ANATOMY OF A DISASTER THE WEEK THAT ROCKED WALL STREET

WHEN YOU CONSIDER HOW RECENTLY IT HAPPENED AND THE EFFECT IT HAD ON US ALL, IT IS SURPRISING HOW FEW OF US FULLY UNDERSTAND THE DOMINO EFFECT THAT LED TO WHAT WE NOW REFER TO AS THE GLOBAL FINANCIAL CRISIS. *DISCOVERY CHANNEL MAGAZINE'S* **CHRIS WRIGHT**, WHO COVERED THE CRISIS AND ITS AFTERMATH, BREAKS DOWN THE KEY EVENTS OF A WEEK THAT CHANGED EVERYTHING

OVER THE COURSE OF 2007 AND 2008, BANKS LENDING SUB-PRIME MORTGAGES CREATED A CRIPPLING CREDIT CRISIS THAT FORCED THE CLOSURE OF SEVERAL BANKS AND INVESTMENT FIRMS. THE RECESSION WHICH FOLLOWED HAS BEEN DESCRIBED AS ONE OF THE WORST FACING THE UNITED STATES SINCE THE GREAT DEPRESSION

PHOTO: CORBIS/CLICK PHOTOS

DRAMATIS PERSONAE

THE CAST OF THE DRAMA, AND THEIR JOBS IN 2008

HANK PAULSON
US Secretary of the Treasury
THE EQUIVALENT OF FINANCE MINISTER IN MANY ASIAN COUNTRIES

BEN BERNANKE
Chairman of the Federal Reserve
THE UNITED STATES' CENTRAL BANK

DICK FULD
CEO of Lehman Brothers

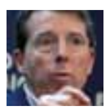
TIMOTHY GEITHNER
President of the Federal Reserve Bank of New York
THE HIGHEST NEW YORK REPRESENTATIVE OF THE FED (THESE DAYS HE IS US SECRETARY OF THE TREASURY, PAULSON'S OLD JOB)

