

Wall Street and the Making of the Subprime Disaster

**How Investment Banks Fueled the Subprime Boom, Made Billions,
and Caused the Current Foreclosure Crisis**

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INTRODUCTION

Follow the subprime mortgage money to Wall Street.

The subprime foreclosure crisis is deepening. Tens of thousands of Americans are losing their homes this holiday season, and millions more, after years of making mortgage payments, are seeing their rates adjust to unaffordable levels. According to Congressional estimates, 2 million American homeowners with subprime mortgages will soon lose their homes if nothing is done to remedy the situation.¹ As the country begins to reckon with the costs of the subprime boom, it is urgent that the parties responsible for causing this crisis be held accountable.

To discover who wielded power in the subprime mortgage market – and who is primarily responsible for the current crisis – it is necessary to “follow the money.” And as this report shows, the subprime money trail leads straight to the doors of Wall Street’s largest investment banks: Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers, Bear Stearns, and others.ⁱ

The report shows that the investment banks were the key sources of funding for subprime mortgage lenders at the height of the boom – without this support, the lenders collapsed. The investment banks, in their powerful role as subprime funders, encouraged lenders to produce massive quantities of the mortgages, regardless of quality or legality. The motive? In the past six years, the hottest products on Wall Street were a collection of complex, lucrative financial products that relied heavily on high-yielding subprime mortgages. The investment banks were reaping billions in revenues for churning out these subprime-related bonds, and bankers who worked with them were taking home some of the biggest bonuses on Wall Street.

The following is a brief summary of each section of the report:

- **Part I: Investment banks’ subprime motive: billions in revenues and bonuses.** Subprime-related bonds were the hottest products in the US financial markets from 2001 to 2006, and bankers who worked in these fields took home some of the largest bonuses on Wall Street.
- **Part II: Investment banks provided subprime lenders with essential funding.** Investment banks forged agreements with subprime lenders to buy mortgages and supplied them with lines of credit that were tapped on a daily basis.
- **Part III: Pressure from Wall Street caused spike in predatory lending.** The investment banks pushed lenders to produce more loans with high rates and prepayment penalties, both of which signal predatory lending practices.
- **Part IV: Investment banks pumped up demand for risk-laden subprime bonds.** Since investment banks “make markets” for these subprime mortgage-backed bonds, they were able to set inflated prices for the bonds and encourage investors to purchase the bonds, including financial products that were largely untested.
- **Part V: As bonus season approaches, investment banks are scrambling to hide losses.** There have been large subprime-related writedowns at some banks, but analysts project that billions more are coming.
- **Part VI: The big five investment banks are projected to pay out \$38 billion in bonuses this year – even more than last year.** Because revenues were strong through the first half of the year, the investment banks are still preparing to pay out record bonuses.

Though there were many foot soldiers in this war on American homeownership, investment banks held the high command, and they profited heavily. The following report will illuminate this leading role.

ⁱ Also Citigroup, Deutsche Bank, RBS Greenwich, Credit Suisse First Boston, JP Morgan, Wachovia, Barclay’s, UBS, Banc of America, HSBC. Some of these are banking conglomerates with investment banking operations. Investment banks, unlike commercial banks, issue securities on behalf of governments and corporations.

I. INVESTMENT BANKS' SUBPRIME MOTIVE: BILLIONS IN REVENUES & BONUSES

By creating, selling, and trading subprime mortgage-related bonds, investment banks generated enormous revenues and drove bonus payouts to record levels.

*"These are the trades that make people famous."*²

– Christopher Ricciardi, formerly a managing director at Merrill Lynch, on CDOs (collateralized debt obligations), which relied heavily on subprime mortgage-backed securities. He said this in 2007, prior to the meltdown.

As US bond markets picked up in the wake of the dot-com collapse, new fixed income (bond) products replaced tech stocks as the profitable darlings of the highest-paid bankers on Wall Street. These relatively new innovations in structured finance relied heavily on securitized subprime mortgages. Bankers who worked with them consistently received some of the biggest bonuses on Wall Street, as the revenues produced in their divisions lifted net revenues to new records. Long before these subprime-related bonds started causing problems, they were generating record paydays for the biggest banks – 2006 was a banner year for Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns: \$130 billion in net revenue and \$60 billion in compensation, \$36 billion of which came in the form of bonuses (all new records).³

A. SUBPRIME-RELATED BONDS: WALL STREET'S "HOT PRODUCTS" AFTER THE DOT COM BUST

Structured financial products such as collateralized debt obligations (CDOs – see "CDOs Up Close") replaced tech stocks as the hottest products on Wall Street in the wake of the dot com collapse.⁴ These CDOs and other complex instruments relied heavily on high-yielding subprime mortgage-backed securities.

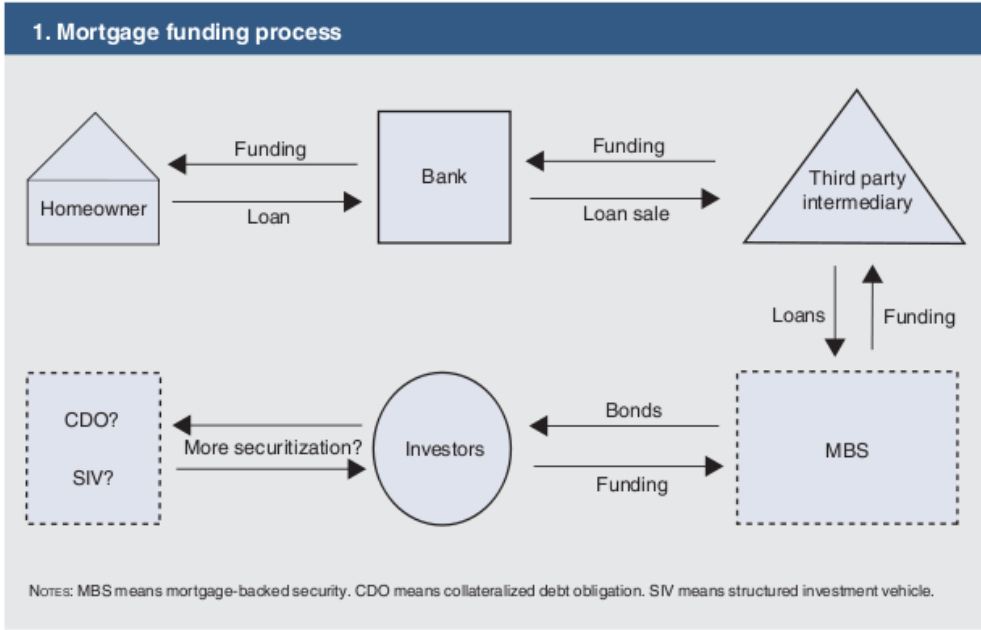
An *Investor's Business Daily* article from early 2006 tells the story of just how integral these financial instruments were to the investment banks' profits in the years following the tech boom:

- ***Investor's Business Daily:*** "Investment banks make money in much the same way they always have: advising on mergers, arranging bond and stock issues and selling them to investors, and trading for their own account. What changes with every cycle are the hot products – and who's positioned to win the most deals. In the late 1990s, firms touted the number of technology initial public offerings they led. Then the nearly three-year bear market dried up IPO issuance. Deals have picked up since, but they're still far from 2000 levels. **In their place, offerings of bonds and complicated financial instruments like derivatives have increased. The hot housing market helped.** During another year of higher sales, prices and mortgage originations, Wall Street was busy arranging pools of mortgage and home-equity loans."⁵ [emphasis added]

The investment banks' recent multi-billion dollar writedowns in CDOs signal the extent to which these financial instruments relied on subprime mortgages. This is confirmed by other sources, including "The Subprime Lending Crisis," a recent report by the Joint Economic Committee of Congress, which noted that **"subprime mortgages have, until recently, been considered terrific assets to include in CDO structures."**⁶

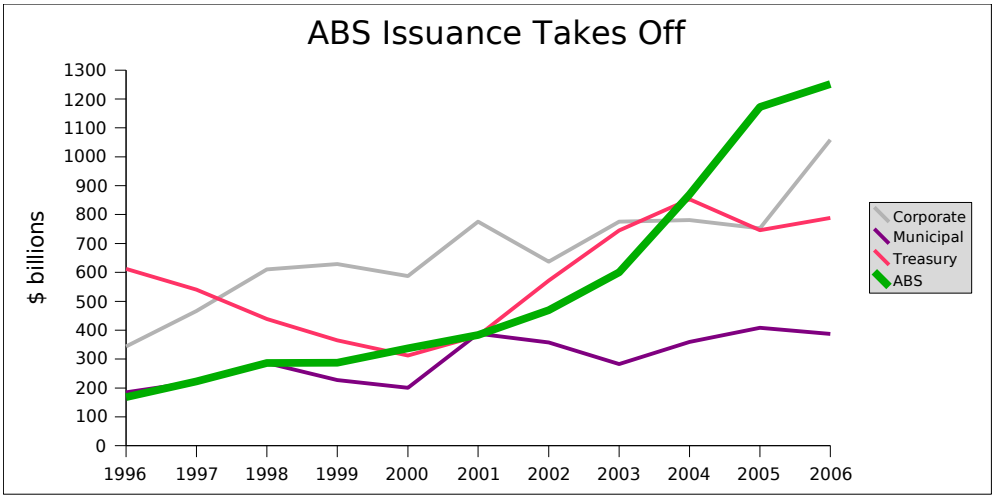
What are mortgage-backed securities (MBS)?

Mortgage-backed securities are bonds backed by regular payments from pools of mortgages. Borrower payments of principal and interest are passed through to investors who purchase these securities. The securities can either be issued by a government related entity (Ginnie Mae, Fannie Mae, or Freddie Mac) or a private entity. If a mortgage is securitized by one of these government related entities, it has to conform to certain standards, and is called a *conforming* loan; subprime loans are *non-conforming*. Around two-thirds of outstanding mortgage debt in the US has been securitized. For more on the securitization process, see the box "How a Mortgage Gets Securitized." For definitions of *asset-backed securities*, *structured finance*, and *securitization*, see the list of key terms at the end of the report.



