The NYSE: This crisis is far more complex than the dot-com collapse or the '70s oil slump

STOCKS: FISHING FOR THE BOTTOM

Bear markets and their subsequent recoveries rarely have a clear V shape, and this one is trickier than usual

By Peter Carbonara

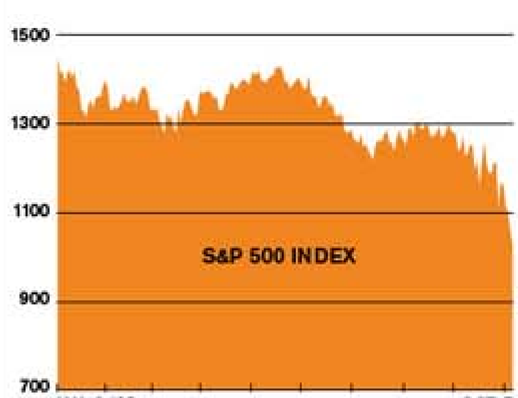
Since the stock market entered bear territory in July, market strategists have been looking for signs of "capitulation"—the cathartic sell-off, the big washout that sets the stage for a stock market recovery, however tentative. On Oct. 7, after Monday's brutal selling, economist and strategist Edward Yardeni spoke for a lot of people when he wrote in a note to clients: "I'm not sure, but that sure seemed like capitulation yesterday."

Yet clean inflection points, when stock prices make a decisive turn up, are devilishly tough to spot. In prior downturns there have been moments when prices plunged to what looked like a market bottom from which they could start climbing again, only to move sideways or falter. In the spring and summer of 2001 the Standard & Poor's 500-stock index seemed to recover from the dot-com collapse of the previous year, only to turn down in late summer, even before September 11.

Back in October 1974, prices plunged, rallied, and then fell again in December. In contrast, the crash of October 1987 was followed by a clear and quick recovery. But that abrupt drop was widely attributed to the effects of automated selling and wasn't long enough to qualify as a bear market.

As for the recent wave of panic selling, Barry Ritholtz, director of equity research at Fusion IQ, a New York financial research firm, says that while we may be at a nadir, he doubts it. "The bottom will have come when people say: 'Screw equities,'" Ritholtz says. He adds that the crisis now weighing on the market—an epic deleveraging wave, a broken financial system, and an historic housing bust—is far more complex and fast-moving than either the dot-com collapse or the oil shock recession of the early 1970s. So previous bear markets may not be of much guidance this time around.

ONE SCARY SLIDE



Data: Bloomberg Financial Markets

DOING THE MATH

That's not to say a bounce-back of sorts isn't conceivable. Fritz Meyer, senior market strategist for mutual fund giant Invesco Aim, says a number of metrics he keeps his eye on—including the number of new lows on the New York Stock Exchange and the Chicago Board Options Exchange's Volatility Index (the so-called fear index)—tell him that market pessimism has gone too far.

Meyer thinks U.S. equities are at or near a bottom, pointing out that most bear markets stabilize at a level roughly 30% below the market's previous high, which is about where the Dow and the S&P are now. He also notes that over 15-year periods, equities produce average annual returns in the double digits. "The stock market has this extraordinary ability to revert to a mean return of about 10%" he says.

Trouble is, the Dow Jones industrial average is now about where it was 10 years ago. So stock market returns would have to be stupendous over the next five years to produce double-digit average returns. | BW |

RICHARD DREW/AP PHOTO

A MONEY MYSTERY AT LEHMAN

A fight is brewing over billions of dollars in collateral —which the firm may have used in other deals

By Matthew Goldstein and David Henry

In 2003, legendary investor Warren E. Buffett called derivatives "weapons of mass destruction." Buffett predicted that the complex financial instruments would morph, mutate, and multiply "until some event makes their toxicity clear." The failure of Lehman Brothers may have been the disaster he imagined.

How lethal was the investment bank's derivatives portfolio? Just look at the long line of banks, hedge funds, and other big investors trying to get their money back. Lehman's bankruptcy threw into jeopardy derivative deals with a staggering 8,000 different firms that had paid Lehman billions of dollars in collateral. Now some trading partners are calling on state and federal courts to reclaim their assets, which have been frozen since the Sept. 15 bankruptcy filing. It will be a "very awesome task to try to unwind all of that," says Lehman's lead bankruptcy attorney, Harvey R. Miller, a partner at Weil, Gotshal & Manges.

It turns out that Lehman, like other big dealers, was running a perfectly legal but highly risky game moving money from firm to firm. It used the collateral from one trading partner to fund more deals with other firms. The same $100 million collected in one deal can be used for many other transactions. "Firms basically can use [the money] as their own collateral for anything they want," says Kenneth Kettering, a former derivatives lawyer and currently a professor at New York Law School. But when the contracts terminate as the result of bankruptcy, the extra collateral is supposed to be returned.

Lehman's travails are only adding to the worries shaking the financial system. Not only has Lehman's debacle snagged the portfolios of such big traders as hedge fund firm Harbinger Capital Partners—it has also helped push global short-term lending markets into a deep freeze. It's enough to make some market watchers wonder if Lehman was too big for the U.S. Treasury and Federal Reserve to let fail.

Derivatives contracts—whose value is tied to the performance of an underlying security or benchmark over a specific period—are designed in part to help firms minimize losses from interest rate fluctuations, corporate bond defaults, and other events. The contracts were a big business for Lehman: When the firm went under in September, roughly 1 million derivative deals had its name on them.

WELSHING ON DEALS

As part of those transactions, buyers had put up collateral in the event of losses. But weeks after Lehman's demise, large sums of leftover collateral have yet to be returned to the trading partners. Bank of America executives tried several times to persuade Lehman officials via e-mail and phone calls to fork over funds, according to a suit. But BofA was rebuffed. In one e-mail exchange, a Lehman employee wrote to BofA: "All activity has been suspended until further notice."

8,000

The number of firms that made derivative deals with Lehman

Data: Weil, Gotshal & Manges

(ABOVE) ILLUSTRATION BY JOHN MALLOY

Nasreen Bulos, a lawyer for one of Dubai's sovereign wealth funds, got the same chilly response. The Global Strategic Equities Fund of Dubai, part of the gulf state's $12 billion investment portfolio, gave Lehman $40 million in June as part of a deal pegged to energy giant BP's stock. According to an affidavit, Bulos started contacting Lehman on Sept. 15 to get back $27 million in collateral. Four days later, Lehman told Bulos it would not honor the request or

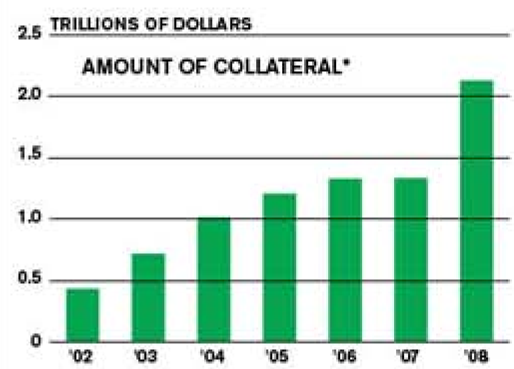
say anything further on the matter.

Both BofA and the Dubai fund have filed suit against Lehman. They're not alone. Some two dozen Goldman Sachs hedge funds say in a suit that Lehman owes them "hundreds of millions of dollars." Others trying to get their collateral back in court: ING, Schroders, Federal Home Loan Bank of Atlanta, the Federal Home Loan Bank of Pittsburgh, and oilman T. Boone Pickens.

Where all that money ended up is a mystery. After Lehman used the collateral for its own deals with other firms, they could have used the money for their own purposes. The International Swaps & Derivatives Assn. (ISDA) estimates that investment shops have collected nearly $2 trillion in collateral as part of derivatives agreements—money that in some cases is used several times over. That's up from

IN JEOPARDY?

As the derivatives markets have grown, firms have put up more collateral for their deals



*Estimated

Data: International Swaps and Derivatives Assn.

Buffett called derivatives "weapons of mass destruction" back in 2003

$700 billion in 2003, the year Buffett made his prescient prediction. "This has been standard practice for many years, and it is very helpful in contributing to the efficiency of the collateral market," says Richard Metcalfe, ISDA's global head of policy.

In rare cases dealers agree to cordon off the collateral—but even that doesn't mean the money is safe. The Federal Home Loan Bank of Pittsburgh, a government lender to small and community banks, appears to have paid extra to keep its collateral in a segregated account, a precautionary measure designed to avoid this kind of mess. Now it's worried the money may have been lumped in with the Lehman assets sold to British bank Barclays.

Free-flowing, promiscuous money from derivatives helped spur the credit boom to new heights. By using their customers' collateral as their own collateral, Lehman and other firms could borrow more money, using the proceeds to buy the kind of high-risk securities that are now imploding. "It was one way for the leverage bubble to grow," says Christian Johnson, a law professor at the University of Utah.

In theory, Lehman's bankruptcy shouldn't have caused such a stir. When a party goes belly up, derivatives contracts are designed to end immediately and get settled outside of court proceedings. But problems can arise when the amount of collateral exceeds the value of the agreements, which can deteriorate over time.

THE MISSING MONEY

Many of the firms now filing claims against Lehman face just that situation. For instance, the Federal Home Loan Bank of Atlanta had a longstanding derivative deal with Lehman to protect against interest rate changes. When Lehman collapsed, the Atlanta bank's agreements were worth $757 million. But it had put up $936 million as collateral. According to court documents, Lehman ignored management's demands to return the extra $179 million.

There's speculation that JPMorgan Chase, Lehman's primary clearinghouse for trades, may have its hands on some of that money. Lawsuits filed by BofA and others allege that Lehman socked away their collateral in accounts at JPMorgan. After the bankruptcy, JPMorgan grabbed $13 billion that Lehman had pledged as guarantees. BofA and others are wondering whether some of that money is rightfully theirs. JPMorgan declined to comment.

It could take a while to hash this out, since the bankruptcy court has never had such a disaster on its docket. Derivatives disputes, at a judge's behest, could end up in mediation. It happened in Enron's bankruptcy back in 2001. But untangling Lehman's web could prove more tedious. The failed energy giant, then considered a big player in derivatives, had contracts worth about $22 billion. Lehman's tally as of its last annual report: $738 billion. |BW|

(RIGHT) PHOTOGRAPH BY DENNIS VAN TINE/ ATLASPRESS

THEY WARNED US

THE WATCHDOGS WHO SAW THE SUBPRIME DISASTER COMING—AND HOW THEY WERE THWARTED BY THE BANKS AND WASHINGTON

By Robert Berner and Brian Grow | Photography by Ethan Hill

More than five years ago, in April 2003, the attorneys general of two small states traveled to Washington with a stern warning for the nation's top bank regulator. Sitting in the spacious Office of the Comptroller of the Currency, with its panoramic view of the capital, the AGs from North Carolina and Iowa said lenders were pushing increasingly risky mortgages. Their host, John D. Hawke Jr., expressed skepticism.

Roy Cooper of North Carolina and Tom Miller of Iowa headed a committee of state officials concerned about new forms of "predatory" lending. They urged Hawke to give states more latitude to limit exorbitant interest rates and fine-print fees. "People out there are struggling with oppressive loans," Cooper recalls saying.

Hawke, a veteran banking industry lawyer appointed to head the OCC by President Bill Clinton in 1998, wouldn't budge. He said he would reinforce federal policies that hindered states from reining in lenders. The AGs left the tense hour-long meeting realizing that Washington had become a foe in the nascent fight against reckless real estate finance. The OCC "took 50 sheriffs off the job during the time the mortgage lending industry was becoming the Wild West," Cooper says.

This was but one of many instances of state posses sounding early alarms about the irresponsible lending at the heart of the current financial crisis. Federal officials brushed aside their concerns. The OCC and its sister agency, the Office of Thrift Supervision (OTS), instead sided with lenders. The beneficiaries ranged from now-defunct subprime factories, such as First Franklin Financial, to a savings and loan owned by Lehman Brothers, the collapsed investment bank.

Some states, including North Carolina and Georgia, passed laws aimed at deterring rash loans only to have federal authorities undercut them. In Iowa and other states, mortgage mills arranged to be acquired by nationally regulated banks and in the process fended off more-assertive state supervision. In Ohio the story took a different twist: State lawmakers acting at the behest of lenders squelched an attempt by the Cleveland City Council to slow the subprime frenzy.

A number of factors contributed to the mortgage disas-

> **FEDERAL AUTHORITIES "TOOK 50 SHERIFFS OFF THE JOB [WHEN] THE MORTGAGE LENDING INDUSTRY WAS BECOMING THE WILD WEST."** ROY COOPER, NORTH CAROLINA AG

ter and credit crunch. Interest rate cuts and unprecedented foreign capital infusions fueled thoughtless lending on Main Street and arrogant gambling on Wall Street. The trading of esoteric derivatives amplified risks it was supposed to mute.

One cause, though, has been largely overlooked: the stifling of prescient state enforcers and legislators who tried to contain the greed and foolishness. They were thwarted in many cases by Washington officials hostile to regulation and a financial industry adept at exploiting this ideology.