JAMIE DIMON
CEO, JPMorgan

LLOYD BLANKFEIN
CEO, Goldman Sachs

JOHN MACK
CEO, Morgan Stanley

BOB DIAMOND
CEO, Barclays Capital



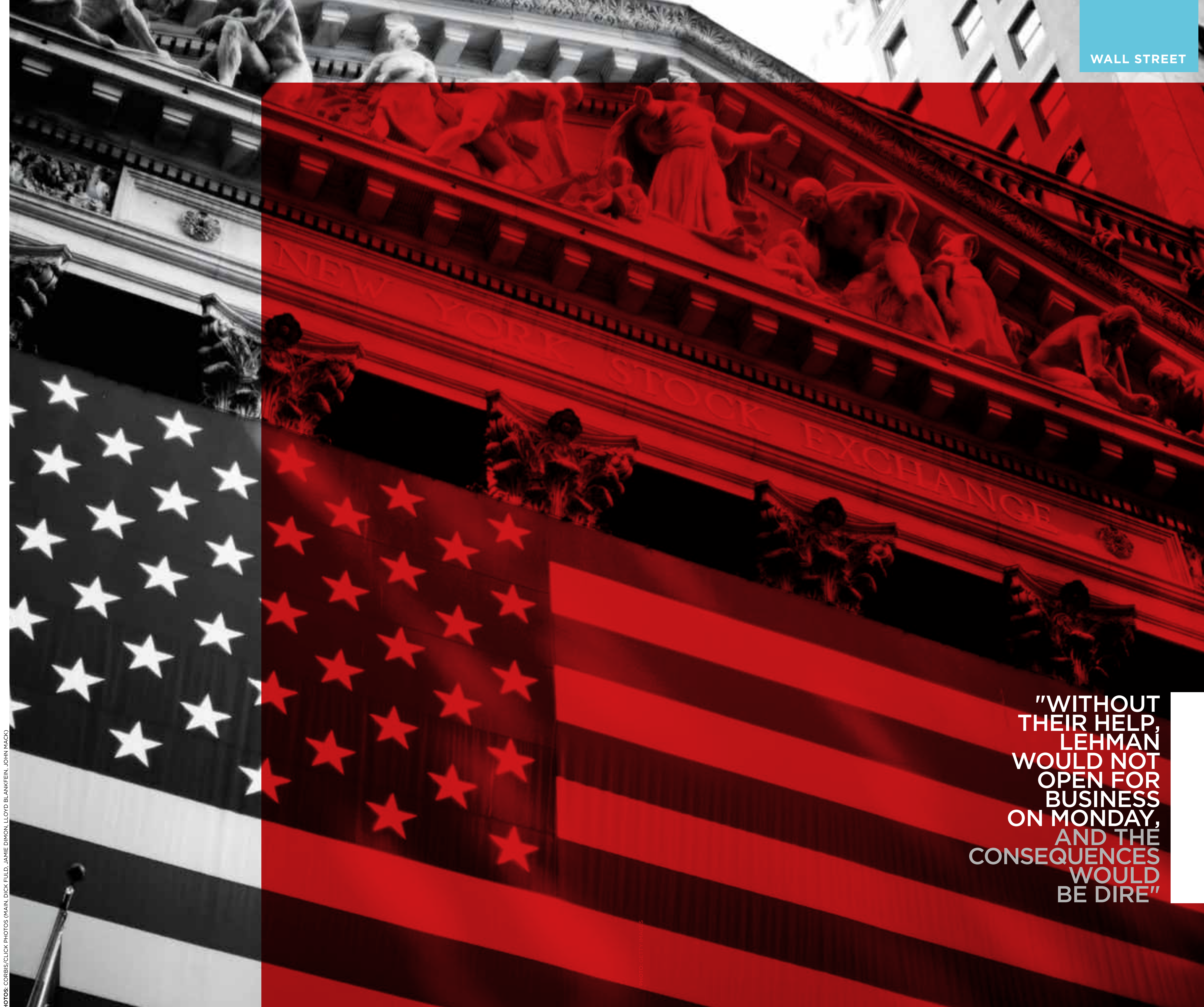
BOB WILLUMSTAD
CEO, AIG

ALISTAIR DARLING
Chancellor of the Exchequer, UK
PAULSON'S OPPOSITE NUMBER

JOHN THAIN
CEO, Merrill Lynch

KEN LEWIS
CEO, Bank of America

VIKRAM PANDIT
CEO, Citigroup



PHOTOS: CORBIS/CLICK PHOTOS (MAIN, DICK FULD, JAMIE DIMON, LLOYD BLANKFEIN, JOHN MACK)

"WITHOUT THEIR HELP, LEHMAN WOULD NOT OPEN FOR BUSINESS ON MONDAY, AND THE CONSEQUENCES WOULD BE DIRE"

FRIDAY
SEPTEMBER 12
2008

At 4pm, as a rattled New York stock exchange closed for the day, the chiefs of the United States' biggest banks started receiving calls from the New York Federal Reserve, commonly known as the Fed. The message: there's a meeting at 6pm, and your attendance is compulsory.

None of the chief executives were surprised. As the accompanying article *(page 40)* shows, it had been clear for months that the banking system was spiralling towards collapse. Bear Stearns, one of America's five historic investment banks, had fallen and been pushed into a merger with JPMorgan in March. Freddie Mac and Fannie Mae, the huge enterprises linked to half the mortgages in the United States, had been taken over by the state in September to stop them from collapsing. And by now, Lehman Brothers, the fourth biggest investment bank in the country, was on the brink of collapse. Insurer AIG, intrinsically linked to every bank in America and plenty more worldwide, looked little better, while investment bank Merrill Lynch was in increasing peril too.

Gradually the bankers ditched what they were doing, with varying degrees of disgruntlement. Goldman Sachs chief executive officer (CEO) Lloyd Blankfein was at a conference where he had just agreed to let Hillary Clinton speak first, ahead of him. After receiving the call from the Fed, he told her he would have to swap back again. Jamie Dimon, who ran JPMorgan, cancelled a dinner with his daughter's boyfriend's parents, whom he was meeting for the first time. It was pouring with rain and the traffic was bumper to bumper; John Mack, CEO of Morgan Stanley, told his driver to use a bicycle lane alongside the West Side Highway in order to make it in time. Hank Paulson, the US Secretary of the Treasury, the man in government in charge of the nation's finances, had flown in from Washington, but his Secret Service Chevrolet Suburban was wedged in the Holland Tunnel between New Jersey and Manhattan, making him late for the very meeting he had just called.

The New York Federal Reserve building, at 33 Liberty Street, looks like an ancient financial landmark should. It is made of stone, stocky, grand, imposing. The sort of place that should have gold in the vault. Which it does, and plenty of it. As the New York arm of America's central bank, the Federal Reserve, it has hosted its fair share of important meetings since its 1924 inauguration. But few were as important as this.

It began, eventually, at 6.45pm. Paulson, New York Federal Reserve president Tim Geithner, and Christopher Cox, the head of America's Securities and Exchange Commission (SEC), the regulator which oversees the stock market, represented the public side of the fence. On the private-sector side were the bank CEOs. Every major bank in America was there, with three notable and deliberate omissions: Dick Fuld, CEO of Lehman Brothers, the very bank that was causing the most trouble at the time; and Ken Lewis of Bank of America and Bob Diamond of Barclays Capital, both of which were in negotiations to buy Lehman.

"We all knew why we were there," writes Paulson, in his account of the financial crisis, *On The Brink*. "Without their help, Lehman would not open for business on Monday, and the consequences for the markets — and for everybody sitting around the table — would be dire." He and Geithner told the gathering the government would not step in this time, as it had in the past. Lehman Brothers was not, as the saying goes, too big to fail. Instead he wanted the banks to work together to save it, because if they didn't, they all had exposures to Lehman and could well fall with it.

ON NORMAL DAYS, TRADERS IN NEW YORK AND ELSEWHERE ALREADY HAVE TO WATCH THE ELETRONIC TRADING BOARDS IN THE NEW YORK STOCK EXCHANGE LIKE HAWKS. DURING THIS TROUBLED WEEK IN 2008, IT WOULD HAVE BEEN VIRTUALLY IMPOSSIBLE TO TEAR ONE'S EYES AWAY — EXCEPT FOR A QUICK MOMENT TO PANIC, PERHAPS

PHOTO: CORBIS/CLICK PHOTOS

Swiftly, the bankers started arguing. Dimon and Vikram Pandit, the CEO of Citigroup, started barracking each other about the state of the equally troubled insurer AIG, which both banks were supposed to be helping. Breaking it up, Paulson told the bankers to reconvene there with their teams at 9am the next morning, Saturday. He added: "This is about our capital markets, our country. We will remember anyone who is not seen as helpful."