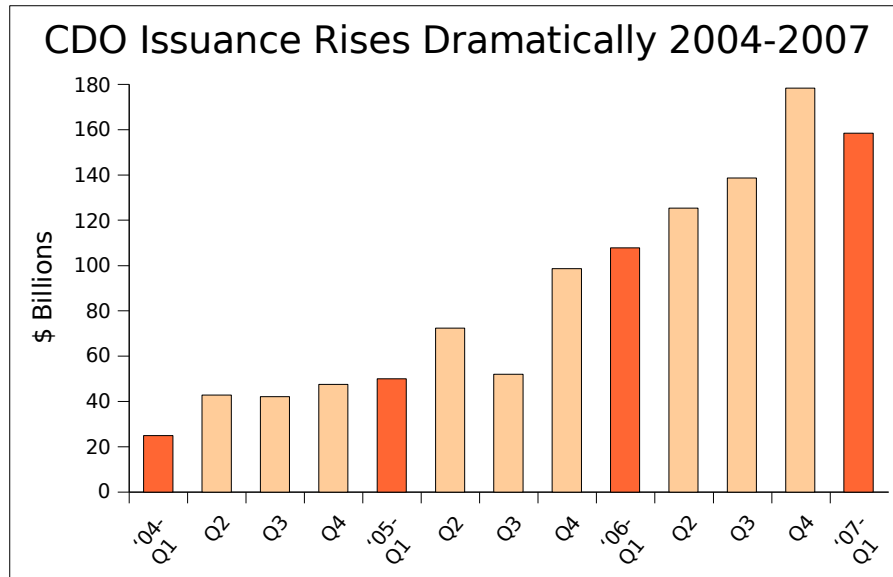
Source: Federal Reserve Bank of Chicago.⁷

The path from subprime loan to CDO. This depiction of the securitization process was recently published by the Chicago Fed for educational purposes. The “third party intermediary” that this chart refers to is an investment bank, which buys the loans from the “bank” (referred to as the “subprime lender” in this report) and structures the mortgage-backed securities offering. The second securitization, in which the mortgage-backed securities are re-packaged into CDOs and other structures, is also underwritten by an investment bank. The “SIV” will be discussed in section IV.



Source: Securities Industry and Financial Markets Association.⁸

ABS (subprime, CDOs, etc.) growth outpaced growth in every other type of bond 1996-2006. Asset-backed securities (ABS) is the bond category which includes subprime MBS and structured financial products such as CDOs, and its rapid growth was driven by subprime market growth. The above graph compares ABS to issuance of corporate, municipal, and treasury debt. ABS also grew faster than prime mortgage-backed securities (MBS), the largest category of bond issuance (ABS was second largest in '06).



Source: Securities Industry and Financial Markets Association.⁹

CDO Issuance jumped from \$157 billion in 2004 to \$550 billion in 2006. Investment banks increasingly looked to subprime mortgage-backed securities to fill the riskiest tranches of CDOs during this time. CDOs were virtually non-existent ten years ago.

For a graph of growth in issuance of subprime mortgage-backed securities, see section II; for a graph of growth of outstanding Asset-Backed Commercial Paper (another type of structured financial product that relies heavily on subprime mortgages), see section IV.

B. BANKERS SCORED BIG BONUSES FOR WORK WITH SUBPRIME-RELATED BONDS

The major investment banks operate on a “pay for performance” system (or, more accurately, “pay for profit”): employees and executives in the business segments that are producing the most net revenue are generally awarded the biggest bonuses (which amount to around 60% of all compensation).¹⁰

Because subprime-related bonds – structured financial products in particular – were such fast-growing sectors in the post-dot com economy, they produced significant revenues for the banks, and this translated into **consistently large bonuses for the bankers and traders that worked with subprime-related securities over the past six years:**

2001: *Derivatives Week* notes that a surge in CDO activities should have led to record bonuses for bankers working in credit derivatives, but instead their revenues would be used to “subsidize other areas.”¹¹

2002: *Investment Dealers Digest* reports that in a year when revenues and bonuses are down almost across the board, Wall Street firms like JP Morgan are facing the dilemma of having to hand out large bonuses to top bankers in profitable fields like CDOs and credit derivatives (or face the prospect of losing key personnel).¹²

2003: *Investment Dealers Digest* reports that group heads in several high-margin fixed income fields, including structured finance, would make more than ever before: \$10-20 million.¹³

2004: *Bloomberg* notes that bankers in structured finance divisions would be among the best-compensated on Wall Street.¹⁴

2005: *The Daily Deal* reports that the “biggest bonus winners” include bankers working in real estate and structured products, with group heads raking in between \$8-12 million.¹⁵

2006: The Options Group, a compensation consultancy, lists Asset-based Lending and CDOs as two of the hottest sectors for compensation and bonuses.¹⁶

In recent years, investment banks also waged hiring battles for top talent in mortgage-related fields. In 2004, for instance, JP Morgan hired away an entire structured finance group from Deutsche Bank in order to boost its CDO operations.¹⁷ The same year, Barclay’s began aggressively building mortgage operations by hiring 40 top employees from other Wall Street firms, according to an article in *American Banker*. These hiring pushes inevitably result in higher levels of compensation for bankers who worked in structured finance. Top talent at the banks naturally migrated from stock desks to bond desks.¹⁸

One of the stars of subprime-related finance was Christopher Ricciardi (quoted above), who liked to be called “**the grandfather of CDOs**,” according to *The Wall Street Journal*. He reportedly earned **\$8 million** annually as a managing director at Merrill Lynch – apparently because his subprime-related trades were making him “famous” – before leaving in 2006.¹⁹

CDOs Up Close

These instruments are now the source of large devaluations by investment banks, including Merrill Lynch, though they were once considered a highly lucrative financial product. CDOs involve the packaging of securities into different “tranches,” or slices, with varying investment grades, so that the same securities issuance can attract investors with varying appetites for risk.

CDOs do not necessarily have to rely on subprime mortgage-backed securities, but they frequently did in recent years: high-yielding subprime mortgage-backed securities often filled the low-rated, high risk tranches of the CDOs. Investors in these tranches – typically hedge funds – receive higher returns, but are the first to lose their shirts in the event of rising defaults. The major problem has been that investors in higher-rated tranches are also suffering losses, which has brought down the values of these “super-senior” tranches. This has raised questions about what sorts of assets were used to fill these low-risk tranches, and what models were being used to evaluate them (see more on this in section IV). Since many investment banks are heavily invested in super-senior tranches, they have been devaluing their CDOs by billions of dollars (called “writedowns”).

C. INVESTMENT BANK REVENUES AND BONUSES RISE TO NEW RECORDS ON STRENGTH OF SUBPRIME WAVE

Recently, the media has been buzzing about how much money the investment banks have been losing due to subprime-related holdings. But long before subprime-related investments were causing problems for the banks, they were generating record revenues and bonuses.

Last year, CEOs at the big five investment banks took home the following bonuses:

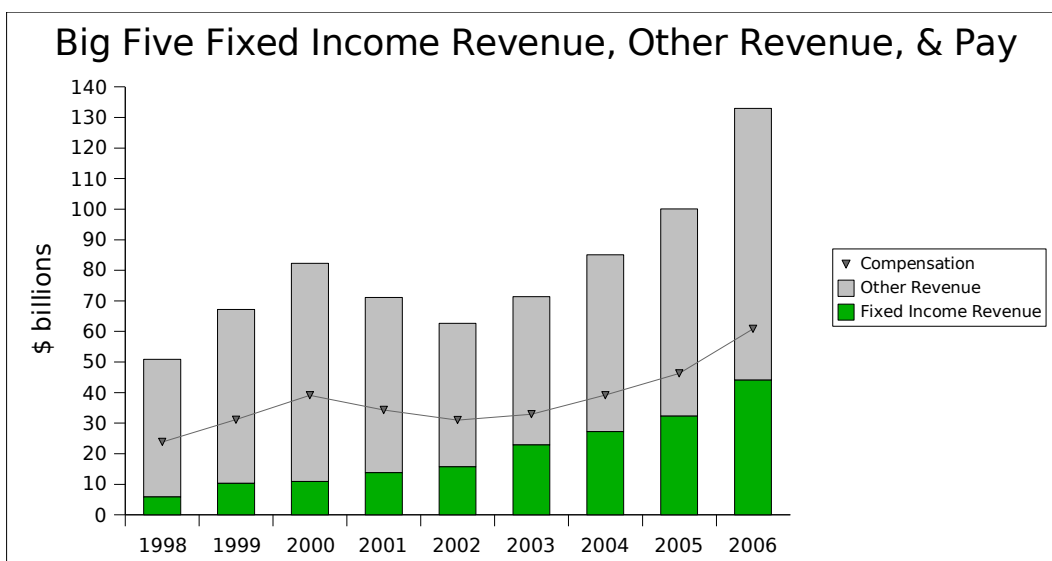
- Goldman Sachs CEO Lloyd Blankfein: **\$53.4 million**
- Morgan Stanley CEO John Mack: **\$40 million**
- Merrill Lynch CEO Stanley O’Neal: **\$47.3 million**
- Lehman Brothers CEO Richard Fuld: **\$10.9 million**

- Bear Stearns CEO James Cayne: **\$14.8 million**

The CEOs received such large bonuses because revenues at the banks had reached new highs in 2006: \$130 billion combined, largely on the strength of record fixed income (bond) revenues.

Though subprime-related revenues are a subset of fixed income net revenue totals, signs of just how important they were in driving revenue growth overall can be found in the investment banks' SEC filings: Management at every one of the five major investment banks reported in discussions of 2006 financial results that **record fixed income revenues at their banks were driven at least in part by growth in structured finance, credit, and other mortgage-related areas.**²⁰

The subprime-related bond markets were not unknown niches in the financial markets – they generated major revenues for the investment banks. And there is not a CEO at a major investment bank whose 2006 bonus was not padded by subprime-related revenues in 2006.²¹



Source: SEC filings.²²

A rising tide: Fixed income (bond) sales and trading net revenues at the big five investment banks – Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns – formed a rising tide that lifted otherwise turbulent revenues and compensation levels after the tech boom. These revenues went from 13% of net revenue in 2000 to 32% in 2003 and 33% in 2006. (These are rough estimates based on figures offered by the companies in SEC filings).

How a Mortgage Gets Securitized

These days, few banks make mortgages in order to keep them on their books and receive payments over the life of the loan. Instead, lenders sell off the loans almost as soon as they are made, as part of the securitization process. The following is a brief, step-by-step description of how this process tends to play out (often unbeknownst to the homeowner).

