
THE WALL STREET JOURNAL.

Debt Bomb: Inside The 'Subprime' Mortgage Debacle --- Day of Reckoning -- 'Subprime' Aftermath: Losing the Family Home --- Mortgages Bolstered Detroit's Middle Class -- Until Money Ran Out

By Mark Whitehouse

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Corrections & Amplifications

The average adjustable-rate subprime mortgage loan charges a margin of about 6.5 percentage points over the six-month London interbank offered rate. A page-one article Wednesday on subprime mortgages incorrectly said the margin was about 6.5%. In addition, community organizer Carlton McBurrows's name was misspelled as Carleton McBurroughs in the article in some editions.

(WSJ June 1, 2007)

(END)

[First in a Series]

DETROIT -- For decades, the 5100 block of West Outer Drive in Detroit has been a model of middle-class home ownership, part of an urban enclave of well-kept Colonial residences and manicured lawns. But on a recent spring day, locals saw something disturbing: dandelions growing wild on several properties.

"When I see dandelions, I worry," says Sylvia Hollifield, an instructor at Michigan State University who has lived on the block for more than 20 years.

Ms. Hollifield's concern is well-founded. Her neighbors are losing interest in their lawns because they're losing their homes -- a result of the recent boom in "subprime" mortgage lending. Over the past several years, seven of the 26 households on the 5100 block have taken out subprime loans, typically aimed at folks with poor or patchy credit.

Some used the money to buy their houses. But most already owned their homes and used the proceeds to pay off credit cards, do renovations and maintain an appearance of middle-class fortitude amid a declining local economy. Three now face eviction because they couldn't meet rising monthly payments. Two more are showing signs of distress.

"This has stripped us of our whole pride," says April Williams, 47 years old, who has until August to pay off her mortgage or vacate the two-story Colonial at 5170, where she and her husband have lived for 11 years. "There's going to be no people left in Detroit if they keep doing this to them."

The fate of people on West Outer Drive offers a glimpse of a drama that is playing out in middle- to lower-income, often minority-dominated communities across the country. In addition to putting families into homes, subprime mortgages and the brokers who peddle them are helping to take families out of homes in which they've lived for years, eroding the benefits that proponents on Wall Street and in Congress have long touted.

The borrowers' difficulties raise questions about how the extension of easy credit to large swaths of the U.S. population will ultimately affect people and the broader economy -- questions that have gained in urgency as a sharp rise in defaults has policy makers wondering what, if anything, they can or should do.

Much of the focus in the subprime debacle has been on the demise of bubble markets in balmy locales such as California and Florida. But the subprime market has also channeled a surprising amount of money into some of America's poorer and more-troubled local economies.

In 2006 alone, according to an analysis of data from First American LoanPerformance, subprime investors from all over the world injected more than a billion dollars into 22 ZIP Codes in Detroit, where home values were falling, unemployment was rising and the foreclosure rate was already the nation's highest. Fourteen ZIP Codes in Memphis, Tenn., attracted an estimated \$460 million. Seventeen ZIP Codes in Newark, N.J., pulled in about \$1.5 billion. In all of those ZIP Codes, subprime mortgages comprised more than half of all home loans made.

The figures show the extent to which the new world of mortgage finance has made the American dream of homeownership accessible to folks in previously underserved communities. By some estimates, subprime lending has accounted for as much as half of the past decade's rise in the U.S. homeownership rate to 69% from 65%. But as the experience of West Outer Drive illustrates, the flood of cash has also encouraged people to get into financially precarious positions, often precisely at the time when they were least able to afford it. In doing so, it may have temporarily alleviated -- but ultimately worsened -- some of the nation's most acute economic problems.

"The market was feeding an addict at its neediest point," says Diane Swonk, who spent 19 years analyzing consumer credit in the Midwest and now serves as chief economist at Chicago-based financial-services firm Mesirow Financial. "Individuals will resist reductions in their standard of living with everything in their power, including mortgaging their futures."

If events unfold as some predict, subprime lending could end up eliminating more homeowners than it created. One study by the Center for Responsible Lending, a nonprofit that focuses on abusive lending practices, forecasts that the subprime boom will result in a total of 2.4 million foreclosures nationwide, most of them on homes people owned before taking out the loans. That outweighs even the most optimistic estimates of the number of homeowners created, which don't exceed two million.

To understand how the legacy of subprime lending looks on the ground, take a ride around the West Outer Drive area with Carlton McBurrows, who grew up in the neighborhood and now works as a community organizer for Acorn, an advocacy group that provides financial counseling to lower-income families. On one recent spring day, he counted four empty houses with big red refuse bins outside -- a sign that banks, having taken possession of the homes, were tossing out all the belongings and debris left behind by the previous inhabitants.

"This is a phenomenon that I've never seen before, and I've lived here all my life," he says. "I think this is just the beginning."

As opposed to other parts of urban Detroit, which tend to be plagued by burned-out homes, the area around the 5100 block of West Outer Drive has remained a place where people try hard to keep up appearances. Originally largely Jewish, the neighborhood became a bastion of home ownership for upwardly mobile blacks beginning in the late 1960s. Though the area's fortunes have slipped somewhat as people have moved out to the suburbs, it has boasted such famous residents as Aretha Franklin, Marvin Gaye and Berry Gordy, the founder of the Motown record label.

"It was like when you made it to Outer Drive, you'd made it," says Deborah Herron, 52, a former administrative assistant who lived in the area for 35 years.

Back in its heyday, the idea that West Outer Drive could suffer from a glut of credit would have seemed far-fetched. Many blacks moving into the neighborhood had to either depend on federal mortgage programs or buy their homes outright. That's because banks actively avoided lending to them, a practice known as "redlining" -- a reference to maps that designated certain neighborhoods as unduly risky. Various attempts to get the money to flow, such as the Community Reinvestment Act of 1977, which pushed banks to do more lending in the communities where they operated, had only a limited effect.

But beginning in the mid-1990s, the evolution of subprime mortgage lending from a local niche business to a global market drastically rearranged lenders' incentives. Instead of putting their own money at risk, subprime lenders began reselling loans in bulk and at a profit to Wall Street banks. The bankers, in turn, transformed a large chunk of the loans into highly rated securities, which attracted investors from all over the world by paying a better return than other securities with the same rating. The investors cared much more about the broader qualities of the securities -- things like the average credit score and overall geographic distribution -- than exactly where and to whom the loans were being made.

"You have no time to look really deeply at every single borrower," says Michael Thiemann, chief investment officer at Collineo Asset Management GmbH, a Dortmund, Germany-based firm that invests on behalf of European banks and insurance companies. "You're looking at statistical distributions."

Suddenly, mortgage lenders saw places like West Outer Drive as attractive targets for new business, because so many families either owned their homes outright or owed much less on their mortgages than their homes were worth. Lenders seeking to tap that equity bombarded the area with radio, television, direct-mail advertisements and armies of agents and brokers, often peddling loans that veiled high interest rates and fat fees behind low introductory payments. Unscrupulous players had little reason to worry about whether or not people could afford the loans: The more contracts they could sign, the more money they stood to make.

"The pendulum has swung too far in the other direction," says Dan Immergluck, a professor of urban planning at Georgia Institute of Technology who has written a book on redlining. "We have too much credit, and too much of the wrong type of credit."

Minority-dominated communities attracted more than their fair share of subprime loans, which carry higher interest rates than traditional mortgages. A 2006 study by the Center for Responsible Lending found that African-Americans were between 6% and 29% more likely to get higher-rate loans than white borrowers with the same credit quality.

Subprime mortgages accounted for more than half of all loans made from 2002 through 2006 in the 48235 ZIP Code, which includes the 5100 block of West Outer Drive, according to estimates from First American LoanPerformance. Over that period, the total volume of subprime lending in the ZIP Code amounted to more than half a billion dollars -- mostly in the form of adjustable-rate mortgages, the payments on which are fixed for an initial period then rise and fall with short-term interest rates.

"A lot of people were steered into subprime loans because of the area they were in, even though they could have qualified for something better," says John Bettis, president of broker Urban Mortgage in Detroit. He says a broker's commission on a \$100,000 subprime loan could easily reach \$5,000, while the commission on a similar prime loan typically wouldn't exceed \$3,000.