As they left to their waiting cars, few went home, instead marshalling their deputies and gathering food for a long night ahead. And Fuld? He found out he hadn't even been invited to a meeting about the future of his own bank, then discovered that Bank of America — who he had hoped to sell his bank to in order to save it — had been frightened off after a close examination of the books. That left only Barclays as a potential buyer. It was not a good evening.

BY 7.30AM, DIMON WAS TELLING HIS MANAGEMENT TEAM TO DRAW UP PLANS FOR THE COLLAPSE OF THE ENTIRE AMERICAN INVESTMENT BANKING INDUSTRY

SATURDAY
SEPTEMBER 13
2008

The nation's most powerful bankers were all up early for a Saturday. At 6.30am John Thain, CEO of Merrill Lynch, and his colleague, Merrill president Greg Fleming, were on the phone to one another, working out whether they should try and sell their bank before it went under. By 7am, Paulson had made his way from the Waldorf Astoria New York hotel, to the Fed. By 7.30am, Dimon was on a conference call with his management team telling them to draw up contingency plans not only for a failure of Lehman, nor even just of Merrill and AIG, but also of Morgan Stanley and Goldman Sachs — that is to say, the collapse of the entire American investment banking industry.

By 8am, the lobby of the Fed was full of bankers and their lawyers. "They were trying to save themselves from their own worst excesses, and, in the process, save Western capitalism from financial catastrophe," writes Andrew Ross Sorkin, whose outstanding book — *Too Big to Fail* — has never revealed its sources, but they clearly include pretty much everyone in the room that day. Many were holding that day's *Wall Street Journal*. On its front page: *Lehman Races Clock; Crisis Spreads.*

The most powerful men in American finance were split into three groups to try to work out how to save Lehman. You might think they would want to see a competitor fail, but they all understood the knock-on effects would be much worse for them than if it survived. According to Sorkin, Geithner told them: "I'm going to come back in two hours. You guys better figure out a solution and get this thing done." Also according to Sorkin, Pandit noted, "This is f...ing nuts."

Meanwhile the other major players in the crisis were spread around the Fed's building, Lehman on the sixth floor (minus Fuld, now considered so stressed and volatile as to be unreliable), Barclays on the fifth and Bank of America, the 13th.

At the same time, several other things were happening. Thain had realised that Lehman was not going to survive the weekend, and that his firm, Merrill Lynch, would be next. He called Fleming, who was not in the room, and told him to initiate discussions with Bank of America about a merger. This would prove to be just the start of an extraordinary day for Thain. Later John Mack, of Morgan Stanley, walked up to him and said, "We should talk". Which is Wall Street shorthand, in these circumstances, for "we should merge." Later still, Goldman Sachs indicated it might be interested in buying Merrill too, and set up a meeting for the next morning. None of them, naturally, knew who was talking to anybody else. The future of American banking was being decided in Chinese whispers. For example, Bank of America had told Paulson and Geithner at 10.30 that morning that it definitely wasn't going to buy Lehman. But certainly nobody told Thain and Merrill that. Information was advantage, and money. At every corner, bankers were looking at one another and thinking of the other as potential partners and saviours. Or as predators.

In the end, Thain had two big meetings that day. One was with Bank of America's CEO Ken Lewis at BofA's corporate apartment at One Central Park at 2.30pm; the other with Mack at Morgan Stanley banker Walid Chammah's apartment at 5pm. Only BofA could seriously do a deal in time, but it, unlike its Wall Street peers, is based in Charlotte, in the US state of North Carolina, and the BofA team had sent many of their bankers back home after deciding not to buy Lehman. Now they set about frantically trying to recall them all, to look at buying Merrill instead.

Also at the same time, AIG was working through the weekend figuring out how close to the edge it was. At that stage in the weekend a JPMorgan team advising AIG had concluded it needed to raise about US$40 billion — a figure that would later get even larger — which seemed unfathomable. AIG chief Bob Willumstad's office was full of some of the biggest names in private equity.

THAIN HAD REALISED THAT LEHMAN BROTHERS WAS NOT GOING TO SURVIVE THE WEEKEND, AND THAT HIS FIRM MERRILL LYNCH WOULD BE NEXT

To the uninitiated, private equity is a form of banking in which a fund invests a lot of money in a company, usually gaining some management control too, in the hope of turning the business around, then cashing out at a big profit later. Today, they looked like vultures looking for tasty scraps from AIG's carcass. As indeed they were.

Hearing of this, the Fed summoned Willumstad for an update on AIG, having been tipped off on just how appalling a state the company was in.

"It gave me a chill to think of the potential impact of AIG's problems," Paulson writes. "The firm had tens of millions of life insurance customers and tens of billions of dollars of contracts guaranteeing 401Ks [pension plans] and other retirement holdings of individuals. If any company defined systemic risk, it was AIG."

Irritated, before long a group of bankers had started doing unkind impersonations of Paulson, Geithner and Cox. Yet as the day wore on, Paulson's mood was lifting. Things seemed to be coming together: Barclays buying Lehman, Bank of America buying Merrill. Job done.