The Bush Administration and many banks clung to what is known as "preemption." It is a legal doctrine that can be invoked in court and at the rulemaking table to assert that, when federal and state authority over business conflict, the feds prevail—even if it means little or no regulation.

"FUNDAMENTAL DISAGREEMENT"

"There is no question that preemption was a significant contributor to the subprime meltdown," says Kathleen E. Keest, a former assistant attorney general in Iowa who now works for the Center for Responsible Lending, a nonprofit in Durham, N.C. "It pushed aside state laws and state law enforcement that would have sent the message that there were still standards in place, and it was a big part of the message to the industry that it could regulate itself without rules."

"That's bull----," says Hawke, the former comptroller. He returned to private law practice in late 2004 with the prominent Washington firm Arnold & Porter. Once again representing lenders as clients, he confirms the substance and tone of the April 2003 meeting with the state AGs, saying they "simply had a fundamental disagreement." But he denies that federal preemption played a role in the subprime debacle.

Hawke blames much of the mess on mortgage brokers and originators who, he says, were the responsibility of states. "I can understand why state AGs would try to offload some responsibility here," he adds. "It's important to remember when people are trying to assign blame here that the courts uniformly upheld our position."

His arguments have some merit. The federal judiciary has bolstered preemption in the name of uniform national rules, not just for banks but also for manufacturers of drugs and consumer products. And state oversight alone is no panacea, as the chaotic state-regulated insurance market illustrates. Inadequate supervision of mortgage companies in some states contributed to the subprime explosion. But the hands-off signals sent from Washington only invited complacency. When some state officials fired warning flares, the Administration doused them.

Consider a clash in 2004 between the OCC and regulators in Michigan. In January of that year attorneys working for Hawke filed a brief in federal court in Grand Rapids on behalf of Wachovia, the national bank with $800 billion in assets based in Charlotte, N.C. Michigan wanted to continue to examine a Wachovia-controlled mortgage unit in the state, which the bank had converted to a wholly owned subsidiary. The parent bank sued, claiming Michigan could no longer look at the mortgage lender's books. Citing the threat of unspecified "hostile state interests," the OCC argued in its brief that "states are not at liberty to obstruct, impair, or condition the exercise of national bank powers, including those powers exercised through an operating subsidiary."

Michigan countered that Wachovia Mortgage was not itself a national bank. The Constitution preserves state authority to protect its residents when federal statutes don't explicitly bar such regulation, Michigan contended. Ken Ross, the state's top financial regulator, says his department fought Wachovia all the way to the U.S. Supreme Court in part because it feared a growing subprime mortgage problem: "We knew there needed to be [state] regulation in place or there could be gaps." The OCC, he adds, "did not have robust regulatory provisions over these operating subsidiaries."

The nation's highest court sided with the Bush Administration, ruling in April 2007 that the OCC had exclusive authority over Wachovia Mortgage. Justice Ruth Bader Ginsburg, writing for a five-member majority, pointed to the potential burdens on mortgage lending if there were "duplicative state examination, supervision, and regulation." In a dissenting opinion, Justice John Paul Stevens said that it is "especially troubling that the court so blithely preempts Michigan laws designed to protect consumers."

By the time of the Supreme Court decision last year, Wachovia and its mortgage operations in Michigan and elsewhere were feeling the ill effects of unwise lending. As real estate prices continued to fall this year, pushing many borrowers into default, Wachovia teetered on the edge of failure.

HOW "PREEMPTION" WORKS

Federal courts often rule that when federal and state regulation conflict, federal rules prevail. Here's how the mortgage industry has taken advantage of the preemption doctrine:

IN THE COURT

Banks argue that tough state enforcement is preempted. Federal regulators sometimes weigh in with briefs backing the industry.

IN THE LEGISLATURE

Banks encourage the U.S. Office of the Comptroller of the Currency and other federal regulators to lobby against restrictive state legislation.

IN THE MARKETPLACE

State-chartered mortgage firms sell themselves to national banks and then declare they are shielded from state oversight.

Data: *BusinessWeek* research

The OCC brought 495 enforcement actions against national banks from 2000 through 2006. Thirteen of those actions were consumer-related. Only one involved subprime mortgage lending. OCC spokesman Robert Garsson says the figures could be misinterpreted because the agency addresses many problems informally during bank examinations. He declined to provide any examples.

Beyond the influence of free-market theory, turf concerns have reinforced the Administration's determination to exercise responsibility for as many lenders as possible—and prevent state incursions, notes Arthur E. Wilmarth Jr., a professor at George Washington University Law School. Almost all of the funding for the OCC and OTS comes from fees paid by nationally chartered institutions.

GEORGIA FIGHT

Hawke says the OCC seeks only to exercise powers that it has long held under federal law. It is far more efficient for national banks to deal with one set of federal rules than a hodgepodge of state directives, he argues, echoing the Supreme Court's majority view. By the late 1990s, he adds, more state legislatures and AGs were trying to bully national banks by, for example, restricting ATM fees charged to nondepositors. State officials "found it politically advantageous to assert these kinds of initiatives," he says. The OCC's heightened preemption campaign "was occasioned by the fact the states were becoming more aggressive."

The current head of the OCC, John C. Dugan, concurs. "To claim that it is our fault from preemption is just a total smokescreen to shield the fact that the state mortgage brokers and mortgage companies were just not regulated," Dugan says.

Efforts in Georgia to rein in unwise lending provoked a particularly fierce federal reaction. In 2002 the state passed a law that imposed "assignee liability" on the mortgage-finance process. Understanding the significance of this requires a little background.

"IT'S IMPORTANT TO REMEMBER WHEN...TRYING TO ASSIGN BLAME HERE THAT THE COURTS UNIFORMLY UPHELD OUR POSITION." FORMER OCC CHIEF JOHN HAWKE

One of the forces that accelerated the proliferation of dangerous home loans was the Wall Street business of buying up millions of mortgages, bundling them into bonds, and selling the securities to pension funds and other investors. Securitization, which grew to a $7 trillion industry, meant the lenders could pass along the risk of default to a huge universe of investors. Many of those investors, in turn, relied uncritically on reassurances from fee-collecting investment banks and ratings agencies that mortgage-backed securities were high-quality. When many of the reassurances proved hollow, the securitization market collapsed this year.

Assignee liability would radically reshape that market by making everyone involved potentially responsible when things go bad. Investment banks that created mortgage-backed securities and investors who bought them would be liable for financial damage if mortgages turned out to be fraudulent. The

In late September the federal government stepped in to arrange a fire sale. Wachovia now may be carved up between Citigroup and Wells Fargo.

Confrontations such as Michigan's battle with Wachovia became far more common after George W. Bush took over the White House in 2001 and instituted a broad deregulatory agenda. The OCC, an arm of the Treasury Dept., has adhered closely to it. The agency oversees more than 1,700 federally chartered banks, controlling two-thirds of all U.S. commercial bank assets. Historically, its examiners have monitored bank capital levels and lending to corporations more attentively than they have the treatment of individual borrowers. "Consumer protection has always been an orphan [among federal bank regulators]," says Adam J. Levitin, a commercial law scholar at Georgetown University Law Center.

financial industry opposed assignee liability, maintaining that it would cripple the market for asset-backed securities. Major ratings agencies later agreed that allowing unlimited damages would be disruptive. The agencies threatened to stop evaluating many bonds tied to mortgages covered by the Georgia law.

But some banking experts speculate that if Georgia's example had spurred more states to adopt broad assignee liability, greater caution would have prevailed in the mortgage-securities market, possibly preventing the blowups of Lehman, Bear Stearns, and other once-mighty institutions. "If the Georgia law had held, it is possible that other states would have followed and there might have been change earlier," says Ellen Seidman, who headed the OTS from 1997 through 2001.

"OUTGUNNED" ADVOCATES

Roy Barnes, Georgia's governor in 2002, understood the potential significance of assignee liability when he signed the state's new Fair Lending Act that year. He recalls a breakfast meeting with banking lobbyists during which he admonished the industry to clean up reckless lending. He jokingly threatened to hire "the longest-haired, sandal-wearing bank commissioner you ever saw." But the bankers fought back, seeking to undermine the new law.

The OCC's Hawke assisted the industry by issuing a ruling in July 2003 saying the Georgia law did not apply to national banks or their subsidiaries. A fact sheet prepared at the time—and still available on the OCC's Web site—says: "There is no evidence of predatory lending by national banks or their operating subsidiaries, in Georgia or elsewhere."

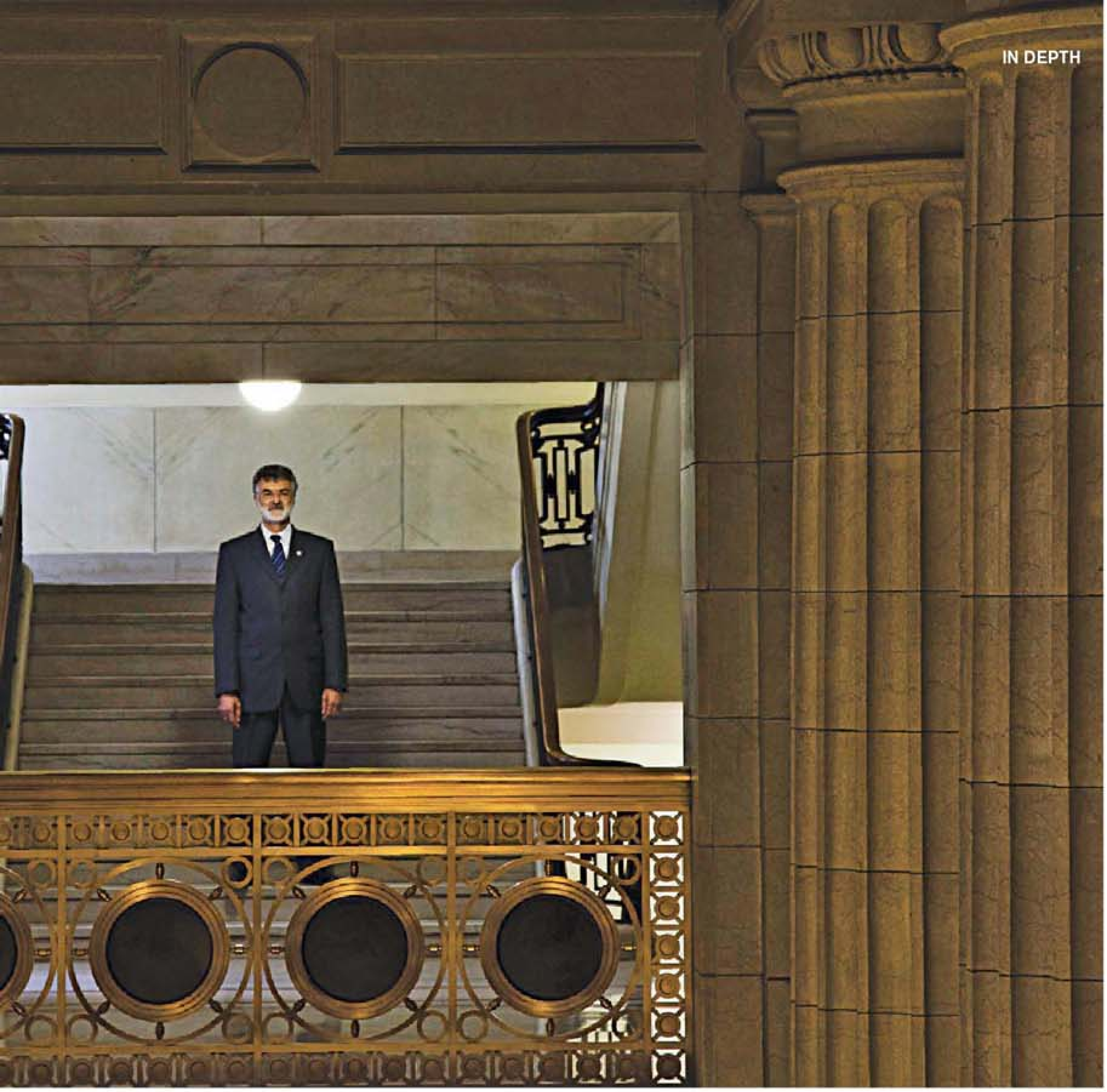
The OCC ruling had been requested by Cleveland-based National City Bank on behalf of several of its units, including First Franklin Financial, a subprime lender that operated in Georgia and other states. First Franklin, which was acquired by Merrill Lynch in 2006, has been hit with dozens of suits alleging unfair lending practices. Merrill shut down First Franklin's troubled lending business in March. Itself hobbled by mortgage-securities losses, Merrill agreed last month to be acquired by Bank of America. The bank and Merrill declined to comment.

In August 2004, Hawke went a step further in a letter to the Georgia Banking Dept. He said even state-chartered mortgage brokers and lenders were exempt from the Georgia law—if the loans they handled were funded at closing by a national bank or its subsidiary.

