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Special Edition

Diary of a Crisis

Aftershocks from Lehman Collapse

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This special edition of **ECONOMIC CURRENTS** contains excerpts from my diary detailing the fateful two weeks following the collapse of Lehman Brothers. The fear and panic are palpable. Rereading these pages is like reliving a car crash in slow motion, with every detail seared into my memory as I scrambled to make sense of it all on a real-time basis for my management and clients. I have witnessed in others what appears to be amnesia about the financial crisis. My sense is that the trauma was so widespread and debilitating that many choose not to remember.

The indented parts indicate my contemporary analysis, written as the crisis expanded. These developed from internal emails to a publication I call "Fed Flash" because of the prominent role played by the Federal Reserve during the early days of the crisis. The shift from dates to timestamps underscores how fast the markets and the economy were imploding.

Monday, September 15, 2008

At 1:00 am EDT, Lehman Brothers announced it was filing for bankruptcy. Its 25,000 employees learned of the filing from news reports. No direct communication came from the CEO, Dick Fuld, or other Lehman executives...

...Before the day was over, Treasury Secretary Hank Paulson had met with the President; spoken with SEC Chairman Chris Cox; New York Federal Reserve President Tim Geithner (several times); the CEOs of Wachovia, Wells Fargo, and GE; Warren Buffet; and presidential candidates McCain and Obama, in that order. He ended the day with calls from the Governor of New York and another one to Tim Geithner. By the market's close, the insurer AIG's stock price had plummeted 61%, which was a precursor of things to come.

Tuesday, September 16, 2008

Barclays purchased much of Lehman's investment banking unit, which included some 10,000 employees. That was no doubt a better deal for Barclays than they could have cut for that part of the company over the weekend. My friend, Mike Moore, head of the Chicago office was spared, if being acquired out of bankruptcy and losing your net worth could be considered being "saved."

The Federal Open Market Committee (FOMC) met as scheduled and agreed to keep the fed funds target at 2%. The vote was unanimous. All, however, were not in attendance...Tim Geithner was in New York trying to avert an AIG bankruptcy. Paulson's schedule shows that he and Geithner spoke at least nine times that day, often with Fed Chairman Ben Bernanke on the line as AIG's stock price plummeted another 32% by midday and was downgraded by three ratings agencies: Fitch, Moody's and Standard and Poor's.

Fed officials met with both JPMorgan Chase and Goldman Sachs in a last-ditch effort to find private capital to fund the insurance company AIG's short-term obligations. The losses were mounting too quickly for anyone but the government to step in. A spokesman for the New York Fed confirmed that meetings regarding the fate of AIG were underway and that the company could need as much as $75 billion in emergency financing — even that figure turned out to be too little.

> "Once Lehman fell, there was nowhere for the economy to go but down. The question was how far?"

At 9:00 p.m. EDT, the Fed released details of an $85 billion loan to AIG to meet its current insurance obligations, particularly in the financial services industry. AIG, the largest insurance company, played a very big role in insuring the mortgage-backed securities held by large financial firms, not the least of which included more than $100 billion in securities at Citigroup. If AIG had failed, it would have dramatically compromised the already stressed balance sheets of a broad range of banks and primary dealers on Wall Street. The Fed had to act.

That said, Fed officials were clearly unhappy about the deal especially after drawing a line in the sand with Lehman just a few days prior. In exchange for its loan, the Fed took control of 80% of AIG and received a commitment by AIG to sell off a good portion of its subsidiaries to pay the loan back over a two-year period. The interest rate charged for the loan was a staggering 850 basis points above LIBOR, which pushed the rate into double digits.

Wednesday, September 17, 2008

The panic that had taken hold of financial markets intensified. Investors fled anything that had any kind of risk associated with it to what they perceived as the relative safety of the U.S. Treasury market.

Goldman Sachs and Morgan Stanley, two of the five remaining titans of Wall Street, were caught in the stampede. Investors sold their stocks, while clients cashed in their accounts...

...That afternoon, Bernanke assembled his Washington team and Geithner in New York to place a call to Paulson. Conditions in financial markets were melting down faster than anyone had anticipated; something needed to be done. Bernanke appealed to Paulson, who had already assembled his own team, to reach out to Congress for a systemic bailout of the financial system.

