The reaction was most evident in the massive credit-default-swap market, where the cost of insurance against bond defaults shot up Monday in its largest one-day rise ever. In the U.S., the average cost of five-year insurance on $10 million in debt rose to $194,000 from $152,000 Friday, according to the Markit CDX index.

When the cost of default insurance rises, that generates losses for sellers of insurance, such as banks, hedge funds and insurance companies. At the same time, those sellers must put up extra cash as collateral to guarantee they will be able to make good on their obligations. On Monday alone, sellers of insurance had to find some $140 billion to make such margin calls, estimates asset-management firm Bridgewater Associates. As investors scrambled to get the cash, they were forced to sell whatever they could -- a liquidation that hit financial markets around the world.

The cash calls added to the problems of AIG, which was already teetering toward collapse as it sought to meet more than $14 billion in added collateral payments triggered by a downgrade in its credit rating. AIG was one of the biggest sellers in the default insurance market, with contracts outstanding on more than $400 billion in bonds.

To make matters worse, actual trading in the CDS market declined to a trickle as players tried to assess how much of their money was tied up in Lehman. The bankruptcy meant that many hedge funds and banks that were on the profitable side of a trade with Lehman were now out of luck because they couldn't collect their money. Also, clients of Lehman's prime brokerage, which provides lending and trading services to hedge funds, would have to try to retrieve their money or their securities through the courts.

Autonomy Capital Research, a London-based hedge fund that was started in 2003 by former Lehman trader Robert Charles Gibbins, was among the Lehman clients who got caught. When Lehman filed for bankruptcy protection, it froze about $60 million of Autonomy's funds, according to a person close to the situation. That is about 2% of the $2.5 billion Autonomy manages. An official at Autonomy declined to comment.

Spooked that other securities firms could fail, hedge funds rushed to buy default insurance on the firms with which they did business. But sellers were hesitant, prompting something akin to what happens if every homeowner in a neighborhood tries to buy homeowners insurance at exactly the same time. The moves dramatically drove up the cost of insurance on Morgan Stanley and Goldman Sachs debt in what became a dangerous spiral of fear about those firms.

At the same time, hedge funds began pulling their money out of the two firms. Over the next few days, for example, Morgan Stanley would lose about 10% of the assets in its prime-brokerage business.

"It was just mayhem," says Thomas Priore, the CEO of New York-based hedge fund Institutional Credit Partners LLC. "People were paralyzed by fear of what could erupt."

Amid the uncertainty about how Lehman's bankruptcy would affect other financial institutions, rumors and confusion sparked wild swings in stock prices. On Tuesday, for example, a London-based analyst issued a report saying that Swiss banking giant UBS AG, already hurt by tens of billions of dollars in write-downs, might lose another $4 billion because of its exposure to Lehman.

Shares in UBS fell 17% on the day. UBS subsequently said its exposure was no more than $300 million.

Rising concerns about the health of financial institutions quickly spread to the markets on which banks depend to borrow money. At around 7 a.m. Tuesday in New York, the market got its first jolt of how bad the day was going to be: In London, the British Bankers' Association reported a huge rise in the London interbank offered rate, a benchmark that is supposed to reflect banks' borrowing costs. In its sharpest spike ever, overnight dollar Libor had risen to 6.44% from 3.11%. But even at those rates, banks were balking at lending to one another.

Within a few hours, the markets had shifted their focus to the fate of Goldman Sachs and Morgan Stanley, which found themselves fighting to restore investors' flagging confidence. During an earnings presentation in which he answered one after another question about the firm's ability to borrow money, Goldman chief financial officer David Viniar made an admission: "We certainly did not anticipate exactly what happened to Lehman," he said.

Morgan Stanley's stock, meanwhile, plunged 28% in early trading as investors bet that it would be the next after Lehman to fall. At around 4 p.m., the firm decided to report its third-quarter earnings a day early, in the hope that the decent results would halt the stock decline.

"I care that it could be contagion," Morgan Stanley chief financial officer Colm Kelleher said in a conference call with analysts. "You've got fear in the market."

Even as Morgan Stanley's call was taking place, the Lehman fallout cropped up in a different corner of finance: so-called money-market funds, widely seen as a safe alternative to bank deposits. Many of the funds had bought IOUs, known as commercial paper, which Lehman issued to borrow money for short periods. Now, though, the paper was worth only 20 cents on the dollar.

At around 5 p.m. New York time, a well-known money-market fund manager called The Reserve said that its main fund, the Reserve Primary Fund, owned Lehman debt with a face value of $785 million. The result, said The Reserve, which had criticized its rivals for taking on too much risk in the commercial-paper market, was that its net asset value had fallen below $1 a share -- the first time a money-market fund had "broken the buck" in 14 years.

The trouble in the commercial-paper market presented a particularly serious threat to the broader economy. Companies all over the world depend on commercial paper for short-term borrowings, which they use for everything from paying salaries to buying raw materials. But as jittery money-market funds pulled out, the market all but froze.

