Transcript: Inside the Meltdown

ANNOUNCER: On September 18th, 2008, the secretary of the Treasury, Henry Paulson, and the chairman of the Federal Reserve, Ben Bernanke, arrived for an emergency meeting at the Capitol.

JOE NOCERA, *The New York Times*: On Thursday, late afternoon, they go to Nancy Pelosi's office and there's a meeting of the senior legislators from both parties in both House and Senate.

ANNOUNCER: In the past seven months, they had bailed out one bank and let another one fail, nationalized three of the nation's largest companies, and watched in horror as the credit markets froze.

Sen. CHRISTOPHER DODD (D-CT), Banking Committee Chairman: It was obviously a big meeting. I had no idea I was going to hear what I heard. We turned it right over to Ben Bernanke and Hank Paulson.

Rep. BARNEY FRANK (D-MA), Financial Services Cmmt. Chairman: And they said they needed the authority to use $700 billion dollars to unstop the credit markets.

Sen. CHRISTOPHER DODD: Sitting in that room with Hank Paulson saying to us in very measured tones, no hyperbole, no excessive adjectives, that, "Unless you act, the financial system of this country and the world will melt down in a matter of days. "

JOE NOCERA: Bernanke said, "If we don't do this tomorrow, we won't have an economy on Monday."

Sen. CHRISTOPHER DODD: There was literally a pause in that room where the oxygen left.

ANNOUNCER: Tonight on FRONTLINE, from the boardrooms on Wall Street to the back rooms in Washington, FRONTLINE goes Inside the Meltdown.

NEWSCASTER: We learned today home foreclosures in the last three months-

NARRATOR: The story begins in the spring of 2008, after the housing bubble had burst.

NEWSCASTER: Home prices were at a record high just two years ago.

NARRATOR: Wall Street had gambled heavily on home mortgages, especially risky ones.

NEWSCASTER: Sales of existing homes fell 8.6 percent last month-

NARRATOR: As the housing market crashed, fear crept in.

NEWSCASTER: Foreclosure filings on 303,410 U.S. properties in December.

NARRATOR: What if there were a run on any of the Wall Street houses?

NEWSCASTER: Shaky home mortgages are triggering fears of a financial meltdown on Wall Street.

NARRATOR: Then on Monday, March 10, a rumor about Bear Stearns.

BRYAN BURROUGH, Vanity Fair: Pretty normal morning. And then suddenly, around 11:00 o'clock, there's a tremor. The stock starts to go down. The CFO of Bear starts calling down to his desks, to the repo guys, the bond guys, "Anybody hear anything? Anybody know anything? What is this?" "Yeah, the rumor is that we're running out of cash and that we might be in trouble."

NARRATOR: Bear's former chairman, Alan "Ace" Greenberg, had seen it happen before.

ALAN GREENBERG, Fmr. Chairman, Bear Stearns: Rumors are such that they just can plain put you out of business. People that you have been doing business with for years, all of a sudden, they just say, "No, we don't want to touch it."

NARRATOR: On the Street, they say rumors - even unfounded rumors - are a contagion that can kill a company in just a few days.

DAVID FABER, CNBC Anchor: -causing the stock the most activity. Bear Stearns suffering from, well, what you can do with any of these stocks these days, mainly start a rumor-

KATE KELLY, *The Wall Street Journal*: CNBC is ubiquitous on trading desks. It's ubiquitous on Wall Street. People watch it absolutely all day long. They tune into it- when there are flash lines up on the screen, they want to tune in immediately. So they have a profound impact on what's happening.

DAVID FABER: Those are the kinds of concerns in this market-

BILL BAMBER, Sr. Managing Dir., Bear Stearns: It was nothing short of surreal. You are watching on CNBC, et cetera- I mean, they are talking about where you work.

CNBC ANCHOR: The only bank in the red right now, basically, Bear Stearns, although it is dragging the rest of the financial markets down, as well-

NARRATOR: Bear's stock was in freefall. Once it traded as high as $171, now it hovered around $60.

JEFFREY LANE, CEO, Bear Stearns Asset Management: When people get nervous, they want the money out because you don't want to be the last person when there's a run on a bank. The stock started to go down. More and more people called up and said, "I want my money out or I won't trade with Bear Stearns." And it just completely unwound.

CNBC ANCHOR: And it happens because those that who do business with a firm such as that lose confidence. And when they lose confidence, they pull their lines, and that's it, it's done. Pack your bags.

NARRATOR: Inside Bear, they knew they needed to reassure the market. They turned to former chairman Ace Greenberg.

ALAN GREENBERG: Somebody came over to me and said, "You've got to make a statement. We're in trouble." I called the chief financial officer. I said, "Are we in trouble? He said, "No, everything's fine."

NARRATOR: They had nearly $18 billion dollars in cash reserves. Ace called CNBC.

ALAN GREENBERG: So I said, "It's ridiculous. Everything's fine." Which it was.

BRYAN BURROUGH, Vanity Fair: He says, "This is ridiculous," which then kind of, as they say, put pants on the problem because CNBC then starts running a crawler, you know, "Ace Greenberg calls rumors of imminent demise ridiculous," which is a little bit, you know, like screaming, "I'm really not beating my wife, honest."

CNBC ANCHOR: Very sharp rally on Wall Street, with the exception of Bear Stearns. It has been a roller-coaster.

NARRATOR: The rumors swirling around Bear were about its massive investments in subprime mortgages, what would become known as "toxic assets."

DAVID FABER, CNBC Anchor: They were big in mortgages. They were big in packaging them and creating securities out of them, buying them.

NARRATOR: The road to riches for Bear was simple: Buy hundreds of thousands of mortgages, then bundle them into securities and sell them to investors.