By then support for the Georgia law was already eroding. Barnes, a Democrat, lost his reelection campaign in November 2002, and his Republican successor moved to dilute the lending act. Still, supporters mobilized to defend the legislation. One was William J. Brennan Jr., an Atlanta legal aid attorney who specializes in housing and had testified before the U.S. Congress in 2000 about what he saw as the looming mortgage mess. He told the House Financial Services Committee: "The entry of many prominent national banks into the subprime mortgage-lending business has resulted not in reform, but in the expansion of the abusive practices." Federal regulators, he testified, "have done little to stop" the trend. In early 2003, Brennan and a legal aid colleague, Karen E. Brown, consulted with Georgia legislators trying to block amendments softening the lending law. At a hearing in February, Brennan requested a police escort because he feared that angry mortgage brokers would block his way. "The words that come to mind are 'outgunned' and 'overwhelmed,'" says Brown.

The Georgia legislature sharply curtailed the assignee liability provision in March 2003 and eliminated other elements of the law as well. Subprime lenders such as Ameriquest Mortgage that had halted lending in Georgia in protest of the law resumed marketing high-interest, high-fee mortgages.

"IT WAS PURE GREED, BASED ON EXPLOITATION. [SOME SUBPRIME LENDING] IS JUST THE SAME AS ORGANIZED CRIME." FRANK JACKSON, MAYOR OF CLEVELAND



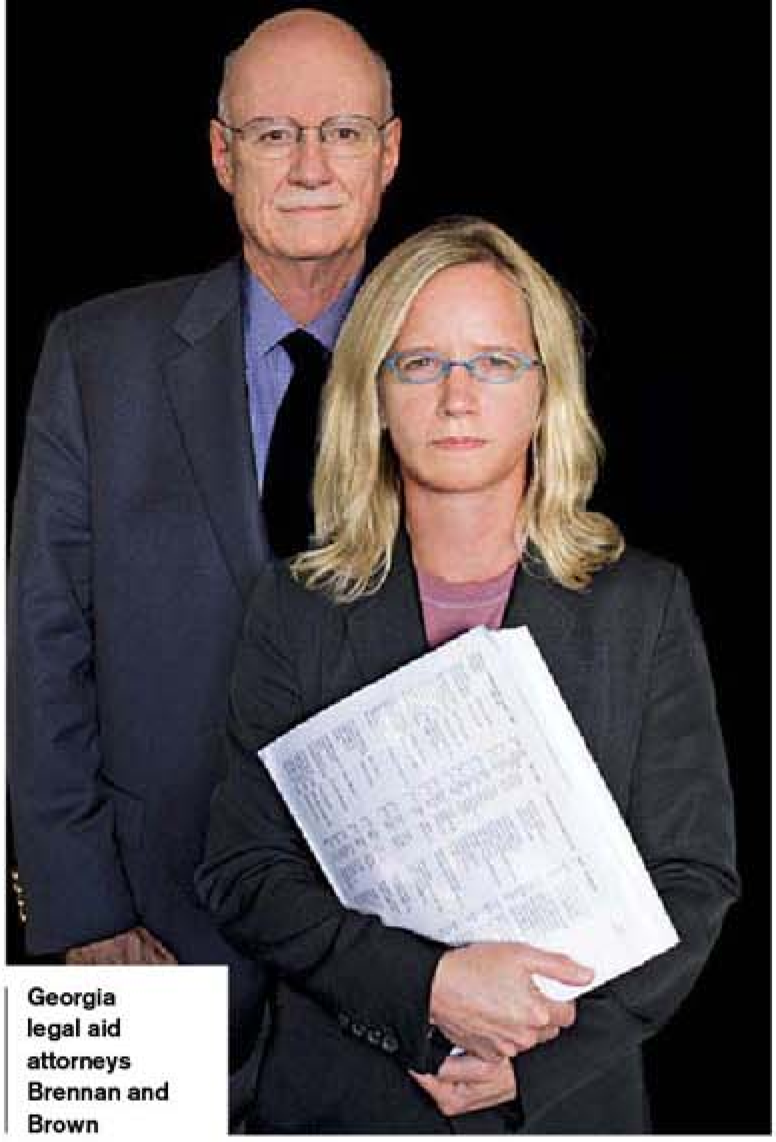
But by late 2007, Ameriquest had gone out of business after agreeing to a $325 million settlement to resolve suits alleging that it had made fraudulent loans.

ESCAPING STATE ENFORCEMENT

Georgia now has the sixth-highest rate of foreclosure in the country. Consumer advocates and state attorneys general contend the weakening of the state's law was a severe blow to efforts to curb careless lending. "Had the Georgia Fair Lending Act not been watered down, we would be in a very different place right now," says Brown.

In some states, dubious local mortgage firms sold themselves to national banks, gaining protection against state enforcement. The Iowa Division of Banking in 2006 sought to examine a subprime broker called Okoboji Mortgage in the town of Arnolds Park. A borrower had accused the firm (named for an area lake) of duplicitous lending practices. Cheryl Riley, a 52-year-old janitor, told state officials she had not received the 30-year fixed-rate mortgage she thought she had arranged with Okoboji in 2005. Instead of one monthly statement, Riley got two: one for a 9.25% adjustable-rate loan and another for a 15-year fixed loan at 12%. Both rates were far higher than what Riley and her husband thought they had negotiated. "We were horrified," she says.

A preliminary state investigation found that Okoboji's manager had headed a mortgage firm in Nebraska that lost its license for falsifying loan documents. But Okoboji refused Iowa's demand for an examination, forcing the agency to file suit in August 2006. Okoboji responded by announcing that it had been acquired by Wells Fargo, a nationally chartered bank reg-



Georgia legal aid attorneys Brennan and Brown

ulated by the OCC. Okoboji handed in its state license, saying it no longer had to comply with Iowa rules. "We'd had red flags but were now blocked from investigating," says Shauna Shields, an Iowa assistant AG.

Okoboji's former manager, Lyda Neuhaus, calls Nebraska's earlier actions "a witch hunt" based on "12 miserable complaints." Her father, Juan Alonso, who owned Okoboji, says he sold his company because he wanted to retire, not to escape state regulation. Both deny any wrongdoing. A Wells Fargo spokesman declined to comment on Iowa's concern about Okoboji and defended the acquisition as benefiting customers and shareholders.

"PLAYING FIELD WITH NO RULES"

The experience with Okoboji was the sort of thing that Iowa AG Miller had warned about when he joined his counterpart from North Carolina on their visit to OCC chief Hawke in 2003. "Now, we could not do anything with federally chartered banks or subsidiaries," Miller says. In 2006 and 2007 the Iowa legislature shot down proposals by Miller for more-restrictive lending laws. Lax regulatory standards at the federal level helped undermine his efforts, he explains. State-chartered banks insisted that tougher rules in Iowa would put them at a competitive disadvantage with federally chartered banks overseen by the OCC. "We had to acknowledge the [political] environment we were in," Miller says.

The banking industry repeated the argument for regulatory "parity" in many states that tried and failed to tighten supervision of subprime lenders, says Keest of the Center for Responsible Lending: "State institutions then wanted a level playing field, which was a playing field with no rules."

Hawke says that it would have been inappropriate for the states to impose more-stringent standards on federally chartered institutions: "Had they tried to apply those rules to national banks, they clearly would have been preempted."

In Cleveland in 2002, Frank G. Jackson, then a member of the City Council, could see that many lower-income residents were being persuaded by lenders to pile on high-interest debt. "It was pure greed, based on exploitation," he says. "[Some subprime lending] is just the same as organized crime." He started negotiating with mortgage lenders for more-favorable terms. To his surprise, the lenders bypassed him and persuaded the state legislature to enact a less stringent version of an anti-predatory lending act he was drafting. "I figured the good faith had ended, so I passed my law [at the city level]," Jackson says. That law required lenders to register with the city and provided counseling to prospective borrowers.

His accomplishment was short-lived. That same year, the American Financial Services Assn. (AFSA), a national trade group, sued to block Ohio municipalities from passing lending laws that conflicted with state statutes. The Ohio Supreme Court later sided with the industry. AFSA's goal was to ward off conflicts between federal, state, and local rules, says spokesman Bill Himpler. "Different municipalities moving different anti-predatory lending legislation... would have brought the credit markets to a screeching halt."

Fulfilling Jackson's fears, the Cleveland area has become one of the places worst hit by the mortgage catastrophe. More than 80,000 homes have gone into foreclosure since 2000, the highest per capita rate in the country.

In January, Jackson, elected the city's mayor in 2005, tried a new tactic. He filed suit in state court against Lehman, Wells Fargo, and 19 other lenders, alleging that they sold "toxic subprime mortgages... under circumstances that made the resulting spike in foreclosures a foreseeable and inevitable result." The city's attorneys based the suit on an Ohio law banning "public nuisances," which is usually used against defendants such as manufacturers whose factories emit pollution. The idea was to steer clear of conventional banking law and head off any claim of federal preemption. The suit is pending; the banks all deny wrongdoing. | BW |

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Countrywide's $8.4 Billion Truce

The preemption issue resurfaced on Oct. 6 when *The New York Times* reported that a group of states had pressured Bank of America's Countrywide Financial mortgage unit to resolve pending suits by setting aside $8.4 billion for borrowers. "This agreement demonstrates the effectiveness of states in addressing predatory lending... proving states should not be preempted by federal legislation," said California AG Jerry Brown.

To read the *Times* article, go to http://bx.businessweek.com/state-attorneys-general

RISK AND REWARD IN RUSSIA

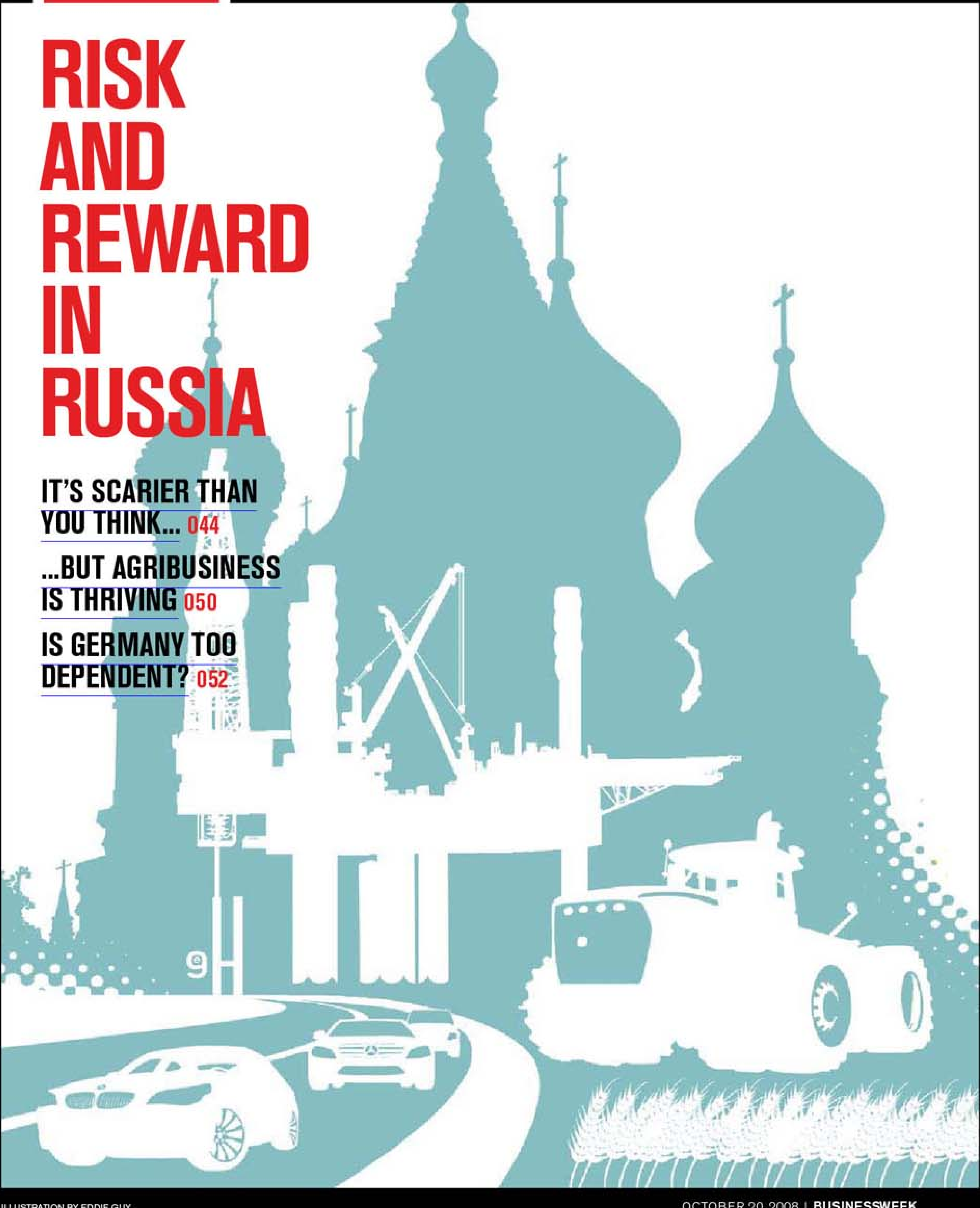
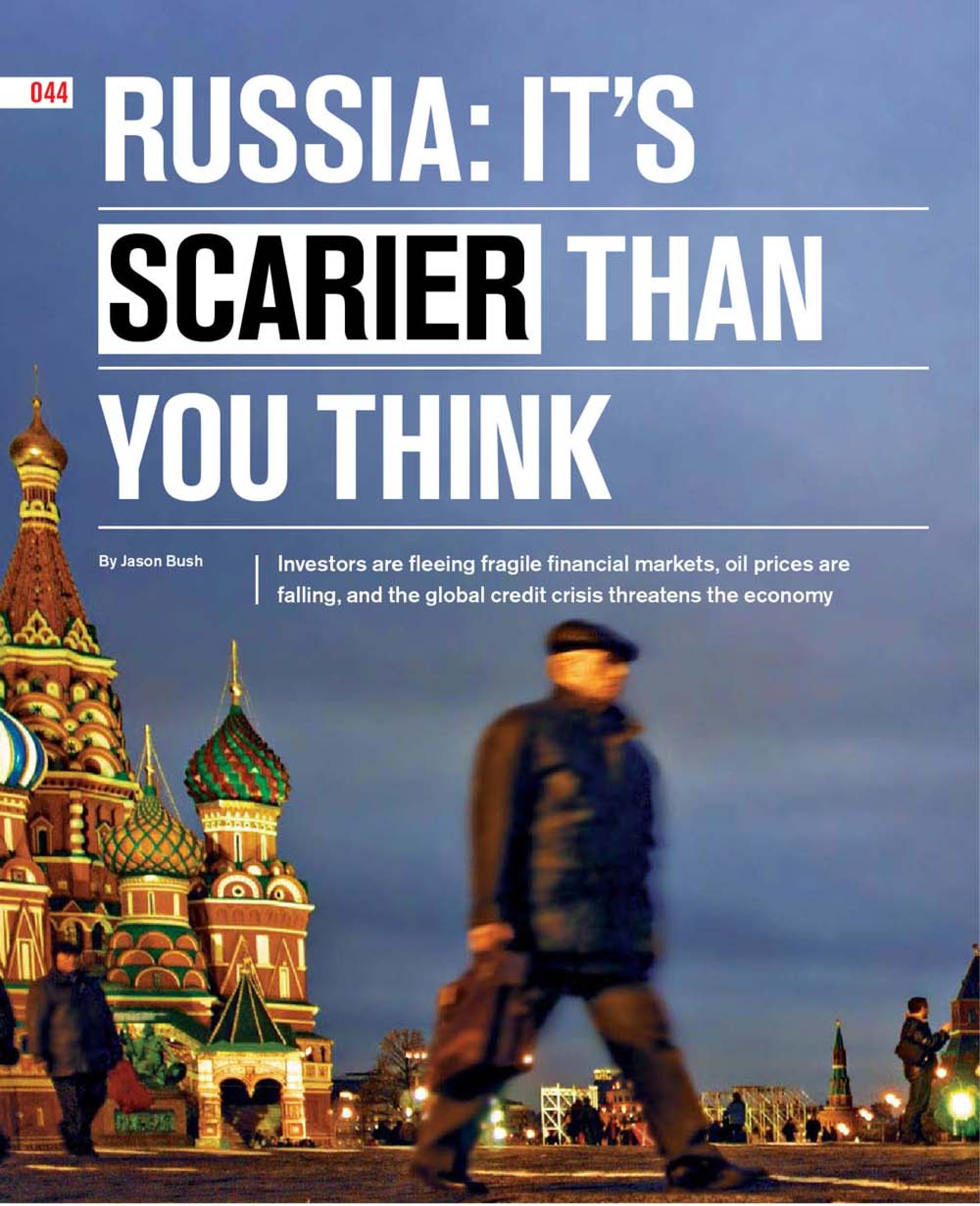