1. Once the homeowner signs on the dotted line, the *broker* transfers the mortgage to the mortgage lender, or *originator*, who provided the funds for the mortgage.
2. The originator quickly sells this mortgage and others like it to another entity, typically the subsidiary of an investment bank, known as the *seller* or *issuer*, which pools the mortgages.
3. The seller creates an entity known as a *Special Purpose Vehicle* (SPV), which exists for the sole purpose of holding the pool of mortgages. The SPV is typically organized as a *trust*.
4. The mortgages are transferred by the issuer to the SPV in exchange for the securities that will be backed by proceeds from the mortgages. The securities are then transferred to the *underwriter*, typically an investment bank.
5. A *servicer* is contracted to collect payments on the mortgages in the trust, as well as foreclose and refinance when necessary, a *trustee* is enlisted to represent the interests of investors in the mortgage notes, and a *rating agency* is hired (by the underwriter) to rate the securities.
6. The underwriter sells the securities to *investors* on the secondary market.
7. The investors – often investment banks themselves, or hedge funds controlled by investment banks – either hold onto the mortgage-backed securities in the hopes of collecting payments from borrowers, or they sell their securities to an entity (an investment bank) which re-packages them in new forms, such as CDOs or SIVs.

Though several mortgage originators have set up shell *issuers* through which the securities are offered, the *underwriter* – again, an investment bank – is the crucial player in this process, because it is providing access to the investors that are the final source of funding for the mortgage.

II. INVESTMENT BANKS PROVIDED SUBPRIME LENDERS WITH CRITICAL FUNDING in return for subprime mortgages to convert to lucrative bonds, the investment banks provided lenders with essential funding streams.

"Someone is financing these companies to begin with. Someone is buying these mortgages, and it is Wall Street."²³

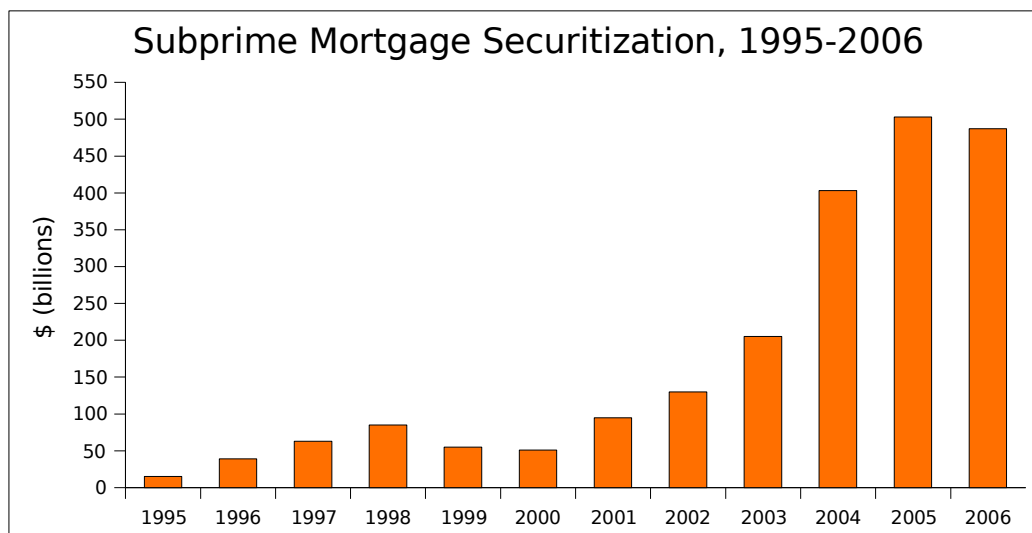
-Andrew Cuomo, then Secretary of Housing and Urban Development, at a hearing on predatory lending, May 2000

Wall Street investment banks were subprime mortgage lenders' single most important source of capital, and therefore wielded tremendous power in the subprime mortgage market. These lenders raised cash for their lending activities through frequent *private-label securitizations*, which are controlled by investment banks and shielded from government oversight. By buying up mortgages, the investment banks granted lenders quick access to capital for further lending activities. The investment banks, in turn, were able to produce the lucrative subprime-related bonds that generated so much revenue and bonus money over the past several years.

A. THE CRUCIAL ROLE OF MORTGAGE SECURITIZATION

Mortgage securitization is the key source of capital for subprime mortgage lenders, which use the process to quickly convert mortgages into money for further lending, rather than wait for the borrower to pay out over the life of the loan.

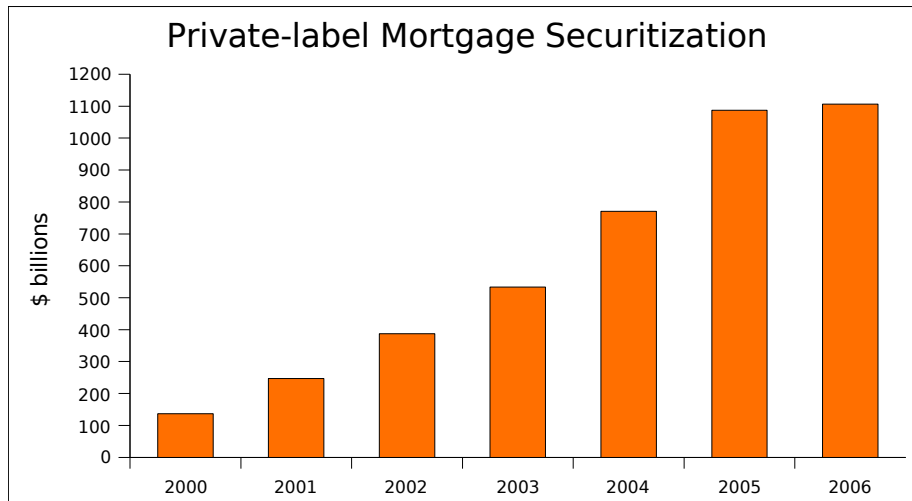
In a typical securitization, the lender sells off mortgages – which it has either originated directly through retail channels or purchased from independent brokers – to an investment bank. The investment bank pools the loans and places them in a trust, then sells securities (bonds) that are backed by payments from the mortgages in the trust to investors. Investment banks are typically known as the *underwriters* for the securities offerings, because they structure the offerings and take on the risk of having to sell the securities. **Investment banks – the crucial links between lenders and investors – are the most powerful players in the subprime mortgage securitization process.**



Source: *Inside Mortgage Finance*.

The rapid rise of Subprime. Subprime mortgage securitizations went from a small segment of the mortgage market to a dominant one – around 20% of all mortgage securitizations by 2006.

An absence of government oversight adds to the investment banks' power in the subprime mortgage securitization process. A great deal of mortgages are securitized by government related entities – Fannie Mae, Freddie Mac, and Ginnie Mae – but mortgages which do not meet the underwriting standards of these entities (*non-conforming* loans), such as subprime mortgages, have to go through *private-label*, or *non-agency* securitizations, in which the issuer of the securities is a private entity.²⁴ In private-label securitizations, the endorsement of a government-backed entity like Fannie Mae and the sense of safety this provides investors is replaced by the endorsement of a prestigious investment bank such as Goldman Sachs or Morgan Stanley.²⁵



Source: *Asset-Backed Alert*.²⁶

Stunning growth in private-label securitization (this is not just a subprime problem). *Private-label securitizations put many risky products into the mortgage markets: subprime, Alt-A (for borrowers with FICO more than 620 but less than prime), and jumbo (loans larger than \$417,000). These loans typically don't meet agency standards, but investment banks were more than willing to underwrite offerings of them over the past six years.*

B. SUBPRIME LENDERS DEPEND HEAVILY ON STRONG RELATIONSHIPS WITH INVESTMENT BANKS

Because investment banks run the securitization process, subprime lenders must develop strong relationships with them in order to access capital.²⁷ **Rather than merely carry one of these companies through an offering of securities, investment banks are constantly providing capital to subprime lenders with whom they do business.**

The typical subprime mortgage originator has strong ties to several investment banks, and typically notes these relationships in annual reports and SEC filings (if publicly traded) as a sign of their strength as a company. For instance, in its 2006 annual report, New Century Financial, a subprime lender, listed “Long-Standing Institutional Relationships,” as a competitive advantage:

- **New Century Financial on its “competitive advantage”:** “We have developed long-standing relationships with a variety of institutional loan buyers, including Credit Suisse First Boston (DLJ Mortgage Capital, Inc.), Goldman Sachs, JPMorgan Chase, Lehman Brothers, Morgan Stanley, Residential Funding Corporation and UBS Real Estate Securities Inc. These loan buyers regularly bid on and purchase large loan pools from us, and we frequently enter into committed forward loan sale agreements with them.”²⁸

Of course, as will be illustrated in part E of this section, these buyers can pull the plug at a moment's notice, and

when they do, the subprime lenders collapse very quickly. This was the case for New Century, which imploded in March 2007 when loan buyers wanted out.

C. INVESTMENT BANKS PROVIDE SUBPRIME LENDERS WITH DAY-TO-DAY FINANCING

Subprime lenders typically enter into arrangements with investment banks that provide them with financing. These can take a number of forms, but the most common are *purchase agreements* and *warehouse lines of credit*.²⁹

- *Purchase agreements* – Subprime lenders enter into these agreements with investment banks so that they are guaranteed a buyer for the mortgages they make. Investment banks, in turn, are assured access to a batch of mortgages to securitize. As part of the agreement, the investment bank typically sets the prices and quantities of the types of loans it wants to buy.
- *Warehouse lines of credit* – Lenders use these to fund cycles of mortgage lending, tapping them on a day-to-day basis as short-term financing for new loan originations that will eventually be sold off for securitization. In return for this line of credit, the subprime lender typically agrees to grant the investment bank the right to either buy the mortgages or sell securities on a certain portion of the mortgage pool. Warehouse lenders have detailed knowledge of the lender's operations, according to an unnamed source for an *Investment Dealers Digest* article: "They have that day-to-day pipeline exposure to what the mortgage lender's doing."³⁰

These funding cycles encourage lenders to make as many loans as possible, with very little regard to quality. Lenders are also very dependent on these agreements and facilities, which they usually enter into with a handful of investment banks. Without this financing from investment banks, the lenders often cannot sustain their operations. This dependence is frequently acknowledged in SEC filings.³¹

D. INVESTMENT BANKS PURCHASED SUBPRIME LENDERS IN ORDER TO KEEP THE BOND MATERIAL COMING

As the subprime market took off over the last six years, major investment banks rushed to acquire subprime mortgage lenders in order to bring the lending operations in-house. The industry publication *Mortgage Banking* explored this phenomenon in depth in an article called "The Vertical Integration Strategy," and attributed the rise in subprime lender acquisitions to a hunger for bond-related revenues.

