

- NOVEMBER 10, 2008

CRISIS MODE

Paulson, Bernanke Strained for Consensus in Bailout

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WASHINGTON -- Federal Reserve Chairman Ben Bernanke reached the end of his rope on Wednesday afternoon, Sept. 17. Lehman Brothers Holdings Inc. had collapsed. [American International Group Inc.](#) had been effectively nationalized with \$85 billion of Fed money. Investors were stampeding out of money-market mutual funds. Credit markets were reeling, stocks were wobbling and bank failures loomed.

Mr. Bernanke called Treasury Secretary Henry Paulson. The Fed chairman, a Princeton academic with an occasional quaver in his voice, leaned toward the speakerphone on his office coffee table and spoke unusually bluntly to Mr. Paulson, a strong-willed former college football player and Wall Street executive.

The Fed had been stretched to its limits and couldn't do it any more, Mr. Bernanke said. Although Mr. Paulson had been resisting such a move for months, Mr. Bernanke said it was time for the Treasury secretary to go to Congress to seek funds and authority for a broader rescue. Mr. Paulson didn't commit, but by the next morning, he had.

In public, Messrs. Bernanke and Paulson marched in lock step. Behind the scenes, the two men and their lieutenants sometimes tussled -- over the fate of Lehman Brothers, how to handle Congress and the limits of the Fed's authority. At times, each man felt handcuffed by legal limits on his own power, and consequently pushed the other to move more aggressively. Their differences helped define the government's approach to the crisis.

The debates helped shape an ad hoc strategy that at times sowed confusion about Washington's approach, and sparked criticism of the nation's two top economic physicians at a time when restoring confidence was a top priority.

Pressing tasks for President-elect Barack Obama's new economic team -- to be announced in the coming days -- will be to calm markets and decide which of the Bernanke-Paulson decisions to endorse and which to seek to alter, and how to manage the relationship between the Treasury, the White House and the Fed after the inauguration.

Mr. Paulson will be leaving, but Mr. Bernanke, whose term extends to 2010, will remain. A key player will be Timothy Geithner, either continuing as president of the Federal Reserve Bank of New York or as Mr. Paulson's successor. Mr. Geithner, one of the Fed's key crisis managers, is among a handful of people on Mr. Obama's short list to run Treasury.

The Fed and the Treasury had operational styles that mirrored their bosses. Inside the Fed, there were running debates resembling academic seminars, with Mr. Bernanke running discussions but often offering few opinions. The Treasury was run in command-and-control fashion, with Mr. Paulson the general, listening to his troops, making decisions quickly, and often calling to check on the status of a request just hours after issuing it.

The two men rarely allowed daylight to seep between them in public. "Bernanke is a very careful guy, and I believe that if he had any differences, he would have been talking to Paulson about them," says House Financial Services Committee Chairman Barney Frank, the Massachusetts Democrat. "He would not deal with us directly."

Their decisions have left many questions. Why did they let Lehman Brothers fail just six months after deciding its smaller rival, Bear Stearns Cos., couldn't be allowed to collapse? Why didn't they go to Congress sooner? When they did go, why did Mr. Paulson argue against an option pushed by the Fed -- putting capital into banks -- that he ended up embracing a few days later?

The following account of pivotal moments during September and October is based on interviews with government officials, lawmakers and others.

The Lehman Crisis

On Tuesday, Sept. 9, a day after the government nationalized mortgage giants Fannie Mae and Freddie Mac, Lehman was on the brink of failure. Potential acquirers were circling, but many expected government assistance. Mr. Paulson had a message. "There's no government money here," he told several CEOs in telephone calls. Some pushed back, saying the government couldn't let Lehman fail. Mr. Paulson was unwavering.

One day later, he called Mr. Bernanke and Mr. Geithner and told them he wouldn't support using federal money to save Lehman.

Fed and Treasury officials figured they were in a better position to handle the collapse of an investment bank than they had been back in March, when the Fed interceded to prevent Bear Stearns from failing. The Fed had new lending mechanisms that investment banks themselves could tap for short-term funds if Lehman went under and credit markets froze up.

