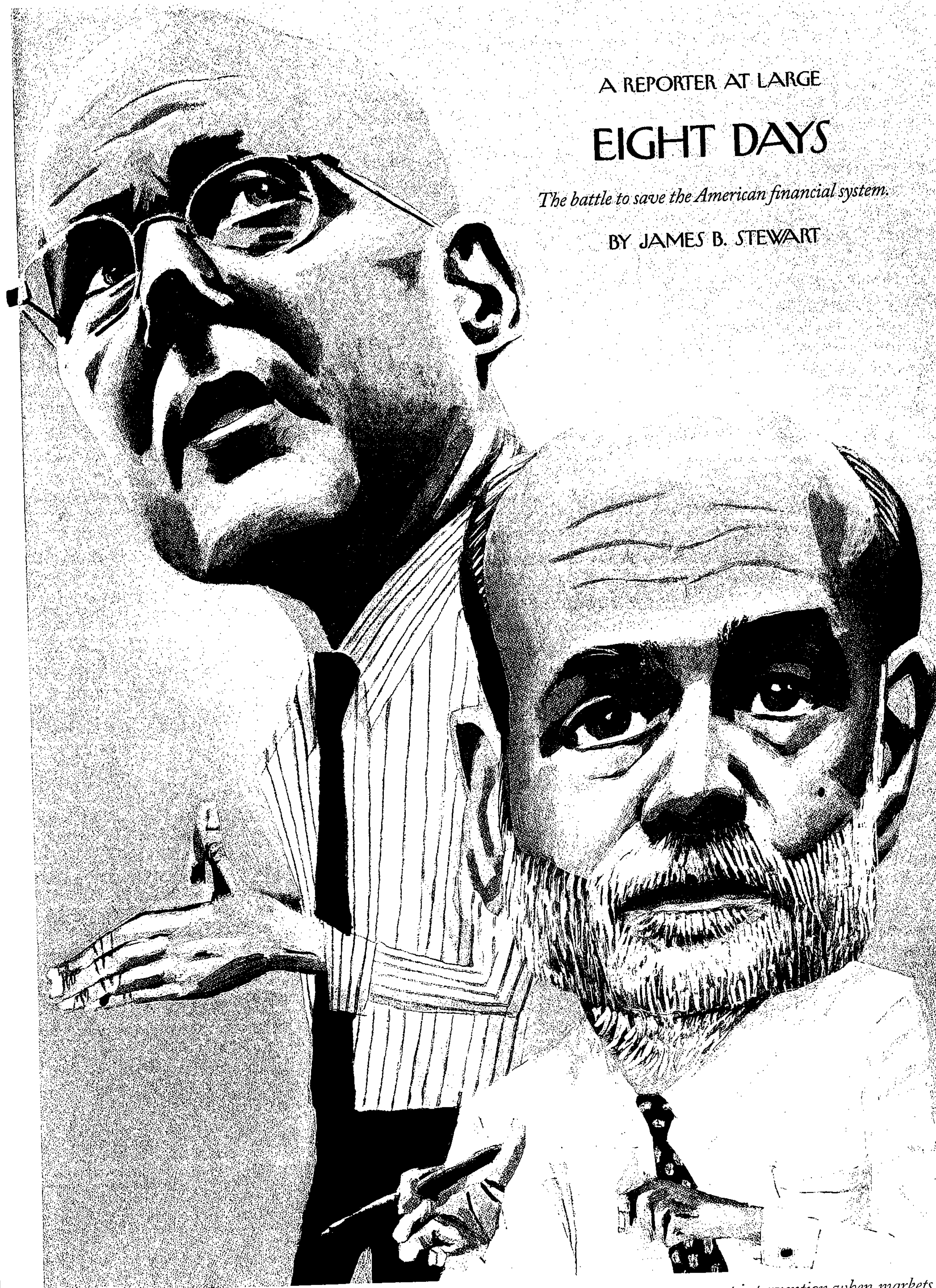
A REPORTER AT LARGE

EIGHT DAYS

The battle to save the American financial system.