On Wednesday, the freeze in lending markets triggered a dramatic turn of events in the U.K. Amid growing concerns about its heavy dependence on markets to fund its business, HBOS PLC, the UK's biggest mortgage lender, saw it share price plummet by 19%. The situation was a red flag for government officials, who suffered embarrassment earlier this year when they were forced to nationalize troubled mortgage lender Northern Rock PLC, which had become the target of the country's first bank run in more than a century.

Moving quickly, the government brokered an emergency sale of HBOS to U.K.

bank Lloyds TSB Group PLC. In a sign of their desperation to make the deal happen, officials went so far as to amend the U.K.'s antitrust rules, which could have prevented the merger. Together, HBOS and Lloyds control nearly a third of the U.K. mortgage market.

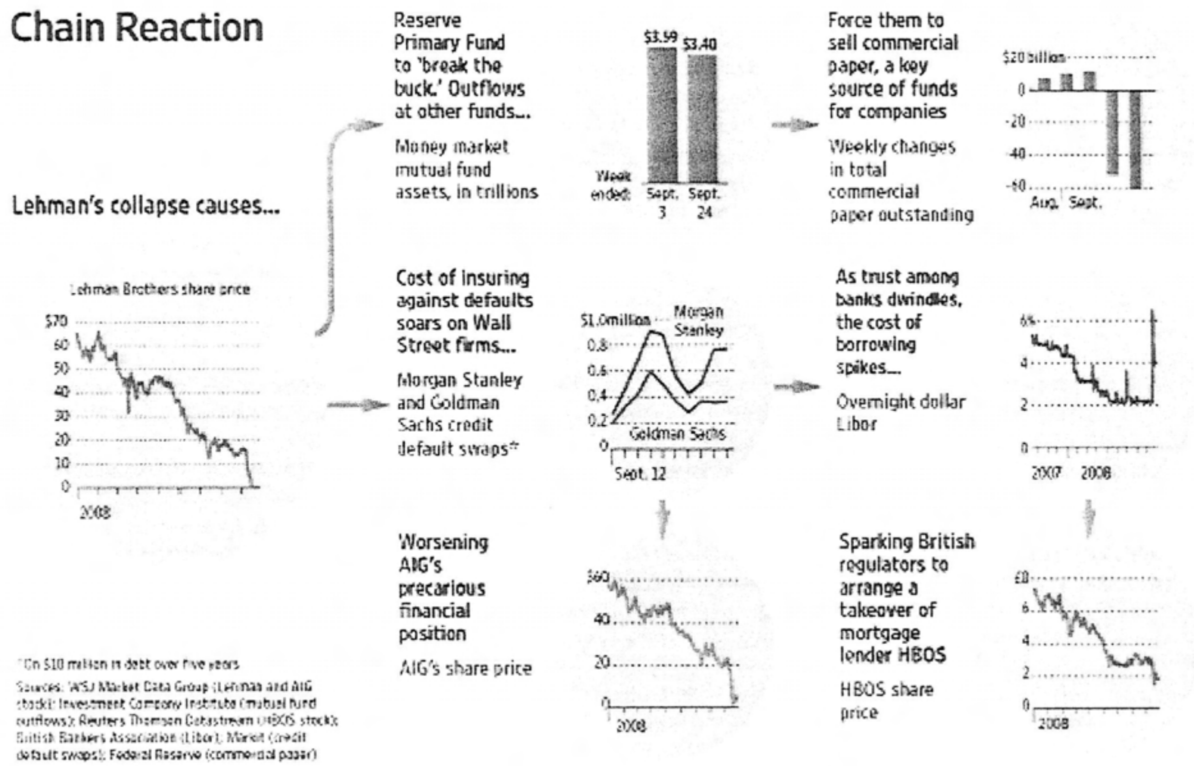
Back in New York, the situation at Morgan Stanley and Goldman Sachs was worsening rapidly. In the middle of the trading day, at about 2 p.m., Morgan Stanley CEO John Mack dispatched an email to employees: "What's happening out here? It's very clear to me -- we're in the midst of a market controlled by fear and rumors." By the end of Wednesday, employees at Morgan Stanley and Goldman were shell-shocked. Morgan Stanley's shares had fallen 24% to $21.75 while Goldman, the largest investment bank by market value, fell 14% to $114.50.

By Thursday, Messrs. Paulson and Bernanke decided that the fallout presented too great a threat to the financial system and the economy. In the biggest government intervention in financial markets since the 1930s, they extended federal insurance to some $3.4 trillion in money-market funds and proposed a $700 billion plan to take bad assets off the balance sheets of banks.

Three days later, Goldman Sachs and Morgan Stanley applied to the Fed to become commercial banks -- a historic move that ended the tradition of lightly regulated Wall Street securities firms that take big risks in the pursuit of equally big returns.

To some, the government's decision to resort to a bailout represents a tacit admission: For all officials' desire to allow markets to punish the risk-taking that engendered the crisis, banks have the upper hand. "Lehman demonstrated that it's much harder than we thought to deal effectively with banks' misbehavior," says Charles Wyplosz, an economics professor at the Graduate Institute in Geneva. "You have to look the devil in the eyes and the eyes are pretty frightening."

Sue Craig in New York, Michael M. Phillips in Washington and Neil Shah in London contributed to this article.



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