The boom in subprime lending paved the way to home ownership for many people: Over the past three years, three people on the 5100 block have used subprime loans to buy homes. In at least two of those cases, though, the experience has not gone well. Raymond Dixon, a 36-year-old with his own business installing security systems, borrowed \$180,000 from Fremont Investment & Loan in 2004 to buy a first home for himself, his wife and six children, across the street from Ms. Hollifield at 5151 West Outer Drive. After all the papers had been signed, he says, he realized that he had paid more than \$20,000 to the broker and other go-betweens. "They took us for a ride," he says.

Bishop Charles Ellis, senior pastor of the Greater Grace Temple in Detroit, says he has heard many similar complaints from people in the area who, either because they were new to the process or had good experiences in the past, had put too much trust in subprime-mortgage brokers. Still, he believes many bear responsibility for their predicaments. "If you have a contract in front of you, you have to read that contract," he says.

Mr. Dixon defaulted on the loan after the monthly payment jumped to more than \$1,500 from \$1,142 -- a rise he says put too much strain on his income from his security business. The foreclosure process began in late November, and Mr. Dixon says he expects an eviction notice this week. A spokesman for Fremont said the company, which is in the process of exiting the residential mortgage business, has taken measures to reduce defaults but does not comment on specific customers.

Up at the north end of the block, Jennifer Moore and her husband, John, bought a two-story beige-brick house in December 2004. She says her husband had excellent credit, but in the rush to buy his "dream house" he agreed to take out two subprime loans from EquiFirst Corp., one for \$164,000 and the other for \$41,000 -- a "piggyback" arrangement that allowed him to avoid a down payment. Ms. Moore said the real-estate agent told them they could refinance into a fixed-rate loan within two years, after which the payments on the larger loan were scheduled to reset.

Mr. Moore's death in 2006 scuttled the refinancing plans. Now Ms. Moore, a 56-year-old clerical worker for Wayne County, has fallen behind on the monthly mortgage payments, which she says rose earlier this year to \$2,200 from about \$1,450. After more than 30 years as a homeowner, she now expects to lose the house -- including the back porch she built to take in the sun and the library she decorated with her son's baseball and basketball trophies. "I'll get an apartment," she says. "I'm not going to buy another place." An EquiFirst spokeswoman said the company doesn't comment on specific customers.

For many who already owned their homes, offers of easy credit came at a time when a severe economic downturn had left them in need of money to maintain middle-class lifestyles. Since the year 2000, the slump led by the auto industry has cost the Detroit metropolitan area about 20,000 jobs a year, helping turn the shopping areas near West Outer Drive into scenes of defunct businesses, payday lenders and liquor stores. According to the latest data from the Internal Revenue Service, households in the 48235 ZIP Code reported an average adjusted gross income of \$32,902 in 2004, up slightly from \$32,817 in 2001 but down 6% in inflation-adjusted terms.

April Williams was feeling the pain of the downturn back in 2002, when she saw an ad from subprime lender World Wide Financial Services Inc. offering cash to solve her financial problems. At the time, production slowdowns at Ford Motor Co. were squeezing her husband's income from an assembly-line job, and they'd heard rumors that more cutbacks were coming. Still, after a loan officer from World Wide paid a visit, they became convinced they could afford stainless-steel appliances, custom tile, a new bay window, and central air-conditioning -- and a \$195,500 loan to retire their old mortgage and pay for the improvements. The loan carried an interest rate of 9.75% for the first two years, then a "margin" of 9.125 percentage points over the benchmark short-term rate at which banks lend money to each other -- known as the London interbank offered rate, or Libor. The average subprime loan charges a margin of about 6.5% over six-month Libor, which as of Tuesday stood at 5.38%.

"I knew better than to be stupid like that," she says. "But they caught me at a time when I was down."

She wasn't alone. Locals say West Outer Drive became a beehive of renovation activity in the first half of the decade, even as the economy sagged. Up the block from Ms. Williams, Ordell Walker, who says he left a job at DaimlerChrysler several years ago, put in a new driveway, glass-brick windows on the basement and stairwell, and much more. To get the cash, he jacked up his mortgage to \$205,000 from \$108,000 in 2002, partly with the help of World Wide. "A lot of people took the cash," he says. "I wish I'd never done it myself."

Last year, the Michigan Office of Financial and Insurance Services revoked World Wide's license amid allegations of fraud. Jeff Arnstein, who was a team leader at World Wide in 2002 and who Ms. Williams says processed her loan, said he didn't remember the specific case but he believed the loan was properly underwritten. "My heart goes out to them," he said. "But it's not the fault of the mortgage company that put them in their loan." Mr. Arnstein now works for First Mortgage Corp. near Phoenix.

Both Ms. Williams and Mr. Walker have found themselves in a predicament now common among homeowners in Detroit: They've tried to sell their houses, but can't find buyers willing to pay what they owe on their mortgages. After two years on the market, Ms. Williams says her house has attracted a high bid of \$140,000, nowhere near the \$211,000 debt she must settle to avoid eviction. That leaves her with little option but to abandon the house -- the worst outcome for the neighborhood, because it means the property could end up gutted with a big red debris bin out front.

Kevin Lightsey, a local agent at Keller Williams Realty, says he doubts such foreclosed homes are likely to find new owners willing to live there. "Nobody's going to want to buy into a neighborhood with 20% foreclosures," he says. "You end up with no neighborhood." First American LoanPerformance estimates that, as of March, about one in three subprime loans made from 2002 through 2006 in the 48235 ZIP Code were more than 60 days in arrears, meaning they were either already in foreclosure or well on their way there. Even loans made in 2006 had a delinquency rate of about 17%.

Some subprime borrowers on the 5100 block of West Outer Drive say they are doing fine and planning to stay put. Kevin Ransom, a 42-year-old investment banker who grew up in the area, moved into the red-brick Colonial across from Ms. Hollifield in 1999, leaving behind a job in New York. He bumped up his mortgage debt to \$208,250 from \$170,100 back in 1999, and put the money into a new roof, marble floors, custom ceilings and a finished basement. He says his income has grown enough to make the monthly payment, which has risen to about \$1,700, from \$1,200 when he took out the most recent loan in 2002.

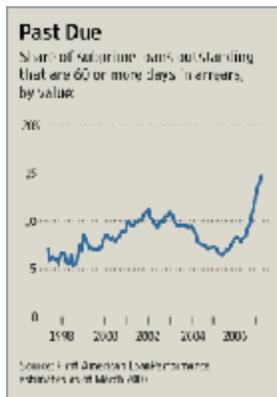
"I always had a desire to come back home and try to be in a community," says Mr. Ransom.

Still, he's worried about the way some of his neighbors are losing interest in their homes. Consider Jacqueline McNeal, a school principal who has lived in the house two doors north of Mr. Ransom since 1995. In 2002, she says, she took out a \$112,700 loan from Full Spectrum Lending, a subprime arm of Countrywide Financial Corp., to pay off department-store bills, provide financial help to some out-of-work relatives and retire her old fixed-rate mortgage. But last year, as the interest rate on her loan rose to 12% from an initial 8.75%, she fell behind amid a litany of difficulties, including a teachers' strike and problems with the payment of her back property taxes. A Countrywide spokesman said there was nothing inappropriate in the origination or the servicing of the loan.

Now in foreclosure, Ms. McNeal has until early July to come up with the money or be evicted. She doubts she can sell the house, and the missed payments have dented her credit to the point where she can't get another loan. So she's letting the dandelions grow.

"You have two options -- to sell it or to refinance it," she says. "But if you can't do either, what can you do?"

(See related letters: "Letters to the Editor: Subprime Sorrow: Borrower Knowledge Would Even the Equation" -- WSJ June 4, 2007)



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THE WALL STREET JOURNAL.

Debt Bomb --- Lending a Hand: How Wall Street Stoked The Mortgage Meltdown --- Lehman and Others Transformed the Market For Riskiest Borrowers

By Michael Hudson

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Corrections & Amplifications

Industrywide volume of securities backed by subprime mortgages rose to \$508 billion in 2005 from \$93.75 billion in 2001, according to trade publication Inside Mortgage Finance. In some editions yesterday, a page-one article about the role of Wall Street in the subprime-mortgage meltdown and the accompanying graphic incorrectly indicated that volume in 2001 was \$61 billion.