BY JAMES B. STEWART



Henry Paulson, Ben Bernanke, and Timothy Geithner were willing to countenance government intervention when markets failed. Their

ms outraged both Republicans and Democrats. Illustrations by Mark Ulriksen.

FRIDAY, SEPTEMBER 12

Let's don't be alarmist.

The most important week in American financial history since the Great Depression began at 8 A.M. on a Friday in the middle of September last year. I have pieced together this account of it from scores of interviews with participants and observers. Many of the principals agreed to be interviewed, including Henry Paulson, who was Secretary of the Treasury; Ben Bernanke, the chairman of the Federal Reserve System; and Timothy Geithner, who was president of the New York Federal Reserve. As time has passed, memories inevitably have been colored by hindsight and efforts to shade the truth, to affix blame and claim credit, but, as one Treasury official told me, referring to himself and his colleagues, "For better or worse, we're the ones responsible. The more accurately the story is told, the better our policies will be received."

As Bernanke hurried to the Department of the Treasury for his weekly breakfast with Secretary Paulson, crisis loomed. Lehman Brothers Holdings, Inc., a global financial-services firm that started out as a drygoods store in 1850, faced imminent bankruptcy. Its collapse could be catastrophic, and a solution had to be found that weekend, before markets opened on Monday. Paulson, a former chairman of the powerful investment bank Goldman Sachs, is tall, excitable, garrulous, and supremely self-confident. Reared as a Christian Scientist in the affluent Chicago suburb of Barrington Hills, he was an Eagle Scout in high school and a football player at Dartmouth before graduating from Harvard Business School. Paulson doesn't use e-mail and tends to ask rapid-fire questions, in a distinctive, rasping voice. He once told a colleague, "I didn't get the charm gene."

Nor, evidently, did Bernanke, a soft-spoken former professor of economics at Stanford and Princeton. When White House officials first interviewed Bernanke for the post of Fed chairman, he was so quiet they worried that he lacked, as one put it, "assertiveness." He grew up in a small town in South Carolina, played alto saxophone in the marching band, and wrote an unpublished novel. He graduated from Harvard summa cum laude, and earned a Ph.D. in economics at

M.I.T. He is an expert in the economic history of the Great Depression.

Both men were appointed by President George W. Bush, but, unlike the Administration's free-market absolutists, they, along with Geithner, considered themselves pragmatists—proponents of government action when markets fail. The two camps had long coexisted among Republicans, sometimes uneasily, but during the Bush Administration, with its anti-regulation rhetoric and cuts in marginal tax rates, free-market proponents seemed to be in their element. Bernanke's predecessor at the Fed, Alan Greenspan, kept interest rates exceptionally low. Regulators at the Securities and Exchange Commission tolerated high leverage at investment banks, and the Fed and the Federal Deposit Insurance Corporation tolerated lax real-estate lending standards. Housing prices shot up. In October, 2007, the Dow Jones Industrial Average reached a peak of 14,093. Unheeded by Bernanke, Paulson, or just about anyone in a position of authority, an asset bubble had grown to perilous and historic proportions.

That year, the bubble had begun to deflate. Defaults among subprime-mortgage borrowers rose, and then the elaborate infrastructure of mortgage-backed securities started to erode. In an attempt to contain the damage, Paulson and Bernanke presided over what many considered the greatest government intrusion into markets and finance since the nineteen-thirties.

In March, 2008, the government ushered the failing investment bank Bear Stearns into a merger with JPMorgan Chase, a deal that was made possible by $29 billion of government financing for Bear Stearns' troubled assets. In early September, the Treasury rescued the government-backed private mortgage agencies Fannie Mae and Freddie Mac, pledging up to $200 billion in capital. Such interventions put taxpayer money at risk and made a mockery of the notion of "moral hazard," a guiding principle of economics which posits that unless actors bear the consequences of their actions they will act recklessly.