ILLUSTRATION BY EDDIE GUY

RUSSIA: IT'S SCARIER THAN YOU THINK

By Jason Bush

Investors are fleeing fragile financial markets, oil prices are falling, and the global credit crisis threatens the economy



RUSSIA

Take a stroll through central Moscow, and you'd be hard-pressed to find evidence of the global economic turmoil. Shiny new malls are packed with shoppers. The streets are filled with Mercedes, BMWs, and Land Rovers. On the Presnenskaya Embankment, overlooking the Moskva River, a half-dozen skyscrapers are nearing completion at the Moscow International Business Centre, a $12 billion development intended to become the city's new financial hub. The world credit crisis "doesn't affect us at all," says Tatiana Ilyinishna, a pensioner hauling bags of groceries outside a supermarket near the city's Kiev Railway Station. "Everything here is splendid."

But scratch the surface a bit, and things are less splendid than they appear. As the financial crisis spreads, Russians are suddenly discovering that their economy is shakier than many had cared to believe. Credit is increasingly tight, economic growth is slowing, and Russia's fragile financial markets have taken a beating. On Oct. 6 the benchmark RTS index plunged 19%, to its lowest level since August 2005. "The current situation is very serious," says Evgeny Nadorshin, chief economist at Trust Investment Bank in Moscow. "A few months ago we thought that we could look forward to a calm life, but now we've lost our advantage and are in the same boat as everybody else."

"ROGUE STATE" FEARS

Western investors have pulled out en masse in the past few months. Until recently foreigners accounted for up to 70% of investment in Russian equities. They started throttling back earlier this year as they began to worry about increasing risk in emerging markets. Then they got spooked by Russia's invasion of Georgia and began stampeding for the exits. With the collapse of Lehman Brothers in September, the stampede turned into a rout, forcing almost daily halts in trading. The market is down 60% since peaking in May. Falling oil prices, meanwhile, have taken some of the luster off Gazprom, Ros-

A trader in Moscow, where the market has plunged 60% since May

neft, Lukoil, and other stars of Russia's key export sector.

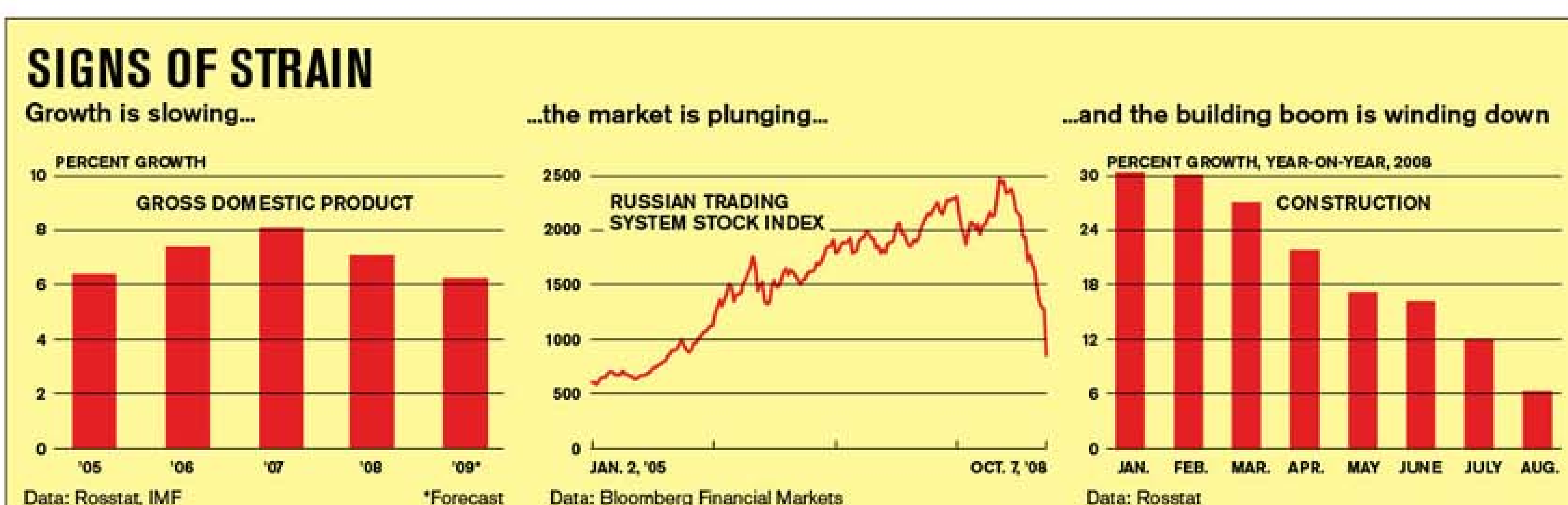
Nor is it just bankers and portfolio investors who are becoming stingier with their cash. Foreign direct investment, crucial to the modernization of Russia's economy, is off sharply. In the first half of this year, government statistics show, long-term investment in factories, real estate, and companies fell by 30%, to $11 billion. And things have only worsened since the war in the Caucasus and the tussle last summer over TNK-BP, a troubled joint venture between oil giant BP and Russian billionaires that led to the ouster of its CEO, Robert Dudley. "Before Russia invaded Georgia, I was getting 100 to 150 e-mails a day that required a response. I was getting five afterward," says Jamison Firestone, manager of law firm Firestone Duncan in Moscow. "When you talk to investors now there's a general sense that Russia is turning into some kind of rogue state."

WORSE TROUBLES AHEAD?

As the financial crisis intensifies, economists no longer debate whether growth will slow in the Russian economy but by how much. The International Monetary Fund, for instance, on Sept. 26 cut its Russian growth forecast for 2008 from 7.7% to 7.1%, and for next year it's now predicting 6% to 6.5%, down from 7.3%. While 6% growth may sound pretty good, last year Russia's economy expanded by 8.1%. And some are warning of far worse troubles ahead if the financial crisis persists. "I think it's a massive negative. We are going to see a sharp decline in the growth rate," says Anders Aslund, senior fellow at the Peterson Institute for International Economics in Washington. If oil prices plunge to $50 per barrel, Moscow analysts warn that growth could fall below 4%.

The crux of Russia's problem is that it depends on the outside world to provide much of the cash that keeps the financial system afloat. The implications go well beyond stock prices. Foreigners have purchased about two-thirds of the $170 billion in bonds issued by Russian companies. Foreign banks also have put up roughly half of Russia's accumulated $900 billion in bank loans, including almost all long-term debt, estimates Moscow investment bank Troika Dialog. "The flight of capital has exposed the complete dearth of domestic investment," says Joshua Tulgan, director of investor relations at Russian telecom operator Mobile TeleSystems. Without access to long-term capital, many Russian companies have been forced to resort to short-term borrowing to finance expansion, adds Johann Jonach, country manager for Austria's Raiffeisen bank, the largest foreign bank in Russia.

With global credit markets in lockdown, Russia Inc. is running short of cash. On Oct. 7 the Kremlin announced it would provide $36 billion in emergency loans to Russian banks. That followed September pledges of more than $150 billion in relief and loans for banks and for Russian companies in danger of defaulting on international debts. One worrisome fact is that about 55% of outstanding corporate loans in Russia have a maturity of one year or less. And on Sept. 17, Mirax Group,



(PREVIOUS SPREAD) YOLA MONAKHOV/BLOOMBERG NEWS; (ABOVE) MIKHAIL GALUSTOW/BLOOMBERG NEWS

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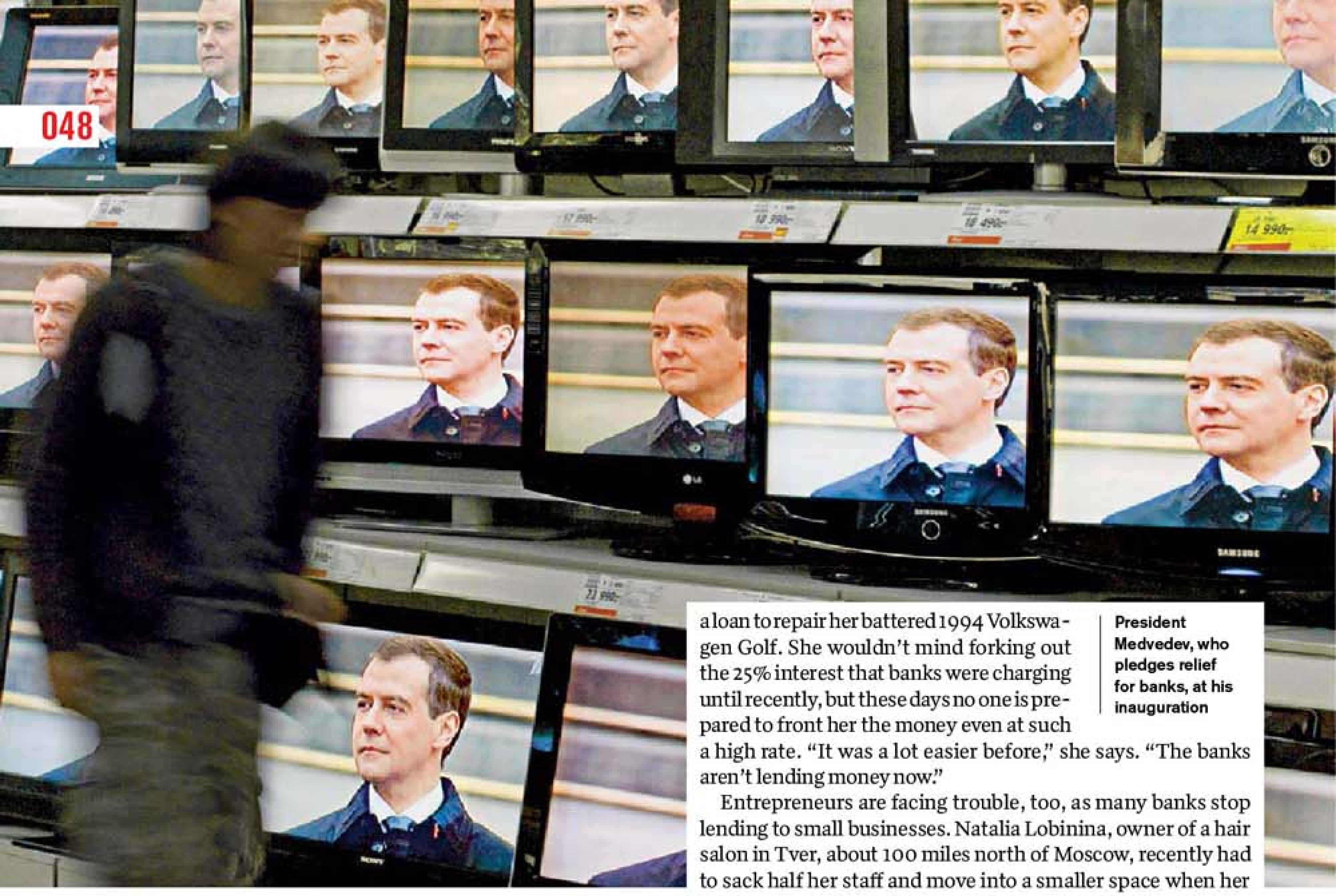

