5 weeks on the brink: Reliving meltdown of '08

By ERIN McCLAM, AP National Writer
57 mins ago

NEW YORK – The nation was focused on a tropical storm spinning off the Carolinas and a hurricane headed for Florida. People were gaming out how a political novice named Sarah Palin might upend the presidential campaign.

The Dow Jones industrial average closed at 11,220 on Sept. 5, the Friday after Labor Day last year. There was an economic slowdown under way — no one doubted that. Whether it amounted to a bona fide recession was semantics, a question for economists.

But on Sunday morning, the federal government took an extraordinary step: It seized control of mortgage giants Fannie Mae and Freddie Mac, committing up to $200 billion of taxpayer money.

The companies, which combined either hold or guarantee half the mortgage debt in America, were posting billions of dollars in losses each quarter as an increasing number of homeowners stopped paying back their loans. Investors doubted the companies had the financial strength to survive the housing crash.

President George W. Bush, with less than five months to go in his presidency, said taking over Fannie and Freddie would be "critical to returning the economy to stronger sustained growth."

It turned out to be the beginning of something much more dire — far beyond a correction, far beyond even a garden-variety recession, far beyond anything most people had lived through.

What it turned out to be was the beginning of five weeks that shook the American financial system to its foundations. The stock market convulsed. Wall Street itself was redrawn. The word "depression" was suddenly on everyone's lips.

One year later, the economy is only now beginning to show signs — tentative at that — of pulling out of the Great Recession, the longest economic contraction since World War II. The Dow, while still more than 30 percent off its peak, is no longer the source of a daily national ulcer.

But for five weeks in September and October last year, venerable Wall Street investment houses staggered, or disintegrated outright. The government concocted unprecedented rescue plans with 12-digit price tags almost impossible to comprehend.

It was a time when no place for money seemed safe.

In those first few days after the government stepped in to save Fannie and Freddie, Wall Street liked what it saw. Analysts figured interest rates on mortgages would drop substantially because of the security offered by the federal intervention.

The Dow floated back over 11,500. And after a long year of rising foreclosures, particularly on homes held by the less-than-ideal borrowers, there was hope of a turnaround.

"It saves Armageddon from happening," one insider, Dave Rovelli, managing director of U.S. equity trading at Canaccord Adams in New York, offered on the Monday after the Fannie and Freddie takeover.

But not 24 hours later, the landscape looked very different.

The next day, Sept. 9, Wall Street was consumed by worries about Lehman Brothers, the fourth-largest investment bank in the country, hammered by the deterioration of its heavy portfolio of mortgage-backed securities and other real estate-related assets.

Specifically, investors wondered whether Lehman had enough cash to survive. Talks with a state-owned Korean bank broke down. And the U.S. government was conspicuously silent.

By day's end, Lehman's stock price had fallen by almost half. The bank, which predated the Civil War and had survived the Great Depression, was left with a market value of $5.4 billion — less than the online discount broker TD Ameritrade.

There were whispers that Lehman's lenders, who provided the money it needed to stay in business, were about to run for the hills.

For the rest of the week, investor confidence in Lehman steadily eroded. That weekend, officials from the Treasury Department, the Federal Reserve and major Wall Street banks met at the New York Fed's stately headquarters in downtown Manhattan.

Treasury Secretary Henry Paulson was adamantly opposed to having the government step in to save Lehman. No other bank stepped forward, either. Instead, Bank of America, pushed by the Fed and Treasury Department, bought Merrill Lynch, another storied but troubled Wall Street investment house.

Meanwhile, that Sunday night, the buzzards began circling at Lehman's Manhattan headquarters. Television crews lined the avenue across from the building, which featured giant, high-tech video screens. People held up cell phones and took pictures.

"Are you enjoying watching this?" one man said as he left the building. "You think this is funny?"

Not many people who paid attention to finance did. On Monday, Sept. 15, Lehman, founded in Alabama to serve cotton farmers, a firm that survived even the destruction of its headquarters in and around the World Trade Center, filed for bankruptcy.

Now three of the former Big Five investment houses — Lehman, Merrill and Bear Stearns, which had been forced to sell itself to JPMorgan Chase earlier in the year — were gone, at least in their former, mighty forms.

The financial crisis shifted into a terrifying higher gear.

The Dow lost more than 504 points that day, the most since the New York Stock Exchange reopened after the 9/11 terrorist attacks. About $700 billion in stock market wealth, much of it tied up in retirement plans, evaporated.

And now there were other problems: It had become painfully apparent that banks had hundreds of billions of dollars in bad debt on their books, most of it from risky bets made on securities tied to mortgages that were going sour.

Credit markets, which had been in turmoil for the better part of a year, began to tighten even further. And a new name surfaced on the financial death-watch list: American International Group, the largest insurer in the world.

Like Lehman Brothers, AIG had been hammered by the implosion of the subprime mortgage market and the credit crisis. The difference? It did business with almost every financial institution in the world, selling disastrously mispriced insurance policies on exotic investments.

AIG was so large, its tentacles so vast, that its collapse could have done almost inconceivable damage around the world. If Lehman's fall had dealt a body blow to the global economy, AIG had the potential for a knockout.

So the government stepped in again — this time with an emergency $85 billion loan. In exchange, the government got a stake of nearly 80 percent in the company.

The American taxpayer now owned two mortgage giants and the world's biggest insurer.

Lehman Brothers and AIG had both assured investors in the months before that they would be fine. Now no one trusted anyone. Wall Street responded with another anxiety attack. On Wednesday, Sept. 17, the Dow fell 449 more points.