PHOTOS: CORBIS/CLICK PHOTOS

ABOVE: EVERYONE WAITED ON TENTERHOOKS, INCLUDING MEDIA CAMPED NEAR THE NEW YORK STOCK EXCHANGE, TO SEE HOW EVENTS ON WALL STREET WOULD CHANGE THE WORLD **LEFT:** SEPTEMBER 19, 2008, THE DAY THAT HANK PAULSON, THEN US SECRETARY OF THE TREASURY, SHARED THE TROUBLED ASSET RELIEF PROGAM WITH THE WORLD. MARKETS RALLIED, BUT NO ONE KNEW IF IT WOULD HOLD

SUNDAY SEPTEMBER 14 2008

It was after midnight on the Saturday night when the Barclays team prepared to leave, having struck an in-principle agreement to buy the "good" bits of Lehman Brothers for US$3.5 billion while the other banks helped to finance the debt of the "bad" bits (Lehman's real estate assets) to the tune of US$33 billion — an investment, essentially, to protect them from the knock-on effect of Lehman going under on Monday. On the way out, they briefed the many other bankers still there late at night on the plan. It is probably an understatement to say it didn't go down well, but recognising the lack of other options and the systemic risk otherwise, they set about making a term sheet, a document that sets out the basics of a deal.

It was also after midnight when the many bankers in AIG's offices made an unfortunate discovery: that one of the company's businesses had lost US$20 billion more than anyone had thought. The amount of money the company needed had just gone up, from US$40 billion to US$60 billion.

Global capital did not sleep that Saturday night. Sorkin reckons that at 3am, there were still more than 200 Merrill Lynch and Bank of America bankers and lawyers working their way through a second round of pizza delivery at the law firm of Wachtell, Lipton, Rozen & Katz, as they tried to complete the due diligence process. The Fed guys, reasonably optimistic, left their meeting with Barclays at 4am. Diamond, at that point, was just dialling in to a board meeting.

By 8am, the big cheeses were back at the New York Fed. Despite the lack of sleep, there was a somewhat better mood, as it appeared the Barclays-Lehman deal was on track.

The problem was, nobody involved in the Barclays-Lehman idea had spoken to the British regulators, who had a rather different view of the whole situation. Before they would approve a deal, they wanted assurances that Barclays would get help from the US government. And in any case, Barclays would need to have a shareholder vote to buy Lehman, which would take 30 to 60 days. Neither the American nor British governments were prepared to guarantee Lehman's assets in the meantime.

Sir Callum McCarthy, head of the UK's Financial Services Authority, had been trying to get hold of Geithner, his opposite number in America, to explain these facts, but was unable to get him on the phone. Finally, on Sunday morning New York time (afternoon in London), they spoke. Geithner and Paulson were aghast. The only person in the UK who could get around this was Alistair Darling, the Chancellor of the Exchequer, if he granted a waiver about the issues of concern. Paulson got hold of him at about 4pm UK time. Darling was by now facing big problems at several UK institutions, particularly HBOS and Lloyds, but to some degree even at Barclays itself. It was not clear that Barclays was in sufficiently robust health to be buying anything.

"He made it clear, without a hint of apology in his voice, that there was no way Barclays would buy Lehman," Paulson writes. "He was not willing to have us unload our problem on the British taxpayer. He was delivering a clear message — we would get no help from the British. Our last hope for Lehman was gone."

It was over. In that phone call with Darling, the death knell was sounded on a 150-year-old bank, which on the previous Friday had been the fourth largest investment bank in the United States.

Paulson went back to the main conference room, passing through all the executives on the first floor ("like pushing through a crowd at a stadium", he writes) and told the CEOs. His precise words were, "The British screwed us."

The bankers were incredulous, having just figured out a way to get enough money to save the bank, after working on the problem all night. But Paulson said there was no way back. Lehman would file for bankruptcy that day — and an emergency trading session would be opened that afternoon, on a Sunday, for the banks to unwind their exposures to Lehman, before it fell.

It is just a bank, you might think. Paulson did not see it that way. "Lehman was as good as dead, and AIG's problems were spiralling out of control," he writes. "With the United States sinking deeper into recession, the failure of a large financial institution would reverberate throughout the country — and far beyond our shores. I could see credit tightening, strapped companies slashing jobs, foreclosures rising ever faster: millions of Americans would lose their livelihoods and their homes. It would take years for us to dig ourselves out from under such a disaster."

Regrettably, every word of this vision proved to be correct. Overwhelmed, he took a moment to call his wife, Wendy. "What if the system collapses?" he said to her. "Everybody is looking to me, and I don't have the answer. I am really scared."

Yet there was no time to wallow. Now, attention turned to Merrill, which everyone knew would go under the following morning too if a deal wasn't sorted out before the markets reopened. According to Sorkin, Paulson told Thain: "If you don't find a buyer by this weekend, heaven help you, and heaven help our country." At the same time, the problems at AIG were getting worse. By Sunday evening its top brass were back at the Fed, spelling out just how close they were to bankruptcy.

In brighter news, later that day Merrill and Bank of America struck a deal for BofA to buy Merrill at US$29 a share, widely considered an extraordinary outcome for Merrill. The firm was saved, yet at the same time it was lost. "In a matter of hours, Merrill Lynch, with a history of nearly one hundred years as one of the most storied names on Wall Street, would be sold to Bank of America for the biggest premium in the history of banking mergers," writes Sorkin. "It was, as one newspaper later put it, as if Wal-Mart were buying Tiffany's."

As 7pm arrived in New York, Asian markets were preparing to open on Monday morning, by their time zone. Cox at the SEC had wanted to hold a press conference hours earlier, to announce Lehman's bankruptcy before any markets reopened. But he could not do so until Lehman formally filed, which it was flatly refusing to do. A meeting among lawyers to try and make it happen came within a hair of turning into a brawl.