Rep. BARNEY FRANK (D-MA), Financial Services Cmmt. Chairman: Thirty years ago, if you got a mortgage, you went to the a bank and that bank frisked you pretty good before giving you the money because the bank expected you to pay the bank back. In 2005, a mortgage lender lends money to a lot of people and does not expect to be repaid by them, but bundles up the right to be repaid by them and sells it to a lot of other people.

NARRATOR: The bigger the housing market grew, the more Bear and other investment banks bought.

JOE NOCERA: Accelerating housing prices created a mentality among everybody involved in the mortgage industry, from the buyer of the house to the broker, the mortgage broker, to the bank, to Wall Street, that housing prices could only go up.

BRYAN BURROUGH: Everybody did this. You know, everybody made tons of money in '05, '06.

NARRATOR: By '07, the party was over.

GRETCHEN MORGENSON, *The New York Times*: People started to see that foreclosures were rising. Certainly, the home price appreciation that we had enjoyed for many years during the bubble was stopping.

JON HILSENRATH, *The Wall Street Journal*: They were stuck with these investments that were rapidly declining in value.

JEFFREY LANE, CEO, Bear Stearns Asset Management: It was a formula for disaster. It was a traditional game of "Hot potato, hot potato." And as it turned out, everybody ended up with a potato.

[*www.pbs.org: Roots of the crisis*]

NARRATOR: As the smallest investment bank on Wall Street, Bear Stearns looked vulnerable. Wednesday, two days into the crisis, they needed to do something to restore confidence.

BRYAN BURROUGH: If you're a Wall Street firm beset by rumors, the best you can do is bring out the CEO to say, "Well, this is really nothing serious." And by Wednesday morning, that's where Bear had come to.

DAVID FABER: I called over to their head of PR, talked to them about it, saying, you know, "Your stock just keeps getting hammered. I talked to a lot of people. I think they would want to hear from Alan."

NARRATOR: Alan Schwartz, Bear's CEO, decided to give Faber the interview.

DAVID FABER: Joining me now first on CNBC is Alan Schwartz. He is Bear Stearns president and CEO. Mr. Schwartz, thanks so much for being here this morning.

BILL BAMBER: Everything went quiet on the trading floor as we listened to the interview, everyone very focused on listening because this- we knew this would be the nexus point for how the rest of the week would play out.

DAVID FABER: So what I'm told by a hedge fund that I know well that last night, they tried to close out a mortgage, a credit protection-

NARRATOR: Faber's first question was a tough one. He raised the specter that one of Bear's most important trading partners, Goldman Sachs, might be deserting them.

DAVID FABER: You're saying you're not aware that that would be the case.

ALAN SCHWARTZ: I'm not aware that, you know, on a specific trade from one counterparty to another-

BRYAN BURROUGH: If you're just living out in Schenectady, that doesn't sound all that bad. In fact, that is a kiss of death. He has all but driven a spear through Schwartz's heart because he's saying that Bear Stearns is not trustworthy in the eyes of those it trades with.

KATE KELLY, *The Wall Street Journal*: For Bear, it turns out to be a big blow because it's a public acknowledgement of what sounds like a specific example, and Alan looks to some people like he's not on the ball.

ALAN SCHWARTZ: -and I think the situation with time will stabilize.

DAVID FABER: Well, Alan Schwartz, thank you so much for being here this morning. Appreciate it.

NARRATOR: Bear had borrowed heavily to invest in toxic assets and other high-risk securities. To survive, it would have to find more lenders willing to loan it money.

JOHN CASSIDY, *The New Yorker*: Bear Stearns rolls over its loans every night or every few nights in what's known as the repo market. And that gives its lenders an opportunity, each night, if they want to, to call in some of their loans or to demand more collateral. What this amounts to, effectively, is that investment banks- there's a vote of confidence every night on whether they survive or not.

NARRATOR: And that night, the markets were voting no confidence in Bear Stearns. Their stock was dropping and the cash reserves were beginning to dwindle.

JEFFREY LANE: This stuff became a self-fulfilling prophecy. You know, a lot of people that perhaps would not have acted, in listening to some of the things that were going on, said, "I can't leave my assets there anymore. I have to have them out."

ALAN GREENBERG: You're sitting in the middle of an avalanche. What can you do if you're on the side of a mountain and an avalanche comes at you? An avalanche goes what, 60 miles an hour? You can't outrun it, right? What can you do?

NEWSCASTER: The story has continued to mushroom, and there are concerns amongst-

NARRATOR: On Thursday, Bear's stock continued to fall, and the reserve was almost completely gone.

BRYAN BURROUGH: By 6:00 o'clock, it's very clear that they do not have enough money to open the next day. They have 12 to 14 hours to do something unprecedented in terms of raising emergency capital or go under.

NARRATOR: They had one last chance, the Federal Reserve Bank in New York. Tim Geithner was in charge.

PAUL KRUGMAN, Economist, Princeton University: Geithner is a Larry Summers protege from Treasury. He worked his way up during the Summers years at Treasury.

MARK LANDLER, *The New York Times*: He's 47 years old - he looks like he's about 32 - universally liked and respected.

PAUL KRUGMAN: Extremely smart, extremely aware of this stuff, very discrete, controlled.

MARK LANDLER: And he sort of serves as an intermediary between Washington and Wall Street because he sits in Manhattan, but he works for the Federal Reserve system.

NARRATOR: That night, Bear Stearns's fate would be in Tim Geithner's hands.

JOHN CASSIDY: Geithner's people went to Bear's headquarters and started to look through all the accounts. Geithner told me he initially thought that they should let Bear go under.

BRYAN BURROUGH: By midnight, by 1:00, 2:00 in the morning, everybody and their mother has teams at Bear - Morgan, the Fed, the SEC - and they find out Bear is stuffed to the gills with toxic waste.

NARRATOR: They found billions in hidden subprime mortgage loans, and something worse, credit default swaps, a form of insurance. Bear had promised if bonds it sold insured failed, they would pay.