(WSJ June 28, 2007)

(END)

[Inside the 'subprime' mortgage debacle -- Second in a Series]

Twelve years ago, Lehman Brothers Holdings Inc. sent a vice president to California to check out First Alliance Mortgage Co. Lehman was thinking about tapping into First Alliance's lucrative business of making "subprime" home loans to consumers with sketchy credit.

The vice president, Eric Hibbert, wrote a memo describing First Alliance as a financial "sweat shop" specializing in "high pressure sales for people who are in a weak state." At First Alliance, he said, employees leave their "ethics at the door."

The big Wall Street investment bank decided First Alliance wasn't breaking any laws. Lehman went on to lend the mortgage company roughly \$500 million and helped sell more than \$700 million in bonds backed by First Alliance customers' loans. But First Alliance later collapsed. Lehman landed in court, where a federal jury found the firm helped First Alliance defraud customers.

Today, Lehman is a prime example of how Wall Street's money and expertise have helped transform subprime lending into a major force in the U.S. financial markets. Lehman says it is proud of its role in helping provide credit to consumers who might otherwise have been unable to buy a home, and proud of the controls it has brought to a sometimes-unruly business.

Now, however, that business is in deep trouble, and some consumer advocates and policy makers are pointing the finger at Wall Street. Roughly 13% of subprime loans stand in or near foreclosure, bringing turmoil and sometimes eviction to tens of thousands of homeowners. Dozens of lenders have gone out of business. Bear Stearns Cos. is trying to bail out a hedge fund it manages that was hurt by subprime mortgage losses.

Critics say Wall Street firms helped create the mess by throwing so much money at the market that lenders had a growing incentive to push through shaky loans and mislead borrowers.

At a hearing in April, Sen. Robert Menendez (D., N.J.), said Wall Street firms "looked the other way" as they profited from questionable loans, "fueling a market that has very little discipline over itself."

Federal Reserve chief Ben Bernanke said in a May speech that some lenders focused more on feeding the marketplace than on the quality of loans, in part because most of the risks that loans would go bad were passed to investors. As a result, "mortgage applications with little documentation were vulnerable to misrepresentation or overestimation of repayment capacity by both lenders and borrowers," he said.

A generation ago, housing finance was different. Bankers took in deposits, lent that money to home buyers and collected interest and principal until the mortgages were paid. Wall Street wasn't much involved.

Now it plays a central role. Wall Street firms provide working capital that allows thousands of mortgage firms to make loans. After lenders sign up consumers for home loans, investment banks pool the income streams from these loans into bonds known as mortgage-backed securities. The banks sell them to yield-hungry investors around the world.

Before the mid-1990s, mortgage-backed securities consisted mostly of loans to borrowers with good credit and cash to make ample down payments. Then investment banks found they could do the same with riskier loans to borrowers with modest incomes and flawed credits. Pooling the loans created a cushion against defaults by diversifying the risk. The high interest rates on the loans made for bonds with high yields that investors savored. New technology helped make it easier for lenders to collect and collate mounds of information on borrowers.

Lehman, one of Wall Street's biggest players in the subprime boom, says it has gone to great lengths to screen loans for fraud and vet the lenders it works with. "No financial institution would knowingly want to make or securitize a loan that it expected would later go into default," David Sherr, Lehman's head of securitized products, told Mr. Menendez and other senators. "Rather, the success of mortgage-backed securities as an investment vehicle depends upon the expectation that homeowners generally will make their monthly payments, since those payments form the basis for the cash flows to bondholders."

At the sector's peak in 2005, with the housing market booming, loan defaults remained low. Wall Street pooled a record \$508 billion in subprime mortgages in bonds, up from \$56 billion in 2000, according to trade publication Inside Mortgage Finance. The figure slid to \$483 billion last year as the housing market slumped and subprime defaults picked up.

Lehman topped other Wall Street firms over the past two years, packaging more than \$50 billion in subprime-mortgage-backed securities in both 2005 and 2006. Overall, Lehman officials say the subprime business has accounted for 3% of the firm's overall revenues in recent quarters, or roughly \$500 million in 2006.

Lehman has also been a leader in investment banks' push to buy their own lenders. Through its subprime unit BNC Mortgage Inc., it lends directly to consumers, bringing in more fees and giving it more control over the quality of the loans.

Lehman's deep involvement in the business has also made the firm a target of criticism. In more than 15 lawsuits and in interviews, borrowers and former employees have claimed that the investment bank's in-house lending outlets used improper tactics during the recent mortgage boom to put borrowers into loans they couldn't afford.

Twenty-five former employees said in interviews that front-line workers and managers exaggerated borrowers' creditworthiness by falsifying tax forms, pay stubs and other information, or by ignoring inaccurate data submitted by independent mortgage brokers. In some instances, several ex-employees said, brokers or in-house employees altered documents with the help of scissors, tape and Wite-Out.

"Anything to make the deal work," says Coleen Columbo, a former mortgage underwriter in California for Lehman's BNC unit. She and five other ex-employees are pursuing a lawsuit in state court in Sacramento that claims BNC's management retaliated against workers who complained about fraud.

Lehman officials say there's no evidence to support such claims. They say the firm has tough antifraud controls and goes to great lengths to ensure that it works with mortgage brokers and lenders who meet high standards and that loans are based on accurate information.

Lehman says company records clearly refute specific details of the accounts given by these former employees. It says most of them never raised concerns during their tenures at Lehman lending units, even though that was a requirement of their jobs. Some employees contacted by The Wall Street Journal said they weren't aware of improper practices.

"We think it is misleading to extrapolate from a handful of cases, in each of which we have a strong defense, and make a judgment about the way we conduct our business," Lehman says.

Lehman's history in subprime goes back to the mid-1990s, when the sector was still tiny. Back then, Lehman established itself as a leader in the market for subprime-mortgage-backed securities. It built a staff of experts who had worked at other securities firms and established relationships with subprime-mortgage lenders.

One of them was First Alliance. Mr. Hibbert, the Lehman vice president, traveled to Orange, Calif., in June 1995 to help decide whether Lehman should provide financing to First Alliance and underwrite its mortgage-backed bonds. In his memo, Mr. Hibbert reported back that there was "little risk of fraud or impropriety" at First Alliance. But he also said it was clear it made some loans "where the borrower has no real capacity for repayment."

Lehman officials say Mr. Hibbert ultimately supported going forward with First Alliance, a decision the investment bank made on the basis of extensive discussions and a 140-page memo. They also note that the \$25 million line of credit that Lehman initially wrote for First Alliance was small compared with what other firms were putting up to finance the lender.

By late 1998, Prudential Securities and other investment banks had abandoned First Alliance. Federal regulators and seven states were investigating allegations it used deceptive sales tactics to get borrowers into loans with excessive upfront fees. First Alliance trained loan officers to use a sales pitch designed to "confuse and mislead" borrowers and disguise fees, U.S. District Judge David Carter in California found in a 2003 bankruptcy-related proceeding.

During the turmoil, Lehman helped keep First Alliance afloat with more loans. In early 1999, an internal Lehman memo noted the proliferation of government probes targeting the lender -- and the possibility that involvement with the lender might produce bad publicity for the investment bank. But the memo recommended going forward, arguing that First Alliance's borrowers rarely defaulted on their loans and noting that Lehman stood to earn millions in fees by managing the lender's mortgage-backed securities deals.

Lehman officials say they took close account of First Alliance's practices. Its reviews showed the lender was committed to improving its practices -- it hired a new in-house counsel, along with a chief financial officer who once worked at Lehman.

First Alliance shut down in March 2000 as pressure from lawsuits and investigations grew. In 2003 a federal jury in California delivered a \$50.1 million verdict in a class action against First Alliance, attributing 10% of the damages -- \$5.1 million -- to Lehman. (A federal appeals panel upheld the jury's decision but instructed the trial court to recalculate the dollar award. That decision is pending.) Lehman also settled a lawsuit filed in Broward County Circuit Court by Florida authorities who said Lehman was an "accomplice" in First Alliance's frauds. The investment bank admitted no wrongdoing but agreed to pay \$400,000 and review its practices.