- ***Mortgage Banking***: "Why have the Wall Street firms so aggressively embraced this vertical-integration strategy? The answer is to protect and leverage the returns from their mortgage underwriting and securitization desks that purchased and securitized the bulk of alt-A and subprime loans in 2005. **In fact, revenues from the fixed income divisions currently represent the largest component of the revenue mix for these broker-dealers, validating the core focus that Wall Street has assigned to the mortgage market.**"³² [emphasis added]

Lehman Brothers and Bear Stearns were market leaders in this respect, though other major investment banks also acquired subprime lenders in recent years: Morgan Stanley (Saxon Capital); Merrill Lynch (First Franklin); and Goldman Sachs (Southern Pacific).

E. INVESTMENT BANKS CAN EASILY PULL THE PLUG ON SUBPRIME LENDERS

Subprime mortgage lenders typically depend on investment banks to keep funding them, rather than holding assets that they can easily convert to cash through trades (*liquid* assets). As a result, they have no capital on hand to see them through rocky periods – they only have a massive investment bank standing behind them and feeding them money.

Two mechanisms allow investment banks to withdraw support from the lenders very quickly, and offer evidence of just how much power the banks wield over lenders:

- *Margin Calls* – Warehouse financing agreements allow the investment banks to re-evaluate the value of the mortgage collateral offered by subprime lenders to secure outstanding borrowings. If the bank determines that the subprime lender needs to post more collateral, it makes a “margin call” and requires the subprime lender to post more. If the lender cannot post enough collateral, they lose the line of credit, and this can trigger other margin calls.
- *Repurchase agreements* – These agreements allow the investment banks to force subprime lenders to buy back loans that the lender has sold to the investment bank that are in foreclosure or otherwise deficient, based on certain terms.

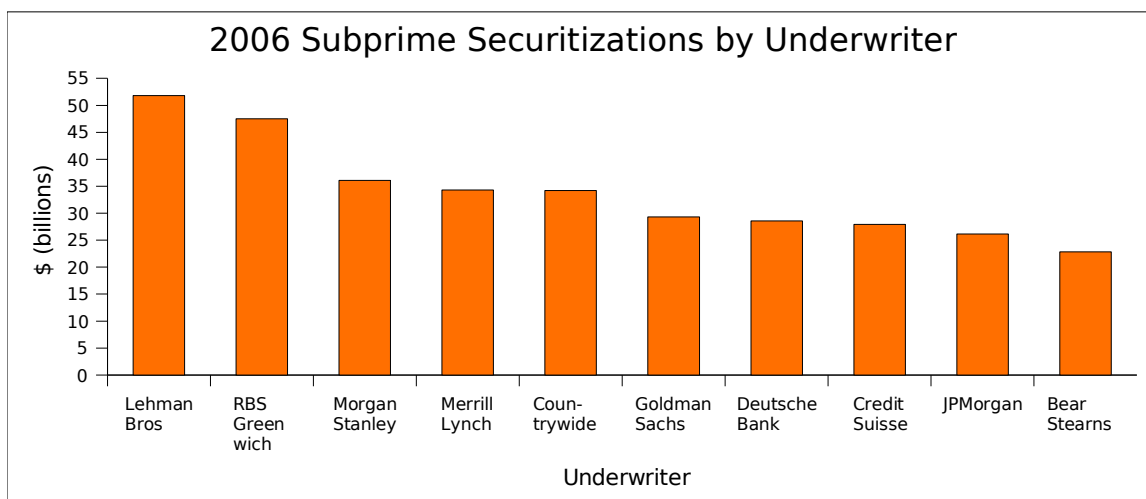
Once these subprime lenders stop making money, investment banks typically use these mechanisms to pull the plug on the lender, and this frequently causes lenders to collapse.

This scenario played out with two subprime lenders who went bankrupt in late 2006, and was well illustrated in a *Mortgage Line* article titled “The B&C Meltdown: It’s All About Capital”:

- **“It’s All About Capital.”** “Wall Street (Merrill Lynch, others) said to Ownit and MLN [the subprime lenders]: buyback the delinquent loans you sold us or we won’t lend you more money. MLN and Ownit said: can’t we talk about this? We don’t have a lot of money. (I’m paraphrasing.) Wall Street said: we can talk all you want but we want our money. The rest you read about in National Mortgage News, MSN and American Banker, not to mention some of the bigger dailies.”³³

F. A HANDFUL OF INVESTMENT BANKS CONTROL FUNDING FOR THE SUBPRIME MARKET

Ten investment banks served as underwriters for 70% of the \$486 billion in subprime mortgage securitizations in 2006. Because they control such large shares of the market, individual investment banks have extraordinary clout with the various players in the market – the lenders who originate the mortgages, the servicers who collect payments from the securitized mortgages, and the ratings agencies who assign ratings to the mortgage-backed securities. The ramifications of this will be explored in upcoming sections.



Source: *Inside Mortgage Finance*

No major investment bank skipped the subprime securitization binge. These ten controlled 70% of the market in 2006 – a strong indicator of where power was concentrated. (Countrywide is a special case in that it has its own securities arm that acts as underwriter for many of its deals)

III. PRESSURE FROM WALL STREET CAUSED SPIKE IN PREDATORY LENDING

The investment banks' pricing schemes and demand for large quantities of subprime mortgages encouraged predatory practices.

Through their relationships with subprime mortgage lenders, investment banks essentially set the underwriting criteria in the subprime market: they tell the lenders what types of mortgages they want to securitize, how much they will pay for them, and how many they want.³⁴ During the subprime boom, the investment banks oversaw a loosening of underwriting standards and pressured lenders to originate excessive amounts of subprime mortgages so that the investment banks could create lucrative subprime-related bonds. The firms' demands trumped the needs of American homeowners in determining the types of mortgages made available on the market. The result was a significant spike in predatory and abusive lending.

A. INVESTMENT BANKS SET LENDING STANDARDS IN THE SUBPRIME MARKET

Because investment banks provide subprime lenders with necessary funding, they wield a great deal of power in determining what sorts of loans are offered to subprime borrowers. The fact that Wall Street's investment banks, and not subprime mortgage lenders, set underwriting criteria in the subprime market is acknowledged by leading lending experts:

- **Kurt Eggert, Professor of Law at Chapman University, in testimony to Congress, April 2007:** "I think we've had a presentation of the secondary market as mere passive, you know, purchasers of loans and oh, they may select a loan, but it's really the lenders who decide loans. But if you talk to people on the origination side they'll tell you the complete opposite. They'll say, you know, our underwriting criteria are set by the secondary market. They tell us what kinds of loans they want to buy. They tell us what underwriting criteria they want us to use. And that's what we do because we're selling to them."³⁵ Eggert was responding to presentations offered by industry insiders who were testifying.
- **Allen Fishbein, Director of Housing Policy for the Consumer Federation of America:** "They are providing the liquidity through the investments in this market and are responsible for really setting the standards that loan originators apply at the front end of the market."³⁶

Though "the secondary market" can refer to ratings agencies and investors as well as investment banks, findings in Section IV will reveal the degree to which investment banks are the prime movers and power brokers in the secondary market.

B. INVESTMENT BANKS PAID HIGHER PRICES FOR LOANS WITH PREDATORY CHARACTERISTICS

Investment banks set underwriting criteria in the subprime mortgage market by telling lenders what types of loans they want to buy, how much they want, and what prices they want to pay. The nature of this process is illustrated by an excerpt from the 2006 annual report filed by Fremont General, the parent of Fremont Investment & Loan, a major subprime lender.

- **Fremont General:** "The Company sought to maximize the premiums on whole loan sales and securitizations by closely monitoring the requirements of the various institutional purchasers, investors and rating agencies, and focusing on originating the types of loans that met their criteria and for which higher premiums were more likely to be realized. The Company also sought to maximize access to the secondary mortgage market by maintaining a number of relationships with the various institutions who purchase loans in this market."³⁷

In October 2007 testimony to Congress, Jim Campen, executive director of Americans for Fairness in Lending, noted "Fremont, the largest high- APR lender in Boston in 2005 and the second-largest statewide, was **well-known for the egregious quality of its loans**, but seems to have been allowed to proceed unchecked at least through the end of 2006."³⁸ Fremont was sued earlier in 2007 by Attorney General Martha Coakley, who charged "**unfair and deceptive conduct on a broad scale.**" **Goldman Sachs was the top purchaser of**

Fremont's mortgages in 2006, with \$5.3 billion worth of purchases.³⁹

The following are brief descriptions of a few of the types of loans that met the criteria of investment banks like Goldman Sachs during the subprime boom:

- **Hybrid adjustable rate mortgages (ARMs).** These loans carry low, fixed teaser rates (7-8%) that jump to much higher adjustable rates (14%+ pegged to an index) after two or three years. Often, subprime ARM borrowers' ability to re-pay is judged based on the low, initial rate. Underwriters accept higher rates of re-financing and foreclosure by saddling these borrowers with prepayment penalties and judging ability to pay based on the value of the underlying asset – a widely recognized predatory tactic. ARMs went from 73% of subprime loans in 2001 to 91% by 2006, and are causing many of the subprime foreclosures today.⁴⁰
- **Low- and no-documentation.** A lack of documentation of income or residence means that the credit of the borrower cannot be verified and the loan is therefore riskier and carries higher interest rates. Lending without regard for the borrower's ability to pay is widely considered a predatory tactic. These went from 28% of subprime loans in 2001 to 50% by 2006.
- **Interest-only.** Payments from these loans only cover interest on the mortgage, not principal, and leave the borrower in the vulnerable position of having to re-finance or sell their house down the road. These went from 0% of subprime loans in 2001 to 38% in 2005, before dipping down to 23% in 2006.

Investment banks paid more for each of these types of mortgages because the loans could be packaged into more lucrative securities. Higher interest rates on the loans themselves eventually translated into more bond-related revenues for the investment banks. But because they entail such prohibitive costs for homeowners themselves, these types of loans often signal predatory circumstances at origination.⁴¹

In testimony before the US Senate in September 2006, Allen Fishbein, director of housing and credit policy at the Consumer Federation of America, noted that “traditionally, these types of loans were niche products that were offered to upscale borrowers with particular cash flow needs or to those expecting to remain in their homes for a short time.”⁴² In recent years, however, these mortgages began to be mass marketed to a wide array of borrowers, many of whom did not understand the underlying risks and expenses involved – and many of whom were not properly informed of these risks.