President Medvedev, who pledges relief for banks, at his inauguration

one of Russia's largest construction companies, announced it was suspending all new work because of lack of financing and wouldn't take out new loans for at least a year. Although Mirax will continue working on projects that are already started—including the 93-story Federation Tower, which will be the tallest building in Europe—it's putting some 50 other projects on ice. And it's halting construction of a 46-story tower in Kiev and a 52-story skyscraper in London's financial district. "Bank financing for developrs has practically ceased," says Dmitry Lutsenko, a Mirax board member. "Obviously everyone is concerned about the current crisis."

Mirax's problems are just the tip of the iceberg, with many smaller developers expected to go under. Construction growth, a powerful driver of economic activity, slowed to just 6.4% year-on-year in August, down from 29% in the first quarter. As dozens of new buildings hit the market, construction sites and billboards across Moscow are plastered with posters offering space in recently finished office and apartment blocks.

Even Russia's seemingly insatiable consumers are starting to feel the pinch. Inflation has jumped to 15%, about double its level a year ago, and banks are becoming stingier with consumer loans. Housing prices, which rose by 90% last year, have stagnated since August and may fall by 20% or more by the end of 2009, predicts IRN, a real estate consultancy. Sales of foreign cars plummeted by 12% after banks cut back drastically on approvals for new auto loans. Russians even seem to have gone off their beer: Production fell by 10% in August amid slumping sales. Olga Vasilevna, a sales clerk in Moscow, says she can't get a loan to repair her battered 1994 Volkswagen Golf. She wouldn't mind forking out the 25% interest that banks were charging until recently, but these days no one is prepared to front her the money even at such a high rate. "It was a lot easier before," she says. "The banks aren't lending money now."

Entrepreneurs are facing trouble, too, as many banks stop lending to small businesses. Natalia Lobinina, owner of a hair salon in Tver, about 100 miles north of Moscow, recently had to sack half her staff and move into a smaller space when her lease expired. Although she says her business is going well, the new rent was too expensive, and no bank would lend her the $300,000 she needed to buy her own shop. "Now the problems are even worse," says Lobinina, who is also an official in Opora, a small business lobbying group. Only 25% of small businesses in her region have access to bank finance, she says.

CHRONIC UNDERINVESTMENT

For economists, some comfort comes from the relative smallness of Russia's financial sector is relatively small, so the credit crunch doesn't hurt the country as much as it's harming the U.S. and Europe. Bank loans account for some 10% of corporate finance, and the bond market is only about a decade old, so roughly half of all capital investment by companies comes from retained earnings. But that has led to chronic underinvestment. Capital expenditures represent around 20% of Russia's gross domestic product, compared with about 30% in most emerging markets and 40% in China. "Russia's economy is still very detached from the stock market," says Sergei Guriev, rector of the New Economic School in Moscow.

That phenomenon is easy to see at Uralchem, a Moscow-based company that exports chemicals such as ammonium nitrate, used for fertilizer. Uralchem is raking in cash thanks to high global chemical prices and is expected to earn $450 million on sales of $1 billion this year, up from profits of $200 million on revenues of $700 million in 2007. The company had planned to float 10% of its shares in London in September but was forced to pull the offering amid the global market turmoil. However, management is pressing ahead with plans

(LEFT) SERGEI KARPUKHIN/REUTERS

to invest in a giant phosphorous mine and to increase capacity at its three chemical plants. "We have a comfortable cash cushion," says Anton Vishanenko, Uralchem's chief financial officer.

At the heart of Russia's financial woes is a dearth of long-term private savings. In the U.S., private pension funds manage assets worth about 40% of gross domestic product. The equivalent figure in Russia is just 2.5%. Nor are Russians overly keen on putting money in the bank. Instead, they'd rather spend their cash. Household deposits are the equivalent of some 17% of GDP, compared with about 45% in the U.S. Only 4% of Russians trust commercial banks, according to a poll by the National Financial Research Agency in Moscow. "Our country is so unpredictable that you could be left with nothing," says Kira Gorodilova, 28, an oil market analyst at a Russian energy company. "People are reluctant to put money in the bank."

Russian troops pulling back after the confrontation in neighboring Georgia

(RIGHT) SEAN SMITH/GUARDIAN NEWS MEDIA LTD 2008

Unlike ordinary Russians, the Kremlin is sitting on piles of cash, owing to years of record-high oil prices. It has $560 billion in foreign exchange reserves, plus $160 billion in two sovereign wealth funds financed from oil taxes. The snag is that most of the money is in fixed income securities of governments abroad, doing nothing to feed the local financial system. The government wants to hang on to the money as a cushion in case oil prices take a serious tumble. And if Russia were to pump it into the domestic economy, inflation would rise even faster than it has been.

To jump-start savings, the government has long toyed with pension reform, an issue that has reemerged on the political agenda in the wake of recent financial turmoil. But previous attempts have met with little success. Since 2004, Russians under 30 have been able to pay part of their pension contributions into private funds. But only 5% have opted to do so, largely because no one has bothered to explain the reform to the public. "Young people don't care much about pensions—there'll be time for that later," says Andrei Volkov, 24, a management student shopping at Moscow's Evropeisky Mall, a consumer paradise crammed with stores such as Zara, Benetton, and adidas. "We love to spend more than to save."

With domestic capital in short supply, Russia can ill afford repeated blows to investor confidence. True, seasoned investors play down the legal and political risks, saying they are justified by juicy returns. "Clearly it's ridiculous to expect the same kind of law and order in Russia that you have in Switzerland. It's an emerging market," says Boris Fedorov, a former finance minister who today is senior managing partner of UFG Asset Management, a leading Russian investment company.

In fact, many foreigners already invested in Russia seem more worried about Washington's hostile reaction to the military invasion of Georgia than about the increasingly authoritarian stance of Prime Minister Vladimir Putin and President Dmitry Medvedev. In September, American investors and the U.S. envoy to Moscow met for a breakfast at the elegant Marriot Grand Hotel on Tverskaya Street, just up the road from Red Square. The assembled managers were itching to hear what Ambassador John Beyrle had to say but complained loudly about Washington's tough line on Moscow's moves. "The mood in the room was quite combative," says Sergei Riabokybylko, who heads the Russian affiliate of real estate consultant Cushman & Wakefield. "Instead of aggressive rhetoric [by the U.S.], business here would like to see a more engaged discussion with Russia."

For investors with the stomach for rough-and-tumble emerging markets, Russia is not so much a wicked wolf that needs to be taught a lesson as a lucrative golden goose that needs gentle coaxing if it is to keep laying its precious eggs. Given the country's 140 million people and its growing middle class, money is still likely to be made even if growth slows. This year, for instance, Russia overtook Germany as Europe's largest car market, and foreign automakers are slugging it out. "The Russian market is tremendously important for us," says Heidi McCormack, director for new business development in Russia at General Motors, which has seen its sales in the country jump by 40% in the past year, giving it some 10% of the market.

Despite Russia's continued attractions, though, veteran investors acknowledge they are nervously watching how the credit crisis will unfold both in Russia and abroad. That, they say, is a far more serious concern than the tensions over Georgia. And if existing investors are wary, Moscow will have an even tougher job persuading skeptical newcomers more easily spooked by the political and legal risks. All of which means the country may see the breakneck pace of development over the past decade slow markedly. "It looked like Russia was not going to get hit," says Andrew Somers, president of the American Chamber of Commerce. "Well, it has been hit. Just as in the U.S., the question is: When is this over?" |BW|

Business Exchange

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Oligarch in Hot Water

Oleg Deripaska, the Russian oligarch Forbes ranks as the world's ninth-richest man, is experiencing a sudden reversal of fortune. On Oct. 6, *The Moscow Times* reported that Deripaska has been forced to turn over his minority stake in Canadian auto-parts maker Magna International, valued at $912 million, to creditors. Deripaska, who made his fortune in aluminum, borrowed billions from foreign banks last year to finance a string of acquisitions. Now, as the worth of his publicly listed companies has plummeted right along with the rest of the Russian stock market, he is reportedly caught in a liquidity squeeze.

To read *The Moscow Times* article, go to http://bx.businessweek.com/russian-business

THE BUSINESS BOOM UNFOLDING DOWN ON THE RUSSIAN FARM

By Jason Bush

Investors are pouring billions into agribusiness—and trying to reverse decades of Soviet mismanagement

USMAN, RUSSIA

Under a baking sun, two green combine harvesters trundled across a vast expanse of yellow barley, unloading their grain into waiting trucks. It was a bumper harvest in Usman, a rural district some 300 miles south of Moscow. Yields of barley almost doubled this year. And there was plenty more to come. On the endless plains of southern Russia this summer, wheat, corn, and sunflowers towered high above the rich black soil for mile after mile.

Just four years ago the same fields sprouted nothing but wild grasses. Although this land had been farmed for centuries, the tradition nearly died out in the 1990s. The Soviet *kolkhozy*, or collective farms—hardly paragons of agricultural efficiency—went bankrupt as communism collapsed, and villagers abandoned the land. "When Gorbachev came to power, everything began to fall apart," says Alexander Gulov, a former boss of a collective farm in Usman.

But farming in the area, and across Russia's traditional grain belt, is making a comeback. Commodities traders, food processors, shipping outfits, and others are buying up farms, hoping to cash in on high global grain prices. These new investors are pouring billions of dollars into land, then revamping management and technology in operations that span thousands of acres. Today, large agricultural holding companies control some 10% of Russia's farmland, up from 4% in 2003—though in the most productive areas they have more than a quarter of the land, according to the Institute for Agricultural Market Studies in Moscow. "There's huge potential here," says Robert Coleman, a South African who oversees farms in the region for Agro-Invest, a Moscow group that owns 100,000 acres around Usman. "We've invested in big machines, are applying Western ideas, and are getting great results."

It's easy to see why there's so much interest. The U.N. says Russia has some 480,000 square miles of arable land—an area more than twice the size of France. That's 8% of the world's total, much of it highly fertile "black earth." But owing to decades of agricultural mismanagement, Russia accounts for less than 4% of global crop production and is a net food importer.

Among the biggest of the new outfits is Agro-Invest. Over the past two years it has spent some $350 million and now has nearly 900,000 acres. The company farms wheat, barley, corn, and oilseed across a broad swath of southern Russia. Although it's still operating at a loss, revenue is on track to top $40 million this year, roughly double the level in 2007. "Today only big agro-industrial holdings can be profitable in farming, because it requires huge financial resources," says Zorigto Sakhanov, Agro-Invest's chairman. In December, Agro-Invest's parent company, Swedish-backed Black Earth Farming, raised $256 million with a listing in Stockholm, giving it a market capitalization of roughly $1 billion.

Other investors are joining the land grab. Alpcot Agro, a Swedish company, has invested $230 million in Russia and controls over 120,000 acres. Russia's RAV Agro-Pro, with Israeli, U.S., and British funding, has some 370,000 acres. Danish-backed Trigon Agri has acquired 300,000 acres in Russia and Ukraine since it was established two years ago. All three companies plan public share offerings when global market conditions improve.

