value. Dozens of smaller companies in the mortgage business have suffered huge losses or folded completely.

The crisis of confidence has exploded beyond Wall Street, driving the dollar to record lows—and helping send the prices of commodities, especially oil, soaring to historic highs. The results could be devastating for the U.S. economy. "The subprime crisis and its fallout on commodity and foreign-exchange markets significantly raises the odds of a recession early next year," says Mark Zandi, chief economist at Moody's Economy.com.

And it's far from over. As stunning as today's losses are, more carnage lies ahead. Wall Street banks are holding tens of billions in risky securities on their books, and no one seems to have any idea what they're worth. In conference calls and press releases, banks have been changing their estimates of the value of these assets. Merrill Lynch, for example, predicted a $4.5 billion subprime loss for the third quarter, then jolted investors and analysts three weeks later by announcing that its real deficit was $7.9 billion—or 76% more than the initial estimate. (Oops!) In fact, Wall Street banks are sitting on rotting piles of highly suspect, thinly traded securities no one wants to touch. "Whenever the market turns against you, you take the biggest losses in illiquid securities," says Richard Bookstaber, former head of risk management at Salomon Bros. "Because there are so few buyers, you're forced to sell at a discount that is both huge and highly unpredictable."

What really spooks investors is the fog surrounding the future. One problem is that they can't trust management's estimates of future losses. Citi, for example, says it will take additional write-downs of $8 billion to $11 billion in the fourth quarter. But it's impossible to know whether those numbers have any relation to reality. Presumably, they are based on a theoretical model, but such models have proved highly unreliable. When Citi actually brings the securities to market, it may have to slash their prices to unload them, forcing it to take a much bigger write-down. The banks are also far from forthcoming with detailed information on their positions, making it difficult for analysts to assess what the future holds. "The risk to investors is far greater because we're getting so little information," says Michael Mayo, an analyst at Deutsche Bank.

Backed by Treasury Secretary Henry Paulson, Bank of America, Citi, and J.P. Morgan are trying to establish a giant fund that would buy distressed debt so that investors who own it don't have to unload it at fire-sale prices. The hope is that the market will rebound before too long and that the bonds will regain much of their value. But there's no guarantee that the bonds will ever bounce back, and the bailout fund may simply delay the day of reckoning, pushing losses further into the future.

Just how big could those losses be? Both Mayo and analyst Meredith Whitney of CIBC project that write-downs could total $50 billion or more by the end of the year. Longer term, Mayo sees losses climbing to $70 to $100 billion. The wide range simply underscores the uncertainty surrounding subprime. "This will take two to three years to play out," says Mayo, explaining that it will take that long for lenders to foreclose on troubled mortgages and sell the collateral—in this case, hundreds of thousands of homes—to recoup part of their loans.