In addition to paying more for these types loans, the investment banks also pressured subprime mortgage originators to loosen their lending standards and make more of them.

- **Wall Street to Ownit CEO: make more low-documentation loans.** William D. Dallas, CEO of bankrupt mortgage lender Ownit, said in an interview with the *New York Times* that he was told by investment banks – Merrill Lynch, in particular – that he should offer more low-documentation loans in which the borrower's income is not verified, and that if he didn't, he would be foregoing profits.⁴³ Dallas reportedly disagreed, but complied with the demands of the banks. Ownit collapsed in December 2006.

In early 2007, *Mortgage Banking* noted that investment banks were rushing to acquire wholesale subprime lenders (which purchase loans from independent brokers) as opposed to retail businesses (which originate loans through their own offices and employees) because this would allow the investment banks to avoid liability for predatory lending practices.

- **Mortgage Banking: Investment banks averse to fair lending law compliance.** “Retail lending, with its direct-customer interface, opens up the exposure to fair lending and compliance concerns, which Wall Street firms are averse to.”⁴⁴

C. CONGRESS: SUBPRIME EXPLOSION CAUSED SIGNIFICANT SPIKE IN PREDATORY LENDING

“The Subprime Lending Crisis,” a report released by the Joint Economic Committee of Congress, noted a

“marked increase in predatory lending” in the subprime boom years, in part because the financial intermediaries in the subprime market are only weakly regulated.⁴⁵

The report linked the rise in predatory lending to a deterioration in underwriting standards, and had this to say regarding the reasons the subprime market accelerated, despite signs that the housing boom that had sustained many subprime borrowers could not continue:

- “Since underwriting deteriorated from 2001 to 2005, and the accelerating housing price boom was giving subprime borrowers important help (see Part II), a cautious analyst might have questioned whether the improvements in subprime performance could be sustained. The financial intermediaries who expanded the supply of these loans were apparently not troubled by this issue. The reasons for their lack of curiosity may lie in the strong incentives they had for expanding the subprime market.”⁴⁶

Those incentives can be traced to the massive revenues and bonuses generated by investment banks in the secondary market through structured financial products such as CDOs, as discussed in Part I.

One Fannie Mae study estimated that 50% of subprime borrowers could have qualified for prime loans.⁴⁷ This is a clear sign that predatory lenders tend to steer subprime borrowers toward expensive, subprime loans in the interest of garnering more fees for their work.

D. CURRENT LAWS HELP INVESTMENT BANKS AVOID LIABILITY FOR BUYING PREDATORY LOANS

Whether or not they were aware of the predatory nature of loans they were packaging and selling as securities, the investment banks knew that they had virtually no legal liability related to the origination of the mortgage. This is due to the current legal framework surrounding lending, which is widely noted by predatory lending experts to be deficient in holding Wall Street accountable for predatory lending.

Once a mortgage lender sells a mortgage to an investment bank, the homeowner’s legal options virtually disappear.⁴⁸ The most important legal hurdle in a securitization is the “true sale” of the mortgage note from the mortgage lender to the securitizer – the liability associated with the origination of the mortgage does not transfer in this sale. A legal doctrine known as *holder in due course* offers investment banks and investors this protection. Though investment banks may have purchased pools of mortgages full of predatory and abusive loans, they are, by and large, immune from any legal challenges by the homeowner.

Investment banks exploit this legal framework to reap profits from predatory and abusive loans. With no strong legal incentive to avoid buying these loans, investment banks fund subprime lenders regardless of potentially exploitative practices. In fact, as spelled out above, they appear to encourage these practices in order to boost the supply of subprime mortgages to securitize. In testimony to Congress in April, Christopher Peterson, a Professor at the University of Florida’s Levin School of Law, offered his take on why investment banks purchase predatory loans – and why they are responsible for problems in the subprime market.

- **Christopher Peterson, Professor of Law at University of Florida, to Congress, April 2007:** “And if I could encapsulate it – the sentence that was said earlier was that no one would want to purchase a predatory loan. I think that that's false. Sure, you would. If you could purchase it and then especially if you could purchase it through a shell company that didn't have your fingerprints all over it and then you sold it to some sucker at a profit, then you'd want to do it, right? And you would pretend that you didn't know that it was a predatory loan, or you would actually not know that it was a predatory loan because you didn't check, right? Those are the – that's the situation when you would want to buy a predatory loan. And I think that's what's been happening.”⁴⁹

How does Wall Street avoid liability for packaging predatory loans? Lobbying power, according to the *New York Times*: see Section V, Part D.

E. LEHMAN BROTHERS' 2003 LEGAL WIN EMBOLDENS WALL STREET TO BUY PREDATORY LOANS

In 2003, investment banks were further encouraged to purchase predatory loans without fear of substantial liability when Lehman Brothers was held minimally liable for funding First Alliance, a subprime lender based in California. First Alliance had been notorious for its predatory practices, often targeting elderly people and other vulnerable borrowers for extremely costly loans. This was well-known and well-documented, even by Lehman Brothers executives.

In 1995, before Lehman began funding the company and tapping into its profits, Eric Hibbert, a Lehman Brothers vice president, was dispatched to check out First Alliance's operations.⁵⁰ According to a June 2007 *Wall Street Journal* article, he penned a memo that described First Alliance for the bad actor that it was in no uncertain terms:

- First Alliance is a financial "sweat shop."
- The company specializes in "high pressure sales for people who are in a weak state."
- Employees leave their "ethics at the door."
- The company made some loans "where the borrower has no real capacity for repayment."

Despite clear signs that the company preyed upon its customers, Lehman Brothers went on to lend the company \$500 million through a warehouse line of credit and sold \$700 million worth of First Alliance loans.

After a 4-year fight, the investment bank was held responsible for just 10% of the damages done to the plaintiffs in the class action suit, and had to pay \$5 million – a paltry sum when compared with the subprime-related revenues the investment bank continued to rake in.

Wall Street evidently took the outcome of the case as a green light to provide even more support to subprime lenders, regardless of the legality of the loans they were financing. The judgment was entered in late 2003, and subprime mortgage securitization went from \$202 billion in 2003 to \$401 billion in 2004, a 100% increase that constitutes the largest year-to-year jump in the history of subprime mortgage securitization.

IV. INVESTMENT BANKS PUMPED UP DEMAND FOR RISK-LADEN SUBPRIME BONDS

As sellers and purchasers of large volumes of bonds, investment banks created the market for subprime securities, overvalued these securities, re-packaged them, and pushed demand to unsustainable levels.

Commentators often peg blame for the surge in the subprime-related bond market on nebulous market pressures, such as investor appetite, ignoring the degree to which investment banks generate investor demand through their roles as the prime movers in the secondary market. The investment banks buy and sell securities in extremely large volumes, work their sales networks to convince investors to purchase the securities, frequently maintain large positions in these securities in order to profit through proprietary trades, control investors such as hedge funds that take large positions in these securities, inflate the value of the securities, and then turn around and re-package them in new structures in order to re-start the cycle and generate more revenues. The investment banks fueled the supply of subprime loans to fulfill high levels of demand for which they were primarily responsible. In other words, they worked both ends of the deal to “make” this market.

A. INVESTMENT BANKS WIELD SIGNIFICANT INFLUENCE OVER INVESTOR DEMAND

Investment banks influenced investor demand for subprime mortgage-backed securities by making markets for them, controlling hedge funds that purchased these securities, and trading the securities for their own account:

1. Making Markets

The investment banks facilitated customer sales and purchases of subprime mortgage-backed securities by buying and selling large quantities of the securities. In-house computer models also allowed them to rapidly calculate prices for the complex securities. In the world of finance this is known as “making markets,” because the investment bank does the important work of providing liquidity in the market – meaning that the securities are rendered tradeable by the investment banks’ positions. As part of this process, investment banks leveraged their clout with big investors in their sales networks to convince them to buy subprime mortgage-related securities.

2. Hedge Funds

Investment banks control many of the world’s hedge funds. Goldman Sachs, for instance, is the world’s number one manager of hedge funds. Hedge funds were often top customers for subprime bonds during the boom.⁵¹ The investment banks also control many hedge funds indirectly by lending them money through their prime brokerage segments. *The Economist* reported in a September 22, 2007 article that “the hedge funds that buy mortgage-linked debt also borrow heavily from the prime-brokerage arms of banks that originated many of the underlying loans. So a bank can push risk out of the front door, only to find it sneaking through the back.”⁵²

3. Proprietary Trading

Investment banks also make large bets with their own money as part of their proprietary trading operations. Much of the revenue in fixed income divisions over the past several years was reportedly generated by these trades. Goldman Sachs appears to have managed to escape the subprime turmoil by making a large bet, with its own money, against the subprime market. Other investment banks, obviously enough, did differently.

Between making markets, tapping sales networks, controlling hedge funds, and taking large proprietary positions in subprime-backed bonds, **investment banks both fueled and accounted for much of the investor demand that is frequently attributed to a more generalized appetite for risk in the financial markets.**

B. COMPLEX INNOVATIONS IN STRUCTURED FINANCE OBSCURED RISK, FUELED MARKET

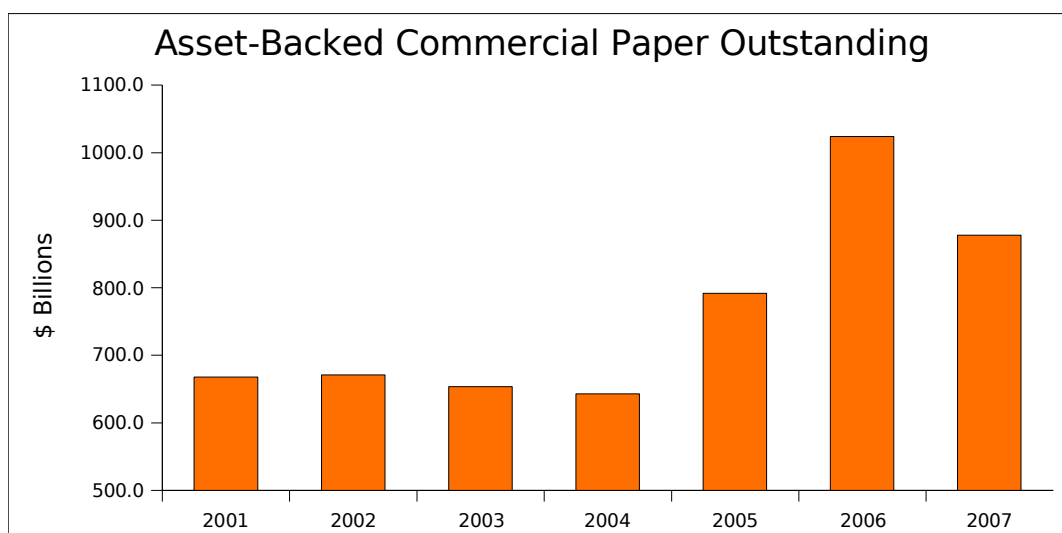
Many structured financial products that rely heavily on mortgage-backed securities are recent Wall Street innovations that are untested, unregulated and little understood by even the most sophisticated investors. Investment banks played a leading role in pushing these instruments to the forefront by developing them, selling

them to customers, and stamping them with their approval, even though the products were untested.

