richard A. Gephardt	D	479,702
6. Newt Gingrich	R	462,829
SENATE 1999-2000 to 2005-06		
1. John Kerry	D	$5,505,003
2. Charles E. Schumer	**D**	**3,668,060**
3. Joseph I. Lieberman	D	3,224,075
4. Hillary R. Clinton	D	2,400,053
5. Christopher J. Dodd	D	1,783,530
6. John McCain	R	1,354,001

... while Senate Democrats have become more dependent on such money.

Share of total donations to the Democratic Senatorial Campaign Committee by securities and investment firms.



Source: Center for Responsive Politics

THE NEW YORK TIMES

But Mr. Schumer, a member of the Banking and Finance Committees, repeatedly took other steps to protect industry players from government oversight and tougher rules, a review of his record shows. Over the years, he has also helped save financial institutions billions of dollars in higher taxes or fees.

He succeeded in limiting efforts to regulate credit-rating agencies, for example, sponsored legislation that cut fees paid by Wall Street firms to finance government oversight, pushed to allow banks to have lower capital reserves and called for the revision of regulations to make corporations' balance sheets more transparent.

"Since the financial meltdown,

BRENDAN SMIALOWSKI FOR THE NEW YORK TIMES

Senator Charles Schumer meeting with Neel T. Kashkari, center, the official in charge of the $700 billion federal bailout.

people have been asking, 'Where was Congress? Why didn't they see this coming? Why didn't they provide better oversight?' " said Barbara Roper, director of investor protection for the Consumer Federation of America. "And the answer for some, including Senator Schumer, is that they were actually too busy pursuing a deregulatory agenda. Their focus was on how we have to lighten up regulation on Wall Street."

In recent weeks, Mr. Schumer has worked closely with the Bush administration to try to mitigate the damage to New York's financial institutions. And as members of Congress and President-elect Barack Obama have called for new regulations to prevent future upheavals, Mr. Schumer has endorsed the need for reforms while still trying to make them palatable for Wall Street.

Calling himself "an almost obsessive defender of New York jobs," Mr. Schumer has often talked of the need to avoid excessive regulation of an industry that is increasingly threatened by global competition. At the same time, Mr. Schumer has cast himself as a populist who looks out for the middle class.

ONLINE: *Copies of letters sent to federal regulators by Senator Charles E. Schumer arguing positions supportive of Wall Street firms; and previous articles and multimedia in this series:* **nytimes.com/reckoning**

In an interview, Mr. Schumer said that until the recent market turmoil, he did not fully appreciate how much risk Wall Street had assumed and how much damage its practices could inflict on ordinary Americans. "It is a learning process, no question about it, an evolution," he said, adding that he now believed that investors and homeowners must be better protected.

But he defended his record. "Wall Street and Main Street are tied together," he said. "Often times, they are not in conflict. When they are in conflict, I tend to side with Main Street."

While Mr. Schumer has taken

some pro-consumer stances, his critics fault him for tilting too far toward Wall Street in balancing his responsibilities.

"He is serving the parochial interest of a very small group of financial people, bankers, investment bankers, fund managers, private equity firms, rather than serving the general public," said John C. Bogle, the founder and former chairman of the Vanguard Group, the giant mutual fund house. "It has hurt the American investor first and the average American taxpayer."

Navigating the Street

Brash and brainy (perfect SATs and double Harvard degrees), Chuck Schumer, now 58, learned early in his career how to talk to the financiers and chief executives who would become a vital constituency for him. Though he did not grow up in that world — his father owned a small exterminating business in Brooklyn — he quickly showed a keen grasp of complex financial issues.

And, recognizing how central Wall Street is to the city's economy, he committed himself to keeping it strong.

"So much of what happens in this town is because we are the world financial center," Mr. Schumer said at City Hall in January 2007. "It helps support our museums, it provides the tax base for schools and health care. If we lose being the financial center, the rest goes down the drain."

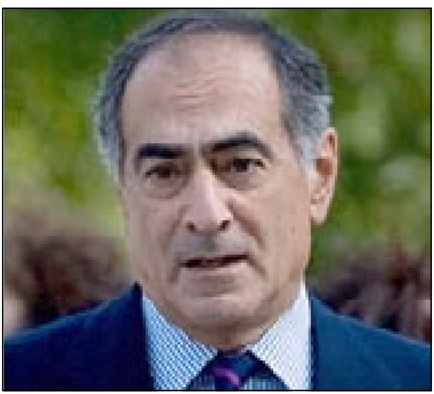
Soon after arriving in Congress in 1981, Mr. Schumer snared a seat on the Financial Services Committee, which he viewed as the best way to help New York. While reliably liberal on many social issues, he established himself as a pragmatic Democrat willing to align with powerful business interests.

Mr. Schumer's political rise — he moved in 1999 to the Senate, where he now has a party leadership post — paralleled Wall Street's growing influence in Washington. As more Americans invested in the markets and financial institutions had a greater global reach, the industry came to rival the manufacturing sector as a driving force of the United States economy.

And in the 1990s, Democratic officials developed close links to a new generation of Wall Street leaders — labeled "New Moneycrats" by one author — who shared a free-market agenda.

Mr. Schumer became a magnet for campaign donations from wealthy industry executives, including Jamie Dimon, now the chief executive of JPMorgan Chase; John J. Mack, the chief executive at Morgan Stanley; and Charles O. Prince III, the former chief executive of Citigroup. And he was not at all reluctant to ask them for more.

Donors describe the Schumer pitch as unusually aggressive: He calls repeatedly to suggest breakfast or dinner, coffee or cocktails. He enlists intermediaries to invite prospects to events and recruits several senators to tag along. And he presses for the maximum contribution — "I need you to max out," he is known to say — then follows up by asking that a donor's spouse



BRENDAN SMIALOWSKI FOR THE NEW YORK TIMES

JOHN MACK

At Morgan Stanley, he bent Senator Charles Schumer's ear.

PATRICK ANDRADE FOR THE NEW YORK TIMES

JAMIE DIMON

Mr. Schumer has counted on titans like the head of JPMorgan Chase.

and four or five friends write checks, too.

"He was probably the kid that sold the most candy in grade school," said Julie Domenick, a Democratic lobbyist who has given to the senatorial campaign committee. "He is not shy."

Mr. Schumer, in the interview, acknowledged his full-speed-ahead approach. "Any job I do, I work hard at and I try to succeed at," he said.

As a result, he has collected over his career more in campaign contributions from the securities and investment industry than any of his peers in Congress, with the exception of Senator John F. Kerry of Massachusetts, the Democratic nominee for president in 2004, according to the Center for Responsive Politics, which analyzed federal data. (By 2005, Mr. Schumer had so much cash in reserve that he shut down his fund-raising efforts.)

In the last two-year election cycle, he helped raise more than $120 million for the Democrats' Senate campaign committee, drawing nearly four times as much money from Wall Street as the National Republican Senatorial Committee. Donors often mention his "pro-business message" and record of addressing their concerns. John A. Kanas, the former chief executive of North Fork Bank, said: "He would solicit my opinion, listen to my advice and he appeared to take it into consideration."

Lee A. Pickard, a lawyer representing clients including the Bank of New York, whose employees have been significant donors to Mr. Schumer and other Senate Democrats, turned to Mr. Schumer last year to successfully beat back a regulatory initiative by the Securities and Exchange Commission. "If you get Chuck Schumer on your side, you are O.K.," he said.

That may help explain why some of the wealthiest financiers in Manhattan attended the Sept. 22 breakfast hosted by Mr. Kravis at his office overlooking Central Park. A Republican with long ties to the Bush family, Mr. Kravis spent much of this year trying to help Senator John McCain, the eventual Republican nominee for president.

But last year, Mr. Kravis went to Capitol Hill to oppose a proposal that would have more than doubled taxes for executives at hedge funds and private equity firms like his, costing them up to $25 billion over 10 years.

Mr. Schumer had said publicly he would support the measure only if it also applied to executives at energy, venture capital and real estate partnerships, and he introduced alternative legislation that would do just that. His position was identical to that of lobbyists for a group paid by Mr. Kravis and other finance industry executives.

The Schumer bill, called a "poison pill" by the leading Republican advocate of the tax increase, went nowhere after provoking opposition from an array of industries.

At the breakfast meeting, Mr. Schumer, accompanied by fellow Senate Democrats Kent Conrad of North Dakota and Maria Cantwell of Washington, assessed the political landscape as debate over the bailout was beginning.

"On the right, you have those who view any government intervention as a threat to free markets," one executive recalled Mr. Schumer explaining. "On the left, you have people who choose to view this as a government handout to the rich. In the middle, you have everyone who knows and takes the Treasury secretary seriously and recognizes that if something is not done here, we could be staring into an abyss."

Within days, the businessmen sent out checks to the Senate campaign committee.

'Their Go-To Guy'

To Christopher Cox, the Republican chairman of the Securities and Exchange Commission, the need for action was obvious in the spring of 2006.

His agency, which would later be criticized for a 2004 ruling that let banks pile up debt, had grown deeply concerned about lack of oversight of the nation's largest credit-rating agencies, like Standard & Poor's and Moody's Investors Service. Linchpins of the financial system, their ratings are vital to safeguarding investors by evaluating the risks of bonds and other debt. After the collapse of Enron and WorldCom, which had repeatedly been awarded favorable ratings, the agencies had agreed to meet voluntary standards.

But the S.E.C. concluded that those agreements were inadequate, so Mr. Cox urged Congress to give his agency oversight powers. "Without additional legislative authority, the S.E.C. will not be able to regulate in a thoroughgoing way," he told the Senate banking committee at an April 2006 hearing.

The plan drew broad, bipartisan support on Capitol Hill. But executives at the credit-rating agencies soon began pressing Mr. Schumer and other allies in Congress to block the proposal or at least limit its reach, according to current and former employees.

"They knew Schumer would support them," said one former Moody's executive, who asked not to be named because he still works in the industry. "He was their go-to guy," the executive said.

While the Manhattan-based agencies were not significant campaign donors to Mr. Schumer or the Senate campaign committee, their lobbyists and many of their clients were.

At that time, revenues for the agencies were skyrocketing. The housing market was robust, and Wall Street investment firms were paying the agencies to rate various mortgage-backed securities after first advising the firms — and also collecting fees — on how to package them to get high credit ratings.

It was an obvious conflict of interest, financial experts now say. Despite their high ratings, many of those securities, based on risky loans, would prove worthless, roiling markets and threatening financial institutions worldwide.

But Mr. Schumer argued that the companies voluntarily met requirements to eliminate such possible conflicts. He suggested that regulators simply encourage competition and disclosure of agencies' ratings methods. There was perhaps no need for an intrusive new law, he said in the spring of 2006. "They've implemented their codes of conduct," Mr. Schumer told Mr. Cox at a Senate hearing. "They're making good-faith efforts."

Mr. Schumer could not stop the legislation from passing, but he managed to get the measure amended so that it explicitly prohibited the S.E.C. from regulating the procedures and methods the agencies use to determine ratings.

Richard Y. Roberts, a former S.E.C. commissioner, said the amendment Mr. Schumer won was troubling, adding that it could block the S.E.C. from punishing a credit-rating agency that consistently issued unreliable ratings.

Sean J. Egan, managing director of a small Pennsylvania agency, Egan-Jones Ratings, and a proponent of the tougher regulations, was more blunt. "The bill was eviscerated," he said. "You have stripped away basic safeguards for the investors."

At times in Congress, Mr. Schumer has teamed up with Republicans, like former Senator Phil Gramm of Texas, who aggressively promoted a free-market agenda. Mr. Schumer pushed for the Gramm-Leach-Bliley law, passed in November 1999, which knocked down the walls between investment banks and commercial banks and allowed financial supermarkets to flourish. The law also weakened regulatory oversight by fracturing it among different agencies.

In 2001, Mr. Schumer and Mr. Gramm jointly proposed legislation that would cut fees paid by Wall Street firms and others to the S.E.C. in half, or by $14 billion, over the coming decade. Their proposal included some extra money for salaries of commission employees.

But with trading volumes high, Mr. Schumer argued, the government was collecting far too much money from those fees and using it to subsidize other government operations. "It is a tax, an unintended but very real tax, on all sorts of investors," he said at the time.

But some Democrats, pointing to the recent corporate accounting scandals, argued that the S.E.C. budget should be doubled or tripled so it could more effectively combat fraud that could lead to a major economic collapse.

"We are making a tragic mistake," Representative John J. LaFalce, Democrat of New York, warned in arguing for a much smaller reduction in S.E.C. fees. "We give the industry what it asks for unwittingly."

Mr. Schumer's argument prevailed, and the fee cut passed overwhelmingly.

Some consumer advocates laud Mr. Schumer for his stances on consumer finance issues, including combating high interest rates on credit cards, challenging predatory lending practices and advocating legislation to allow bankruptcy courts to force banks to accept lower interest rates so that families facing foreclosure could stay in their homes.

"He is a strong advocate for families and homeowners to make sure they are not taken advantage of," said Eric Stein, senior vice president at the Center for Responsible Lending, a nonprofit group that combats abusive lending practices.

But those efforts mostly affect commercial banks and mortgage lending operations around the country and in New York, not the securities and investment businesses in Manhattan.

"He built his career in large part based on his ties to Wall Street," said Christopher Whalen, managing director of Institutional Risk Analytics, which advises investors on the regulatory system. "And he has given the Street what it wanted."

Mr. Schumer, though, has a surprising defender in Alfonse M. D'Amato, the onetime Republican senator he ousted.

"Don't take someone to task simply because a group has supported him politically and now he supports legislation that helps them," Mr. D'Amato said. "The question is, is the legislation good or bad? With Chuck, it is clear he tries to do what is best for the state and city as a whole."

Doling Out Criticism

For Mr. Schumer, Wall Street's crisis has been especially painful to watch. "It is horrible, just awful," he said in the interview. "And it affects everybody."

And he has already begun identifying those he faults for the devastation. Subprime lenders top the list, but he has lashed out with particular fury at the credit-rating industry, which he once defended but now says misled him and the investing public.

"The work at these ratings firms was severely compromised, and the companies were some of the biggest contributors to the current financial crisis," Mr. Schumer said earlier this month in response to an S.E.C. move that same day to tighten control over the agencies. "The lesson from this is that the three major firms' stranglehold on the ratings industry must be loosened." Mr. Schumer has also blamed the Bush administration for its push to ease rules. "After eight years of deregulatory zeal by the Bush administration, an attitude of 'the market can do no wrong' has led it down a short path to economic recession," Mr. Schumer said on the Senate floor in September.

He has not assigned responsibility to himself or fellow Democrats, saying he had no way of knowing of the misdeeds going on on Wall Street. "I wish I was omniscient," he said. "I'm not."

Since the economy began to fall apart, Mr. Schumer has joined others in calling for new regulations to combat abuses. He has proposed tougher rules for credit-rating agencies, even changing the way they are paid so they are compensated by investors, not by the companies they are evaluating. He has said he is open to imposing regulations on hedge funds, which currently operate with limited government oversight.

And while he previously succeeded in limiting consumers' rights to sue financial institutions, he says he now favors offering that remedy in certain circumstances.

But he is also warning that any new rules must be carefully crafted so they don't impose excessive burdens.

"You need to provide safety and security to investors in order to attract them to the markets," Mr. Schumer told Wall Street executives in a speech last month. "On the other hand, you must be sure that regulation does not snuff out the entrepreneurial vigor and financial innovation that drives economic growth and makes financial institutions successful and profitable."

And he is seeking some regulatory concessions for some Wall Street supporters. He has proposed, for example, that the government lift a cap on how big the giant banks can get, an issue important to institutions like JPMorgan Chase. Lifting the cap would allow the biggest banks to absorb weaker ones, but it would also limit competition and increase the risks to the financial system posed by failure of one of the giants.

