The Reckoning

# How the Thundering Herd Faltered and Fell

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

### The Reckoning

*Doubling Down*

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Merrill Lynch, via Bloomberg News, left; David Karp/Bloomberg News, right

Ahmass Fakahany, left, and Osman Semerci, center, worked under E. Stanley O’Neal to expand Merrill’s investments related to mortgages. Such investments led to a $7.9 billion write-down a year ago, and Mr. O’Neal was forced out.

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Richard Sheinwald/Bloomberg News, left; Douglas Fry/Cazenove Group, via Bloomberg News

In 1997, J. P. Morgan bankers like Blythe Masters, left, and William Winters served on a small team that pioneered synthetic C.D.O.’s.

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Susan Farley for The New York Times

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

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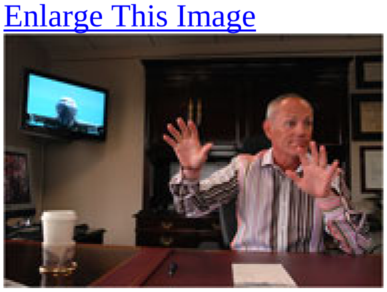

Axel Koester for The New York Times

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

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

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

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

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

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

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

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

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

While questionable mortgages made to risky borrowers prompted the credit crisis, regulators and investors who continue to pick through the wreckage are finding that exotic products known as derivatives — like those that Merrill used — transformed a financial brush fire into a conflagration.

As subprime lenders began toppling after record waves of homeowners defaulted on their mortgages, Merrill was left with $71 billion of eroding mortgage exotica on its books and billions in losses.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Although Merrill had a scant presence in the C.D.O. market in 2002, four years later it was the world’s biggest underwriter of the products.

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

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

The number of mortgage-related C.D.O.’s being produced across Wall Street was staggering, and all of that activity represented a gamble that mortgages underwritten during the most manic lending boom ever would pay off.

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

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

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

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

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

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

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

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

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

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

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

billion on its C.D.O.'s. Through October, some $260 billion of asset-backed C.D.O.'s have started to default.

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

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

The following Monday, Merrill — torn apart by its C.D.O. venture — was taken over by Bank of America.

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