Thursday, September 18, 2008

At about 11:00 a.m. EDT, the Federal Reserve noticed that $550 billion in money market accounts had been withdrawn in less than two hours. The Treasury pumped $105 billion into the system to offset those losses but simply couldn't keep up with the outflows. An estimated $5.5 trillion would have been drawn out by 2:00 p.m. if the run had been allowed to continue.

Liquidity provided by money market funds was critical to financing of short-term commercial paper, which many large firms relied upon to pay vendors and employees.

Paulson's calls to and from individual firms, policy makers and his counterparts abroad increased. The crisis was intensifying. What was once thought to be a U.S. problem was becoming global in scope. Paulson's conversations with his former colleague, Lloyd Blankfein of Goldman, were particularly frequent.

Bernanke and Paulson called closed-door meetings with Congress to brief leaders in the House of Representatives and the Senate on the severity of the crisis. Once Lehman fell, there was nowhere for the economy to go but down. The question was how far?

Credit and access to funding were evaporating. Firms would soon (within days) be laying off people because they had lost the short-term funding to make payroll, the wealth people had in their homes was falling and leaving them with underwater assets, home equity lines of credit were cancelled and credit cards were revoked. Moreover, there was no discretion as "good" borrowers were hit along with subprime borrowers. Liquidity is the oil of the market machine; without it, the machine literally seized up.

Later in an interview on "60 Minutes," Bernanke said, "I kind of scared them; I kind of scared myself."

Many wonder now why Bernanke and Paulson didn't act sooner. The government-assisted sale of Bear Stearns to JPMorgan Chase months earlier had already burned a lot of political capital. They both admitted later that they feared being turned down if conditions did not appear critical enough to force Congress to act. Bernanke, however, has since expressed regret that he did not at least try to get Congress on board earlier because it might have mitigated some of the pain.

Friday, September 19, 2008

Treasury announced it would temporarily guarantee money market accounts to stem the electronic run on the financial system. Both retail (individual) and institutional accounts would be insured up to $250,000...

Paulson went to speak at the Council of Foreign Relations to lay out a **bailout** deal for the banks. The event was widely covered by the **press** to get the message out that an unpopular bailout was on the way...He warned that it would be "hundreds of billions...[but] cost Americans far less than the alternative."

Treasury released a three-and-a-half page draft proposal to stabilize the financial system, with a large blank spot for whatever it might eventually be named. The legislation would give the Treasury Secretary unprecedented authority to:

- Purchase up to $700 billion mortgage-related assets from any financial institution headquartered in the United States;
- Hire and fire whoever would be needed to get the job done; and,
- Issue new regulations as needs emerged.

In return, the Treasury would focus on stabilizing financial markets and protecting taxpayers. Paulson would also report to Congress regularly on the progress of the program...Oh, and by the way, "the decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency." Treasury Secretary Paulson and whoever his successor might be would have unprecedented authority over the structure and regulation of financial markets and, hence, the economy. Congress was considered almost a footnote to any changes in legislation that might be needed...

> "You just can't blink, or sleep for that matter, without something new happening."

Sunday, September 21, 2008

Paulson also hit the airwaves to try to ramp up public support for the plan. He taped interviews with "Meet the Press" at NBC studios, did a live interview with George Stephanopoulos at ABC, taped an interview with "Fox News Sunday" and taped an interview with CBS News all before 10:00 a.m. (EDT), Sunday...

The *New York Times* printed a copy of the initial draft in its Sunday edition. That, combined with reports from several other news outlets, fanned public outrage over bailouts. The proposal was widely viewed as a bailout for Hank Paulson's friends on Wall Street and, as a result, almost instantaneously rejected. It was also seen as an outrageous grab for power and a slap in the face to Congress on the eve of a major election.

9:30 pm EDT

The Fed announced that its Board of Governors had approved the applications of Goldman Sachs and Morgan Stanley to become bank holding companies. That would open the Fed's discount window to both and hopefully stop the run on their stocks initiated by Lehman's failure and the AIG debacle the week prior. The trade-off would be a greater level of scrutiny by the Federal Reserve as their regulator...

Monday, September 22, 2008

Very few understood the magnitude of the crisis on Wall Street and what it could mean for Main Street. Congress was going to have a particularly hard time justifying such an extraordinary expense for big banks when so many Americans were already suffering. It was seen as elitist and foolish (it still is by many) for Congress to help so few when so many were hurting…

Bernanke later commented that everything he did for Wall Street was for one reason and one reason only, to mitigate the losses and pain that would eventually be felt on Main Street. Paulson, however, was very poor at connecting the dots from Wall Street to Main Street for the average American, let alone to those in Congress. Bernanke and Paulson intensified their lobbying for quick passage of the bill in Congress.