Mr. Schumer is also calling for the adoption of European-style regulations that impose far fewer rules and instead require banks to meet certain performance standards, a system institutions generally prefer but some banking experts criticize as not rigorous enough.

In recent weeks, Mr. Schumer has listened to Wall Street leaders for advice on what should come next. At a dinner at Morgan

Schumer's Stands ▸▸

Stanley's headquarters the night before the presidential election, John Mack, the chief executive, and a dozen top hedge fund officials talked with Mr. Schumer about possible changes affecting their industry.

"People feel like he is going to be fair and reasonable," said one Morgan Stanley executive, who asked not to be identified because the session was private. "He is mindful that this is a very big part of his constituency — Wall Street." □

Griff Palmer contributed reporting from New York.

Schumer's Stands

1 2 3 NEXT

Through most of his career, Charles E. Schumer has been a champion of consumers, when it comes to consumer banking and mortgage issues. But he also has been a Wall Street ally, taking up regulatory fights on the industry's behalf. Here are some of his efforts to defend the interests of the financial services' industry.

	ISSUE	POSITION	OUTCOME
Private Securities Litigation Reform Act of 1995	Legislation intended to curtail lawsuits claiming securities fraud.	Mr. Schumer supported Republican-sponsored legislation limiting monetary damages and requiring investors to prove intentional misstatements to pursue a suit.	President Clinton vetoed the legislation. Mr. Schumer joined with Republicans, and other House Democrats to override the veto.
Disclosure rules regarding derivatives in 1997	The Financial Accounting Standards Board sought more detailed reporting of corporate investments involving derivatives.	Mr. Schumer co-signed a letter that cited concern by corporate clients and Wall Street firms about the "potential danger of disclosing sensitive information to competitors."	The rule went into effect in 2000.
Gramm-Leach-Bliley Act of 1999	Legislation allowing banks, investment banks and insurance companies to merge, creating financial supermarkets, like Citigroup.	Mr. Schumer was an advocate of the legislation, saying "if we didn't pass this bill, we could find London or Frankfurt or years down the road Shanghai becoming the financial capital of the world."	The legislation, after years of negotiations over the topic, won widespread support in Congress.

Schumer's Stands

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	ISSUE	POSITION	OUTCOME
Investor and Capital Markets Fee Relief Act, 2001	Cutting S.E.C. fees paid by securities firms by $14 billion over 10 years.	Co-sponsored Senate version of the legislation, which included money for some S.E.C. raises.	With intense lobbying from Wall Street, the legislation was passed.
Pension Protection Act, 2006	Legislation modifying rules governing employee pension plans.	Mr. Schumer added key industry protections into a bill that eased restrictions on pension fund investments in stocks and hedge funds.	Some labor leaders thought the changes would leave pension funds vulnerable. Mr. Schumer prevailed.
Regulation of Credit Rating Agencies, 2006	Legislation to regulate creditrating agencies, to combat conflicts of interest exposed by Enron's collapse.	Mr. Schumer questioned if the legislation was necessary, urging Christopher Cox, the S.E.C. chairman, to agree to a voluntary code of conduct promoted by the industry.	Legislation passed, but after Mr. Schumer pushed for an amendment that set limits on the S.E.C.'s power to regulate the agencies.
The Bloomberg-Schumer Report, 2007	Mr. Schumer and Mayor Michael Bloomberg of New York called for a relaxation of financial sector regulations.	"If New York does not stay no. 1 in terms of financial services, we could lose everything else," Mr. Schumer said.	The agenda faltered after the financial collapse started, although Mr. Schumer is still pushing some of the ideas.

Schumer's Stands

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	ISSUE	POSITION	OUTCOME
Banning Soft Dollars, 2007	Mr. Cox asks Congress to ban "soft dollars," extra commissions paid to brokers during a stock trade.	Mr. Schumer berated Mr. Cox, saying that abuses had been corrected and the ban threatened independent Wall Street research firms.	Mr. Cox abandoned the proposal. The payments, worth billions of dollars a year, still are made.
Private Equity and Hedge Fund Tax Rates, 2007	Doubling the tax rates paid by hedge fund and private equity partners	Mr. Schumer, echoing an industry lobbying line, effectively stalled the legislation by arguing all business partnerships should have to pay the higher tax.	Mr. Schumer supported a motion last year that would have imposed the higher tax on financial firms. But since it failed, the matter never came to a final vote.
Shortselling, 2008	Facing large declines in its stock during the market troubles in September, Morgan Stanley sought a temporary ban on short-selling of financial stocks.	John Mack, of Morgan Stanley, asked Mr. Schumer for help. Mr. Schumer called Treasury Secretary Henry M. Paulson Jr., Federal Reserve Chairman Ben Bernanke and Mr. Cox advocating the short-selling ban.	The temporary ban was imposed after many voices including Senator Hillary Clinton, Democrat of New York, advocated it.

On Wall Street, Bonuses, Not Profits, Were Real

"As a result of the extraordinary growth at Merrill during my tenure as C.E.O., the board saw fit to increase my compensation each year."

— E. Stanley O'Neal, the former chief executive of Merrill Lynch, March 2008

By LOUISE STORY

FIRST PUBLISHED: DECEMBER 18, 2008

FOR DOW KIM, 2006 was a very good year. While his salary at Merrill Lynch was $350,000, his total compensation was 100 times that — $35 million.

The difference between the two amounts was his bonus, a rich reward for the robust earnings made by the traders he oversaw in Merrill's mortgage business.

Mr. Kim's colleagues, not only at his level, but far down the ranks, also pocketed large paychecks. In all, Merrill handed out $5 billion to $6 billion in bonuses that year. A 20-something analyst with a base salary of $130,000 collected a bonus of $250,000. And a 30-something trader with a $180,000 salary got $5 million.

But Merrill's record earnings in 2006 — $7.5 billion — turned out to be a mirage. The company has since lost three times that amount, largely because the mortgage investments that supposedly had powered some of those profits plunged in value.

Unlike the earnings, however, the bonuses have not been reversed.

As regulators and shareholders sift through the rubble of the financial crisis, questions are being asked about what role lavish bonuses played in the debacle. Scrutiny over pay is intensifying as banks like Merrill prepare to dole out bonuses even after they have had to be propped up with billions of dollars of taxpayers' money. While bonuses are expected to be half of what they were a year ago, some bankers could still collect millions of dollars.

Critics say bonuses never should have been so big in the first place, because they were based on ephemeral earnings. These people contend that Wall Street's pay structure, in which bonuses are based on short-term profits, encouraged employees to act like gamblers at a casino — and let them collect their winnings while the roulette wheel was still spinning.

"Compensation was flawed top to bottom," said Lucian A. Bebchuk, a professor at Harvard Law School and an expert on compensation. "The whole organization was responding to distorted incentives."

Even Wall Streeters concede they were dazzled by the money. To earn bigger bonuses, many traders ignored or played down the risks they took until their bonuses were paid. Their bosses often turned a blind eye because it was in their interest as well.

"That's a call that senior management or risk management should question, but of course their pay was tied to it too," said Brian Lin, a former mortgage trader at Merrill Lynch.

PATRICK ANDRADE FOR THE NEW YORK TIMES

Brian Lin is a former mortgage trader at Merrill Lynch who lost his job at Merrill and now works at RRMS Advisors.

The highest-ranking executives at four firms have agreed under pressure to go without their bonuses, including John A. Thain, who initially wanted a bonus this year since he joined Merrill Lynch as chief executive after its ill-fated mortgage bets were made. And four former executives at one hard-hit bank, UBS of Switzerland, recently volunteered to return some of the bonuses they were paid before the financial crisis. But few think others on Wall Street will follow that lead.

For now, most banks are looking forward rather than backward. Morgan Stanley and UBS are attaching new strings to bonuses, allowing them to pull back part of workers' payouts if they turn out to have been based on illusory profits. Those policies, had they been in place in recent years, might have clawed back hundreds of millions of dollars of compensation paid out in 2006 to employees at all levels, including senior executives who are still at those banks.

A Bonus Bonanza

For Wall Street, much of this decade represented a new Gilded Age. Salaries were merely play money — a pittance compared to bonuses. Bonus season became an annual celebration of the riches to be had in the markets. That was especially so in the New York area, where nearly $1 out of every $4 that companies paid employees last year went to someone in the financial industry. Bankers celebrated with five-figure dinners, vied to outspend each other at charity auctions and spent their newfound fortunes on new homes, cars and art.

The bonanza redefined success for an entire generation. Graduates of top universities sought their fortunes in banking, rather than in careers like medicine, engineering or teaching. Wall Street worked its rookies hard, but it held out the promise of rich rewards. In college dorms, tales of 30-year-olds pulling down $5 million a year were legion.

While top executives received the biggest bonuses, what is striking is how many employees throughout the ranks took home large paychecks. On Wall Street, the first goal was to make "a buck" — a million dollars. More than 100 people in Merrill's bond unit alone broke the million-dollar mark in 2006. Goldman Sachs paid more than $20 million apiece to more than 50 people that year, according to a person familiar with the matter. Goldman declined to comment.

Pay was tied to profit, and profit to the easy, borrowed money that could be invested in markets like mortgage securities. As the financial industry's role in the economy grew, workers' pay ballooned, leaping sixfold since 1975, nearly twice as much as the increase in pay for the average American worker.

"The financial services industry was in a bubble," said Mark Zandi, chief economist at Moody's Economy.com. "The industry got a bigger share of the economic pie."

A Money Machine

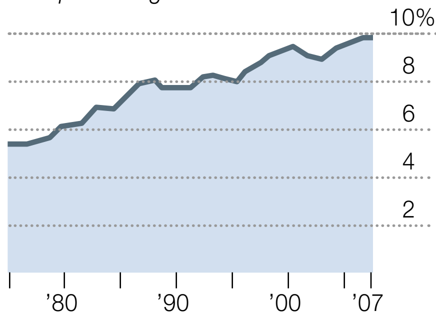
Dow Kim stepped into this milieu in the mid-1980s, fresh from the Wharton School at the University of Pennsylvania. Born in Seoul and raised there and in Singapore, Mr. Kim moved to the United States at 16 to attend Phillips Academy in Andover, Mass. A quiet workaholic in an industry of workaholics, he seemed to rise through the ranks by sheer will. After a stint trading bonds in Tokyo, he moved to New York to oversee Merrill's fixed-income business in 2001. Two years later, he became co-president.

Financials Gain

Wall Street has been capturing a greater share of profits and salaries for more than 30 years.

Financial services profits
As a percentage of U.S. total

Financial services wages and salaries
As a percentage of U.S. total

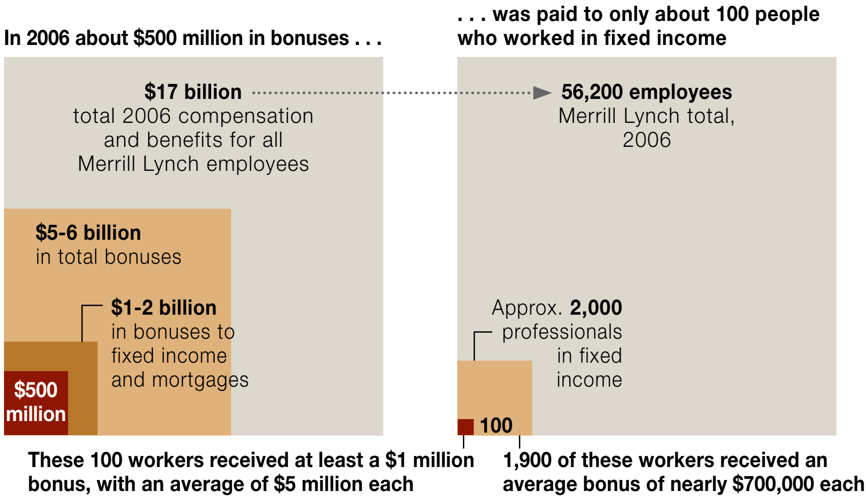


Source: Moody'sEconomy.com THE NEW YORK TIMES

It Was Good to Be a Mortgage-Related Professional . . .

1 2 NEXT

A select few who worked in the fixed-income division of Merrill Lynch, where the profit in mortgages was booked, were well paid in 2006.



Source: Estimates from several industry sources

THE NEW YORK TIMES

Even as tremors began to reverberate through the housing market and his own company, Mr. Kim exuded optimism.

After several of his key deputies left the firm in the summer of 2006, he appointed a former colleague from Asia, Osman Semerci, as his deputy, and beneath Mr. Semerci he installed Dale M. Lattanzio and Douglas J. Mallach. Mr. Lattanzio promptly purchased a $5 million home, as well as oceanfront property in Mantoloking, a wealthy enclave in New Jersey, according to county records.

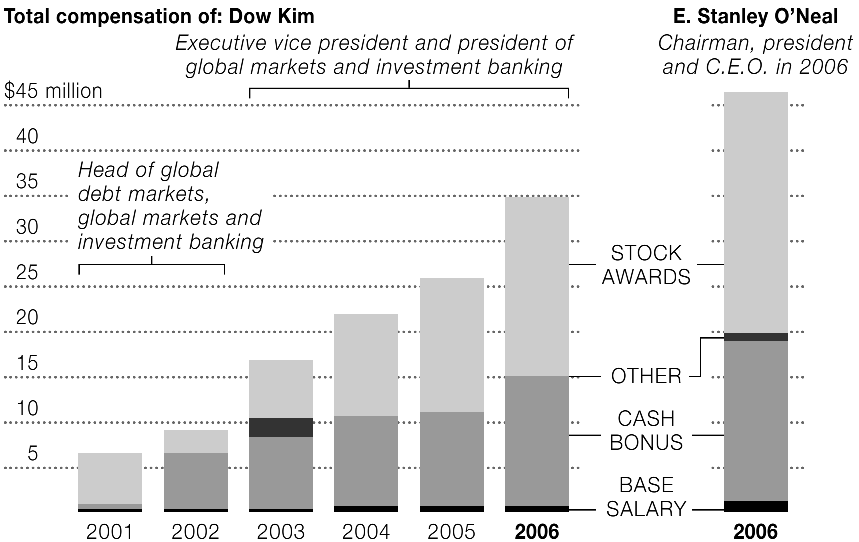
Merrill and the executives in this article declined to comment or say whether they would return past bonuses. Mr. Mallach did not return telephone calls.

Mr. Semerci, Mr. Lattanzio and

. . . Especially at the Top

1 2 NEXT

Dow Kim, co-head of investment banking and global markets of Merrill Lynch and the executive who oversaw the growth of the fixed-income and mortgage units, was paid $117 million since 2001. In 2006, he made nearly as much as the chief executive, E. Stanley O'Neal. After the collapse of the mortgage market, much of the profit that his pay was based on was erased in write-downs.



Source: Equilar

THE NEW YORK TIMES

Mr. Mallach joined Mr. Kim as Merrill entered a new phase in its mortgage buildup. That September, the bank spent $1.3 billion to buy the First Franklin Financial Corporation, a mortgage lender in California, in part so it could bundle its mortgages into lucrative bonds.

Yet Mr. Kim was growing restless. That same month, he told E. Stanley O'Neal, Merrill's chief executive, that he was considering starting his own hedge fund. His traders were stunned. But Mr. O'Neal persuaded Mr. Kim to stay, assuring him that the future was bright for

Merrill's mortgage business, and, by extension, for Mr. Kim.

Mr. Kim stepped to the lectern on the bond trading floor and told his anxious traders that he was not going anywhere, and that business was looking up, according to four former employees who were there. The traders erupted in applause.

"No one wanted to stop this thing," said former mortgage analyst at Merrill. "It was a machine, and we all knew it was going to be a very, very good year."

