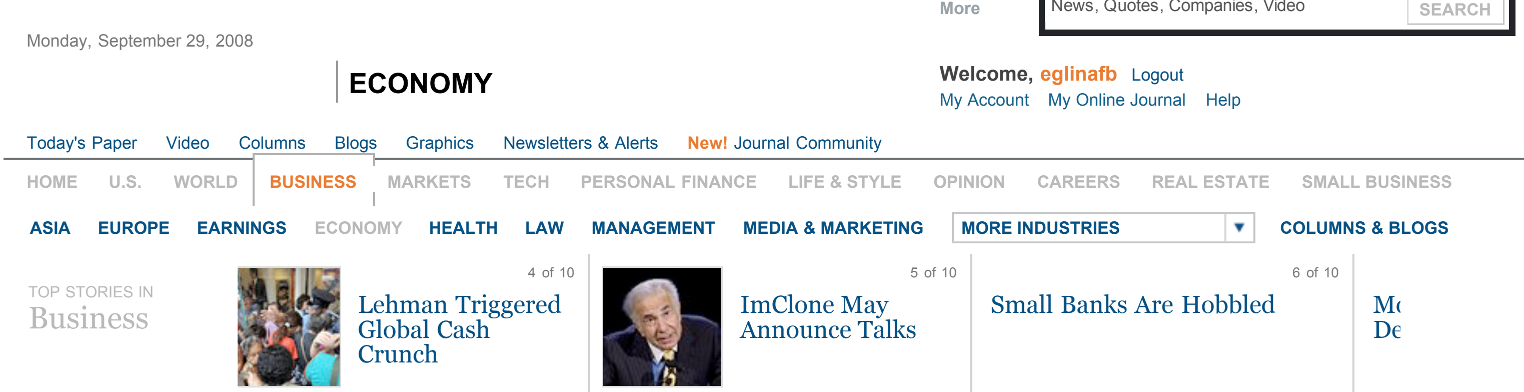

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Lehman's Demise Triggered Cash Crunch Around Globe

Decision to Let Firm Fail Marked a Turning Point in Crisis

By CARRICK MOLLENKAMP and MARK WHITEHOUSE in London, JON HILSENRATH in Washington and IANTHE JEANNE DUGAN in New York

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Two weeks ago, Wall Street titans and the government's most powerful economic stewards made a fateful choice: Rather than propping up another failing financial institution, they let 158-year-old Lehman Brothers Holdings Inc. collapse.

Now, the consequences of that decision look more dire than almost anyone imagined.

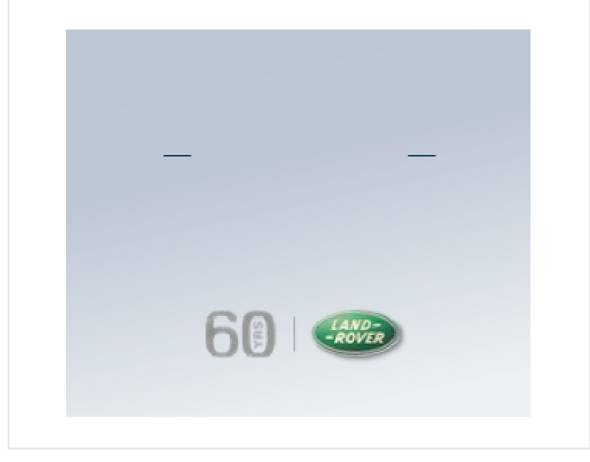
AFP/Getty Images

A policeman tries to calm and direct customers crowding the entrance of a branch of Hong Kong's Bank of East Asia after rumors spread about BEA's exposure to assets linked to failed investment bank Lehman Brothers.

Lehman's bankruptcy filing in the early hours of Monday, Sept. 15, sparked a chain reaction that sent credit markets into disarray. It accelerated the downward spiral of giant U.S. insurer American International Group Inc. and precipitated losses for everyone from Norwegian pensioners to investors in the Reserve Primary Fund, a U.S. money-market mutual fund that was supposed to be as safe as cash. Within days, the chaos enveloped even Wall Street pillars Goldman Sachs Group Inc. and Morgan Stanley. Alarmed U.S. officials rushed to unveil a more systemic solution to the crisis, leading to Sunday's agreement with congressional leaders on a $700 billion financial-markets bailout plan.

The genesis and aftermath of Lehman's downfall illustrate the difficult position policy makers are in as they grapple with a deepening financial crisis. They don't want to be seen as too willing to step in and save financial institutions that got into trouble by taking big risks. But in an age where markets, banks and investors are linked through a web of complex and opaque financial relationships, the pain of letting a large institution go has proved almost overwhelming.

