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No Bailout: Feds Made New Policy Clear in One Dramatic Weekend

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When Treasury Secretary Henry M. Paulson Jr. flew to New York Friday evening, he brought only one change of clothes. And he planned to send a simple message to the powerbrokers of the financial world: No government bailouts would be offered to Wall Street.

Paulson ended up staying until Monday, relying on the Waldorf Astoria hotel to clean his clothes, while presiding over an unprecedented series of meetings that reshaped the financial landscape and sealed the fate of some of the biggest names in banking. On little sleep and with the underpinnings of world markets hanging in the balance, senior government leaders decided not to rescue Lehman Brothers and Merrill Lynch, forcing the former to file for bankruptcy protection and the latter to sell itself to Bank of America.

Accounts by insiders at the gathering show how senior government officials in a single weekend recast the debate about how the credit crisis would be addressed after the mammoth taxpayer bailouts of Fannie Mae and Freddie Mac this month, as well as investment bank Bear Stearns in March. These sources spoke on condition of anonymity because they either were not authorized to speak or described private conversations.

The dramatic events of the weekend were set in motion after investor confidence in Lehman Brothers slipped away over the last few weeks.

Paulson, who speaks daily to Wall Street chief executives over the phone, had been telling Lehman's chief executive, Richard S. Fuld Jr., that the firm had to consider either a broad restructuring or an outright sale ever since the firm announced a second-quarter loss of $2.8 billion in July.

In recent weeks, as problems intensified at Lehman, the Federal Reserve Bank of New York stepped up its contingency planning for what might happen to the financial system if the storied investment bank were to collapse.

By late last week, the firm's reckoning had come. Many on Wall Street said they thought the bank, after being in business for nearly 160 years, would not survive when markets opened Monday.

Some Wall Street executives had a hard time believing that the Fed and Treasury would let Lehman fail, assuming the government would step in at the last minute, just as it had in the case of Bear Stearns. In March, the Fed risked $29 billion to back J.P. Morgan Chase's buyout of Bear Stearns, a deal that was strongly endorsed by Paulson.

Friday morning, Paulson told his policy director Michele Davis and legislative affairs chief Kevin

Fromer to send a message to Wall Street through the media that the government would not put up money in a deal for Lehman. Later that day, he flew to New York to drive home the point hard.

At about 6 p.m., in a large conference room just off the lobby on the ground floor of the New York Federal Reserve, Paulson sat at a long oval table with Securities and Exchange Commissioner Christopher Cox by his side. New York Fed Chairman Timothy F. Geithner sat directly opposite.

The meeting was open to chief executives only, and about 20 of these finance titans sat quietly around the table. The New York City subway, located below the room, periodically sent screeches and rumbles into the meeting.

Paulson, a former Goldman Sachs chairman, made an impassioned case: There would be no government money available for a Lehman Brothers buyout, he said. He had opened public coffers twice and was not prepared to do it again.

Geithner was more restrained, but his presentation no less dramatic. He revealed that the Fed had been drawing up contingency plans for a Lehman bankruptcy and was prepared to use them if no private-sector deal could be struck.

The opening statements, combined with news reports that the government was drawing the line at a bailout, meant the government couldn't change tacks later without undermining its credibility in any future negotiations.

The executives shared their views on a wide range of subjects. Several asked Paulson and Geithner whether there would be a broader government effort to address unfolding problems at Merrill Lynch, Washington Mutual and American International Group, among others, once Lehman's situation was resolved.

Paulson and Geithner stressed there would be no government money to help any firm that ran into trouble next.

Before 9 p.m., Paulson and Geithner asked the executives to go back to their firms and analyze the situation with their best people. Banks that had examined Lehman's assets were to share their findings with the rest of the group by the next morning.

The officials also laid out plans for the weekend. Some firms would delineate a scenario in which Lehman's healthy assets would be sold to a suitor and the bad assets would be spun off to a separate enterprise, which would receive new funding from a consortium of Wall Street banks. Most of the participants hoped for this outcome because it would prevent Lehman's assets from becoming devalued, which could trigger losses at other firms that hold similar assets.

A separate group would work on predicting what would happen if no one bought Lehman and the firm was forced to file for bankruptcy.