Merrill Lynch celebrated its success even before the year was over. In November, the company hosted a three-day golf tournament at Pebble Beach, Calif.

Mr. Kim, an avid golfer, played alongside William H. Gross, a founder of Pimco, the big bond house; and Ralph R. Cioffi, who oversaw two Bear Stearns hedge funds whose subsequent collapse in 2007 would send shock waves through the financial world.

"There didn't seem to be an end in sight," said a person who attended the tournament.

Back in New York, Mr. Kim's team was eagerly bundling risky home mortgages into bonds. One of the last deals they put together that year was called "Costa Bella," or beautiful coast — a name that recalls Pebble Beach. The $500 million bundle of loans, a type of investment known as a collateralized debt obligation, was managed by Mr. Gross's Pimco.

Merrill Lynch collected about $5 million in fees for concocting Costa Bella, which included mortgages originated by First Franklin.

But Costa Bella, like so many other C.D.O.'s, was filled with loans that borrowers could not repay. Initially part of it was rated AAA, but Costa Bella is now deeply troubled. The losses on the investment far exceed the money Merrill collected for putting the deal together.

So Much for So Few

By the time Costa Bella ran into trouble, the Merrill bankers who had devised it had collected their bonuses for 2006. Mr. Kim's fixed-income unit generated more than half of Merrill's revenue that year, according to people with direct knowledge of the matter. As a reward, Mr. O'Neal and Mr. Kim paid nearly a third of Merrill's $5 billion to $6 billion bonus pool to the 2,000 professionals in the division.

Mr. O'Neal himself was paid $46 million, according to Equilar, an executive compensation research firm and data provider in California. Mr. Kim received $35 million. About 57 percent of their pay was in stock, which would lose much of its value over the next two years, but even the cash portions of their bonus were generous: $18.5 million for Mr. O'Neal, and $14.5 million for Mr. Kim, according to Equilar.

Mr. Kim and his deputies were given wide discretion about how to dole out their pot of money. Mr. Semerci was among the highest earners in 2006, at more than $20 million. Below him, Mr. Mallach and Mr. Lattanzio each earned more than $10 million. They were among just over 100 people who accounted for some $500 million of the pool, according to people with direct knowledge of the matter.

After that blowout, Merrill pushed even deeper into the mortgage business, despite growing signs that the housing bubble was starting to burst. That decision proved disastrous. As the problems in the subprime mortgage market exploded into a full-blown crisis, the value of Merrill's investments plummeted. The firm has since written down its investments by more than $54 billion, selling some of them for pennies on the dollar.

Mr. Lin, the former Merrill trader, arrived late to the party. He was one of the last people hired onto Merrill's mortgage desk, in the summer of 2007. Even then, Merrill guaranteed Mr. Lin a bonus if he joined the firm. Mr. Lin would not disclose his bonus, but such payouts were often in the seven figures.

Mr. Lin said he quickly noticed that traders across Wall Street were reluctant to admit what now seems so obvious: Their mortgage investments were worth far less than they had thought.

"It's always human nature," said Mr. Lin, who lost his job at Merrill last summer and now works at RRMS Advisors, a consulting firm that advises investors in troubled mortgage investments. "You want to pull for the market to do well because you're vested."

But critics question why Wall Street embraced the risky deals even as the housing and mortgage markets began to weaken.

"What happened to their investments was of no interest to them, because they would already be paid," said Paul Hodgson, senior research associate at the Corporate Library, a shareholder activist group. Some Wall Street executives argue that paying a larger portion of bonuses in the form of stock, rather than in cash, might keep employees from making short-sighted decision. But Mr. Hodgson contended that would not go far enough, in part because the cash rewards alone were so high. Mr. Kim, for example, was paid a total of $116.6 million in cash and stock from 2001 to 2007. Of that, $55 million was in cash, according to Equilar.

Leaving the Scene

As the damage at Merrill became clear in 2007, Mr. Kim, his deputies and finally Mr. O'Neal left the firm. Mr. Kim opened a hedge fund, but it quickly closed. Mr. Semerci and Mr. Lattanzio landed at a hedge fund in London.

All three departed without collecting bonuses in 2007. Mr. O'Neal, however, got even richer by leaving Merrill Lynch. He was awarded an exit package worth $161 million.

Clawing back the 2006 bonuses at Merrill would not come close to making up for the company's losses, which exceed all the profits that the firm earned over the previous 20 years. This fall, the once-proud firm was sold to Bank of America, ending its 94-year history as an independent firm.

Mr. Bebchuk of Harvard Law School said investment banks like Merrill were brought to their knees because their employees chased after the rich rewards that executives promised them.

"They were trying to get as much of this or that paper, they were doing it with excitement and vigor, and that was because they knew they would be making huge amounts of money by the end of the year," he said. □

Ben White contributed reporting.

Tax Break May Have Helped Cause Housing Bubble

"Tonight, I propose a new tax cut for homeownership that says to every middle-income working family in this country, if you sell your home, you will not have to pay a capital gains tax on it ever — not ever."

— President Bill Clinton, at the 1996 Democratic National Convention

By VIKAS BAJAJ and DAVID LEONHARDT

FIRST PUBLISHED: DECEMBER 19, 2008

RYAN J. WAMPLER had never made much money selling his own homes.

Starting in 1999, however, he began to do very well. Three times in eight years, Mr. Wampler — himself a home builder and developer — sold his home in the Phoenix area, always for a nice profit. With prices in Phoenix soaring, he made almost $700,000 on the three sales.

And thanks to a tax break proposed by President Bill Clinton and approved by Congress in 1997, he did not have to pay tax on most of that profit. It was a break that had not been available to generations of Americans before him. The benefits also did not apply to other investments, be they stocks, bonds or stakes in a small business. Those gains were all taxed at rates of up to 20 percent.

The different tax treatments gave people a new incentive to plow ever more money into real estate, and they did so. "When you give that big an incentive for people to buy and sell homes," said Mr. Wampler, 44, a mild-mannered native of Phoenix who has two children, "they are going to buy and sell homes."

By itself, the change in the tax law did not cause the housing bubble, economists say. Several other factors — a relaxation of lending standards, a failure by regulators to intervene, a sharp decline in interest rates and a collective belief that house prices could never fall — probably played larger roles.

But many economists say that the law had a noticeable impact, allowing home sales to become tax-free windfalls. A recent study of the provision by an economist at the Federal Reserve suggests that the number of homes sold was almost 17 percent higher over the last

PHOTOGRAPHS BY MONICA ALMEIDA/ THE NEW YORK TIMES

Ryan J. Wampler, left, a home builder in the Phoenix area, and a home he once owned in Scottsdale, Ariz. He made nearly $700,000 on three sales of his own homes in eight years.

decade than it would have been without the law.

Vernon L. Smith, a Nobel laureate and economics professor at George Mason University, has said the tax law change was responsible for "fueling the mother of all housing bubbles."

By favoring real estate, the tax code pushed many Americans to begin thinking of their houses more as an investment than as a place to live. It helped change the national conversation about housing. Not only did real estate look like a can't-miss investment for much of the last decade, it was also a tax-free one.

Together with the other housing subsidies that had already been in the tax code — the mortgage-interest deduction chief among them — the law gave people a motive to buy more and more real estate. Lax lending standards and low interest rates then gave people the means to do so.

Referring to the special treatment for capital gains on homes, Charles O. Rossotti, the Internal Revenue Service commissioner from 1997 to 2002, said: "Why insist in effect that they put it in housing to get that benefit? Why not let them invest in other things that might be more productive, like stocks and bonds?"

The provision — part of a sprawling bill called the Taxpayer Relief Act of 1997 — exempted most home sales from capital-gains taxes. The first $500,000 in gains from any home sale was exempt from taxes for a married couple, as long as they had lived in the home for at least two of the previous five years. (For singles, the first $250,000 was exempt.)

Mr. Wampler said he never sold a home simply because of the law's existence, but it played a role in his decisions and also became part of his stock pitch to potential customers who were considering buying the homes he was building in the desert. He would point out that the tax benefits would increase their returns on a house, relative to stocks.

"Why not put your money on the highest-yielding investment with the highest tax benefit?" he said recently.

During the boom years, he prospered. But today he owns 80 acres of land on the outskirts of Phoenix that he cannot sell. He owes $8 million to his banks, which may soon foreclose on his land.

"I am literally dying on the vine," he said.

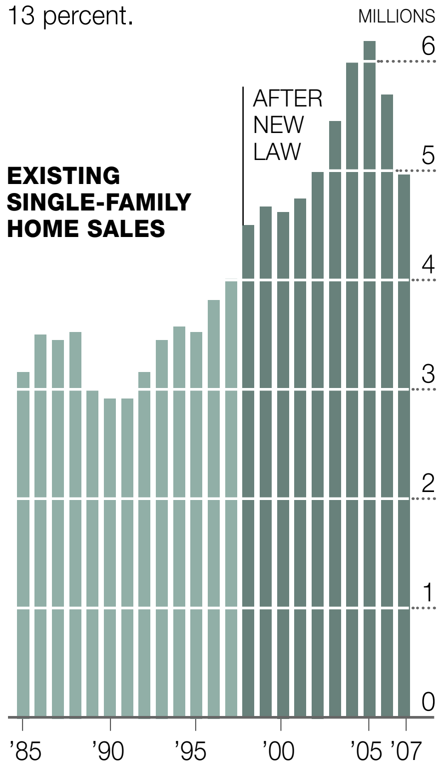
The change in the tax law had its roots in a Chicago speech that Senator Bob Dole, Mr. Clinton's Republican opponent in the 1996 presidential election, gave on Aug. 5 of that year. Trailing Mr. Clinton in the polls, Mr. Dole came out for an enormous tax cut, including an across-the-board reduction in the capital-gains tax.

The proposal made Mr. Clinton's political advisers more nervous than almost anything else during the campaign. The campaign's chief spokesman, Joe Lockhart, traveled to Chicago to stand outside the ballroom where Mr. Dole was speaking and make the case that the Dole tax cut would cause the deficit to soar.

At the same time, Mr. Clinton's aides began scrambling to come up with their own tax proposal. Dick Morris, the president's chief outside political adviser,

A Sales Surge

In 1997, Congress passed an act eliminating capital gains taxes on profits of $500,000 or less on most home sales. The following year, single-family home sales jumped 13 percent.



Source: National Association of Realtors

THE NEW YORK TIMES

argued that Mr. Clinton could assure his re-election by matching Mr. Dole's call for a big cut in the capital-gains tax.

But members of Mr. Clinton's economic team, led by Treasury Secretary Robert E. Rubin, disliked that idea. They thought it would undo the tough work the administration had done to reduce the budget deficit. So they instead went looking for smaller tax cuts that would allow their boss to campaign as both a fiscal conservative and a tax cutter.

Getting rid of capital gains on most home sales seemed like the perfect idea.

Treasury officials had become interested in that provision earlier in Mr. Clinton's term after Jane G. Gravelle, an economist at the Congressional Research Service, had called it to their attention, according to Eric J. Toder, an official in the tax policy office at the time. He and his colleagues were looking for ways to simplify the tax code, and Ms. Gravelle told them that eliminating capital-gains taxes on houses was an excellent candidate.

The tax forced homeowners to keep track of all their renovations over many years, because the cost of those renovations could be subtracted from their taxable gain. Even renovations on previous homes often qualified, as long as people had deferred the tax in the past by buying a new house at least as valuable as their old one.

"It was very hard for people to keep track of that information," said Leslie B. Samuels, the assistant Treasury secretary for tax policy from 1993 to 1996.

People could also avoid the tax under a one-time exemption, for profits of up to $125,000, if they were older than 55. Thus, the tax raised relatively little revenue — perhaps just a few hundred million dollars in today's terms. "It was the worst kind of tax system," Ms. Gravelle said recently. "It raised very little revenue, but it caused all these distortions and compliance problems."

Three weeks after Mr. Dole's speech, with support from top Treasury officials, the proposal made it into Mr. Clinton's speech at the Democratic convention. During the presidential debates that followed, he used it to parry Mr. Dole's calls for a big tax cut. The following summer, Mr. Clinton signed the provision into law.

At the time, Realtors and home builders lobbied for the provision and there was only scant opposition. Grover Norquist — a conservative activist and adviser to Newt Gingrich — said home sales did not deserve special treatment. But Republicans ended up voting for the bill by even wider margins than Democrats.

Today, it is the subject for considerably more debate. Ms. Gravelle and Mr. Samuels said they thought the law had done more good than ill. And William G. Gale, director of economic studies at the Brookings Institution, said he did not think that the change in the law was central to the bubble. Low interest rates, he said, were far more important.

The law's defenders say that it also removed at least one tax incentive that had pushed homeowners to trade up. Before 1997, people had to buy a house that was at least as valuable as their previous one to avoid the tax, or else take the one-time exemption. Now they could buy a smaller property or move into a rental.

But many economists say the net effect of the law was clearly to inflate the real estate market. Dean Baker, co-director of the Center for Economic and Policy Research, a liberal policy group in Washington, criticized the exemption as "a backward policy" that "helped push more money into housing."

A spokesman for Mr. Clinton declined to comment for this article.

Perhaps the most detailed analysis of the provision has been the study by a Federal Reserve economist, Hui Shan, who did the analysis while at M.I.T. Ms. Shan looked at homeowners with significant equity gains, before and after 1997, and compared the likelihood of their selling their house. Her study covered 16 towns around Boston and took into account a host of other factors, like the general rise in home prices at the time.

Among homes that had appreciated less than $500,000, she concluded that the change caused a 17 percent increase in sales in the decade after 1997. Before the law changed, many people apparently avoided paying the tax by simply staying in their homes.

Ms. Shan also found that sales actually declined among homes with more than $500,000 of gains after the law passed. (Under the new law, couples have to pay taxes on gains above $500,000, even if they roll all those gains into a new house.) Nationwide, however, less than 5 percent of home sales over the last decade had gains of more than $500,000, according to Moody's Economy.com.

Despite the criticism, there has been little political support for trimming the tax breaks for housing. In 2005, a bipartisan panel of tax experts, which was appointed by President Bush and included Mr. Rossotti, concluded, "The tax preferences that favor housing exceed what is necessary to encourage homeownership." Among other things, it recommended increasing to three years the amount of time people had to stay in homes to claim the tax break on a sale. But Mr. Bush and other policy makers largely ignored the panel's report.

Geo Hartley, a lawyer who has lived in Los Angeles and Washington over the last two decades, captures the divergent effects that the law appears to have. Mr. Hartley, who is 59 and single, said he found the old law "weird," because it led him to buy bigger houses than he wanted.

Since the law changed, Mr. Hartley has bought smaller homes. But he has also moved more frequently, knowing that most of the gains on his houses would not be taxed. He lived in one house in Los Angeles for a full decade before 2000. Since then, he has moved three times, making a handsome — and mostly tax-free — profit each time.

"It's part of the thinking that gets you more motivated to buy and sell property," said Mr. Hartley, who now lives in a town house in Washington that he is trying to sell, "and have the American dream of owning a home." □

White House Philosophy Stoked Mortgage Bonfire

"We can put light where there's darkness, and hope where there's despondency in this country. And part of it is working together as a nation to encourage folks to own their own home."

— President Bush, Oct. 15, 2002

By JO BECKER, SHERYL GAY STOLBERG and STEPHEN LABATON

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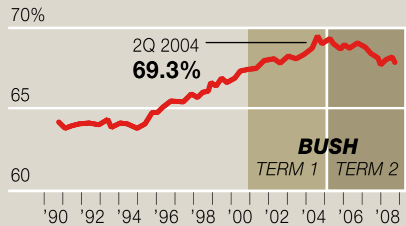
WASHINGTON — The global financial system was teetering on the edge of collapse when President Bush and his economics team huddled in the Roosevelt Room of the White House for a briefing that, in the words of one participant, "scared the hell out of everybody."