In hindsight, some critics say the systemic crisis that has emerged since the Lehman collapse could have been avoided if the government had stepped in. Before Lehman, federal officials had dealt with a series of financial brushfires in a way designed to keep troubled institutions such as Fannie Mae, Freddie Mac and Bear Stearns Cos. in business. Judging them as too



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big to fail, officials committed billions of taxpayer dollars to prop them up. Not so Lehman.

"I don't understand why they didn't understand that the markets would be completely spooked by this failure," says Richard Portes, professor of economics at London Business School and president of the Centre for Economic Policy Research. Rather than showing the government's resolve, he says, letting Lehman fail only exacerbated the central problem that has afflicted markets since the financial crisis began more than a year ago: Nobody knows which financial firms will be able to make good on their debts.

To be sure, Lehman's downfall was largely of its own making. The firm bet heavily on investments in overheated real-estate markets, used large amounts of borrowed money to supercharge its returns, then was slower than others to recognize its losses and raise capital when its bets went wrong. The depth of the firm's woes made finding a willing buyer a difficult task, leaving officials with few viable options.

Given the limited time and information available, many experts believe government officials made the best choices possible.

Struggle for Capital

As they watched Lehman struggle to raise capital, policy makers -- including Treasury Secretary Henry Paulson, Federal Reserve Chairman Ben Bernanke and New York Fed President Timothy Geithner -- mulled the question of whether they could let Lehman fail. On the one hand, they didn't want to come to the rescue because they were concerned about moral hazard, the idea that bailouts encourage irresponsible risk-taking, according to people familiar with the planning. They doubted Lehman had viable buyers and they thought the market and the Fed had had time to prepare to handle the fallout if a big institution collapsed. Still, some Fed officials were leery of sending signals that the Fed was done working with Wall Street to stop the spreading crisis. Mr. Geithner, for one, had been telling others that the markets were still in for serious trouble.

"If you don't do something, the outcome is going to be bad," Mr. Geithner told executives as they gathered to bargain over Lehman's fate at the New York Fed's downtown headquarters on Friday night, Sept. 12, according to a person in the meeting.

At one point, officials raised with Wall Street bankers the possibility of a private-sector rescue fund, but the bankers either balked at the idea of bailing out a competitor or didn't have the extra funds needed, people familiar with the situation said.

Prepare the Markets

Over the weekend, as possible buyouts by Bank of America Corp. and U.K. bank Barclays PLC fell through, Fed officials focused on what needed to be done to prepare markets for what would be the largest bankruptcy in U.S. history. Lehman's total assets of more than $630 billion dwarf WorldCom's assets when the telecom company filed for bankruptcy in 2002 with assets of $104 billion.

Officials were particularly concerned with two areas: the credit-default-swap market, where players buy and sell insurance against defaults on corporate and other bonds; and the so-called repo market, where Wall Street banks fund their investments by putting up securities as collateral for short-term loans.

The Fed had been pushing Wall Street firms for months to set up a new clearinghouse for credit-default swaps. The idea was to provide a more orderly settlement of trades in this opaque, diffuse market with a staggering $55 trillion in notional value, and, among other things, make the market less vulnerable if a major dealer failed. But that hadn't gotten off the ground. As a result, nobody knew exactly which firms had made trades with Lehman and for what amounts. On Monday, those trades would be stuck in limbo. In a last-ditch effort to ease the problem, New York Fed staff worked with Lehman officials and the firm's major trading partners to figure out which firms were on opposite sides of trades with Lehman and cancel them out. If, for example, two of Lehman's trading partners had made opposite bets on the debt of General Motors Corp., they could cancel their trades with Lehman and face each other directly instead.

The Fed had also seen with the collapse of Bear Stearns how the repo market was prone to severe disruptions when lenders got skittish, a problem that threatened to cut off crucial

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funding to Wall Street banks. Because repo loans are made for periods of as little as a day, the funding can disappear suddenly -- one reason the Fed set up an emergency facility to lend to securities firms in the wake of Bear Stearns's collapse. Fed officials worked furiously through Sunday to expand that facility, allowing banks to put up as collateral for loans a wider range of securities, including stocks.

On Sunday, after the Barclays deal fell through, the group began to "spray foam on the runway" -- the term Mr. Geithner used to describe measures to cushion the blow. By that night, Fed officials recognized that their preparations might not cover all contingencies. Still, they expected the turbulence to settle down after a time, with the help of the expanded lending facilities they hurried Sunday to put in place. They also felt that financial institutions and markets had been given enough time to prepare for the shock of a large failure since the crisis consumed Bear Stearns in March.