Senior government officials told reporters that Mr. Paulson was drawing a line in the sand: There would be no public money spilled to rescue Lehman. Some Fed officials, including Mr. Geithner, were uncomfortable with that public stand. Mr. Geithner had spent much of his career attending to financial-market fires. One of his mentors, Clinton administration Treasury Secretary Robert Rubin, had taught him the value of "preserving optionality" -- not limiting your choices. The Treasury, some officials believed, was breaking that rule.

That Friday night, Sept. 12, when Wall Street CEOs gathered at the Federal Reserve Bank of New York, Mr. Geithner warned them there was no political will for a bailout. "I think there was a lot of pressure on them to stop intervening, to see if the market worked," says Mr. Frank.

Mr. Paulson's strategy was to pressure other Wall Street firms to help rescue Lehman. "It can't just be every man for himself," Mr. Paulson told the executives. They needed to collectively figure out a way to save Lehman or to facilitate an orderly wind-down of the firm, he told them.

U.S. officials questioned the executives over the weekend about what it would take to get someone to take over Lehman. Mr. Paulson would say a day after Lehman collapsed that he "never once" considered putting taxpayer money on the line. But that weekend, some Fed officials believed Mr. Paulson was prepared to do just that, despite his public stand against it. Fed officials were prepared to back a deal too, if they could find a viable buyer.

But Lehman was in worse shape than Fed officials had realized. Rivals pored over Lehman's books that weekend and concluded its assets could be overvalued by more than \$30 billion. A Lehman spokesman counters that Fed and Securities and Exchange Commission staff had been closely monitoring the firm and hadn't questioned the firm's asset values to firm executives.

Bank of America Corp. and Barclays PLC were interested, but wanted the Fed to take many of Lehman's shaky assets itself, something Mr. Bernanke didn't think he had legal authority to do. The Fed can make emergency loans, but only against good collateral.

Instead, Bank of America opted to buy Merrill Lynch & Co. British regulators balked at quickly blessing a proposed deal with Barclays. To open for business Monday, Lehman needed broad debt guarantees from the U.S. government, something officials felt they couldn't do. Messrs. Bernanke and Paulson felt they'd run out of options.

"We don't have a deal," a somber Mr. Paulson told the assembled CEOs Sunday morning.

Mr. Paulson, Mr. Bernanke and Mr. Geithner all understood that the market was in for a severe shock. Mr. Geithner spoke with Messrs. Bernanke and Paulson about "spraying foam on the runway" to soften the blow of Lehman's crash.

Conversation in Mr. Geithner's office turned to a broader rescue. Fed and Treasury staff members had been studying options for buying Wall Street's bad assets and injecting new capital directly into banks.

The Treasury secretary didn't think he'd be able to persuade Congress to approve spending billions of dollars of public money unless the crisis got significantly worse. Now, with the imminent failure of Lehman, it was getting worse. "I want a proposal right away," Mr. Paulson told his staff that Sunday night, Sept. 14.

Debating Fed Authority

The Fed was pushed to its limits by the collapse of Lehman Brothers and the bailout of AIG, a firm it didn't regulate. Before calling Mr. Paulson on Sept. 17, Mr. Bernanke gathered his top lieutenants, including Fed Vice Chairman Donald Kohn, a longtime Fed insider, and Kevin Warsh, the Fed governor who had become a bridge for Mr. Bernanke to Wall Street. Mr. Geithner joined by phone.

Short-term lending markets were freezing. Fed officials believed the problems required more than what a central bank was designed to do -- provide emergency loans to healthy institutions in tumultuous times. The Fed wasn't set up to rescue failing institutions; that was for the Treasury and Congress to handle. Fed officials argued that the central bank's emergency powers didn't allow it to buy assets. And its own balance sheet already had been stretched by the other rescues.

Treasury officials, on the other hand, maintained that the Fed had broad legal authority and could possibly take on distressed assets from banks directly, without Congressional approval.