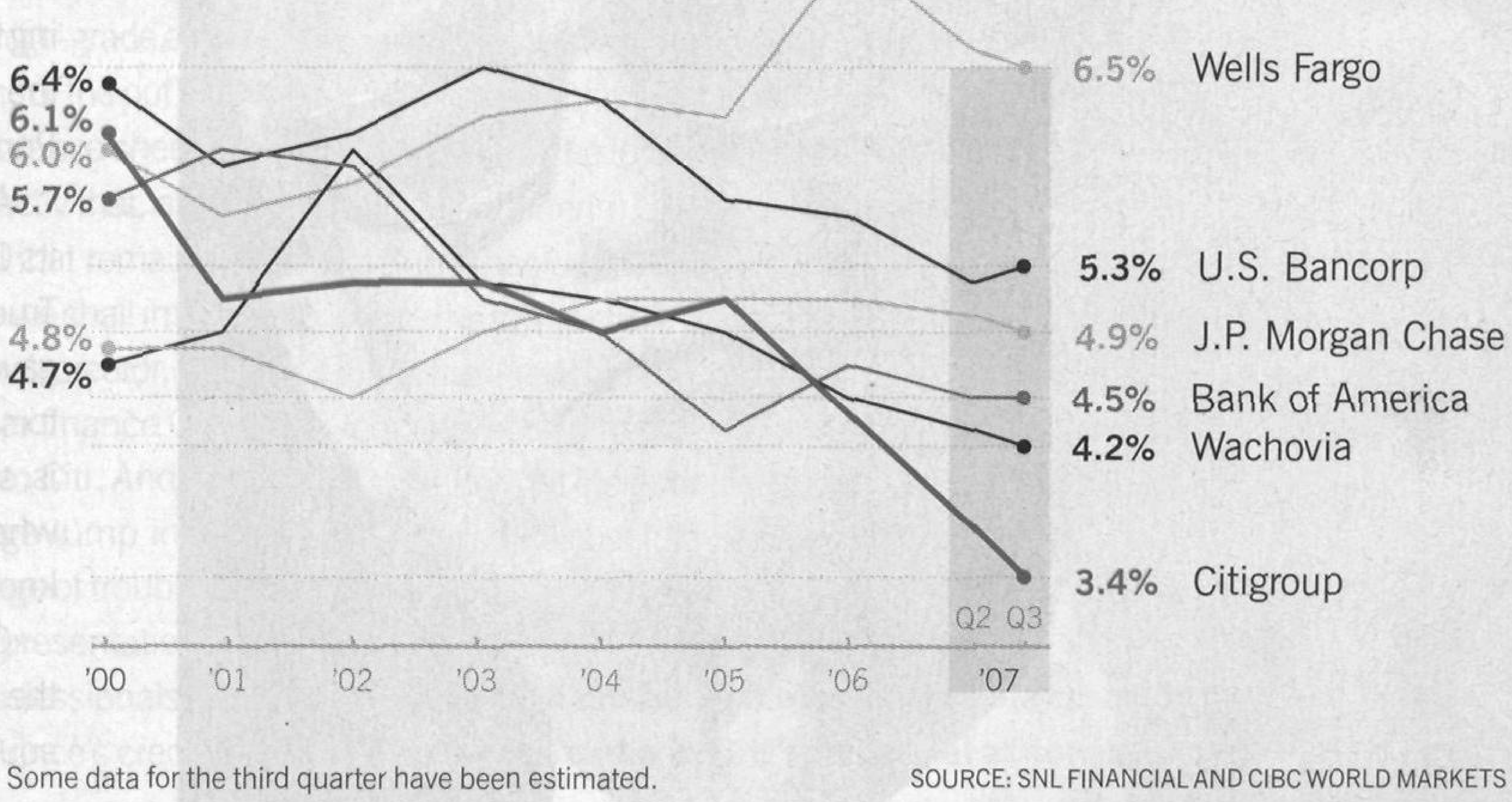
In this special report, we take a broad tour of the financial wreckage, featuring a close look at Citigroup and comments on the plunging dollar, the echoes of Enron, and CEO accountability. Here, we'll try to dispel the biggest mystery of the subprime crisis: How did the Wall Street firms manage to pile mountains of high-risk mortgage debt, bonds that most investors and analysts thought the firms were selling to their customers, onto their own books? Their gambit amounted to massive speculation in subprime mortgages. Investors are justly aghast that Wall Street ignored the obvious pitfalls. We'll explain how it happened by examining one of the firms deepest in the subprime swamp, Merrill Lynch. Presumably, many other banks followed similar

For Citi, a Case of TOO LITTLE CAPITAL

TAKING A PIERCING LOOK at Citigroup's swooning capital ratio, as shown on this chart, CIBC analyst Meredith Whitney (right) caused a commotion on Oct. 31 by questioning whether a shortage of capital might force Citi to cut its dividend next year. Citi shot back that the dividend was safe. But Whitney's red flag caused the banking crowd to remember 1990, when a capital-strapped Citi, then headed by John Reed, reduced its dividend by more than 40%.

BLOOMBERG NEWS

Ratio of Tangible Equity to Tangible Assets



Some data for the third quarter have been estimated.

SOURCE: SNL FINANCIAL AND CIBC WORLD MARKETS