It was Sept. 18. Lehman Brothers had just gone belly-up, overwhelmed by toxic mortgages. Bank of America had swal-

Homeownership rates hit historic highs during George W. Bush's tenure but have since dropped to about where they were when he took office.

HOMEOWNERSHIP (through 3Q '08)



Source: U.S. Census Bureau THE NEW YORK TIMES

lowed Merrill Lynch in a hastily arranged sale. Two days earlier, Mr. Bush had agreed to pump $85 billion into the failing insurance giant American International Group.

The president listened as Ben S. Bernanke, chairman of the Federal Reserve, laid out the latest terrifying news: The credit markets, gripped by panic, had frozen overnight, and banks were refusing to lend money.

Then his Treasury secretary, Henry M. Paulson Jr., told him that to stave off disaster, he would have to sign off on the biggest government bailout in history.

Mr. Bush, according to several people in the room, paused for a single, stunned moment to take it all in.

"How," he wondered aloud, "did we get here?"

Eight years after arriving in Washington vowing to spread the dream of homeownership, Mr. Bush is leaving office, as he himself said recently, "faced with the prospect of a global meltdown" with roots in the housing sector he so ardently championed.

Bush on the Economy

1 2 3 4 NEXT

As the financial crisis has unfolded, the president's views of the nation's financial health evolved, as did the remedies.

Events

Summer 2007 Crisis in the credit and financial markets. Collapse of two Bear Stearns hedge funds, major losses at financial institutions holding billions of dollars of assets backed by mortgages.

2007

MAY JUNE JULY AUG. SEPT.

Bush's statements

July 7 *radio address*
"Our nation's strong economy is no accident. It is the result of the hard work of the American people and pro-growth policies in Washington."

Aug. 31 *speech in the Rose Garden*
"The markets are in a period of transition, as participants reassess and re-price risk. This process has been unfolding for some time, and it's going to take more time to fully play out. As it does, America's overall economy will remain strong enough to weather any turbulence."

There are plenty of culprits, like lenders who peddled easy credit, consumers who took on mortgages they could not afford and Wall Street chieftains who loaded up on mortgage-backed securities without regard to the risk.

But the story of how we got here is partly one of Mr. Bush's own making, according to a review of his tenure that included interviews with dozens of current and former administration officials.

From his earliest days in office, Mr. Bush paired his belief that Americans do best when they own their own home with his conviction that markets do best when let alone.

He pushed hard to expand ho-

Bush on the Economy

1 2 3 4 NEXT

As the financial crisis has unfolded, the president's views of the nation's financial health evolved, as did the remedies.

December
Recession begins

2007 | **2008**

OCT. NOV. DEC. JAN. FEB.

Jan. 4 *meeting with his Working Group on Financial Markets*
"This economy of ours is on a solid foundation, but we can't take economic growth for granted."

Feb. 28
news conference
"I don't think we're headed to a recession, but no question we're in a slowdown."

meownership, especially among minorities, an initiative that dovetailed with his ambition to expand the Republican tent — and with the business interests of some of his biggest donors. But his housing policies and hands-off approach to regulation encouraged lax lending standards.

Mr. Bush did foresee the danger posed by Fannie Mae and Freddie Mac, the government-sponsored mortgage finance giants. The president spent years pushing a recalcitrant Congress to toughen regulation of the companies, but was unwilling to compromise when his former Treasury secretary wanted to cut a deal. And the regulator Mr. Bush chose to oversee them — an old prep school buddy — pronounced the compa-

Bush on the Economy

1 2 3 4 NEXT ▶

As the financial crisis has unfolded, the president's views of the nation's financial health evolved, as did the remedies.

March 16
The government rescues Bear Stearns from collapse by arranging to finance its acquisition by JPMorgan Chase.

July 13 Treasury Secretary Paulson asks for authority to inject billions of dollars into Fannie Mae and Feddie Mac, but says he does not expect to use it.

2008

MARCH | APRIL | MAY | JUNE | JULY

March 17 *meeting with Treasury Secretary Paulson*
"You've reaffirmed the fact that our financial institutions are strong, and that our capital markets are functioning efficiently and effectively."

April 25 *statement on tax rebates*
"It's obvious our economy is in a slowdown. Fortunately, we recognized the signs early and took action."

nies sound even as they headed toward insolvency.

As early as 2006, top advisers to Mr. Bush dismissed warnings from people inside and outside the White House that housing prices were inflated and that a foreclosure crisis was looming. And when the economy deteriorated, Mr. Bush and his team misdiagnosed the reasons and scope of the downturn; as recently as February, for example, Mr. Bush was still calling it a "rough patch."

The result was a series of piecemeal policy prescriptions that lagged behind the escalating crisis.

"There is no question we did not recognize the severity of the problems," said Al Hubbard, Mr.

Bush on the Economy

1 2 3 4 NEXT

Sept. 7 The government seizes Fannie Mae and Freddie Mac, promising to pump up to $100 billion into each.

Sept. 15 Lehman Brothers declares bankruptcy. Merrill Lynch agrees to be acquired by Bank of America.

Sept. 16 The government announces an $85 billion emergency loan to rescue American International Group.

Sept. 20 President Bush requests authority for the Treasury Department to buy as much as $700 billion in distressed mortgage-related assets.

Sept. 25 Washington Mutual is seized.

Dec. 19 Bush administration announces bailout of General Motors and Chrysler.

2008

AUG. | SEPT. | OCT. | NOV. | DEC.

Sept. 20 *news conference*
"This is a big package, because it was a big problem."

Oct. 20 *roundtable in Alexandria, La.*
"If I felt that the crisis could be contained in Wall Street, then I'd have taken a different course of action."

Dec. 17 *interview with Fox News*
"I am a free-market guy, but I'm not going to let this economy crater in order to preserve the free-market system."

Bush's former chief economics adviser, who left the White House in December 2007. "Had we, we would have attacked them."

Looking back, Keith B. Hennessey, Mr. Bush's current chief economics adviser, says he and his colleagues did the best they could "with the information we had at the time." But Mr. Hennessey did say he regretted that the administration did not pay more heed to the dangers of easy lending practices. And both Mr. Paulson and his predecessor, John W. Snow, say the housing push went too far.

"The Bush administration took a lot of pride that homeownership had reached historic highs," Mr. Snow said in an interview. "But what we forgot in the process was that it has to be done in the context of people being able to afford their house. We now realize there was a high cost."

For much of the Bush presidency, the White House was preoccupied by terrorism and war; on the economic front, its pressing concerns were cutting taxes and privatizing Social Security. The housing market was a bright spot: ever-rising home values kept the economy humming, as owners drew down on their equity to buy consumer goods and pack their children off to college.

Lawrence B. Lindsey, Mr. Bush's first chief economics adviser, said there was little impetus to raise alarms about the proliferation of easy credit that was helping Mr. Bush meet housing goals.

"No one wanted to stop that bubble," Mr. Lindsey said. "It would have conflicted with the president's own policies."

Today, millions of Americans are facing foreclosure, homeownership rates are virtually no higher than when Mr. Bush took office, Fannie and Freddie are in a government conservatorship, and the bailout cost to taxpayers could run in the trillions.

As the economy has shed jobs — 533,000 last month alone — and his party has been punished by irate voters, the weakened president has granted his Treasury secretary extraordinary leeway in managing the crisis.

Never once, Mr. Paulson said in a recent interview, has Mr. Bush overruled him. "I've got a boss," he explained, who "understands that when you're dealing with something as unprecedented and fast-moving as this we need to have a different operating style."

Mr. Paulson and other senior advisers to Mr. Bush say the administration has responded well to the turmoil, demonstrating flexibility under difficult circumstances. "There is not any playbook," Mr. Paulson said.

The president declined to be interviewed for this article. But in recent weeks Mr. Bush has shared his views of how the nation came to the brink of economic disaster. He cites corporate greed and market excesses fueled by a flood of foreign cash — "Wall Street got drunk," he has said — and the policies of past administrations. He blames Congress for failing to reform Fannie and Freddie. Last week, Fox News asked Mr. Bush if he was worried about being the Herbert Hoover of the 21st century.

"No," Mr. Bush replied. "I will be known as somebody who saw a problem and put the chips on the table to prevent the economy from collapsing."

But in private moments, aides say, the president is looking inward. During a recent ride aboard Marine One, the presidential helicopter, Mr. Bush sounded a reflective note.

"We absolutely wanted to increase homeownership," Tony Fratto, his deputy press secretary, recalled him saying. "But we never wanted lenders to make bad decisions."

A Policy Gone Awry

Darrin West could not believe it. The president of the United States was standing in his living room.

It was June 17, 2002, a day Mr. West recalls as "the highlight of my life." Mr. Bush, in Atlanta to unveil a plan to increase the number of minority homeowners by 5.5 million, was touring Park Place South, a development of starter homes in a neighborhood once marked by blight and crime.

Mr. West had patrolled there as a police officer, and now he was the proud owner of a $130,000 town house, bought with an adjustable-rate mortgage and a $20,000 government loan as his down payment — just the sort of creative public-private financing Mr. Bush was promoting.

"Part of economic security," Mr. Bush declared that day, "is owning your own home."

A lot has changed since then. Mr. West, beset by personal problems, left Atlanta. Unable to sell his home for what he owed, he said, he gave it back to the bank last year. Like other communities across America, Park Place South has been hit with a foreclosure crisis affecting at least 10 percent of its 232 homes, according to Masharn Wilson, a developer who led Mr. Bush's tour.

"I just don't think what he envisioned was actually carried out," she said.

Park Place South is, in microcosm, the story of a well-intentioned policy gone awry. Advocating homeownership is hardly novel; the Clinton administration did it, too. For Mr. Bush, it was part of his vision of an "ownership society," in which Americans would rely less on the government for health care, retirement and shelter. It was also good politics, a way to court black and Hispanic voters.

But for much of Mr. Bush's tenure, government statistics show, incomes for most families remained relatively stagnant while housing prices skyrocketed. That put homeownership increasingly out of reach for first-time buyers like Mr. West.

So Mr. Bush had to, in his words, "use the mighty muscle of the federal government" to meet his goal. He proposed affordable housing tax incentives. He insisted that Fannie Mae and Freddie Mac meet ambitious new goals for low-income lending.

Concerned that down payments were a barrier, Mr. Bush persuaded Congress to spend up to $200 million a year to help first-time buyers with down payments and closing costs.

And he pushed to allow first-time buyers to qualify for federally insured mortgages with no money down. Republican Congressional leaders and some housing advocates balked, arguing that homeowners with no stake in their investments would be more prone to walk away, as Mr. West did. Many economic experts, including some in the White House, now share that view.

The president also leaned on mortgage brokers and lenders to devise their own innovations. "Corporate America," he said, "has a responsibility to work to make America a compassionate place."

And corporate America, eyeing a lucrative market, delivered in ways Mr. Bush might not have expected, with a proliferation of too-good-to-be-true teaser rates and interest-only loans that were sold to investors in a loosely regulated environment.

"This administration made decisions that allowed the free market to operate as a barroom brawl instead of a prize fight," said L. William Seidman, who advised Republican presidents and led the savings and loan bailout in the 1990s. "To make the market work well, you have to have a lot of rules."

But Mr. Bush populated the financial system's alphabet soup of oversight agencies with people who, like him, wanted fewer rules, not more.

Like Minds on Laissez-Faire

The president's first chairman of the Securities and Exchange Commission promised a "kinder, gentler" agency. The second was pushed out amid industry complaints that he was too aggressive. Under its current leader, the agency failed to police the catastrophic decisions that toppled the investment bank Bear Stearns and contributed to the current crisis, according to a recent inspector general's report.

As for Mr. Bush's banking regulators, they once brandished a chain saw over a 9,000-page pile of regulations as they promised to ease burdens on the industry. When states tried to use consumer protection laws to crack down on predatory lending, the comptroller of the currency blocked the effort, asserting that states had no authority over national banks.

The administration won that fight at the Supreme Court. But Roy Cooper, North Carolina's attorney general, said, "They took 50 sheriffs off the beat at a time when lending was becoming the Wild West."

The president did push rules aimed at forcing lenders to more clearly explain loan terms. But the White House shelved them in 2004, after industry-friendly members of Congress threatened to block confirmation of his new housing secretary.

In the 2004 election cycle, mortgage bankers and brokers poured nearly $847,000 into Mr. Bush's re-election campaign, more than triple their contributions in 2000, according to the nonpartisan Center for Responsive Politics. The administration did not finalize the new rules until last month.

Among the Republican Party's top 10 donors in 2004 was Roland Arnall. He founded Ameriquest, then the nation's largest lender in the subprime market, which focuses on less creditworthy borrowers. In July 2005, the company agreed to set aside $325 million to settle allegations in 30 states that it had preyed on borrowers with hidden fees and ballooning payments. It was an early signal that deceptive lending practices, which would later set off a wave of foreclosures, were widespread.

Andrew H. Card Jr., Mr. Bush's former chief of staff, said White House aides discussed Ameriquest's troubles, though not what they might portend for the economy. Mr. Bush had just nominated Mr. Arnall as his ambassador to the Netherlands, and the White House was primarily concerned with making sure he would be confirmed.

"Maybe I was asleep at the switch," Mr. Card said in an interview.

Brian Montgomery, the Federal Housing Administration commissioner, understood the significance. His agency insures home loans, traditionally for the same low-income minority borrowers Mr. Bush wanted to help. When he arrived in June 2005, he was shocked to find those customers had been lured away by the "fool's gold" of subprime loans. The Ameriquest settlement, he said, reinforced his concern that the industry was exploiting borrowers.

In December 2005, Mr. Montgomery drafted a memo and brought it to the White House. "I don't think this is what the president had in mind here," he recalled telling Ryan Streeter, then the president's chief housing policy analyst.

It was an opportunity to address the risky subprime lending practices head on. But that was never seriously discussed. More senior aides, like Karl Rove, Mr. Bush's chief political strategist, were wary of overly regulating an industry that, Mr. Rove said in an interview, provided "a valuable service to people who could not otherwise get credit." While he had some concerns about the industry's practices, he said, "it did provide an opportunity for people, a lot of whom are still in their houses today."

The White House pursued a narrower plan offered by Mr. Montgomery that would have allowed the F.H.A. to loosen standards so it could lure back subprime borrowers by insuring similar, but safer, loans. It passed the House but died in the Senate, where Republican senators feared that the agency would merely be mimicking the private sector's risky practices — a view Mr. Rove said he shared.

Looking back at the episode, Mr. Montgomery broke down in tears. While he acknowledged that the bill did not get to the root of the problem, he said he would "go to my grave believing" that at least some homeowners might have been spared foreclosure.

Today, administration officials say it is fair to ask whether Mr. Bush's ownership push backfired. Mr. Paulson said the administration, like others before it, "over-incented housing." Mr. Hennessey put it this way: "I would not say too much emphasis on expanding homeownership. I would say not enough early focus on easy lending practices."

'We Told You So'

Armando Falcon Jr. was preparing to take on a couple of giants.

A soft-spoken Texan, Mr. Falcon ran the Office of Federal Housing Enterprise Oversight, a tiny government agency that oversaw Fannie Mae and Freddie Mac, two pillars of the American housing industry. In February 2003, he was finishing a blockbuster report that warned the pillars could crumble.

Created by Congress, Fannie and Freddie — called G.S.E.'s, for government-sponsored entities — bought trillions of dollars' worth of mortgages to hold or sell to investors as guaranteed securities. The companies were also Washington powerhouses, stuffing lawmakers' campaign coffers and hiring bare-knuckled lobbyists.

Mr. Falcon's report outlined a worst-case situation in which Fannie and Freddie could default on debt, setting off "contagious illiquidity in the market" — in other words, a financial meltdown. He also raised red flags about the companies' soaring use of derivatives, the complex financial instruments that economic experts now blame for spreading the housing collapse.