JOE NOCERA: They were really very mysterious instruments that only the sort of financial wizards understood.

CHARLES DUHIGG, *The New York Times*: Credit default swap is basically just an agreement that I have with you, where I sell you insurance on some bond you own. If the bond goes belly up, I promise to pay you. And as long as the bond doesn't go belly up, you pay me for selling you insurance.

NARRATOR: Geithner's investigators told him that Bear had made credit default swap deals worth hundreds of billions of dollars all over Wall Street and around the world.

JOHN CASSIDY: Through the night, things changed as the people in the Fed discovered the positions that Bear was in and discovered what would happen if they did go under.

Rep. BARNEY FRANK: Because Bear Stearns was so indebted to so many other people, their failure to repay their debt, or pay their debt, would cause a cascade of other failures.

CHARLES DUHIGG: Every single part of Wall Street at this point is plugged into another part of Wall Street. And if I go down, I can now drag down that guy. And if he goes down, he can drag down that guy, and he can drag down that guy. And this is a huge web that connects everyone in these completely unforeseen ways.

JOHN CASSIDY: They then reported back to Geithner that, "Look," you know, "this is a lot more complicated than it appears."

NARRATOR: Geithner saw what central bankers fear most, "systemic risk." Bear was frighteningly interconnected with other banks up and down Wall Street. Geithner picked up a phone at 4:00 in the morning and called his boss at the Federal Reserve, Ben Bernanke.

MARK LANDLER: Ben Bernanke is a highly, highly respected scholar, and not only a scholar of economics but of the Great Depression.

PAUL KRUGMAN: If he weren't chairman of the Fed, he'd be top of the list of people you'd be going to for advice and understanding of all this stuff.

NARRATOR: On this night, one of the Depression expert's darkest fears was being realized.

GRETCHEN MORGENSON: Ben Bernanke felt that the risk to the system, the financial system as a whole, would be too great if Bear Stearns were allowed to go bankrupt.

MARK GERTLER, Economist, NYU: It was clear that this had to be contained. There was no doubt in his mind. He, more than anyone else, appreciated what would happen if it got out of control.

JOE NOCERA: He was absolutely determined to be an activist Fed governor, that when the crisis came along, his Fed would throw every weapon it had at the problem.

NARRATOR: But the Federal Reserve was prohibited from directly lending cash to Bear, an unregulated investment bank. Bernanke was prepared to get around the rules, and he did.

KATE KELLY: Very early in the morning, the Federal Reserve has a conference call. Ben Bernanke's on it, Tim Geithner's on it, among others.

JOHN CASSIDY: They eventually came up with this idea of giving a loan to JPMorgan, which was Bear's clearing bank, and having JPMorgan pass on the cash to Bear, so indirectly lending to them via JPMorgan.

DAVID FABER, CNBC Anchor: We have important news to share with you about Bear Stearns, a company that I've been reporting on all week.

BILL BAMBER: It was about 8:30 that they announced the deal.

DAVID FABER: Let me share with this press release that has just hit. The Federal Reserve Bank and JPMorgan Chase announce that they have agreed to provide secured funding to Bear Stearns as necessary-

CNBC HOST: Make no mistake, the Federal Reserve is bailing out Bear Stearns and they're using JPMorgan as a conduit to do it.

NARRATOR: But Bernanke's unprecedented plan almost immediately backfired.

Sen. CHRISTOPHER DODD: Because Bear Stearns was the only one to get that treatment, obviously, the Fed was sending a message, "This is an institution that's about to fail." So to single them out, in a sense, was to virtually assign them to a death sentence.

CNBC HOST: People are starting to trade this company as if its entire fate is totally in question at this point.

BILL BAMBER: At the opening at 9:30, you promptly had a- basically, a 50 percent sell-off in the stock.

CNBC HOST: At 10:00 o'clock Eastern time, Bear Stearns hit $30. And people sort of gasped as it hit $30. Two things are going on-

NARRATOR: In Washington, at the Treasury Department, the secretary, Henry Paulson, was also beginning to worry about systemic risk.

KATE KELLY: Paulson was picturing a 1,000 to 2,000-point drop in the Dow that Monday, possibly the failure in very short order of a number of other investment banks - Lehman Brothers, Morgan Stanley and so on. Paulson just thought that the uncertainty was too great.

NARRATOR: Paulson thought he knew the markets well. Only two years before, he had run Bear's largest competitor.

GRETCHEN MORGENSON: Henry Paulson came from Goldman Sachs. He was the chief executive officer, came up through the investment banking world.

MARK LANDLER: He's a true Wall Street nuts-and-bolts guy, not the most articulate man, very smart, very, very intense.

NARRATOR: The loan to save Bear was not Henry Paulson's idea, or style. It was the Fed's call. From now on, though, Paulson would get involved. He and Ben Bernanke would face the crisis together.

JON HILSENRATH, *The Wall Street Journal*: It helps me to think about this crisis as a patient that's going through spasms, and each time, the spasms seem to be getting worse. And it helps me to think about Bernanke and Paulson as two doctors in the room trying to settle the patient down.

NARRATOR: Saturday morning, hundreds of lawyers and accountants from Bear's competitors descended to examine the books.

JEFFREY LANE: It was like being picked over in a cemetery. The body was dead or dying, so there were people picking over the carcass. It's just really the ugliest thing I've ever seen.

NARRATOR: In the end, no one wanted to take on Bear Stearns's debt. But on Sunday morning, Bernanke pushed back, creating a shotgun marriage between Bear and JPMorgan. Paulson went along, as Bernanke guaranteed the deal with a $30 billion dowry to cover Bear's toxic assets.

ALAN GREENBERG: I'd say it was certainly- the lending of $30 billion dollars against those securities made it palatable for JPMorgan to go ahead. Without that, there wouldn't have been a deal.