Out in Usman, the foreign investors' confidence is shared by locals. "Russia's possibilities are simply colossal," says Viktor Karnushin, Agro-Invest's regional boss. He says the

ZHURAVLEV IVAN/ITAR-TASS/CORBIS

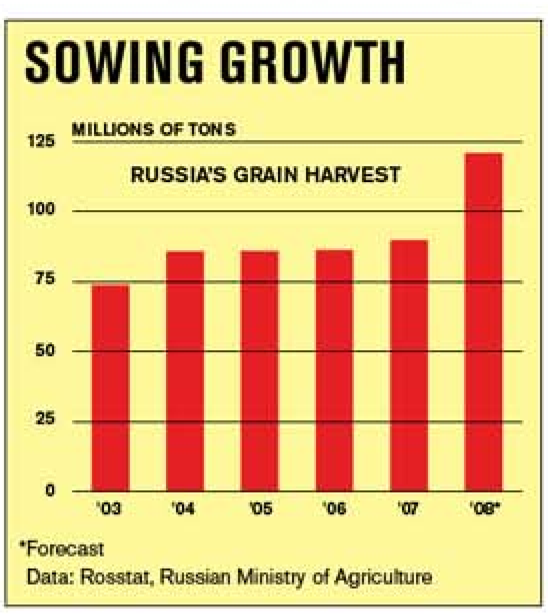
company will boost the acreage under cultivation by 50% in the coming year, and productivity will improve rapidly as the farms use more imported machinery. Wheat yields, he says, should climb by 25%. "People were worried [in the 1990s] about the future, but now they understand that everything will be O.K.," says the former army colonel.

He can't wait to show off the farm's latest acquisition: a $300,000 Canadian Bourgault cultivator. In recent years the farm has replaced most of its rusty old Russian tractors and harvesters with equipment from Illinois-based John Deere. "There's simply no comparison," says tractor driver Nikolai Yaroslavtsev, who complains that his old Russian model was forever breaking down. These days a GPS navigation device helps the tractor stay on course as it traverses the fields. All the new technology means the company employs 340 people on land that was farmed by 3,000 during the collective farm days—and Agro-Invest grows more crops.

Throughout Russia, there's huge potential for similar productivity gains. Grain yields in the country average around 1 ton per acre, only about a quarter of what farmers in Western Europe get, says investment bank Troika Dialog. But Russian land averages $400 per acre—a mere 10% of the cost in France, and 20% of the price of land in Brazil.

Russian land averages $400 per acre—10% of the cost in France

In the countryside, Russia's capitalist revolution is still a work in progress. A communist-era ban on the sale of agricultural land wasn't scrapped until 2003. Even now, local authorities suspicious of outside investors often find ways to block land sales. About three-quarters of farmland is still controlled by the former collectives, and 10% belongs to small farmers. And there's always the risk—as with Russia's oil and gas industries—of a backlash against foreign ownership. Foreigners are barred from buying farmland, although companies such as Black Earth Farming have circumvented the restrictions by creating a Russian subsidiary, while Alpcot Agro and others hold long-term leases on their land. "Business is very local in Russia, and you need to have support from the local authorities," says Bjorn Lindstrom, investment manager for Alpcot.



*Forecast

Data: Rosstat, Russian Ministry of Agriculture

Local farmers in Usman have no shortage of gripes, especially when it comes to the soaring costs of fuel and fertilizer. Domestic grain prices, meanwhile, are 40% below international levels because the Kremlin has placed restrictions on exports to keep a lid on inflation. If Russia wants to boost food exports, it will need to invest billions to upgrade ports and railways.

Such pitfalls explain why investment in land may not be the safe bet it might seem. "If grain prices were to fall, a lot of these companies would face real problems," warns Kingsmill Bond, an analyst at Troika Dialog. But there's still no denying the potential: "The land is cheap," he says. "And there's lots of it." | BW |

HOW GERMANY IS LOCKED IN A BEAR HUG

By Jack Ewing

Its economy is becoming increasingly dependent on Russia

Daimler says Russia helped Mercedes earn a 1% increase in operating profits

ALEXANDER GRONSKY/AGENCY.PHOTOGRAPHER.RU

FRANKFURT, GERMANY

German Chancellor Angela Merkel isn't known as a great fan of Russia's government, but her tone was remarkably mild when she met President Dmitry Medvedev in St. Petersburg on Oct. 2. She called Russia's incursion into Georgia in August "not appropriate," but otherwise avoided the subject and even enjoyed a lengthy dinner with Medvedev aboard a restaurant ship on the Neva River.

The swift return to cordial relations was recognition of just how intertwined the German and Russian economies have become. Manufacturing everything from luxury autos to machinery to food, some 4,600 German companies are active in Russia and 70,000 German jobs depend on business with the country. Germany is also Russia's largest trading partner, with $45 billion in two-way trade during the first six months of this year. Little wonder that the 25 German businesspeople who joined Merkel in St. Petersburg seemed anxious to forgive the events in Georgia and get back to doing deals with Russian partners. The biggest deal: an agreement allowing energy supplier E.ON to acquire 25% of a huge Siberian natural gas field owned by state-controlled Gazprom. The Dusseldorf-based utility traded control of a 3% stake in Gazprom valued at $5.4 billion, ending years of stalemated negotiations.

Merkel's rhetoric on Russia is generally harsher than that of her Social Democratic predecessor, Gerhard Schröder, a pal of Prime Minister Vladimir Putin who now works for Gazprom. But Germany's business lobby makes sure that Merkel never forgets how much their companies depend on the former Soviet state. "Whatever we can do to advise our government, we are doing," says Klaus Mangold, a former Daimler executive who leads the East European committee of the German Federation of Industries. In fact, Merkel rarely says anything that would damage German-Russian economic ties. "The economic cooperation is advantageous for both sides," she told an audience that included Medvedev in St. Petersburg. Russia is also a crucial energy supplier: Germany buys 36% of its gas and 32% of its oil from the country.

As trade with Europe and the U.S. has flattened, exploding Russian demand has helped insulate Germany from global economic turmoil. Russian trade is particularly important for sectors such as the German machinery industry, which has boosted exports to Russia fivefold since 2000, to $8.8 billion last year. In the first seven months of 2008, machinery sales to Russia hit $6.4 billion, a 29% increase vs. the same period a year earlier. By contrast, machinery exports to the U.S.—which has a much larger economy than Russia—were stagnant at $9.9 billion in the first seven months. "Russia has more than made up for the U.S.," says Ralph Wiechers, chief economist for the German Engineering Federation.

A CHANGE IN PACE

So far, German businesspeople say, growth in business from Russia seems to be cooling but remains high. "It isn't yet exhausted, but it won't continue at the same pace," says Andreas Hartleif, CEO of VEKA, a German maker of plastic window and sliding door frames that has factories in Moscow and Novosibirsk. Not all German exporters are so laid back. Russia is important for German carmakers trying to make up for slower U.S. sales, which the weak dollar has hammered. Not only are Russia's nouveau riche keen to get behind the wheel of a Mercedes or a Porsche, but they are willing to pay for costly options. Daimler cited Russia as one reason its Mercedes car division eked out a 1% increase in operating profit in the second quarter. Says BMW brand chief Friedrich Eichiner: "We sell 10 times as many cars in the U.S., but Russia is very profitable."

Even though Russia accounts for only about 3% of German exports, for many companies it is one of the few growth markets left. Says Gerd Hassel, economist at BHF-Bank in Frankfurt: "An economic slowdown in Russia would be very decisive for the German economy." |BW|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THE NEW AGE OF FRUGALITY

By Steve Hamm

Illustration by Brian Cronin

Americans' charge-it culture is getting an overdue reality check. But will the new discipline stick?

On a shady lane in New Hope, Pa., a quiet revolution in American culture may be taking shape. Here, a family of four lives in a white, colonial-style house in a manner that once would have been considered All-American but more recently has been seen as just plain weird: They're frugal.

Meet Leah Ingram, Bill Behre, and daughters Jane, 13, and Annie, 11. They walk most everywhere, they rarely eat out, they sometimes buy clothing at consignment shops, and they turn the lights off when they leave a room.

Theirs is no hard-luck-in-a-recession story. The Ingram-Behre family is solidly middle-class, fully employed, and not especially threatened by the conniptions gripping Wall Street. Behre, 43, is a dean at the College of New Jersey, while Ingram, 42, is a successful freelance writer and etiquette expert. They have no credit card debt.

That's now. A little more than a year ago, the family was ensnared in America's consume-at-all-costs culture. During the days of soaring home prices and easy credit, they took out a $101,000 home-equity loan on a previous house and spent lavishly on a lifestyle upgrade—going on three cruises in two years and taking the kids on annual pilgrimages to Disney World. "After 9/11 it became patriotic to shop, and we became as patriotic as anybody," laments Behre, sitting in the dining room after a meal of chicken stir-fry—washed down with tap water.

Ingram and Behre are harbingers of a dawning Age of Frugality. People who overconsumed during the past decade are now rejecting extravagant lifestyles. They're spending less, and more wisely. Some are getting their finances in order. Others are fearful of losing their jobs, shocked by investment losses, or hunkering down amid the general uncertainty.

The penny-pinching is already showing up in the numbers; this quarter could mark the first fall in personal consumption in 17 years. And with credit tight and Americans loaded down with $2.6 trillion in personal debt, consumer borrowing dropped in August, the first such contraction since 1991. Menzie D. Chinn, who teaches economics at the University of Wisconsin, figures consumers won't be in a position to spend freely for five years.

Which brings us to what John Maynard Keynes called the

(TOP) COURTESY THRIFT: A CYCLOPEDIA

Ingram, Behre, and family: living within their means

paradox of thrift. What's good for the individual, argued the famous economist, can ignite or deepen a recession. But that won't deter the newly thrifty. "I can't help the economy," says Kim Schultz, a resident of hard-hit Avoca, Mich., who with her husband, Jon, owes $40,000 in credit-card debt. "I've got to help myself." On the other hand, this newfound austerity could—emphasis on could—rewire Americans as savers rather than spenders. And that would help put the economy on a sounder footing over the long haul.

Thrift has gone in and out of style since the founding of the republic. In the *McGuffey Reader* of the 19th century, Benjamin Franklin was held up as a paragon of virtue for his frugal ways. Later, people who lived through the Great Depression were in some cases marked for life by the experience. Typical of them is Bernard Handel, an 82-year-old resident of Poughkeepsie, N.Y., who grew up poor in the Bronx. In the early 1930s, his father's grocery store failed and his dad couldn't find another job for several years. To this day, even though Handel became very wealthy, he shops for food with coupons, drives a Honda, and takes the subway rather than taxis. "I just don't believe in throwing money away," he says.

A RUDE AWAKENING

Handel's baby-boomer children grew up without psychological scars from the Depression. And the boomers' children have come of age in an era of abundance, easy credit, and a taste for luxury. So it's no wonder that the sudden need for thrift comes as an upsetting shock for many. Some are calling for a massive public education effort on the level of the anti-drunk-driving and anti-smoking campaigns that have been so successful. "We want to build a culture that's more hospitable to thrift, so it's not seen as odd but fostered and nudged along," says Barbara Dafoe Whitehead, co-author of *For a New Thrift: Confronting the Debt Culture*, a new report from The Institute for American Values, a think tank.

To be sure, there are odd moments on the journey to a thriftier lifestyle. To demonstrate, Bill Behre pulls out a mobile phone and twists it back and forth so the light glints off of rhinestones glued on by daughter Annie be-

CHRIS CRISMAN

IN THE LAND OF PLENTY, WHY PAY?

"Freegans" are trading in consumerism for dumpster-diving

By Michelle Conlin

Josh Corlew's grocery bill is zero. The furniture in his Nashville home didn't cost him anything, either. His fridge, TV, and microwave—all free. It's been two years now since he last bought the ingredients for his signature sausage dish. Corlew, a 26-year-old nonprofit manager, has effectively dropped out of Consumer Nation. He goes shopping in the disposable culture's garbage instead.

Corlew is part of a growing number of Americans for whom getting stuff for free is next to godliness. Yes, most everyone is cutting back. But these folks take frugality to its extreme. In cities like New York and wealthy suburbs like Grosse Pointe, Mich., and Plano, Tex., it is possible to live like a king (well, a duke anyway) out of a dumpster. Sushi, cashmere sweaters, even Apple computers—all for the taking. "We're used to fulfilling most of our needs through the marketplace," says Syracuse University culture professor Robert Thompson. "But now with technology there is access to more that is free than in any time in the history of the world."

As you might expect, the free movement is heavy on idealism. None more so than the so-called freegans. They believe America's consumer society is inherently corrupt and wasteful, and they want no part of it. Skeptics might see another motive at work: Freegans don't pay for anything. Corlew, who prefers the term "conscious consumer" over freegan, insists his "bin diving" or "dumpstering" is as much a war on wretched excess as anything else. "This is about distancing myself from the consumerism of America," says Corlew. "Every time we buy something, we're saying we support the system that brought it about."

Alexi Ahrens, who lives near Minneapolis, is less idealistic about her secret hobby.

fore she got a new phone. Behre's own phone was ruined in a rainstorm, so he's using this gaudy hand-me-down until he can get a free replacement in March. "This is the ultimate in frugal," he says.