It took until midnight for Lehman's board meeting to creak along to a vote on whether or not to file for bankruptcy. It was passed, and Lehman formally filed at 1.45am. As Sorkin writes, Fuld said, "I guess this is goodbye." He went home, with no job to return to. And the bank he had headed, gone too.

MONDAY SEPTEMBER 15 2008

None of the principal players in the crisis and its resolution had time to rest from their exhausting weekend. Lack of sleep would become a fixture for the rest of the week and beyond, adding further stress to the momentous decisions being made. Barclays' Diamond for example, having had a call from Lehman the previous night, was now wondering if he could buy the bits of Lehman he wanted from the bankruptcy, which would be better for him anyway. He would not be saddled with the bad stuff, with no need for approval from the regulators in the UK or a shareholder vote. He set up a meeting with the relevant Lehman team for 5am.

Everyone, whenever they got up, did two things. First, check how markets in Asia and Europe were responding, then see what the press made of it. The *Wall Street Journal* that morning had doubled its usual headline point size and run it over two lines: *Crisis on Wall Street as Lehman Totters, Merrill is Sold and AIG Seeks to Raise Cash* (Lehman had formally filed for bankruptcy protection after the *Journal* had gone to press). As it happened, early in the morning, well before the US markets opened, other world markets were not badly down. Generally, the mood in America displayed a certain satisfaction that "fat-cat bankers" at Lehman had not been bailed out by the state.

First thing in the morning, Paulson got a call from President George W. Bush, one of several such calls in recent days. Paulson brought him up to speed. Around the same time, Dimon, having spent the weekend trying to help save Lehman, was being tasked (alongside Goldman Sachs) with saving another firm, by raising money for AIG. Over at Lehman, Fuld, now jobless, was arriving at headquarters to help organise bankruptcy. He was supposedly escorted upstairs by security, in case he was attacked by his former employees.

That morning, a meeting between the banks and the government about AIG took place back at the New York Fed building, with which they were all far too familiar with by now.

LEHMAN REFUSED TO FILE FOR BANKRUPTCY, AND A MEETING TO TRY AND MAKE IT HAPPEN CAME WITHIN A HAIR OF TURNING INTO A BRAWL

A PROTESTER OUTSIDE AIG'S HEADQUARTERS, DRESSED AS THE GRIM REAPER. NEWS OF AIG'S TROUBLES MARKED THE FIRST STAGES OF WIDER PANIC

PHOTO: CORBIS/CLICK PHOTOS

PHOTOS: CORBIS/CLICK PHOTOS

Why the urgency? AIG was much more than just an insurer. Every bank on Wall Street had a lot of exposure to it and would be badly hit if it fell — as would countless others worldwide.

Sorkin summed up the situation. All banks have to meet capital requirements set by their national regulators. European banks in particular had been allowed to meet some of those requirements by using things called credit default swaps. The idea of these was that AIG, which was rated AAA by the rating agencies, the highest of all possible ratings, would use that rating and apply it to banks' riskier assets. But if AIG failed, those wraps, as they were called in the industry, would disappear. Banks would have to value those assets at their real worth, and to stay in line with regulatory requirements, would have had to raise billions of dollars. In this climate, that was impossible. AIG had more than US$300 billion of these credit default swaps out there. In addition, many Asian governments owned AIG investments. So in many ways, AIG's collapse would have been much, much worse for world finance than Lehman Brothers'.

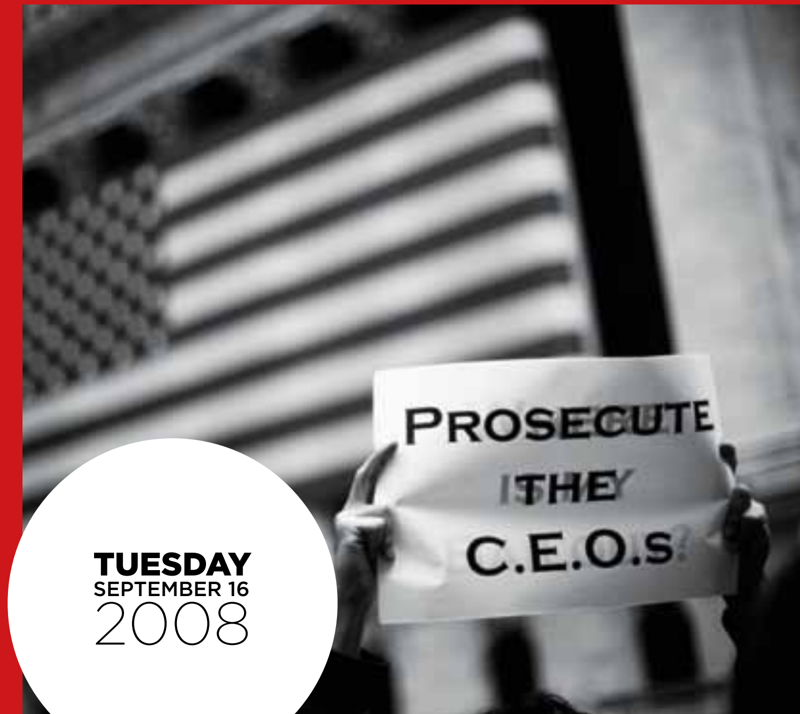
At 1.30pm, Paulson, now in Washington, spoke with the press at the White House. The questions were stern. Why did you bail out Bear Stearns and let Lehman fail? Does that mean you won't do any more bailouts? Next, the two hopefuls running for US presidency in November's election, Barack Obama and John McCain, were briefed, and urged not to make the situation worse by using it for political gain.