While conversations between the executives continued, Paulson and Geithner left the meeting and took the elevators to Geithner's office on the 13th floor. An office suite was set up for Treasury officials, including Chief of Staff Jim Wilkinson, as well as Dan Jester and Steve Shafran, both senior advisers who have worked at the investment bank Goldman Sachs. Separate rooms were given to the SEC staff.

Though many of the government officials concluded a deal was unlikely, Paulson was optimistic that a private solution would emerge for Lehman and possibly even Merrill or AIG.

On Saturday, the scene turned chaotic as hundreds of bankers flowed in and out of the vault-like New York Fed building, which is nestled between the narrow streets of Lower Manhattan. Right outside the conference room on the first floor, a spread of coffee, bagels and doughnuts was set up. The media tried to get photos and names of everyone who entered the building.

The morning also brought dark clouds. Some of the banking analysts revealed that Lehman's assets were of far worse quality than had previously been thought. It might be hard to find a firm to buy them.

Two possible suitors included Bank of America and Barclays, which had told Treasury of their interest in phone conversations before the weekend. But both companies said they wanted federal guarantees.

Through the day, Paulson, Geithner and their Fed and Treasury colleagues darted upstairs to the 13th-floor executive suites, huddling in a small conference room off of Geithner's office or in an unused office provided to Paulson for the weekend. There, they discussed their options, often with Fed Chairman Ben S. Bernanke and Vice Chairman Donald Kohn joining by phone.

Besides keeping the White House informed, Paulson began to speak privately with chief executives to evaluate their firms' exposure to a Lehman liquidation, advising what action they should take.

One of these conversations occurred Saturday afternoon between John Thain, chief executive of Merrill Lynch, and Paulson. The two talked at length alone. The conversation remained private and was not shared with other participants at the meetings. And Paulson, when later asked, would not reveal what they talked about.

Shortly after the conversation, Thain began work on the deal that would see his firm sold to Bank of America for about $50 billion. At that point, it became clear to Paulson that Bank of America was no longer a potential savior for Lehman.

The British bank Barclays remained the last hope to buy Lehman. But a flurry of conversations with Barclays' British regulator, which was concerned about whether the bank was overreaching for Lehman, suggested that the possibility was remote.

By Saturday night, it appeared all but certain to senior officials at the Treasury and the Fed that Lehman would end up in bankruptcy protection. But they waited until they heard definitively from Barclays' regulator before sharing that conclusion with the bankers who had set up shop on the first floor of the building.

Until then, the senior government officials had divided their time equally between efforts to arrange a sale of Lehman and contingency planning to prevent a market rout on Monday if Lehman were to collapse. Starting about 7 p.m. Saturday, the officials turned all their attention to dealing with the fallout of Lehman's failure, not preventing it.

Early Sunday morning, British regulators told Paulson that they had serious problems with the deal, all but killing the possibility of a Barclays buyout. At 10 a.m., Geithner and Paulson passed that information to the investment bankers who had spent the previous 24 hours trying to organize a consortium to finance an enterprise that would hold Lehman's bad assets.

The executives were stunned. The consortium wouldn't be necessary. Rather, they needed to prepare for the liquidation of Lehman and its impact on their companies.

Lehman's board made a last-ditch effort to save the firm, arguing for funding from the Fed that would give it time to find another solution. But Fed officials were firmly convinced that no one would do business with the firm come Monday morning.

Sunday evening, the firm decided to file for bankruptcy protection.

That freed Paulson to begin informing members of Congress, including Rep. Barney Frank (D-Mass.), chairman of the House Financial Services Committee, senators on both sides of the aisle and New York Mayor Michael Bloomberg. Other Treasury officials shifted gears to work on another unfolding problem at AIG, which appeared to them to be on the verge of a collapse. Some involved in this effort said discussions about AIG's troubles intensified as the weekend progressed.

As the bankruptcy of Lehman became official, someone remarked about the historic nature of the weekend.

Jim Wilkinson, Paulson's chief of staff, was within earshot of the comment and responded to the group discussing the events: "This would be extremely interesting from an analytical perspective if wasn't happening to us."

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