Today, the White House cites that report — and its subsequent effort to better regulate Fannie and Freddie — as evidence that it foresaw the crisis and tried to avert it. Bush officials recently wrote up a talking points memo headlined "G.S.E.'s — We Told You So."

But the back story is more complicated. To begin with, on the day Mr. Falcon issued his report, the White House tried to fire him.

At the time, Fannie and Freddie were allies in the president's quest to drive up homeownership rates; Franklin D. Raines, then Fannie's chief executive, has fond memories of visiting Mr. Bush in the Oval Office and flying aboard Air Force One to a housing event. "They loved us," he said.

So when Mr. Falcon refused to deep-six his report, Mr. Raines took his complaints to top Treasury officials and the White House. "I'm going to do what I need to do to defend my company and my position," Mr. Raines told Mr. Falcon.

Days later, as Mr. Falcon was in New York preparing to deliver a speech about his findings, his cellphone rang. It was the White House personnel office, he said, telling him he was about to be unemployed.

His warnings were buried in the next day's news coverage, trumped by the White House announcement that Mr. Bush would replace Mr. Falcon, a Democrat appointed by Bill Clinton, with Mark C. Brickell, a leader in the derivatives industry that Mr. Falcon's report had flagged.

It was not until 2003, when Freddie became embroiled in an accounting scandal, that the White House took on the companies in earnest. Mr. Bush decided to quit the long-standing practice of rewarding supporters with high-paying appointments to the companies' boards — "political plums," in Mr. Rove's words. He also withdrew Mr. Brickell's nomination and threw his support behind Mr. Falcon, beginning an intense effort to give his little regulatory agency more power.

Mr. Falcon lacked explicit authority to limit the size of the companies' mammoth investment portfolios, or tell them how much capital they needed to guard against losses. White House officials wanted that to change. They also wanted the power to put the companies into receivership, hoping that would end what Mr. Card, the former chief of staff, called "the myth of government backing," which gave the companies a competitive edge because investors assumed the government would not let them fail.

By the spring of 2005 a deal with Congress seemed within reach, Mr. Snow, the former Treasury secretary, said in an interview.

Michael G. Oxley, an Ohio Republican and then-chairman of the House Financial Services Committee, had produced what Mr. Snow viewed as "a pretty darned good bill," a watered-down version of what the president sought. But at the urging of Mr. Card and the White House economics team, the president decided to hold out for a tougher bill in the Senate.

Mr. Card said he feared that Mr. Snow was "more interested in the deal than the result." When the bill passed the House, the president issued a statement opposing it, effectively killing any chance of compromise. Mr. Oxley was furious.

"The problem with those guys at the White House, they had all the answers and they didn't think they had to listen to anyone, including the Treasury secretary," Mr. Oxley said in a recent interview. "They were driving the ideological train. He was in the caboose, and they were in the engine room."

Mr. Card and Mr. Hennessey said they had no regrets. They are convinced, Mr. Hennessey said, that the Oxley bill would have produced "the worst of all possible outcomes," the illusion of reform without the substance.

Still, some former White House and Treasury officials continue to debate whether Mr. Bush's all-or-nothing approach scuttled a measure that, while imperfect, might have given an aggressive regulator enough power to keep the companies from failing.

Mr. Snow, for one, calls Mr. Oxley "a hero," adding, "He saw the need to move. It didn't get done. And it's too bad, because I think if it had, I think we could well have avoided a big contributor to the current crisis."

Unheeded Warnings

Jason Thomas had a nagging feeling.

The New Century Financial Corporation, a huge subprime lender whose mortgages were bundled into securities sold around the world, was headed for bankruptcy in March 2007. Mr. Thomas, an economic analyst for President Bush, was responsible for determining whether it was a hint of things to come.

At 29, Mr. Thomas had followed a fast-track career path that took him from a Buffalo meatpacking plant, where he worked as a statistician, to the White House. He was seen as a whiz kid, "a brilliant guy," his former boss, Mr. Hubbard, says.

As Mr. Thomas began digging into New Century's failure that spring, he became fixated on a particular statistic, the rent-to-own ratio.

Typically, as home prices increase, rental costs rise proportionally. But Mr. Thomas sent charts to top White House and Treasury officials showing that the monthly cost of owning far outpaced the cost to rent. To Mr. Thomas, it was a sign that housing prices were wildly inflated and bound to plunge, a condition that could set off a foreclosure crisis as conventional and subprime borrowers with little equity found they owed more than their houses were worth.

It was not the Bush team's first warning. The previous year, Mr. Lindsey, the former chief economics adviser, returned to the White House to tell his old colleagues that housing prices were headed for a crash. But housing values are hard to evaluate, and Mr. Lindsey had a reputation as a market pessimist, said Mr. Hubbard, adding, "I thought, 'He's always a bear.' "

In retrospect, Mr. Hubbard said, Mr. Lindsey was "absolutely right," and Mr. Thomas's charts "should have been a signal."

Instead, the prevailing view at the White House was that the problems in the housing market were limited to subprime borrowers unable to make their payments as their adjustable mortgages reset to higher rates. That belief was shared by Mr. Bush's new Treasury secretary, Mr. Paulson.

Mr. Paulson, a former chairman of the Wall Street firm Goldman Sachs, had been given unusual power; he had accepted the job only after the president guaranteed him that Treasury, not the White House, would have the dominant role in shaping economic policy. That shift merely continued an imbalance of power that stifled robust policy debate, several former Bush aides say.

Throughout the spring of 2007, Mr. Paulson declared that "the housing market is at or near the bottom," with the problem "largely contained." That position underscored nearly every action the Bush administration took in the ensuing months as it offered one limited response after another.

By that August, the problems had spread beyond New Century. Credit was tightening, amid questions about how heavily banks were invested in securities linked to mortgages. Still, Mr. Bush predicted that the turmoil would resolve itself with a "soft landing."

The plan Mr. Bush announced on Aug. 31 reflected that belief. Called "F.H.A. Secure," it aimed to help about 80,000 homeowners refinance their loans. Mr. Montgomery, the housing commissioner, said that he knew the modest program was not enough — the White House later expanded the agency's rescue role — and that he would be "flying the plane and fixing it at the same time."

That fall, Representative Rahm Emanuel, a leading Democrat, former investment banker and now the incoming chief of staff to President-elect Barack Obama, warned the White House it was not doing enough. He said he told Joshua B. Bolten, Mr. Bush's chief of staff, and Mr. Paulson in a series of phone calls that the credit crisis would get "deep and serious" and that the only answer was big, internationally coordinated government intervention.

"You got to strangle this thing and suffocate it," he recalled saying.

Instead, Mr. Bush developed Hope Now, a voluntary public-private partnership to help struggling homeowners refinance loans. And he worked with Congress to pass a stimulus package that sent taxpayers $150 billion in tax rebates.

In a speech to the Economic Club of New York in March 2008, he cautioned against Washington's temptation "to say that anything short of a massive government intervention in the housing market amounts to inaction," adding that government action could make it harder for the markets to recover.

Dominoes Start to Fall

Within days, Bear Sterns collapsed, prompting the Federal Reserve to engineer a hasty sale. Some economic experts, including Timothy F. Geithner, the president of the New York Federal Reserve Bank (and Mr. Obama's choice for Treasury secretary) feared that Fannie Mae and Freddie Mac could be the next to fall.

Mr. Bush was still leaning on Congress to revamp the tiny agency that oversaw the two companies, and had acceded to Mr. Paulson's request for the negotiating room that he had denied Mr. Snow. Still, there was no deal.

Over the previous two years, the White House had effectively set the agency adrift. Mr. Falcon left in 2005 and was replaced by a temporary director, who was in turn replaced by James B. Lockhart, a friend of Mr. Bush from their days at Andover, and a former deputy commissioner of the Social Security Administration who had once run a software company.

On Mr. Lockhart's watch, both Freddie and Fannie had plunged into the riskiest part of the market, gobbling up more than $400 billion in subprime and other alternative mortgages. With the companies on precarious footing, Mr. Geithner had been advocating that the administration seize them or take other steps to reassure the market that the government would back their debt, according to two people with direct knowledge of his views.

In an Oval Office meeting on March 17, however, Mr. Paulson barely mentioned the idea, according to several people present. He wanted to use the troubled companies to unlock the frozen credit market by allowing Fannie and Freddie to buy more mortgage-backed securities from overburdened banks. To that end, Mr. Lockhart's office planned to lift restraints on the companies' huge portfolios — a decision derided by former White House and Treasury officials who had worked so hard to limit them.

But Mr. Paulson told Mr. Bush the companies would shore themselves up later by raising more capital.

"Can they?" Mr. Bush asked.

"We're hoping so," the Treasury secretary replied.

That turned out to be incorrect, and did not surprise Mr. Thomas, the Bush economic adviser. Throughout that spring and summer, he warned the White House and Treasury that, in the stark words of one e-mail message, "Freddie Mac is in trouble." And Mr. Lockhart, he charged, was allowing the company to cover up its insolvency with dubious accounting maneuvers.

But Mr. Lockhart continued to offer reassurances. In a July appearance on CNBC, he declared that the companies were well managed and "worsts were not coming to worst." An infuriated Mr. Thomas sent a fresh round of e-mail messages accusing Mr. Lockhart of "pimping for the stock prices of the undercapitalized firms he regulates."

Mr. Lockhart defended himself, insisting in an interview that he was aware of the companies' vulnerabilities, but did not want to rattle markets.

"A regulator," he said, "does not air dirty laundry in public."

Soon afterward, the companies' stocks lost half their value in a single day, prompting Congress to quickly give Mr. Paulson the power to spend $200 billion to prop them up and to finally pass Mr. Bush's long-sought reform bill, but it was too late. In September, the government seized control of Freddie Mac and Fannie Mae.

In an interview, Mr. Paulson said the administration had no justification to take over the companies any sooner. But Mr. Falcon disagreed: "They absolutely could have if they had thought there was a real danger."

By Sept. 18, when Mr. Bush and his team had their fateful meeting in the Roosevelt Room after the failure of Lehman Brothers and the emergency rescue of A.I.G., Mr. Paulson was warning of an economic calamity greater than the Great Depression. Suddenly, historic government intervention seemed the only option. When Mr. Paulson spelled out what would become a $700 billion plan to rescue the nation's banking system, the president did not hesitate.

"Is that enough?" Mr. Bush asked.

"It's a lot," the Treasury secretary recalled replying. "It will make a difference." And in any event, he told Mr. Bush, "I don't think we can get more."

As the meeting wrapped up, a handful of aides retreated to the White House Situation Room to call Vice President Dick Cheney in Florida, where he was attending a fund-raiser. Mr. Cheney had long played a leading role in economic policy, though housing was not a primary interest, and like Mr. Bush he had a deep aversion to government intervention in the market. Nonetheless, he backed the bailout, convinced that too many Americans would suffer if Washington did nothing.

Mr. Bush typically darts out of such meetings quickly. But this time, he lingered, patting people on the back and trying to soothe his downcast staff. "During times of adversity, he bucks everybody up," Mr. Paulson said.

It was not the end of the failures or government interventions; the administration has since stepped in to rescue Citigroup and, just last week, the Detroit automakers. With 31 days left in office, Mr. Bush says he will leave it to historians to analyze "what went right and what went wrong," as he put it in a speech last week to the American Enterprise Institute.

Mr. Bush said he was too focused on the present to do much looking back.

"It turns out," he said, "this isn't one of the presidencies where you ride off into the sunset, you know, kind of waving goodbye." □

Kitty Bennett contributed reporting.

Once Trusted Mortgage Pioneers, Now Scrutinized

"We are team-oriented, highly ethical, extremely competitive, profit-oriented, risk-averse, consumer-focused, and we try as much as possible to squeeze out any ego. Hubris is the beginning of the end."

— Herbert Sandler, June 2005

By MICHAEL MOSS
and GERALDINE FABRIKANT

FIRST PUBLISHED: DECEMBER 25, 2008

RICHARD A. WRIGHT/THE NEW YORK TIMES

Herbert and Marion Sandler outside the Golden West Savings and Loan in 1969. Golden became World Savings' parent.

SAN FRANCISCO — Herbert Sandler, the founder of the Center for Responsible Lending, is standing in his bay-front office watching a DVD that trains brokers to pitch mortgages by extolling the glories of the real estate boom.

The video reeks of hucksterism, and it infuriates Mr. Sandler.

"I would not have approved that!" he declares. "I don't think we should be selling our loans based on home prices continuing to go up."

But the DVD was produced in 2005 by a mortgage lender that Mr. Sandler and his wife, Marion, ran at the time: World Savings Bank. And the video was a small part of a broad and aggressive effort by their company to market risky loans at the height of the housing bubble.

The Sandlers long viewed themselves — and were viewed by many others — as the mortgage industry's model citizens. Now they too have been swept into the maelstrom surrounding who is to blame for the housing bust and the growing number of home foreclosures.

Once invited by Congress to testify about good lending practices, the Sandlers were recently parodied on "Saturday Night Live" as greedy bankers who handily sold their bank — and pocketed $2.3 billion in shares and cash — in 2006 before many of their loans began to sour.

Renee Feltz contributed reporting and research.

Last month, the United States attorney's office in San Francisco announced dual inquiries into whether World Savings engaged in predatory lending practices or misled investors about its financial well-being. And the bank has been sued by numerous borrowers who claim they were misled into taking out mortgages they could not afford.

At the center of the controversy is an exotic but popular mortgage the Sandlers pioneered that helped generate billions of dollars of revenue at their bank.

Known as an option ARM — and named "Pick-A-Pay" by World Savings — it is now seen by an array of housing analysts and regulators as the Typhoid Mary of the mortgage industry.

Pick-A-Pay allowed homeowners to make monthly mortgage payments that were so small they did not cover their interest charges. That meant the total principal owed would actually grow over time, not shrink as is normally the case.

Now held by an estimated two million homeowners, the option adjustable rate mortgage will be at the forefront of a further wave of homeowner distress that could greatly delay or even derail an economic recovery, mortgage industry analysts say.

The Wachovia Corporation, which bought the Sandlers' bank two years ago, was so battered by the souring portfolio of World Savings that it began writing off losses now projected at tens of billions of dollars and eventually stopped offering option ARMs.

Through it all, the Sandlers have maintained they did nothing wrong beyond misjudging the real estate bubble.

"I didn't mislead anybody, and to the best of my knowledge, our company didn't, though there may have been an isolated case here and there," Mr. Sandler said. "If home prices hadn't declined by 50 percent, nobody would be raising these questions."

Mr. Sandler also finds it incredible that borrowers feel victimized by Pick-A-Pay. "All of a sudden their home is worth half of what it was, and they say they didn't know."

Yet the Sandlers embraced practices like the use of independent brokers who used questionable methods to reel in borrowers. These and other practices, critics contend, undermined the conservative lending practices that the Sandlers built their reputations upon.

"This product is the most destructive financial weapon ever deployed against the American middle class," said William J. Purdy III, a housing lawyer in California who is representing elderly World Savings customers struggling to repay their loans. "People who have this loan are now trapped, and they can't get another loan."

The Birth of Pick-A-Pay

Marion Sandler, now 78, was a Wall Street analyst in the early 1960s when she and her husband decided to buy a bank that took only savings deposits and made mortgage loans — a thrift, or savings and loan, in banking shorthand — and run it themselves.

Mr. Sandler, now 77, was a lawyer in Manhattan who grew up poor on the Lower East Side, the son of a compulsive gambler whose earnings were consumed by loan sharks.

The Sandlers searched for a thrift in the sizzling California market and paid $3.8 million in 1963 for an Oakland enterprise called Golden West Savings and Loan Association, which later became the parent company of World Savings. It had a main office and one branch.