Lehman calls the First Alliance saga an aberration, and says it is unfair to use it to draw conclusions about how it does business more than a decade later.

The subprime market contracted between 1999 and 2001, as continuing ripples from that era's Russian debt crisis and the collapse of hedge fund Long-Term Capital Management prompted investors to pull back from riskier markets. The crisis also presented a buying opportunity.

In 1999 Lehman started operating its own subprime lending unit, Finance America, as a joint venture with an ailing subprime lender named Amresco Inc. as a minority partner. It bought out Amresco in 2001 and another minority investor in 2004. Lehman also took an ownership stake in California-based BNC Mortgage in 2000 after helping management take the company private. It bought out management's remaining stake in 2004 and last year merged Finance America into BNC. Earlier this month, it said it would merge BNC with its Aurora Loan Services unit.

With interest rates low and the economy recovering, the market took off, and BNC and Finance America grew quickly. They ballooned from \$3 billion in total loan originations in 2001 to \$24 billion in 2005, ranking Lehman No. 11 among all subprime lenders.

As subprime grew, Lehman officials say, fraudulent schemes pushed by rogue mortgage brokers and others became more sophisticated throughout the industry. By taking full ownership of BNC and Finance America, the firm says, it was in a better position to combat these practices.

When Lehman consolidated its control of the two companies in 2004, Lehman officials say, the lenders' practices were consistent with industry standards. But they acknowledge the lenders -- like others in the subprime industry -- had problems with loan quality and fraud prevention. "Since then, we have worked long and hard, as we have

taken control, to make these companies models for the industry on best practices for fraud detection and borrower protection," the firm says.

Since the start of 2004, BNC has nearly doubled the size of its staff devoted to quality control, fraud investigations and other jobs that help ensure the lender makes good loans.

Some former employees claim, however, that the pressure to boost loan volume during the boom years of 2004 and 2005 prompted some workers at the lending units to step over the line and push through questionable loans.

Dena Ivezic, a mortgage underwriter for both companies in Downers Grove, Ill., in late 2005 and early 2006, says some staffers at her branch used "cut and paste" techniques to fabricate documents they needed to get loans approved. Some workers tried "to take a stand" against such practices, she says, but "they were reprimanded for not being cooperative -- not wanting to be creative about making deals work. . . . Everybody else just kind of bottled up and just never said anything, because you needed a job."

Cedric Washington, a former regional sales manager for Finance America in California, contended that employees at the lender actively pushed through questionable loans. In a 2005 employment-discrimination lawsuit in state court in Sacramento, Mr. Washington said he witnessed a fellow manager alter a loan document by forging a borrower's initials. Later, he said, he discovered Finance America employees forged borrowers' signatures on credit disclosures and used falsified documents to inflate loan applicants' incomes.

In one instance, the lawsuit said, a loan officer submitted a loan on a duplex that was "not a home or duplex at all but merely a greenhouse." Mr. Washington complained the loan was backed by falsified collateral, the suit said, but a Finance America executive refused to pull the loan.

BNC officials said Mr. Washington himself was complicit in fraud, which he denied, according to the lawsuit. Lehman officials say his lawsuit "had no merit" and was "not brought in good faith." It was settled last year for an undisclosed sum. As for Ms. Ivezic, Lehman says she worked at BNC for just 4 1/2 months and her experiences are "hardly representative of BNC's employee base."

Other former employees contacted by the Journal said that fraud wasn't a problem at the lenders. They say their managers didn't hesitate to reject fishy loans. "Everything we did was by the guidelines," says Barbara Webb, a loan underwriter for both Finance America and BNC in Texas from 2004 into 2006.

Lehman officials say they have procedures in place to prevent mortgage brokers and others in the loan process from bending rules. BNC reviews brokers before putting them on its approved list and rechecks them annually, searching state licenses and lawsuits and making sure they're not on federal officials' watch list for problem brokers.

BNC says it has stopped doing business with more than 900 since 2003, largely because of fraud. It works with an average of about 1,800 brokers a month.

At BNC's headquarters in Irvine, Calif., officials say they've designed their business with an eye to weeding out bad loans. Mortgage underwriters and loan processors -- who make sure loan-application data is accurate -- get extensive training in how to spot fraud. Under BNC's organizational chart, they're set apart from sales, to avoid pressure to let problem loans slip through, BNC officials say.

Lehman notes the Office of Thrift Supervision, BNC's regulator, received just three complaints about the company from April 2006 through March 2007, a tiny fraction of the roughly 60,000 loans it made during that span.

Some complaints have surfaced in court. Borrowers' lawsuits in Pennsylvania, Louisiana, Mississippi and other states have alleged Finance America and BNC took advantage of unsophisticated borrowers or used falsified information to approve loans.

A lawsuit in state court in Saginaw, Mich., by UAW/GM Legal Services Plan, which serves auto workers and retirees, alleges a mortgage broker "confused and pressured" an elderly couple into signing up for a BNC loan that obligated them to pay as much as 17.5% as the interest rate adjusted upward. The suit says BNC was aware of "the seamy details of what happened here" because it prepared the documents, vetted the application and gave the broker "a set of instructions for how to proceed."

George and Evelyn Lee's July 2006 loan was pooled by Lehman with nearly 4,000 other subprime home loans from BNC into a securities deal that produced more than \$800 million in mortgage-backed bonds.

The broker in the case, Real Financial LLC, has been the subject of 25 complaints to Michigan financial regulators and a fraud lawsuit that's pending in federal court in Michigan. State regulators dismissed many of the complaints, but have upheld eight of them and referred others for investigation.

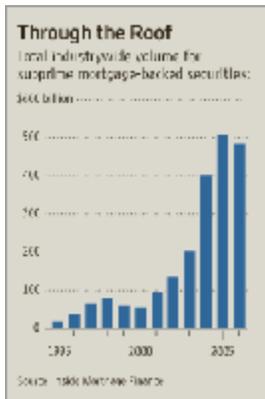
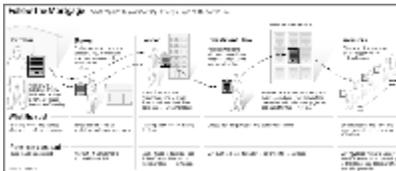
Real Financial's attorney says the allegations stem from an unfavorable economy that's sparked rising foreclosures and unjustified complaints against lenders and brokers.

Lehman says it wasn't aware of complaints about Real Financial until the lawsuit was filed, but has since removed the firm from its broker list. "BNC was not aware of anything wrong with the Lees' loan because all it saw was the loan application which was in good order," Lehman said. "Real Financial was not BNC's agent, and BNC gave it no 'instructions' whatsoever. We strongly believe BNC has been added to this case only as a 'deep pocket.'"

Despite the controversy that's emerged in the subprime business, Lehman officials say they're proud of their role in helping the market grow and offering access to credit for consumers who might not otherwise have the chance.

"We think it's a business we should all be working to improve, not diminish," the firm says.

(See related letters: "Letters to the Editor: America's Misallocation of Income and Assets" -- WSJ July 9, 2007)



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THE WALL STREET JOURNAL.

Debt Bomb: Inside the 'subprime' mortgage debacle --- The Middlemen: Mortgage Mess Shines Light on Brokers' Role --- Job-Hopping Mr. Shaikh Left Trail of Lawsuits, Failed License Exams

By Ruth Simon and James R. Hagerty

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[Third in a series]

In 2005, World Savings Bank honored Secure Financial Inc. with a "Top Broker Award." It was a tribute to the sales prowess of Zak Khan, who arranged more than a hundred mortgages out of the small real-estate firm's Union City, Calif., office.

But Mr. Khan, a onetime professional cricket player, wasn't all he seemed. For starters, his real name is Altaf A. Shaikh. Contrary to California law, he never held a license to broker mortgage loans. Still, he managed to find jobs at a variety of mortgage firms since 1997, leaving a trail of unhappy borrowers and a lengthening list of criminal charges and lawsuits filed against him.