The stock market, which had seemed calm in Asian and European trading hours, was now falling. The Dow Jones Industrial Average, the key benchmark of US stocks, fell 504.48 points, in the biggest one-day decline since the first day of trading after the September 11 attacks. AIG lost 65 percent of its value. Paulson was even now being warned by behemoth General Electric that it could be in trouble, since it could no longer access the commercial paper market, a short-term form of a bond used to fund day-to-day company operations.

"If mighty GE was having trouble rolling its commercial paper over, so were hundreds of other industrial companies," Paulson writes. "If they all had to slash their inventories and cut back operations, we would see massive job cuts spreading throughout an already suffering economy." Already it was becoming clear just how widespread the repercussions of the financial crisis would be. "It was the dismal beginning of what would be a thoroughly dismal week," he writes.

Meanwhile, over a hundred bankers and lawyers were gathered in AIG, trying to work out a way to save the company. They would spend all day crunching numbers. Yet by 1am, people had started to leave and it had become increasingly clear that AIG could not be saved without a government bailout. Morgan Stanley bankers who were advising the Fed started waking people up to tell them their conclusion. A conference call was set up for 3am.

ALTHOUGH PAULSON AND EVERYONE ELSE INVOLVED IN TRYING TO KEEP THE AMERICAN ECONOMY FROM COLLAPSING HAD BEEN THROUGH A TERRIBLE WEEK, THINGS DID NOT GET EASIER. AMONG OTHER THINGS, THEY HAD TO DEAL WITH THE MAN ON THE STREET, WHO WOULD BE LOOKING FOR SOMEONE TO BLAME, NOW THAT DISASTER SEEMED TO BE NO LONGER IMMINENT



TUESDAY
SEPTEMBER 16
2008

While the Federal Reserve held one of its long-scheduled board meetings in Washington, Geithner, who would normally be there, stayed in New York and instead turned up unexpected at a meeting at AIG's headquarters with the many JPMorgan, Goldman Sachs and Morgan Stanley bankers, who were advising how to fix it. By now it had become clear just who was exposed to an AIG failure. The short answer was, pretty much everyone. The list turned out to be headed by the Dutch bank, ABN AMRO, recently acquired by the Royal Bank of Scotland. It was a further illustration that the ramifications of the crisis would spread far beyond this same handful of buildings in New York where the drama was being played out. Second was a French bank, Calyon. AIG was due to run out of money at about 1pm, when it would go under.

But Geithner dropped a bombshell. Having spent weeks telling everyone that there was absolutely no chance of a bailout, or any use of government money, he asked them to work out if AIG could be saved with the government involved after all. The Fed would lend AIG US$14 billion, in order to keep it alive for the rest of the day — and would ultimately put an eye-watering US$85 billion into the company, to end up owning 80 percent of it.

Before getting the loan, AIG would have to post collateral, which means pledging things it owns as a way to guarantee the government's money. The only way that it could do this was with stock certificates on the premises. And so a woman called Kathleen Shannon, an AIG executive, ended up walking from her office over to the Fed building, with a briefcase worth US$14 billion.

Nobody was happy about this, but they did not have much choice. "AIG's incompetence was stunning, but I didn't have time to be angry," writes Paulson, who instead had to explain the situation to President Bush. Not an easy task. They had to tell him that he, a Republican president, was about to see US$85 billion of public money go into reviving a failing insurance company. Tougher still, they also had to go and tell Congress. To nobody's great surprise, this was the day Willumstad, AIG's chief, lost his job.