It was also in the interest of investment banks to develop as many of these new bonds as possible: every time they re-packaged mortgage-backed securities into one of these complex structures, they earned fees for putting the deal together and selling the securities. The underwriters who structured the offering also typically earned more for these deals because there was a higher level of complexity.

There are many types of structured financial products, but two of the most important for the purposes of this report are CDOs (explained in Section I) and SIVs – or more accurately, the short-term bonds that these SIVs issue.

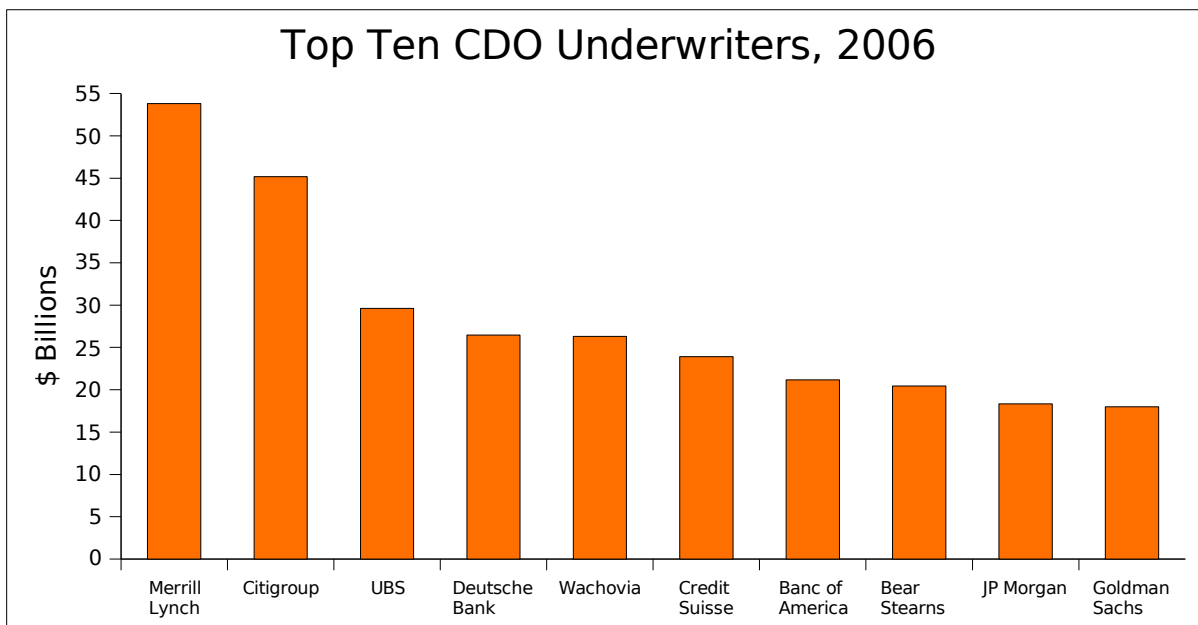
Structured Investment Vehicles (SIVs) are quasi-independent banking entities set up by investment banks to take advantage of interest rate spreads. SIVs issue short-term commercial notes – called *asset-backed commercial paper* – with lower interest rates in order to fund purchases of long-term mortgage-backed securities with higher interest rates (very often subprime mortgage-backed securities). As long as the returns from the long-term assets outpace the expenses of the borrowing the entity is doing in the short-term, SIVs make off with a profit. In recent months, the market for the SIVs' short-term paper has dried up over concerns about the value of the long-term mortgage-backed securities that are supposed to cover payments on the short-term paper.



Source: *Asset Backed Alert*

Market for Asset-Backed Commercial Paper Takes Off, Dries Up. Levels of outstanding ABCP (which is issued by SIVs) remained relatively flat until 2004, when the subprime wave apparently caught up with this market. These figures are for the first week in November in each of the past seven years – note the sheer drop from 2006 to 2007, a clear sign that this market was boosted in large part by the subprime mortgage market.

There will be more on the off-balance sheet nature of SIVs and the problems they are currently posing in the next section.



Source: Thomson Financial.⁵³

CDO Underwriting in 2006: Merrill and Citigroup in the lead, but others close behind. CDO underwriting was a major money maker for these banks, because the fees for structuring these deals were about three times higher than they were for other bond issues. Merrill Lynch, for instance, could have earned between \$500 million and \$1 billion for just putting together these offerings – before it even began generating fees through trading activities.

Because the field of structured finance is relatively new and grew so fast, it is not tightly regulated. In 2002, however, *Investment Dealers Digest* noted that regulators had been moving to increase oversight of this segment of the bond market.

- **Investment Dealers Digest in 2002: structured finance is threatened by regulation.** “In the never-ending drive to wring more profits out of a traditionally low-margin business, Wall Street banks have steered structured finance into more esoteric, more lucrative and riskier waters. Such moves are earning bankers a big payday, but are also driving federal regulators and accounting standard-setters to begin making the most serious and possibly harmful changes in the market’s history.”⁵⁴

Evidently, the changes were not sufficient, and bankers in these fields continued to earn a “big payday.”

C. INACCURATE MODELING INFLATED THE VALUE OF SUBPRIME-BACKED BONDS

Investment banks typically determined the value of mortgage-backed securities using complex mathematical models. These models predicted rates of foreclosure, default and prepayment, as well as market declines and other variables that affect payment streams from the underlying mortgages.

Despite their sophistication, the investment banks’ models turned out to be dead wrong. The models severely underestimated the number of borrowers who would enter default and face foreclosure and inflated the value of the bonds that the investment bank sold.

How could this happen? A recent *Forbes* article offers one explanation:

- **Forbes:** “Wall Street firms like Merrill Lynch, Citigroup and Bear Stearns spend tens of millions of dollars a year managing risk. They field departments full of smart analysts to assess market, credit, liquidity and operational risk. The process is marked by a formal governance structure and risk-tolerance limits.

That's what the banks tell investors, anyway. When it came to their exposure to the subprime mortgage market, none of this seemed to matter. ‘Executives believe what they want to believe,’ says Frederick Cannon, a bank analyst at Keefe, Bruyette & Woods. **‘They know [booms] are going to end, but they don't know when. In the meantime, it's a lot of fun to make money.’**⁵⁵ [emphasis added]

The article goes on to note that “by any risk manager’s measure, bonds backed by exotic subprime mortgages were a dubious bet,” and they were relatively untested.

No matter what these complex models were saying, a closer look at the characteristics of the loans underlying these securities reveals obvious signs of trouble.

A Goldman Sachs securitization profiled by *Fortune* had some obvious problems, including:

- 58% of the 8,274 loans in the pool assembled by Goldman were **low- or no-documentation** loans, meaning that many important characteristics of the borrowers had not been verified.
- The average equity of the second-mortgage borrowers was 0.71% – an extremely **high loan-to-value ratio of 99.29%**. This means that homeowners were essentially borrowing the entire cost of the home.

Fortune noted that months after Goldman sold the securities, the “mathematical models used to assemble and market this issue - and the models that Moody's and S&P used to rate it - proved to be horribly flawed.”⁵⁶

D. INVESTMENT BANKS SHAPED MORTGAGE-BACKED BOND RATINGS

Rating agencies such as Moody’s, Standard and Poor’s, and Fitch’s assign ratings to mortgage-backed securities that are intended to inform investors of the credit risk associated with the securities. Ratings are absolutely critical to the valuation of bonds. The ratings agencies have been coming under fire recently for inflating the ratings of subprime-related bonds. But it is important to recognize that these rating agencies are compensated by the same investment banks whose bonds they rate.

The system warps rating agencies’ incentives, similar to the way food critics would be influenced if they were paid by restaurant owners, or movie critics’ reviews would be skewed if they were compensated by producers. It also gives investment banks undue control over mortgage-backed bond ratings.

Columbia Law School Professor John Coffee argued that investment banks had unique power over mortgage-backed bond ratings in testimony to Congress at a September 26, 2007 hearing titled “The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets.”

- **John Coffee, Professor of Law at Columbia, to Congress: investment banks have unique control of ratings.** “What's causing this [inflation of ratings]? I give a number of reasons, but one distinctive factor is this market is behaving very differently in its rating of corporate bonds as opposed to its rating of structured, financed products. And I think that's because structured finance gives new power to the investment banks. They are assembling large pools of securitized assets, they are repeat players, and they can remove their business if they don't get what they like. They have much more power than the traditional corporation, which was only .01 percent of the agency's business.”⁵⁷

The system allows investment banks to shop around for the best ratings, and they do. In an interview with the *Wall Street Journal*, Mark Adelson, a former Moody’s executive, said that “it was always about shopping around,” but Wall Street called it by other names, like “best execution” and “maximizing value.”⁵⁸

- **Moody's lost two-thirds of its market share in rating commercial mortgage-backed securities upon establishing tougher standards in that sector.** The *Wall Street Journal* reported in July that Moody's had gone from 75% market share in rating CMBS issuances to 25% in the three months after it began requiring additional credit enhancement for those securities.⁵⁹ Moody's executives guessed that investment banks were seeking laxer standards from other agencies. Morgan Stanley refused comment when asked why they had sought ratings from other agencies on its CMBS issuance.

Ratings agencies, like other players in the securitization market, played a part in causing the current situation. Still, their role is overshadowed by investment banks' control of the system. At a Senate hearing in April 2007, Senator Robert Menendez asked witnesses whether ratings agencies and investment banks were responsible for the subprime mess. Predatory lending expert Christopher Peterson answered that investment banks were the "primary culprit."