Financial markets rallied. The Dow Jones Industrial Average (DJIA) jumped 779 points over two days, or 7.3%, while the S&P 500 Index jumped 4% on hopes that the government would deal with "toxic" mortgage assets in a more systematic way than it had done to date. The brief reprieve in the financial markets' downward slide allowed me a moment to reflect on what was happening and share my conclusions with management and clients.

> "Breathe!" That was the word that my cardiologist said to me while he was trying to place a device in the center of my heart to close a hole that could have been fatal if it had not been addressed. I had stopped breathing (as I held my breath) because I was awake during the procedure, just in case I needed to let them know that I was slipping into cardiac arrest...
>
> I bring up that as an example now because much of the last year on Wall Street felt like that 45 minutes on the operating table. I keep reminding myself to breathe, look for signs of cardiac arrest, all while my surgeons (Bernanke, Paulson and Congress) tried to plug the hole discovered in the heart of our financial system.
>
> Bear with me as I stretch the analogy a bit further. The first two days after successful surgery, the device that was nestled into the center of my heart set off alarms at all the stores that I visited--a particular inconvenience as it was only a few days prior to Christmas and I was racing to finish last minute shopping.
>
> In a similar way, the broad sweeping plan hatched by the Fed, the Treasury and Congress last night will likely close the hole in the heart of our financial system; however, it will take some time to grow into the tissue before it can stop setting off alarm bells.
>
> I won't give the government as much credit in handling the crisis as I gave my cardiologist. I do believe, however, that regardless of how these policies will have to be revised to deal with any problems down the road, the fact that they exist at all provides a much-needed shot of confidence in the financial system, which had all but disappeared…(Fed Flash, Mesirow Financial)

Behind the scenes, Paulson was scrambling to secure Congressional support by getting on the phone with members of Congress. Speaker of the House Nancy Pelosi topped his list. He needed her support to get the legislation through the House of Representatives and, ultimately, the Senate...

Tuesday, September 23, 2008

Chairman Bernanke and Treasury Secretary Paulson went to Capitol Hill to start two days of testimony justifying what was now called the "Emergency Economic Stabilization Act." The Chairman's prepared remarks were short, direct and urgent. He concisely explained the events leading up to the turbulence created by Fannie Mae, Freddie Mac, Lehman and AIG...

Financial market participants had finally started to realize the depth and breadth of the subprime crisis when Fannie and Freddie were placed into conservatorship in a surprise move by the government over the Labor Day weekend. Those actions accelerated the run on Lehman and by extension, AIG. Bernanke warned about the seizure in the markets, including the scare in cash markets the week prior...

...In a Fed Flash I penned that day I said:

> The current deal is only the first chapter in the book that redefines the parameters of our financial markets. Changes to bank structure, regulation, etc. are all still to be defined...Nobody is happy that we have reached this point, but now that we have, it is paramount that we do not cause any further human toll for Main Street. The single scariest event I have ever studied (the Great Depression) or seen is the fear that cash is not safe in the U.S. We hit that point last week.

However, public support, which was critical for Congress on the eve of yet another election, was already waning...

Wednesday, September 24, 2008

7:00 am CDT

> The Fed announced this morning that it broadened its international swap agreements to include more foreign central banks. An additional $30 billion would be added to the already $247 billion made available to ease funding pressures in the last week. What does it mean?
>
> We might not like the $700 billion bailout proposed by Paulson but the time for debate has ended. If we don't act soon, we may lose the opportunity to do anything at all.

The move has to be seen not on its own or as a single event but as the first chapter in a long series of books (think Harry Potter times a hundred) that lays out the framework of a new financial system for the 21st century, a global financial system in which regulation and monetary policy are viewed in their entirety rather than piecemeal. (Fed Flash, Mesirow Financial)

9:53 am CDT

Bernanke amended his comments yesterday to include the economic ramifications of the current financial crisis for Main Street. He highlighted the problems that tighter credit conditions were already causing businesses and consumers and underscored that the downside risks to the outlook had increased. He also emphasized the need for Congress to pass the bailout plan proposed by Treasury Secretary Paulson as a critical component of the outlook for even a moderate recovery in growth.