As defaults pummel the home-loan industry, Mr. Shaikh represents an extreme case of one of the big vulnerabilities in the business: mortgage brokers. In recent years, these middlemen have assumed a crucial role in handling surging volumes of business for lenders. Today, mortgage brokers are involved in about 58% of home loans, up from 40% a decade ago, according to Wholesale Access, a research firm in Columbia, Md.

Mortgage brokers originate about half of loans made to borrowers with good credit. Their presence is even greater in other segments of the mortgage market where defaults are rising. Brokers originate about three-quarters of subprime mortgages made to borrowers with scuffed credit, according to Wholesale Access. They also originate 70% of so-called Alt-A mortgages, a gray area that falls between prime and subprime. World Savings, which gave the award to Mr. Shaikh's employer, made prime and Alt-A loans.

Mortgage brokers didn't set the standards for the many aggressive loans that are now going sour. But they provided the low-cost sales force that made it possible for lenders to quickly ramp up production without hiring employees. As business surged, some brokers put borrowers into loans they didn't understand, couldn't afford or were otherwise ill-suited for, one reason defaults have skyrocketed. In the worst cases, brokers have been known to falsify information and resort to other fraudulent means to get mortgage loans approved. Critics say regulators and lenders haven't done nearly enough to insure the quality and integrity of this independent sales force.

"The mortgage brokers are the wild, wild West of mortgage finance," Sen. Charles Schumer, a New York Democrat, says in an interview. "We need to bring a sheriff to town."

Mortgage brokers say it isn't fair to single them out. Joseph Falk, legislative chairman of the National Association of Mortgage Brokers, says regulators, lenders and their Wall Street financiers all contributed to the subprime mess. Borrowers also can be cheated by loan officers at banks, he notes, adding: "There's plenty of blame to go around."

The ranks of mortgage brokers have surged in part because they offer lenders such as banks or thrifts a way to reach more borrowers without the heavy expense of operating large numbers of branches. Brokers find customers, advise them on which types of loans are available and collect fees from lenders for handling the initial processing. Unlike bank employees, brokers don't get medical benefits or need to be laid off when business is slow. Brokers are particularly active in low-income neighborhoods where there are few bank branches and where many residents may assume that a big institution wouldn't want to deal with them.

When brokers cross the line into blatantly unethical or even criminal behavior, there's often little to stop them. Surveys by the Conference of State Bank Supervisors show that 32 states don't require people to pass a test before obtaining a mortgage-broker license, and nine states don't require criminal background checks on license applicants. Brokers who run afoul of authorities in one state often can set up shop in another.

Mr. Shaikh, 46 years old, was able to skip from one employer to another for years with little scrutiny -- until California prosecutors finally caught up with him. In May, Mr. Shaikh pleaded no contest to charges of grand theft in a plea agreement reached with nine California counties. Prosecutors alleged that he lied to borrowers about the terms of their loans, forged documents and had checks written to companies he controlled without the borrowers' knowledge. A court hearing, set for August, will determine the amount of restitution Mr. Shaikh must pay and whether he will be required to serve a one-year jail term, as the prosecutors have requested.

"The tragedy of this thing is that many of these people had better credit than the product that was offered to them," says William Denny, a deputy district attorney in Alameda County, Calif., who coordinated the multicounty settlement of the criminal case.

A spokesman for Wachovia Corp., which bought World Savings last year, says the company "acted appropriately at all times in this situation." The spokesman adds that Mr. Shaikh "was not an employee or an agent" of the company, which wasn't a defendant in the criminal proceeding. "We feel that World Savings is a victim of fraud in this matter as well," the spokesman says.

Jeff Widman, the lawyer representing Mr. Shaikh in a lawsuit brought by borrowers, says his client has "generally denied the allegations." Most of the borrowers "consented happily to the terms of these loans and their fees," he adds.

In an interview earlier this year, Mr. Shaikh, a stocky, genial man with gray hair, declined to discuss his legal problems. He said he immigrated to the U.S. from Pakistan in 1989. He settled in Fremont, home to some of his wife's relatives. At first, he worked at a Taco Bell restaurant and sold leather jackets, imported from Pakistan, at a flea market. Court records show that he and his wife filed for Chapter 7 bankruptcy protection in 1994, citing assets of \$17,000 and liabilities of \$416,000. That year, Mr. Shaikh earned \$3,000 a month as a salesman at a Mitsubishi dealership, according to bankruptcy filings.

In 1997, a friend who worked at Ameriquest Mortgage Co. persuaded Mr. Shaikh to join the company, then a small but fast-growing subprime mortgage lender.

He was getting in on the early stages of a gold rush. Spurred by the housing boom of the first half of this decade, the number of mortgage brokerage firms nationwide has soared to more than 50,000 from 23,000 in 1995, according to Wholesale Access. At the height of the boom in 2003 and 2004, the most successful loan officers at those firms could earn as much as \$400,000 a year, says Tom LaMalfa, managing director of Wholesale Access.

Court records show Mr. Shaikh was an assistant manager and, in October 1998, was promoted to manager of Ameriquest's Campbell, Calif., office. In that job, he didn't need a license.

In 2000, Mr. Shaikh and Ameriquest were sued by a borrower whose home was foreclosed on the previous year because a refinancing wasn't completed by a promised deadline. Mr. Shaikh failed to tell the holder of a second mortgage, who was foreclosing on the loan, to postpone the foreclosure sale, according to the lawsuit, filed in Alameda County Superior Court. The case was settled in 2002, according to Joseph Kafka, the borrowers' attorney.

Mr. Shaikh left Ameriquest in May 1999 for the San Jose branch of Atlantic Financial Mortgage Inc., a local firm. Later that year, Ameriquest sued him in Santa Clara County Superior Court for allegedly trying to steal Ameriquest customers and employees. In 2002, a Superior Court judge ruled in favor of Ameriquest.

"Mr. Shaikh's employment was terminated, and we're not able to comment on the reasons behind it," says an Ameriquest spokesman.

At Atlantic, Mr. Shaikh's customers included Nathaniel Winn and Arnetta Petty Winn, an elderly couple in Oakland. In a telephone call in May 1999, Mr. Shaikh told the Winns his company specialized in making low-interest home loans to senior citizens on fixed incomes, according to a lawsuit the couple filed in 2002 in Alameda County Superior Court. At a meeting at their home days later, Mr. Shaikh said he could refinance the Winns into a new mortgage with a "senior discount" that would lower their monthly payments and allow them to pay off \$4,200 in debts. He also offered to hire Nathaniel to do some landscaping, Ms. Winn says in an interview.

But the couple's monthly payments rose with the new mortgage, and their loan balance climbed by about \$15,000 to \$100,000. The Winns received just \$1,600 in cash from the refinancing, according to loan documents, while Atlantic got more than \$5,700. The couple also paid a \$3,500 prepayment penalty.

In February 2004, a Superior Court judge issued a default judgment and ordered Atlantic and Mr. Shaikh to pay the couple \$340,000. Mrs. Winn says she is still hoping to collect. Edwin Mendaros, Atlantic's owner, didn't respond to repeated calls requesting comment.

Mr. Shaikh was next hired as an assistant to a loan officer at Home Advantage Corp., a Fremont mortgage broker located in a stucco building adjacent to a shopping center. Within six months, the company received a call from a wholesale lender complaining about a "discrepancy" in a mortgage application Mr. Shaikh had worked on, says the firm's president, Rana Ahmed. "We actually had to fire him," Mr. Ahmed says.

Mr. Ahmed says he doesn't always check references because, in the mortgage business, "references are not reliable." And he says he never heard from prospective employers seeking to check Mr. Shaikh's references.

In January 2001, Mr. Shaikh signed on with Hampton Financial, a local San Jose real-estate and mortgage firm. In nearby Union City, he opened an office called As West Coast Marketing, scouting for potential borrowers and helping them fill out mortgage applications that were then processed by Hampton.