But Lehman's bankruptcy, filed early Monday morning in federal bankruptcy court -- case No. 08-13555 -- proved far more destabilizing, and spread much further, than many had expected. The bankruptcy immediately wiped out huge investments for Lehman shareholders and bondholders. Among the biggest was Norway's government pension fund, which invests the country's surplus oil revenue. As of the end of 2007, the most recent data available, the fund owned more than $800 million worth of Lehman bonds and stock. Lehman's demise has become a lightning rod for critics who have long questioned the way the government was investing the oil resources. A spokesman said the fund's management is "very concerned and monitoring the situation closely."

The government's decision to let Lehman go marked a turning point in the way investors assess risk. When the Fed stepped in to engineer the takeover of Bear Stearns by J.P. Morgan Chase & Co. in March, Bear's shareholders lost most of their investments, but bondholders came out well. In the financial hierarchy of risk, this wasn't surprising, since bondholders have more contractual rights to get their money back than equity holders. But it created a false impression among investors that the government would step in to rescue bondholders when the next bank ran into trouble. By letting Lehman fail, the government had suddenly disabused the market of that notion.

The reaction was most evident in the massive credit-default-swap market, where the cost of insurance against bond defaults shot up Monday in its largest one-day rise ever. In the U.S., the average cost of five-year insurance on $10 million in debt rose to $194,000 from $152,000 Friday, according to the Markit CDX index.

When the cost of default insurance rises, that generates losses for sellers of insurance, such as banks, hedge funds and insurance companies. At the same time, those sellers must put up extra cash as collateral to guarantee they will be able to make good on their obligations. On Monday alone, sellers of insurance had to find some $140 billion to make such margin calls, estimates asset-management firm Bridgewater Associates. As investors scrambled to get the cash, they were forced to sell whatever they could -- a liquidation that hit financial markets around the world.

Cash Calls

The cash calls added to the problems of AIG, which was already teetering toward collapse as it sought to meet more than $14 billion in added collateral payments triggered by a downgrade in its credit rating. AIG was one of the biggest sellers in the default insurance market, with contracts outstanding on more than $400 billion in bonds.

To make matters worse, actual trading in the CDS market declined to a trickle as players tried to assess how much of their money was tied up in Lehman. The bankruptcy meant that many hedge funds and banks that were on the profitable side of a trade with Lehman were now out of luck because they couldn't collect their money. Also, clients of Lehman's prime brokerage, which provides lending and trading services to hedge funds, would have to try to retrieve their money or their securities through the courts.

Autonomy Capital Research, a London-based hedge fund that was started in 2003 by former Lehman trader Robert Charles Gibbins, was among the Lehman clients who got caught. When Lehman filed for bankruptcy protection, it froze about $60 million of Autonomy's funds, according to a person close to the situation. That is about 2% of the $2.5 billion Autonomy manages. An official at Autonomy declined to comment.

Spooked that other securities firms could fail, hedge funds rushed to buy default insurance on the firms with which they did business. But sellers were hesitant, prompting something akin to what happens if every homeowner in a neighborhood tries to buy homeowners insurance at exactly the same time. The moves dramatically drove up the cost of insurance on Morgan Stanley and Goldman Sachs debt in what became a dangerous spiral of fear about those firms.

At the same time, hedge funds began pulling their money out of the two firms. Over the next few days, for example, Morgan Stanley would lose about 10% of the assets in its prime-brokerage business.

"It was just mayhem," says Thomas Priore, the CEO of New York-based hedge fund Institutional Credit Partners LLC. "People were paralyzed by fear of what could erupt."

Amid the uncertainty about how Lehman's bankruptcy would affect other financial institutions, rumors and confusion sparked wild swings in stock prices. On Tuesday, for example, a London-based analyst issued a report saying that Swiss banking giant UBS AG, already hurt by tens of billions of dollars in write-downs, might lose another $4 billion because of its exposure to Lehman. Shares in UBS fell 17% on the day. UBS subsequently said its exposure was no more than $300 million.

Rising concerns about the health of financial institutions quickly spread to the markets on which banks depend to borrow money. At around 7 a.m. Tuesday in New York, the market got its first jolt of how bad the day was going to be: In London, the British Bankers' Association reported a huge rise in the London interbank offered rate, a benchmark that is supposed to reflect banks' borrowing costs. In its sharpest spike ever, overnight dollar Libor had risen to 6.44% from 3.11%. But even at those rates, banks were balking at lending to one another.

Within a few hours, the markets had shifted their focus to the fate of Goldman Sachs and Morgan Stanley, which found themselves fighting to restore investors' flagging confidence. During an earnings presentation in which he answered one after another question about the firm's ability to borrow money, Goldman chief financial officer David Viniar made an admission: "We certainly did not anticipate exactly what happened to Lehman," he said.