Mr. Paulson, Mr. Bernanke and others had debated the issue for weeks. Mr. Paulson wanted to avoid Congress. He had come away from a July hearing with the impression that Congress wouldn't grant any new authority. He feared that asking lawmakers for the power to purchase hundreds of billions of dollars of assets could incite panic and plunge the country into a recession. He worried Congress might exacerbate the problem by rebuffing an administration request.

Fed officials decided to push Treasury to go to Congress right away. In his Sept. 17 call to Mr. Paulson, Mr. Bernanke told him that he would publicly back the move, placing Mr. Bernanke in the middle of what was sure to be a messy political battle. Mr. Paulson didn't commit right away, still fearing Congress would reject the plan. But he, too, was watching from his office as credit markets froze and stocks sank.

Early the next morning, Mr. Paulson told Mr. Bernanke he was ready to turn to Congress for public money, and that he wanted to do it that afternoon.

Mr. Paulson had already laid some groundwork, telling his staff late last year to begin drawing up just-in-case crisis plans. Two assistant secretaries, Neel Kashkari, a former junior Goldman Sachs Group Inc. investment banker who had become Mr. Paulson's go-to staffer, and Phillip Swagel, who oversaw

economic policy at Treasury, had outlined options, including purchasing distressed assets from financial institutions, taking equity stakes in banks and guaranteeing mortgages.

Inside the Bush administration, officials called it their "break the glass" plan. They didn't expect to use it.

Mr. Paulson felt that if banks could get mortgage-backed securities and other troubled assets off their books, they could raise capital and begin lending again. He was wary of the alternative, injecting capital directly into banks by taking government stakes. He worried that the government would be forced to pick winners and losers, and that banks might sit on the capital instead of deploying it. He feared that asking Congress for the right to invest in companies would make private investors unwilling to put money into the banks for fear of being diluted by the government. By April, Mr. Paulson had winnowed his list of options to one: purchasing assets.

The Fed staff also spent months studying the options. Mr. Bernanke agreed that buying assets was a useful tool. But he also thought the Treasury might need to invest directly in banks, an approach taken by Sweden, Japan and others in previous financial crises.

Bailout Backlash

Around midnight on Saturday, Sept. 20, Treasury officials emailed a three-page legislative proposal to offices on Capitol Hill, asking for authority to spend \$700 billion to buy assets from financial institutions, with few restraints and little oversight. Mr. Paulson had done little advance work on the issue with Congress, fearing that talking about a potential bailout could be counterproductive if word leaked. His proposal sparked an almost immediate backlash.

Mr. Paulson wanted flexibility to use the money any way he saw fit. Privately, he told his staff that equity injections might be needed. But in public testimony, he all but ruled out that option, describing it as something a government would do for failing institutions, not the solvent ones he wanted to assist.

In his own congressional testimony, Mr. Bernanke emphasized that the Treasury needed to have the flexibility to invest directly and wanted to be able to change tactics if needed.

Congress rejected the plan a few days after the hearings. Not only did Republicans mobilize against it, but some private economists questioned whether it was the right way and how it would work. George Soros, the hedge-fund investor and a donor to many Democrats, urged Democratic lawmakers to insist on direct equity investments.

Amid the confusion, policy makers lost critical time. "The ability to communicate to the public how the plan was going to work was muddled from the very start," says Anil Kashyap, a University of Chicago business school economist. Between Sept. 18, when Mr. Bernanke and Mr. Paulson first went to Congress, and Oct. 3, when the plan legislation was approved, the U.S. stock market lost roughly \$1.5 trillion in value.

Meanwhile, Treasury officials were growing concerned about efforts by some Democrats to carve out a top role in the bailout program for Sheila Bair, chairman of the Federal Deposit Insurance Corp., which insures deposits at close to 8,500 banks. Connecticut Democrat Christopher Dodd, chairman of the Senate Banking Committee, wanted the FDIC to be given a senior role overseeing the program. Democrats also wanted the FDIC to manage some assets bought by the government. Treasury viewed that as a conflict of interest and fought successfully to limit the FDIC's role.