LEHMAN GONE, MERRILL MERGED, AIG BAILED; BUT STILL THE PROBLEMS WOULD NOT GO AWAY

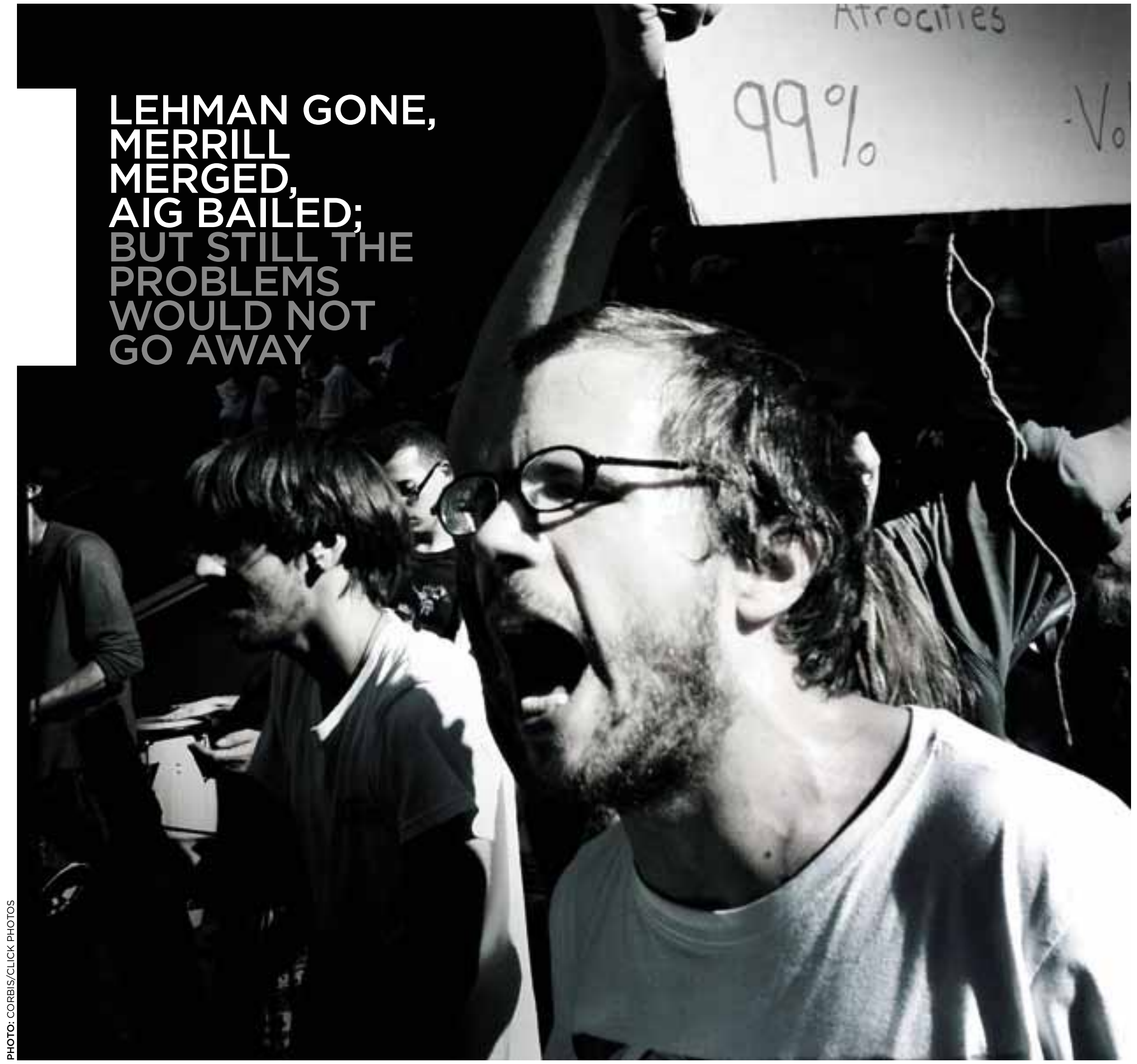


PHOTO: CORBIS/CLICK PHOTOS

ABOVE: A CONSEQUENCE OF THE FINANCIAL CRISIS WAS THE BIRTH OF THE PROTEST MOVEMENT KNOWN AS OCCUPY WALL STREET, WHICH BEGAN ON SEPTEMBER 17, 2011. BORN IN ZUCCOTTI PARK IN THE WALL STREET DISTRICT, IT SOON SPREAD WORLDWIDE

WEDNESDAY SEPTEMBER 17 2008

Lehman gone, Merrill merged, AIG bailed. But still the problems would not go away. "Tuesday was bad," Paulson writes. "Wednesday was worse."

Money market funds are supposed to be the safest of safe investments. They aim to make just enough to provide a steady return, invest in simple things, and are scarcely more complicated or risky than a bank deposit. But reports were starting to appear of investors trying to pull their money out of money market funds, particularly those with anything to do with Lehman. One, the Reserve Primary Fund, with US$62.6 billion in assets, had suddenly found a glut of investors trying to pull out, and froze all redemptions for a week. With the word out, dozens of fund managers then started reporting the same problem, of panicking people demanding their money back, essentially to hide it under the bed. The impact was now hitting ordinary people — 30 million Americans had holdings in these funds. "The Lehman-induced panic was spreading like a plague," writes Sorkin, "the Black Death of Wall Street."

All over the world, money was freezing. Markets were locking up. Lehman funds from London to Tokyo were being grabbed by regulators and the overspill was growing constantly. "When investors — pension funds, mutual funds, insurance companies, even central banks — couldn't withdraw their assets from Lehman accounts, it meant that in the interlinking daisy chain of the markets, they would be less able to meet the demands of their own counterparts," writes Paulson. "Suddenly everyone felt at risk and increasingly wary of dealing with any counterparty." Fear was killing the markets. Paulson started fielding calls from France, Germany and China.

Paulson was suffering. He had taken to dry retching in quiet corners, overcome by stress. If the safest of the safe were in trouble, where might it end? Market chat had turned to the unthinkable. Morgan Stanley and Goldman could actually follow Lehman, and go under. By now nobody was listening to facts, or maybe they just weren't trusting them. When Morgan stock fell 28 percent in a few hours on Tuesday, Mack had brought the quarterly earnings report — with quite good numbers and US$1.43 billion in profits — forward a day, in order to calm the market.

But it made no difference. Clients such as hedge funds were demanding money back out of fear. Mack wrote to his staff on Wednesday: "It's very clear to me — we're in the midst of a market controlled by fear and rumours, and short sellers are driving our stock down." It wasn't all a grand conspiracy. Many of the funds needed the money because they had cash locked up in Lehman that wouldn't be freed for months, years, or maybe never, by bankruptcy proceedings. Liquidity — the industry term for the flow of money around the system — was drying up, as confidence and trust evaporated. And to top it all off, later that day Mack's chief financial officer, the man in charge of the finances, had grim news. Morgan Stanley was going to be out of money by Friday.