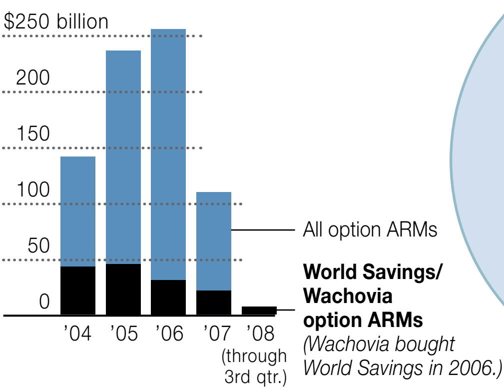
When Reagan era deregulation arrived, the Sandlers and two other competitors were able to market option ARMs for the first time in 1981. Before that, lawmakers balked at the loan because of its potential peril to borrowers.

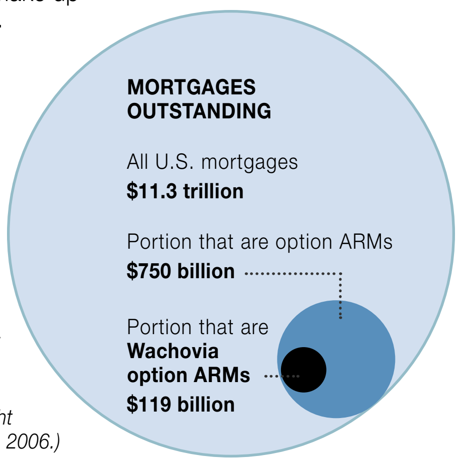
World Savings initially attract-

Option ARMs

Option ARMs are a type of adjustable-rate mortgage, pioneered by World Savings, that let buyers choose among various payment options. Because these mortgages can tempt buyers by offering low initial rates that can suddenly rise after a few years, they are now largely faulted for abetting the mortgage crisis. Few option ARMs are currently being offered, although they make up about 7 percent of outstanding mortgages.

NEW OPTION ARMS ISSUED





Source: Inside Mortgage Finance

THE NEW YORK TIMES

ed borrowers whose incomes fluctuated, like professionals with big year-end bonuses. In the recent housing boom, when World Savings started calling the loan Pick-A-Pay, they began marketing it to a much broader audience, including people with financial troubles, like deeply indebted blue-collar workers.

As the entire thrift industry soared after deregulation, the Sandlers' business also took off. They avoided financial problems by doing things like scrutinizing borrowers' incomes to make sure loans were manageable and performing astute appraisals so the size of a mortgage was in line with the value of a home.

"Our protection was our total underwriting of the loan," Mr. Sandler said. "From scratch."

When many of the Sandlers' competitors in the thrift industry later began collapsing under the weight of bad loans and investments, Congress and the media invited the couple to speak about the proper way to do business.

"The deregulatory situation attracted bums, charlatans, crooks, phonies, con men," Mr. Sandler told an ABC News program in 1990.

The Sandlers also held onto World Savings' loans rather than selling them off to Wall Street to be repackaged as securities. They say this made them more alert to risky borrowers than were lenders who sold off their loans.

When foreclosures occurred, World Savings executives would drive to the house to see if they had made mistakes appraising the property or underwriting the loan. "We called these the van tours," Mr. Sandler said. "And we would say, 'O.K., have we done anything wrong here?' "

More Philanthropic Work

As the Sandlers' wealth increased, so did their philanthropy. Over the years, they financed scientific research and groups like Human Rights Watch and the American Civil Liberties Union. More recently they founded and financed ProPublica, a nonprofit investigative journalism enterprise that has collaborated with The New York Times on coverage and a news archive. Its 14-member advisory board includes two top New York Times Company editors.

The Sandlers' giving intersected most directly with their business interests in 2002 when they helped create an advocacy group for low-income borrowers called the Center for Responsible Lending.

The center was the successor to a smaller organization in North Carolina, whose director, Martin Eakes, had helped the elderly and minorities avoid predatory banking practices.

"I said, 'Isn't that incredible what he is doing?' " Mr. Sandler recalled. "I said to Martin, 'What would it take to do what you do on a national scale?' "

Mr. Eakes, who became the center's executive director, had also just helped secure a new mortgage lending law in North Carolina that prohibited, among other things, the use of prepayment penalties.

"I hated prepayment penalties," Mr. Eakes recalled, noting that such charges make it hard for cash-poor borrowers to refinance a loan for one with more manageable terms.

While Mr. Sandler supported the center's antipredatory goals, he disagreed with Mr. Eakes's position on prepayment penalties and sought to change his mind.

Mr. Sandler acknowledges that some lenders used the penalties to lock borrowers into "absolutely awful" loans. But he said his bank used the penalties to fend off unethical brokers who enticed borrowers with low-interest-rate loans that often had hidden fees.

"You have to understand how independent brokers work," Mr. Sandler says. "They are the whores of the world."

Despite that distaste, World Savings made extensive use of brokers. By 2006, they were generating some 60 percent of its loan business, he acknowledged. He said he was compelled to do so because of brokers were a dominant force in the mortgage industry.

As a check on the representations that brokers made to borrowers, World Savings sought to telephone applicants to ensure that they understood the terms of their loan. These calls reached only about half of the borrowers, however, according to a former World Savings executive. Mr. Sandler did not dispute that point.

Customer complaints that an unethical broker had misrepresented the terms of World Savings loans is at the heart of a lawsuit filed against the bank and others in Alameda County, Calif. The broker was sentenced to a year in prison for misleading at least 90 World Savings borrowers.

Mr. Sandler points out that the company was itself a victim of this broker, that it cooperated fully with authorities, and that it was not charged with any wrongdoing.

Others have also raised questions about how carefully World Savings disclosed lending terms to its borrowers.

In August, a federal judge in South Carolina ruled that World Savings had violated the federal Truth in Lending Act by telling borrowers that choosing to make minimum monthly payments on Pick-A-Pay mortgages might cause their principal to grow — when in fact it certainly would occur.

Wachovia, which is defending the case, has appealed the ruling. Mr. Sandler said he was not familiar with this lawsuit, but generally, he says, "Wachovia's legal defense is deficient."

A Speedy Merger

By 2005, World Savings lending had started to slow, after more than quadrupling since 1998. The next year, Wachovia bought the bank in a hastily arranged deal. The Sandlers say they sold their firm at the top of the market because they were growing older and wanted to devote themselves to philanthropy.

Some current and former Wachovia officials say that the merger was agreed to in days and that it was impossible to conduct a thorough vetting of World Savings' loans. Others say the portfolio was adequately scrutinized.

"Herb and his wife had run a tight ship," said Robert Brown, a Wachovia board member. "There was not a huge concern about it because they had not had any delinquencies and foreclosures."

Others were less sanguine. The creditworthiness of World Savings borrowers edged down from 2004 to 2006, according to Wachovia's data. Over all, Pick-A-Pay borrowers had credit scores well below the industry average for traditional loans.

"I don't think anyone thought a Pick-A-Pay product was a customer friendly product," says a former Wachovia executive who requested anonymity to preserve professional relationships. "It is easy to mislead them."

World Savings lending volume dipped again in 2006 shortly after the sale to Wachovia was initiated, according to the company's federal filings.

This prompted World Savings to attract more borrowers by taking a step that some regulators were starting to frown upon, and which the company had been resisting for years: it allowed borrowers to make monthly payments based on an annual interest rate of just 1 percent. While World Savings continued to scrutinize borrowers' ability to manage increased payments, the move to rock-bottom rates lured customers whose financial reliability was harder to verify.

Russell W. Kettell, a former chief financial officer of World Savings, says the merger created "pressure" for "a pretty good-sized increase in loan volume."

Asked if Wachovia ordered World Savings to drop its rate, Mr. Kettell said, "No, but they wanted volume and wanted growth."

A swift increase in option ARM lending had prompted federal regulators to weigh tougher controls on lending standards in 2005. Of the $238 billion in option ARM loans made nationally in 2005, World Savings issued about $52 billion, or more than one-fifth of the total.

Susan Schmidt Bies, a governor of the Federal Reserve System until last year, said the surge in volume caught regulators by surprise, and that she regrets not acting more quickly to protect borrowers because she believes that they could not understand the risky nature of option ARMs.

"When you get into people whose mortgage payments are taking half of their cash flow, they are in over their heads, and these loans should not have been sold to this customer base," she said. "This makes me sick when I see this happening."

In March 2006, two months before the Wachovia deal, Mr. Sandler wrote regulators and objected to several aspects of the new rules, including the regulator's conclusion that option ARMS "were untested in a stress environment."

He argued in the letter that World Savings had few loan losses in the recession of the early 1990s. Then again, the current financial crisis is far more severe than what occurred then — far more severe than anything the country has faced since the Great Depression.

By the third quarter of this year, Wachovia was projecting $26.1 billion of losses on a World Savings loan portfolio worth a total of about $124 billion. About 6.2 percent of the Pick-A-Pay loans were more than 90 days late, it said, compared with an industry average of 8 percent on option ARMs and 1 percent on Wachovia's traditional loans.

Wells Fargo, which is now buying Wachovia, is more pessimistic: it expects losses of $36 billion on the loans unless efforts to stem foreclosures help rescue part of the portfolio. The losses caused analysts and others to reassess the Sandlers' legacy.

After the "Saturday Night Live" skit, Paul Steiger, the former executive editor of The Wall Street Journal and the editor in chief of ProPublica, was among those who wrote to the show's producer, Lorne Michaels, saying the Sandlers had been unfairly vilified. Mr. Michaels apologized for the skit (which suggested that the Sandlers "should be shot") and removed it from NBC's Web site.

Mr. Sandler says Wachovia did not work hard enough to help struggling borrowers, and that his loans became scapegoats for other problems at Wachovia. He remains confident that losses on its loans will not reach Wells Fargo's projections.

He says World Savings was hit especially hard because it had made so many loans in volatile markets like inland California, but he disputes homeowner assertions that his option ARMs are at fault.

"We have not been able to identify one delinquency, much less a foreclosure, that is due to the product," Mr. Sandler said, adding that "if home prices had not dropped, you wouldn't see" a single article.

Over all, analysts expect the option ARM fallout to be brutal. Fitch Ratings, a leading credit rating agency, recently reported that payments on nearly half of the $200 billion worth of option ARMs it tracks will jump 63 percent in the next two years — causing mortgage delinquencies to rise sharply.

Mr. Sandler says that his loans are not in the pool that will become distressed in the next few years; he says they reset at a later date. He adds that were he not sure that the market would recover he would have sold his Wachovia stock at the time of the takeover. His charity has sold off much of its Wachovia stock, but he said he and his wife retain a substantial portion of their personal holdings.

Still, the Sandlers have their detractors.

"As the largest and most respected regulated institution providing option ARMs, I hold the Sandlers responsible because a large percentage of home borrowers — but not all — should have been advised that it was in their best interest to have a fixed-rate mortgage," said Robert Gnaizda, general counsel for the Greenlining Institute, a homeowner advocacy group. “I believe that financial institutions have a quasi-fiduciary responsibility not to mislead the borrower.”

Mr. Sandler insists that World Savings prided itself on ethical conduct and that untoward behavior was never tolerated. “We were also a family, and you expected people to live their personal and business lives in a particular way,” he said. □

This article has been revised to reflect the following correction published on January 6, 2009: A headline on Dec. 25 with an article about Herbert and Marion Sandler, bankers and philanthropists whose World Savings Bank originated a type of adjustable-rate mortgage called Pick-a-Pay that has led to many foreclosures as the real estate market and the economy collapsed, described incorrectly the consequences to the Sandlers of the criminal and legal investigations of the practices of the bank, which they sold to Wachovia in 2006. As the article noted, the Sandlers were once trusted mortgage pioneers and now face scrutiny, but they are not “pariahs.”

This article has been revised to reflect the following correction published on January 16, 2009: An article on Dec. 25 about Herbert and Marion Sandler, bankers and philanthropists whose World Savings Bank pioneered a type of adjustable-rate mortgage called the Option ARM, referred imprecisely to their discussions on prepayment penalties with Martin Eakes, the chief executive officer of the Center for Responsible Lending, which the Sandlers helped found in 2002. During the housing boom, they were among those who persuaded Mr. Eakes of the acceptability of some proposed state regulations that would strictly limit, though not ban, prepayment penalties on the small fraction of prime mortgages that had them, including those from World Savings. Mr. Eakes and the Center for Responsible Lending have continued to oppose prepayment penalties generally, on both prime and sub-prime mortgages; Mr. Eakes did not “drop his opposition.”

Chinese Savings Helped Inflate American Bubble

"Usually it's the rich country lending to the poor. This time, it's the poor country lending to the rich."

— Niall Ferguson

By MARK LANDLER

FIRST PUBLISHED: DECEMBER 26, 2008

WASHINGTON — In March 2005, a low-key Princeton economist who had become a Federal Reserve governor coined a novel theory to explain the growing tendency of Americans to borrow from foreigners, particularly the Chinese, to finance their heavy spending.

The problem, he said, was not that Americans spend too much, but that foreigners save too much. The Chinese have piled up so much excess savings that they lend money to the United States at low rates, underwriting American consumption.

This colossal credit cycle could not last forever, he said. But in a global economy, the transfer of Chinese money to America was a market phenomenon that would take years, even a decade, to work itself out. For now, he said, "we probably have little choice except to be patient."

Today, the dependence of the United States on Chinese money looks less benign. And the economist who proposed the theory, Ben S. Bernanke, is dealing with the consequences, having been promoted to chairman of the Fed in 2006, as these cross-border money flows were reaching stratospheric levels.

In the past decade, China has invested upward of $1 trillion, mostly earnings from manufacturing exports, into American government bonds and government-backed mortgage debt.

That has lowered interest rates and helped fuel a historic consumption binge and housing bubble in the United States.

China, some economists say, lulled American consumers, and their leaders, into complacency about their spendthrift ways.

"This was a blinking red light," said Kenneth S. Rogoff, a professor of economics at Harvard and a former chief economist at the International Monetary Fund. "We should have reacted to it."

In hindsight, many economists say, the United States should have recognized that borrowing from abroad for consumption and deficit spending at home was not a formula for economic success. Even as that weakness is becoming more widely recognized, however, the United States is likely to be more addicted than ever to foreign creditors to finance record government spending to revive the broken economy.

David Barboza contributed reporting from Shanghai, and Keith Bradsher from Hong Kong.

To be sure, there were few ready remedies. Some critics argue that the United States could have pushed Beijing harder to abandon its policy of keeping the value of its currency weak — a policy that made its exports less expensive and helped turn it into the world's leading manufacturing power. If China had allowed its currency to float according to market demand in the past decade, its export growth probably would have moderated. And it would not have acquired the same vast hoard of dollars to invest abroad.

Others say the Federal Reserve and the Treasury Department should have seen the Chinese lending for what it was: a giant stimulus to the American economy, not unlike interest rate cuts by the Fed. These critics say the Fed under Alan Greenspan contributed to the creation of the housing bubble by leaving interest rates too low for too long, even as Chinese investment further stoked an easy-money economy. The Fed should have cut interest rates less in the middle of this decade, they say, and started raising them sooner, to help reduce speculation in real estate.