Public criticism of Paulson and Bernanke was scathing. The bailouts had brought into rare alignment the Republican right wing, averse to any tampering with the free market, and the Democratic left, outraged by the government rescue of Wall Street's overpaid élite. Senator Jim Bunning, Republican of Kentucky, called for the two men to resign, and argued that the bailouts were "a calamity for our free market system." He stated, "Simply put, it is socialism," and told a Bloomberg journalist that Paulson was "acting like the minister of finance in China." Nouriel Roubini, an economics professor at New York University's Stern School of Business, who had warned about the housing bubble back in 2004, declared that "socialism is indeed alive and well in America," but with a twist: "This is socialism for the rich, the well connected, and Wall Street."

The previous afternoon, September 11th, Timothy Geithner, at the New York Fed, had told Paulson and Bernanke that Lehman was unlikely to be able to open for business on Monday. Since its origins, in cotton trading, Lehman had underwritten countless stock and bond offerings, had become a force in mergers and acquisitions, and was perhaps best known for its bond index, the equivalent of the Dow Jones Industrial Average for stocks. In 2005 and 2006, it was the largest underwriter of subprime-mortgage-backed securities.

As recently as 2007, Lehman had reported record profits, thanks largely to its leverage of thirty to one, meaning that for every dollar of tangible capital it had thirty dollars of debt. Most of its assets were funded by borrowed money, and now, given the steep decline in mortgage-backed securities, no one believed that the assets were worth their nominal value of $640 billion; Lehman's share price was down ninety-four per cent from the previous year. A run on its assets was already under way, its liquidity was vanishing, and its stock price had fallen by forty-two per cent just the previous day; it couldn't survive the weekend. Global markets and the financial system were far more fragile than they had been in March, when Bear Stearns faltered, and Geithner, warning that the consequences of a Lehman bankruptcy would be quite bad, argued that an alternative had to be found. Otherwise, he said, the damage almost certainly would not be contained.

Bernanke, coming from a different perspective, had arrived at much the same position. As a scholar of the Depression, he had argued that the collapse of banks and other financial institutions at the time had made the Depression much worse by constricting credit. He had become a proponent of intervening to provide liquidity and encourage lending. He argued that the risks of insufficient action—lack of action had led Japan into a prolonged slump in the nineteen-nineties—were far greater than those of overdoing it.

Paulson had headed Goldman's investment-banking operations, including mergers and acquisitions. As its chief executive, he had first opposed, then embraced, the firm's decision, in 1999, to go public, showing both flexibility and decisiveness.

But as Paulson and Bernanke sat down on September 12th the morning news included reports in which anonymous Treasury officials appeared to say that Paulson was ruling out the possibility of any government financial assistance to Lehman.

Paulson acknowledged to Bernanke that he had authorized the comments. He was under intense political pressure from the White House and Capitol Hill to curb the furor over the rescue of Fannie Mae and Freddie Mac the previous weekend, as well as continuing resentment over Bear Stearns. More important, every private business he had spoken with about acquiring Lehman was insisting on some kind of government funding. Nevertheless, Paulson assured Bernanke, he was committed to finding a buyer.

All summer, Paulson had been pressing Lehman's chairman and chief executive, Richard S. Fuld, Jr., to find a buyer or a major investor for the firm. Fuld, at sixty-two, was intensely aggressive. He joined Lehman Brothers in 1969, as a trader, and had subsequently driven Lehman's ambitious expansion. But Fuld had been slow to grasp the severity of the firm's plight, and Paulson was frustrated that Fuld kept insisting on what Paulson deemed unrealistic terms, including too high a price. (Fuld's lawyer did not reply to requests for comment for this account.) As a result, Paulson had taken it upon himself to find a buyer, and he had come up with two serious candidates: Bank of America and Barclays, one of the largest banks in the U.K.