But Messrs. Bernanke and Paulson wanted help from the FDIC on another front: orchestrating a deal to save Wachovia Corp. through a shotgun marriage to [Citigroup](#) Inc. Ms. Bair was reluctant to offer FDIC assistance for the deal because it would expose her agency to potentially hundreds of billions of dollars of Wachovia losses.

Mr. Bernanke lobbied her late into the night on Sunday, Sept. 28. At about 4 a.m., FDIC officials agreed to a deal similar to the one pushed by the Fed, though it subsequently unraveled when Wells Fargo & Co. made a competing offer that didn't require government aid.

A little more than a week later, Messrs. Bernanke and Paulson pushed her for even more. Europe had extended an unprecedented guarantee of debt issued by banks. Mr. Paulson believed banks in the U.S. would be at a disadvantage if the U.S. didn't take a similar step.

On Wednesday afternoon, Oct. 8, Mr. Paulson and Mr. Bernanke met with Ms. Bair in Mr. Paulson's office and pushed her for a blanket guarantee of bank debts. Mr. Geithner also pushed hard for broad guarantees. Ms. Bair didn't think she had the legal authority to do it.

She left without making a commitment. The next day, she sent a memo to the two officials, proposing a compromise. Rather than guarantee 100% of bank debts, she proposed that the FDIC guarantee certain debts up to 90% of their value. Messrs. Paulson and Bernanke said that wouldn't work, but they agreed to allow the FDIC to cap the level of debt it would back, and to charge fees. "We had to respond," she says. "The FDIC was really the only legal mechanism" to guarantee bank debts.

In some ways, the U.S. has been ahead of the curve. The Fed slashed interest rates long before other central banks would move. Mr. Bernanke, a student of the Great Depression, says U.S. officials were ahead in other ways. In Japan during the 1990s and in the U.S. during the 1930s, policy makers didn't start fixing banking systems until many banks had already failed. "That is not the situation we face today," Mr. Bernanke said in a speech in New York last month. This time, he said, action to fix banks had been "prompt and decisive."

Some outsiders question that. "The policy of intervening as little as possible ensured that we were always one step behind," says Raghuram Rajan of the University of Chicago, a former chief economist at the International Monetary Fund.

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- **Real Time Econ: Hoover-Era Law Was Behind Fed-Treasury Debates**

Hoover-Era Law Was Behind Fed-Treasury Debates

Behind many intense debates between the Federal Reserve and the U.S. Treasury in recent months is a Hoover-era law that gives the Fed authority to lend expansively during a crisis.

Over the past year, the Fed has leaned heavily on this law, which gives it authority to lend to business or even individuals in "unusual and exigent" circumstances. It was the clause used to justify a \$29 billion loan to Bear Stearns Cos. which has since lost value, an \$85 billion credit line to American International Group Inc., a new government commercial-paper program and several other steps.

Fed officials have argued to Treasury officials and to critics of its handling of the Lehman Brothers collapse that the law also leaves it constrained in important ways.

The law, a single paragraph dropped into section 13 of the Federal Reserve Act in 1932, allows the Fed to make loans to almost anyone during a crisis as long as they are "secured to the satisfaction" of officials.

During debates about Lehman Brothers, Fed officials felt constrained because of doubts about the value of Lehman's assets that would be used as collateral for a loan. When Treasury officials pushed the Fed to acquire Wall Street's shaky assets more aggressively, Fed officials said they were limited by the law to

making loans, and couldn't buy assets. Buying assets, they said, should be for the Treasury and Congress to sort out.

The 13(3) provision, as it is called, was originally tucked into a Depression-era highway construction bill, according to a [Federal Reserve Bank of Minneapolis history](#) of the provision. It was used sparingly, even during the Depression, because other provisions were enacted that permitted the government to start commercial lending.

Just 123 loans were made under the unusual and exigent provision over four years in the 1930s by the Federal Reserve, totaling about \$1.5 million. At other times, such as after the Sept. 11, 2001 terror attacks, the Fed has declined to use the authority. Fed staff has started studying whether that provision, or other aspects of its charter, should be reconsidered in the aftermath of the crisis. —Jon Hilsenrath

