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Merrill's own subprime warnings unheeded

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By [Al Yoon](#)

NEW YORK (Reuters) - Merrill Lynch & Co Inc's own investment advice on subprime loans appears to have gone unheeded in its executive office.

Merrill Chief Executive Officer Stan O'Neal maintained an aggressive tack on subprime securities into 2007 even as investors began balking at the bonds and some in the industry labeled pricing as irrational.

Merrill Lynch MER.N equity analyst Kenneth Bruce in September 2006 warned clients that companies with subprime exposure could face lower earnings, since demand for the debt "could dissipate quickly" as credit worsened. Bruce's call coincided with soaring prices on subprime bonds even as mortgage defaults escalated.

Bruce declined to comment, a Merrill spokeswoman said. He covers mortgage companies for Merrill.

O'Neal, who led the New York-based company through four consecutive years of record profit as housing boomed, will likely be ousted, according to published reports. Board sentiment on O'Neal apparently soured after the company recorded an \$8.4 billion write-down in the third quarter, triggering Merrill's biggest quarterly loss ever.

Bruce made his call, which also suggested an "asset fire-sale" could cause prices to tumble, as Merrill prepared to buy subprime lender First Franklin Financial Corp from National City Corp NCC.N.

The First Franklin deal puzzled analysts because the market for subprime loans was souring in a hurry when the deal was announced. Home price appreciation that allowed subprime borrowers to refinance and escape sharp increases in mortgage payments had also come to a halt.

That led to increased bearish bets by some investors, including hedge funds. Prices on the lower-rated portions of a key subprime bond index began falling briskly, and today are worth about a fifth of their initial value.

Nevertheless, Merrill pushed through on the First Franklin deal, paying \$1.3 billion in December.

Last week, O'Neal admitted the company underestimated its exposure to the subprime market. But he defended the rationale behind the First Franklin deal.

"The idea behind First Franklin was to be able to more directly control the quality of the loans that were being taken into inventory as raw material, if you will, for securitization," O'Neal said.

By purchasing First Franklin, "we believed we would be able to gain more quality control over the assets as opposed to purchasing from third party mortgage brokers," he said.



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