Both Morgan and Goldman, the only investment banks left standing in the United States, set about discussing mergers with the big commercial banks, Citigroup and JPMorgan (Bank of America was out of the picture, having bought Merrill). Received wisdom now had it that these boring banks, backed by safe and stable deposits, were in much better shape than investment banks.

"Behind every problem lurked another problem," Sorkin writes. Not bailing out Lehman might have appeased the masses, but the consequences were proving abysmal. "The confidence that had supported the financial system had been upended. No one knew the rules of engagement anymore." Meanwhile, rumours continued to fly; Goldman's Blankfein accused JPMorgan of spreading them. Extraordinarily, JPMorgan's Dimon actually sent a company-wide email telling his staff not to badmouth or poach from their competitors.

That morning, writes Sorkin, Paulson told his staff: "This is an economic 9/11." He warned that the entire economy was on the brink of collapse. His efforts now focused on forming a new plan to save the system, and to get this passed by Congress. "Treasury staff worked straight through the night to Thursday morning," Paulson recalls in his book. "Most people broke for an hour around 5am or 6am to go home, shower and change their clothes, then came straight back to the office." Others slept in their offices. "All learned to get by on little sleep and bad food."

One bit of good news came with an agreement between Lehman's US operations and Barclays, which had agreed to buy them for US$1.75 billion, saving up to 10,000 jobs. The remaining parts appeared to be cast adrift but that would work out too. Nomura, the Japanese bank, bought Lehman's Asian business, even guaranteeing their new employees' bonuses at pre-crisis levels.

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The spiral continued, and then oddly reversed. The UK regulator had put a temporary ban on short-selling stocks for 29 financial stocks. Rumour had it the US regulator would do the same (which it subsequently did). And at 3pm, rumours started to circulate about a new plan from the Treasury.

Paulson, in the meantime, had been telling President Bush at the White House that the financial system would collapse if they didn't take action, and could create a depression even worse than the Great Depression. Ben Bernanke, chairman of the Federal Reserve, who was in the same meeting, backed him up. And so they told the president they planned to ask Congress for US$500 billion to buy toxic assets from the banks to stabilise the financial system.

Next they told Congress too, meeting the majority of Capitol Hill's most powerful leaders at 7pm. This time Bernanke took the lead, explaining how the financial crisis would soon lead to General Motors, the car giant, going bankrupt and unemployment rising. "It is a matter of days," he said, according to Paulson, "before there is a meltdown in the global financial system."

Back in New York, Morgan Stanley was almost out of cash and out of time. The company needed, if not a full merger, then a powerful partner. It had been reaching out to the China Investment Corporation (CIC), China's sovereign wealth fund, which already owned 9.9 percent of the bank. Gao Xiqing, CIC's president, had indicated he might be interested in going up to 49 percent. To talk things over, Gao headed for New York.

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Back in the press room of the Treasury Building in Washington, Paulson announced to the world his plan to save American finance: the Troubled Asset Relief Program, or TARP. The idea was it would buy all the dodgy assets — worthless real estate, complex structured securities — that were weighing down the system. This should free up the banks to get back to what they were good at, restoring confidence in the markets and keeping the economy alive. He said the state would guarantee all those money market funds that were suddenly in trouble too. "I am convinced," he said, "that this bold approach will cost American families far less than the alternative — a continuing series of financial institution failures and frozen credit markets unable to fund economic expansion."

Markets rallied slightly, then held. At the same time, Morgan Stanley was looking down a barrel, and had that morning given up on a mooted merger with Wachovia bank. Morgan was still hopeful about the China deal, but then received an unexpected call from Japan. Jonathan Kindred — who ran Morgan Stanley's securities business in Tokyo — told him Mitsubishi UFJ, Japan's largest bank, wanted to do a deal. This turned out to be just as well, because when Gao arrived at 9pm that night, his offer was so absurdly low they were stunned.

By midnight, a bankruptcy court was approving the sale of Lehman's US business to Barclays. It would be the most complex bankruptcy ever undertaken in the United States, yet they were trying to get the sale approved within eight hours of starting the court proceedings. In the end, the judge signed off on the deal at 12.41am, pausing only to call Lehman "the only true icon to fall in the tsunami that has befallen the credit markets".

And so ended perhaps the most turbulent week in Wall Street's history. There was much left to happen, and things would get worse before they got better.

On the Saturday afternoon, desperate, Morgan Stanley woke up all the Mitsubishi executives they could find — it was the middle of the night in Japan — and said if they were serious, they needed to get working to come up with a deal. There was a growing sense that, just as with Lehman and Merrill the previous weekend, if Morgan Stanley didn't announce a merger by the time markets opened on Monday, it would go under — with Goldman (by now deep in merger talks with Wachovia) right behind it. Meanwhile, Paulson put his draft TARP legislation — now set at US$700 billion — to Congress, asking them to pass the largest single expenditure in the history of America's federal government. Remarkably, this was just three pages long.

Finally, Morgan Stanley secured US$9 billion of investment from the Japanese, a sum they paid *by cheque*. It and Goldman were given bank holding company status, which meant they could accept deposits. This news stabilised both banks, and their stocks stopped falling. On one hand, accepting that status meant that both banks, the absolute cream of global investment banking, had admitted that their business model was broken. On the other hand, they were still alive.