NARRATOR: But Paulson still had misgivings. He immediately issued a warning to Wall Street: This was not going to happen again. He invoked a central precept of the catechism of the free market, "moral hazard."

HENRY PAULSON, Secretary of the Treasury: I'm as aware as anyone is of moral hazard. I'm also aware of-

JOE NOCERA: Moral hazard poses the question: If you bail somebody out of a problem they themselves cause, what incentive will they have the next time to avoid making the same mistake?

NARRATOR: As a hard-bitten veteran of Wall Street, Paulson had personally made hundreds of millions of dollars believing the best government was no government.

MARK LANDLER: He's an unapologetic free marketeer. He's a Republican. He has that deregulatory mindset that the Bush Administration has. That's why he was chosen.

NARRATOR: That same Sunday afternoon, as the very last details of the deal were being ironed out, Paulson decided to starkly make the moral hazard point. He picked up the phone and called JPMorgan's CEO.

JOE NOCERA: Paulson wanted to send a message that, "This is not going to be a bailout that you're going to like if you're Bear Stearns." You know, "You did dumb things, and you're going to be punished."

NARRATOR: Thirty percent of Bear's stock was held by its own employees. At the end of the week, that stock was selling for $30 a share. JPMorgan was offering $4.

CHARLES DUHIGG: Paulson says, "No, I want you to do it for $2 a share. We don't want anyone in America, particularly on Wall Street, to think that the government has a safety net for you whenever you need it. I want it to be so, so painful for any Bear Stearns shareholder that it's almost as if they went out of business."

NARRATOR: At 6:00 o'clock, the Bear employees received the word.

BILL BAMBER, Sr. Managing Dir., Bear Stearns: A lot of the price talk that we had been hearing was, you know, in the $20 range, maybe $15. So when they announced that we were being sold to JPMorgan for the princely sum of $2 per share, it was- it was a shock.

JEFFREY LANE: I think there were people that actually cried.

ALAN GREENBERG: People thought it was a misprint. They thought it must have been a couple zeros left off. They were wrong, it was $2.

[*www.pbs.org: Read the interview*]

JEFFREY LANE: You know, how could this possibly have happened? You know, total denial, no responsibility.

NARRATOR: It had taken seven days. Bear Stearns was gone.

NEWSCASTER: They're saying that the bubble will not burst. There's plenty room left-

NEWSCASTER: July was still the strongest housing sales market.

NARRATOR: Bear Stearns had not been alone betting on housing. Until the market collapsed, the entire country had been encouraged to do the same thing.

PETER SCHIFF, Economist: You could see that people were taking mortgages that they obviously couldn't afford.

THOMAS OLLQUIST, Senior VP, Lehman Brothers: You'd go to a cocktail party or you'd go to a barbecue, and two or three of the people that were there were telling you how wealthy they were because the value of their home had gone so high.

PETER SCHIFF: Nobody cared if they could afford the payments because the act of buying the house itself meant that you were going to get rich.

JOE NOCERA: The government's attitude towards homeowners was, "They did it to themselves. That's the way it goes." The government's attitude towards Wall Street was, "These are a bunch of smart, sophisticated people. Yeah, they made some mistakes, but the system is fine and we'll be OK."

HENRY PAULSON: I have the greatest confidence in the resiliency, flexibility and strength of our economy and our capital markets.

NARRATOR: Both Paulson and Bernanke continued to insist all was well in the face of mounting evidence that the housing market had turned toxic.

BEN BERNANKE, Federal Reserve Chairman: The impact of the problems in the subprime market seems likely to be contained.

GRETCHEN MORGENSON: "Contained." That was their word "contained." And meaning that it was not going to spread. It wasn't going to infect the rest of the economy.

Pres. GEORGE W. BUSH: When will the economy turn around? I'm not an economist, but I do believe that we're growing. And I can remember, you know, this press conference here where people are yelling recession this, recession that, as if you're economists. And I'm an optimist. I believe there's a lot of positive things for our economy.

NEWSCASTER: Profits in the banking industry are plunging.

NEWSCASTER: -in America has now soared to 6.1 percent.

NEWSCASTER: The Dow has tumbled 240 points while the NASDAQ sank 46.

NARRATOR: Throughout the summer of 2008, the toxic mortgages continued to eat away at every major Wall Street firm.

PAUL KRUGMAN: The losses on housing are real. The losses on subprime mortgages are real. And there is something like a trillion dollars of losses to the financial system that are going to show up one way or another.

NEWSCASTER: Nervous investors were dumping shares of the mortgage giants Fannie Mae and Freddie Mac.

NARRATOR: The next crisis wouldn't be on Wall Street- Fannie Mae and Freddie Mac, the largest mortgage lenders in the world.

NEWSCASTER: Fannie Mae and Freddie Mac are in big trouble.

CHARLES DUHIGG: A crisis of confidence started. And in two weeks, two of the most powerful, largest companies on earth lost 60 percent of their stock value.

NARRATOR: Created by the government to promote affordable housing, the failure of these publicly traded, privately run companies was almost unthinkable. They held $5 trillion in mortgages.

CHARLES DUHIGG: They're enormous. Every institutional investor owns either Fannie and Freddie shares, or more importantly, Fannie and Freddie debt.

NARRATOR: Their possible failure would be the very definition of systemic risk.

JOHN CASSIDY: Bernanke and Paulson feared that this could be a major catastrophe, and you know, they had to do something about it.

NARRATOR: Henry Paulson swallowed hard and nationalized Fannie and Freddie.

HENRY PAULSON: [*September 7, 2008*] Good morning, everyone. We have determined that it is necessary to take action.

NARRATOR: The government fired the management and took over the day-to-day operations.

JOHN CASSIDY: Clearly, Bernanke and Paulson didn't want to nationalize Fannie and Freddie. That was the last thing they wanted. But the sort of logic of events just led them down there.