"People are scared to death," said Bill Stone, chief investment strategist for PNC Wealth Management.

And they were scared around the world. The crisis that infected the U.S. financial system posed grave danger around the world — not just by hammering markets, but by plunging the world into a severe recession, perhaps worse.

With the panic in full motion and banks hoarding cash, central banks around the world decided to work together. On Sept. 18, they pledged to inject as much as $180 billion into money market funds to head off what they feared could be a wave of panicked withdrawals.

Back home, in Washington, the Fed pumped $105 billion into the U.S. banking system, and Bush canceled a trip to huddle with economic advisers. But everyone knew the solution would need to be much grander.

That afternoon, the Dow shot up 400 points, most of it in the final hours of trading, on a report that the government was putting together a plan to buy the bad debt off the books of banks.

The idea was that it would cleanse balance sheets of the difficult-to-value mortgage-related assets that were holding them back. No one knew exactly how much they were worth, so no one really knew exactly how sick the banks were.

At the Capitol on the night of Friday, Sept. 19 and in conference calls the following day, Paulson and Fed chief Ben Bernanke laid out a nightmare scenario: Say no to the plan and risk an utter collapse on Wall Street and maybe even a worldwide depression.

"When you listen to them describing this," said New York Sen. Charles Schumer, who was in the room, "you gulp."

A name caught on for the junk clogging bank balance sheets: toxic assets. And if that sounded strange, it was nothing compared with the price tag that surfaced over that weekend: $700 billion.

Twelve digits long, eight times as big as the AIG rescue, a number so big most Americans couldn't even comprehend it.

President Bush, seeking both to soothe a highly anxious nation and prod Congress into passing the breathtaking bailout, said: "This is a big package because it was a big problem."

More ominously, speaking of the tumultuous week in finance, he said: "So when one card started to go, we were worried about the whole deck going down, and so therefore moved, and moved hard."

Sens. John McCain and Barack Obama, in the middle of their fall presidential campaign, both supported the bailout package. House Republicans voiced strong objections. Besides being too expensive, they said, the program blurred public and private enterprise.

In a bit of theatrics in the White House Cabinet Room, Paulson knelt before House Speaker Nancy Pelosi, begging her to pass the bailout package even if it meant forgoing Republican support. According to other published accounts of the meeting, Bush, speaking of the economy, warned: "If money isn't loosened up, this sucker could go down."

In the nation's banking system, the aftershocks continued.

On Thursday, Sept. 25, Washington Mutual — which earlier in the decade had run TV commercials mocking stodgy bankers in suits and hyping "the power of yes" in its eagerness to grant mortgages — was seized by the Federal Deposit Insurance Corp., the largest American bank failure ever. What was left was gobbled up by JPMorgan Chase.

Four days later, Citigroup agreed to buy the banking operations of Wachovia, which, like WaMu, had done huge business in adjustable-rate mortgages, enticing borrowers who later defaulted on their home loans. (Wells Fargo later bested Citigroup's offer and bought all of Wachovia.)

That same day, Monday, Sept. 29, the bailout came up for a vote in the House. As the roll call began, the Dow was down about 210 points.

Representatives locked in their votes while C-SPAN showed the running tally. The "no" totals marched higher and higher. On Wall Street, traders' faces were tense. Their jaws literally dropped.

The bailout failed, 228-205. In a span of just five minutes, the Dow fell 400 more points. When the closing bell mercifully sounded, it was off nearly 778 points, easily its worst performance ever. More than $1 trillion in market value had evaporated, a first.

The Dow stood at 10,365. Congressional leaders scrambled to find a way to pass the bailout. Wall Street rallied the next day, Sept. 30, but remained nervous. "If it doesn't pass, then look out below," one trader said. "It could get ugly."

It finally did pass, and was swiftly signed into law on Oct. 3, after Republicans won provisions to raise the amount of personal bank deposits insured by the government and an easing of accounting rules for banks.

It got ugly anyway. From there, the stock market executed a slow-motion crash.

On Monday, Oct. 5, the Dow swooned below 10,000 for the first time since 2004, making an elevator-shaft drop of 800 points, its biggest ever during a single trading day, before recovering somewhat.

The next day, 508 points more. The day after that, 189 — despite an emergency interest-rate cut by the Federal Reserve. The day after that, 678. And on Friday, Oct. 10, 128 more.

In a single week, the Dow had lost almost 20 percent of its value, a staggering 1,874-point plunge. The average stood at 8,451, its lowest level in more than five years. It was the worst week in the history of the stock market.

On the floor of the New York Stock Exchange, anxiety ran so high that one trader compared it to a football game — when the Dow would peek into positive territory, lusty cheers would go up.

The following Monday, Oct. 13, Secretary Paulson summoned the CEOs of the nation's biggest banks to an extraordinary meeting at the Treasury. He told them that instead of buying their toxic assets, he had decided it was best to inject $125 billion into their institutions to signal to the world that the government would not let any of them fail. The strings attached included limits on executive pay and dividends, and after much grumbling all of the CEOs signed on before leaving.

The program was later extended to hundreds of other banks around the country, but the issue of toxic assets on bank balance sheets remains to this day.

The nation settled in for an economic winter whose length no one could predict. Traders were drowning their sorrows in bars near the exchange. And at a nearby coffee shop, Sandeep Bhanote was reflecting on the week with a Wall Street friend.

"I have a client who lived through the Depression and wars and everything," said Bhanote, a software engineer. "And he said, `You know, we survived, and you will, too.'"

In hindsight, it sounds like common sense. But only in hindsight.