In December 2001, Mr. Shaikh arranged for Mohammad and Karima Ebrahimi to get a \$198,000 mortgage from World Savings to buy a home in Fremont. The good-faith estimate, a calculation of the fees borrowers can expect to pay at closing that is required by regulators, provided that the Ebrahimis would pay the broker \$1,980. But when the loan closed, it included additional commissions of \$8,570, according to a lawsuit by the couple and two other borrowers that was before Santa Clara County Superior Court.

Patricia DeLuca, Hampton's owner, terminated her relationship with Mr. Shaikh in early 2002 because of complaints and questions from borrowers and according to her attorney, John Crowley. Ms. DeLuca settled the lawsuit brought by the Ebrahimis and the other borrowers for \$25,000 and filed a cross-complaint alleging that Mr. Shaikh and others conspired to engage in "wrongful and fraudulent conduct," according to court records. In testimony related to her cross-complaint, Ms. DeLuca said World Savings briefly cut its ties to her because of problems with loans originated by Mr. Shaikh. The Ebrahimi lawsuit names Mr. Shaikh, Ms. DeLuca and "Does 1 through 10."

In testimony related to Ms. DeLuca's cross-complaint, Mr. Shaikh said he failed the licensing exam "three or four times," beginning first in 2000 or 2001.

In a decision filed in April of this year, Superior Court Judge Mary Jo Levinger found "no evidence" that Ms. DeLuca knew that commissions had been altered so the payments would be higher. The judge ordered Mr. Shaikh to pay \$75,000 in damages and attorney's fees. Mr. Shaikh is appealing the decision.

Mr. Shaikh moved to Golden Gate Mortgage, a local mortgage broker in Hayward, Calif., in early 2003. There he introduced himself to customers as Zak Khan. Dean E. Johnson, a lawyer for Mr. Shaikh, says he used the name "because he found that many of his American friends and customers found Altaf Shaikh hard to pronounce and spell."

In 2004, he arranged for JoAnn Curran, a retired manager, to refinance the mortgage on her home in Alamo, Calif.

Ms. Curran says that at a meeting with Mr. Shaikh at a Starbucks coffee shop, he told her he owned his own mortgage company and could get her a new mortgage with a low interest rate that would allow her to pull out cash to pay some of her son's medical bills. "It was too good of a deal to pass up," she says. Still, she found it odd that Mr. Shaikh notarized her loan documents on the hood of a car.

While Mr. Shaikh was working at Golden Gate, he and his wife bought a \$2 million two-story beige stucco house with a swimming pool on a cul-de-sac in Fremont, according to public-records data compiled by RealQuest.com. The following year, the couple bought a three-bedroom home in Las Vegas for \$328,000.

Mr. Shaikh says he left Golden Gate in September 2004 because the owner, Nadeem Shahzada, hadn't lived up to his promises on compensation and because he had an offer from Secure Financial. Michael Lauer, an attorney representing Mr. Shahzada, says, "It was a mutually desirable parting."

Mr. Lauer says Mr. Shaikh didn't need a license for the duties he was supposed to perform at Golden Gate, but declines to specify what those duties were. Mr. Shahzada "didn't know he [Mr. Shaikh] was doing the things he was alleged to have done," Mr. Lauer says.

In response to complaints from several borrowers, the California Department of Real Estate issued an order in January 2005 that told Mr. Shaikh, also known as "Zack Khan," to "desist and refrain" from making mortgages without a license.

Tom Pool, an assistant real-estate commissioner, says the department doesn't send notices of such orders to lenders because "there are thousands and thousands of lenders out there. I don't think it's practical." He notes that anyone can check whether a broker is licensed or has been disciplined on the department's Web site.

Mr. Pool calls Mr. Shaikh's continued presence in the mortgage industry "kind of perplexing. I'm not sure those who allowed him to work are doing their due diligence."

Atiya Khan says she was working as a property manager when a family friend introduced her to Mr. Shaikh, and he persuaded her to set up Secure Financial. "He is a famous personality back home with a good decent family," she says. "We went to his house. He introduced his family" she adds. "All these things to make you trust him."

Mr. Shaikh then persuaded Ms. Khan, a property manager at the time, to obtain a license that would let her broker loans, says Thomas Swihart, her attorney. The two leased an office, but Ms. Khan, who lived in another part of California, says her understanding at the time was that he hadn't yet gone into business. But in fact, using Ms. Khan's broker's license and picking up the pseudonym Zak Khan he had used previously, he started churning out mortgage sales, says Ms. Khan's lawyer. "He took her license and ran with it and defrauded a lot of people," Mr. Swihart says.

In May 2005, Pedro Franco, a landscaper, showed up in lawyer Pamela Simmons's office after receiving a closing statement for a mortgage loan with a check stapled to it. Mr. Franco thought that was odd because, while he had talked to Mr. Shaikh, he didn't recall ever signing the final loan documents. Mr. Franco also discovered that some numbers on his closing statement had been whited out: A \$15,650 payment to Secure Financial appeared as \$650. Mr. Franco had also received a \$29,787 check as part of the deal, not the \$40,000 he says he had discussed with Mr. Shaikh.

The next day, Ms. Simmons received a visit from Rosendo Zamudio, whose loan from Mr. Shaikh and World Savings included a \$7,655 payment to Bay Area Marketing, a company owned by Mr. Shaikh, that didn't appear on his closing statement. This meant the numbers on Mr. Zamudio's loan documents didn't add up properly. As Ms. Simmons began making inquiries, Mr. Shaikh called Mr. Zamudio and offered to come to the borrower's home to work out the misunderstanding.

"I called the local police because I didn't want my client meeting with him," Ms. Simmons recalls. Mr. Shaikh was arrested in May 2005 and charged by the Santa Cruz County District Attorney with criminal fraud and grand theft.

Prosecutors say Mr. Shaikh didn't disclose to borrowers payments to Bay Area Marketing or that he was earning an extra 2% of the loan amount from World Savings for putting borrowers into more costly mortgages that also contained prepayment penalties. They further allege that he failed to tell borrowers that their loans carried prepayment penalties and that those who made the minimum payment would see their loan balances rise. And they say he forged notarization seals on borrowers' closing statements, though his notary license expired in 2001. Prosecutors say they are continuing to investigate whether other individuals in the real-estate industry aided the fraud crimes.

Other aggrieved borrowers found their way to Ms. Simmons, who specializes in consumer real-estate law. In March 2006, Ms. Simmons filed a lawsuit in Alameda County Superior Court on behalf of borrowers who had contacted her about their dealings with Mr. Shaikh.

Ms. Simmons says she called World Savings to inform it of Mr. Shaikh's first arrest just after the event. Instead of freezing all pending transactions involving Mr. Shaikh, the civil lawsuit alleges, World Savings "continued to fund at least 20 loans" presented to it by Mr. Khan and Secure Financial.

Borrowers who called World Savings to check out Zak Khan were reassured that they could rely on him, the lawsuit further alleges, and World Savings "ignored numerous, and often vociferous, complaints" from borrowers.

A spokesman for Wachovia, World Savings' new parent, says World Savings "checked the license of Secure Financial," rather than that of Mr. Shaikh, because the company "is the broker listed on the loans." He adds the

company terminated its relationship with Secure Financial on May 9, 2005, and contacted customers who "had loans in process to confirm that they were, in fact, seeking a loan and had received or expected to receive our disclosures." Wachovia says it has since agreed to the rescission of dozens of loans originated by Mr. Shaikh.

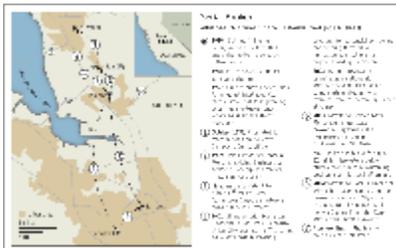
The Wachovia spokesman adds that the "Top Broker" award was "not a company-sanctioned award. It was a local market certificate given by a World Savings salesperson" to roughly eight brokers. Secure Financial originated about 125 loans for World Savings in a one-year period, the spokesman says.

Ms. Khan, a defendant in the civil lawsuit, has filed a cross-complaint against Mr. Shaikh, alleging that she was tricked into forming Secure Financial and that Mr. Shaikh forged her signature on "numerous loan documents" without her knowledge or consent. Ms. Khan says she has never made a mortgage loan and never had any contact with World Savings. "I was out of the picture," she says.