HENRY PAULSON: We examined all options available and determined that FHFA, the Federal Reserve and Treasury have moved to address this difficult issue.

CHARLES DUHIGG: It sent this huge confidence shock wave through the entire economy because all of a sudden, people were saying, "If two of the largest companies on earth can fail, that means anyone can fail." At that point, there is no company too large to not fail from the housing bubble.

NARRATOR: One day later, Monday, September 8th, the toxic mortgage contagion was loose again.

DAVID FABER, CNBC: That statement is certainly true in the case of Lehman Brothers, shares of which have been down as much as 18 percent this morning.

NARRATOR: This time, it was the investment bank Lehman Brothers. Its chief, Dick Fuld, was a fixture on Wall Street.

MICHAEL PETRUCELLI, Senior VP, Lehman Brothers: He was Wall Street's longest-serving CEO. My impression is most people would associate Dick Fuld and Lehman Brothers as one.

THOMAS OLLQUIST: He was an aggressive trader and he ran the company with an aggressive direction. He not only commanded and demanded loyalty, I think he inspired loyalty.

CHARLES DUHIGG: Fuld had been with Lehman for so long that a certain type of arrogance had crept into how Lehman did business. They had drunk their own Kool-Aid.

NARRATOR: Fuld had taken Lehman deeply into the high-risk real estate mortgage market. The employees in the trenches saw it firsthand.

MICHAEL PETRUCELLI: We kept pushing the envelope on acceptable loan terms. There were fixed rate 30-year loans, and then we had these alternative A loans. Then we had 40-year loans. Then we had loans where people only pay the interest and don't have to pay principal back for 10 years. Then we had option ARMs that had very low rates, and in fact, not only were you not paying back principal, in fact, your principal grew over time. I think, in hindsight, it's easy to see there was a bubble. But you know, when you're at a party having a good time, sometimes it's hard to stop and leave the party.

NARRATOR: Now, in the wake of Fannie and Freddie, those toxic investments that had made Lehman billions were dragging it under.

HENRY KAUFMAN, Dir., Lehman Brothers: When there are rumors spread or uncertainties about the sanctity of a financial institution, that liquidity can dry up very quickly.

MICHAEL PETRUCELLI: It was melting. It was painful. Stock price was going lower every day. We didn't get a lot of good news on CNBC.

DAVID FABER, CNBC Anchor: That is a new low for Lehman Brothers, the embattled investment bank that's-

NEWSCASTER: Lehman Brothers stock has been plummeting along with confidence in its ability to survive-

NARRATOR: At the Treasury, Secretary Paulson was watching the Lehman meltdown.

CHARLES DUHIGG: So Hank Paulson's sitting there, and it turns out that we're having the largest crisis Wall Street has seen since the Great Depression and he's at the center of it. And at this point, the question becomes, What does Hank Paulson do?

JON HILSENRATH: Hank Paulson started to show signs of bailout exhaustion. He had literally just finished resolving the Fannie Mae/Freddie Mac problem.

NARRATOR: And Paulson was under immense political pressure.

Rep. BARNEY FRANK: You had a conservative secretary of the Treasury in a conservative administration. There was a lot right-wing criticism over Bear Stearns. I had the Republican members of the Committee on Financial Services wanting to tear into Paulson and Bernanke for what they did to Bear Stearns.

COMMITTEE MEMBER: Do you really think we can believe exactly what you're saying, Secretary Paulson?

Rep. BARNEY FRANK: I was sort of defending them against their own Republican colleagues. You had people saying, "Hey, look, this is the market. If you don't let some people go belly up, then you lose the discipline of the market."

JOE NOCERA: Paulson really thought, "Somebody's got to go down. We can't keep putting the finger in the dike."

NARRATOR: When he'd run Goldman Sachs, Hank Paulson had vigorously competed with Dick Fuld. Now, in a series of tough telephone conversations, Paulson insisted that Fuld find a buyer for Lehman Brothers.

JON HILSENRATH: Fuld and Paulson were in regular contact over the course of the summer. Paulson was warning Fuld that the firm ran the risk of failure if it didn't act very quickly.

NARRATOR: But it appears Fuld never thought the government would let Lehman fail.

GRETCHEN MORGENSON: There must have been a sense inside that it, too, would somehow survive, be merged, some shotgun marriage.

MICHAEL PETRUCELLI: I thought it would be something similar to the Bear Stearns. There would be some arranged merger, acquisition.

DAVID FABER: If Bear was a problem, Lehman was certainly more of a problem- larger firm, more interconnected. They never thought- how could they not- they're going to figure out a way to save them.

NARRATOR: Now moral hazard seemed to be driving Paulson's decision. If Fuld didn't sell his company, he would pay for Lehman's greed.

JOE NOCERA: When I interviewed the secretary of the Treasury, I was really astounded at the vehemence of his reaction towards Dick Fuld. He was very angry. And whether that predated him being Treasury secretary or not, I don't know, but he was very, very angry. He said, you know, "I told Dick Fuld to sell the firm or to look for a buyer because he had a problem, and he wouldn't do it." And he's just, you know, practically pounding the table with his fist.

CHARLES DUHIGG: At this point, he makes a critical decision, because of this issue of moral hazard, that Lehman will be allowed to fail.

JON HILSENRATH: It was a very high stakes game of signalling that he was playing. He wanted to show these guys, you know, all of his old buddies on Wall Street, that they were going to need to step up and do something themselves.

NARRATOR: Friday night, after the markets closed, Paulson and Bernanke summoned the heads of Wall Street's largest firms to the Federal Reserve Bank in New York.

JON HILSENRATH: They walked through the main foyer past this giant bronze statue, through the stone hallway, and into a large conference room.

NARRATOR: They wanted to make sure the message from the federal government was clear, there would be no bailout.

JON HILSENRATH: Bernanke told them that now is the time for collective action. They couldn't spend their time this weekend looking out for their individual interests, they had to find a way to resolve the problem for all of Wall Street.

