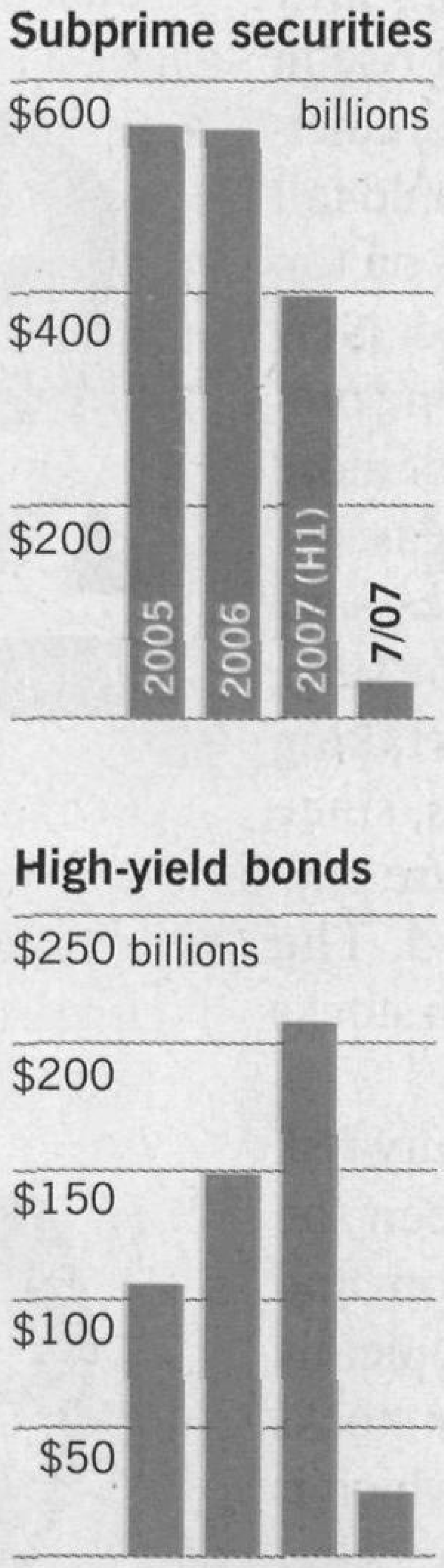
margin. That enabled them to give their clients—endowments, pension funds, wealthy individuals—supercharged returns of 20% or more. And guess who loaned those hedge funds the money to buy the loans on margin: the prime brokerage arms of the same investment banks that underwrote them. Caution vanished. The Wall Street money machine was in overdrive.

THE FED tried to put on the brakes, raising short-term interest rates from a record low 1% in 2003 to 5.25% by mid-2006. Central banks from the European Central Bank to the Reserve Bank of Australia followed suit.

The rate hikes threatened to put a serious dent in Wall Street's profits. For one thing, higher mortgage costs finally began to have an impact on home sales, which meant that the investment banks faced a sharp dropoff in home loans to underwrite. And higher rates were likely to dampen the LBO business as well. But the investment banks found a way to keep business rolling. They loosened their credit standards, agreeing to purchase far-lower-quality loans.

The effects were dramatic. Knowing that Wall Street stood ready to buy up almost any kind of mortgage, lenders started ladling out cash to homebuyers with poor credit histories who had very little hope of paying it back. In 2005 and 2006 the volume of subprime mortgages exploded. The loans often included seductive features such as teaser rates that doubled or tripled after a year or two, or low monthly payments that didn't cover the full interest charge (the unpaid interest would be added to an ever-rising loan balance). Lenders also increasingly allowed homebuyers to borrow money for the down payment with so-called piggyback loans. The aggressive practices helped create a new, high-risk stratum of homeowners who

Issuance of risky bonds has slowed sharply.



SOURCE: MOODY'S ECONOMY.COM

simply couldn't afford their houses and were bound to default in large numbers. Sooner rather than later, as it turned out.

The players in LBO financing followed the same script. The deals became riskier and riskier as the KKRs and Blackstones bought bigger companies, sometimes after bidding wars that ratcheted up the prices, and piled on debt to cover the cost. Earlier this year KKR agreed to pay $26 billion for credit card processor First Data, borrowing $19 billion to finance the deal. Once the deal closes, interest payments will eat up almost all of the company's cash flow, leaving little margin for error.

Here again, instead of slowing the flow of money—as would have been prudent—Wall Street relaxed the rules. Companies were regularly granted "covenant-lite" loans that waived the formerly ironclad requirement that they maintain a specified ratio of cash flow to interest payments, ensuring an adequate cushion against an industry downturn, say, or a recession. Companies like Univision and Freescale Semiconductor even have the option of making interest payments in the form of bonds, a feature resembling those mortgages where homeowners pile on more debt in lieu of paying interest.

Lowering standards worked beautifully—at least for a while. By 2006 investment banks were collecting almost $6 billion from underwriting mortgages and other loans, 60% more than in 2003. In the first half of 2007, revenues were running at an even faster pace.

Investors never balked at buying the dubious paper Wall Street churned out. Incredibly, even as the world got markedly riskier, risk premiums got narrower. Between late 2005 and May 2007 the spread between junk bonds and Treasuries dropped from 3.8 points to a 20-year low of 2.6 points.

Party on, dudes!

THE END seemed to come suddenly, but there had been plenty of warning signs. One banker describes how he and his colleagues were caught off-guard. "We're not dumb—we knew it would happen sometime," he says. "But not in August and not this swiftly. Plus, subprime? We thought we'd dodged that bullet." Indeed, defaults and delinquencies on subprime mortgages began rising in mid-2006. The markets shrugged off the news. In February of this year, HSBC reported a loss of $1.8 billion on its portfolio of subprime loans. Rates on mortgage-backed securities rose, small lenders went under, but still the stock and bond markets barely noticed.

In June investors got an even clearer signal of trouble ahead. Bear Stearns announced problems at two of its hedge funds that would cascade into losses of $1.4 billion of their investors' money. Yields on every form of debt started to shoot skyward. Yet even then, stock investors continued to hope that the crisis would pass. In mid-July, two days after the Bear Stearns announcement, the Dow Jones industrial average hit an all-time high, topping 14,000 for the first time.

WALL STREET FOUND A SIMPLE WAY TO KEEP THE MONEY MACHINE MOVING: LOWER LENDING STANDARDS.

The pace of bad news picked up. The German government had to bail out a bank; BNP Paribas suspended activity at three funds holding asset-backed securities; American Home Mortgage shut down. Stock prices finally began to tumble, with the Dow dropping below 13,000 by Aug. 15. Risk was back, with a vengeance.

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