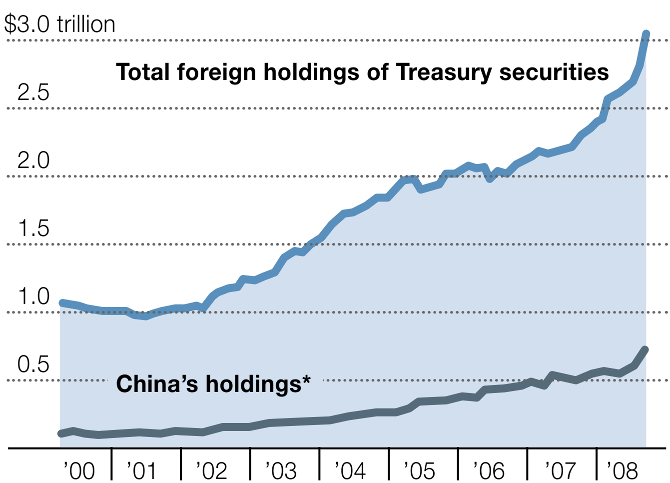
Today, with the wreckage around him, Mr. Bernanke said he regretted that more was not done to regulate financial institutions and mortgage providers, which might have prevented the flood of investment, including that from China, from being so badly used. But the Fed's role in regulation is limited to banks. And stricter regulation by itself would not have been enough, he insisted.

"Achieving a better balance of international capital flows early on could have significantly reduced the risks to the financial system," Mr. Bernanke said in an interview in his office overlooking the Washington Mall.

Debt Spree

1 2 3 4 NEXT

As China's coffers swelled because of its growing trade surplus, it invested heavily in United States government debt, which was also growing.



*Includes Hong Kong.

Sources: Treasury Department; Bankrate.com; Federal Reserve; Bureau of Economic Analysis, via Haver Analytics

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"However," he continued, "this could only have been done through international cooperation, not by the United States alone. The problem was recognized, but sufficient international cooperation was not forthcoming."

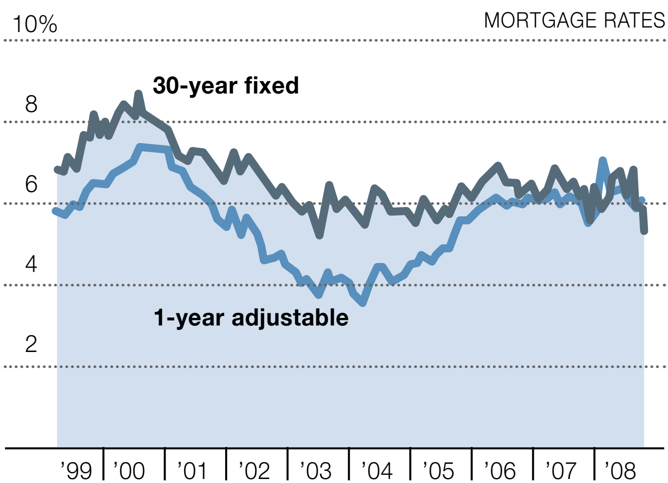
The inaction was because of a range of factors, political and economic. By the yardsticks that appeared to matter most — prosperity and growth — the relationship between China and the United States also seemed to be paying off for both countries. Neither had a strong incentive to break an addiction: China to strong export growth and financial stability; the United States to cheap imports and low-cost foreign loans.

In Washington, China was treated as a threat by some people, but mostly because it lured

Debt Spree

1 2 3 4 NEXT

The easy availability of money from foreign investors helped keep interest rates low in the United States.



Sources: Treasury Department; Bankrate.com; Federal Reserve; Bureau of Economic Analysis, via Haver Analytics

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away manufacturing jobs. Others argued that China's heavy lending to this country was risky because Chinese leaders could decide to withdraw money at a moment's notice, creating a panicky run on the dollar.

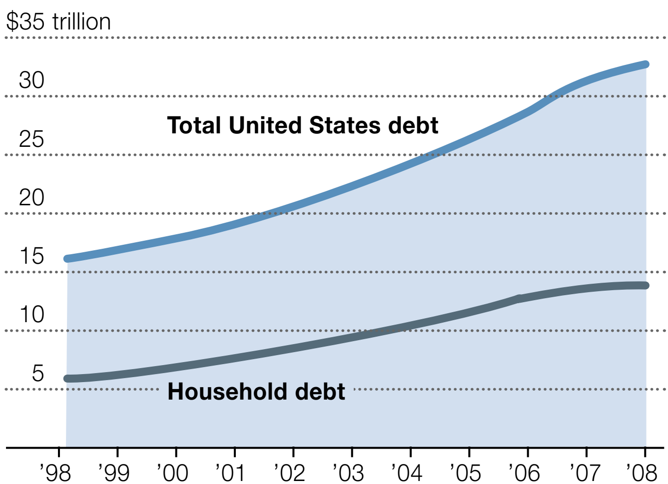
Mr. Bernanke viewed such international investment flows through a different lens. He argued that Chinese invested savings abroad because consumers in China did not have enough confidence to spend. Changing that situation would take years, and did not amount to a pressing problem for the Americans.

"The global savings glut story did us a collective disservice," said Edwin M. Truman, a former Fed and Treasury official. "It created the idea that the world was doing it to us and we couldn't do anything about it."

Debt Spree

1 2 3 4 NEXT ▸

With so much cheap money available, everyone, particularly consumers, loaded up on debt.



Sources: Treasury Department; Bankrate.com; Federal Reserve; Bureau of Economic Analysis, via Haver Analytics

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But Mr. Bernanke's theory fit the prevailing hands-off, pro-market ideology of recent years. Mr. Greenspan and the Bush administration treated the record American trade deficit and heavy foreign borrowing as an abstract threat, not an urgent problem.

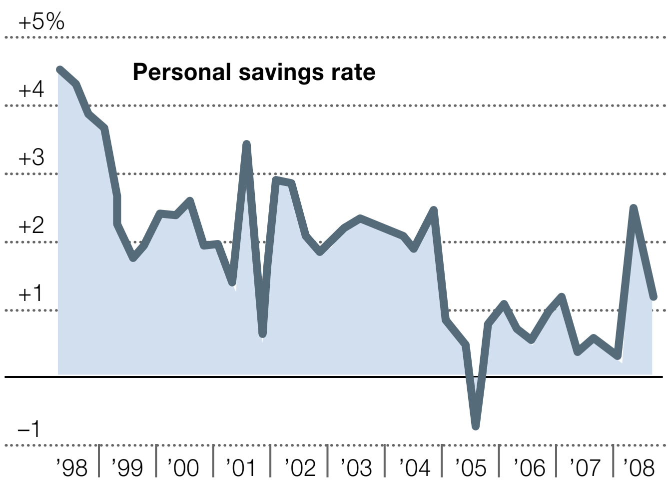
Mr. Bernanke, after he took charge of the Fed, warned that the imbalances between the countries were growing more serious. By then, however, it was too late to do much about them. And the White House still regarded imbalances as an arcane subject best left to economists.

By itself, money from China is not a bad thing. As American officials like to note, it speaks to the attractiveness of the United States as a destination for foreign investment. In the 19th century, the United States built its

Debt Spree

1 2 3 4 NEXT

As the housing bubble grew, consumers plowed more money into real estate — and their savings rate plunged.



Sources: Treasury Department; Bankrate.com; Federal Reserve; Bureau of Economic Analysis, via Haver Analytics

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railroads with capital borrowed from the British.

In the past decade, China arguably enabled an American boom. Low-cost Chinese goods helped keep a lid on inflation, while the flood of Chinese investment helped the government finance mortgages and a public debt of close to $11 trillion.

But Americans did not use the lower-cost money afforded by Chinese investment to build a 21st-century equivalent of the railroads. Instead, the government engaged in a costly war in Iraq, and consumers used loose credit to buy sport utility vehicles and larger homes. Banks and investors, eagerly seeking higher interest rates in this easy-money environment, created risky new securities like collateralized debt obligations.

"Nobody wanted to get off this drug," said Senator Lindsey Graham, the South Carolina Republican who pushed legislation to punish China by imposing stiff tariffs. "Their drug was an endless line of customers for made-in-China products. Our drug was the Chinese products and cash."

Mr. Graham said he understood the addiction: he was speaking by phone from a Wal-Mart store in Anderson, S.C., where he was Christmas shopping in aisles lined with items from China.

A New Economic Dance

The United States has been here before. In the 1980s, it ran heavy trade deficits with Japan, which recycled some of its trading profits into American government bonds.

At that time, the deficits were viewed as a grave threat to America's economic might. Action took the form of a 1985 agreement known as the Plaza Accord. The world's major economies intervened in currency markets to drive down the value of the dollar and drive up the Japanese yen.

The arrangement did slow the growth of the trade deficit for a time. But economists blamed the sharp revaluation of the Japanese yen for halting Japan's rapid growth. The lesson of the Plaza Accord was not lost on China, which at that time was just emerging as an export power.

China tied itself even more tightly to the United States than did Japan. In 1995, it devalued its currency and set a firm exchange rate of roughly 8.3 to the dollar, a level that remained fixed for a decade.

During the Asian financial crisis of 1997-98, China clung firmly to its currency policy, earning praise from the Clinton administration for helping check the spiral of devaluation sweeping Asia. Its low wages attracted hundreds of billions of dollars in foreign investment.

By the early part of this decade, the United States was importing huge amounts of Chinese-made goods — toys, shoes, flat-screen televisions and auto parts — while selling much less to China in return.

"For consumers, this was a net benefit because of the availability of cheaper goods," said Laurence H. Meyer, a former Fed governor. "There's no question that China put downward pressure on inflation rates."

But in classical economics, that trade gap could not have persisted for long without bankrupting the American economy. Except that China recycled its trade profits right back into the United States.

It did so to protect its own interests. China kept its banks under tight state control and its currency on a short leash to ensure financial stability. It required companies and individuals to save in the state-run banking system most foreign currency — primarily dollars — that they earned from foreign trade and investment.

As foreign trade surged, this hoard of dollars became enormous. In 2000, the reserves were less than $200 billion; today they are about $2 trillion.

Chinese leaders chose to park the bulk of that in safe securities backed by the American government, including Treasury bonds and the debt of Fannie Mae and Freddie Mac, which had implicit government backing.

This not only allowed the United States to continue to finance its trade deficit, but, by creating greater demand for United States securities, it also helped push interest rates below where they would otherwise have been. For years, China's government was eager to buy American debt at yields many in the private sector felt were too low.

This financial and trade embrace between the United States and China grew so tight that Niall Ferguson, a financial historian, has dubbed the two countries Chimerica.

'Tiptoeing' Around a Partner

Being attached at the hip was not entirely comfortable for either side, though for widely differing reasons.

In the United States, more people worried about cheap Chinese goods than cheap Chinese loans. By 2003, China's trade surplus with the United States was ballooning, and lawmakers in Congress were restive. Senator Graham and Senator Charles E. Schumer, Democrat of New York, introduced a bill threatening to impose a 27 percent duty on Chinese goods.

"We had a moment where we caught everyone's attention: the White House and China," Mr. Graham recalled.

At the People's Bank of China, the central bank, a consensus was also emerging in late 2004: China should break its tight link to the dollar, which would make its exports more expensive. Yu Yongding, a leading economic adviser, pressed the case. The American trade and budget deficits were not sustainable, he warned. China was wrong to keep its currency artificially depressed and depend too much on selling cheap goods.

Proponents of revaluation in China argued that the country's currency policies denied the fruits of prosperity to Chinese consumers. Beijing was investing their savings in low-yielding American government securities. And with a weak currency, they said, Chinese could not afford many imported goods.

The central bank's English-speaking governor, Zhou Xiaochuan, was among those who favored a sizable revaluation.

But when Beijing acted to amend its currency policy in 2005, under heavy pressure from Congress and the White House, it moved cautiously. The renminbi was allowed to climb only 2 percent. The Communist Party opted for only incremental adjustments to its economic model after a decade of fast growth. Little changed: China's exports kept soaring and investment poured into steel mills and garment factories.

But American officials eased the pressure. They decided to put more emphasis on urging Chinese consumers to spend more of their savings, which they hoped would eventually bring the two economies into better balance. On a tour of China, John W. Snow, the Treasury secretary at the time, even urged the Chinese to start using credit cards.

China kicked off its own campaign to encourage domestic consumption, which it hoped would provide a new source. But Chinese save with the same zeal that, until recently, Americans spent. Shorn of the social safety net of the old Communist state, they squirrel away money to pay for hospital visits, housing or retirement. This accounts for the savings glut identified by Mr. Bernanke.

Privately, Chinese officials confided to visiting Americans that the effort was not achieving much.

"It is sometimes hard to change successful models," said Robert B. Zoellick, who negotiated with the Chinese as a deputy secretary of state. "It is prototypically American to say, 'This worked well, but now you've got to change it.' "

In Washington, some critics say too little was done. A former Treasury official, Timothy D. Adams, tried to get the I.M.F. to act as a watchdog for currency manipulation by China, which would have subjected Beijing to more global pressure.

Yet when Mr. Snow was succeeded as Treasury secretary by Henry M. Paulson Jr. in 2006, the

I.M.F. was sidelined, according to several officials, and Mr. Paulson took command of China policy.

He was not shy about his credentials. As an investment banker with Goldman Sachs, Mr. Paulson made 70 trips to China. In his office hangs a watercolor depicting the hometown of Zhu Rongji, a forceful former prime minister.

"I pushed very hard on currency because I believed it was important for China to get to a market-determined currency," Mr. Paulson said in an interview. But he conceded he did not get what he wanted.

In late 2006, Mr. Paulson invited Mr. Bernanke to accompany him to Beijing. Mr. Bernanke used the occasion to deliver a blunt speech to the Chinese Academy of Social Sciences, in which he advised the Chinese to reorient their economy and revalue their currency.

At the last minute, however, Mr. Bernanke deleted a reference to the exchange rate being an "effective subsidy" for Chinese exports, out of fear that it could be used as a pretext for a trade lawsuit against China.

Critics detected a pattern. They noted that in its twice-yearly reports to Congress about trading partners, the Treasury Department had never branded China a currency manipulator.

"We're tiptoeing around, desperately trying not to irritate or offend the Chinese," said Thea M. Lee, public policy director of the A.F.L.-C.I.O. "But to get concrete results, you have to be confrontational."

An Embrace That Won't Let Go

For China, too, this crisis has been a time of reckoning. Americans are buying fewer Chinese DVD players and microwave ovens. Trade is collapsing, and thousands of workers are losing their jobs. Chinese leaders are terrified of social unrest.

Having allowed the renminbi to rise a little after 2005, the Chinese government is now under intense pressure domestically to reverse course and depreciate it. China's fortunes remain tethered to those of the United States. And the reverse is equally true.

In a glassed-in room in a nondescript office building in Washington, the Treasury conducts nearly daily auctions of billions of dollars' worth of government bonds. An old Army helmet sits on a shelf: as a lark, Treasury officials have been known to strap it on while they monitor incoming bids.

For the past five years, China has been one of the most prolific bidders. It holds $652 billion in Treasury debt, up from $459 billion a year ago. Add in its Fannie Mae bonds and other holdings, and analysts figure China owns $1 of every $10 of America's public debt.

The Treasury is conducting more auctions than ever to finance its $700 billion bailout of the banks. Still more will be needed to pay for the incoming Obama administration's stimulus package. The United States, economists say, will depend on the Chinese to keep buying that debt, perpetuating the American habit.

Even so, Mr. Paulson said he viewed the debate over global imbalances as hopelessly academic. He expressed doubt that Mr. Bernanke or anyone else could have solved the problem as it was germinating.

"One lesson that I have clearly learned," said Mr. Paulson, sitting beneath his Chinese watercolor. "You don't get dramatic change, or reform, or action unless there is a crisis." □

Postscript published on December 31, 2008:

The headline on a front-page article on Friday [Dec. 26], on the role in the housing bubble and consumption binge in the United States played by investment from China, could have been misunderstood. The article described how the United States has been tolerating a huge trade deficit with China while Chinese authorities have invested huge sums in American government securities from savings partly created by the inflow of American dollars. "Dollar Shift: Chinese Pockets Filled as Americans' Emptied" meant to describe the complications of that situation; it did not mean to imply that China has profited from the weakness of the American economy.