CHARLES DUHIGG: Tim Geithner says, "Somebody needs to buy Lehman. You need to figure out how to rescue Lehman because otherwise, they're going to go bankrupt."

JON HILSENRATH: Geithner pointed out to the group that there was no political will for a bail-out in Washington.

NARRATOR: That weekend, a now familiar sight: Lehman's books opened up to their competitors. Now Dick Fuld was desperate to do a deal.

JOE NOCERA: On that last weekend, they really did think they had a deal lined up with either Bank of America or Barclays. But neither Bank of American America nor Barclays were willing to do the deal without the same kind of government guarantees that Bear Stearns got. And this time, unfortunately for Lehman, unfortunately for Mr. Fuld, this time the government said no.

NARRATOR: Moral hazard trumped systemic risk. The government would not intervene. There were no options left. Bankruptcy was now a certainty.

HENRY PAULSON: Good afternoon, everyone. And I hope you all had an enjoyable weekend. [*laughter*] Yeah. Yeah. Well-

JOHN CASSIDY: The Fed and the Treasury thought that Lehman could go under without causing a major conflagration. It would be a big event, but it wouldn't cause a cataclysm.

HENRY PAULSON: But the American people can remain confident in the soundness and the resilience of our financial system. Thank you very much.

NARRATOR: As soon as he left this room, Paulson would be told the markets were crashing.

NEWSCASTER: The stock market dropped by hundreds of points right from the open-

NARRATOR: Lehman Brothers had been far more interconnected than Paulson believed. Systemic risk became a reality.

JOE NOCERA: No bank wants to lend to any other bank because they're afraid that the other bank won't be able to pay them back, even though this inter-bank lending is at the very, very heart of the banking system, of the worldwide banking system.

NARRATOR: Banks stopped lending. The credit markets froze.

MARK GERTLER: We're no longer just talking about mortgages, we're talking about car loans, loans to small businesses, commercial paper borrowing by large banks. Commercial banks are now infected. This is like a disease spread.

NEWSCASTER: It's a tough day, man. It's a tough day.

ADAM DAVIDSON, Planet Money / NPR: There's nobody able to get a loan, these short-term loans. The safest companies in the world, the most rock solid banks in the world, unable to borrow money.

CHARLES DUHIGG: Everything freezes, and that's what causes the crisis. And it really started because Lehman Brothers went into bankruptcy. No one forecasted that this was going to happen. But it turns out that this one decision made all the difference.

[*www.pbs.org: Watch this program again on line*]

NEWSCASTER: Investors were shaken by Lehman's bankruptcy.

NARRATOR: The meltdown was happening. Commerce in America was grinding to a halt.

PAUL KRUGMAN: I'm sure that Paulson is sitting there- and he doesn't strike me as the most reflective guy necessarily, but he must have been sitting there, everybody was sitting there saying, "My God, we may be presiding over the second Great Depression." This is the utter nightmare of an economic policy maker. You're sitting there and you may have just made the decision that destroyed the world. Absolutely terrifying moment.

NARRATOR: With the credit markets frozen, there was soon a new big company at risk.

NEWSCASTER: AIG plunging. At one point, they were down 70 percent-

NARRATOR: The world's largest insurance company, AIG had invested tens of billions of their insurance profits in risky investments tied to the housing market.

JOE NOCERA: AIG has problems that make everybody else's problems look like child's play.

MICHAEL GREENBERGER, Federal regulator, 1997-'99: AIG does not have the money in the bank to support the commitments it made.

NEWSCASTER: They face the hammer of a credit rating's agency downgrade, which would force them to come up with tens of billions of dollars-

NARRATOR: AIG had sold tens hundreds of billions of dollars of unregulated credit default swaps, insurance policies based on the bet that companies like Lehman Brothers would never go bankrupt. Now the unthinkable had happened. Lehman was bankrupt.

CHARLES DUHIGG: When Lehman goes bankrupt, all of a sudden, AIG says, "We're sitting on this huge deficit. We just promised to pay all these people millions and millions of dollars if Lehman went bankrupt, assuming that Lehman could never possibly go bankrupt. And now Lehman has gone bankrupt."

NEWSCASTER: If AIG can't raise $100 billion, they'll have to announce bankruptcy tonight.

NARRATOR: AIG desperately needed cash, but now the credit markets were frozen. No one was lending money. Paulson and Bernanke were their only hope.

JOHN CASSIDY: AIG was the biggest insurance company in the country. It had sold trillions of dollars worth of credit default swaps. It did businesses with every big bank and institution in the world, basically.

NICK ASHOOH, Sr. Vice President, AIG: For there to be such a global, precipitous failure of an organization like AIG I think would have been very, very disruptive. I think everybody realized that.

JOE NOCERA: They swallow hard and they do what they have to do. And so much for moral hazard, right? So much for moral hazard because you can't let AIG fail.

MICHAEL GREENBERGER, Federal regulator, 1997-'99: They had to throw their principles out the door and save the economy. And whatever criticism there would be of government intervention was a small price to pay for the deluge that would have occurred if AIG had collapsed.

NARRATOR: Key members of Congress, many of whom still knew few specifics, were called.

Rep. BARNEY FRANK: Paulson and Bernanke asked us to meet with them and said, "We're giving them $85 billion." I said to Bernanke, "Do you have $85 billion?" He said, "I got $800 billion dollars."

NARRATOR: Bernanke lent AIG $85 billion. The United States government now controlled the world's largest insurance company.

PAUL KRUGMAN: We have, effectively, a full nationalization and the government taking an 80 percent ownership stake in AIG.

NARRATOR: As the system crumbled and one firm after another faced uncertainty, a strong feeling began to sweep over Wall Street. Maybe the government, maybe Paulson and Bernanke, had lost control of the situation.