- **Christopher Peterson, Professor of Law at University of Florida:** "So as far as the yes or no question that you asked earlier, responsibility – I would give for the rating agencies – you know, maybe they didn't do as good a job as they could have, but ultimately I don't in the end see them as the primary culprit. They're trying to sell a product, accurate ratings, and maybe I'll regret this statement later, but I'd probably give them more or less a pass. But I do think that the investment banks are very much responsible for this. I think that a lot of them knew or should've known that this sort of thing could happen, and they were profiting from the transaction fees and packaging and selling these loans."⁶⁰

E. INVESTMENT BANKS ALLEGEDLY SUPPRESSED DUE DILIGENCE REPORTS ON SUBPRIME BONDS

As part of the due diligence process for mortgage-backed bonds, investment banks commission reports from outside firms. These were allegedly ignored and suppressed by investment banks during the subprime boom in order to enhance the value of the securities being offered.

- **Credit Suisse First Boston is being sued for suppressing due diligence reports.** The attorney for the institutional investor, an insurer, argues that his client would not have invested in the mortgage-backed securities if they had had access to the due diligence reports available to CSFB.⁶¹

Investors do not have access to the investment banks' due diligence reports, and prospectuses filed by the underwriter do not include information from the due diligence reports. When they rate mortgage-backed bonds, ratings agencies have access to report summaries but not the entire report.

Employees at due diligence firms claim that their findings were frequently ignored by the investment banks that asked them to ascertain whether blocks of mortgages conformed to certain standards.

- Keith Johnson, president of Clayton Holdings, a large due-diligence firm: **"In some cases we felt that we were potted plants."**⁶²

V. WALL STREET HIDES LOSSES, FIGHT REFORMS AS BONUS SEASON NEARS

The investment banks are writing down billions but still setting up Enron-esque deals to postpone the acknowledgment of subprime-related losses.

Despite billions in writedowns (devaluations) of subprime mortgage-related securities, experts say that much more is on the way from the big investment banks. Several of the banks are reportedly moving bad assets off their books temporarily, in order to postpone the acknowledgment of subprime-related losses. Late last summer, Citigroup was revealed to have massive off-balance sheet subprime exposure in “structured investment vehicles.” The Treasury Department came to its aid in October to help organize a super fund that would buy up its assets. Meanwhile, Wall Street firms successfully took the teeth out of a bill that would have held them liable for buying predatory loans.

A. BILLIONS IN WRITEDOWNS, BUT EXPERTS SAY MORE IS ON THE WAY

Though investment banks unloaded much of the bad subprime-related bonds, most had held on to billions of dollars worth of subprime-related securities. The securities have plummeted in value after this summer’s meltdown in the subprime market: no one trusts the models that had been used to value the securities, and few investors are willing to pay any significant price for them. These financial instruments are widely viewed as black boxes in the wake of the subprime boom – it’s hard to know what’s inside, so why take the risk on the underlying assets?

The following is a list of some of the writedowns so far, which total about \$50 billion at the major investment banks:

- Merrill Lynch: \$8.4 billion.⁶³
- Citigroup: \$11 billion.
- Morgan Stanley: \$3.7 billion.
- Bear Stearns: \$1.2 billion.

Much more is on the way, according to some estimates. For instance, a Goldman Sachs analyst recently lowered his rating of Citigroup to “sell” after estimating that the bank would write down \$15 billion in mortgage-related losses in the next two quarters.⁶⁴ According to one trader quoted in *The Wall Street Journal*, “the overwhelming sentiment on the floor is, things are much worse than people fear (in credit markets) and that we’re still not getting a straight scoop from banks and investors.”⁶⁵

A recent estimate from the Organization for Economic Cooperation and Development predicts losses in the mortgage sector will total \$300 billion, of which only \$50 billion has been accounted for by major banks.⁶⁶

Furthermore, the next wave of losses may hit institutional investors such as pension funds that are generally risk-averse, but had been dipping into the subprime trough to boost returns in recent years. A *Bloomberg* article recently reported that municipal investment fund managers in Florida had invested money in the structured investment vehicles which invested heavily in subprime paper, and may be facing losses in the near-future.⁶⁷

B. ENRON-STYLE OFF-BALANCE SHEET ACCOUNTING TACTICS COMING TO LIGHT

Murky accounting methods similar to those that inflated the value of the energy-trading Goliath – and eventually spelled its end – have been employed by the banking giants in the area of subprime mortgage-backed securities.⁶⁸

Over the past few months, several forms of complex off-balance sheet structures and transactions have come to light, adding to concerns that the banks are more exposed to subprime risk than previously thought. It also appears that the investment banks are using these methods to postpone acknowledgment of losses:

Liquidity Puts

Citigroup, in particular, forged these agreements with investors purchasing CDOs backed in part by subprime mortgage assets. The agreements granted investors the option to sell the CDOs back to the bank in the event of financial difficulty. Citigroup moved the CDOs off its balance sheet without accounting for the fact that it could be required to re-purchase the assets at some point in the future. The legality of this is unclear:

- **Floyd Norris, *New York Times*:** “With such a put in existence, I don’t understand how the banks could get the original loans off their balance sheets. How could they claim they had sold something if they could be forced to buy it back? It will be interesting to see if the Securities and Exchange Commission challenges the accounting.”⁶⁹

This summer, when the subprime market tanked, Citigroup was forced to buy back \$25 billion in CDOs that were suffering dramatic declines in value.

It is unclear which other investment banks also entered into these agreements. According to FT Alphaville, the *Financial Times* blog, Bank of America entered into similar agreements that forced them to buy back \$12 billion in off-balance sheet CDOs.⁷⁰

Structured Investment Vehicles (SIVs)

Structured Investment Vehicles have been constructed in such a way that they can collapse very quickly and infect the balance sheet of the investment bank that set them up. A stagnant market for the SIVs’ short-term asset-backed commercial paper may lead to a “fire sale” of the SIVs’ long term mortgage-backed assets, many of which are subprime-related. Though SIVs are set up to be independent from the investment banks that create them, the investment banks essentially have to stand behind them when they suffer losses, and let these transfer to their balance sheets (much as the profits from these SIVs had been transferred).⁷¹

Hedge fund agreements

Some Wall Street firms have allegedly begun delaying losses by transferring mortgage-backed securities to hedge funds in recent months. *The Wall Street Journal* reported on November 2 that Merrill Lynch was quietly entering into agreements with hedge funds through which they moved billions in mortgage-backed assets off of their books.⁷² In a typical deal, a hedge fund purchased \$1 billion in commercial assets, some of which was backed by mortgages, from Merrill Lynch. The agreements reportedly stipulate that Merrill Lynch will buy back the assets for a minimum price after a period of a year if the hedge fund is unable to unload them. The tactic allows the banks to delay accounting for losses associated with writing down the value of the assets.

Merrill Lynch has denied forging these agreements.

C. THE TREASURY UNITES WITH SEVERAL BANKS TO BAIL OUT SIVs

Though the Treasury Department has no clear plan in place to aid struggling homeowners, it moved very quickly to come to the aid of investment banks with massive exposure to the off-balance sheet SIVs described above.

Treasury-led discussions with Citigroup, JP Morgan, and Banc of America Securities in September and October resulted in the planned creation of a \$80 billion “super SIV” that is intended to stave off fire-sales of SIV mortgage-backed assets by purchasing them from the SIVs. Secretary Henry Paulson’s justification for his intervention – which does not involve putting up financial resources for the fund – was that the fire-sale scenario could send shock waves through the credit markets and the broader economy.⁷³

The plan has been widely criticized as a bailout of Citigroup.⁷⁴ Citigroup’s SIV assets account for 25% of the worldwide SIV total – around \$80 billion. This makes the bank the leading SIV manager in the world, far ahead of most other investment banks, which haven’t developed the same affinity for the off-balance sheet

financial structures. JP Morgan and Banc of America, the other two investment banks developing the super fund, reportedly have no SIVs.

It is also questionable that more re-packaging of subprime assets will make the situation any better. Warren Buffet waxed poetic on this point in an interview with the *Financial Times*:

- **Warren Buffet:** “One of the lessons that investors seem to have to learn over and over again, and will again in the future, is that not only can you not turn a toad into a prince by kissing it, but you cannot turn a toad into a prince by repackaging it. But very imaginative people in the securities market try to do that. If you have bad mortgages they do not come better by repackaging them. To some extent the chickens are coming home to roost for the mortgage originators and securitisers.”⁷⁵

D. WALL STREET SUCCESSFULLY FIGHTS REFORMS OF THE MORTGAGE MARKET

Congressman Barney Frank’s lending law reform bill, HR 3915, recently passed the House. While the bill does institute some needed reforms of the mortgage market, it was the subject of significant criticism from consumer groups for failing to hold Wall Street accountable for loans purchased from predatory lenders. The *New York Times* editorial page also weighed in against any watering-down of the bill before it passed:

- **New York Times editorial:** “The House will vote today on much needed legislation to curtail abusive mortgage lending. Last minute lobbying to weaken the bill is coming from all corners: from brokers who hawked the junk loans, lenders who advanced the cash and Wall Street banks that bought the loans and repackaged them into securities for sale to investors. **Having profited so immensely during the mortgage bubble, they now want to keep the world safe for future financial excesses.**”⁷⁶ [emphasis added]

In the end, Wall Street won out: the bill shies away from implementing significant liability for the Wall Street firms that package predatory loans.⁷⁷

In a 2003 interview with *American Banker*, John Taylor, chief executive of the National Reinvestment Coalition, said “the role that Wall Street plays is the untapped universe on trying to impact predatory lenders. We need to use everything in our power – whether it’s media review, government regulatory oversight, congressional hearings – to take the profit motive in predatory lending out of Wall Street.”⁷⁸

Unfortunately, it appears that this is still the case in 2007.

VI. BIG FIVE BANKS PREPARE FOR RECORD BONUSES DESPITE FAILURES

Though Wall Street bonuses are projected to be somewhat lower overall, bankers at the big five banks will take home even more this year – a combined \$38 billion.

Strong revenues in the first half of the year, combined with Goldman Sachs' record-setting revenues, will lift bonuses at the big five investment banks to a combined \$38 billion this year, \$2 billion more than last year. This is happening despite massive writedowns from four of these banks – Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns. Even the CEOs that have lost their jobs as a result of the subprime meltdown made off with tens of millions in compensation. Traders who worked with subprime-related securities will earn less this year, and Wall Street bonuses are projected to be somewhat lower on average, but all in all, bankers are not taking the subprime hit that investors and homeowners are experiencing.