Around the country, efforts are now under way to improve quality control of mortgage brokers. Lenders are beefing up their scrutiny of mortgage brokers and other third parties. The Conference of State Bank Supervisors is setting up a national database that would allow consumers and regulators to check whether brokers are licensed or have been subject to regulatory enforcement actions. Sen. Schumer of New York in early May introduced legislation that would establish a fiduciary duty for brokers and others who arrange home mortgage loans to look after their customers' interests.

Mr. Shaikh is now working in the Fremont area as a car salesman, according to Mr. Johnson, his attorney.

Zahid Hussain in Islamabad contributed to this article.



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THE WALL STREET JOURNAL.

Debt Bomb: Inside the 'subprime' mortgage debacle --- Seeds of Excess: How Credit Got So Easy And Why It's Tightening --- Responses to S&L Mess, Asian Crisis, Tech Bust All Fed Into the Boom

By Greg Ip and Jon E. Hilsenrath

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[Fourth in a Series]

An extraordinary credit boom that created many first-time homeowners and financed a wave of corporate takeovers seems to be waning. Home buyers with poor credit are having trouble borrowing. Institutional investors from Milwaukee to Dusseldorf to Sydney are reporting losses. Banks are stuck with corporate debt that investors won't buy. Stocks are on a roller coaster, with financial powerhouses like Bear Stearns Cos. and Blackstone Group coming under intense pressure.

The origins of the boom and this unfolding reversal predate last year's mistakes. They trace to changes in the banking system provoked by the collapse of the savings-and-loan industry in the 1980s, the reaction of governments to the Asian financial crisis of the late 1990s, and the Federal Reserve's response to the 2000-01 bursting of the tech-stock bubble.

When the Fed cut interest rates to the lowest level in a generation to avoid a severe downturn, then-Chairman Alan Greenspan anticipated that making short-term credit so cheap would have unintended consequences. "I don't know what it is, but we're doing some damage because this is not the way credit markets should operate," he and a colleague recall him saying at the time.

Now the consequences of moves the Fed and others made are becoming clearer.

Low interest rates engineered by central banks and reinforced by a tidal wave of overseas savings fueled home prices and leveraged buyouts. Pension funds and endowments, unhappy with skimpy returns, shoved cash at hedge funds and private-equity firms, which borrowed heavily to make big bets. The investments of choice were opaque financial instruments that shifted default risk from lenders to global investors. The question now: When the dust settles, will the world be better off?

"These adverse periods are very painful, but they're inevitable if we choose to maintain a system in which people are free to take risks, a necessary condition for maximum sustainable economic growth," Mr. Greenspan says today. The evolving financial architecture is distributing risks away from highly leveraged banks toward investors better able to handle them, keeping the banks and economy more stable than in the past, he says. Economic growth, particularly outside the U.S., is strong, and even in the U.S., unemployment remains low. The financial system has absorbed the latest shock.

So far. But credit problems once seen as isolated to a few subprime-mortgage lenders are beginning to propagate across markets and borders in unpredicted ways and degrees. A system designed to distribute and absorb risk might, instead, have bred it, by making it so easy for investors to buy complex securities they didn't fully understand. And the interconnectedness of markets could mean that a sudden change in sentiment by investors in all sorts of markets could destabilize the financial system and hurt economic growth.

When a technology stock and investment plunge and the Sept. 11 terrorist attacks pushed the economy into recession in 2001, the Fed slashed interest rates. But even by mid-2003, job creation and business investment were still anemic, and the inflation rate was slipping toward 1%. The Fed began to study Japan's unhappy bout

with deflation -- generally declining prices -- which made it harder to repay debts and left the central bank seemingly powerless to stimulate growth.

"Even though we perceive the risks [of deflation] as minor, the potential consequences are very substantial and could be quite negative," Mr. Greenspan said in May 2003. A month later, the Fed cut the target for its key federal-funds interest rate, a benchmark for all short-term rates, to 1%. It said the rate would stay there as long as necessary, figuring low rates would bolster housing and consumer spending until business investment and exports recovered. The rate stayed at 1% for a year.

Mr. Greenspan raised vague fears with colleagues over the possibility this policy could create distortions in the economy, but he says today that such risks were an acceptable price for insuring against deflation. "Central banks cannot avoid taking risks. Such trade-offs are an integral part of policy. We were always confronted with choices."

Fed officials who were there at the time generally maintain their policy was right, even in hindsight. The economy has grown steadily, avoiding both deflation and serious inflation. Yet some say they may have planted seeds of excess in the housing and subprime-loan markets.

Robert Eisenbeis, retired research director at the Federal Reserve Bank of Atlanta, says the Fed overreacted to the threat of deflation and kept rates low for too long. As a result, it "overstimulated the housing market, and now we're dealing with the consequences."

Edward Gramlich, a Fed governor in Washington from 1997 to 2005, says he failed to realize at the time that low rates were making it so easy for lenders to market subprime mortgages with low introductory rates. The Fed and other regulators could have prevented some of the resulting pain with more rigorous supervision of mortgage lenders besides banks, he says. "We didn't have that, and we're paying for it now."

In June 2004, the Fed began to raise the short-term target rate, eventually taking it to 5.25%, where it has been for the past year. Such a boost usually leads to a rise, as well, in long-term rates, which are important to rates on 30-year conventional mortgages and corporate bonds. This time, it didn't. Mr. Greenspan expressed concern that investors were willing to accept low returns for taking on risk. "What they perceive as newly abundant liquidity can readily disappear," he said in August 2005, six months before retiring. "History has not dealt kindly with the aftermath of protracted periods of low risk premiums."

Looking back, he says today: "We tried in 2004 to move long-term rates higher in order to get mortgage interest rates up and take some of the fizz out of the housing market. But we failed."

Something besides Fed policy was at work. Both Mr. Greenspan and his successor, Ben Bernanke, point to an unanticipated surge in capital pouring into the U.S. from overseas.

In June 1998, U.S. Treasury officials made a plea to China that they would be reminded of repeatedly in the following years. Thailand had devalued its currency in 1997, touching off a crisis in the region that led other countries to devalue and in some cases default on foreign debt. The yen was sliding. Chinese officials, who pegged their currency to the U.S. dollar, "let it be known . . . that if things kept going this way they'd have no choice but to devalue," recalls Ted Truman, a Treasury official at the time. The U.S., fearing such a move would trigger another round of devaluations, urged the Chinese to hold their peg, and praised them when they did so.

But times changed. As recessions and depressed currencies held down imports and goosed exports in other Asian countries, the countries ran trade surpluses that replenished foreign-exchange reserves. Determined never to be so tied to the onerous conditions of the International Monetary Fund, they have kept those policies in place. Thai reserves, effectively exhausted in 1997, now stand at \$73 billion.

Long after the crisis passed, China's economic fundamentals suggested its currency should rise against the dollar. China let it rise only slowly, continuing to juice exports and produce trade surpluses that pushed China's foreign-exchange reserves above \$1 trillion. When the U.S. pressed China to let its currency float, China reminded the U.S. of the fixed exchange rate's stabilizing role in 1998. China put much of its cash -- part of what Mr. Bernanke has called a "global saving glut" -- into U.S. Treasuries, helping hold down long-term U.S. interest rates. Chinese government entities also recently poured \$3 billion into U.S. private-equity firm Blackstone.

Lou Barnes, co-owner of a small Colorado mortgage bank called Boulder West Inc., has been in the mortgage business since the late 1970s. For most of that time, a borrower had to fully document his income. Lenders offered the first no-documentation loans in the mid-1990s, but for no more than 70% of the value of the house

being purchased. A few years back, he says, that began to change as Wall Street investment banks and wholesalers demanded ever more mortgages from even the least creditworthy -- or "subprime" -- customers.

"All of us felt the suction from Wall Street. One day you would get an email saying, 'We will buy no-doc loans at 95% loan-to-value,' and an old-timer like me had never seen one," says Mr. Barnes. "It wasn't long before the no-doc emails said 100%."