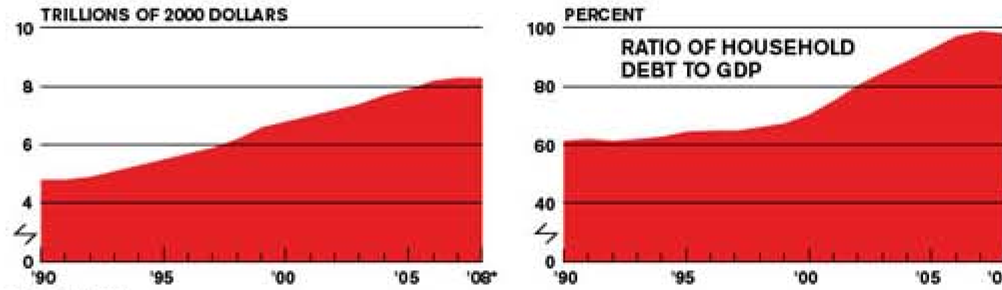
It was Ingram who got things started. She was raised by a thrifty mother, but by the time she married Behre, mom's influence had worn off and she'd amassed $30,000 in credit-card debt. Controlling spending was hit or miss until the early 2000s, when the family embarked on a shopping spree.

Things nearly spun out of control after they upgraded to a better house. Despite raiding their retirement funds to help with the down payment, they ended up with higher monthly payments. Ingram remembers the day, May 24, 2007, they sold their previous home, and realized her family would take away only $60,000 even though the place had nearly doubled in value, to $490,000. "I was practically nauseated when I realized what our out-of-control spending had done," she says. She and Behre made a pact: They would live more frugally. Then they broke the news to the kids. No more cruises or Disney vacations. They'd get an allowance of $20 a month. And they'd be walking to school, the store, and friends' houses. The girls were intrigued at first. Then they realized their comfortable, materialistic lives were really changing. Annie, whose shopping-for-pleasure habit had been indulged by her parents, suddenly had to make do at a secondhand store called Plato's Closet. Now the girls are resigned to this new way of life.

Sticking to the program requires vigilance. When Ingram does drive, she calculates the relative costs of traveling a few more miles to get gas for a few cents cheaper. And on the rare occasions they do go out to dinner, she feels guilty. "I want to keep myself accountable," she says. "I don't want to backslide." So far, the plan is working. In the old days, the family overspent their checking account by an average of $300 a month—dipping into the home-equity funds to make up the difference. Now they're in the black by about $800 a month. Since making their big changes, they accelerated payments

LIVING LARGE

Personal consumption has soared... ...as has household debt



*As of July 31

Data: U.S. Commerce Dept. Bureau of Economic Analysis

Data: U.S. Federal Reserve, BEA

(TOP TO BOTTOM) CHARTS BY LAUREL DAUNIS-ALLEN/BW; PHOTOGRAPH BY JOHN CHIASSON

Corlew scrounging for free eats

"It's a little bit of adventure in suburbia," she says. Ahrens, 33, does her rounds between 2 and 3 a.m. and scavenges for food, clothing, and furniture (she once found a Tiffany lamp, but gave it to a neighbor).

More recently she turned her dumpstering into a kind of business. When her computer technician job at a financial-planning firm became part-time, Ahrens went into overdrive. She started haunting corporate loading docks. At a photo-processing factory that was closing, she found late-model processing equipment, computers, and unused office supplies. Ahrens sold them on eBay for $2,000.

Not bad, right? But what if you don't want to climb into a giant garbage can to get your free groceries or barely used PC? Maybe Freecycle is more your thing. A Craigslist-type Web site, Freecycle lets people post items they don't want and ones they do. Giveaways have included everything from a camping trailer to a pair of rats. Freecycle now has 6 million members internationally, and since Wall Street imploded it has been registering 50,000 more each week, up from 25,000 previously. Freecycle and the Freegans are among the fastest-growing groups on Yahoo!

Many of the adherents of the free movement say they got the thrift trait from their Depression-era forebears. "I'm a penny-pincher. I work hard for my money, and I want it to last as long as possible," says 58-year-old Roger Latzgo, who built his Pennsylvania home entirely of materials he found for free. "I wanted to free myself from the weight of a mortgage, the root of which, by the way, means death."

Think this sounds crazy, dear manager? The free movement is already starting to invade the workplace. At Yahoo, Freecycle events—where employees swap their stuff—are all the rage. They have featured plenty of Prada clothes, original Eames chairs—even founder David Filo's smelly adidas sneakers.

on a car loan and managed to pay it off.

Ingram has started a blog, The Lean Green Family, where she encourages others to be more frugal. She and Behre say they've learned valuable lessons. One is to be flexible: Give yourself a treat every now and then. Another is to have a goal. They're saving for a new recreation room. "Being frugal is like dieting," says Behre. "It's more sustainable if you have a target you're aiming for."

As joblessness creeps up, many more Americans will receive their own crash course in frugality. It has already happened to Ned Penberthy, 53, a salesman who lives in Pelham, N.Y. He recently got a new job, took a cut in base pay, and has been living the frugal lifestyle ever since. Penberthy says he's in it for the long haul—willing to spend more up front to reap savings over the next several years. He installed expensive but energy-sipping CFL light bulbs in his house, and replaced some of his appliances with more efficient ones. For him, every penny counts. For instance, he switched from shaving cream to a bar of shaving soap. He figures he saves $6 a year that way. "It's not much, but there's a psychological benefit," he says.

Like a lot of boomers, Penberthy has a nest egg, but many people in their 20s and 30s have little to fall back on. To get on track, they have to learn the difference between necessities and discretionary spending. "They need to go back to [psychologist Abraham] Maslow's hierarchy of needs—food, clothing, shelter, and transportation," says Kristine E. Miele, a financial planner. She's offering "Lessons for Life" classes, gradually weaning young people off their spending habits one luxury at a time.

-3.7%

Contraction of consumer borrowing in August,* the first such drop since January 1998.

*Based on a seasonally adjusted annual rate
Data: Federal Reserve

In the past, consumers have gone shopping the moment the sun came out. But this time? Market researchers trying to divine the consumer psyche are picking up signs that attitudes are changing. Booz & Co. recently conducted a survey of nearly 1,000 households. Among other findings, 43% of respondents said they are eating at home more and 25% said they were cutting spending on hobbies and sports activities. In both cases, most said they'd continue doing so even when the economy improves. Much the way pump prices have prompted many Americans to forsake SUVs for small cars, the collapse of home values and 401(k)s will make consumers think twice before hitting the mall. | BW |

—With Lauren Young and Burt Helm in New York

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COSTCO'S ARTFUL DISCOUNTS

By Jena McGregor

With costs of everything on the rise, the big box retailer gets creative

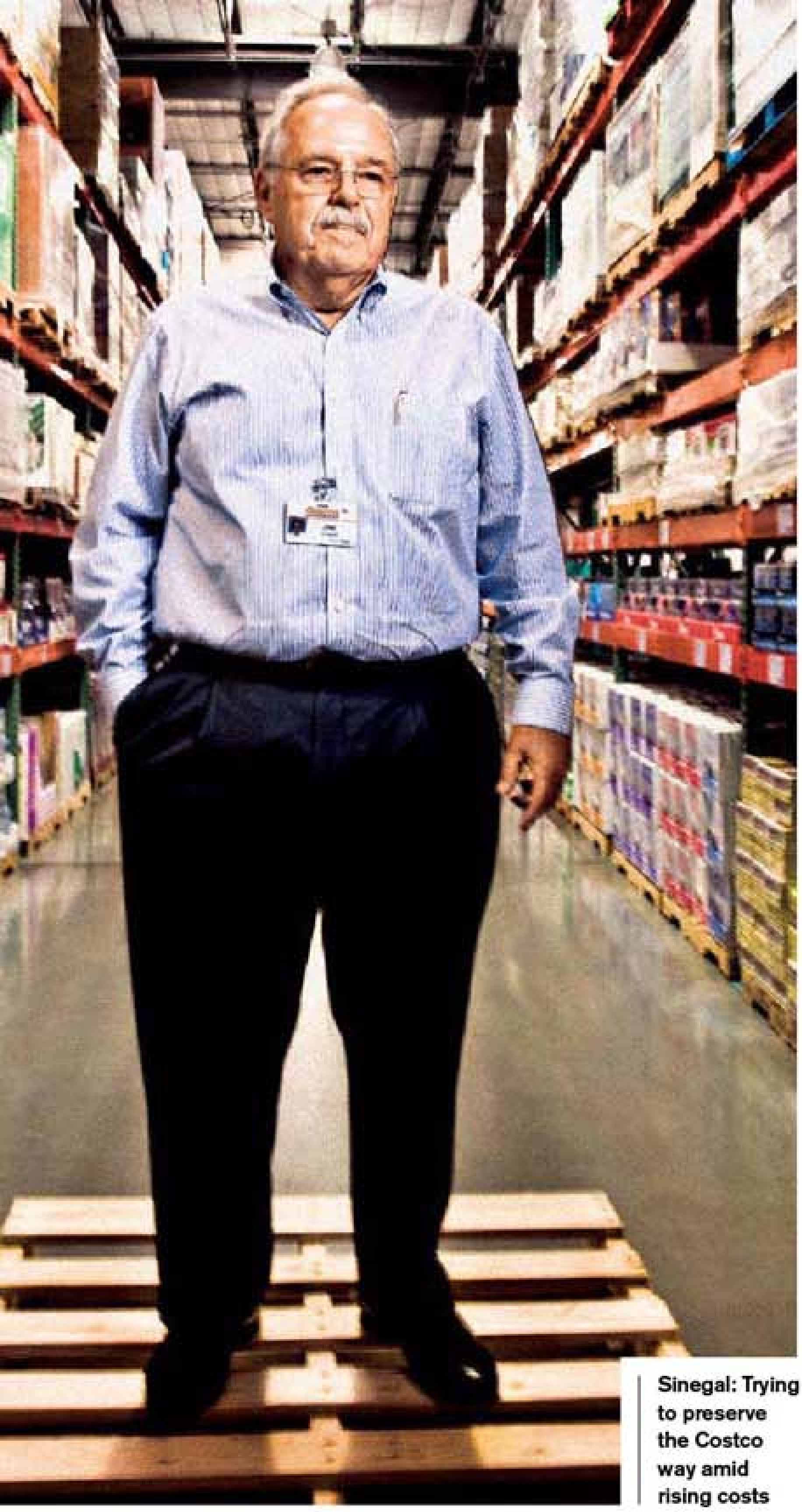
In the fickle world of retailing, where hot concepts can be as fleeting as pop stardom, Costco has been a fortress of stability over the years. The $72 billion discount warehouse chain has built an empire of 544 stores in 40 states on one proposition to which it is fanatically devoted: keeping the prices of its quirky assortment of wares, everything from bulk antacids to flat-screen televisions, as low as possible.

The beauty of Costco's deep-discount, high-volume model is that it works even when the economy is at its worst: The company has held up well during past economic downturns.

But one thing the model doesn't account for is the toxic brew of recession and surging prices. And that dread scenario, last seen in the 1970s, is turning 2008 into one of the most challenging stretches in Costco's 25-year history.

Despite slowing economic growth, soaring commodities prices this year have forced manufacturers around the world to hike the prices they charge retailers, which in turn have raised their prices on consumers. Yet Costco can't raise prices as easily as its rivals can. It gets around three-quarters of its operating profits from membership fees, which range from $50 to $100 a year. If Costco were to hike prices too high, some of the 29 million households that carry memberships would simply let them expire. Profits could suffer.

Costco Chief Executive James Sinegal isn't panicking and throwing out the playbook, however—he's sticking with what he does best. Sinegal, 72, is cranking up Costco's already aggressive cost-cutting machine to new levels,



Sinegal: Trying to preserve the Costco way amid rising costs

challenging managers to find ways to pare. After Procter & Gamble announced a 6% price hike on Bounty paper towels and Charmin toilet paper, for example, Costco bought hundreds of truckloads at the old price and stuffed them into storage depots, saving customers precious pennies per roll. It has even looked into growing its own pumpkins to help preserve the $5.99 price tag on its store-baked pies. "If that stuff doesn't really turn you on," says Sinegal, "then you're in the wrong business."

So far, the results have been mixed. Membership growth is up 7.3% from last year, while sales at stores open at least a year grew by 7% in September. But higher costs are pinching profits. The company warned Wall Street in July that its fourth-quarter profits would be "well below" expectations. On Oct. 8 the company reported earnings-per-share growth that fell short of those lowered expectations.

One thing working in Costco's favor is its buzz factor. The chain is known for its constantly changing roster of high-quality goods, which entices shoppers to make impulse buys. Anyone can walk into Wal-Mart for cheap underwear, but getting a discount Cartier watch is something else entirely—especially when customers know it may not be there when they come back. Such deals, more prevalent in a weak economy, have made Costco a place where even the highly affluent like to brag about shopping. (The average member household makes upward of $75,000 a year.) David Novak, CEO of YUM! Brands, says he buys wine and cleaning equipment at Costco. As QVC CEO Michael George, a longtime member, puts it: "You don't just go there for bargains. You go there for the treasure hunt."