A. THE TOP FIVE INVESTMENT BANKS WILL PAY OUT A RECORD \$38 BILLION IN BONUSES

Investment banks have yet to announce their bonus payouts yet, and will not cut bonus checks until next year, but *Bloomberg* has estimated that the top five investment banks will pay out \$38 billion in bonuses this year – even more than last year.⁷⁹ This amounts to an average bonus of \$201,500 per employee.

The banks' bonus pools are reportedly large, despite multi-billion dollar losses in the subprime market, because revenues were strong through the first half of 2007, and because Goldman Sachs will make a record payout, even more than the \$16.9 billion in compensation that it paid last year. The top three executives at Goldman are expected to collect a combined \$200 million in bonus money.

Aside from the top five banks, however, bonuses are not expected to reach record levels on Wall Street. Some experts are projecting a 15% drop, while others say bonus levels will be relatively flat.

Bond traders – referred to by one *New York Times* article as the “Kings of Wall Street” over the past six years – will see their bonuses slashed 5-15%.⁸⁰ That may not be the case at Goldman Sachs, however, since traders at the firm reportedly managed to adequately hedge against losses in the subprime sector.

But where bond revenues and bonuses leave off, other revenues and bonuses will pick up. According to estimates from Johnson & Associates, a compensation consulting firm, some bankers will make more:

- **Investment bankers** – those who underwrite offerings and put together mergers and acquisitions – are expected to take home **10-20% more**.⁸¹
- **Equities traders** are expected to take home **5% more**.
- **Equities derivatives traders** are slated to take home **15% more**.

B. CEOs GET AXED, BUT STILL TAKE HOME MILLIONS

CEOs at Merrill Lynch and Citigroup have lost their jobs because of the subprime-related writedowns at those banks, but both are taking home sizable pay packages:

- **Citigroup CEO Chuck Prince** is taking home **\$42 million in stock**, bonus, and other benefits, plus the **\$53 million** in stock that he already held. Prince resigned after board pressure began to build against him due to large writedowns related to subprime mortgage-related securities holdings.⁸²
- **Merrill Lynch CEO Stanley O'Neal** left the firm with a reported **\$161 million** severance package.⁸³ O'Neal was forced to resign after the firm reported an \$8.4 billion subprime-related writedown. O'Neal's replacement, John Thain, will receive an initial pay package of \$50 million.

CONCLUSION

What will the bonus system reward next, if investment banks are not held accountable this time around?

“Two things stand out about the credit crisis cascading through Wall Street: It is both totally shocking and utterly predictable. Shocking, because a pack of the highest-paid executives on the planet, lauded as the best minds in business and backed by cadres of math whizzes and computer geeks, managed to lose tens of billions of dollars on exotic instruments built on the shaky foundation of subprime mortgages. Predictable because whether it's junk bonds or tech stocks or emerging-market debt, Wall Street always rides a wave until it crashes.”⁸⁴

-Fortune, November 12, 2007

The hot sector on Wall Street tends to lift revenues and bonus pools before giving out under its own weight. During the dot com era, top bankers worked in stock trading, underwriting, and research, putting together deals and engaging in trading activities that scored them record bonuses. Their activities eventually resulted in massive class action lawsuits and high profile investigations from New York Attorney General Eliot Spitzer. Certain practices allegedly inflated the value of stocks and ripped off legions of investors, many of whom were middle-class Americans just starting to put their money in the stock market – and encouraged to do so by the star analysts of Wall Street.

The Spitzer investigations led to a \$1.5 billion settlement, but this didn't curb the investment banks' appetite for quick money. Of course, \$1.5 billion is a paltry sum when held up next to the \$36 billion in bonuses that five investment banks handed out last year.

Now, as the subprime market collapses, it is clear that the same pieces were in place this time around: highly-compensated top talent at subprime-related bond desks, several years of skyrocketing revenues and bonuses that were pushed higher by the subprime sector, and alleged improprieties that pushed the market to unsustainable levels. “Dot com” was not a niche business at these investment banks, and neither was “subprime.”

In the wake of this collapse, other sectors will likely pick up and start driving the banks' revenues. What will be the next “hot” Wall Street business segment – the next “dot com” or “subprime” – that drives revenues and bonuses up in future years? Will the market once again be pushed to unsustainable levels, before crashing down on American homeowners, investors, and consumers?

Will Wall Street's investment banks continue to reward short-term greed at the expense of long-term prosperity?

Key Terms

Subprime Mortgages – Subprime mortgages are made to borrowers with impaired or limited credit histories. Subprime loans tend to carry higher interest rates and stiffer terms than prime loans because they are thought to carry more risk for the lender. Subprime loans are not the same as predatory loans. Still, according to the Center for Responsible Lending, “*nearly all abusive mortgage lending occurs in the subprime market.*”

Predatory Lending – This has a much contested definition, and no legal definition in the United States, but it generally refers to lending practices which somehow deceive, coerce, or mislead borrowers in a way that results in high and unnecessary lending costs. Examples of practices include charging excessive fees and steering borrowers towards more expensive loans. Borrowers who are less educated, elderly, low-income, or racial minorities are frequently, but not exclusively, targets of predatory lenders.

Investment bank – A bank which issues securities on behalf of companies and governments in order to help them raise money from the secondary market.

Subprime Mortgage Originator/Lender – Typically an independent (and largely unregulated) lender that does not take deposits, but rather raises money through the secondary market in order to make subprime loans (see above). These lenders pay mortgage brokers fees for the loans that they sign up homeowners for.

Adjustable Rate Mortgage (ARM) – Mortgages that carry interest rates that periodically adjust to an index.

Hybrid ARMs – ARMs with fixed teaser rates (~7%) for two years that then reset to a higher adjustable rate (~14-17%). These mortgages account for many of the foreclosures happening now, as many loans reset to high rates.

Fixed Income – This refers to any investment which yields a regular return. It is typically called a **bond**.

Mortgage-backed security (MBS) – A security, or bond, that is backed by the payments from a pool of mortgages.

Securitization – This process has produced much of the growth in the bond market over the past ten years. In securitizations, assets such as mortgages and student loans are pooled together in Special Purpose Entities (SPEs) that are bankruptcy-remote and stripped of much of the credit and legal risk associated with the assets. These entities issue securities to investors, who then receive monthly payments from the assets in the pool. Investment banks play a key role in these securitizations, structuring them, performing due diligence on the underlying assets, and selling them to investors.

Asset-backed securities (ABS) – These securities are backed by proceeds from credit card, student loan, home equity loan, home equity line of credit, and subprime mortgage assets. Confusingly enough, subprime mortgage-related debt is typically included in ABS rather than MBS. Subprime mortgage-related securities were key drivers of growth in this category over the past six years. CDOs and other structured financial products are typically included in this category.

Structured finance – This definition varies somewhat, but it typically refers to a set of complex bonds backed by payments from pooled assets, such as credit card debt and student loans, but most often mortgages (products of the securitization process described above). Investment banks slice and dice these securities offerings into segments called “tranches” that carry varying levels of risk based on the nature of the underlying asset or security, and are intended to appeal to different types of investors (ranging from hedge funds to pension funds). A full review of the various kinds of structured financial products is beyond the scope of this report, though collateralized debt obligations (CDOs) are the most widespread products.

Collateralized Debt Obligation (CDO) – A structured financial product, often backed by pools of mortgages, which is typically sliced into “tranches” with varying ratings and levels of risk. It is structured so that investors in high-risk, lower-rated tranches are the first to lose their shirts in the event of defaults on assets in the pools. Lately, CDOs have been causing the multi-billion dollar writedowns at the banks, as higher-rated tranches are facing much higher losses than expected.

Structured Investment Vehicle (SIV) -- A banking entity set up by an investment bank which borrows short term money by issuing commercial paper and then uses this money to invest in long-term debt, typically mortgage-backed securities, which produces a higher yield. The bank makes money on the spread between short-term and long-term interest rates. These entities have resulted in trouble for Citigroup, which controlled fully a quarter of the global SIV sector. These SIVs are heavily invested in under-performing mortgage assets.

Bonus Pool – Though investment banks cut regular paychecks for employees, they also set aside money each quarter for the year-end bonus pool. This is accounted for in SEC filings under “Compensation and Benefits,” but these amounts are not typically calculated until October or November, announced in December, and the checks (and stocks options) are not paid out until January or February.

Organizations

National Training and Information Center (NTIC) is a 35 year-old network of community organizations that is dedicated to community organizing as a means of creating a more just and equitable society. NTIC is made up of 22 affiliate organizations in 10 states and works with 50 additional allied organizations from across the country. NTIC is most famous for leading the 1976 passage of the Community Reinvestment Act, a piece of landmark policy that has resulted in over \$3 trillion worth of home loans being made in low-income neighborhoods.

The *Save the American Dream* campaign is a national anti-foreclosure campaign recently launched by NTIC. More at savetheamericandream.org.

Northwest Bronx Community and Clergy Coalition (NWBCCC) is a thirty-three year old broad-based, membership driven, social justice community organization. The members of the Coalition seek social, economic, environmental, and racial justice for our families, our communities, and ourselves. We do this through community organizing that utilizes non-violent confrontation, negotiation, and principled compromise. See northwestbronx.org for more information.

People United for Sustainable Housing, Buffalo (PUSH-Buffalo) is a grassroots, non-profit community organization working to rebuild the West Side of Buffalo. PUSH organizes residents to confront institutions that perpetuate poverty on the West Side and to create and implement an action plan for improving the neighborhood. See pushbuffalo.org for more information.

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- 2 Serena Ng and Carrick Mollenkamp, "Pioneer of CDOs Helped Move Merrill Deeply Into Business," *Wall Street Journal*, October 26, 2007.
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- 21 There is a spillover effect in the Wall Street bonus system: inflated revenues in specific divisions also lift

bonuses for bankers in divisions that aren't producing proportionate revenues, as well as those in the executive suite who don't work in specific business segments. This is true to the extent that *eFinancial News* reported in 2002 that bond traders in UK found themselves in a dilemma – they had reaped record revenues through three quarters, but if they took risks over the next quarter their revenues would probably just end up padding the bonuses of bankers in divisions that were less profitable. Why take the risk, when they had already made so much money. “Ian Kerr’s Personal View,” *eFinancial News*, August 30, 2002.

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- 28 New Century Financial 2006 SEC 10-K, page 3, accessed at SEC Edgar: <http://www.sec.gov/Archives/edgar/data/1287286/000089256906000258/a18540e10vk.htm>.
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