Morgan Stanley's stock, meanwhile, plunged 28% in early trading as investors bet that it would be the next after Lehman to fall. At around 4 p.m., the firm decided to report its third-quarter earnings a day early, in the hope that the decent results would halt the stock decline.

"I care that it could be contagion," Morgan Stanley chief financial officer Colm Kelleher said in a conference call with analysts. "You've got fear in the market."

Even as Morgan Stanley's call was taking place, the Lehman fallout cropped up in a different corner of finance: so-called money-market funds, widely seen as a safe alternative to bank deposits. Many of the funds had bought IOUs, known as commercial paper, which Lehman issued to borrow money for short periods. Now, though, the paper was worth only 20 cents on the dollar.

At around 5 p.m. New York time, a well-known money-market fund manager called The Reserve said that its main fund, the Reserve Primary Fund, owned Lehman debt with a face value of $785 million. The result, said The Reserve, which had criticized its rivals for taking on too much risk in the commercial-paper market, was that its net asset value had fallen below $1 a share -- the first time a money-market fund had "broken the buck" in 14 years.

The trouble in the commercial-paper market presented a particularly serious threat to the broader economy. Companies all over the world depend on commercial paper for short-term borrowings, which they use for everything from paying salaries to buying raw materials. But as jittery money-market funds pulled out, the market all but froze.

On Wednesday, the freeze in lending markets triggered a dramatic turn of events in the U.K. Amid growing concerns about its heavy dependence on markets to fund its business, HBOS PLC, the UK's biggest mortgage lender, saw it share price plummet by 19%. The situation was a red flag for government officials, who suffered embarrassment earlier this year when they were forced to nationalize troubled mortgage lender Northern Rock PLC, which had become the target of the country's first bank run in more than a century.

Moving quickly, the government brokered an emergency sale of HBOS to U.K. bank Lloyds TSB Group PLC. In a sign of their desperation to make the deal happen, officials went so far as to amend the U.K.'s antitrust rules, which could have prevented the merger. Together, HBOS and Lloyds control nearly a third of the U.K. mortgage market.

Back in New York, the situation at Morgan Stanley and Goldman Sachs was worsening rapidly. In the middle of the trading day, at about 2 p.m., Morgan Stanley CEO John Mack dispatched an email to employees: "What's happening out here? It's very clear to me -- we're in the midst of a market controlled by fear and rumors." By the end of Wednesday, employees at Morgan Stanley and Goldman were shell-shocked. Morgan Stanley's shares had fallen 24% to $21.75 while Goldman, the largest investment bank by market value, fell 14% to $114.50.

By Thursday, Messrs. Paulson and Bernanke decided that the fallout presented too great a threat to the financial system and the economy. In the biggest government intervention in financial markets since the 1930s, they extended federal insurance to some $3.4 trillion in money-market funds and proposed a $700 billion plan to take bad assets off the balance sheets of banks.

Three days later, Goldman Sachs and Morgan Stanley applied to the Fed to become commercial banks -- a historic move that ended the tradition of lightly regulated Wall Street securities firms that take big risks in the pursuit of equally big returns.

To some, the government's decision to resort to a bailout represents a tacit admission: For all officials' desire to allow markets to punish the risk-taking that engendered the crisis, banks have the upper hand. "Lehman demonstrated that it's much harder than we thought to deal effectively with banks' misbehavior," says Charles Wyplosz, an economics professor at the Graduate Institute in Geneva. "You have to look the devil in the eyes and the eyes are pretty frightening."

—Sue Craig in New York, Michael M. Phillips in Washington and Neil Shah in London contributed to this article.

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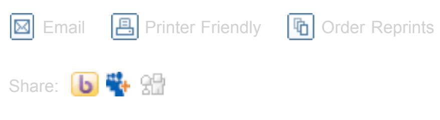

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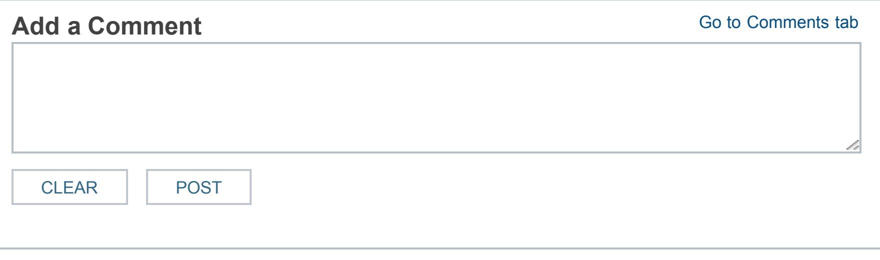

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