Saying Yes, WaMu Built Empire on Shaky Loans

"We hope to do to this industry what Wal-Mart did to theirs, Starbucks did to theirs, Costco did to theirs and Lowe's-Home Depot did to their industry. And I think if we've done our job, five years from now you're not going to call us a bank."

— Kerry K. Killinger, chief executive of Washington Mutual, 2003

By PETER S. GOODMAN and GRETCHEN MORGENSON

FIRST PUBLISHED: DECEMBER 28, 2008

SAN DIEGO — As a supervisor at a Washington Mutual mortgage processing center, John D. Parsons was accustomed to seeing baby sitters claiming salaries worthy of college presidents, and schoolteachers with incomes rivaling stockbrokers'. He rarely questioned them. A real estate frenzy was under way and WaMu, as his bank was known, was all about saying yes.

Yet even by WaMu's relaxed standards, one mortgage four years ago raised eyebrows. The borrower was claiming a six-figure income and an unusual profession: mariachi singer.

Mr. Parsons could not verify the singer's income, so he had him photographed in front of his home dressed in his mariachi outfit. The photo went into a WaMu file. Approved.

"I'd lie if I said every piece of documentation was properly signed and dated," said Mr. Parsons, speaking through wire-reinforced glass at a California prison near here, where he is serving 16 months for theft after his fourth arrest — all involving drugs.

While Mr. Parsons, whose incarceration is not related to his work for WaMu, oversaw a team screening mortgage applications, he was snorting methamphetamine daily, he said.

"In our world, it was tolerated," said Sherri Zaback, who worked for Mr. Parsons and recalls seeing drug paraphernalia on his desk. "Everybody said, 'He gets the job done.' "

At WaMu, getting the job done meant lending money to nearly anyone who asked for it — the force behind the bank's meteoric rise and its precipitous collapse this year in the biggest bank failure in American history.

On a financial landscape littered with wreckage, WaMu, a

SANDY HUFFAKER FOR THE NEW YORK TIMES

"It was just disheartening. Just spit it out and get it done. That's what they wanted us to do. Garbage in, and garbage out."

SHERRI ZABACK

A mortgage screener for Washington Mutual

Seattle-based bank that opened branches at a clip worthy of a fast-food chain, stands out as a singularly brazen case of lax lending. By the first half of this year, the value of its bad loans had reached $11.5 billion, nearly tripling from $4.2 billion a year earlier.

Interviews with two dozen former employees, mortgage brokers, real estate agents and appraisers reveal the relentless pressure to churn out loans that produced such results. While that sample may not fully represent a bank with tens of thousands of people, it does reflect the views of employees in WaMu mortgage operations in California, Florida, Illinois and Texas.

Their accounts are consistent with those of 89 other former employees who are confidential witnesses in a class action filed against WaMu in federal court in Seattle by former shareholders.

According to these accounts, pressure to keep lending emanated from the top, where executives profited from the swift expansion — not least, Kerry K. Killinger, who was WaMu's chief executive from 1990 until he was forced out in September.

Between 2001 and 2007, Mr. Killinger received compensation of $88 million, according to the Corporate Library, a research firm. He declined to respond to a list of questions, and his spokesman said he was unavailable for an interview.

During Mr. Killinger's tenure, WaMu pressed sales agents to pump out loans while disregarding borrowers' incomes and assets, according to former employees. The bank set up what insiders described as a system of dubious legality that enabled real estate agents to collect fees of more than $10,000 for bringing in borrowers, sometimes making the agents more beholden to WaMu than they were to their clients.

WaMu gave mortgage brokers handsome commissions for selling the riskiest loans, which carried higher fees, bolstering profits and ultimately the compensation of the bank's executives. WaMu pressured appraisers to provide inflated property values that made loans appear less risky, enabling Wall Street to bundle them more easily for sale to investors.

"It was the Wild West," said Steven M. Knobel, a founder of an appraisal company, Mitchell, Maxwell & Jackson, that did business with WaMu until 2007. "If you were alive, they would give you a loan. Actually, I think if you were dead, they would still give you a loan."

JPMorgan Chase, which bought WaMu for $1.9 billion in September and received $25 billion a few weeks later as part of the taxpayer bailout of the financial services industry, declined to make former WaMu executives available for interviews.

JPMorgan also declined to comment on WaMu's operations before it bought the company. "It is a different era for our customers and for the company," a spokesman said.

For those who placed their faith and money in WaMu, the bank's implosion came as a shock.

"I never had a clue about the amount of off-the-cliff activity that was going on at Washington Mutual, and I was in constant contact with the company," said Vincent Au, president of Avalon Partners, an investment firm. "There were people at WaMu that orchestrated nothing more than a sham or charade. These people broke every fundamental rule of running a company."

'Like a Sweatshop'

Some WaMu employees who worked for the bank during the boom now have regrets.

"It was a disgrace," said Dana Zweibel, a former financial representative at a WaMu branch in Tampa, Fla. "We were giving loans to people that never should have had loans."

If Ms. Zweibel doubted whether customers could pay, supervisors directed her to keep selling, she said.

"We were told from up above that that's not our concern," she said. "Our concern is just to write the loan."

The ultimate supervisor at

WaMu was Mr. Killinger, who joined the company in 1983 and became chief executive in 1990. He inherited a bank that was founded in 1889 and had survived the Depression and the savings and loan scandal of the 1980s.

An investment analyst by training, he was attuned to Wall Street's hunger for growth. Between late 1996 and early 2002, he transformed WaMu into the nation's sixth-largest bank through a series of acquisitions.

A crucial deal came in 1999, with the purchase of Long Beach Financial, a California lender specializing in subprime mortgages, loans extended to borrowers with troubled credit.

WaMu underscored its eagerness to lend with an advertising campaign introduced during the 2003 Academy Awards: "The Power of Yes." No mere advertising pitch, this was also the mantra inside the bank, underwriters said.

"WaMu came out with that slogan, and that was what we had to live by," Ms. Zaback said. "We joked about it a lot." A file would get marked problematic and then somehow get approved. "We'd say: 'O.K.! The power of yes.' "

Revenue at WaMu's home-lending unit swelled from $707 million in 2002 to almost $2 billion the following year, when the "The Power of Yes" campaign started.

Between 2000 and 2003, WaMu's retail branches grew 70 percent, reaching 2,200 across 38 states, as the bank used an image of cheeky irreverence to attract new customers. In offbeat television ads, casually dressed WaMu employees ridiculed staid bankers in suits.

Branches were pushed to increase lending. "It was just disgusting," said Ms. Zweibel, the Tampa representative. "They wanted you to spend time, while you're running teller transactions and opening checking accounts, selling people loans."

Employees in Tampa who fell short were ordered to drive to a WaMu office in Sarasota, an hour away. There, they sat in a phone bank with 20 other people, calling customers to push home equity loans.

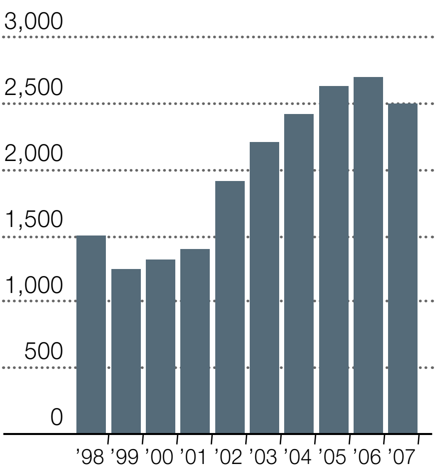
"The regional manager would be over your shoulder, listening to every word," Ms. Zweibel recalled. "They treated us like we were in a sweatshop."

On the other end of the country, at WaMu's San Diego processing office, Ms. Zaback's job was to take loan applications from branches in Southern California and make sure they passed muster. Most of the loans she said she handled merely re-

WaMu's Expansion

From 1999 to 2006, Washington Mutual expanded its local branches at a rapid pace. In the beginning, the bank's stock soared as the housing boom expanded. But WaMu had lax lending standards and collapsed in September under the weight of billions of dollars in souring loans.

BANKING AND LENDING BRANCHES



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Source: S.E.C. filings

THE NEW YORK TIMES

quired borrowers to provide an address and Social Security number, and to state their income and assets.

She ran applications through WaMu's computer system for approval. If she needed more information, she had to consult with a loan officer — which she described as an unpleasant experience. "They would be furious," Ms. Zaback said. "They would put it on you, that they weren't going to get paid if you stood in the way."

On one loan application in 2005, a borrower identified himself as a gardener and listed his monthly income at $12,000, Ms. Zaback recalled. She could not verify his business license, so she took the file to her boss, Mr. Parsons.

He used the mariachi singer as inspiration: a photo of the borrower's truck emblazoned with the name of his landscaping business went into the file. Approved.

Mr. Parsons, who worked for WaMu in San Diego from about 2002 through 2005, said his supervisors constantly praised his performance. "My numbers were through the roof," he said.

On another occasion, Ms. Zaback asked a loan officer for verification of an applicant's assets. The officer sent a letter from a bank showing a balance of about $150,000 in the borrower's account, she recalled. But when Ms. Zaback called the bank to confirm, she was told the balance was only $5,000.

The loan officer yelled at her, Ms. Zaback recalled. "She said, 'We don't call the bank to verify.' " Ms. Zaback said she told Mr. Parsons that she no longer wanted to work with that loan officer, but he replied: "Too bad."

Shortly thereafter, Mr. Parsons disappeared from the office. Ms. Zaback later learned of his arrest for burglary and drug possession.

The sheer workload at WaMu ensured that loan reviews were limited. Ms. Zaback's office had 108 people, and several hundred new files a day. She was required to process at least 10 files daily.

"I'd typically spend a maximum of 35 minutes per file," she said. "It was just disheartening. Just spit it out and get it done. That's what they wanted us to do. Garbage in, and garbage out."

Referral Fees for Loans

WaMu's boiler room culture flourished in Southern California, where housing prices rose so rapidly during the bubble that creative financing was needed to attract buyers.

To that end, WaMu embraced so-called option ARMs, adjustable rate mortgages that enticed borrowers with a selection of low initial rates and allowed them to decide how much to pay each month. But people who opted for minimum payments were underpaying the interest due and adding to their principal, eventually causing loan payments to balloon.

Customers were often left with the impression that low payments would continue long term, according to former WaMu sales agents.

For WaMu, variable-rate loans — option ARMs, in particular — were especially attractive because they carried higher fees than other loans, and allowed WaMu to book profits on interest payments that borrowers deferred. Because WaMu was selling many of its loans to investors, it did not worry about defaults: by the time loans went bad, they were often in other hands.

WaMu's adjustable-rate mortgages expanded from about one-fourth of new home loans in 2003 to 70 percent by 2006. In 2005 and 2006 — when WaMu pushed option ARMs most aggressively — Mr. Killinger received pay of \$19 million and \$24 million respectively.

The ARM Loan Niche

WaMu's retail mortgage office in Downey, Calif., specialized in selling option ARMs to Latino customers who spoke little English and depended on advice from real estate brokers, according to a former sales agent who requested anonymity because he was still in the mortgage business.

According to that agent, WaMu turned real estate agents into a pipeline for loan applications by enabling them to collect "referral fees" for clients who became WaMu borrowers.

Buyers were typically oblivious to agents' fees, the agent said, and agents rarely explained the loan terms.

"Their Realtor was their trusted friend," the agent said. "The Realtors would sell them on a minimum payment, and that was an outright lie."

According to the agent, the strategy was the brainchild of Thomas Ramirez, who oversaw a sales team of about 20 agents at the Downey branch during the first half of this decade, and now works for Wells Fargo.

Mr. Ramirez confirmed that he and his team enabled real estate agents to collect commissions, but he maintained that the fees were fully disclosed.

"I don't think the bank would have let us do the program if it was bad," Mr. Ramirez said.

Mr. Ramirez's team sold nearly $1 billion worth of loans in 2004, he said. His performance made him a perennial member of WaMu's President's Club, which brought big bonuses and recognition at an awards ceremony typically hosted by Mr. Killinger in tropical venues like Hawaii.

Mr. Ramirez's success prompted WaMu to populate a neighboring building in Downey with loan processors, underwriters and appraisers who worked for him. The fees proved so enticing that real estate agents arrived in Downey from all over Southern California, bearing six and seven loan applications at a time, the former agent said.

WaMu banned referral fees in 2006, fearing they could be construed as illegal payments from the bank to agents. But the bank allowed Mr. Ramirez's team to continue using the referral fees, the agent said.

Forced Out With Millions

By 2005, the word was out that WaMu would accept applications with a mere statement of the borrower's income and assets — often with no documentation required — so long as credit scores were adequate, according to Ms. Zaback and other underwriters.

"We had a flier that said, 'A thin file is a good file,' " recalled Michele Culbertson, a wholesale sales agent with WaMu.

Martine Lado, an agent in the Irvine, Calif., office, said she coached brokers to leave parts of applications blank to avoid prompting verification if the borrower's job or income was sketchy.

"We were looking for people who understood how to do loans at WaMu," Ms. Lado said.

Top producers became heroes. Craig Clark, called the "king of the option ARM" by colleagues, closed loans totaling about $1 billion in 2005, according to four of his former coworkers, a tally he amassed in part by challenging anyone who doubted him.

"He was a bulldozer when it came to getting his stuff done," said Lisa Alvarez, who worked in the Irvine office from 2003 to 2006.

Christine Crocker, who managed WaMu's wholesale underwriting division in Irvine, recalled one mortgage to an elderly couple from a broker on Mr. Clark's team.

With a fixed income of about $3,200 a month, the couple needed a fixed-rate loan. But their broker earned a commission of three percentage points by arranging an option ARM for them, and did so by listing their income as $7,000 a month. Soon, their payment jumped from roughly $1,000 a month to about $3,000, causing them to fall behind.

Mr. Clark, who now works for JPMorgan, referred calls to a company spokesman, who provided no further details.

In 2006, WaMu slowed option ARM lending. But earlier, ill-considered loans had already begun hurting its results. In 2007, it recorded a $67 million loss and shut down its subprime lending unit.

By the time shareholders joined WaMu for its annual meeting in Seattle last April, WaMu had posted a first-quarter loss of $1.14 billion and increased its loan loss reserve to $3.5 billion. Its stock had lost more than half its value in the previous two months. Anger was in the air.

Some shareholders were irate that Mr. Killinger and other executives were excluding mortgage losses from the computation of their bonuses. Others were enraged that WaMu turned down an $8-a-share takeover bid from JPMorgan.

“Calm down and have a little faith,” Mr. Killinger told the crowd. “We will get through this.”

WaMu asked shareholders to approve a $7 billion investment by Texas Pacific Group, a private equity firm, and other unnamed investors. David Bonderman, a founder of Texas Pacific and a former WaMu director, declined to comment.

Hostile shareholders argued that the deal would dilute their holdings, but Mr. Killinger forced it through, saying WaMu desperately needed new capital.

Weeks later, with WaMu in tatters, directors stripped Mr. Killinger of his board chairmanship. And the bank began including mortgage losses when calculating executive bonuses.

In September, Mr. Killinger was forced to retire. Later that month, with WaMu buckling under roughly $180 billion in mortgage-related loans, regulators seized the bank and sold it to JPMorgan for $1.9 billion, a fraction of the $40 billion valuation the stock market gave WaMu at its peak.

Billions that investors had plowed into WaMu were wiped out, as were prospects for many of the bank’s 50,000 employees. But Mr. Killinger still had his millions, rankling laid-off workers and shareholders alike.

“Kerry has made over $100 million over his tenure based on the aggressiveness that sunk the company,” said Mr. Au, the money manager. “How does he justify taking that money?”

In June, Mr. Au sent an e-mail message to the company asking executives to return some of their pay. He says he has not heard back. □