Until the late 1990s, the subprime market was dominated by home-equity lines used by borrowers to consolidate debt and by loans on mobile homes. But when the Fed held rates down after 2001, lenders could offer borrowers with sketchy credit histories adjustable-rate mortgages with introductory rates that seemed affordable. Mr. Barnes says customers were asking about "2/28" subprime loans. These offered a low starter rate for two years, then adjusted for the remaining 28 to a rate that was often three percentage points higher than a prime customer normally paid. Customers, he says, seldom appreciated how high that rate could be once the Fed returned rates to normal levels.

Demand from consumers, on one side, and Wall Street and its customers on the other side prompted lenders to make more and more subprime loans. Originations rose to \$600 billion or more in both 2005 and 2006 from \$160 billion in 2001, according to Inside Mortgage Finance, an industry publication.

At first, delinquencies were surprisingly low. As a result, the credit ratings for bonds backed by the mortgages assumed a modest default rate. Standards for getting a mortgage fell. About 45% of all subprime loans in 2006 went to borrowers who didn't fully document their income, making it easier for them to overstate their creditworthiness.

The delinquency rate was a mirage: It was low mainly because home prices were rising so much that borrowers who fell behind could easily refinance. When home prices stopped rising in 2006, and fell in some regions, that game ended. Borrowers with subprime loans made in 2006 fell behind on monthly payments much more quickly than mortgages made a year or two earlier.

When banks get in trouble, federal deposit insurance encourages depositors not to flee, and in extremis, banks can borrow directly from the Fed. But banks are no longer the dominant lenders. After the S&L crisis in the 1980s and early 1990s, regulators insisted banks and thrifts hold more capital against risky loans. This tipped the playing field in favor of unregulated lenders. They financed themselves not by deposits but by Wall Street credit lines and by "securitization" of their loans -- in effect, the sale of the loans to investors.

The consequences proved painful. New Century Financial Corp., founded in 1995 by three former S&L executives, was the nation's second largest subprime lender by 2006. When its borrowers began falling behind, Wall Street cut off its lines of credit and forced it to buy back some of its poorly performing loans. New Century couldn't fall back on deposit insurance or the Fed. It filed for bankruptcy protection in April, wiping out shareholders and triggering market-wide fears about the health of the subprime business.

Home buyers were not alone. In August 2002, Qwest Communications International Inc. -- heavily indebted, beaten down by the telecom bust and under investigation by the Securities and Exchange Commission -- decided to sell its Yellow Pages business. Private-equity firms Carlyle Group and Welsh, Carson, Anderson & Stowe agreed to buy it for \$7 billion, about \$5.5 billion of it borrowed. The business produced steady cash flow that could be used to pay down the debt.

The buyers were worried they might not be able to borrow as much as they needed. "We were coming out of a pretty bad credit cycle," says Daniel Toscano, managing director at Deutsche Bank, which helped to manage the fund-raising. Instead, they tapped into a gusher. Within a year, Dex Media Inc., as the business became known, was back in the market. It borrowed \$889 million to pay a dividend to Carlyle and Welsh Carson, and then \$250 million more to pay another dividend. In just 15 months, the private-equity buyers made back most of their investment and still owned the company.

By 2006, the volume of such leveraged buyouts was smashing records from the 1980s. Generous credit markets enabled private-equity firms to do larger deals and pay themselves bigger dividends. They boosted returns -- and attracted more investors, which enabled even bigger deals.

As in subprime mortgages, lenders began to ease borrowing requirements. They agreed, for instance, to "covenant-lite debt," which dropped once-standard performance requirements, and "PIK-toggle" notes, which allowed borrowers to toggle interest payments on and off like a faucet.

Bankers began marketing debt deals for companies that, unlike Yellow Pages, didn't have comfortable cash flow. There was Chrysler, burning cash rather than producing it. And there was First Data Corp., whose post-takeover cash flow would barely cover interest payments and capital spending, according to Standard & Poor's LCD, a unit of S&P which tracks the high-yield market.

Last month, investors began to balk. Now many banks find themselves having committed to lend about \$200 billion that they had intended to turn over to investors, but can't.

The subprime and LBO booms required willing lenders. The stock-market collapse and low interest rates of 2001 to 2004 nurtured a class of investors and products to fill that role. Managers of pension and endowment funds long had divided their assets among domestic stocks, bonds and cash. The funds saw their performance suffer when the stock market and then bond yields tumbled.

A few endowments, most notably at Yale and Harvard, had for years been spreading their investments more broadly, going into hedge funds, real estate, foreign stocks, even timberland. The goal was holdings that wouldn't suffer in sync with stocks in a bear market. Sure enough, in 2000 and 2001, even as stocks tumbled, Harvard Management Co. earned returns of 32.2% and -2.7% respectively. Yale's returns were 41% and 9.2%.

Other institutions wanted their money managed the same way, seeding a flood of hedge funds that bought other untraditional investments such as credit derivatives. University endowments poured roughly \$40 billion into hedge funds between 2000 and 2006, according to Hedge Fund Intelligence, a newsletter. "I call it the 'Let's all look like Yale effect,'" says Jeremy Grantham, chairman of Boston money manager GMO LLC.

Low interest rates made many investors willing to buy exotic securities in an effort to boost returns. Wall Street had just the vehicle: securitization, or turning loans that once sat quietly on banks' books into securities that can be sold in global markets.

Securitization, long common in conventional mortgages, had been supercharged in the early 1990s when the federal Resolution Trust Corp. took over S&Ls that held more than \$400 billion of assets. Though some thought it would take the RTC a century to unload them, it took only a few years. The agency successfully securitized new classes of assets, such as delinquent home loans or commercial loans.

In the late 1990s, Wall Street went a step further, packaging bigger pools of securities into collateralized debt obligations, or CDOs, and carving them into "tranches," each with a different level of risk and return. Riskier tranches suffered the first losses if some underlying loans defaulted. Other tranches offered lower returns because riskier tranches would take the first hits if the business went sour.

Because of the way they were structured, some CDO tranches got triple-A ratings from Moody's Investors Service and Standard & Poor's even though they contained subprime loans. That lured traditionally conservative investors such as commercial banks, insurance companies and pension funds.

The upside was evident: Many borrowers got loans they wouldn't otherwise have had. The taxpayer-backed deposit fund was less likely to bear the cost of sloppy lending practices. Banks shifted risks to investors more willing to bear them -- leaving the banks able to make more loans. Investors could pick either more-risky or less-risky slices. And Wall Street middlemen made handsome profits.

Now the downside, too, is painfully evident. Final investors were so many steps removed from the original loans that it became hard for them to know the true value and risk of securities they bought. Some were satisfied with a triple-A rating on a CDO -- seemingly as safe as a U.S. Treasury bond but with more yield. Yet as defaults ate through the cushion of lower-rated tranches with unexpected speed, rating agencies were forced to rethink their models -- and lower the ratings on many of these investments.

Some structures were so opaque that markets couldn't value them. But ratings cuts sometimes forced an acknowledgment that securities owned weren't worth as much as thought. In May, Swiss bank UBS AG shut down a hedge fund after a \$124 million loss. In June, two Bear Stearns hedge funds saw as much as \$1.6 billion of investor capital wiped out by bad mortgage bets and pulled credit lines. The trouble spread to hedge funds in Sydney, Australia, a mortgage insurer in Milwaukee and a bank in Dusseldorf, Germany.

Even Harvard has been hit. The university lost about \$350 million through an investment in Sowood Capital Management, a hedge-fund firm founded by one of the university's former in-house money managers.

Recent events show that financial innovations meant to distribute risk can end up multiplying it instead, in ways neither regulators nor investors fully understand. Mr. Grantham, the Boston money manager, says his portfolios are behaving in ways he hadn't expected.

Fed officials believe that even if their policies led to housing and debt bubbles, the strength of the overall economy shows that the policy was, on balance, the right one. Of course, that assumes the current problems don't culminate in a recession.

Market veterans predict the most egregious underwriting practices and products will disappear, but the benefits of innovation will continue.

Lessons have been learned -- the hard way. "The structures are here to stay," says Glenn Reynolds, chief executive of research firm CreditSights. "But you have to run it like a prudent risk-taking venture, not like it's casino night and you're on a bender."

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