TOUGH BANANAS

From his Issaquah (Wash.) office outfitted with mismatched secondhand folding chairs, Sinegal, the son of a coal miner, constantly trawls for new brands to keep those wealthy shoppers coming through the doors. "I tell our people every week, 'Call Coach,'" says Sinegal, referring to the New York handbag maker. "They have to be concerned about the economy." Coffee maker Starbucks recently agreed to sell five $20 gift cards for $79.99 at Costco this fall, a deal it doesn't offer customers in its own cafés. Over the past year, Waterford crystal, Versace dinnerware, Lilly Pulitzer dresses, and Herman Miller chairs have all made their way into Costco's stores. "I think their store will probably look like Saks pretty soon," says an executive of one popular fashion brand.

Yet it is these optional, nice-to-have products—what economists call discretionary items—that are the most vulnerable to a cutback in consumer spending. To keep members coming in, Costco must hold the line on prices for food and sundries, which account for more than half of all sales. In many cases that means tough bargaining with suppliers.

Take bananas. For years, Costco bought 85% of its supply from the Ecuadoran brand Bonita. But after heavy rains and flooding threatened the crop last year, Bonita tried to add an extra $6 fee per case. With margins on bananas already razor-thin, Costco's head of fresh-food buying, Jeffrey Lyons, went looking for sources that would accept a lower fee. For 10 weeks, Costco had very few bananas in its stores. Bonita "had us, it thought, over a barrel," Lyons says. "We can't give in to that kind of pressure." He now buys bananas from companies in five different countries; Bonita is no longer one of the providers. Bonita's North America distributor, Pacific Fruit, did not respond to requests for comment.

Costco is also joining forces with its suppliers to dream up new ways to rein in costs. For example, the chain typically buys 70% of the premium macadamia nuts produced by Mauna Loa, a unit of Hershey. Now it's working with Hershey to use smaller nuts in a new chocolate-nut cluster that will be sold at Costco. Because Hershey won't have to risk unloading those smaller nuts at a steep discount, it can afford to ease its prices on the premium nuts. Everybody wins.

The tiniest tweaks to Costco's well-oiled supply chain have yielded impressive results. One simple change involved giving cheap restaurant-style buzzers to drivers who deliver goods to Costco warehouses. Instead of parking their vehicles and making the long hike to the front of the building with their paperwork, they now exchange their inventory list for a buzzer at the guard booth and then back up to the loading door without leaving their cabs. The buzzer goes off when the truck has been unloaded. That time-saver alone is expected to save Costco around $7 million next year in labor costs.

Costco has even gotten vendors to redesign product packages to fit more items on a pallet, the wooden platforms it uses to ship and display its goods. Putting cashews into square containers instead of round ones will decrease the number of pallets shipped by 24,000 this year, cutting the number of trucks by 600. By reshaping everything from laundry detergent buckets to milk jugs, Costco has needed 200,000 fewer pallets overall.

Sinegal acknowledges that he can't hold back the cost increases forever. Indeed, within the past six months Costco has twice raised the price of its popular rotisserie chickens, by a total of 20%, to $5.99. But he isn't giving in to higher costs without a fight. "The biggest concern to me is that we lose our way and...start thinking it doesn't matter if you charge another dime or another dollar or another hundred dollars," he says. "Without those disciplines, we don't have anything." |BW|

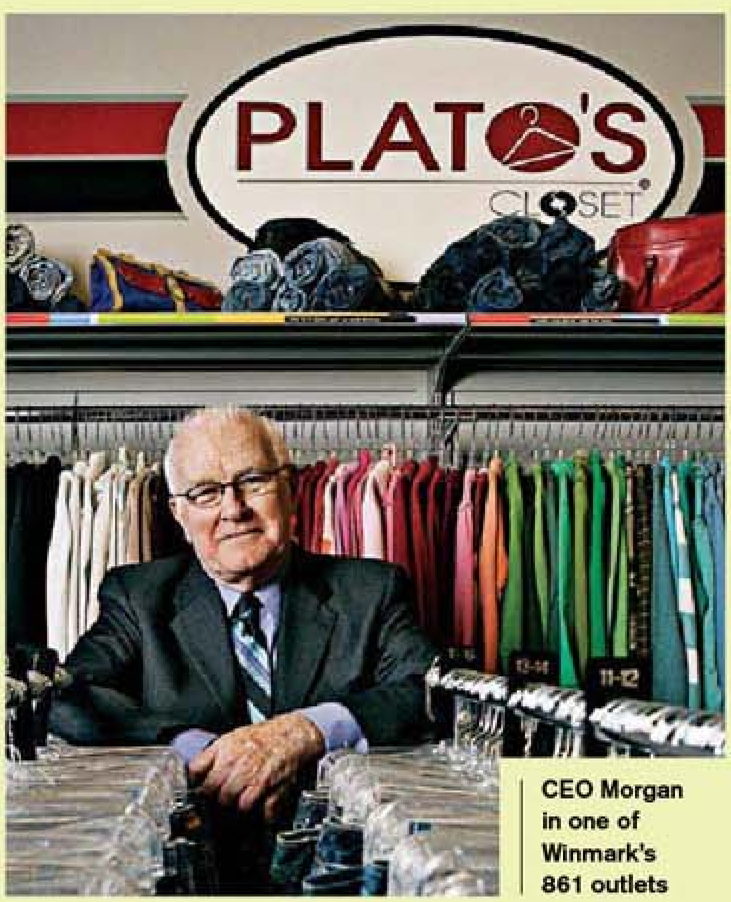
BUSINESSWEEK.COM For more on Costco's money-saving strategies, watch a video report at www.businessweek.com/go/tv/costco

THRIFT SHOPS ON EASY STREET

Winmark's used-goods empire is outperforming other retailers

By Jane Porter

Hard times have been pretty good to Rita Cortese. Since 2006, she has owned a Plato's Closet used clothing store in Deptford, N.J. In recent months, Cortese says, business has exploded as people descend on her store to buy or sell castoff shirts, dresses, and jeans. Cortese is so busy she recently built a shed out back to contain her overflowing inventory.



CEO Morgan in one of Winmark's 861 outlets

THOMAS STRAND

Winmark, the Nasdaq-listed company that sold Cortese her Plato's Closet franchise, is a rarity in a scorched retail landscape: It's growing rapidly and making money. Sales at Plato's Closet outlets open more than a year were up 19.6% in August, vs. 1.7% for the industry as a whole. "I don't wish this economy on anyone," says John Morgan, Winmark's chief executive. "But we're going to make hay while the sun shines."

The company that would become Winmark was born 25 years ago as Play It Again Sports, which sold used hockey sticks, baseball mitts, and so forth. Ten years later the company went public as Grow Biz. But by 2000, it was suffering the usual ills of overexpansion. Enter Morgan, who renamed it Winmark and focused on four franchises: Play It Again Sports, Once Upon A Child (kids' apparel), Music Go Round (used musical instruments), and Plato's Closet (which, like the other franchises, also sells some new items). Today, Winmark has 861 stores nationwide.

Franchisees pay a $20,000 one-time fee, plus 3% to 5% of weekly sales. In return, Winmark provides the business model, training, and marketing. "All the risk falls on the franchisee," says Graeme Rein, research analyst for Bares Capital Management, which owns 14% of the company. "It's on their shoulders to create a profit." Because franchisees pay cash on the spot, they have powerful bargaining leverage. For example, Cortese pays $6.80 for a pair of Hollister jeans and resells them for $18.

Since consumers are going to be hurting for a while, it's a fair bet that Winmark, whose stock has suffered this year along with the rest of the market, will continue to outperform the retail sector. Not that Morgan, who owns a quarter of the company, is standing pat. He's plowing Winmark profits into another franchise operation he expects to do well in hard times—leasing office equipment to credit-parched small businesses. And guess who he's recruiting to run the franchises: managers who've lost their jobs.

Smith was able to cut monthly payments on her California home by nearly $2,000

MAX S. GERBER

STRATEGIES

IndyMac: Thinking Beyond Foreclosure

The FDIC has started a loan modification program at the bank that could offer a blueprint for the industry

By Christopher Palmeri

Diane Smith could have been another foreclosure statistic. The 56-year-old mother of two refinanced her Los Angeles home in 2006 to pay for a kitchen remodeling. But Smith, a small business owner, found herself in trouble earlier this year after the teaser rate on her adjustable-rate mortgage expired and banks began lowering spending limits on her credit cards.

That's when her mortgage lender, IndyMac Federal Bank, made her an offer she couldn't refuse. In September the bank knocked the rate on her loan down to 4.75% a month, slashing her monthly payments from $6,000 to $4,050. The bank also provided counseling to help Smith manage her household expenses. "Banks should do that before they give a loan," she says.

Smith is one of more than 3,000 borrowers who have signed on to a fast-track loan modification program launched by IndyMac, the insolvent

California lender seized by the feds in July. Officials from the Federal Deposit Insurance Corp. have moved quickly to tackle the 60,000 delinquent mortgages in IndyMac's portfolio of 742,000 home loans. In late August letters went out to 7,500 distressed borrowers, offering new terms. The FDIC says those taking part have seen their monthly payments lowered by $430, on average.

SIMPLIFIED PROCESS

FDIC Chairman Sheila C. Bair is hoping the IndyMac initiative will provide a blueprint for the rest of the industry. Lenders have been under fire from politicians and consumer advocates for not doing enough to stave off a wave of foreclosures: Filings were up 82% in the first half of the year. The FDIC and investors will end up footing the bill for IndyMac's loan modification program. If the plan succeeds, it will keep families like Smith's in their homes and could help arrest the rot in the complex, mortgage-backed securities that precipitated the worldwide financial meltdown. "Theirs is the first systematic effort to really simplify the loan modification process," says Austin King, director of the financial justice unit at Acorn, a community advocacy group. "That is the solution to the mortgage crisis."

Like it or not, more lenders may be compelled to negotiate new terms with delinquent borrowers. On Oct. 6, Bank of America announced it had reached a legal settlement with authorities in 11 states that had been looking into allegations of predatory lending practices at Countrywide Financial, the tottering mortgage lender it acquired earlier this year. As part of that deal, Bank of America has committed to modifying loans for nearly 400,000 customers.

Bankers have long argued that there is no one-size-fits-all solution to the mortgage mess. Loan workouts, they say, must be done on a case-by-case basis. Yet the IndyMac program was designed around a simple formula: Borrowers' mortgage payments should amount to no more than 38% of their gross income. "The key is to make the new loans affordable," says John Bovenzi, the senior FDIC executive now serving as CEO at IndyMac.

Bovenzi also knows how to tailor his pitch. At banks, the traditional approach is to send delinquent borrowers a form letter asking them to call the bank to discuss their payment problems. But instead of using regular mail, IndyMac sent out its letters in overnight delivery packages, which had to be signed for (to prevent the contents from being mistaken for junk mail). What those envelopes contained was—by bank standards—a remarkably straightforward piece of communication: a letter stating "We want to help you stay in your home," at the top, accompanied by a dollar figure—the new, lower monthly payment being offered. All the recipient had to do was sign a couple of forms and pop them into a prepaid return envelope.

$430

Average monthly savings for borrowers who have signed on to IndyMac's loan-modification program

Data: FDIC

IndyMac's new management readily acknowledges that not all distressed borrowers can be helped. As many as one-third just don't have the income to support even reduced payments, reckon insiders at the bank. One such case involved a Nevada woman who wanted to relocate after her husband—the family's sole breadwinner—was incapacitated by a stroke. In what's known as a "cash for keys" offer, IndyMac paid her $5,000 to surrender her home.

As word of its program has gotten around, IndyMac has been deluged with inquiries from borrowers looking to refinance on better terms, though it's debatable whether many of them are in need of assistance. One Washington (D.C.) woman telephoned senior FDIC officials as well as the top four IndyMac executives to badger them about lowering payments on an investment property. The bank postponed a scheduled foreclosure but hasn't agreed to renegotiate. "This is like triage after a train crash," says IndyMac spokesman Evan Wagner. "You take care of the worst cases first."

Bovenzi has plenty of experience in dealing with bad loans. An FDIC veteran, he worked at the agency during the savings and loan crisis of the late '80s and early '90s. One of the key lessons from that era: Debt workouts can pay off for lenders as well as for borrowers. Bair, in a Sept. 17 speech to Congress, noted that the FDIC's recovery rate on nonperforming loans averages just 32% of the loan's value. If the loan is current, the agency gets 87%.

It's too early to judge whether the IndyMac program will succeed. There are studies that show many loan modifications offer at best only temporary reprieves: Many borrowers will continue to fall behind on payments. Plus, there's no guarantee that whoever buys IndyMac will carry on with the program. Already several would-be buyers have visited its Pasadena headquarters to pore over the books. In the meantime, Bovenzi—who once headed an FDIC unit called the Liquidation Dept.—has been busy dumping assets. First to go were the season tickets to Los Angeles Dodgers game used to entertain corporate clients. A company-owned Porsche went for $65,000 on AutoTrader.com in August. Next on the list: the paintings hanging on the walls. |BW|

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How Do You Spell Relief?
Valparaiso University law professor Alan White looked at 4,344 renegotiated subprime loans and found that only half of the modified loans resulted in lower payments. In many cases the amount owed actually rose as missed payments and late fees were added to the loan's principal. His conclusion: "The subprime crisis will be worked out only over many years."

To read White's study, go to **http://bx.businessweek.com/mortgage-crisis**