Bernanke, too, had talked to Kenneth Lewis, the chairman and C.E.O. of Bank of America. Lewis, a native of Walnut Grove, Mississippi, and a graduate of Georgia State, had joined a small regional bank, North Carolina National, in 1969,

as a credit analyst, and had worked his way up the ranks as the bank transformed itself into NationsBank Corporation, by swallowing a succession of other banks and thrifts, and then, in 1998, into Bank of America, whose headquarters were moved from San Francisco to Charlotte. Lewis became the bank's C.E.O. in 2001. He had never fit in with his Wall Street or West Coast counterparts, and once remarked, "I've had all of the fun I can stand in investment banking at the moment." Unlike commercial banks, which take deposits and make loans, investment banks raise capital for an array of financial services, from underwriting stock and bond offerings, to managing corporate takeovers, to trading, acting both for clients and for themselves. Bank of America was a commercial bank, and Lehman was an investment bank, but Lewis was interested in it anyway—provided that the government was willing to lend against Lehman's bad assets.

Paulson had urged Lewis and Fuld to talk. Bank of America auditors were now trying to determine how much government assistance the bank would need. Meanwhile, Barclays' president, Bob Diamond, an American, saw Lehman as an opportunity to increase Barclays' U.S. investment-banking operations. Paulson, in their first conversation, had been typically direct: "Bob, there's no government money."

"I hear you," Diamond replied. "We'll try." He took Paulson's comments as sincere but not necessarily definitive. Barclays would see what it could offer for Lehman; if there was a gap, maybe the government would step in after all.

In the case of Bear Stearns, the Fed had relied on emergency powers, bestowed by the Federal Reserve Act, that allow it to lend in "unusual and exigent circumstances," when the loans are "secured to the satisfaction" of the Fed. JPMorgan had guaranteed Bear's obligations until the deal closed.

Over breakfast, Bernanke and Paulson discussed a plan, first proposed by Paulson the day before, to engineer a similar "private sector" solution, whereby Bank of America or Barclays would indeed receive financing for Lehman's troubled assets—but not from the government. Instead, other banks would be asked to join a consortium, in order to spread the risk. In other words, Wall Street's strongest competitors would be asked to put their differences aside and act together for the common good. There was precedent for this in the rescue of Long-Term Capital Management, in 1998, when William McDonough, the president of the New York Fed, summoned bankers to address that crisis. Surely the bankers would recognize that the failure of Lehman imperilled them all.

When Jamie Dimon, the C.E.O. of JPMorgan Chase, learned that A.I.G. faced a disastrous cash crisis, his message to Robert Willumstad, the chief executive, one participant recalled, was blunt: "Stop pussyfooting around."

Christopher Flowers, the billionaire founder of the private-equity firm J. C. Flowers & Company and a self-described "lowlife grave dancer" with an eye for failing banks, found himself, Zelig-like, in the midst of the week's deal-making. Slender, bespectacled, and rumpled, Flowers was a math whiz who liked chess, and those skills made him a formidable opponent in the intricate moves of financial takeovers—in some cases as an adviser to firms doing deals, in others as an actual investor.

Flowers knew Paulson well, having spent twenty years at Goldman Sachs, and had worked with Bank of America officials in the merger with NationsBank. He talked regularly to Maurice (Hank) Greenberg, the former chief executive of the giant insurance conglomerate A.I.G., and did business with others in the insurance industry, especially executives at Germany's Allianz.

Earlier in the week, a Bank of America official told Flowers that the firm was considering buying Lehman and said that it wanted him as a partner in the deal. Flowers and a Bank of America team had spent the previous twenty-four hours at a midtown law office going over Lehman's books. Its finances turned out to be far worse than Flowers had expected. The exposure to risky residential mortgages was widely known, but not the firm's $32-billion portfolio of commercial-real-estate assets, much of it of dubious quality.

Then an A.I.G. executive asked him to join a meeting at A.I.G.'s headquarters, in lower Manhattan. "What's the problem?" Flowers asked. A.I.G., it turned out, was facing a liquidity crisis, the result of disastrous bets made by its Financial Products division, based in London. A.I.G. Financial Products had become one of the largest issuers of credit-default swaps, a product similar to insurance: the buyer pays the company in return for a promise of reimbursement in the event of default on a bond or other debt security. If the likelihood of default increased, A.I.G. had to post collateral with its swaps buyers, or counterparties, to guarantee eventual payment. A.I.G. had been a pioneer in credit-default swaps, barely ten years earlier, and since then had amassed hun-

"The trailer didn't live up to the teaser."