GRETCHEN MORGENSON, *The New York Times*: There's been a sense that there isn't an over-arching plan. And that, I think, contributed to a sense that there wasn't someone in control and that the government was reacting instead of acting. And that was damaging to confidence.

NEWSCASTER: The stock market suffered one of its worse days in years. The Dow Jones Industrial Average lost more than 4 percent-

NARRATOR: Wednesday, it's been just two days since Lehman collapsed.

MICHAEL GREENBERGER: All hell has broken loose. And by that time, Bernanke at the Fed is looking at the Great Depression and all he's learned about what should have been done to save the American public from the Great Depression.

NARRATOR: Bernanke was nearly out of ammunition.

MARTIN FELDSTEIN, Economist, Harvard University: There's a limit to what the Federal Reserve can do. Indeed, many people would think they've gone beyond the normal limits of what a central bank should do.

NARRATOR: Bernanke decided to try something new. To do it, he'd have to get Paulson on board.

CHARLES DUHIGG: Bernanke basically calls up Paulson and says, "There's no end game in sight that looks good. Things only look like they're going to get worse. We have to do something more direct, more direct involvement of government in the banking sector."

NARRATOR: Bernanke told the Republican secretary of the Treasury they needed to initiate a full-scale bail-out of the nation's financial system.

MARK LANDLER: Bernanke says to Paulson, "You have to go to Congress. We can't do this anymore on a case-by-case basis."

JON HILSENRATH: What was different about this call is that you have this fairly mild-mannered Princeton professor who speaks in a more demanding and assertive tone than he usually does, telling Paulson that they really had to do something. They had to turn to Congress and get Congress involved in a broader rescue.

MARK LANDLER: At that point, Paulson bowed to the inevitable. One thing Paulson said to me in an interview is, "When the situation changes, you have to be willing to change with the situation.'

NARRATOR: The next day, Paulson and Bernanke headed to Capitol Hill for that meeting with the congressional leadership.

Sen. CHRISTOPHER DODD: I had no idea I was going to hear what I heard, sitting in that room with Hank Paulson saying to us in very measured tones that, "Unless you act, the financial system of this country and the world will melt down in a matter of days." There was literally a pause in that room where the oxygen left.

NARRATOR: Paulson carried an emergency plan his staff had drafted.

GRETCHEN MORGENSON: His plan was a $700 billion - a request for that money from the taxpayer - to be used to buy the kinds of toxic mortgage securities that were creating so many problems for the banks.

Rep. BARNEY FRANK: And they needed it- they said to us they needed it by Monday. We said, "Well that's not reasonable."

JOE NOCERA: Harry Reid, the Senate Democratic leader, said, "This is the U.S. Senate. We can't move that fast."

MARK LANDLER: Paulson felt that he needed to move swiftly and almost the economic equivalent of "Shock and Awe.'

Sen. CHRISTOPHER DODD: Hank has never been in this culture before. And the Wall Street culture is obviously different than a Washington culture. So you end up sending up a three-and-a-half page bill saying, "Give me $700 billion. And by the way, no agency can intervene and no court can intervene." I mean, that's rather remarkable.

Rep. NANCY PELOSI (D-CA), House Speaker: We just had what I believe was a very productive meeting-

MARK LANDLER: It's as close to a blank check as you can get without actually asking for a blank check.

NARRATOR: Paulson said he wanted the money in order to buy the toxic assets from the banks.

MARK LANDLER: And predictably, the reaction on Capitol Hill was toxic. They were furious.

Rep. SCOTT GARRETT (R), New Jersey: America, you should be outraged about what Washington is about to do!

Rep. JOHN CULBERSON (R), Texas: It is an unprecedented, unaffordable and unacceptable expansion of federal power that our kids can not afford!

NARRATOR: Conservative Republicans in the House were in full revolt.

Rep. PAUL BROUN (R), Georgia: This is essentially Mr. Paulson's bill to help his friends, and I can't buy it.

MARK GERTLER: It became increasingly like The Bonfire of the Vanities just in terms of the extreme, extreme craziness and all the people going before the camera to pontificate. I mean, it was- it was an insane environment to operate under.

Rep. LOUIE GOHMERT (R), Texas: Please! Please don't betray this nation's great history!

NARRATOR: On September 29th, the House of Representatives voted on the bill.

Sen. CHRISTOPHER DODD: I was in the cloakroom of the Senate watching that vote, and I didn't have a good feeling about it.

CHARLES DUHIGG: The House Republicans, who had initially voiced support for the bail-out package, pulled their support. Everything falls apart. We're literally sitting in the newsroom, everyone expects the bill to pass, then they have the vote and the bill fails.

NEWSCASTER: They didn't pass it. The did not pass it. And I see that the Dow traders are standing there watching in amazement, and I don't blame them!

NEWSCASTER: Look at the Dow Jones industrial average!

NEWSCASTER: The market right now is down 521 points.

NARRATOR: Ninety-five Democrats also voted against the measure.

DAVID FABER, CNBC Anchor: The shock of the fact that it wasn't going to pass on the first go there was amazing to people. "Oh, my God, these guys don't know what they're doing. We're in really deep trouble."

MARK LANDLER: I thought it was one of those moments where you could not actually see the bottom. I wasn't sure where the market was going to stop, and I had a very bad feeling that forces had been unleashed that we couldn't control.

NEWSCASTER: A history-making 777-point nosedive-

NEWSCASTER: -plunged for the single greatest point loss in the Dow average in one day ever.

NARRATOR: With the market crashing, Congress felt intense pressure to reconsider Paulson's plan to buy the toxic assets. At the same time, behind closed doors, another idea was in play. This one involved even more government intervention, capital injection.

PAUL KRUGMAN: The Fed wanted to do it, do it the way the Swedes did it, do it the way the Japanese did it, do it the way Franklin Roosevelt did it and do capital injections.