Separately, the Fed Chairman acknowledged that threats to inflation were abating, particularly in financial markets. He stopped short, however, of removing inflation from the list of concerns.

On net, Bernanke is trying to more clearly connect the dots between Wall Street and Main Street so the lawmakers can better justify their support to their constituents and get the bailout passed. He also opened the door a crack to additional monetary easing, but only a crack. The Fed would clearly rather resolve the current crisis by getting credit spreads to narrow than by cutting rates any further. (Fed Flash, Mesirow Financial)

That night, President George W. Bush went on prime-time television to appeal to the American public to support what was now seen as Paulson's $700 billion bailout of his friends on Wall Street. He offered extra protections for taxpayers so that they might benefit once the companies helped by bailout funds recovered. He opened the door to limits on executive compensation, which was widely popular with the public but opposed by Wall Street. (It is probably still one of the greatest sources of tension between those who took TARP funds and the public.) I went to bed knowing that I would be working more on trying to decipher the financial market crisis.

Thursday, September 25, 2008

Credit markets completely seized up, lending between banks came to a virtual standstill, the inter-bank lending rate or "LIBOR" widened to a record spread between it and the overnight fed funds rate as and the yield on the 3-month Treasury bill moved into negative territory. I wrote a Fed Flash arguing that the Fed, in conjunction with other central banks, would have to further lower the fed funds rate as their efforts to narrow credit spreads had failed.

I argued that economic conditions would get worse before they got better but was "oddly optimistic" that Congress would ultimately pass a bailout package. The question was when, and what damage might be done in the interim. The clock was ticking.

Later that day, I flew from Chicago to Utah for a meeting of the 2008 National Arts Policy Roundtable, hosted by Robert Redford at his Sundance Preserve…The Roundtable is comprised of a mix of political and business leaders, artists and groups working on better integrating the arts into public education. The goal is to reduce high-school dropout rates and increase college attainment among the most economically disadvantaged populations. It is a population that appeared to be radically expanding when I was attending the conference…

The FDIC announced that Washington Mutual would be merged into JPMorgan Chase. Both companies had been rumored to be in merger talks since January 2008. The rapid deterioration of financial markets in the period since Lehman went under, however, made the merger a necessity rather than a choice.

The deal, which was heralded by the FDIC because it came at no cost to the insurance fund, set into motion a chain of events that led to the insolvency and eventual fight over ownership rights for Wachovia.

Friday, September 26, 2008

3:54 am CDT

FYI - The link to the Federal Reserve's news release below came out moments before I sent my Fed Flash; you just can't blink, or sleep for that matter, without something new happening. [I was so tired that I actually just attached the link for those who wanted more information than I could explain on very little sleep.]

It confirms that the Fed and its counterparts abroad are not only upping the funds available for overnight funding to almost $300 billion but also increasing the length of time, from overnight to one week, that those funds may be used to ease the current crunch in liquidity. The hope is to bridge the end-of-quarter need for funds with a week-long swap facility versus an overnight only swap facility.

If the Fed and its counterparts abroad ultimately fail to narrow the record-high risk premiums we are currently experiencing, then they will have to lower the base from which market rates are priced. An internationally coordinated rate cut would be especially powerful and could come as soon as next week.

That said, opposition to additional rate cuts both at home and abroad remains high, which means we may have to wait until the Fed's next officially scheduled meeting for anyone to do anything.

From the Federal Reserve:
https://www.federalreserve.gov/newsevents/pressreleases/monetary20080926a.htm
Federal Reserve and other central banks announce operations to address funding pressures over quarter end. (Fed Flash, Mesirow Financial)

The panic that started on Wall Street had reached Main Street, even if Main Street didn't realize why it was critical to save Wall Street from itself. The demand for the resources that Americans for the Arts was trying to get would be rising as the resources to supply those services—charitable donations and government funding—diminished...

Saturday, September 27, 2008

I returned to Chicago, bracing for the next round of bailout negotiations. It was Saturday and I was hoping that I could get at least one night's sleep before the next flurry of policy agreements was released. Paulson and Bernanke had been working hard to get Congress to come to some kind of a compromise over the bailout plan and by Sunday morning, they thought that they had found it.

Sunday, September 28, 2008

9:16 pm CDT

About 30 minutes ago, Congress and the Bush Administration announced that it had made a breakthrough in its $700 billion bailout ("rescue") negotiations.

This time it seems that the deal may actually pass, despite what look to be more cosmetic than substantive changes to Paulson's initial proposal a week ago. Congress has agreed to...