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dreds of billions of dollars in exposure.

The risk to A.I.G. from the huge portfolio had seemed minimal, since the likelihood of default in any given transaction was low. As a result, A.I.G. hadn't hedged its own exposure to its swap portfolio, and was earning enormous profits on the business. But during the summer of 2008, as increasing numbers of borrowers became unable to pay their mortgages, default rates rose. The U.S. ratings agencies began a wholesale downgrade of mortgage-backed securities, triggering demands that A.I.G. provide ever-larger amounts of collateral to buyers of its swaps. It wasn't clear how A.I.G. could come up with the cash.

When Flowers and a group from his firm arrived, dozens of investment bankers, private-equity investors, and A.I.G. officials were meeting in various conference rooms. Flowers and his team were given their own conference room, where they and some A.I.G. finance officers examined a spreadsheet, tracking the parent company's cash flow and liquidity. The cash-flow projections showed A.I.G. to be in dire need of capital. It was facing a $6-billion cash shortfall by the following Wednesday, a figure that would rise to $25 billion the next week, and $39 billion the week after that.

Flowers looked up from the figures. "Bankruptcy," he said.

"Wait a minute," one of the A.I.G. finance officers replied. "Let's don't be alarmist."

"All I know is if you don't pay six billion next week you're going to have some very unhappy people," Flowers replied.

Robert Willumstad, A.I.G.'s chief executive, walked in as the group was eating sandwiches. Willumstad, a reserved old-school banker and twenty-year Citigroup executive who lost a succession struggle, had always wanted to run a large public company. He got his chance in June, when the board of A.I.G.—at its peak the world's largest insurance company—ousted the company's chief. Willumstad, who had been the board chairman, had formulated an ambitious restructuring and turnaround plan and was just beginning to implement it. But the deterioration in the Financial Products division and the mounting collateral demands were sources of growing concern. Willumstad had hired JPMorgan to advise A.I.G. and help it raise capital.

That morning, Willumstad had called Geithner at the New York Fed, concerned that the ratings agencies were going to downgrade A.I.G., perhaps as soon as Monday. Depending on the severity of the downgrade, it would prompt more collateral calls, of anywhere from $13 billion to $18 billion. A.I.G.'s cash crisis was potentially catastrophic. Willumstad told Geithner that he needed to raise $20 billion. A.I.G., an insurance company, was even farther from the Fed's mandate than Lehman. Geithner stressed that A.I.G. needed to find a private-sector solution, but he agreed to send some Fed officials over to assess the situation.

Flowers and Willumstad also called Jamie Dimon, the C.E.O. of JPMorgan. Dimon was even more forceful. As one participant recalls, "His message was: Stop pussyfooting around. Get real, get serious. This is urgent."

"Call Warren Buffett," Flowers told Willumstad, and gave him the number of Buffett's private phone. "Don't even wait one second."

Buffett answered, and Willumstad described the liquidity crisis. Buffett asked some questions and said that he needed more time. Later, he called back to say that he might be interested in some of A.I.G.'s businesses if they were for sale, but he didn't want to get involved with the parent company. Always reluctant to invest in companies whose operations he didn't thoroughly understand, Buffett said that A.I.G. was too complicated. (Buffett did not respond to requests for comment for this account.)

That afternoon, Fed staff members called a number of Wall Street C.E.O.s and asked them to attend an emergency meeting. Among the C.E.O.s were Jamie Dimon; Vikram Pandit, of Citigroup; Brady Dougan, of Credit Suisse Group; John Thain, of Merrill Lynch; John Mack, of Morgan Stanley; and Lloyd Blankfein, Paulson's successor at Goldman Sachs. As one veteran of the Long-Term Capital Management rescue remarked, "That kind of call is never good news."