NARRATOR: Some insiders wanted to inject billions of dollars into ailing banks in order to boost confidence and unfreeze credit, but Paulson didn't like the idea of capital injections.

PAUL KRUGMAN: I think there was just a general distaste for the idea that we're going to have anything that looks like a partial nationalization of the financial system. It was just so alien to where he and his administration were coming from.

NARRATOR: Publicly, Bernanke stood by Paulson, supporting the announced plan to purchase toxic assets.

PAUL KRUGMAN: Maybe if Bernanke had been in office longer, he would have been able to say to Paulson, "We don't want this to be a game of chicken, but if you go with this plan, I'm going to say- I'm going to publicly disagree. You don't want responsibility for that." He probably couldn't do that.

NARRATOR: As Paulson held his ground, others quietly inserted six lines of text into the bill authorizing capital injections.

MARK LANDLER: If you weren't looking for it, if you didn't know exactly where to go in this many-hundred-page document, you would simply have missed it entirely.

NARRATOR: By the end of the week, under intense pressure, a revised bill finally cleared the House.

PRESIDING OFFICER: The yeas are 263, the nays are 171. The motion is adopted.

NARRATOR: But even before the toxic asset plan could get on track, systemic risk had gone global.

JOE NOCERA: We had a contagion that operated almost around the globe. The panic from Lehman spreads to AIG, spreads to Morgan Stanley, spreads to Goldman Sachs. Suddenly, Ireland is having problems. Suddenly, the Bank of England is bailing out banks. Suddenly, Iceland is bankrupt. The state of Iceland, it's bankrupt, an entire country! Suddenly, China has gone from being one of the world's highest-growth countries to almost a no-growth country in the flash of an eye. That's contagion.

NARRATOR: By October, Paulson decided he had no choice. He would have to use that provision in the law for "capital injections."

MARK LANDLER: And he was put in the position of doing the last thing he wanted to do, which was to step in directly with government capital into the banking system. For him, this is a step- this is a true crossing of the Rubicon.

NARRATOR: Then on Sunday, October 12th, something extraordinary. Paulson personally called the CEOs of the nation's nine largest banks and told them to come to his office the next day at the Treasury building. Sheila Bair from the FDIC was there.

SHEILA BAIR, Chairman, FDIC: The meeting was at Treasury. Treasury was being pretty- holding it close as to what they wanted to talk about at the meeting.

DAVID FABER: They were all just summoned to show up, and I'm not sure any of them had any idea about of what was to come.

NARRATOR: The nine CEOs sat in alphabetical order across the table from Paulson and Bernanke.

JON HILSENRATH: You have Wells Fargo all the way at the end and you have Bank of America more towards another end. And you have, basically, the icons of Wall Street who are showing up.

NARRATOR: Paulson said the entire banking system was in deep trouble.

MARK LANDLER, *The New York Times*: That has to have been an extraordinary moment and a difficult moment for Paulson, as well. You can only imagine how it must have felt to sit across a table from not only the man who replaced you at Goldman Sachs but most of the guys that you competed against in your professional career.

SHEILA BAIR: It was serious. It was somber. And the government did most of the talking.

JON HILSENRATH: It was made clear to these nine very powerful CEOs when they sat down at the table that this wasn't a negotiation.

NARRATOR: Paulson hoped one bold act would boost the nation's confidence in the banks and get them lending again, a direct infusion of cash.

MARK LANDLER: And then he basically came out and said it: "We want to take a stake in the largest banks in the country."

NARRATOR: Paulson and Bernanke were offering each of the banks tens of billions. The government would become a major stockholder.

MARK LANDLER: And that then set off a pretty lively discussion.

DAVID FABER: Some of them were, like, "I don't want the money." But it was, like, "You're taking the money."

SHEILA BAIR: The government was very assertive. Treasury was very assertive on why the program was there, why they needed to take it with all the conditions.

DAVID FABER: "Here's the plan. Here's what we're doing. Here's what we need you to do. You'll get the money in a few weeks."

NARRATOR: Paulson gave each man a single piece of paper spelling out the conditions.

MARK LANDLER: Before they had to leave town that night, they were told, "Return this document with your signature on it." And all nine of them did so.

NARRATOR: Paulson would spend $125 billion that day. Moral hazard was a thing of the past.

[*www.pbs.org: Analysis of Paulson's decisions*]

MARK LANDLER: You could almost see the regret in his face as he stepped to the microphone.

HENRY PAULSON, Treasury Secretary: [*October 14, 2008*] Good morning. Today, we are taking decisive actions to protect the U.S. economy. We regret having to take these actions. Today's actions are not what we ever wanted to do, but today's actions are what we must do to restore confidence in our financial system.

MARK LANDLER: In a way, he had to overcome an ideological aversion to the government taking a central role in the financial system.

HENRY PAULSON: Government owning a stake in any private U.S. company is objectionable to most Americans, me included.

MARK LANDLER: So it's been a very difficult journey for him.

HENRY PAULSON: -without access to financing is totally unacceptable-

CHARLES DUHIGG: So Hank Paulson, the happy capitalist warrior who spent his life pursuing and defending free markets, is now the biggest interventionist Treasury secretary we've had since the Great Depression.

Pres. BARACK OBAMA: We start 2009 in the midst of a crisis-

NARRATOR: Last month, Henry Paulson was replaced by President Obama's choice, Tim Geithner.

NEWSCASTER: The markets reacted with a 4 percent drop-

NARRATOR: Ben Bernanke will stay on at the Federal Reserve until at least 2010. So far, they have spent $350 billion to save the financial system.

NEWSCASTER: Two major banks sank deeper into the red-

NARRATOR: They have said they will spend trillions more.

NEWSCASTER: Thain paid out $4 billion-

NARRATOR: And still nobody knows if it will be enough.

NEWSCASTER: -and all eyes are now on Barack Obama to turn it around.

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