I am still hoping for a coordinated ease in monetary policy to [establish] the credibility of the package to investors. The ECB will have to reverse course and ease soon. The Fed is probably still more reluctant to take rates lower. (Fed Flash, Mesirow Financial)

Monday, September 29, 2008

Prior to the open of financial markets in the U.S., the FDIC announced that Citigroup would acquire Wachovia to avert further stresses on the banking sector. The problem, however, was that this deal differed from the deal cut for Washington Mutual. Not only were shareholders essentially zeroed out—Citi agreed to pay a mere $2 billion for Wachovia, which had been in merger talks for more than tenfold that amount earlier in the year with Wells Fargo—but also zeroed out bondholders.

That added insult to injury to the bond market, which was already seizing up due to investor uncertainty. Prior to the WaMu merger, Wachovia was considered the stronger financial institution. After the announced merger with Citi, Wachovia was treated as the weaker of the two institutions. Bond buyers had literally no idea of who to trust and, as a result, stopped buying bank bonds.

9:40 am CDT

The Fed has just announced a massive expansion of its coordinated efforts with central banks abroad to provide liquidity to cash-strapped banks. The crunch on cash is particularly acute given the end of quarter funding needs, but should ease up later this week. That easing of credit conditions later in the week, however, is highly contingent upon the passage of the bailout plan today. Moreover, credit conditions are likely to remain relatively tight in the near term, even if a package is approved.

This is to say nothing of real economic conditions, which continue to deteriorate. Indeed, the best we can hope in the near term is for the bailout to mitigate losses. The bailout and additional actions - further easing by central banks at home and abroad - will do more to help the economy in late 2009 and 2010 than today. (Fed Flash, Mesirow Financial)

Later that day, the vote for the $700 billion bailout package was taken to the floor of the House of Representatives for passage: It fell 12 votes shy of the 240 needed for passage.

1:45 pm CDT

The House is regrouping after failing to pass the Treasury's bailout plan. There is no consensus. The House is deeply split over whether or not the bill can be salvaged. At one point, the Dow was down almost 700 points in response to the fear that the bailout would not pass. The credit markets are in even more trouble. There will not be another vote today.

However, there are several people working feverishly to get a deal done later in the week. Every day that passes creates additional pressure on credit markets. The hope is that at least some of the pressures will ease up with the end of the quarter on Wednesday. Banks in particular are facing an end-of -the-quarter crunch in cash flow but not enough to make much of a difference for Main Street. Indeed, we are getting close to a point in time when central banks will have to ease either way. It would serve the economy and financial markets well to get a deal done and then give it some extra momentum by cutting interest rates to ensure that it works.

That said, we can't escape the economy getting worse before it gets better, no matter what happens. We can only mitigate the human toll this crisis is taking on Main Street quite substantially by moving forward on a bill as soon as possible. (Fed Flash, Mesirow Financial)

3:00 pm CDT

The Dow Jones Industrial Average closed at 10,365, down a record-breaking 778 points, or 7% from Friday's close. The S&P 500 was off an even more severe 8.8%. About $1.2 trillion in market value was wiped away in a day.

Tuesday, October 1, 2008

10:45 am CDT

The Senate passed the $700 billion rescue package after some add-ons to make the bill more palatable to Main Street; tax cuts (more than $100 billion), higher deposit insurance, warrants for taxpayers and some minor limits to CEO pay were all part of the revised plan. There is also a role for an oversight board and some ability by Congress to release the funds in increments, rather than all at once.

It also seems that the House is ready to deliver the votes necessary to pass the bill. This is despite very little cosmetic surgery over the course of the debate on the package.

I would expect the equity markets to remain skittish about the bill until it actually becomes law (i.e., "Fool me once, shame on you; fool me twice, shame on me!"). Once it does pass, however, there will be champagne (beer?) flowing on Wall Street.

It will take much more time and many more [interventions by the Federal Reserve and the government], however, for Main Street to see a real improvement. Moreover, a further deterioration in economic conditions suggests that the Fed will ease (maybe as soon as this weekend, when its counterparts across the world convene in Europe) to further alleviate market turmoil and calm the recent panic that has snowballed from Wall Street to Main Street in recent months.

Bottom line: Main Street probably needs this bill more than Wall Street. Too bad nobody thought to connect the dots between these two entities sooner…
(Fed Flash, Mesirow Financial)

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