At 6 P.M., a line of black town cars and S.U.V.s made their way along Maiden Lane, in lower Manhattan, and entered the garage of the New York Federal Reserve Bank, a seventeen-story Italian Renaissance-style fortress. (Underground, in the bank's vault, is the largest stockpile of monetary gold in the world.) The New York Fed implements the monetary policy set by the Federal Reserve Board, in Washington, and oversees the banks in the nation's financial capital. Timothy Geithner had become president of the New York Fed, after a long career in the Treasury Department, on the recommendation of two former Treasury Secretaries, Lawrence Summers and Robert Rubin. Although he had degrees in Asian Studies and government from Dartmouth, and a

graduate degree in East Asian Studies and international economics from the Johns Hopkins School of Advanced International Studies, Geithner lacked a Ph.D. and an M.B.A.; he also lacked experience on Wall Street and in banking. He was forty-seven but looked much younger, and some felt that he lacked the gravitas to be a Fed president. But he seemed to have no trouble holding his own in discussions with Summers and Bernanke, sometimes punctuating his remarks with profanity, and thereby injecting some blunt common sense into the debates.

A number of the C.E.O.s brought their chief financial officers to the meeting. Several European banks, including Deutsche Bank, Royal Bank of Scotland, and BNP Paribas, sent their ranking officers who were in New York. The meeting took place in a conference room off the building's lobby. Paulson was there, too, and he and Geithner sat at a large rectangular table, surrounded by other government officials.

The chairman of the Securities and Exchange Commission, Christopher Cox, was also present. Cox, a former Republican congressman who had represented Orange County, California, for seventeen years, was on hand as a regulator, since Lehman and other investment banks are subject to S.E.C. oversight.

Geithner thanked the bankers for coming on short notice, then turned the meeting over to Paulson, who said that, despite the rescues of Bear Stearns and Fannie and Freddie, there would be no government money for Lehman. Fortunately, there were two potential saviors. Paulson didn't name them, but everyone present assumed that they were Barclays and Bank of America, both conspicuously absent from the meeting. Still, there was likely to be a pool of Lehman assets that some buyers would not take. It would be up to the C.E.O.s in the room to finance that pool.

Paulson now acknowledges, as some in the room suspected, that the government was more amenable to funding a rescue than it let on. "We said, 'No public money,'" he told me. "We said this publicly. We repeated it when these guys came in. But to ourselves we said, 'If there's a chance to put in public money and avert a disaster, we're open to it.'"

Speaking for the Federal Reserve, Geithner noted that Lehman's trouble had been highly visible, and that investors had had weeks, if not months, to prepare for its demise. Even so, he said, a Lehman failure could be "catastrophic," and it would likely be impossible to contain the damage entirely.

Cox told the C.E.O.s he realized that they were usually competitors. However, he said, their collective well-being turned on a well-functioning market, and the purpose of the meeting was to restore that market.

Lehman wasn't the only vulnerable investment bank. Even if it found a buyer, who would be next to face a run, and possible ruin?

Paulson reminded the C.E.O.s that Lehman was unlikely to open for business on Monday morning, so they had just forty-eight hours to resolve the crisis.

Geithner divided the C.E.O.s into three working groups: the first, led by Goldman Sachs and Credit Suisse, was asked to value Lehman's troubled assets and assess the amount that the firms would have to finance. The second, which included Merrill Lynch, Citigroup, and Morgan Stanley, was told to consider various structures under which Lehman could be sold and its bad assets recapitalized. The third was told to prepare for a Lehman bankruptcy.

The meeting ended at about nine-thirty, and the working groups agreed to reconvene the next morning.

SATURDAY, SEPTEMBER 13

Have you been watching A.I.G.?

At 8 A.M., the Wall Street C.E.O.s, dressed in slacks and sports shirts, reassembled in the Fed conference room, some carrying coffee and crumb cake. Paulson and Geithner said that Barclays was the most likely buyer for Lehman but that negotiations with Bank of America were continuing. In either case, there had to be a "private solution" for the toxic assets.

The chief executives were unsure how expensive that solution might be. And why should Wall Street firms finance a transaction to benefit a competitor like Barclays?

Dimon spoke up. "Look, we're all in a fix. This is something we have to do in the best interests of the global financial system."

Geithner again broke the group into teams, saying that they would reconvene in several hours. When they did, the